Michael Dauderstädt

From Crisis to Cohesion

Restoring Growth in Southern Europe

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AT A GLANCE

- **Contrary to widespread belief, it was neither profligate public spending nor a decline in price competitiveness that caused the crisis in Southern Europe. Current account deficits resulted from rising imports driven by expanding internal demand, not from weak exports.**

- **The economic policy goals of the creditor institutions (budget consolidation, internal devaluation and growth) and the policy requirements based on them are not consistent, let alone mutually reinforcing. In fact, they are contradictory and responsible for the continued weak growth.**

- **New growth should not be based only on current account surpluses, but also on stronger domestic demand including an expansion of the non-tradable sector through profitable investment projects. However, these countries need to upgrade their export specialisations, as they currently compete with other low-wage, low-tech suppliers such as China.**

- **On the national level, all these countries need support to qualify their workforces, to improve innovation through stronger efforts in research and development, and to strengthen their industrial structure. Weak banking sectors and, particularly in the case of Greece, the threat of national insolvency and an exit from the euro, prevent a recovery.**

- **On the European level, the ECB needs to continue and strengthen its unconventional monetary policy. The euro area needs a proper treasury with the capacity to run an active fiscal policy and to finance an appropriately large European investment programme. The EU should temporarily tolerate national industrial policy measures, including promoting import substitution, even if they violate competition rules.**

1

GROWTH AND COMPETITIVENESS

On 25 March 2017, the European Union (EU) celebrated the sixtieth anniversary of the Treaty of Rome. The Commission has published a white paper on the future of Europe (EU Commission 2017), which, among other issues, addresses the questions of growth and cohesion in Europe. »Making Europe great again«, according to SPD leader Martin Schulz, means restoring growth in Southern Europe. Growth in Europe, and specifically in the Eurozone, has been weak since the Great Recession of 2009. This poor performance of the euro area is caused by the crisis in Southern Europe, where gross domestic product (GDP) has fallen in three countries and grown only minimally in Italy. This paper summarises and slightly extends a larger study on growth strategies for Southern Europe (Dauderstädt 2016).

First, it makes sense to clarify the basic causes of growth and its relation to the often wrongly defined factor competitiveness. Economic growth depends on supply and demand. Changes in supply are caused by changing quantities and qualities of labour and capital employed and the efficiency of their combination (= productivity). Demand results from income spent on consumption and investment by households, enterprises, and government plus net exports (= external demand = foreign income spent on domestic supply). Income not spent is saved and reduces demand if no other domestic or foreign entity is willing to borrow and spend these savings. The resulting balances of assets and liabilities (debt) are a normal feature of growth.

The economic debate is about the primacy of supply or demand. While supply will shrink without demand, demand without sufficient supply will lead to inflation. Exports, still less export surpluses, are not a necessary condition for growth. Otherwise, the world economy could not grow: the planet does not have external trade with alien civilisations. But in an open economy, in particular a small open economy, foreign trade increases the opportunities for supply and demand and contributes to rising productivity.

Competitiveness is the ability of an economy to sustain and increase its living standards without creating risky external imbalances. From this it is obvious that competitiveness does not mean lowering living standards, for instance by reducing wages – although this may be temporarily necessary to correct imbalances. Competitiveness is based on productivity and a pattern of regional and sectoral trade specialisation rather than low costs, which in fact imply low income. A highly competitive economy is one that exports products to growing markets whose expanding demand is not very price-sensitive. Such a propitious mix of price and income elasticities allows strong growth within balance-of-payments constraints (Section 2.3 below; Hein/Detzer 2015).

2

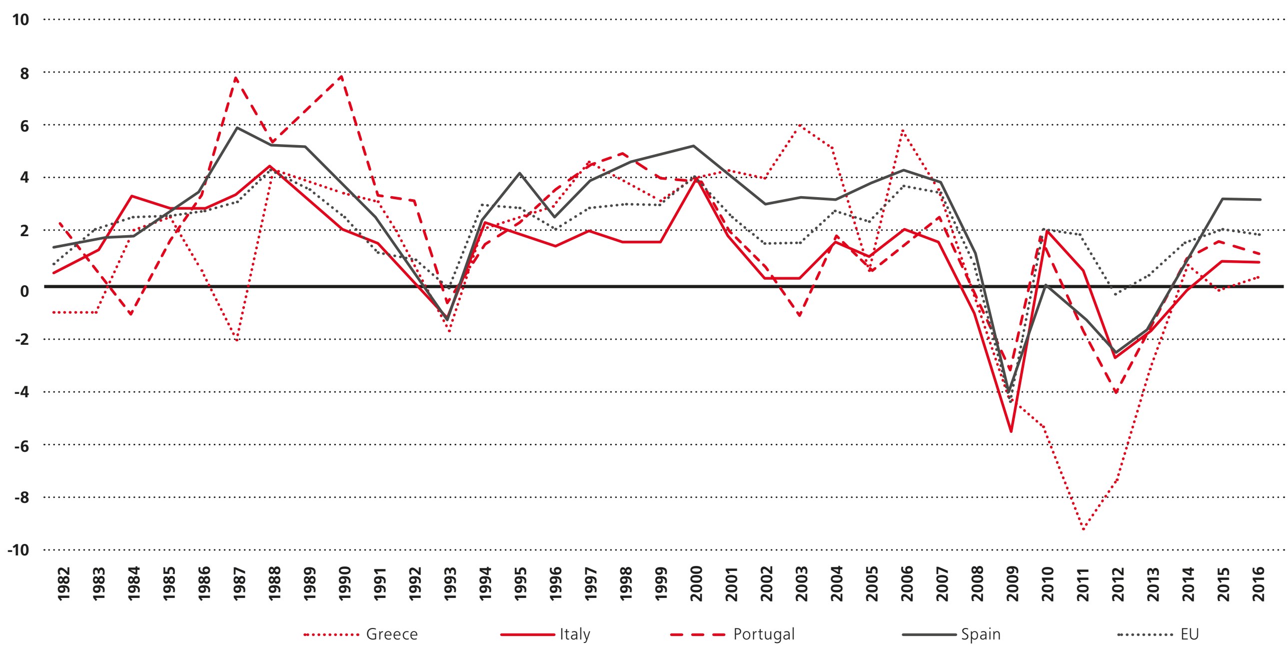
SOUTHERN EUROPE'S GROWTH REVISITED

The four countries addressed in this paper, Greece, Italy, Portugal and Spain (GIPS), have long formed the poor(er) Southern periphery of Europe, with per capita income only about half the EU average. In the post-war period between 1950 and 1980, all four enjoyed strong growth that allowed them to catch up to some extent with the richer European countries. This prosperous period gave way to weaker and volatile growth in Greece after 1980 (following accession to the then European Economic Community) and Italy after 1990, but continued in Spain and Portugal (despite the debt crisis of 1984). For more details see figure 1.

All four joined the European Economic and Monetary Union (EMU) in 1999 (Greece in 2001). Their adoption of the euro led to lower interest rates, which boosted economic growth, albeit to different degrees: strongly and longer in Spain and Greece, shorter in Portugal (where growth rates declined after 2002) and weaker in Italy. This catching-up phase ended suddenly with the global financial crisis and the Great Recession of 2009.

The recovery in Southern Europe was weaker than in Germany and ended when the sovereign debt panic struck. The euro area also suffered from an early switch to a more re-

Figure 1
Southern European Growth 1980–2016



Source: IMF WEO.

strictive fiscal and monetary policy that led to a double-dip recession. The banking crisis and the sovereign debt crisis reinforced each other while the EU and the ECB failed to respond decisively. The crisis exposed the institutional deficits of the EMU, such as the lack of a clear lender of last resort and a central treasury.

Austerity policies led Greece, Portugal and Spain into a deep recession with disastrous social consequences. Italy continued its economic stagnation. Not until 2014 did the Spanish and Portuguese economies start to recover while Greece and Italy experienced weak growth (or none at all). Even in 2016, none of them had GDP higher than in 2007.

In the following sections we focus on the period 2000–2015 when all four economies were members of the euro area. It makes sense to differentiate between the periods before and after the turning point of the 2008/9 crisis.

2.1. THE DRIVERS OF SOUTHERN EUROPEAN GROWTH

In order to better understand the growth models of the four economies we will analyse its drivers on the supply and the demand side.

On *the supply side* output growth depends on labour input and productivity (see table 1). The number of hours worked (employment) and labour productivity increased satisfactorily between 2000 and 2007, supported by strong investment. Italy's performance was the weakest while Spain combined strong labour input with weak productivity growth. After the crisis, it was mostly labour input (i.e. increasing unemployment) that declined while productivity improved (except in Greece). Labour productivity benefited from better education and an increasing capital stock.

On *the demand side* all four economies showed strong growth in consumption and investment, with Italy again the relative laggard. After the shock, both demand components declined (see table 2). Investment, however, fell heavily while consumption decreased moderately (except in Greece). The wage share declined after 2009. These changes in internal demand were reflected in the current accounts. While three countries (all except Italy) ran large external deficits until 2009, the trade balances improved substantially (albeit with only Spain achieving a surplus).

Given the crucial role of debt in the euro crisis, it makes sense to take a closer look at the sectoral accounts to discover which sectors increased their liabilities to finance extra demand. Usually private households have positive financial balances (net wealth), corresponding to negative balances (net debt) in the corporate and public sectors. Contrary to widespread belief, it was not profligate public spending and exploding sovereign debt that caused the Southern European

Table 1
Growth of Labour Input and Productivity (Average annual change in percent)

	2000–2007		2009–2014	
	Labour input (hours worked)	**Labour productivity**	**Labour input (hours worked)**	**Labour productivity**
Greece	1.4	2.2	-4.4	-0.3
Italy	0.9	0.3	-0.9	0.4
Portugal	0.2	1.2	-2.1	1.4
Spain	3.0	0.4	-2.2	1.8
Germany	0.1	1.5	0.8	1.1

Source: Conference Board (https://www.conference-board.org/data/economydatabase/index.cfm?id=27762); own calculations

Table 2
Development of Demand (nominal, change in percent)

	2000–2007		2009–2014	
	Consumption	**Investment**	**Consumption**	**Investment**
Greece	64.5	64.1	–20.7	–50.5
Spain	63.4	97.2	–1.6	–19.1
Italy	29.4	39.1	–0.8	–18.9
Portugal	40.4	9.6	–5.9	–32.1
Germany	13.8	2.9	11.7	9.5

Source: Eurostat, own calculations.

debt crisis. Actually, until 2008, the public sector's balance improved in Spain and Italy and declined moderately in Greece (by 10 percentage points of GDP) and Portugal (by 17 percentage points of GDP). Budget deficits shrunk until 2009 in all four countries, but increased afterwards. The corporate sector increased its debt only in Spain and Italy. Private households, however, took on new liabilities and thus substantially reduced their net wealth – by 30 to 50 percent of GDP between 2000 and 2008. After the financial crisis, the private sector deleveraged. The corporate sector reduced its net debt in Spain and Italy (but not in Greece and Portugal) and private households increased their net wealth by 10 to 20 percent of GDP (except in Italy). The public sector increased its debt substantially (by 30 to 50 percent of GDP) in order to bail out banks and stimulate the economy. In three countries (Italy being the exception) the net external investment position deteriorated strongly.

2.2. THE RISKS OF SOUTHERN EUROPE'S PRE-CRISIS GROWTH MODEL

Persistent current account deficits and increasing foreign debt are two problems linked to the pre-crisis growth model in Europe's southern periphery. Behind these external phenomena lie three internal features that have created some concern:

– Increases in inflation and wages above the Eurozone average, causing a »real appreciation« that makes imports cheaper and exports more expensive;
– Rising levels of gross debt;
– Strong growth in the non-tradable sector at the relative expense of the tradable sector.

Many observers blamed the current account deficits on the higher nominal unit labour costs of the GIPS countries, which were interpreted as declining competitiveness. Actually, between 2000 and 2008 (and between 2000 and 2013) all four countries experienced stronger export growth than the so-called »export champion« Germany. Their export market shares hardly changed between 2000 and 2008 (Kang and Shambaugh 2016). Therefore, competitiveness did not decline if one understands it as the capacity to sell abroad. The exclusive focus on unit labour costs neglects the much more important role of financial flows, which fuelled growth in Southern Europe (Gabrisch 2017; Storm/Naastepad 2014).

The major cause of current account deficits was not declining competitiveness but expanding imports due to growing internal demand. The external deficits reflect the price and income elasticities of exports and imports. Rising incomes led to higher imports while less vigorous growth in the northern Eurozone economies limited the growth of exports from Southern Europe. Internal demand in Southern Europe increased because of rising incomes (wages and profits) and growing inflows of private sector credit. Both developments are closely linked. Rising incomes encourage people to take on more debt, in particular when interest levels are relatively low. The same type of reasoning determines the behaviour of banks, which are more willing to lend when incomes and asset prices are rising.

A large share of these loans were used to expand the production of non-tradables, notably housing and non-residential property. In a monetary union, profitable investment in the non-tradable sector should be no problem, even if it leads to higher imports, because it will be financed by an integrated financial sector (Collignon 2014). The problem that was exposed or created (depending on the point of view) by the global financial market crisis, was the overstretched balance sheets of the national banking sectors. Their expansion had been based on an assumption of continuous growth of the national economies – including rising household incomes, corporate profits and government revenues. With the sudden recession and the collapse of bank credit, many debtors became illiquid if not insolvent and many investments were no longer profitable.

When the inter-bank market collapsed in the crisis and the EU started to treat each banking sector and country's sovereign debt as a separate national problem, this created a vicious circle of weak banking sectors, overstretched public finances and recession. On the one hand, banks with many non-performing loans have to rely on central banks for fresh money – and in the event of insolvency on their national treasury. On the other hand, when the quality of sovereign debt falls into doubt, banks holding it become illiquid if not insolvent. Additionally, weak banks will lend less to the private sector, dampening economic growth and reducing tax revenues. Thus state finances become more fragile and need more reliable access to credit markets or other sources of finance (from central banks, other governments or supranational bodies such as the International Monetary Fund).

2.3 WEAK STRUCTURAL COMPETITIVENESS

International competitiveness is not about reducing domestic incomes in order to become the cheapest supplier but about upgrading the economy in a way that allows domestic incomes and living standards to rise without endangering the external balance. For the relatively poor GIPS countries, this means that they should be able to grow faster than the richer EU core without running a current account deficit. In economic theory (Hein/Detzer 2015), the feasible rate of growth is the »balance-of-payments-constrained growth rate« (BP-CGR). The core variables are the price and income elasticities of imports and exports.

As already explained above (section 2.2) the problem was rising imports due to rising incomes rather than declining exports due to rising prices. Nonetheless the high income elasticity of imports points to a structural weakness of the domestic supply which is not able to fulfil domestic demand. Furthermore, the specialisation pattern of the GIPS economies relies too heavily on low-wage, low-tech industries, which, after the opening of the European market in the 1990s, compete against Central and Eastern Europe, China and other emerging economies with much lower wages. More of their exports should go to growing markets such as China.

Actually, given these structural weaknesses, it is their relatively good export performance that is surprising. Not only did unit labour costs increase faster in the GIPS than in the core Eurozone; their global price competitiveness was also

harmed by the strong appreciation of the euro against the US dollar, which increased their export prices much more strongly than domestic costs (by about 80 percent between 2003 and 2008). Germany faced the same problem, but was able to sell its capital goods and premium cars because its supply structure fitted optimally with the global demand pattern, in particular the Chinese.
Various analysts see the GIPS crises as having structural causes. Two schools of thought are of specific importance:

- *Supply side theories* point out the low ranking of the GIPS in comparative multi-country evaluations of competitiveness such as the World Economic Forum Global Competitiveness Indicators and the World Bank's »Doing Business« Report. They accordingly call for structural reforms, basically the liberalisation of product and labour markets, privatisation, and a leaner welfare state. (Mathes 2015, Thimann 2015)

- *Varieties of capitalism* scholars (Hall 2015; Hancké 2013; Noelke 2015; Scharpf 2016) believe that the GIPS economies are structurally unfit to survive in a monetary union due to having different industrial relations traditions, innovation and education systems, and state-market relationships.

Both approaches are relatively pessimistic about the outlook for reforms. But both have difficulties explaining the good performance of the GIPS economies before the crisis.

3

NEW GROWTH IN SOUTHERN EUROPE

The strategy currently imposed on the debtor countries by the Troika (EU, ECB, IMF) is inconsistent as it aims at achieving three almost incompatible goals:

1. Budget consolidation, which has been the top priority,

2. Balancing the current account, narrowly (and lopsided) interpreted as restoring price competitiveness by lowering wages,

3. Economic growth, which has been belatedly added to the list.

Austerity (1) and wage cuts (2) reduce demand and harm growth (3). The multiplier effects have been critically underestimated. A declining GDP increases the debt ratio (where it forms the denominator; debt is the numerator of the ratio). Lower wages reduce tax revenues, thus further undermining budget consolidation. Wage flexibility might well be ineffectual in a currency union (Gali/Monacelli 2016). In the end, current accounts turned positive due to reduced import demand rather than increasing exports. One central problem of all the GIPS economies is the high level of uncertainty – caused by the conflicts over economic policy and distribution of adjustment costs – that prevents investment.

Actually, the sovereign debt of advanced economies has hardly ever declined in absolute terms (except through default or restructuring). Usually, it has declined in relative terms (decreasing ratio of debt/GDP) due to financial repression (medium inflation plus low interest rates) and strong nominal GDP growth (Reinhart/Rogoff 2013). The ECB belatedly adopted the right policies in summer 2012 by lowering interest rates and buying sovereign debt on the secondary market without indicating any limits (Bibow 2016). Unfortunately, the crisis had already deepened so much that even zero or negative interest rates did not lead to strong growth in lending and investment. Nor could monetary expansion stop the deflationary trends in the Eurozone. Given the continued deleveraging of the private sector, recovery depends on an expansionary fiscal policy (v. Weizsäcker 2016), which the EU has excluded from its tool kit and which is prohibited on the national level by the strict fiscal rules.

Basically, Southern Europe can adopt two strategies, which are not mutually exclusive and should complement each other. The first is strengthening exports and reducing imports; the second is the expansion of internal supply and demand, in particular in the non-tradable sector. While the first option is widely acknowledged, the second might appear to be a repetition of the failed pre-crisis strategy.

– **Rebalancing external trade** therefore requires an upgrading of the tradable sector (including tourism) rather than lower wages. This involves long-term structural policies such as vocational training, better qualification of workers (and the unemployed), and higher spending on research and development. Measures to promote import substitution (in particular energy) are even more important than policies to promote exports, since the cause of the pre-crisis current account deficits was strong imports rather than weak exports.

– **Expanding the domestic market** should not be limited by balance of payments constraints in a monetary union, as Collignon (2014) shows in a flow-of-funds analysis. As long as projects geared towards the domestic market such as housing are profitable they are perfect investments for the savings of surplus countries in a currency union. The necessary funds would normally be channelled through the banking system (as they were until the financial market crisis) or via expansion of the money supply by lending from the national central banks to the local commercial banks. The insolvency risk of these local banks depends on the sustainability of the investments financed. But the same logic applies to investments in deficit regions within a member state (such as the eastern part of Germany. Public debt in deficit countries will provide a sustainable return on investment for the banking sector, too, as long as the underlying economy grows nominally faster than the interest rate. Debt ratios converge to the ratio between budget deficit (as a percentage of GDP) and (nominal) GDP (Domar). In a general crisis (as in 2008/9), the ECB has to stabilise financial markets in order to prevent the undesirable equilibrium of excessive risk aversion towards (public) debt and corresponding disproportionate interest rates (Ehnts 2015). It should in fact aim at the better of the possible multiple equilibria, namely low interest rates and confidence in sovereign debt (De Grauwe/Yuemei 2012).

National strategies and reforms have to be accompanied by European ones if Europe is to achieve recovery and balanced growth. The next of the two following sections will deal with national issues, the last with the European dimension.

4

COUNTRY-SPECIFIC STRATEGIES

The following section draws on country studies prepared by national experts: Greece by Jens Bastian (Bastian 2015), Portugal by Ricardo Mamede (Mamede 2015), Spain by Domenec Devesa, and Italy by Giancarlo Dente.

4.1 GREECE: STABILISING THE FINANCIAL SECTOR

In Greece, it is the vicious circle of government and bank insolvency that has to be broken. The constant uncertainty about Greece's membership of the monetary union (the spectre of »Grexit«) and the status of its sovereign debt have led to capital flight, a credit crunch and a collapse in investment. The austerity policies have created a social catastrophe and undermined any prospect of a demand-led recovery.

The IMF thinks that Greece might need a debt restructuring (although the lengthening of maturities and lower interest rates have already eased the debt servicing burden). Greece is the only Eurozone member that does not benefit from the ECB's quantitative easing (de Grauwe 2016). Greece needs the clear support of its creditors and additional investment, including the repatriation of flight capital.

A growth strategy for Greece should include:
- A national export strategy;
- An improved business climate;
- A comprehensive policy framework for small and medium enterprises (SMEs) including better access to credits;
- A program to attract foreign investors.

Tourism is probably the sector with the best prospects in the short and medium term. But it depends on a reliable financial system, too.

4.2 PORTUGAL: INDUSTRIAL POLICY AND INVESTMENT IN EDUCATION

Portugal has the most negative international investment position, but its manufacturing sector is better developed than Greece's. Its rapid growth in the late 1980s continued within the monetary union, but came to an early stop in 2003 when the euro appreciated and the oil price jumped. Investment collapsed as enterprises anticipated low demand in the wake of austerity and wage restraint. Weak demand is also exacerbated by Portugal's income distribution, which is one of the most unequal in the EU.

To promote internal growth, Portugal should ease its austerity policy and spend more on job creation (for example in the overburdened health sector), adjusting extremely low social benefits, qualification of jobless workers, modest public investment in areas that create jobs and lower imports, such as modernising building insulation.

In the long run, Portugal has to develop a modern, internationally competitive corporate sector. Most big Portuguese enterprises are not export-oriented. They need better qualified employees who are familiar with global markets and well versed in high-tech engineering and IT. The relationship between universities and the corporate sector should be strengthened.

4.3 SPAIN: CAREFUL CONSOLIDATION AND LABOUR FORCE RETRAINING

In 2015/16, Spain began showing first signs of recovery, aided by the slow pace of budget consolidation. Spain's current account changed substantially for the better because of tourism and growing exports of other services. The improvement of the balance of trade in goods, however, was mainly due to lower imports. Nonetheless, the exports of some industries affected by Chinese competition, such as shoes, clothing and textiles, have grown well since 2007. Studies by the BVBA bank and the Consejo Empresarial de la Competitividad (business council for competitiveness) show that several Spanish industries are well placed with strong productivity and highly qualified personnel.

A growth strategy for Spain should aim at: stabilising the trade surplus and increasing the contribution of net exports to GDP; increasing the share of manufacturing in the economy, and in overall exports; reducing imports of intermediate goods; increasing the technology intensity and value added of exports by developing new industries such as IT, software and biotechnology; diversifying exports regionally (less focus on the EU).

Besides exports, Spain must rely on other sources of growth. The budget deficit should be reduced, but slowly. Income policies should protect wages and guarantee that internal devaluation also occurs at the expense of profits, as lower wage costs are often not translated into lower export prices. Spain needs to retrain hundreds of thousands of workers in the construction sector. Spending on research and development should be at least 3 percent of GDP. SMEs and start-ups should be fostered through, among other measures, a better bankruptcy law, support to develop export markets, and the reduction of excessive legal and administrative obstacles.

4.4 ITALY: PROMOTING INNOVATION AND UPGRADING THE LABOUR FORCE

Italy is the largest Southern European economy by far. It did not suffer from a sovereign debt crisis but faces severe problems in its banking sector, which might affect how financial markets perceive the risks of its public debt. The economy has grown, but growth has been weak, even during the Southern European boom of 1998–2008. The lack of productivity growth in spite of several labour market reforms is a central problem.

For a high-income country, Italy's economy is atypically characterised by a specialisation in labour-intensive low-wage, low- and medium-tech industries and by an extremely high share of SMEs. It has a large manufacturing sector, which provides more than 80 percent of its goods exports. There are several successful subsectors but generally manufacturing still suffers from the deep recession of 2009, high unit labour costs and a lack of innovation.

Better-targeted labour market reforms should close the gap between wage and productivity growth. Italy needs to improve the education of its labour force, as the proportion completing tertiary education is much lower than in the EU. In particular, it should train and employ more researchers. Their number has grown much more slowly than in Germany or the EU as a whole. Italy is spending too little on research and development.

5

BALANCED GROWTH IN EUROPE

Growth in Southern Europe is highly unlikely to be restored without substantial changes in the European growth model. For decades, European economic policy has been biased towards the supply side and eyed the demand side with suspicion. The list of goals in the Lisbon Strategy and Europe 2020, the Stability and Growth Pact, and the indicators in the macroeconomic imbalance procedure (MIP) are revealing: Almost all are concerned with too much demand and favour supply side measures such as increasing labour input.[1] Some recent cautious corrections of this lop-sided approach have to be strengthened and extended. Foreign demand for exports from the euro area will be supported by a weak euro, which corrects the pre-2008 overvaluation. The ECB's current unconventional policy has been helpful in this regard. Three domestic demand components need attention and support:

1. **Wages** drive consumption and should grow in step with productivity. Actually, econometric studies (Onaran/Obst 2015) show that growth is wage-led in most EU countries. This implies stable real unit labour costs, at the least. Given the long-term decline of the wage share in many countries, there is even distributional space for higher wage growth. While wage-setting should remain the prerogative of the trade unions and employers, public policy can provide guidance by setting public sector wages and statutory minimum wages. Social benefits per recipient, which define a reservation wage, should increase in line with GDP/capita. Wage restraint is a poor and harmful way to restore competitiveness and reduce current account deficits (Section 3 above; Limbers et al. 2016).

2. **Investment** has been particularly weak in Europe. Investment depends primarily on expectations regarding demand and stable political conditions. Trying to stimulate investment through higher profits (to be achieved by lower taxes, wages or interest rates) has not worked. Before 2008, the share of gross fixed capital formation in GDP was around 20 percent, and declined to slightly above 17 percent in 2013. If one compares the current level with the peak of 2007, the annual gap amounts to approximately 450 billion euros. The major European initiative to restore investment is the European Fund for Strategic Investment (EFSI). However, with a planned non-recurring volume of 315 billion euros it is too small (Fratzscher 2015: 85–86). It should also be better targeted towards promoting growth in Southern Europe and other poorer member states. The strategy needs to focus on rebalancing the external accounts by promoting exports and import substitution in deficit countries (Dauderstädt 2015). The decline in public investment has to be reversed.

3. **Government spending** is not a drag on economic growth but an integral part of it. The redistribution of income stabilises demand by dampening savings in the richer strata of the society. Public spending on education, health and infrastructure increases private sector productivity in the long run. It should not be constrained by limits on budget deficits and public borrowing. The fiscal »golden rule« is a far better guide for regulating public finances (Truger 2015).

The EU wants to promote cohesion and convergence of living conditions throughout the Union. Although absolute income disparities between member states continue to increase (average GDP/capita), growth in the poorer countries of Central and Eastern Europe has been stronger than in the EU core for almost twenty years. It is Southern Europe that stopped converging in 2008. One cause is the poor design of the EMU. Leaving it to erratic, capricious and underregulated capital markets to finance growth in Southern Europe proved to be a fateful mistake.

Far-reaching reforms of the institutional and regulatory design of the EMU are thus necessary to achieve balanced growth in Europe. Three areas call for new initiatives:

– **Monetary policy** has shouldered most of the burden since 2012, when Mario Draghi eventually adopted a more offensive strategy of low interest rates and quanti-

1 The different thresholds for current account balances in the MIP are emblematic: While deficits are seen as a problem when they exceed 4 percent of GDP, surpluses may reach 6 percent.

tative easing. However, this has not been enough. The ECB must become a true lender of last resort for all sovereign debt (including the Greek). It must treat the Eurozone as one single economy with benign neglect of current account imbalances. Support for all commercial banks in the euro area through the system of central banks should be unconditional of nationality and take into account only the quality of their assets.

- **Fiscal policy** has been pro-cyclical and has undermined growth. As mentioned above it should accommodate a rise in public investment. Moreover, it should be expansionary in a period when the private sector is massively deleveraging. A truly single Eurozone economy needs a common treasury with a true fiscal capacity for collecting taxes and issuing bonds (Bibow 2015). The use of special funds and the European Investment Bank (EIB) is too weak a substitute.

- A **banking union** that really treats the financial industries of all member states as part of a single financial market must underpin the currency union. The first steps creating single supervisory and resolution mechanisms and deposit insurance go in the right direction, but are not sufficient. The vicious circle of uncreditworthy banks and growing national debt has to be broken. The solvency of banks must not be judged on the basis of their nationality but on the quality of their balance sheets. Bailing out banks contributes to growth and can even benefit government finances if done in a sensible way (Bianchi 2016).

Cohesion in the European Union and restoring growth in its periphery will ultimately depend on creating viable industries there. The EU has to tolerate temporary exceptions from its single market regulation in order to give infant industries in the poorer regions support and breathing space to develop. Successful late developers such as South Korea and Singapore did not expose their emerging economies completely to global competition but supported their development by well-designed public policies. Europe needs a forward looking industrial policy and must become an European entrepreneurial state (Mazzucato 2015).

List of Figures and Tables

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Imprint

Friedrich-Ebert-Stiftung
Publisher: International Policy Analysis,
Hiroshimastraße 28, D-10785 Berlin, Germany
www.fes.de/ipa

Orders / Contact: info.ipa@fes.de

ISBN: 978-3-95861-803-9

Front cover illustration: biker3, fotolia.com
Design concept: www.stetzer.net
Layout: www.zumweissenroessl.de
Print: www.druckerei-brandt.de

www.fes.de/de/politik-fuer-europa-2017-plus/