CDPR CENTRE FOR DEVELOPMENT POLICY AND RESEARCH
School of Oriental and African Studies

Policy Brief
Number 6, July 2014

From Impasse to Recovery: Overcoming Europe's Prolonged Crisis

Despite recent hopes for economic revival, stagnation continues to plague most countries in the European Union. Results of the recent European elections confirm that many people are turning against the EU and its policies. Throughout the continent economic growth is tepid, unemployment is stubbornly high in most countries and real wages remain low. Meanwhile, government benefits are being slashed in order to reduce debt burdens.

Europe appears to be trapped in an economic impasse. Many people feel that national governments—and EU institutions in particular—are not responding to their needs. Some have started to blame convenient scapegoats, such as immigrants.

Is there a viable way out of this economic and political crisis? This Policy Brief sketches out the broad outlines of a feasible economic strategy. It draws on the contributions of a recently published Memorandum ('Charting Ways out of Europe's Impasse'), which has summarised, in turn, the general findings of a recent three-year EC research programme called the AUGUR project.[1]

A Brief Background

In the two decades leading up to the 2009 economic crisis, there had been a substantial convergence of levels of income per capita across Europe. Part of the explanation was that capital flows among countries counter-balanced divergent trade performances.

But trends in trade competitiveness began to diverge more sharply after 2000, especially among the countries that shared the euro. For example, France, Italy and Spain—as well as the UK—began to lose ground to Germany and other successful exporting countries.

1 The Memorandum has been published by the Vienna Institute for International Economic Studies. See 'Charting Ways Out of Europe's Impasse - A Policy Memorandum, wiiw Policy Note/Policy Report 13, Vienna, June 2014'. The Memorandum was based on contributions from Francis Cripps (Alphametrics), Michael Landesmann (wiiw), Jacques Mazier (Paris-Nord), Robert McDowell (Summerhall), Terry McKinley (SOAS), Pascal Petit (Paris Nord), Terry Ward (Applica) and Enrico Wolleb (ISMERI). This Policy Brief was written for CDPR by Terry McKinley in consultation with Francis Cripps. Also see the Endnote.

The primary factor was widening disparities across countries in the exports of manufactures. This trade component alone accounted for about half of all cross-border income flows within Europe.

Because the countries running current-account deficits had to finance them by capital inflows, they began to face rising debt levels. Yet the Maastricht Treaty had obliged governments to budget for deficits not exceeding 3% of GDP and debt levels not exceeding 60% of GDP.

The Treaty on Stability in 2012 strengthened such conservative budgeting, mandating governments to work towards structural budget deficits of no more than 0.5% of GDP. But the fiscal austerity that has already resulted from seeking to abide by such objectives not only continues to aggravate economic disparities within Europe but also consigns the entire continent to prolonged stagnation.

Projections to 2020 and 2030 by a global macroeconomic model (the CAM, which was used extensively in the AUGUR EC project) suggest that levels of GDP per capita in Germany, other surplus countries in Western Europe and the Nordic countries will increase relative to the European average. At the same time, levels of GDP per capita in France, Italy, Spain and other countries in Southern Europe (and even in the UK) will decline relative to the European average (See Table 1 on next page).

Moreover, across Europe as a whole the average debt level, as a % of GDP, would decline from 87% in 2013 to only 86% in 2020, and would still be 76% in 2030. France's debt level would worsen from 93% in 2013 to 103% of GDP in 2030 and the debt levels of both Italy and Spain would remain close to 100% in 2030.

Hence, projections based on continuation of current fiscal policies suggest that the EU would be driven into an economic and political dead-end. Not only does the EU, and Europe as a whole, need to revive economic growth and employment, but also it needs to overcome the widening disparities in levels of income per capita among its member countries.

The contents of this Development Viewpoint reflect the views of the author(s) and not necessarily those of CDPR or SOAS.

Table 1. Per Capita GDP relative to the European average

Country/ Bloc	2013 Estimate	2020 Projection	2030 Projection
Germany	124	134	153
Other Western Europe	135	133	133
Nordic Countries	138	155	181
United Kingdom	118	111	92
France	113	102	86
Italy	94	92	82
Spain	94	87	81
Other Southern Europe	83	79	72

Source: CAM Modelling

These broad-brush projections highlight what more detailed analysis reinforces: Europe needs to radically change course economically, and the sooner the better. The rest of this Policy Brief summarises some of the key policies that could help the EU move in such a progressive economic direction.

Progressive Policy Options

The EU faces the dual challenge of implementing policies that not only revive aggregate demand within Europe as a whole but also contribute to rebalancing the divergent competitive positions of countries within the Union.

Particularly important will be the boosting of both public and private investment in order to generate broader employment along with rising productivity. Policy interventions also need to ensure that there will be a more equitable distribution of employment and incomes across countries.

This goal will help ensure that all countries in Europe are included in a common effort to secure a viable pattern of trade, investment and financial flows within the continent and with the rest of the world.

The vital task of reviving aggregate demand in Europe will not be compatible, however, with the current self-defeating focus on slashing the public spending of heavily indebted governments. Instead, special assistance will be needed to enable such governments to return more gradually to sustainable levels of fiscal deficits and public debt.

Specifying Policy Targets

Table 2 draws on projections by the CAM macro model to 2030 to estimate the average growth rates of labour supply, employment, productivity and GDP that would be necessary to achieve Europe's economic revival along with a more equitable pattern of income levels.

The projections assume 1) increased labour force participation (primarily for women and the elderly), 2) a fall of the unemployment rate in each country to 5-8%, and 3) a rise in each country's productivity level towards that of Germany.

These objectives imply that between 2014 and 2030 Europe as a whole will need to grow at about 2.7% per year, based on an underlying growth rate of employment of 0.9% and of productivity of 1.8%.

Convergence within Europe will be achieved so long as 1) Germany, other countries in Western Europe and the Nordic countries are growing slower than the average (i.e., 1-2%) while 2) countries in Southern Europe, such as Italy and Spain, and in Eastern Europe will be growing faster than average (i.e., 3-5%).

Table 2. Average growth rates of GDP, employment and productivity

	1998-2007	2008-2013	2014-2030 Projected
GDP	2.2	-0.2	2.7
Employment	0.9	-0.4	0.9
Productivity	1.3	0.2	1.8
Labour Supply	0.6	0.3	0.6

Source: CAM Modelling

New EU Investment Programmes

But such economic convergence will be dependent on reviving investment through concerted industrial policies and location policies across Europe. These efforts will have to significantly exceed, for example, current efforts of the EU's Structural Funds and the European Investment Bank.

Of course, one option could be to increase investment through direct fiscal support from the EU's budget. But a more feasible approach would be the issuance of Euro Bonds by the EU in its own name. Provided that such bonds are backed by the European Central Bank, they will raise substantial international financing at a relatively low cost.

Most importantly, such financing could support ambitious public investment programmes that promote both economic recovery and convergence of productivity across EU member countries. Such investment would support, for

example, long-term projects that build vital infrastructure in transport and communication, protect the environment and advance health and education.

EU financing of public investment could also provide a lever for location policies offering benefits to enterprises that agree to locate new or expanded facilities in regions that need accelerated economic development.

Between 2008 and 2013 average investment as a % of GDP across Europe as a whole dropped from 18.6% to a very low 15.6% (Table 3). The CAM macro model projects that implementation of the public policies outlined above could boost this average investment ratio back up to 20.1% by 2020 and to 22.3% by 2030.

Table 3. Investment as % of GDP

Country/ Bloc	2008	2013	2020 Proj.	2030 Proj.
Europe	**18.6**	**15.6**	**20.1**	**22.3**
Germany	17.0	16.6	19.8	19.7
Other Western Europe	19.1	16.8	19.2	19.2
Nordic Countries	18.1	15.7	17.1	16.2
United Kingdom	14.5	13.5	16.6	19.5
France	18.1	16.6	19.7	22.0
Italy	18.9	15.6	21.9	26.0
Spain	24.7	15.5	22.3	27.7
Other Southern Europe	18.4	9.0	17.2	25.0

Source: CAM Modelling

But in order to promote greater convergence within Europe, the investment ratio in the countries of Southern Europe would have to be increased substantially, to a range of 25-28% by 2030. At the same time, the investment ratios of Germany and other countries in Western Europe would be maintained at 19-20%. The UK's investment ratio would be about the same while France's would be 22%.

Strategic Location Policies

In tandem with public investment programmes, stronger and more strategic location policies need to be implemented in order to improve the distribution of trade and investment between countries and regions.

While EU Structural Funds have been targeted, up until now, at poor regions within countries, location policies need to be scaled up to focus resources, in addition, at the national level. Not only should they be designed to upgrade the competitiveness of lower-income countries but also they should seek to reverse declining competitiveness in higher-income countries. Such comprehensive efforts will contribute to the rebalancing of economic advantages across Europe as a whole.

Unfortunately, in the absence of EU coordination, the competition to convince European and international firms to set up operations in a particular location is usually won by high-income regions that have already managed to attract sizeable clusters of successful industries, particularly manufacturing and service firms specialising in exports.

Thus, development agencies need to be activated at both the national and sub-national level in order to help negotiate agreements that contribute to rebalancing competitive advantages across Europe as a whole. Such support is particularly important in the area of innovation and technology policies, which tend to favour firms already at the high-tech end of the spectrum.

Social Policies

In times of economic difficulty, when governments are pressured to balance budgets by reducing transfers and cutting social services, the principles of 'Social Europe' are particularly relevant. Europe is noteworthy for having a well-established social welfare system. But this system is currently under serious threat.

However, as part of any European economic recovery programme, there is a strong case, in fact, for maintaining social programmes, particularly in lower-income countries and regions. This includes vital programmes for health, education and care for children and the elderly.

Maintaining social spending at decent levels need not, in fact, be costly. Based on analysis of government social spending (adjusted for the greater need of dependents, such as children, the young and the elderly), the CAM model projects that the yearly financial cost of maintaining common standards across the EU would be 0.9% of its combined GDP through 2030 (See Table 4 on next page). The projections show that between 2020 and 2030, initially significant social costs for Southern Europe would decline while corresponding costs for countries such as France and the UK would rise.

The EU contribution to such social spending could be financed in the same way that this Policy Brief has advocated for strategic public investment, namely, through Euro Bonds backed by the ECB.

ECB Financing of Debt

Unfortunately, none of the policies outlined above—which include public investment programmes, strategic location policies, and social policies—will be feasible if the onerous public debt of many governments across Europe is not directly addressed.

Table 4. Final Cost of Social Programmes (% of GDP)

Country/Bloc	2020	2030
Europe	**0.9**	**0.9**
United Kingdom	--	0.9
France	0.1	1.1
Italy	0.4	0.3
Spain	1.1	0.5
Other Southern Europe	2.5	1.3

Source: CAM Modelling

As already indicated, CAM projections suggest that the average debt of Europe as a whole will remain relatively high, even by 2030 (well above 60% of GDP). High debt levels will particularly be the case for major countries such as France, Italy and Spain.

Poorer countries such as Greece and Portugal will continue to face a very bleak future indeed. Hence, some mechanism for the EU-wide financing of their debt burdens, such as through a 'lender of last resort' function, is badly needed.

The mandate of the existing European Stability Mechanism is far too limited for this purpose, and its conditionalities far too burdensome. Hence, the European Central Bank should be mandated to fulfil this requisite function for debt-distressed countries.

In 2013, the average government debt across Europe as a whole represented 87% of the continent's combined GDP. About 30% of this debt was financed by domestic banks and the other 70% by international lenders.

In 2020 when the Europe-wide debt is projected by the CAM model to still be 76% of GDP, the ECB is assumed to account for about 10% of its financing, thereby critically reducing the role of international lenders, which tend to charge high interest rates. By 2030 such ECB financing is most likely to be reduced to a small residual amount, focused on supporting only the worst-affected countries in Southern Europe. Hence, the overall cost of such debt financing should be manageable for the EU.

Summary Remarks

This Policy Brief has drawn on a much longer background Memorandum in order to chart out an ambitious but credible strategy for economic recovery in Europe. This strategy stands in stark contrast to current policies of sustained fiscal austerity.

The proposed recovery strategy has two major components: 1) significantly expanding aggregate demand, particularly public and private investment, and 2) explicitly allocating resources in order to rebalance the differentials in competitiveness that have widened across Europe since 2000. Thus, this strategy is both expansionary and broadly redistributive.

The Policy Brief has focused on the implications of such a strategy for public investment programmes, strategic location policies and social programmes. The costs of such interventions have been examined and how they could be feasibly financed has also been identified.

In addressing costs in particular, the Policy Brief offers proposals on how the onerous debt burden of many EU member states could be reasonably managed and adequately financed—affording them, as a consequence, the fiscal space to undertake the more expansionary economic and social policies that a credible recovery strategy would imply.

The AUGUR project brought together six research groups in Europe plus associates in Brazil, China, India, and South Africa to examine prospects for Europe and other parts of the world under alternative hypotheses about patterns of both global governance and European governance. The final research papers from the project are available in the following book: Eatwell, John, Terry McKinley and Pascal Petit (eds) (2014). Challenges for Europe in the World, 2030. Surrey, United Kingdom and Burlington, Vermont (USA): Ashgate.