

## Flash Economics

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### Should the euro zone also adopt the "overheating theory", like the United States?

The "overheating theory" describes the positive effects of maintaining a significant demand-stimulating policy when the economy has returned to the full employment.

The idea is that if companies are faced with both stimulation of demand and major hiring difficulties, they have to organise themselves better to be able to meet demand: efficiency gains, hiring of less employable people.

This theory is currently being applied in the United States with expansionary fiscal and monetary policies at full employment, which seems to have led to an upturn in labour productivity and the participation rate and therefore in potential growth.

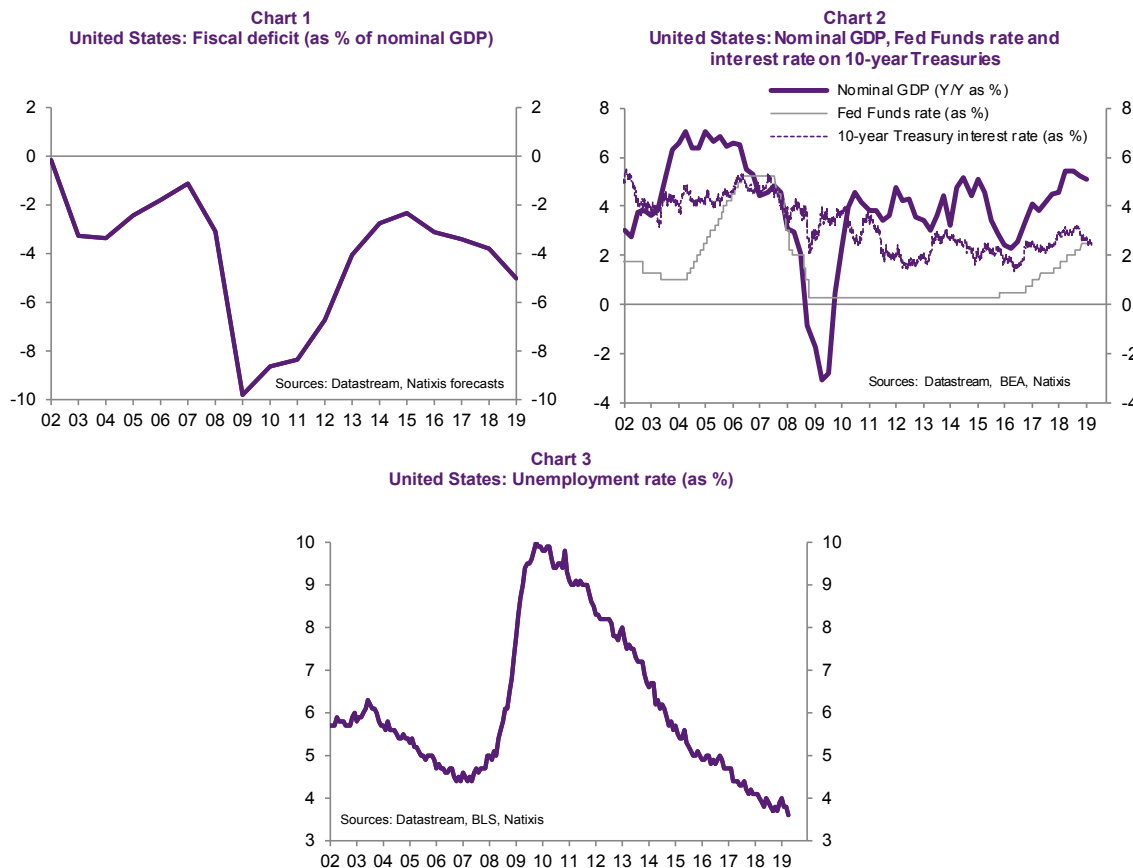
While monetary policy is expansionary in the euro zone, this is not the case with fiscal policy. Does this rejection of the "overheating theory" in the euro zone explain why productivity gains are declining instead of increasing in the zone?

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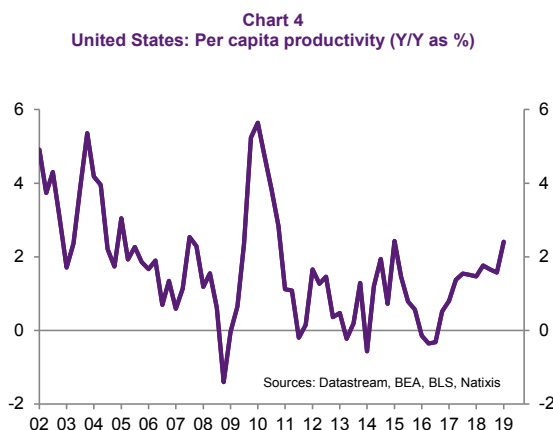
## The United States is applying the "overheating theory", and perhaps with positive results

The United States is currently conducting an **expansionary fiscal policy** (Chart 1) and also an **expansionary monetary policy** (Chart 2) at a time when it is at full employment (Chart 3).

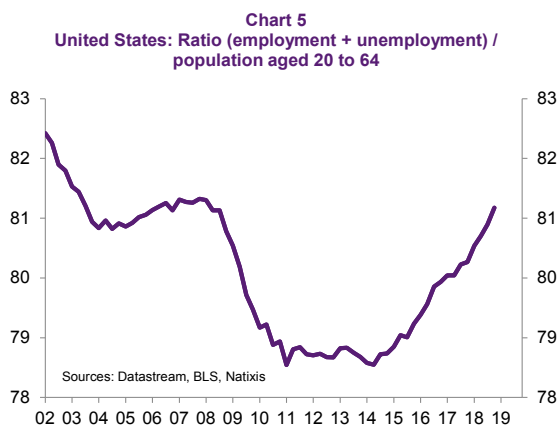


This is perhaps an application of the "overheating theory": boosting demand even at full employment to force companies to become more efficient and to hire less employable people, which drives down structural unemployment. It has to be recognised **that in the recent period, we have seen in the United States:**

- A rise in productivity gains (Chart 4);



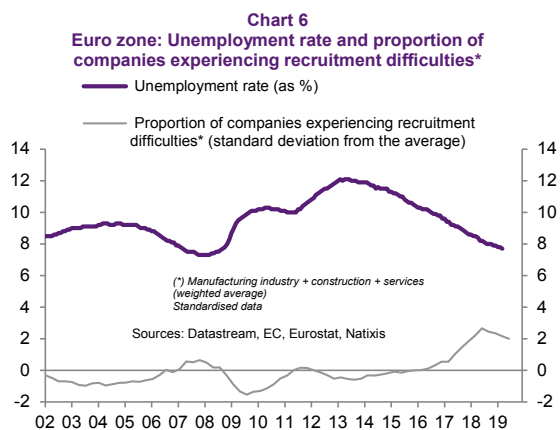
- **A rapid rise in the participation rate (Chart 5**, which we calculate as (employment + unemployment)/population aged 20 to 64, which is not the usual calculation in the United States where there is no age limit).



The application of the overheating theory therefore seems to give positive effects in the United States.

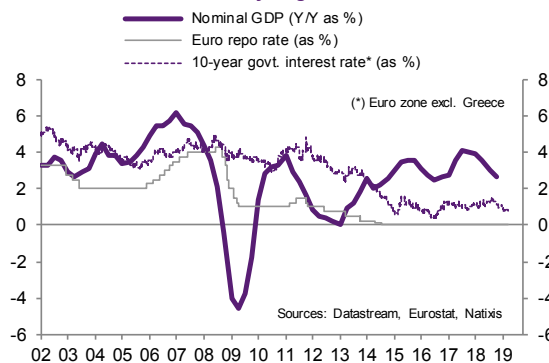
## The euro zone is not applying the overheating theory

The unemployment rate in the euro zone is close to the structural unemployment rate, as shown by the high level of hiring difficulties (Chart 6).

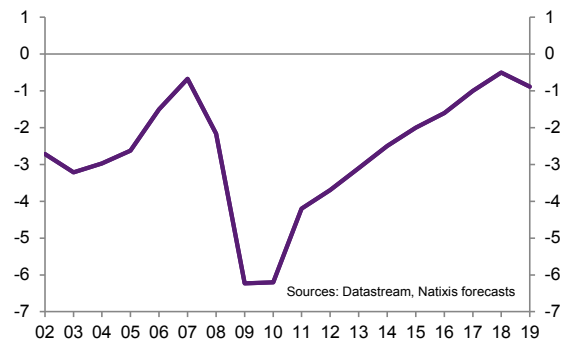


Euro-zone monetary policy is highly expansionary (Chart 7), but fiscal policy is restrictive (Chart 8): the euro zone is not applying the "overheating theory".

**Chart 7**  
Euro zone: Nominal GDP, euro repo rate and interest rate on 10-year government bonds

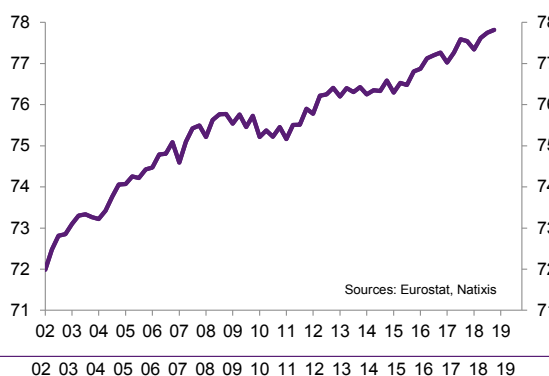


**Chart 8**  
Euro zone: Fiscal deficit (as % of nominal GDP)

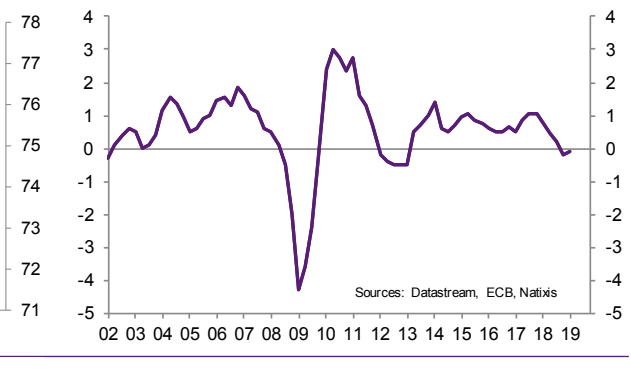


The participation rate in the euro zone (Chart 9) is rising, but not faster than in the past, and productivity gains are declining (Chart 10), while, as we have seen, they are increasing in the United States.

**Chart 9**  
Euro zone: Ratio (employment + unemployment) / population aged 20 to 64



**Chart 10**  
Euro zone: Per capita productivity (Y/Y as %)



The crucial question is therefore: if the euro zone had applied the overheating theory, like the United States, would it enjoy, like the United States, a rise in productivity gains as companies would have to become more efficient to meet demand?

## Conclusion: A practice that is normally rejected, but could it be effective?

The idea of boosting demand at full employment is normally rejected.

This explains why euro-zone fiscal policy is restrictive in 2019.

**But the United States has another approach that we call the overheating theory:** boosting demand significantly at full employment forces companies to become more efficient and to try to reduce structural unemployment. **This practice should be considered, as in the United States we can clearly see rising productivity gains and participation rate**, the cost being an increase in the public debt even at a time when the economy is at full employment.

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