External Imbalances and Resource Allocation: how do we reconcile short- and long- term perspectives?

CompNet's contribution on the role of reallocation / misallocation

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Current account imbalances: is there a role for capital and labor allocation?

- **Euro integration stimulated financial flows across European countries**

  [Martin and Coeurdacier (2009)]

- **Resulted in large current account imbalances, mostly driven by the income channel and imports growth**

  [Gaulier and Vicard, CompNet policy brief 02/2013]

- **Productivity growth was stagnant or even declined in countries with Current Account deficit before the crisis**

- **Need to better understand the role of capital and labor misallocation across or within sectors**
  - Important implications both for the rebalancing process and long-term economic growth

Evidence on misallocation before the crisis

Frictions in input and output markets can distort price signals and generate misallocation of resources, leading to lower output and unemployed resources

Ricardo Reis (Brookings Papers, 2013) focuses on the Portuguese slump in production and employment during the period 2000-2007

- Credit market imperfections tend to modify the benefits from greater financial openness by generating capital misallocation across firms

Gopinath, Kalemli-Ozcan, Karabarbounis, Villegas-Sanchez (mimeo, 2015)

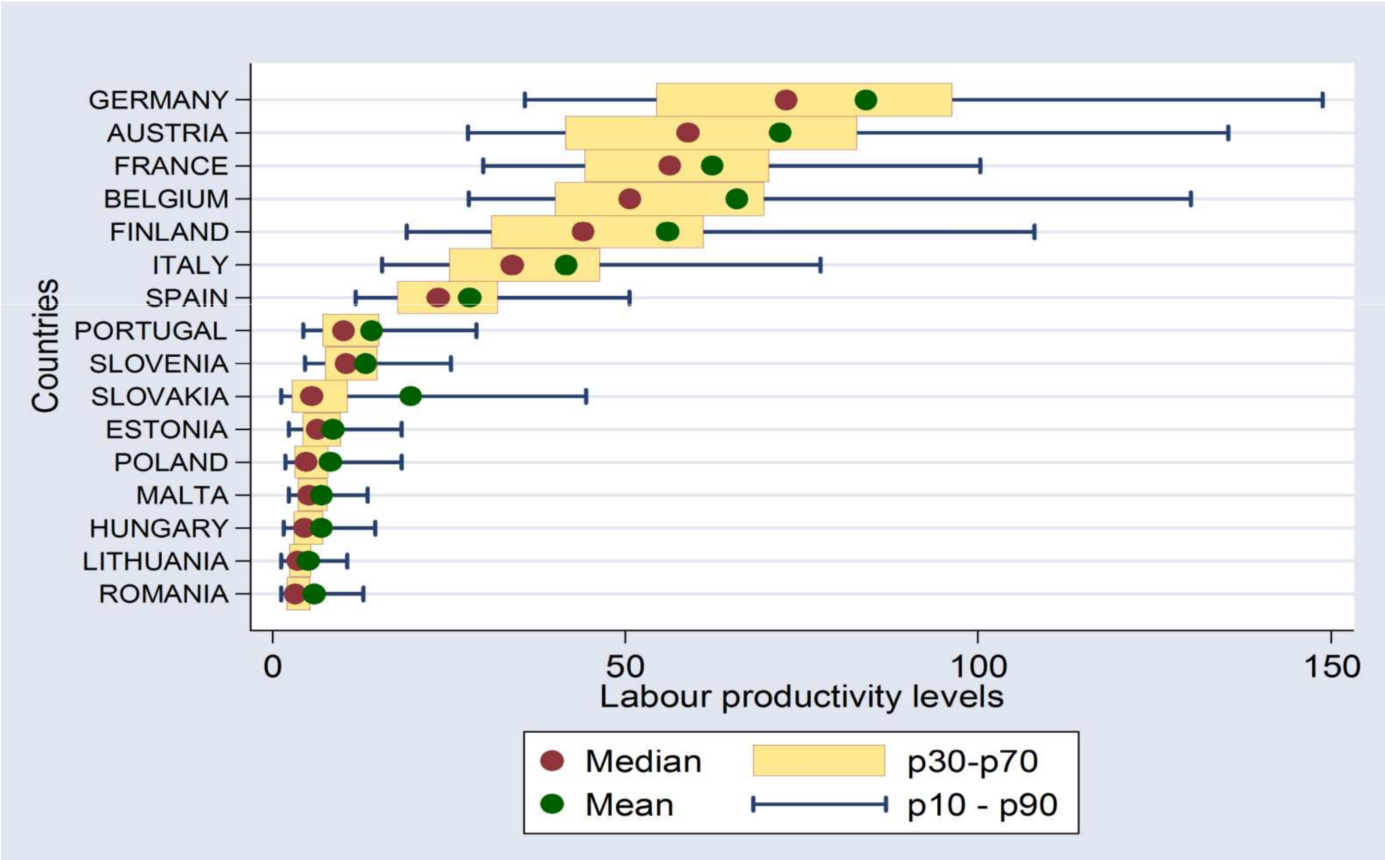
- Document a large increase in the dispersion of capital productivity before and during the crisis (a measure of capital misallocation)
- Role of size-dependent borrowing constraints before the crisis, and investments adjustment costs

What did we learn? What do we need?

- We need to understand more why capital (and labor) may be misallocated under some circumstances
  - Policies keeping capital mobility high, and ensuring that capital is allocated to the right countries, sectors, and firms, may have great impact on long term economic growth
- We need up-to-date indicators of allocative efficiency in labor and capital markets for multiple countries for policy analysis
  - This has been the work of CompNet for the past 3 years
- We need more theoretical and empirical evidence about the economic mechanisms driving the allocation of resources

Evidence #1: The great within-sector dispersion of productivity

- Within-sector reallocation towards best firms can generate substantial aggregate productivity gains



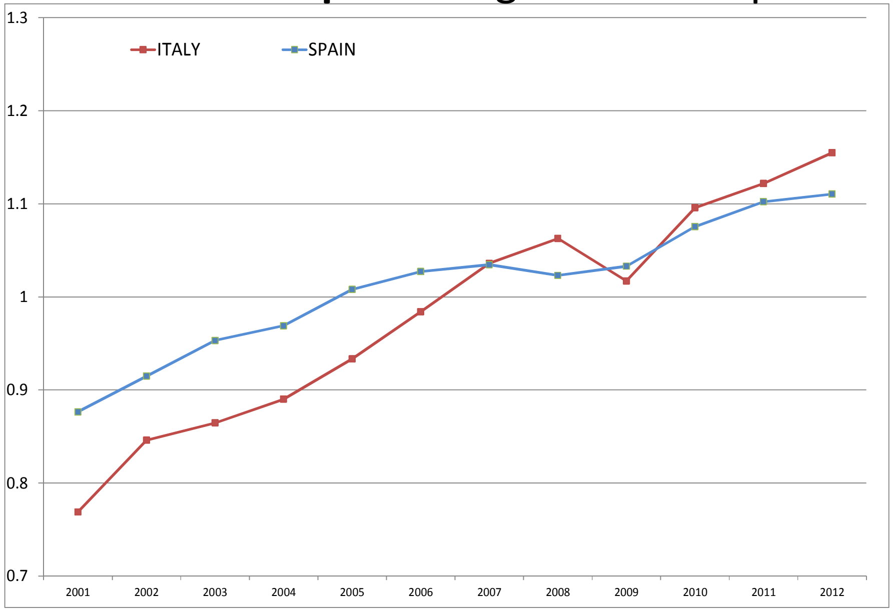
Source: CompNet Task Force (2014), Micro-based evidence of EU competitiveness: the CompNet database, ECB WP N.1634

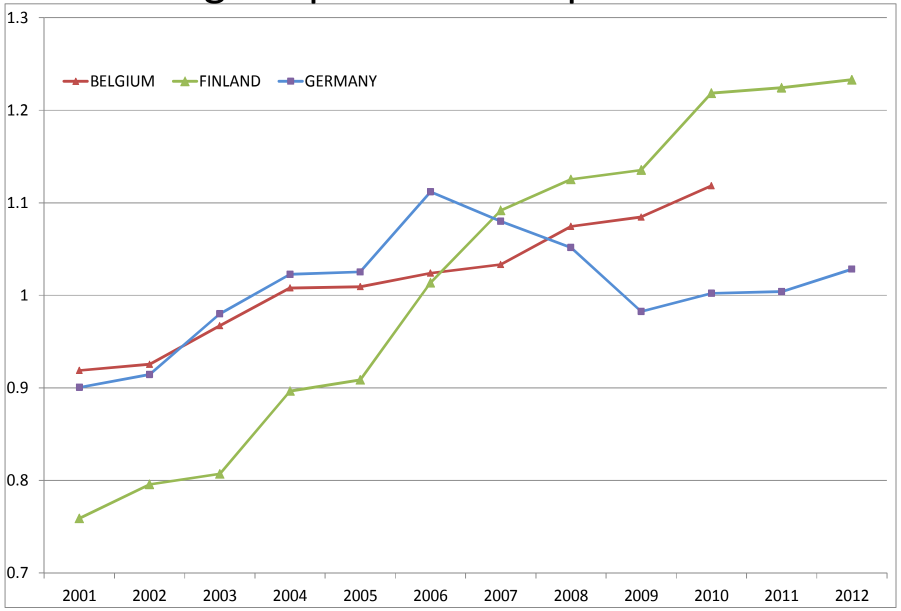
Evidence #2: The increased dispersion of capital productivity before the crisis

- **Allocation of capital deteriorated within sectors before the crisis** (as in Gopinath et al. 2015)

- Some firms with high returns are not able to get enough capital ➔ Negative impact of Total Factor Productivity

Graph: Changes in the dispersion of the marginal product of capital





Source: CompNet final report, chapter 3 (2015)

Evidence #3: misallocation and productivity before the crisis

Garcia-Santana, Moral-Benito, Pijoan-Mas, Ramos (2015) « Growing like Spain: 1995-2007 »

- Decline of Spanish TFP before the crisis explained by the rise of misallocation of labor and capital across firms within sectors
- Spanish TFP fell at an annual rate of 0.7% over the years 1995-2007
- Within-sector misallocation increased at an annual rate of 1.5%.
- **Absent such deterioration, TFP growth would have been around 0.8% per year.**

Dias, Robalo-Marques and Richmond (2014) document similar trends for Portugal before the crisis

- Highlight the role played by capital distortions, esp. in the services sectors

Evidence #4: Cleansing effect during the crisis

Bartelsman, Lopez-Garcia and Presidente (2015), « Assessing labour reallocation process in Europe: productivity enhancing or not? », mimeo

- Provide evidence about the role of within and between sector reallocation
- More productive sectors created more jobs during the crisis (between sector reallocation)
- Initially more productive firms also create more jobs (within-sector reallocation)

Berthou (2015): « Reallocation and current account adjustment during the crisis »

- There is strong heterogeneity in the pattern of within-sector reallocation across European countries during the crisis
- Between 2008 and 2012, within-sector reallocation across firms was more sizeable among European countries with larger current account adjustment.

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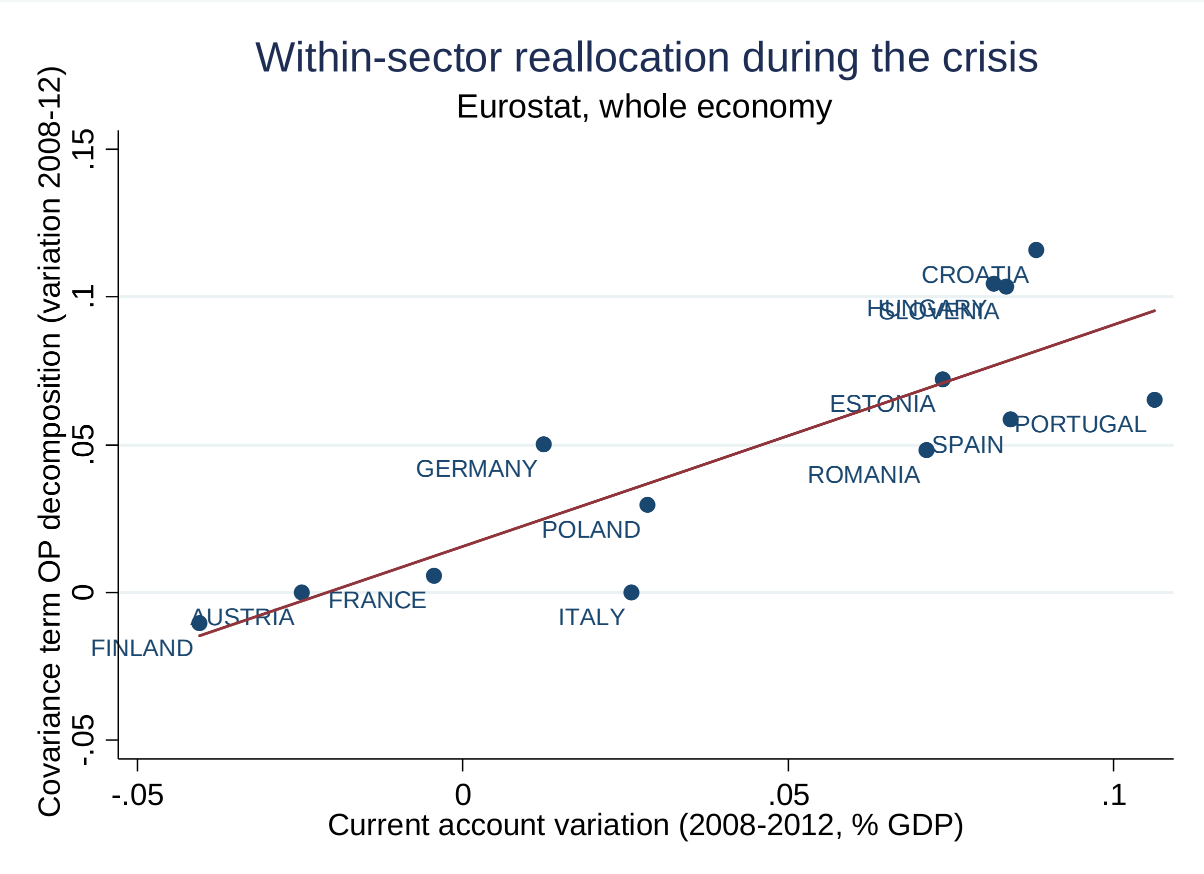


Berthou (2015), ongoing work

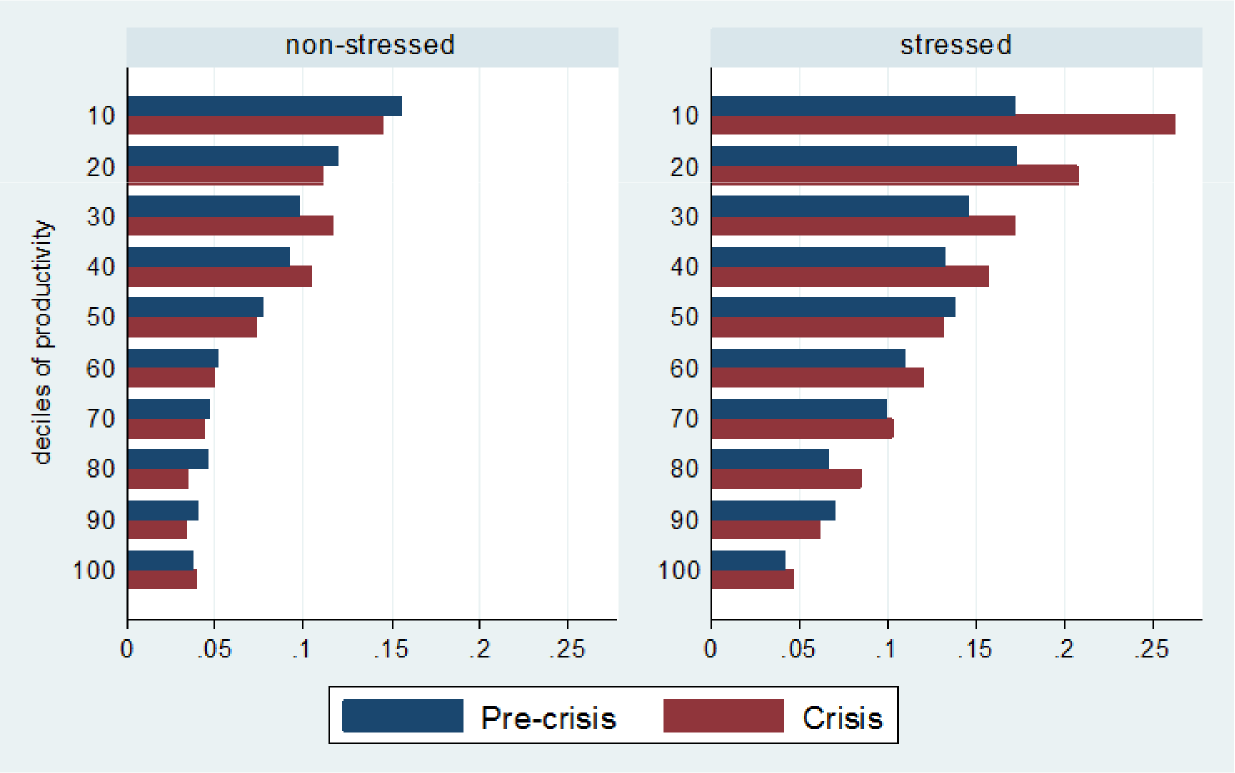
Potential suspects :

- Foreign and domestic demand shocks?
- Credit constraints?
- Structural reforms?

Evidence #4: Cleansing effect during the crisis

Bartelsman, di Mauro and Dorrucci (2015), “Eurozone rebalancing: Are we on the right track for growth? Insights from the CompNet micro-based data”

Graph: Percentage of credit-constrained firms by labour productivity decile in stressed and non-stressed economies



Source: Bartelsman et al. (2015a), based on CompNet data (sample with 20+ employees). Notes: CompNet The non-stressed countries are Belgium, Germany, Finland and France, while the stressed countries are Spain, Italy and Slovenia. Pre-crisis data cover the period 2004-08 (with the exception of Spain, for which only 2008 data are available), while crisis period data cover the period 2009-12.

Ongoing research and way forward

- **Great need to better understand the mechanisms driving the allocation of capital across countries, sectors and firms in Europe**
  - Important for both rebalancing process and long-term growth
  - Need to continue data collection to provide up-to-date analysis

- **Berthou, Manova and Sandoz (2015),** « Productivity, misallocation and trade »
  - Gains from trade (in terms of aggregate productivity) can be modified in the presence of capital market imperfections

- **Di Mauro, Hassan and Ottaviano (2015),** "Banks, Credit and Productivity Growth"
  - Are bank loans rightly allocated across firms?
  - Preliminary evidence based on Italy shows that credit allocation tends to respond very little to key variables such as the capital productivity or TFP