Theoretical and Applied Economics
Volume XVII (2010), No. 12(553), pp. 29-40

Redefining Economic Policy and Institutional Reform – Support for Economic Growth*

Coralia ANGELESCU
Bucharest Academy of Economic Studies
Coralia.angelescu@economie.ase.ro
Laurențiu DINU
Accreo Romania
laurentiu.dinu@accreo.ro

Abstract. *The paper addresses the effects of economic crisis from the perspective of theoretical developments and how they were reflected in the economy, both nationally and among the actors of the international system. Basic economic paradigms such as the role of price as a mechanism regulating the operation of free markets and the ability to determine prices to reflect economic developments have been tested in various markets. In the context of limited resources available, due to economic contraction it is necessary to redefine accepted social balances.*

The example analyzed in the paper is that of social policies. In times of economic expansion, modification of such arrangements, even if suboptimal, proves to be difficult because it involves implicit costs, less visible. Economic crisis brings out such costs. Changing these social arrangements requires first the solution and coherent regulatory mechanisms and implementation. They depend on the quality of institutions and social coordination system as a whole. If these mechanisms are complex national, at supranational level we can add additional layers of decision, which explains the difficulty of

* Ideas in this article were presented at the Symposium „The global crisis and reconstruction of economics", 5-6 November 2010, Faculty of Economics, Bucharest Academy of Economic Studies.

coordination. The degree of consistency in decision-making mechanisms and their quality determine the cost of adapting to new conditions imposed by the balance.

Coordination mechanisms, either national or supranational context, are relevant for redefining of a new balance to streamline existing policies (eg social) that reflects the crisis and the creation of new arrangements to accommodate new engines economic growth.

Keywords: sustainable growth; common economic policies; institutional reform; European model of economic growth; economic and financial crisis.

JEL Codes: E61, E65.
REL Codes: 8E, 8I, 8M, 8N, 20F.

Although one of the most studied concepts and mechanisms, the process of economic growth, researchers continue to offer new perspectives and approaches, not just a theoretical approach and practical solutions in the register. Latest economic crisis seems to call into question the fundamental paradigms of economics and the role of price as a mechanism regulating the operation of free market competition and the ability to determine prices to reflect economic developments, and models that seem to reach their limits, too.

An example of this is to support economic growth through domestic consumption, fueled by loans that are used as collateral and the price of certain goods whose price is determined by the development of bubbles (speculative). The debate on the role in the economy, balance between interventionism and liberalization and financial discipline have again become subjects of bargaining at both national and intergovernmental organizations such as the European Union or multilateral agreements such as the G20.

Growth process is relevant not only for governments or the public as a consumer, but also for the way our societies are structured. The results of this process are assumptions for economic policies aimed at defining acceptable equilibria companies. An example of this are fiscal and social policies. The question of redefining these mechanisms in times of economic contraction or even crisis is one of the elements that cannot be addressed by the immediate or rapid recalibration of economic policies. In this context, the economic growth process, the overall performance of economies, is not anymore a component related to the use of different factors of production but is rather influenced by institutions and their functioning.

Administrative mechanisms, social and societal decision-making or social dialogue become factors that influence economic growth not only by their ability to provide new arrangements and to define a new balance but rather by its ability to provide quality solutions on time. In such a context the competitiveness of economies is largely influenced by capacity, quality and functioning of institutions supporting the economy.

One of the fundamental problems with the operation and reform of the institutions is the kind of costs that their sub-optimal operation require. Mainly, these costs are opportunity or implicit costs and not explicit. Therefore it is more difficult to support the need to reform them on one hand and second to give such a topic priority on the public agenda. In addition, the reform involves institutions and mechanisms to ensure all interest groups a transparent access, including those affected by reforms, in various levels of decision-making mechanism.

Relevant examples in this perspective are social security systems reform or the option that the EU preferred to respond to the financial crisis and its impact on Member States. This issue will be addressed from multiple perspectives throughout the paper. Although the influence of factors such as leadership, structure of the public policy agenda or doctrinal guidelines on the ability of an economy to perform in a crisis situation is not the primary focus of political economy, still this approach may offer clues about the ability institutional mechanisms to perform and influence economic growth.

Similarly, government responses to the common problem of the economic crisis, how to succeed in dealing with public policy recalibration contraction in economic activity and then to the crisis offer clues about the ability of public institutions to address and manage long-term flattening of the economic cycle and the move to an upward trend.

At this moment the most used examples in the debate on crisis management models are: Germany vs. France or Poland as an example of a successful New Member State; the United States of America where the management of structural impabalnces offers a unique approach, as well as China as a potential model for emerging economies in the catching-up process. Europe is a unique landscape in the relationship between institutions and economic environment. The uniqueness of the model derives mainly from the complexity and dynamics of different tiers of decision analysis.

In the context of a national state, depending on the model of governance central tiers of the decision must be considered, with specific structural components (sectoral, horizontal and vertical), regional and local implementation decisions having significant impact on economic policy. Therefore, if the first two levels have significant relevance to the analysis and solution formulation then, the regional and local layers influence economic policy implementation.

Depending on government structure, the state organization, the degree of influence of central, regional and local layers differ. The role, effectiveness and influence of the state organization needs careful consideration. In addition to these elements of national states, the complexity of EU decision is supported by the introduction of an extra layer – the supranational level. Coordination at this level, the balance between Community and national level differ significantly from one sector to another.

Thus, in the case of social affairs or taxation or social policy decision-making power of the community level is relatively low, employing soft means of coordination such as the Open Method of Coordination; however in case of competition policy the supranational level has exclusive rights. From a decision-making perspective, the European Union needs supplementary time to react compared to a national actor (be it even federal), due mainly to the higher degrees of freedom provided to national actors. Therefore for Member States of the European Union, faced with the current economic crisis, the optimal course of action continues to be action at national level.

Though such an option presents optimality characteristics only if the preferences and actions of the member states are either highly correlated or they incorporate a significant degree of coordination. The issue at EU level in structuring its response to the crisis is that, on one hand, it has never managed to coordinate the options and solutions of its actors and, on the other hand the different impact of solutions and the different characteristics of the Member State economies determined different performance at national level. Recent debate insists on a well-known comparison between Germany and the French economy. While Germany has made significant strides not only in terms of capital injection into the economy, having the support of a better position in terms of fiscal space, France preferred not significantly reform the social security system and, therefore, faces, apparently, with an prolonged recession.

In this context, the most important economies in terms of share in the EU GDP are already at different stages of the economic cycle. Therefore, economic policy makers from both countries are faced with different assumptions regarding economic policy formulation. If Germany can now take steps to withdraw fiscal stimulus in the economy, to shift towards limiting fiscal deficits and move towards anti-inflationary policies, France is still in a period in which they should be concerned about the stimulating the economy and the alarming increase of fiscal deficits.

Considering separately these two examples, analyzing them also in the context of the Euro Area, the complexity of the European level decision-making process emerges clearer. This complexity being spurred not only by the different decision-making layers but also the eterogeniety of economic evolution. However, why the focus on the correlation of economic cycles especially in a period of crisis like the present one?!

Motivations, especially the implications of such an approach are of course many, but a good starting point would be very theoretical model that has supported the creation and existence of the euro area – Optimal Currency Area Model[(1)]. Among the key requirements proposed by the author the perfect synchronization of business cycles in the economies of Member States' tax policies and ability to cope with asymmetric shocks[(2).] Two of these conditions are in danger of no longer being observed in the two most important economies in the Eurozone. If we take into account the competitive gap between the economies of Member States within the euro area, one may come to the conclusion that on the medium term and the very existence of the fundamental mechanisms such as the Euro Zone may be under question. From an economic perspective, the mechanisms of coordination within the EU structure are similar in terms of impact with the functioning of institutions in a Member State.

However, the fundamental problem on reforming these mechanism, on the one hand, is the very decision-making system that requires relatively long periods of negotiation between Member States and secondly that these costs are not explicit, as in the case of national institutions. Crises have the specificity of revealing the costs of sub-optimal operation of such mechanisms precisely because the margin for manoeuvre, including fiscal space is limited, consequently shocks are directly sent to the market. Greece and Romania are eloquent examples in this respect, where the need for last resort intervention mechanisms was felt acutely.

Operation of a supranational framework of heterogeneous economies, with different adjustment speeds, showed the need for adjustment mechanisms, which operate automatically and that respond quickly and coherently. An example is the need for access to emergency funds. In practice, the role they play is that of an insurance policy against the risk of policy skidding.

At this point, the only penalty mechanism against states that do not apply appropriate policies, apart from the pressure of other Member States *(peer mats),* is the cost of access to resources in the financial market. The *European Union has not yet explicitly discussed a mechanism that would pass such costs to the states that consistently run the risk of implementation of sub-optimal economic policies.*

Of course such a reform would be difficult to imagine, especially when tha majority of Member States are in breach of the rules of the Stability and Growth Pact. Option to reform the policy framework at the European level may come either from states that are more advanced in reforms implementation (an interesting example being the evolution in the relations between Germany and France) or asymmetric shocks to produce significant impact and thus disturb the normal political cycles. The current economic crisis played the role of an accurate X-ray on the weakness of macroeconomic policy coordination at the global level. Romania is an example that the EU's response was a consistent one, characterized by coordination of international institutions that offered an integrated package of support together with the IMF, World Bank, EBRD and EIB(3). The package involves not only financial support but also technical from the World Bank, a functional review exercise, which aims to strengthen institutions in the key areas for economic growth.

Such an approach proves the integrated approach taken by the European Commission to economic growth model analysis, focusing on institutional development, administrative capacity building and economic policy coherence while the IMF offers a financial safety net.

In the specific case of Romania, this approach has worked for several reasons: the structure and scale of the problem played in this case a significant role. Total aid package, although the highest ever accessed by Romania, Euro 22 billion, may be accessed in 2009-2011 period. The situation is quite different when the risk turns systemic and neither national governments nor supranational EU institutions have sufficient means of control to influence the behavior of governments. In the case of Greece and other Member States such as Ireland or Portugal, that is exactly the fundamental problem. In addition, for some economies like Iceland for example, which has showed the potential of systemic contamination, the problem is even more complicated when the EU policy framework does not even play a role in effectively constraining the behavior of these Member States. In fact, just this part of the problem determines the reluctance of private financial institutions to intervene in the case of a Member State in such a situation - the lack of mechanisms to influence national economic policy.

Analyzing the Treaty codified balance for fiscal policy, Member States retain attributes of sovereignty intact, including in the context of the Lisbon Treaty. The solution adopted by Heads of State and Government is an agreement on mechanisms such as the recently adopted European Semester in the new financial supervisory framework[(4)], which offers a coordination mechanism in a matter in which EU does not have powers to intervene. However the need for both supervision and coordination is becoming obvious since Member States do not seem to have national mechanism to deal with this issues.

This format aims to implement by using the pressure of both Member States and the Community level the implementation of fiscal-budgetary frameworks that focus on consistent quality of public expenditure and allocation of budgetary resources, respecting the strategic priorities of EU policy. In this sense, the economic policy objectives are set by Europe 2020. Therefore, the view expressed in this area by the Commission and the other Member States remains purely consultative, bearing probably political weight.

This solution, however, present the advantages of maintaining the sovereignity attributes of Member States intact, while giving the Commission the mandate to strengthen fiscal discipline by proposing concrete penalty in areas where there is such jurisdiction – such as the Cohesion Policy. Although not optimal, this solution has the advantage of transforming implicit costs, such as the lack of structural reforms, into explicit ones – the penalty of restriction of access to resources managed by the Cohesion Policy.

The need for coordination of economic policies is not necessarily supported only by the argument of the functioning of the optimal currency area.

Economies of scale are another significant factor that determines the choice of Member States to coordinate economic policy options. From this perspective, coherent functioning of the EU Single Market is essential to support an return to scale. Analyzing the responses of Member States, particularly in the context of economic crisis, it appears that protective reflexes have not yet disappeared from Europe.

Even if one takes of the analysis the question of EU internal market scale and focuses solely on developments in Member States, it becomes obvious that economic recovery and positive signs of growth are more likely to appear in large economies, characterized by fiscal space to stimulate domestic demand through fiscal incentive mechanisms. Examples like Germany and Poland, that have managed better than average economic performance in the process of recovery from economic crisis in the former case, and positive growth in the last two years for Poland.

Policies and institutions are the framework conditions to support economic growth. The challenges currently facing by the global economy are far more complex and consists of a system getting closer to reaching its limits. In this respect the earlier conceptual design becomes even more valid, as it puts at the center of the economic performance the ability of an economy to adopt and implement decisions consistently and in a relevant time frame. One of the fundamental problems of the current growth model is that, from certain perspectives, it is soon to reach its limits, not necessarily potential. Thus the current approach of economists, of optimizing the output within the current technological paradigm, seems to be no longer relevant. The current context puts the world economy in a situation significantly different from previous episodes of economic growth or technological progress that has imposed a paradigm shift in technology, or the discovery of new types of resources significantly increased. This episode is determined in particular by limited hydrocarbon resources, on the one hand, and reaching the limits of ecological sustainability, on the other.

The necessary technological leap requires economic policy measures and a policy framework that provides actors with sufficient assurances on the sustainability of the economic development model proposed so the private environment would contribute to the development and implementation of the new technologies required. In this context, the relevant actors of the international system and the European Union, United States, emerging economies such as BRIC group (Brazil, Russia, India and China) are part of international negotiations in various formats for regulating and determining the level of ambition of global action in climate change. Through Europe 2020, a continuation and development of the Lisbon Strategy, the European Union aims to define new growth engines. They focus on human capital (knowledge economy), innovation, green economy and information technologies for a sustainable resolution of the economic growth process.

The remarkable trade of this approach is that, on the one hand, the system used instruments and international economic policies to stimulate economic behavior, and, on the other hand, ecological sustainability or quality of life, in various forms, become factors of the economic growth model. Each of the new directions that will define the pillars of economic growth in the next period depends primarily on the quality of support policies for their development.

In this regard the European model of economic development policies that are used legal and economic mechanisms to manage economic motivation seems to be already taken up by other actors in the international system. An example of this is encouraging the development of green technology where the EU is already significant efforts to provide explicit financial support (funds available through European instruments such as FP7) and the default by using the EU's Internal Market.

Such mechanisms, managed transparently, provide socially acceptable chance of achieving a balance between government intervention and distortion of competition within the market. Yet how this balance is defined and how acceptable is the level of Member States or the relationship between the actors of the global system are matters requiring further consideration.

Use of public resources and tools to define new growth engines requires a significant responsibility in terms of opportunity costs and social income maximization. In this time perspective may be a significant factor in the analysis.

Whatever the short and medium term results, it is very difficult to argue, in terms of rationality, against the need to change current production model mainly due to environmental impact. However as the structure evolves from economies characterized by low value added sectors to produce value-added sectors, there seems to be a positive correlation between their flexibility and ability to withstand business cycle fluctuations. An example are the IT services in Romania but also in new Member States which showed positive growth rates during periods of economic contraction.

Conclusions

The current economic crisis played a very precise X-ray role in highlighting the weakness of the global economic system. The kind of considered in this paper are structural and economic policies. From the structural mechanisms perspective, market imbalances artificially maintained, either through lack of regulation or suboptimal regulatory systems, and competitive imbalances reflected at macro level become elements that require immediate attention in crisis situations.

The economic crisis has demonstrated the need for societal mechanisms to provide coherent solutions to coordinate resource allocation mechanisms to allow recalibration of the economy and adapt to new conditions. One of the essential ingredients of this mechanism is functional independent institutions. Periods of economic growth may hide such imbalances and can perpetuate suboptimal economic policies just because of the resources needed to maintain these arrangements. Examples are social policies which does not reflect the labor market functioning and competitiveness of economic or financial perspective are not sustainable (contributiveness principle).

The quality and capacity of institutions, their social usefulness can be judged by the quality of proposed solutions, tailored to the internal environment. Although there is an option at this point represented by a safety net of international institutions, their role is not to replace national institutions. A significant argument supporting institutional capacity is the speed of recovery from economies that have benefited from strong national institutions, in the context of the economic crisis. This is strongly correlated with the time needed to validate the decision out steps and solutions to codify these rules and ensure the consistent implementation. The last segment of this process is the implementation of new mechanisms that involve institutional reform and adaptation policies.

All these elements are essential parts of the coordination structure of an economy. They are tested in different national perspectives of the international system and various types of actors at national states to supranational structures like the European Union. But we believe that these segments of analysis retains whatever type of player analysis and are useful in defining the performance of any economy.

Notes

(1) The Economic and Monetary Union is based on the macroeconomic models that got their authors a Nobel Prize. Due to its relevance to the actual design of the European EMU, the theory of Optimal Monetary Zones lead to the 1999 awarding of the Nobel Prize to Robert Mundell.

(2) According to Mundell, the four conditions that have to be met so that the Optimal Monetary Zones work are: the business cycles are perfectly synchronised, in order for a centralised monetary policy to be managed optimally; Fiscal policies have to handle the

asymmetric shocks that might occur; Prices and wages are perfectly flexible in OMZ; both labour and goods markets are integrated.

(3) According to the Government normative act that ratified the Stand-by Agreement between Romania and the IMF, stated in the letter of intention issued by the Romanian authorities and signed on the 24th of April 2009 in Bucharest.

(4) At the Autumn Council, in September 2010 in Brussels, the Heads of State and Government of the Member States concluded that a new frame for fiscal supervision at the Union level is necessary. Among the agreed measures there are presenting the annual budget document and multi-annual budgetary frame for analysis to the European institutions. Although the recommendation is only consultative, it can be accompanied by punitive measures through accessing the structural funds in case the financial programming does not comply with the stability and growth pact and/or the qualitative criteria regarding public allowances are not met.

References

Baldwin, R., Venables, T. (1995). *Regional Economic Integration,* in Handbook of International Economics, edited by Grossman and Rogoff, Vol. 3, New York

Baldwin, R., Martin, P., „Two Waves of Globalisation: Superficial Similarities, Fundamental Differences", *NBER Working Paper,* No. 6904, 1999, Cambridge (Mass.)

Baldwin, R., Francois, J., Portes, R. (1997). *The costs and benefits of eastern enlargement: the impact on the EU and central Europe*, Centre for Economic Policy Research

Baldwin, R., „Openness and Growth:What's the Empirical Relationship?", *NBER Working Paper*, No. 9578, 2003, Cambridge

Barry, F. (2004). *Economic Policy, Income Convergence and Structural Change in the EU Periphery*, in Kierzkowski, H. (2004). *Europe and Globalization*

Becker, G. (1975). *Human Capital: A Theoretical and Empirical Analysis*, 2nd ed., NBER, New York

Bhagwati, J.N. (2004). *In Defense of Globalization. Its Evolution and Contemporary Consequences*, New York

Bhagwati, J.N., Panagariya, A., Srinivasan, T.N., „The Muddles over Outsourcing", *Journal of Economic Perspectives*, Vol. 18, No. 4, Fall 2004

Bhorat, H., Lundall, P., „Employment and labor market effects of globalization: Selected issues for policy management", *ILO Employment Strategy Papers*, 2004, ILO, Geneva

Blanchard, O., „The Economic Future of Europe", *NBER Working Paper,* 2004

Dăianu, D., Vrânceanu, R. (2002). *România şi Uniunea Europeană,* Polirom

Dicken, P. (2003). *Global Shift, Reshaping the Global Economic Map in the 21st Century*, London

George, S., Bache, I. (2001). *Politics in the European Union*, Oxford University Press

Held, D., McGrew, A.G., Goldblatt, D., Perraton, J. (1999). *Global Transformations: Politics, Economics and Culture*, Stanford

Hutton,W., Giddens, A. eds. (2000). *On the Edge: Living with Global Capitalism,* London

James, H. (1996). *International Monetary Cooperation since Bretton Woods*, Oxford

Krueger, A., Lindahl, M. (2000). *Education for Growth: Why and for Whom?*, NBER, Cambridge (Mass.)

Krugman, P., Obstfeld, M. (2003). *International Economics: Theory and Policy*, New York

Lynch, Black, „Human Capital Investment and Productivity", *American Economic Review,* 86.2, 1996

Maddison, A. (1982). *Phases of Capitalist Development*, Oxford

Maddison, A (2001). *The World Economy: a Millennial Perspective*, OECD, Paris

Dinu, M., Socol, C., Marinaş, M. (2007). *Modelul european de integrare*, Editura Economică, Bucureşti

Dinu, M., Socol, C., Niculescu, Aura (2006). *Economia României. O viziune asupra tranziției postcomuniste,* Editura Economică, Bucureşti

Dinu, M., Socol, C., Niculescu, Aura (2006). *Fundamentarea şi coordonarea politicilor economice în Uniunea Europeană*, Editura Economică, Bucureşti

Dinu, M., Socol, C., Marinaş, M. (2005). *Mecanismele de convergență şi coeziune*, Editura Economică, Bucureşti

Messerlin, P.A. (2001). *The real cost of European protectionism*, Institut d'Etudes Politiques de Paris and Group d'Economie Mondiale de Sciences Politique

Messerlin, P.A. (2001). *Measuring the Costs of Protection in Europe: European Commercial Policy in the 2000s*, Institute of International Economics, Washington. D.C.

O'Mahony, M., van Ark, B. (2003). *EU Productivity and Competitiveness: An Industry Perspective – Can Europe resume the catching up process*, European Commission

Puşcaş, V. (2003). *Negociind cu UE*, Volumele 1-4, Editura Eikon, Cluj-Napoca

Sapir, A. et al. (2003). *An Agenda for a Growing Europe: The Sapir Report*, Oxford,

Stiglitz, J. (2002). *Globalisation and its Discontents*', London, 2002