AISSEC
Torino 4-5 October 2018

The jewel in the crown or
A fragmented union

Annamaria Simonazzi

Sapienza Università di Roma e CNEL

Background and motivation

• The effects of crises differ for first and latecomer countries.
• The book takes a longer view on the interdependent relations between core and periphery countries in the European Union. It argues that, crisis after crisis, periphery’s different capacities to cope with change aggravated the impoverishment of the productive structures of the Southern countries.
• The first crisis in the 1970s, and the disinflation phase that followed in the 1980s, opened a gap in aggregate demand that political coalitions, anxious to consolidate democratic institutions and/or reduce opposition, eventually filled through welfare and construction expenditures.
• The "peripheral tertiarization" based on construction and welfare came up against increasing difficulty in tackling the hardships and inequities brought about by limited and dependent capital accumulation within the Europeanisation process.
• The current economic crisis together with the institutional structure of EMU have increased the divergence. With Europe's internal demand curbed by the recession, it remains with exports to sustain growth.
The German trade surplus and the emergence of a Central European Manufacturing Core

- The EU & EMU construction as a story of structural change, divergence and major hierarchical reorganization
- The overwhelming importance of finance and big banks as “key factors”
  - The key role of the EU market in easing Germany’s restructuring
- The emergence of the Eastern manufacturing network.
  - Wage differentials, exchange rates, cultural and historical ties (German comparative advantage in the ‘race towards Eastern Europe’) playing a key role
- Differentiated offshoring strategies: i) Germany offshoring medium and low-value productions but keeping home strategic phases as R&D and marketing ii) France and Italy, relocating entire product segments mostly aiming at reducing costs
- Increasingly competitive EP’s producers partly crowding out suppliers located in the SP (weakening of the industrial base reducing SP’s resilience)
Current accounts of Germany, France and Southern European countries vis-a-vis EU 27, 1999-2015 (% of GDP)
Industrial production (left) and production of high tech sectors (right).
Germany, France, SP and EP, 2002-2016
(2002=100)
Divisive integration

- Two different industrial models now co-exist:
  - a strong industrial basis in the core countries, which is export-oriented and has a solid position on the global markets,
  - a less diversified industrial sector in the periphery,
- Appreciable differences within core and periphery
  - Within peripheries: Southern Europe and Eastern Europe
  - Within the core: France falling behind Germany, and sharing many features with the Southern countries
- And within countries/regions, e.g.,
  - North and South of Italy, East and west of Germany
An increasing divide between core and periphery, that got worse in the crisis, and does not seem to shrink in the unequal “recovery”

GDP per capita at constant prices 1960-2016

GDP per-capita as % of the German value
## The macroeconomic scenario

<table>
<thead>
<tr>
<th>GDP growth (%, yoy)</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Periphery</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>0,9</td>
<td>1,5</td>
<td>1,3</td>
<td>1,1</td>
</tr>
<tr>
<td>Spain</td>
<td>3,3</td>
<td>3,1</td>
<td>2,8</td>
<td>2,4</td>
</tr>
<tr>
<td>Portugal</td>
<td>1,6</td>
<td>2,7</td>
<td>2,2</td>
<td>2,0</td>
</tr>
<tr>
<td>Greece</td>
<td>-0,2</td>
<td>1,4</td>
<td>1,9</td>
<td>2,3</td>
</tr>
<tr>
<td>Ireland</td>
<td>5,1</td>
<td>7,8</td>
<td>5,6</td>
<td>4,0</td>
</tr>
<tr>
<td><strong>Core</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>1,9</td>
<td>2,2</td>
<td>1,9</td>
<td>1,9</td>
</tr>
<tr>
<td>France</td>
<td>1,2</td>
<td>2,2</td>
<td>1,7</td>
<td>1,7</td>
</tr>
<tr>
<td><strong>East</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Czek Republic</td>
<td>2,5</td>
<td>4,3</td>
<td>3,0</td>
<td>2,9</td>
</tr>
<tr>
<td>Hungary</td>
<td>2,2</td>
<td>4,0</td>
<td>4,0</td>
<td>3,2</td>
</tr>
<tr>
<td>Poland</td>
<td>3,0</td>
<td>4,6</td>
<td>4,6</td>
<td>3,7</td>
</tr>
<tr>
<td>Slovakia</td>
<td>3,3</td>
<td>3,4</td>
<td>3,9</td>
<td>4,2</td>
</tr>
</tbody>
</table>

Differing growth rates, largely similar anti-EU sentiments.
The current Eurozone crisis has three components

1. An incomplete union:
   - Need to defuse the debt loops and to «complete» the monetary union

2. Austerity and increasing inequalities and poverty that feed popular resentment
   - Coordinated expansion, fiscal union, wage policies

3. A structural core-periphery divide
   - A competition union based on neo-liberal rules:
     The logic of a competition union fosters a dynamic in which the strong economies get stronger and the weak economies get weaker.
     Development policy (industrial policy)
1. How to fix the eurozone: two views

- A monetary union between countries at different levels of development, with two fragilities: a money without a state,
  - missing a lender of last resort that can support the sovereign, it is exposed to risks of financial crisis induced by sudden stops.
  - no common fiscal policy

- inability to reconcile differing political interests to solve the institutional faults:

- The German government - strongly supported by a “north coast alliance” (Lehndorff 2018):
  - no Eurozone budget, no public or private risk-sharing, no bail-out unless under Troika dictate

- A bi-partisan stance:
  On the call for a euro area budget by French President Emmanuel Macron, the SPD’s Olaf Scholz, the German finance minister in the latest CDU-SPD coalition, has bluntly stated that a German finance minister—no matter the party affiliation—must protect German taxpayer money from fiscally irresponsible euro area member country governments.
Alternative views

More pragmatic and flexible neoliberalism: the Franco-German proposal

- extension of the European Stability Mechanism towards a European Monetary Fund, providing more capacities to support counter-cyclical measures in individual crisis-ridden countries and to rescue individual banks (beyond the capacities of the so-called banking union).

Comments:
- The risk-sharing mechanisms financed by rainy day funds and the ex-ante ESM lending facility are too modest to address these fragilities.
- the proposals to enhance market discipline may destabilise the entire euro area, because they increase the vulnerabilities of countries with high legacy debts.
- (strategy of alarmism)

A Marshall Plan for Europe

- a European Growth Bond by the European Investment Bank in the context of a proper European Investment Plan and backed by the ECB.
- risk sharing, eventually leading to some mutualisation of debt
- a new role for the European Stability Mechanism (ESM) to support the full transition from national debts to a single Eurozone public debt (e.g. Eurobonds) with a single yield curve for all countries.. (Dosi et al. 2018)
2. A German reflation?

- If permanent transfer must be avoided, debtor countries «must adjust», and must be made in the position to adjust
  - Austerity and domestic devaluation do not work;
  - Will a reflation by countries with fiscal space do?
- German current reflation
  - Increase in domestic demand: Minimum wages and Private (and public) spending
  - The external surplus
    - Exports: Germany quietly exiting the EZ?
  - Is Germany importing too little?
    - Size and composition of “trickle-down” effects of a German locomotive (Deutsche Bundesbank 2011)
- Global environment more difficult:
  - Is the EU market becoming more important again?
  - Impact on Germany’s EU partners (East and South)
Domestic demand-led growth?

Germany’s average growth rate 2008-2019: 1.39%
(Exports - Imports expressed in million ECU/Euro)

Source: Eurostat. Data refers to monthly trade values in million ECU/Euro | Lines show 36 months averages.
3. Address the fragility of the periphery’s industrial basis

Three interrelated objectives:

• Rebuilding the economic and productive fabric of the areas which have been devastated by the crisis
• Expanding the range of efficient or viable firms: not only export market or “the most innovative sectors”, but also promotion of an investment program targeting the domestic market and physical and social infrastructures.
• Upgrading the production structure and respond to the challenge of new technologies.

Combination of a macroeconomic policy favouring recovery of demand coupled with an industrial policy focused on creating conditions for the areas left behind to catch up. Need to focus on the composition as well as the level of demand.
Long-term effects of the fiscal compact: the case of Italy

- GDP and domestic components of demand still far below pre-crisis level. Exports the only dynamic variable
- Investment and productivity stagnating
- Expenditure in R&D decreased
  - 2008-2016: public expenditure for R&D down 21% in real terms
  - 2008-2015 public expenditure for public universities down by 14%
  - On private R&D, R&D personnel, university students, the gap between Italy and EU avg expanded
- Falling behind in the innovation and technology race, broadening the gap still more
Italy: the sick man of Europe?
GDP and components of demand since the start of the crisis
Productivity?

Figure 3: TFP in manufacturing for Italy, Germany and France (2005=100)
Produttività del lavoro

![Bar chart showing productivity levels in different countries and company sizes.]

- Francia
- Germania
- Italia
- Spagna
- ZE11
- Distanza IT-ZE11
Gräbner et al. 2018

The development of economic complexity in the EMU

average product complexity derived from changes in export composition (1995-1999 vs. 2010-14)

average country complexity in 1999

-0.68 + 1.04 \text{comp}^{**} - 0.31 \text{comp}^{2**}

$R^2=0.38$
The development of economic complexity in the EMU

average product complexity derived from changes in export-composition (1995-1999 vs. 2010-14)

average country complexity in 1999

Eastern countries: $-0.51 + 0.66 \text{ comp}^{***}, R^2=0.65$

All remaining countries: $-0.51 + 0.3 \text{ comp}^{**}, R^2=0.34$

Legend:
- Core
- Periphery
- Eastern
- Finance
A targeted industrial policy

• At the European level:
  – reorientation of strategy targeted at rebalancing the core-periphery divide in Europe (presently inadequate in terms of financing and focus)
  – Juncker Plan; Structural and cohesion funds; Industry 4.0

• At the national level:
  – Support of the domestic investment with policies capable of orienting firms in accordance with the future development targets and accompanying and controlling the development of complex systems

• At the local level
  – Policies targeted to the specific needs of the regions at various levels of development

• Coordination of the various levels of intervention and
• a macroeconomic environment favoring growth: innovation (and restructuring) is hindered by a deflationary environment.
Conclusion

• Sustainability of the European project requires to return to the original political project of Europe, inspired by the **political resolve** to promote convergence

• A more balanced European economic integration calls for a common undertaking to stop domestic devaluations, pursuing production upgrading, diversification and structural change.

• To this end, peripheral countries need a developmental state capable of broadening their productive capacity and increase their capabilities (to reduce the gaps between and within countries).

• The European industrial policy still relies on the idea that competition alone can guarantee a convergence. Combined with a deflationary environment, this approach cannot escape new forms of “social dumping”, or “plain destruction” of the domestic productive capacity of weaker economies.

• A change of strategy is unlikely in the present economic and political program, stubbornly focused on fiscal rectitude and economic rules, in a void of strategic vision, totally blind to mounting structural and political instabilities.
Obstacles to changing the growth model

- German interests have been shifting away from Southern Europe towards Eastern Europe and the emerging markets, but
- the rise of populism puts pressure on governments to take nationalistic positions and
- the fragmentation of international order can recommend a more positive attitude towards the preservation of the Union, since a strong and dynamic European domestic market becomes again a necessary condition for the viability of the German export industry.
- However, the shift from export-led to domestic demand would require a restructuring of the German industry: the size of its export industry (with its value chain) is too large for the domestic market, perhaps too large even for the EU market.
- Given the existence of multiple interdependencies between countries and between different coalitions of interests within and across countries, there are various, opposite forces that affect the core country’ interests in implementing strategies favouring a progressive Europe-wide development.