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## Regional integration and the euro crisis: problems and solutions

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# **Regional integration and the euro crisis: problems and solutions**

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## **Abstract**

Along time the European Union (EU) has been pointed as the most succeeded example of regional integration. Now, this example has been cruelly shaken by the EZ (Euro Zone) crisis, originating increasing doubts about the integration process. It is evident that the proposed solutions for attacking the crisis have hurt the European cohesion making more and more clear the separation of two big regions: one composed by North and Central European countries and the other constituted by the Southern and South-western countries. Why regardless of the uncountable meetings announced as decisive for its solution, and the recurrent EU proclamations of “policies to restore European growth”, the crisis in the EZ looks more and more like an endless problem? Our paper deals with answers to this question emphasizing some problems affecting the solution to the EZ crisis. Some of them are political while others result from misconceptions about putting in place the correct economic policy.

Given the enormous private and public debt accumulated in periphery after the single currency inception, and aggravated by the first attack to the international financial crisis, it is not questionable the need of fiscal consolidation in peripheral countries. Our paper shows why is erroneous to consider budgetary contraction as the only way of attaining fiscal consolidation and explains why austerity is so fiercely advocated by both core and periphery governments. The main reasons for the lack of competitiveness in periphery are explained and the possible options to minimize the structural imbalance inside EZ, between its core and periphery, are indicated.

Our paper shows that the solutions to the EZ crisis applied by national governments, in cooperation with the European Commission, the ECB and the IMF,

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based on further austerity and wage cuts aggravate the crisis, instead of solve it. Such solutions are unlikely to reduce both sovereign and external debt ratios of periphery countries, but surely they will drive Euro Area as a whole to stagnation and lost decades of economic growth, if not to its disintegration. Considering the debt crisis as a problem of the PIIGS (Portugal, Ireland, Italy, Greece, Spain) that can be contained in the periphery is not the most adequate perspective either for solving the crisis or for the credibility of the EU integration process and will inevitably impact on the spreading of the integration model to other regions of the world.

Keywords: Austerity, Euro crisis, Economic Growth, Euro Zone, EMU, Fiscal consolidation, Solvency.

Jel Codes: E12, E44, E62, F15, F34, F36, F55, G01, H63

Theme T: Regional cooperation and integration

## **Introduction**

Until recently the European Union (EU) was considered the most succeeded example of regional integration. Now, this example has been cruelly shaken by the EZ (Eurozone) crisis, originating increasing doubts about the European integration process. The lack of a timely and coherent response to the euro crisis called into question the reliability of the model of integration, exposing EU structural and institutional drawbacks. These problems coincide with impressive changes in the global economic order involving the relative decline of the EU and the United States and the rise of Asia. Trying to fight against its economic decline, Europe has put in place a competitiveness concept that implies drastic adjustments, emphatically called structural reforms. However, such economic adjustments are already menacing social cohesion and political stability in Europe. So, the European replies to the EZ crisis have undermined the EU's importance as a model for regional integration.

In fact, regardless of the uncountable meetings announced as decisive for its solution, and the recurrent EU proclamations of “policies to restore European growth”<sup>1</sup>, the crisis in the EZ looks more and more like an endless problem. Its solution faces

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<sup>1</sup> This is a phrase that appears in every EU announcement. But the statements never become more specific.

many troubles. Some of them are political while others result from misconceptions about putting in place the correct economic policy for attacking the crisis.

It is well recognized that the euro crisis has three components. The first one is a banking crisis that resulted from excessive leverage in both the public and private sectors; the second one is the sharp fall in confidence in eurozone governments and the third is the structural imbalance between the eurozone's core and periphery<sup>2</sup>. This is the most dangerous component, which menaces not only the peripheral countries but also the entire EZ.

Although solving the first two problems is a key condition to avoid a deep depression, Europe cannot avoid lost decades of economic growth if it doesn't conveniently address the third component. This implies a correct diagnosis and putting in place the appropriate policies. While periphery's currently governments and the EC (European Commission) try to push the responsibility for the lack of competitiveness in the periphery to the wrong policies put in place by the former governments, it is clear that the process by which Europe periphery became uncompetitive has more deep reasons.

It is well documented that there is an original sin in the introduction of the Euro. As several authors have noted, theoretically, a single currency should imply a single fiscal structure, however the introduction of the euro as the single currency didn't change the type of fiscal governance in the novel Euro Area: The public finances are now, as before euro, above all a task of the national level, with the EU level basically covering regional funds, agricultural subsidies and administrative costs financed by contributions of member states.

Of course there are some mechanisms that have tried to maintain some macro variables within certain limits, as is the case of the SGP (Stability and Growth Pact) of the EU with two arms. In its preventive arm, the SGP sets out the implementation requirements for looking at the overall MTO (medium-term objectives) of fiscal policy, while in its corrective arm, it should correct the way in which excesses over the Treaty values are treated as part of the EDP (Excessive Deficit Procedure)<sup>3</sup>. However in practice, even in pre-crisis years few countries were at their MTO. Besides, although the European Commission had always placed countries under the EDP when their deficits

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<sup>2</sup> Or north and south, or PIIGS and non-PIIGS

<sup>3</sup> From preventive and corrective arms of the SGP is expected that countries maintain an underlying fiscal position in terms of their MTO close to balance or surplus, thereby ensuring that the absolute deficit would not exceed 3% of GDP in recession and that the public debt would be rapidly brought below 60%.

exceeded 3% of GDP, the debt criterion was never explicitly enforced. Specifically, the EU legislation that implements the requirements of the EDP does not provide any condition for the execution of this criterion (European Commission, 2011)<sup>4</sup>. Curiously, there is no rule in the SGP about the current account deficit although this has played a critical role in the debt crisis and particularly in the Greek and Portuguese cases<sup>5</sup>.

The therapy commonly adopted for both solving the sovereign debt crisis, by increasing the confidence on EU periphery governments and minimizing the structural imbalance between the eurozone's core and periphery, restoring competitiveness, has relied on a combination of fiscal austerity with wage compression and labour market reforms. Our paper argues that although austerity measures in the peripheral countries may reduce intra-area current-account imbalances through income compression, they will also aggravate the budgetary deficit and the debt and may also worsen the underlying solvency problem. Furthermore it aims at demonstrating that fiscal consolidation is not incompatible with economic growth and thus, contrarily to the current faith on the austerity miracle, the crisis should be resolved by promoting growth and reducing imbalances within the EMU by other means than the public spending contraction and cutting wages in the periphery.

The remainder of the paper is as follows. After the introduction, section 2 deals with the need of fiscal consolidation and distinguishes it from budgetary contraction. Section 3 explains why austerity is so fiercely advocated by both core and periphery governments. Section 4 focuses on the reasons for the lack of competitiveness in periphery and shows the possible options to minimize the structural imbalance between core and periphery economies. Section 5 briefly discusses the competitiveness concept prevalent in the EZ and shows how erroneous is to follow an export-led model of growth by an individual country in the EU context, if the aim is to overcome the European stumpy economic growth. Finally, section 6 concludes.

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<sup>4</sup> While this absence does not legally exclude the possibility of countries to be placed in EDP for high levels of debt, it makes it more difficult politically.

<sup>5</sup> The recently implemented MIP (Macroeconomic Imbalance Procedure) Scoreboard tries to solve this and other failures of the regulation. It is part of the six legislative proposals on economic governance adopted by the European Parliament and Council in November 2011. The MIP Scoreboard provides the basis for the economic reading of potential imbalances, and based on it the European Commission will annually identify in its Alert Mechanism Report the cases for which more in-depth analyses are required.

## **2. Fiscal consolidation and budgetary policies**

There is a recurrent misunderstanding in the discussion about budgetary policies, which confuses policy measures with policy outcomes. Budgetary contraction, which is a policy measure, tends to be taken for fiscal consolidation (i.e. improvement of the budgetary balance), which is a policy outcome. Although budgetary contraction (i.e. increasing taxes and/or cutting expenditures) may improve the budgetary balance, it may equally lead to its deterioration. On the other hand, fiscal consolidation can also result from an expansionary budgetary policy. The final outcome will depend on the macroeconomic effects of budgetary measures, in particular how they affect economic growth and, in turn, fiscal revenues. Therefore, fiscal consolidation as a result of policies should be clearly distinguished from policies of budgetary contraction or expansion.

In addition, it is possible to increase the economic impact of fiscal policies by changing the composition of public expenditure or public revenues in a way that maximizes their multiplier effects without necessarily changing the total amount of spending. Conversely, fiscal adjustment that reduces growth and productive investment can diminish the government revenue and eventually increase the debt to GDP ratio.

To sum up, the policy of strong austerity is the contrary to what is needed to end up the recession and to increase the confidence in the EZ governments. The ideological conviction of EC on the expansionary austerity is one reason to this behaviour. But there are two other reasons. First, the budget contraction policy is also implemented in order to diminish the external imbalance, which could be aggravated by the fiscal expansion. Second, the EC gives too much importance to the primary deficit in increasing the public debt.

Respecting to the first reason, it is a fact that the external constraint (i.e. the lack of competitiveness brings about current-account deficits) limits (or even prevents) the role played by fiscal expansion because it would aggravate the external imbalance. However, in such cases, countries that are members of a currency union should resolve first the balance-of-payments problem with specific tools, attacking its original causes, rather than introducing austerity measures. While the structural imbalance will be the focus of the next section, for now, let us say something about the excessive role attributed by EC to the primary deficit.

Euro area debt crisis has not a fiscal origin, although the policy used to bring it to an end has transformed it in a public-debt crisis. But apart this question, it must be

acknowledged that it is not the stock of debt that really matters for the closing of a debt crisis, but the relationship between the stock of debt and some other variables, such as GDP, which captures a country's ability to service its debt. It is usually assumed that the change in the stock of public debt is equal to the deficit accumulated during the period under consideration. This is a simplistic view because the changes in the debt-to-GDP ratio are determined by four variables: the primary (non-interest) deficit, the average interest rate to be paid on the debt, the growth rate of the economy multiplied by the initial stock of debt, and the stock-flow adjustment (*sf*), as shown in equation (1):

	$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} \frac{r_t - \hat{Y}_t}{1 + \hat{Y}_t} \right) + \frac{sf_t}{Y_t}$	(1)
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Where  $t$  is time,  $D$  is the total debt level,  $Y$  is nominal GDP,  $PD$  is the primary deficit,  $r$  is the average (nominal) interest rate paid on government debt,  $\hat{Y}$  is the nominal GDP growth rate and  $sf$  is the stock-flow adjustment<sup>6</sup>.

The equation (1) means that movements in the critical debt-to-GDP ratio depend both on the level of the annual fiscal deficit (the primary deficit, on which so much attention is currently focused in the EU countries) and on changes in the ratio between the value of the stock of debt and the value of GDP. The “snow-ball” effect on debt is the key term because it is the one that measures the self-strengthening effect of debt accumulation arising from the difference between the interest rate paid on public debt and the nominal growth rate of the national economy.

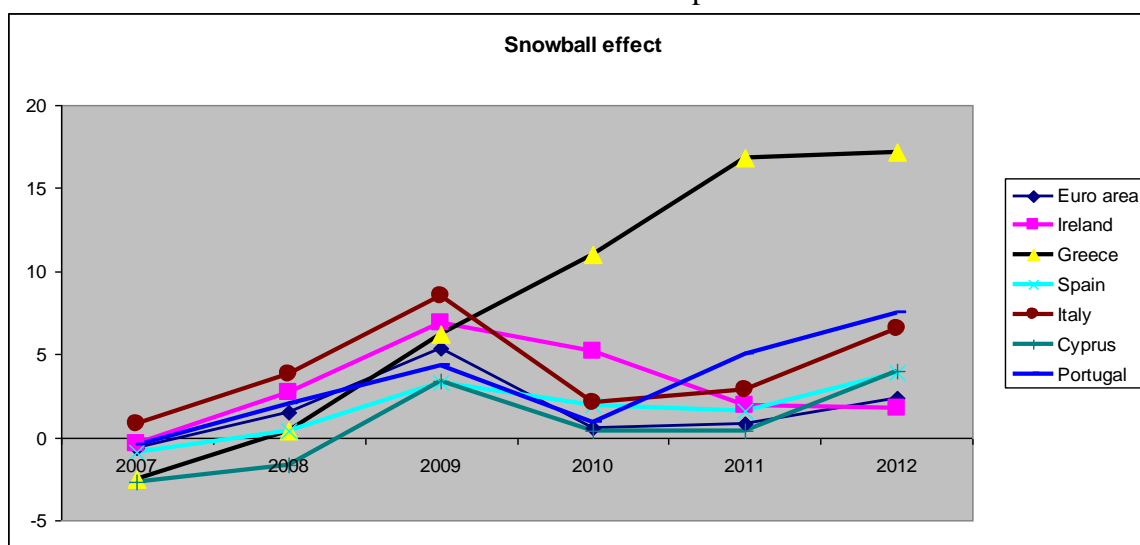
The separation between the primary deficit and the other components is useful also because policymakers are supposed to have direct control over the former but only an indirect influence on the latter. But the decomposition of equation (1) allows several other lessons. First, policymakers have little control over the debt-to-GDP ratio. They only can directly control one ( $PD$ ) out of four factors that determine the growth rate of a country's debt-to-GDP ratio. But, even the  $PD$  cannot be completely controlled by the fiscal authorities, because primary deficits tend to rise during crashes and fall during booms owing to the impact of automatic stabilizers, such as reductions in tax revenues and increases in transfers. Consequently, GDP growth not only affects the denominator

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<sup>6</sup> The stock flow adjustment is a residual that makes compatible a stock variable (the change in debt) with a flow variable (the deficit). Although it is often assumed to be quantitatively small and driven mainly by measurement error the stock-flow adjustment is, quite the opposite, a key driver of debt growth, and therefore deserves much more attention.

but also the numerator of the debt-to-GDP ratio. Second, the growth rate of the economy is an important driver of the debt-to-GDP ratio. Fiscal policies that reduce output growth may therefore increase a country's debt-to-GDP ratio, even if they manage to reduce the primary deficit, which is not certain. Third, economies with growth rates that are higher than the nominal interest rate on public debt can reduce their public-debt-to-GDP ratio, even if they run a primary deficit<sup>7</sup>. Fourth, the stock of debt has only a small effect on debt dynamics, unless it does lead to high interest rates. Even a very large increase in the initial debt-to-GDP ratio will have a small effect on fiscal sustainability. Of course, debt may finish up being permanently higher, but it may not necessarily follow an abrupt growth path. Finally, the decomposition of equation (1) makes it possible to evaluate the importance of the stock-flow adjustment as a factor contributing to actual debt growth. Indeed, it appears to be a major element in rapid debt increases during times of crisis. In fact, in the EZ crisis a large responsibility should be credited to the banking sector that has required huge public-funded rescue operations. This occurrence should fall within the stock-flow reconciliation term.

Figure 1.  
The snowball effect in some European countries



Source: based on AMECO (Last Update 7 November 2012).

Also the snowball effect has a large effect on the increase of the Debt-to-GDP ratio. As can be seen in figure 1 the snowball effect has increased significantly in

<sup>7</sup> However, countries that have debt denominated in foreign currency, or that do not have control over their own monetary policy, may experience sudden surges in borrowing costs during economic crises, exactly when their ability to pay is limited.



Greece since the beginning of the global crisis, accompanying the decrease of the Greek GDP. With the sole exception of Ireland, figure 1 shows that all countries with severe austerity measures have increased the snowball effect. Portugal is a case in point: it is well visible the parallel with Greece after 2010.

The lessons mentioned above make clear why deficits can cause a slow accumulation of public debt but they also explain that they are seldom responsible for an abrupt surge in debt. For all those reasons, the level of a country's fiscal deficit (or surplus) needs to be viewed with caution. Given the impact of many factors on the sustainability of the country's financial position, and moreover on its economic stability and growth prospects, a more systemic perspective is essential. In this perspective, the different types of fiscal revenues and expenditures as well as several other variables with likely impact on fiscal space cannot be overlooked.

The advocates of austerity usually add an analogy with individual agents or households: as an individual agent needs to cut spending for increasing savings so also the government has to take a similar behaviour. But there is a fallacy of composition in such an analogy: an isolated agent, as for instance a household, may be able to increase savings by cutting back spending because such a reduction does not affect its revenues; but this is not true for governments. As a national economy does not function in the same way as an individual agent, a restrictive fiscal policy may not succeed in fiscal consolidation. So, an accurate assessment of the role of fiscal policy has to be considered from a macroeconomic and dynamic perspective, taking into account the impact of that policy on total income and GDP growth, and consequently on fiscal revenues.

An active fiscal policy will affect the fiscal balance by changing the macroeconomic situation through its impact on private sector incomes, as those incomes generate fiscal revenues. Reacting to a crisis that was caused by an excessive private sector borrowing with fiscal contraction is not an appropriate policy response<sup>8</sup>. Moreover in the Euro crisis such reply is inappropriate because this is associated with asset market deflation that has a negative impact on the economy.

The above discussion suggests that the best strategy for reducing public debt is to promote growth-enhancing fiscal policies. As pointed out by Cherif and Hasanov (2012) a positive growth shock unambiguously lowers debt. Moreover, it would seem

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<sup>8</sup> Even crises that were caused by an irresponsible fiscal policy may need a short-term response that might be different from what is needed in the long run.

from the evidence that fiscal expansion tends to be more effective if spending takes precedence over tax cuts, if spending targets infrastructure and social transfers, and if tax cuts, in turn, target lower income groups, which generally have a higher propensity for spending. Fiscal expansion, by increasing the level of activity and income, as noted earlier, raises the revenue stream and reduces the debt-to-GDP ratio, in particular if interest rates are relatively low compared with GDP growth. In this sense, problems associated with the growth of public debt, particularly when that debt is not primarily related to fiscal problems, are best resolved by a strategy of fiscal expansion.

Further, if it is argued that for economic and/or political reasons there is little space for fiscal expansion (Cottarelli and Jaramillo, 2012) there is always the possibility to redirect spending and taxes to support more expansionary measures. Again, this suggests that spending should be given precedence over tax cuts, and that both measures should benefit low-income groups in particular. A more equitable distribution of income would make economic recovery more self-sustaining and improve the chances of achieving fiscal consolidation. In this sense, increasing real wages in line with productivity, and, especially in peripheral countries with large informal sectors, government transfers to the low-income segments of society, are important complements to fiscal expansion.

Another argument used by the EZ authorities is the idea that fiscal expansion is a menace to fiscal sustainability. However, it can be recognised that “The public debt today is much more sustainable than the private debt before the crisis” (TDR, 2011: 82). In fact, with low interest rates and idle capacity as there are now, neither there is crowding out of private investment nor the recovery is threatened by the globally higher public debt ratios. What is valid for EZ individual countries like Greece or Portugal, it is moreover to the EZ as a whole. The EZ as a big economy only should trust in a consolidation through growth. Growth, combined with low interest rates<sup>9</sup>, will bring an increase in revenues and a fall in debt ratios over time.

Overall, fiscal space depends not just on how fiscal policies are put into practice, but also on how well those policies are combined with monetary policy and in accordance with the international financial background. Because demand and budgetary effects differ usually depending on which specific expenditures or taxes are changed, an optimal combination of such changes would achieve a maximum expansionary effect, if

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<sup>9</sup> This implies that monetary policy should continue to maintain low interest rates in order to keep the burden of interest payments for the public sector supportable

there would be a minimum drain of demand in the income circulation process on savings and imports, and a maximum encouragement of additional private spending. Accordingly, there may be a debt paradox (TDR, 2011) meaning that it can be expectable that the income effects of expansionary measures would compensate or even exceed the initial deficit through additional tax incomes and, consequently, the GDP growth acceleration would decrease the debt-to-GDP ratio. To sum up, it is possible that multiplier and accelerator effects on income would increase the tax revenue and finance its own debt service, without the need to increase tax rates. This shows that it is more probable that an expansionary fiscal policy is more able to reduce the deficit and the debt-to-GDP ratio than a restrictive one.

### **3. The obsession of austerity or the faith on the *Expansionary Fiscal Contraction***

The global financial and economic crisis has raised important macroeconomic policy issues concerning the appropriate fiscal response, and its size, composition and duration. After an initial wide consensus on the need of proactive macroeconomic policies to support demand, European policymakers have shifted their focus from fiscal stimulus to fiscal reduction<sup>10</sup>. Because this change was made excessively soon and too quickly, the policy debate is nowadays about what measures should be taken to achieve not only the recuperation from the crisis but also the improvement in fiscal accounts. However, at least apparently this latter purpose is considered more fundamental than the former for increasing the confidence in Euro zone.

In fact, the sharp fall in confidence has been considered as the most problematic aspect of the EZ crisis and, consequently, European Political authorities have put emphasis on the means that can improve it in peripheral countries. However, the EU authorities are imprisoned in their explanations for the EZ crisis and so they are trying to increase confidence showing creditors that both the finance rules will be more severely monitored than in the past and that the countries with higher interest rates on the public debt are being punished. So, ignoring the cycle phase, fiscal policy has been motivated by ensuring that the budget deficit would quickly diminish, as a result of severe public expenditure cuttings, and that the public debt would decrease rapidly. However, the evolution of these two targets has shown how the chosen strategy has

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<sup>10</sup> The prevailing argument was that the impact of fiscal stimulus policy was weak, ineffective or caused distortions, assuming that there is a trade-off between public and private expenditure.

been erroneous. The decreasing of the real budget deficit has been always lower than the estimated and simultaneously the public debt has continuously been enlarged.

Indeed, contrarily to many research concluding that smooth and gradual fiscal consolidations should be preferred to frontloaded or aggressive budget contractions (e.g., Baum *et al.*, 2012; Batini *et al.*, 2012), especially for economies in recession<sup>11</sup> facing high risk premia on public debt, the European authorities opted by quick and large spending cuts instead of a gradual approach. On the other hand, the strategy is erroneous from the public debt point of view, because it is based on the incorrect idea that the main cause of public debt is the primary deficit and, so, reducing primary deficit will cut the public debt.

Of course, for increasing confidence what matters the most is not the absolute amount of public debt but the public-debt-to-GDP ratio. However, even assuming that the immediate policy goal is to reduce the public-debt-to-GDP ratio, this can be done by cutting the numerator (the amount of the debt), increasing the denominator (current GDP), or arriving at a combination of these two options. Nevertheless, the preferred strategy of the mainstream position is reducing the amount of debt, even if the policies chosen to do this may also negatively affect GDP growth.

In fact, although the advocates of fiscal contraction recognize that “fiscal consolidation typically causes short-term contractionary effects” (Bornhorst et al., 2010: 7; see also IMF, 2010b) either they consider that countries subject to market pressures have little choice except to undertake frontloaded fiscal adjustment measures, due to a lack of adequate financing at reasonable rates (Cottarelli and Jaramillo, 2012) or they assume that these short-term costs are moderate and temporary, and much lower than the long-term costs, which allegedly would be avoided as a result of fiscal reduction.

This assumption is used because both European Council and Commission and many European governments believe in the EFC (Expansionary Fiscal Contraction) hypothesis. The EFC, also known as the “expansionary austerity” hypothesis (Giavazzi and Pagano, 1990) predicts that a major reduction in government spending that changes future expectations about taxes and government spending will enhance private consumption, resulting in overall economic expansion. The authors endorsing this hypothesis did not provide a model for EFC but rather described conditions under which

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<sup>11</sup> Baum et al. (2012) call attention to the need to consider that the position in the business cycle affects the impact of fiscal policy on output. If the phase of the cycle is not considered both the cuts in government spending and the revenue multipliers give results very different from the expected.

it was observed in Denmark from 1983–84 and Ireland from 1987–89, a period when the world was undergoing rapid interest rate declines and world wide growth. The EFC view is based on the traditional assumption that reducing the government expenditures will lessen crowding out “making room for the private sector to expand”.

Although the EFC hypothesis can have application under certain restricted circumstances, these conditions are not fulfilled in the present EZ crisis. On the one hand the crowding out effect only happens when the economy is near full employment, which is far from be assured in the present EU context. Furthermore, among the conditions for the EFC hypothesis operating are included not only budget improvement through significant tax increases and spending cuts but also a significant currency devaluation and sufficient liquidity in order to current disposable income do not restrain consumption. Neither the currency devaluation is possible in the EZ countries nor the liquidity can be considered sufficient nowadays with the generalized banking deleverage. If these conditions are not verified, the current disposable income constrains consumption and aggregate demand originating, or aggravating the existent, recession. This is recognized in one of the hypothesis’ seminal text: when disposable income constrains consumption “Keynesian textbook propositions seem to recover their predictive power, as witnessed by the 7% drop in real consumption in 1982 during the first Irish stabilization” (Giavazzi and Pagano, 1990, p. 28).

But the need of fulfilling other conditions or moreover doubts about the functioning of the EFC hypothesis has been emphasized. Some authors studying fiscal contraction occurred in the 1983-86 period in Denmark show that the EFC hypothesis may work but only for large and credible fiscal consolidations, and if other reforms play an important role (Barry and Devereux, 1995; Bergman et al., 2010). Also, an IMF working paper (Guajardo et al, 2011) that studied changes in policy designed to reduce deficits found that austerity had contractionary effects on private domestic demand and GDP and concluded that other studies appeared biased to exaggerating the expansionary effects of austerity.

Although it is evident that the EFC hypothesis is far from being proved and that current European economic conditions are not appropriate for its application, both the European Commission and many EU governments are deeply convinced that this is the best road ahead. A good example of an application of the EFC hypothesis is the policy being pursued nowadays by the government of the British Prime Minister David Cameron. The UK is perhaps the European economy where the conditions are nearer of

being ideal for experiencing the hypothesis: a highly open economy with a flexible exchange rate and some room for further monetary easing. There is both no risk (or default premium) affecting British interest rates and no fear of political-economic chaos discouraging investment. However the failure of “expansionary austerity” in the UK is evident and so, it should give all of its advocates around the world reason to consider and rethink their policy calculations. But, if expansionary austerity is not working in the UK, how well can it possibly work in countries that are less open, that can’t use the exchange-rate channel to boost exports, and that lack the long-term confidence that investors and businesses have in Britain? In fact, in Portugal, Spain, Greece, etc., without autonomous capacity of issue debt, the “expansionary austerity” only can be the straight path to misery.

It is because these austerity advocates don’t recognize the role played by domestic demand on increasing revenues that they focus only on debt stock. But the fiscal consolidation must consider the relationship between the stock of debt and the flow variables, including interest rates and fiscal revenues that affect a country’s ability to support its debt. A major factor that influences changes in the burden of public debt is GDP growth: it is virtually impossible to lower high debt-to-GDP ratios when an economy is stagnant, unless the debtor obtains a significant debt reduction. Greece was the first example; it is not much risky to consider Portugal as the next candidate.

#### **4. The reasons for the lack of competitiveness in periphery**

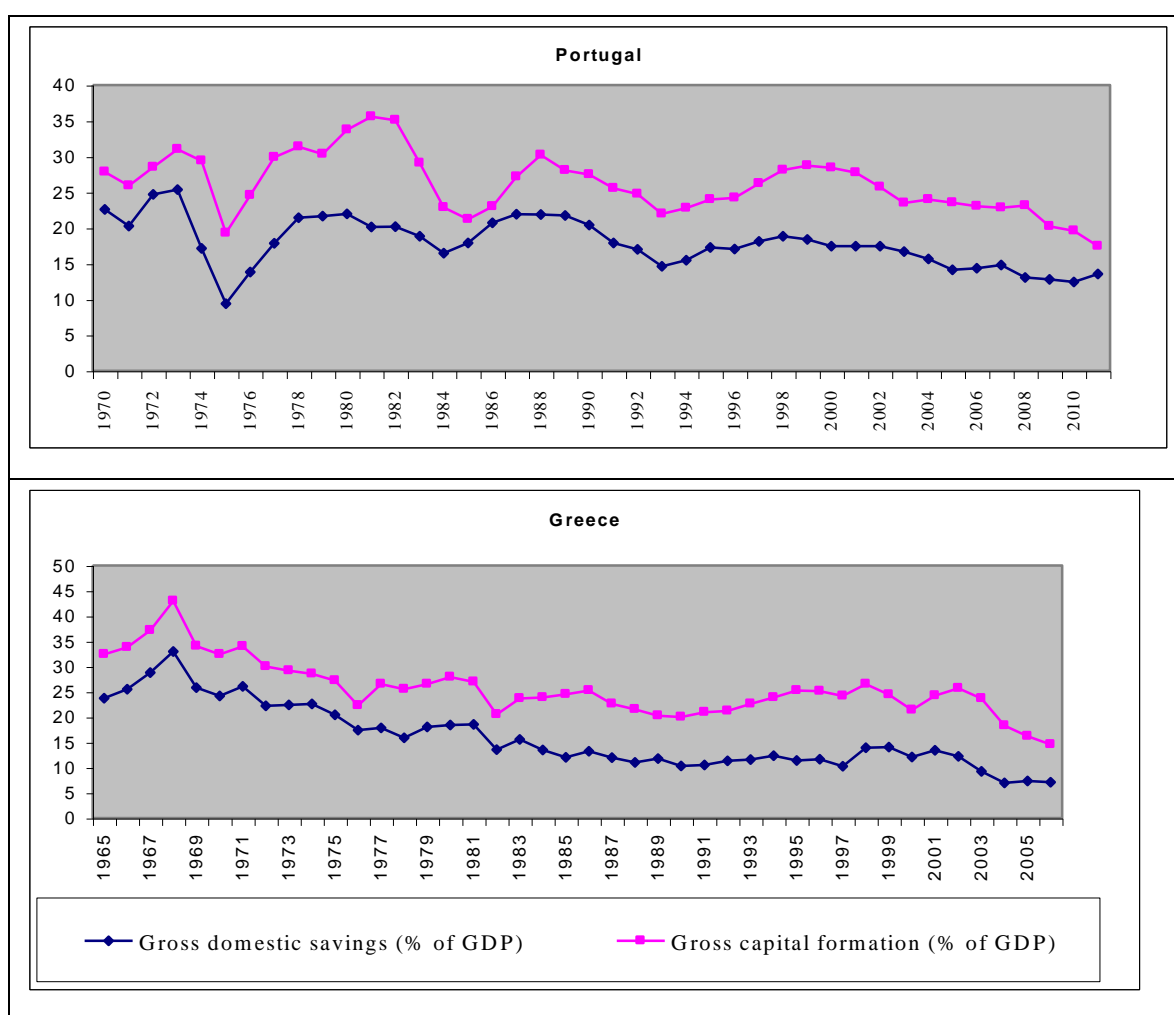
But the European authorities have supported the option by strong austerity mentioned above not only based on the irrational faith on the expansionary austerity but also by other reasons. A moral justification is among them: the ants (people of core countries) worked hardly while grasshoppers (typical of periphery) were singing and dancing; now is not fair that ants pay the wasting. However, this fable is wrongly told. In fact, the lack of competitiveness in European periphery is both the result of rational actions facing market signals and consequence of the failure or the incapacity to take positive and coordinated policies in Europe, particularly within the euro area.

The process by which southern Europe became uncompetitive is firstly the result of market price signals. Not only the incentives those signals produce on economic agents’ behaviour but also the responses that individually rational entrepreneurs played out in macroeconomic terms generated an unbalanced structure in the EZ. Core

countries with money to invest were willing to lend on extraordinarily easy terms to those in the periphery who wanted to spend, and abundant pre-2007 spending made domestic demand increase there and raising wages quickly.

Secondly, the lack of competitiveness in periphery is consequence of the failure or the incapacity to take positive policies and coordinated actions in Europe, which can be seen at two levels: at investment / savings behaviour and at the incomes policy domain. As a matter of fact, some periphery countries, as is the case of Portugal and Greece, have a long tradition of investing more than saving<sup>12</sup>.

Figure 2.  
The persistent imbalance between savings and investment in some periphery countries



Source: based on WDI.

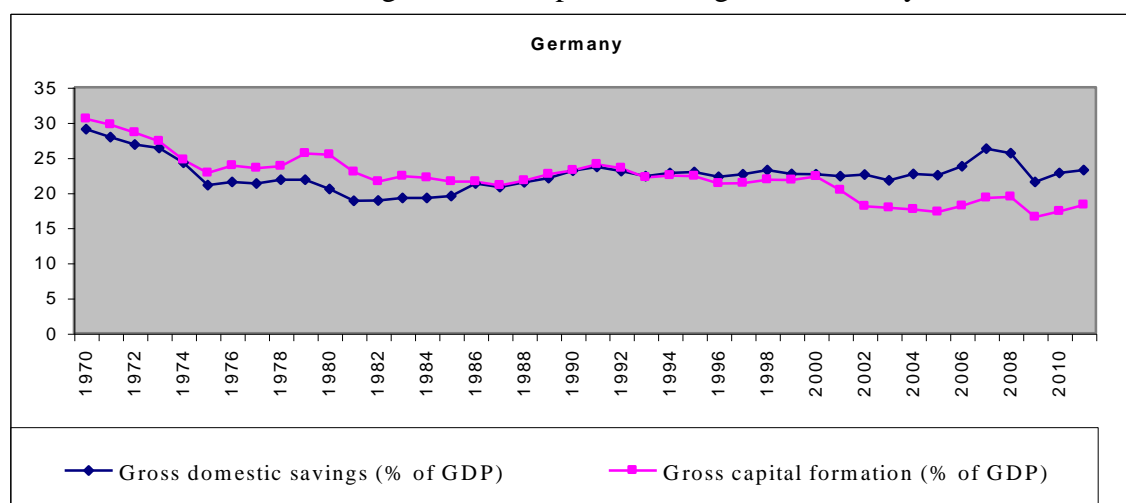
For instance, as figure 2 shows both Portugal and Greece have experienced chronically higher investment rates (measured by Gross Capital Formation) than saving

<sup>12</sup> Although Spain has shown a similar pattern after 1998, before this date the saving / investment ratio was more balanced.

rates. Contrasting with these countries some others as Luxembourg and the Netherlands have showed persistently saving rates higher than investment rates. But there are two other groups of countries: a third group that have interchanged periods of insufficient savings with excess of savings over investment rates (Italy, France) and a fourth group (Germany, Austria) with a balanced pattern until the end of 1990s and a clear excess of savings over investment after this date.

After the Euro inception, while Portugal and Greece have continued with the same savings / investment pattern, some other countries changed their patterns. This means that core countries adapted to the periphery pattern and the Euro Area adopted itself an economic configuration in which periphery wage, price, and productivity levels made sense only so long as it spent roughly more 7 to 8 percent that it earned, with the core countries financing this difference. Complementarily, core countries adopted wage and productivity levels that made sense only as long as they spent less than one euro for every euro that they earned.

Figure 3.  
Saving/investment pattern changed in Germany

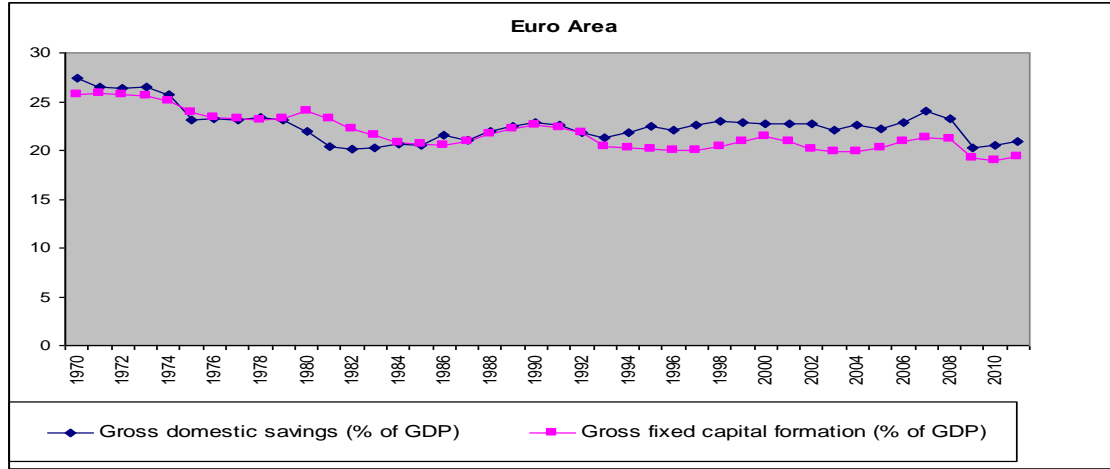


Source: based on WDI.

Figure 3 shows the change of the savings / investment pattern in Germany. Before the entrance of Portugal and Spain to the EU, Germany shows a rate of investment higher than the savings rate. It was the time of the “German miracle” of the former German Federal Republic. From this time to the euro inception the savings roughly equated investment, but after the creation of the EZ the rate of gross domestic savings went largely beyond the gross capital formation. The change in German’ savings / investment pattern influenced the EZ as a whole as is visible from figure 4.



Figure 4.  
Euro Area; gap between saving and investment rate



Source: based on WDI.

But, the change in German' savings / investment pattern was accompanied by a change in the incomes policy, that was detrimental to the intra-euro area equilibrium. In fact, the serious disparities in competitiveness were also accumulated as a result of diverging national wage trends, since the introduction of the Economic and Monetary Union (EMU).

As it is known, in a monetary union national wage trends are the key determinant of the real exchange rate among its member economies. To avoid disturbance in intra-regional competitiveness positions, national wage trends need to follow an implicit rule (see equation 2), which is: the increase in wages ( $\hat{w}_i$ ) must equate the sum of national productivity growth ( $\hat{y}_i$ ) with the agreed union-wide inflation rate ( $\hat{p}_u$ )<sup>13</sup>.

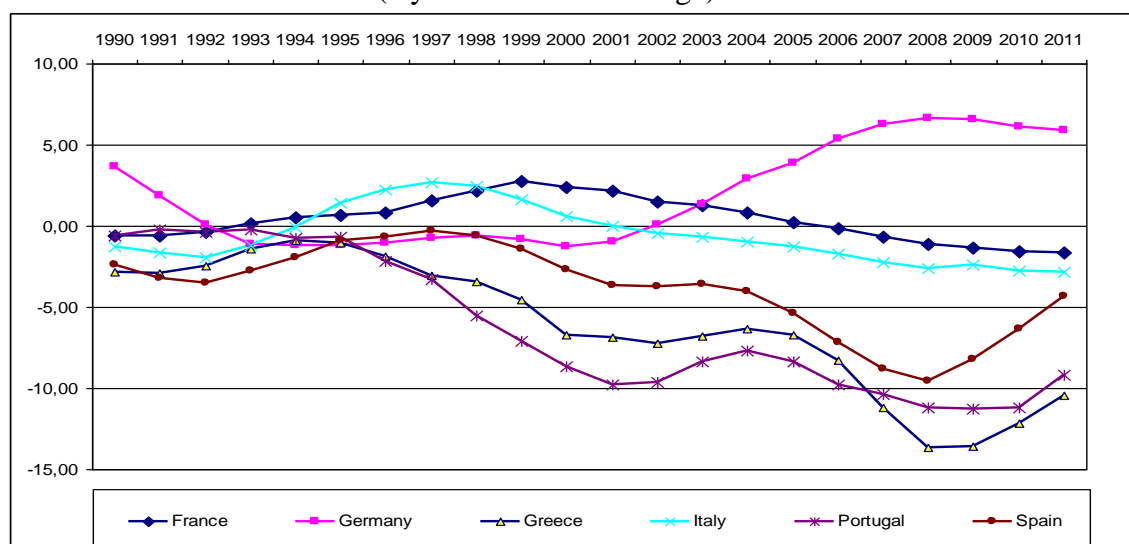
	$\hat{w}_i = \hat{y}_i + \hat{p}_u$	(2)
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Countries in the periphery deviate from this norm by excess, whereas Germany, the economy with the largest trade surplus within the euro area, also ignored that implicit norm, but in a downward direction: Germany modified its former incomes policy adopting a policy of maintaining constant ULC (unit labour costs). As a result, over time Germany experienced cumulative competitiveness gains in comparison with

<sup>13</sup> Defined by the ECB (European Central Bank) as "below but close to 2 per cent".

its European partners, especially in relation to the countries in the periphery (*TDRs 2006* and *2010*; Flassbeck, 2007; Bibow, 2006).

Figure 5.  
Current account balances (3 year backward average) in some Euro Zone countries



Source: Based on WDI data.

Looking at figure 5, which displays the current account balance in percentage of GDP, three points deserve mention: first, the disequilibria in current accounts increase after the introduction of the Euro; second, the surplus of Germany contrasts with the large deficits of Portugal, Spain and Greece in the four years before 2008; third, the surpluses verified in France and Italy in the 1990s were followed by a decreasing trend and increasing deficits in the subsequent decade. Given that EZ is a closed economy (about three quarters of trade is done between members) the solution for disequilibria must be found inside the EZ as a whole.

Now, at least apparently, European core countries do not want that periphery spend more than it earns. If this is so, for we don't lament a generation of "lost" decades, and progressive discredit in European integration, wages, prices, and productivity must shift and the periphery productivity levels need to rise relative to the core countries. Accordingly, given the cumulative distortions along the last decade, for periphery can pay its standard of living with exports and core economies can spend their earnings on those products, wage and price levels need to adjust by approximately 30%. If European authorities are interested in preserving the euro, and in avoiding progressive disintegration, five policy options could be used: 1) Periphery could rearrange its

business sector to become an engine of productivity; 2) Periphery could make an internal devaluation and so enforcing deflation; 3) Periphery could embark in strong austerity and so reducing its taxes and social services substantially; 4) Core countries could accept higher inflation (an extra two percentage points for five years would take care of one-third of the total core-periphery adjustment); 5) Core countries could expand social democracy by making their welfare states more generous.

The first option would be wonderful, but it cannot be attained in the short run. If anyone knew how to bring the periphery's business sector up to the productivity levels of the core countries quickly, it would have happened already. The preference of both European authorities and governments of the core countries goes to the second alternative combined with the third option. However, this is possibly the least prudent, for it implies lost decades of stagnation and perhaps the EU collapse.

So we are left with the last two options or a combination of them with the third alternative. If Euro Area does not adopt some arrangement of the last three options as policy goals over the next years, it will face a severe choice: either lost decades for periphery (and perhaps core countries as well), or persistent one-sided core-periphery payments that will have to be funded through fiscal transfers.

Of course citizens of peripheral countries would prefer the option 4 or 5, but a balanced combination of the three latter options could be a good cooperative solution that will avoid a race to the bottom. Obviously this will require three conditions: first, the abandon of preconceptions about the role played by the aggregate demand, as is the faith on redemption by austerity; second, the existence of periphery's governments that effectively represent the interest of their citizens and not administrations more interested in being considered as good pupils by the core's leaders; third, that governments of core countries be aware of the need of considering the EZ as a single large economy and not as a set of different countries competing for investment and market shares at the expenses of their partners. This will imply the need of adopting a different competitiveness policy in all countries of the EU.

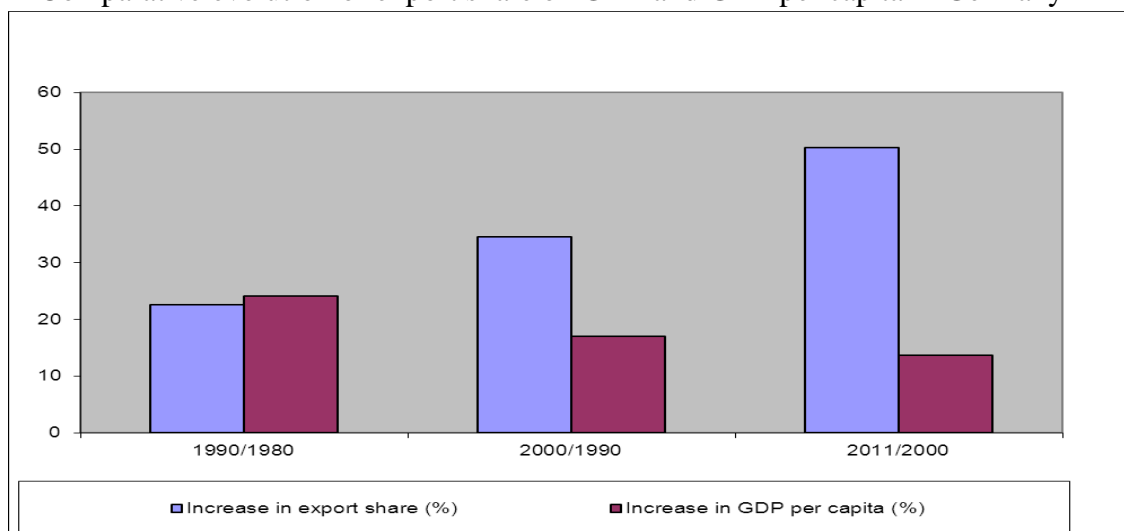
## **5. Competitiveness policy must change**

The competitiveness policy used by the EU is condemned to fail because it is based in prescriptions neither adapted to the EU level of development nor to a monetary union. First, is based on the idea that countries must compete for market shares and

investments, both inside and outside the EU, without establishing similar fiscal and financial rules. Second, the competition with China, Japan and the US is only based on prices, which implies deflationary tendencies, discouraging industrial investment inside the EZ. Third, competitiveness relies in excess in exports as a means of increasing economic growth, without enough attention to the internal market.

This competitiveness policy, based only on decreasing prices, explains why irrespective of the great emphasis put in innovation policy<sup>14</sup>; EZ has lost ground in the most recent technologies. In words of Tabellini and Wyplosz (2006) “the ambitious Lisbon objectives of turning the EU into “the most dynamic, knowledge based economy in the world by 2010” are becoming an embarrassing joke”. This explains also why Germany in spite of increasing substantially its export shares has gathered an economic growth rate significantly lower than in the previous decades. As is visible from figure 6, while from 2000 to 2011 the export share increased 50% from 33% to 50%, GDP per capita only improved 13,66%. This is the result of a competitiveness policy based on structural reforms that have as the main purpose to low unit labour costs.

Figure 6.  
Comparative evolution of export share on GDP and GDP per capita in Germany



Source: Based on WDI data.

<sup>14</sup> See, for instance, European Commission (1995), European Communities (1997) and the huge number of papers about the Lisbon Strategy.

## 6. Conclusion

The nowadays' financial and economic instabilities in the Euro Zone are derived from a not well-resolved debt crisis that has its origins in private debt, and for which the euro area's policy-making mechanisms were ill-equipped to handle. However, imprisoned in ideological prejudices the policy response remains determinedly focused on reducing public expenditure and on "strengthening" the fiscal discipline insisting on measures intended to enforce quickly the Stability and Growth Pact. Simultaneously the misconceptions about competitiveness and structural imbalances, compressing wages and diminishing domestic demand in periphery economies, originate there recessive spirals that soon or late have impact on core countries' growth. Consequently, those attempts to solve the instability, differently from attaining the initially envisaged results, generate an increasing lack of confidence in both the ability of periphery countries to achieve the necessary economic flexibility required for a monetary union of regions with divergent economies and, consequently, a distrust in the capability of EU institutions to control the EZ crisis.

If the re-establishment of confidence is essential to end the recession and to return to economic growth, for the periphery countries individually considered the important question at the public finance level is to find the optimal mix of budget consolidation and growth for the maximisation of confidence. For the EZ as a whole the main question is to find the proper mix of competition and cooperation in order to profit from the potential of its internal market. For both core and periphery countries the increase in competitiveness must be based on improving quality and increasing the innovative content of production and exports, rather than on decreasing prices and wages. Only those correct mixes, together with the right competitiveness policy, can avoid lost decades of economic growth. They are also mandatory for the whole world recommencing to see the EU as an example of regional integration that deserves to be followed.

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