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Is better economic integration in the EU possible?

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In this paper it is argued that European integration has not fulfilled its chief economic promises. Output growth has been increasingly weak and unstable. Productivity growth has been following a decreasing trend. This sorry state of affairs is likely to continue. However, this outcome is not unavoidable. Moreover, the negative consequences implicit in the current architecture of the common currency could be neutralised. For this to happen, the basic paradigms of the economic policies to be followed in the European Union would have to be radically changed. First, the unconditional fiscal consolidation provisions still in force would have to be repelled. Second, 'beggar-thy-neighbour' (or mercantilist) wage policies would have to be 'outlawed'.

Keywords: *European integration, Maastricht Treaty, euro, internal devaluation, income inequality, race to the bottom, productivity stagnation*

JEL codes: *E12, E24, E62, F15, F62*

1 ECONOMIC INTEGRATION HAS NOT FULFILLED ITS PROMISES

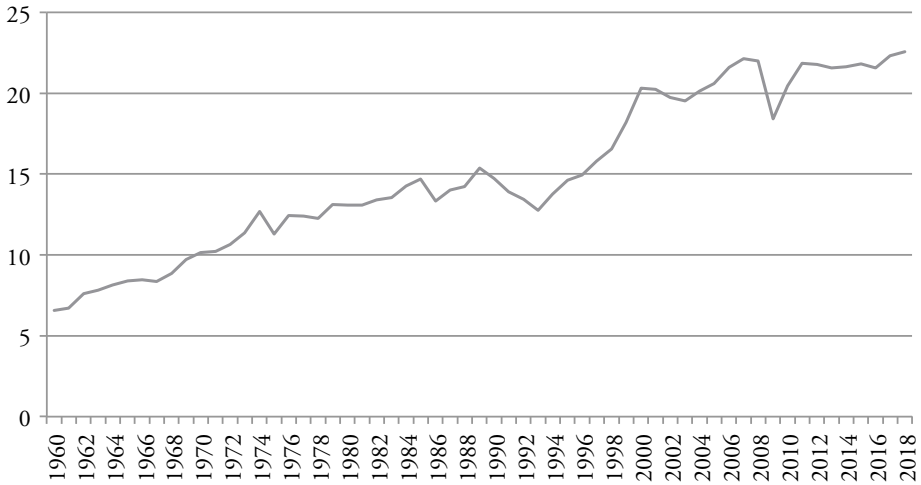
Under the provisions of the Maastricht Treaty, European economic integration has been further advanced. The introduction of the euro crowned the process of internal liberalisation of trade within the European Union (EU) and facilitated the creation of an area of ever freer movements of goods, capital, labour and services throughout the continent. There are many possible measures of advances in economic integration. Perhaps the most unproblematic of these measures (from a statistical point of view) is the share of mutual trade in the EU's aggregate GDP. Figure 1 shows the mutual exports of goods as a percentage of euro-area (EA12, the original 12 euro-area members) GDP since 1960.

Economic integration (just as internal economic liberalisation or globalisation) is generally assumed to be conducive to economic growth (even if it is now often admitted that it may have unwelcome – supposedly transient – distributional effects). Closer integration has been expected to promote faster overall productivity growth – for example, through increased competition and more efficient utilisation of scarce resources.

European integration has failed to deliver on these promises. In actual fact, economic growth in the integrating Europe has been slowing down secularly, since around the mid 1970s (see Figure 2). Prior to the final abandonment of the Bretton Woods rules (which happened in 1973), growth (in per-capita terms) was quite high (on average 3.5 per cent per annum for West Germany and 4.8 per cent for the remaining 11 countries of the future

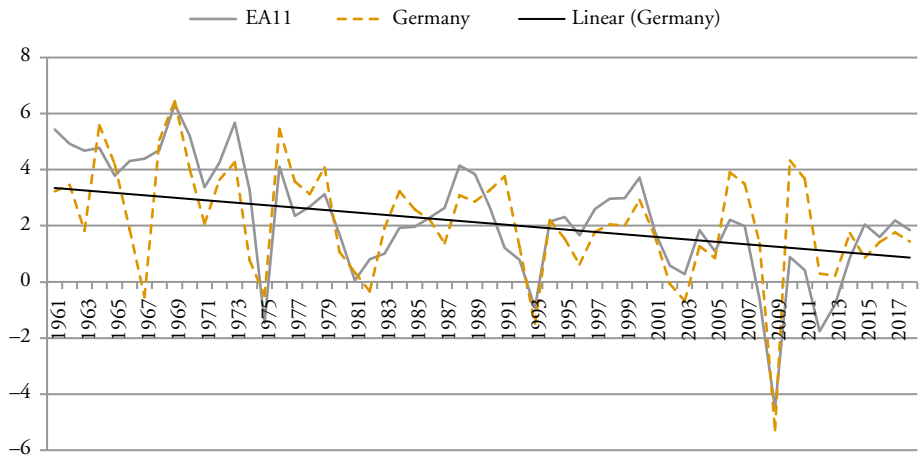
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Note: Until 1990, allowing for West Germany; since 1991, allowing for unified Germany.
Source: AMECO, own calculations.

Figure 1 Intra-EU exports of goods as a percentage of EA12 GDP, 1960–2018



Note: West Germany until 1991, unified Germany since 1992.
Source: AMECO, own calculations.

Figure 2 Growth rates of real per-capita GDP for Germany and the rest of the euro area (EA11), 1961–2018 (percentages)

euro-area group). In the years 1974–1990, growth slowed down to 2.2 per cent and 2.3 per cent respectively. For the years 1991–2018, the average yearly per-capita growth rate for Germany was 1.3 per cent and 1.1 per cent for the remaining 11 countries. As can be seen, the growth rates follow declining trends which – if continued – would push

the EA12 into permanent recession. In addition, growth has become increasingly volatile, with violent ups and downs, and recessions climaxing around 1993, 2003, 2009 and 2012. One may bear in mind that the short-lived recessions in 1975 and 1981 could have been the aftermaths of the oil embargoes (1974, 1979) and the associated shortages severely affecting the 'supply side'. Beyond such shortages materially affecting production, the oil shocks had negative consequences for inflation, income distribution and – especially – private investment.¹

The deep slumps in 1993 and 2009 cannot yet be viewed as 'exogenous shocks'. These slumps were 'endogenous'. They were the consequences of the economic 'architecture' consciously designed by the European economic elites. In 1993 the recession was the consequence of the crash of the ill-designed – excessively rigid – original Exchange Rate Mechanism; in 2009 it was the near-collapse of the EU's financial sector operating by the rules enacted by the EU policy-makers. It may be added that the second-dip recession of 2012 was provoked by the 'fiscal consolidation' hysteria gripping the euro-area decision-makers.² Finally, it is worth observing that the introduction of the euro (since 1998) and the full internal trade liberalisation (the Single European Market, since 1993) have done nothing to accelerate and smooth out GDP growth.³

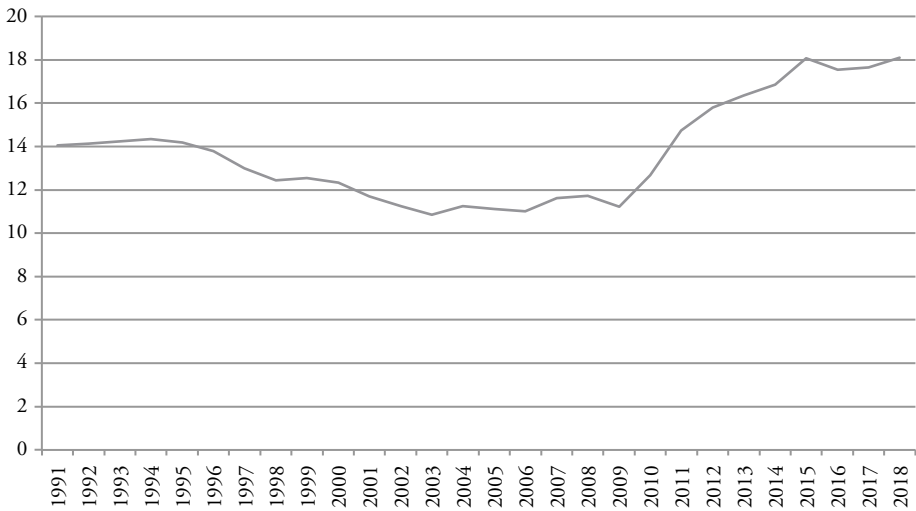
2 IS AN EXCESSIVE DEGREE OF INCOME REDISTRIBUTION THE PROBLEM?

Can it be that the productivity and output growth slowdown has been the price for more pronounced income equality in individual EU member states and the income convergence towards greater income equality between the EU member states? Quite obviously the answer is no. It is generally acknowledged by now (also thanks to research conducted at the OECD, ILO and other international organisations) that income inequality has generally been increasing in individual EU member states. Arguably, the rise in income inequality at the national level must have much to do with the decline in GDP labour shares which started, in most cases, in the mid 1970s. Also the tendencies, which set in around 1975, for 'flattening' the personal income tax systems as well as for falling taxation of profits must have added to growing inequality in disposable incomes. The tendency for the substitution of indirect for direct taxation additionally reduces the overall progressivity of the national taxation systems. It is significant that while the rise in income inequality

1. Actions by the Organization of the Petroleum Exporting Countries (OPEC) cartel produced fundamental *uncertainty*: would the energy prices/supplies be allowed to return to 'normal' levels, or would they, rather, stay at 'abnormal' levels more or less indefinitely? Under such uncertainty the best approach to taking (irreversible) investment decisions (involving technology choice: energy-saving, or traditional) could be of a *wait-and-see* sort.

2. Certainly, the German unification (1991) was an exogenous shock. However, by itself unification did not push Germany (and the rest of the EA11) into recession. In 1991 the West German per-capita GDP increased by 3.8 per cent. Such a development was quite natural given the urgent investment needed by East Germany's disintegrating infrastructure and outdated productive capital stock. However, the over-restrictive macroeconomic policy response to the unification constituted another 'endogenous' (and negative) shock contributing to recession in 1993 and slowing down growth later on (see Bibow 2001a; 2001b).

3. The important question is: why has increasing trade been associated with weakening growth? The answer to this question, suggested by Podkaminer (2014; 2016a; 2018b), is that progressing external liberalisation is responsible for deep and persistent trade imbalances and for wages getting suppressed by unsound international competition (*race to the bottom*). Both developments have negative consequences for long-term output growth.



Note: Coefficient of variation is defined as the (population-weighted) standard deviation of p.c. GDP (at PPS) across the EA12 area, divided by the average p.c. PPS GDP for the whole EA12.

Source: AMECO, own calculations.

Figure 3 Coefficient of variation of per-capita GDP at purchasing power standards (PPS) for the euro area (12 countries), population-weighted, since 1991 (percentages)

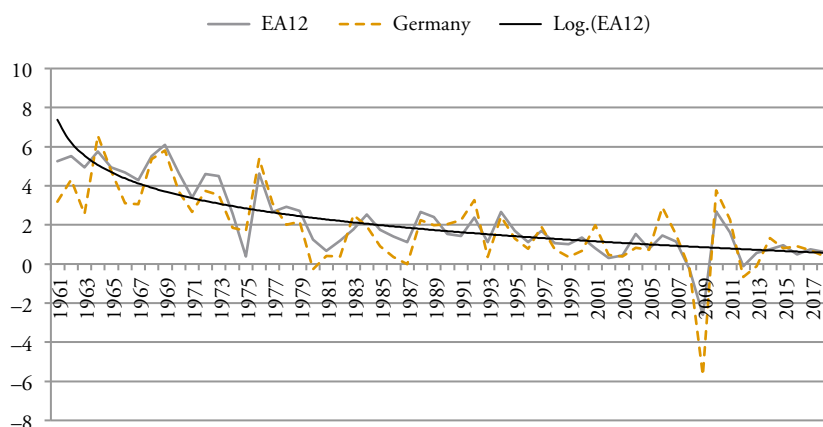
tends to be officially deplored (especially after the unexpected emergence of ‘populist’ political factions across the EU) the ‘official EU’ still does not seem to acknowledge the need to halt the race to the bottom with respect to taxation. In any case it is difficult to attribute growth slowdown to excessive income equalisation within individual countries because the opposite has been the norm.

The dispersion of per-capita incomes *across* the eurozone has been strongly increasing since 2009 (see Figure 3). In terms of per-capita income the ‘old’ EU has shown ‘sigma divergence’ rather than convergence. Again, the eurozone’s weakening performance cannot be put down to any internal cross-country income-equalising redistribution because in actual fact the internal income redistribution works in a way that augments rather than reduces cross-country differences.

3 IS WEAKENING LABOUR PRODUCTIVITY GROWTH RESPONSIBLE FOR THE SLOWDOWN OF OUTPUT GROWTH?

Labour productivity growth has also followed a declining trend (see Figure 4).⁴ Given the rather indisputable acceleration of technological progress and the rather obvious advances

4. Labour productivity in Figure 4 is defined as real GDP per person employed. It goes without saying that the compositions of GDP (and the price structures) have been changing quite radically since 1960. While it is always legitimate to nurture doubts about any specific estimates of the real output’s longer-term dynamics, in the end some estimates need to be accepted, if only provisionally. AMECO seems the best source currently. The same source also offers estimates of productivity defined as nominal GDP per hour worked. However, the hourly productivity statistics start in



Note: West Germany and EA12 including West Germany until 1991. Since 1992 unified Germany and EA12 including unified Germany. Log.(EA12) is the logarithmic regression line fitted to the EA12 series.

Source: AMECO, own calculations.

Figure 4 Growth rate of labour productivity (real GDP per employed person) for EA12 and Germany, 1961–2018 (percentages)

in applied research and innovation activities, the labour productivity growth slowdown is considered a paradox. Some explanations of the paradox suggest that output (and productivity) have been systematically underestimated by the statistics (for example, Mokyr 2014; Feldstein 2015). Others tend to disagree with the mismeasurement thesis yet without offering a coherent explanation of the paradox (for example, Byrne et al. 2016).

Robert Gordon (2015) is the most vocal representative of the ‘supply-siders’ who suggest that technological progress has not prevented the weakening of labour productivity growth. He even goes as far as to blame the post-2008 stagnation itself and the slower growth (since 2004) in potential output ‘emanating from the behaviour of productivity’ (ibid.: 58, emphasis added). This seems to suggest that the supply side needs further ‘structural reforms’, stronger deregulation, more labour market flexibility, etc., so as to strengthen productivity growth and thus contribute to faster growth of output. By implication, the supply-side views on the roots of the secular stagnation (whether in the EU, USA, or at the global level) really ignore the possibility of stagnation emanating from the orientation of the macroeconomic policies followed, or from the prevalence of neoliberal maxims on (for example) labour market or international trade matters. In other words, if the supply-side explanations of the secular stagnation should be accepted, the case for a radical change of the inherited economic paradigms would be rather weak.

However, the results of an econometric examination (Podkaminer 2017) of the links between labour productivity and output growth for various groups of countries indicate that, generally, productivity does not ‘cause’ output. Much more often the causation

(footnote 4 continued)

1995 in most cases. Nonetheless, it appears that hourly productivity growth, whether in nominal or real (recalculated) terms, also follows clearly declining trends (over the years 1996–2018). For example, the average growth rate of real (recalculated) hourly productivity in Germany was 1.7 per cent per annum (1996–2007) and 1.1 per cent per annum (2010–2018). In 2008–2009, the hourly productivity fell 2.4 per cent per annum.

seems to be running in the opposite direction: from output (or its growth rate) to productivity (or its growth rate). This finding, though inconsistent with the ‘mainstream’ ideas on the sources of long-term economic growth, is reminiscent of the classical Kaldor–Verdoorn law (Kaldor 1966). The progressing slowdown in output growth at the global level, initiated in the mid 1970s (amid the wholesale change of economic policy paradigms), may have been mirrored – and followed – by the progressive slowdown in productivity growth (and despite the indisputable acceleration of technological progress). Thus, productivity growth slowdown cannot be the cause of the overall slowdown of output growth in the EU.

4 THE REASONS FOR THE FAILURE⁵

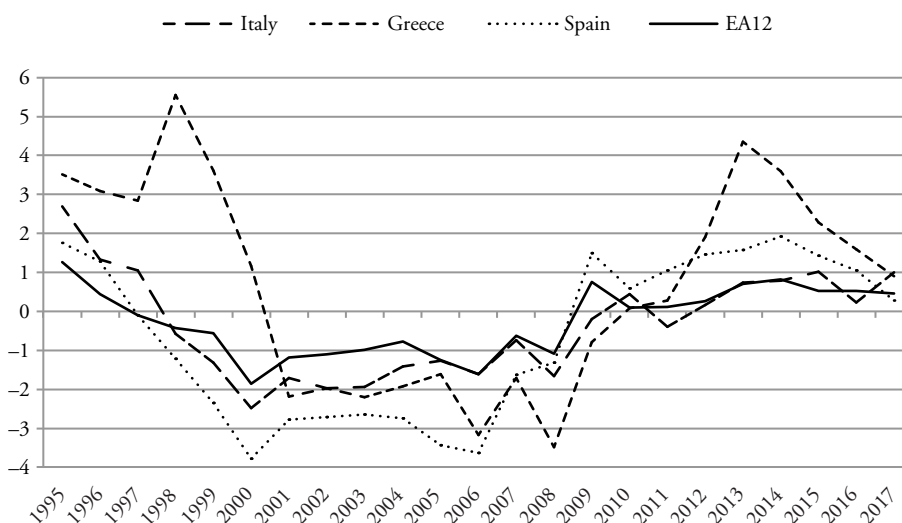
For some authors the economic failure of the EU can be directly attributed to the principles first introduced in the Maastricht Treaty and later reiterated in a series of Fiscal Compacts or Pacts. Combined with the common currency (and the common monetary policy, for a long time embodying the tradition of German central banking), the Maastricht fiscal rules eventually suppressed output growth, generated internal imbalances – and thus paved the ground for the internal economic disintegration of the Union (see for example Laski/ Podkaminer 2012; de Grauwe 2013; Podkaminer 2015; 2016b; Hein/Truger 2017).

The vicious dynamics behind the developing economic drama can be concisely described as follows. First to come is the set of fiscal rules setting narrow limits for public-sector deficits. The fiscal rules are to apply universally – without regard for national specificities. Thus a country (such as Germany) which is capable of producing output in excess of the needs of its private sector (be it private consumption or private investment) cannot rely on the public sector for absorbing the potential excess private-sector savings by means of deficit spending. It is thus left with no other easy option than to attempt to run trade surpluses. For such a country, running trade surpluses becomes a way of supporting domestic growth (and of keeping its own unemployment in check). Of course, for a country to be capable of running trade surpluses there must be some countries capable of running trade deficits. It is understood that for countries running trade deficits this implies not only the accumulation of foreign debt, but also the suppression of domestic output growth and additional unemployment (to be associated with persistent fiscal deficits).

At this stage it is important to consider the way the common currency facilitates the rise of cross-country imbalances. One currency, one monetary policy and one policy interest rate have very different economic implications for various members of the same group. The policy interest rate has been tuned to the average inflation rate calculated for the whole area. That would be fine if inflation (and inflation histories) were similar across the whole area. However, in fact they have been very different.⁶ In consequence, for countries with inflation persistently higher than the average, the real interest rates have tended to be low (or even negative)

5. It is rather obvious that the growth slowdown cannot be attributed to intensified shortages of labour: unemployment has been high since the early 1980s. Neither can it be attributed to intensified shortages of exhaustible natural resources: the continuing secular decline in commodities’ terms of trade indicates that commodities have become less scarce, not more (see for example Mollick et al. 2008).

6. For many decades inflation used to be much higher in (for example) Italy than in Germany. As late as 1996 Italian inflation (measured by the GDP deflator) was still 4 percentage points higher than Germany’s. Later on, the differential narrowed: since 2010 the growth of the GDP deflator has been larger for Germany (not much, about 0.5 percentage points in 2018). Despite the convergence in the recorded inflation rates, the Italian inflation qualitatively still differs rather radically



Source: AMECO, own calculations.

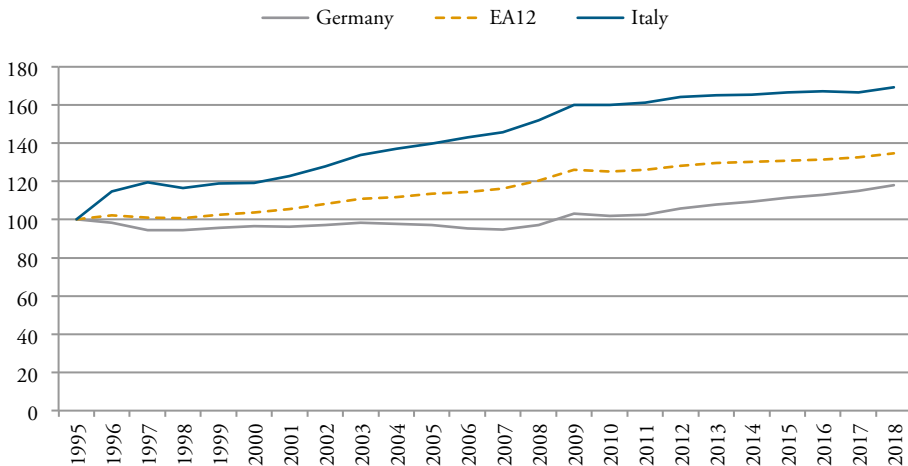
Figure 5 Real short-term interest rates for Greece, Spain, Italy and EU12 (differentials over Germany), 1995–2017 (percentage points)

while – at the same time – the real interest rates may be prohibitively high in countries with much lower inflation. As Figure 5 shows, from the late 1990s (switchover to the common currency) until 2009 (the collapse of the boom in the southern eurozone countries and in Ireland), the real short-term interest rates in Germany were consistently higher than in Spain and Italy. The latter countries enjoyed low real interest rates entirely on account of inflation being much higher than in Germany. The same applied to other high-inflation countries (for example, Ireland and Greece). As long as the governments of the eurozone member states and their national banking systems enjoy the same level of credibility, the cross-country differentials in short-term real interest rates on commercial loans were also approximating the differentials on long-term government bonds. In other words, until 2008 credit to the German private as well as public sectors used to be much more expensive, in real terms, than elsewhere. Of course, such differential developments favouring Germany's partners could not persist indefinitely. As soon as the boom supported by low real interest rates in the South collapsed (under the weight of accumulating domestic and foreign debts), the real interest rates in countries that had had higher inflation became high (in many cases excessively high). It is at this stage that the initial boom fed by low interest rates turned into a (balance-sheet) recession initially engulfing the debtor countries and eventually also their creditors.

The moral to this story is that the principle 'one size fits all' does not work in practice. The common monetary policy has been destabilising growth and inflation: fuelling inflation (and growth) in countries experiencing a boom while suppressing inflation (and growth) in countries experiencing low inflation (or even deflation) and inadequate output performance.

(footnote 6 continued)

from its German equivalent. The former has materialised under the prolonged stagnation/recession, the latter under comparatively stable (if unimpressive) growth. The return of faster growth in Italy is quite likely to involve the return to much higher, historically attested, rates of inflation.



Source: AMECO, own calculations.

Figure 6 Nominal unit labour costs, 1995–2018 (1995=100)

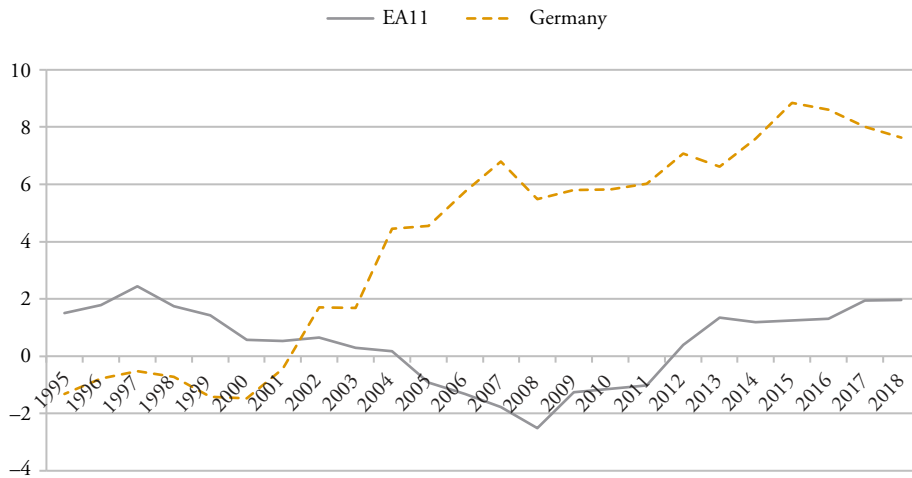
Importantly, as a consequence of differential developments in real interest rates (and inflation), the countries with traditionally low inflation (and, consequently, weak growth in wages, such as Germany) have been gaining cost-competitiveness advantages vs their higher-inflation partners. As can be seen in Figure 6, until 2012 German unit labour costs had been virtually constant. During that period the unit labour costs in Italy (as in other southern eurozone member states) had grown vigorously. Things have been slowly changing since then. But despite the recent moderate rise in the German unit labour cost index, the gap vis-à-vis the rest of the eurozone (and Italy in particular) remains very big. The nearly permanent output stagnation suffered by Italy since 2001 (with outright recession dominant since 2007) appears to have been insufficient as far as the reduction of unit labour costs (that is, primarily the prevailing wage rates) is concerned.

In this way, the low-inflation (and weak-growth) countries have become reliant on ever-rising trade surpluses, while the higher-inflation countries that had earlier priced themselves out of international competition have, since 2008, been forced to reduce their external deficits and to work out (since 2012) the surpluses needed for servicing the inflated foreign debts accumulated during the ‘good years’ (see Figure 7). As a rule, the enforced change in the net external position goes hand in hand with persisting depression (or even recession).

5 THE PITFALL OF ‘INTERNAL DEVALUATION’

Germany’s formidable external competitiveness, represented by its gigantic and persistent trade and current-account surpluses, is a widely acknowledged source of problems troubling some of Germany’s trade partners – and many of the ‘old’ members of the EU in particular. The problems are especially acute for the southern flank of the euro area where the unit labour costs have increased enormously relative to Germany’s.

The coincidence of Germany’s outstanding performance on both relative unit labour costs and external surpluses seems to have given rise to the idea that external surpluses



Source: AMECO.

Figure 7 Net external lending as a percentage of GDP: Germany and the rest of the euro area (EA11), 1995–2018

can be a negatively sloped function of unit labour cost indices. That idea underlies the Euro Plus Pact (European Council 2011) which ‘prioritises fostering competitiveness and convergence’ across the euro area in terms of unit labour costs (see for example European Commission 2015).

One specific policy option often propagated to strengthen Germany’s eurozone partners is ‘internal devaluation’. The internal devaluation is a set of actions (including some labour market reforms) resulting in a sufficiently strong deflation in wages (and prices, in due course). Of course, suppression of wages (and thus of domestic demand) is a bitter medicine if only because it is almost certain to provoke a recession of unforeseeable depth and length. In the first place it may help reduce the trade deficit (or even generate a trade surplus) by reducing demand for imports rather than promoting higher exports. A more attractive alternative is believed to involve the achievement of competitiveness gains through policies promoting much faster growth of labour productivity. Of course, achievement of fast growth of labour productivity (primarily implying a fast change in the structure of production and improved quality of exportable goods and services, etc.) cannot be a bad idea, though it is not quite clear how this could be effectively engineered. The failure of the Lisbon Agenda (and other such policy initiatives) promising a speedy structural change, quality improvements and thus advances in productivity is a case in point.

The major problem with the productivity alternative is that in actual fact the ‘old’ EU has on the whole performed *better* than Germany in terms of labour productivity growth (see Figure 4) in the long run. On labour productivity Germany has been losing out to the rest of the ‘old’ EU secularly.⁷ Germany’s super-competitiveness cannot be squared with

7. On labour productivity growth Western Europe (EU15) has outperformed Germany since 1960 (Podkaminer 2018a). The average yearly growth rate differential (EU14 vs Germany) for the whole period (1960–2017) is 0.26 percentage points (with the median of 0.41 percentage points).

evidence on its relative productivity performance, but, rather, derives from its mercilessly restrictive wage (and fiscal) policies which suppress economic growth not only in Germany, but also in its partners which attempt to align themselves with the ‘leader’.

6 CONCLUDING REMARKS: IS BETTER INTEGRATION IN THE EU POSSIBLE?

Better integration in the EU is possible, at least in theory (as argued by many authors such as Hein/Truger 2017 or de Grauwe 2013). In particular, the negative consequences implicit in the existence of the common currency could be neutralised. However, the basic paradigms of the economic policies to be followed in the EU would have to be radically changed (Laski/Podkaminer 2012).

Two closely related aspects are of crucial importance for a better integration: first, the rejection of the unconditional fiscal consolidation provisions still in force, and second, the prohibition of ‘beggar-thy-neighbour’ (or mercantilist) wage policies.

The latter issue is obviously important because unduly restrictive wage policies (as for example in Germany or Austria) consequently lead to large trade surpluses suppressing growth in countries which fail to follow suit and thus run trade deficits and accumulate foreign debts. Sooner or later, the accumulation of foreign debts tends to end up badly for both the debtors and creditors. Moreover, countries implementing an internal ‘wage moderation’ strategy suffer themselves even before the outbreak of the indebtedness crises. Their growth tends to be weak because suppressed wages mean suppressed consumer demand – and, paradoxically, suppressed investment demand. In practice, the ‘beggar-thy-neighbour’ policy is also a ‘beggar-thyself’ policy (Laski/Podkaminer 2011).

Rejection of the unconditional fiscal consolidation provisions is equally important for countries (again, such as Germany) whose private sector tends, on a permanent basis, to save much in excess of its own investment. Without the ability to run trade surpluses (which never can be sustained indefinitely), such countries eventually must either experience depression, or allow public-sector deficits to absorb the excessive private savings (Laski/Podkaminer 2013; Podkaminer 2019).

The existence of the EU is of vital importance to the Europeans – and especially for the Central and Eastern European nations. Without the EU these nations would once again find themselves alone and in a grey zone between their all too mighty neighbours.

But the EU cannot prosper within the confines of self-imposed limitations that have little economic justification, theoretical or practical. Unless the basic paradigms of economic policy for the EU are overhauled, the EU will remain a stagnant area convulsed by recurring economic (and then social and political) crises. Sooner or later these crises will give rise to further exits or could even precipitate the dissolution of the Union.

Whether the radical change happens before it is too late is of course highly uncertain. In any case it should be the duty of European politicians – and also economists – to voice their concerns about the overall orientation of the economic policies of the Union. Kazimierz Laski was among those who took that duty very seriously.

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