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From crisis to cohesion
Restoring growth in Southern Europe

Weak growth in the euro area has been caused by the crisis in Southern Europe, where, since 2009, gross domestic product (GDP) has fallen in three countries and grown only minimally in Italy. New growth and cohesion require different national strategies and European policies and institutions.

1. Southern Europe's growth revisited

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

The recovery in Southern Europe was weaker than in Germany and ended when the sovereign debt panic struck. The euro area also suffered from an early switch to a more restrictive fiscal and monetary policy that led to a double-dip recession. The banking crisis and the sovereign debt crisis reinforced each other while the EU and the ECB failed to respond decisively. The crisis exposed the institutional deficits of the EMU, such as the lack of a clear lender of last resort and a central treasury.

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

Contrary to widespread belief, it was not profligate public spending and exploding sovereign debt that caused the Southern European debt crisis. Actually, until 2008, the public sector's balance improved in Spain and Italy and declined moderately in Greece and Portugal. Budget deficits shrunk until 2009 in all four countries, but increased afterwards. Private households, however, took on new liabilities and thus substantially reduced their net wealth. After the financial crisis, the private sector deleveraged. The public sector increased its debt substantially (by 30 to 50 percent of GDP) in order to bail out banks and stimulate the economy.

The major cause of current account deficits was not declining competitiveness but expanding imports due to growing internal demand. Actually, between 2000 and 2008 (and between 2000 and 2013) all four countries experienced stronger export growth than the so-called "export champion" Germany. Their export market shares hardly changed between 2000 and 2008.

The high income elasticity of imports points to a structural weakness of the domestic supply which is not able to fulfil domestic demand. Furthermore, the specialisation pattern of the GIPS economies relies too heavily on low-wage, low-tech industries, which, after the opening of the

European market in the 1990s, compete against Central and Eastern Europe, China and other emerging economies with much lower wages.

Actually, given these structural weaknesses, it is their relatively good export performance that is surprising. Not only did unit labour costs increase faster in the GIPS than in the core Eurozone; their global price competitiveness was also harmed by the strong appreciation of the euro against the US dollar, which increased their export prices much more strongly than domestic costs (by about 80 percent between 2003 and 2008).

In a monetary union, profitable investment in the non-tradable sector should be no problem, even if it leads to higher imports, because it will be financed by an integrated financial sector. The problem that was exposed or created by the global financial market crisis, was the overstretched balance sheets of the national banking sectors. Their expansion had been based on an assumption of continuous growth of the national economies. With the sudden recession and the collapse of bank credit, many debtors became illiquid if not insolvent and many investments were no longer profitable.

When the inter-bank market collapsed in the crisis and the EU started to treat each banking sector and country's sovereign debt as a separate national problem, this created a vicious circle of weak banking sectors, overstretched public finances and recession.

2. New growth in Southern Europe

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

1. Budget consolidation, which has been the top priority,
2. Balancing the current account, narrowly (and lopsided) interpreted as restoring price competitiveness by lowering wages,
3. Economic growth, which has been belatedly added to the list.

Austerity (1) and wage cuts (2) reduce demand and harm growth (3). The multiplier effects have been critically underestimated. A declining GDP increases the debt ratio. Lower wages reduce tax revenues, thus further undermining budget consolidation. In the end current accounts turned positive due to reduced import demand rather than increasing exports. One central problem of all the GIPS economies is the high level of uncertainty – caused by the conflicts over economic policy and distribution of adjustment costs – that prevents investment. Given the continued deleveraging of the private sector, recovery depends on an expansionary fiscal policy, which the EU has excluded from its tool kit and which is prohibited on the national level by the strict fiscal rules.

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

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

- **Expanding the domestic market** should not be limited by balance of payments constraints in a monetary union. As long as projects geared towards the domestic market such as housing are profitable they are perfect investments for the savings of surplus countries in a currency union. The necessary funds would normally be channelled through the banking system (as they were until the financial market crisis) or via expansion of the money supply by lending from the national central banks to the local commercial banks. The insolvency risk of these local banks depends on the sustainability of the investments financed. Public debt in deficit countries will provide a sustainable return on investment for the banking sector, too, as long as the underlying economy grows nominally faster than the interest rate. In a general crisis (as in 2008/9), the ECB has to stabilise financial markets in order to prevent the undesirable equilibrium of excessive risk aversion towards (public) debt and corresponding disproportionate interest rates. It should in fact aim at the better of the possible multiple equilibria, namely low interest rates and confidence in sovereign debt.

National strategies and reforms have to be accompanied by European ones if Europe is to achieve recovery and balanced growth.

5. Balanced growth in Europe

Substantial changes in the European growth model are needed to promote sustained growth and cohesion. For decades, European economic policy has been biased towards the supply side and eyed the demand side with suspicion. Some recent cautious corrections of this lop-sided approach have to be strengthened and extended. Foreign demand for exports from the euro area will be supported by a weak euro, which corrects the pre-2008 overvaluation. The ECB's current unconventional policy has been helpful in this regard. Three domestic demand components need attention and support:

1. **Wages** drive consumption and should grow in step with productivity. Actually, econometric studies show that growth is wage-led in most EU countries. This implies stable real unit labour costs, at the least. Given the long-term decline of the wage share in many countries, there is even distributional space for higher wage growth. While wage-setting should remain the prerogative of the trade unions and employers, public policy can provide guidance by setting public sector wages and statutory minimum wages. Social benefits per recipient, which define a reservation wage, should increase in line with GDP/capita. Wage restraint is a poor and harmful way to restore competitiveness and reduce current account deficits.
2. **Investment** has been particularly weak in Europe. Investment depends primarily on expectations regarding demand and stable political conditions. Trying to stimulate investment through higher profits (to be achieved by lower taxes, wages or interest rates) has not worked. Before 2008, the share of gross fixed capital formation in GDP was around 20 percent, and declined to slightly above 17 percent in 2013. If one compares the current level with the peak of 2007, the annual gap amounts to approximately 450 billion euros. The major European initiative to restore investment is the European Fund for Strategic Investment (EFSI). However, with a planned non-recurring volume of 315 billion euros it is too small. It should also be better targeted towards promoting growth in Southern Europe and other poorer member states. The strategy needs to focus on rebalancing the external accounts by promoting exports and import substitution in deficit countries. The decline in public investment has to be reversed.
3. **Government spending** is not a drag on economic growth but an integral part of it. The redistribution of income stabilises demand by dampening savings in the richer strata of the society. Public spending on education, health and infrastructure increases private sector productivity in the long run. It should not be constrained by limits on budget

deficits and public borrowing. The fiscal "golden rule" is a far better guide for regulating public finances.

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

- **Monetary policy** has shouldered most of the burden since 2012, when Mario Draghi eventually adopted a more offensive strategy of low interest rates and quantitative easing. However, this has not been enough. The ECB must become a true lender of last resort for all sovereign debt (including the Greek). It must treat the Eurozone as one single economy with benign neglect of current account imbalances. Support for all commercial banks in the euro area through the system of central banks should be unconditional of nationality and take into account only the quality of their assets.
- **Fiscal policy** has been pro-cyclical and has undermined growth. As mentioned above it should accommodate a rise in public investment. Moreover, it should be expansionary in a period when the private sector is massively deleveraging. A truly single Eurozone economy needs a common treasury with a true fiscal capacity for collecting taxes and issuing bonds. The use of special funds and the European Investment Bank (EIB) is too weak a substitute.
- A **banking union** that really treats the financial industries of all member states as part of a single financial market must underpin the currency union. The first steps creating single supervisory and resolution mechanisms and deposit insurance go in the right direction, but are not sufficient. The vicious circle between the creditworthiness of banks and of the national treasuries has to be broken. The solvency of banks must not be judged on the basis of their nationality but on the quality of their balance sheets. Bailing out banks contributes to growth and can even benefit government finances if done in a sensible way.

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