Italy in the Great Transition: Europe, labour, fairness

ITALY IN THE GREAT TRANSITION: EUROPE, LABOUR, FAIRNESS

PRESENTATION

According to the guidelines of the "European Semester", Italy, along with all the other member states of the European Union and Eurozone, is required to present the European Commission and Council with an updated version of its Stability Programme and National Reform Programme (NRP) this April. The importance of these documents has been amplified by the increasingly pressing need to coordinate economic policies in the Eurozone, not just to reflect decisions taken in recent months – both those already in force (Six-pack) and those which are at ratification stage (Fiscal compact) – but above all, in response to a phase of growing economic, social and financial tensions.

This document, unlike that presented last year by the Italian Democratic Party (Partito Democratico, PD) and the Fondazione Italianieuropei, is not an NRP, but an attempt to offer an analytical contribution and some specific policy guidance for the NRP drawn up by the Monti government. It is structured into an opening chapter dedicated to the Eurozone, a second chapter on Italy, followed by four focus sections concerning distribution of income, regional divides in Italy, the labour market and industrial policies. These focus points were chosen to give visibility to those important economic variables that have been neglected for the purposes of sustainable development (distribution of income and industrial policies), or considered from a perspective with little empirical basis (the labour market and regional divides). We would like to insist upon an analysis of the critical issues in the Eurozone and in Italy, because the debates and initiatives concerning European and Italian policy continue to focus on an unfounded reading of the problems. Without a correct analysis of the problems, the answers are likely to be wrong or at best inadequate. In the European Union and the Eurozone, the chain of recession-stagnation-recession, the rise in unemployment, the uncontrollability of national debt and financial instability is no coincidence. It is the result of an inadequate economic policy, which in turn is the result of an

unfounded analysis. European national governments' promises of growth are at risk of being futile without a radical rethink of economic policy in the Eurozone.

The obsessive insistence on public finance imbalances as being the cause of the Euro's woes is misleading. Given the current European state of affairs, the hopes placed in structural reforms, which are nevertheless useful when well designed, are illusory, given the lack of aggregate demand and the vast unused manufacturing capacity. Instead, if we are to understand the problems of the Eurozone we must necessarily focus on the imbalances in the balance of payments; such imbalances are rooted in differentials of competitiveness, in the short-sighted choices of economic policy implemented at national level (especially in the so-called "periphery countries", but also in "virtuous" states) and, to a great extent, in the inadequacy of the economic governance instruments at European level.

Looking at Italy and at the meagre growth of its economy, we should resist making a dismissive interpretation of the competitiveness problem whereby it is merely necessary to act on the cost of labour, both by implementing wage deflation and by introducing further flexibility. This interpretation should be countered with a line of intervention which improves the productivity of labour through investments in physical and human capital, as well as wide-ranging actions and policies aimed at boosting the total factor productivity. Given our country's aptitude for manufacturing, a priority focus of attention should be that of reactivating industrial policy.

The focus points on Italy also include several proposals. The priorities indicated are to be understood in synergy with the programming proposals defined by the PD over the past two years. For example, the focus on the distribution of wealth should be read bearing in mind the proposals for fiscal reform ("Fisco 20, 20, 20") and those for social policy and welfare reform; while the focus point on industrial policies should be read bearing in mind the measures proposed by the PD for schools, universities, research, innovation, the green economy, and policies for infrastructures and logistics. In short, the focus points contain special and partial aspects of a strategy for sustainable

development which should be interpreted as a coordinated whole of interventions across multiple sectors.

This was the strategy of development, sustainable in economic, social and environmental terms, set out in the document “Europe, Italy. An alternative plan for growth” put forward by the PD and by the Fondazione Italianieuropei in March 2011 as an alternative to the Berlusconi administration’s NRP. This strategy identified two systemic and complementary objectives which together directed and guided all sector reforms: **raising the female employment rate to 60% by 2020** (in other words, around 3 million more women in paid employment compared to today); **enhancing Italy’s productive specialisation**.

These objectives should guide investments in knowledge, industrial and fiscal policy measures, structural reforms (especially the completion of liberalisations, the reorganisation of public institutions and requalification of public expenditure, and the regulation of democracy in the workplace), and investments in logistics.

The female employment objective, which requires the existence of high-quality social services and adequate financial resources, is closely linked to the objective of youth employment and, consequently, that of employment in Southern Italy. The increase in manufacturing specialisation is connected to an improvement in productivity, which in turn can only result from making adequate investments, especially in the manufacturing sector.

As in our NRP of last year, we once again stress that the medium term objectives for public finance (2020) are achievable in economic terms and sustainable in social terms only as part of a strategy which is oriented towards development in the Eurozone and in Italy. Otherwise, the “pessimistic” scenario presented in Chapter 2 of this document would become far more likely, a scenario which incorporates the effects on public finance resulting from the reforms of recent years and from the restrictions imposed by the Fiscal compact.

The aforementioned strategy requires us to take the path indicated most recently in the statement presented in Paris ("Renaissance for Europe") by the Foundation for European Progressive Studies and by the Fondazione Italianieuropei (Italy), the Friedrich Ebert Stiftung (Germany) and the Fondation Jean Jaurès (France), and endorsed by the Italian Democratic Party, Socialist Party of France and the Social-Democratic Party of Germany. It offers an alternative route to the trends in economic policy currently being followed in the eurozone, dictated by the conservative governments of Berlin and Paris, and is the path already indicated in the aforementioned document of March 2011:

I. **To allow the European Stability Mechanism (ESM) to finance itself directly on the market** through the issue of Eurobonds guaranteed jointly by all countries;

II. **To allow the European Central Bank (ECB) to operate as lender of last resort**;

III. **To turn into *Stability bonds* the part of public debt** due to the crisis or, alternatively, the part exceeding 60% of the GDP of each country (for example, according to the "redemption pact" scheme devised by the German government's Council of economic experts);

IV. **To introduce a European wage standard** to make sure that the real wage growth is in line with the rate of growth of productivity; the standard should encourage a redressing of the balance between countries with a trade surplus and those with a deficit;

V. **To update and implement Jacques Delors' idea for a European Development Plan focused on public investments and the production and consumption of common goods**, which are necessary not only to generate sustainable development across the continent, but also to rebalance growth rates in the different areas of the EU. This would be financed with **project bonds** and/or specific fiscal

instruments at European level, including the **financial transaction tax** and an increase in environmental taxation;

VI. **To promote a more balanced distribution of primary income** (that earned on the labour market, particularly in countries with the greatest competitiveness), and **secondary income** (supported by tax interventions and welfare), in order to restore families' spending power and security.

To sum up, we propose a feasible course of action which is focused on enhancing employment, for sustainable development on a macroeconomic, social and environmental scale in Europe and in Italy.

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ITALY IN THE EUROPEAN CRISIS

European unity has never seemed so drastically at risk as in recent months. The long path towards the commercial, monetary and political unification of Europe which began over half a century ago has been brusquely interrupted and could now make a dramatic U-turn. The global economic crisis which exploded in 2007, followed by the Great Transition currently underway, highlighted the structural weaknesses and internal conflicts within the European Union and the Eurozone. The entire apparatus of macroeconomic convergence (Maastricht Treaty, Stability and Growth Pact, and so on), now appears to be insufficient to make the project approved by the European Treaties become a sustainable reality. Not only have there been vast obstacles due to differences in the major macroeconomic accounting areas (deficits, debt, inflation, etc.), but also problems connected with micro-economic structures and attitudes, on which neither market forces nor political measures – not least the Lisbon Strategy – managed to impose corrections and lead to convergence processes. Already, the experience of the European monetary system had not stood the first asymmetrical blow within the European Union, i.e. the need to finance the unification of Germany.[1] The recent crisis seems merely to have confirmed the doubts expressed by many economists as far back as the early 1990s.[2]

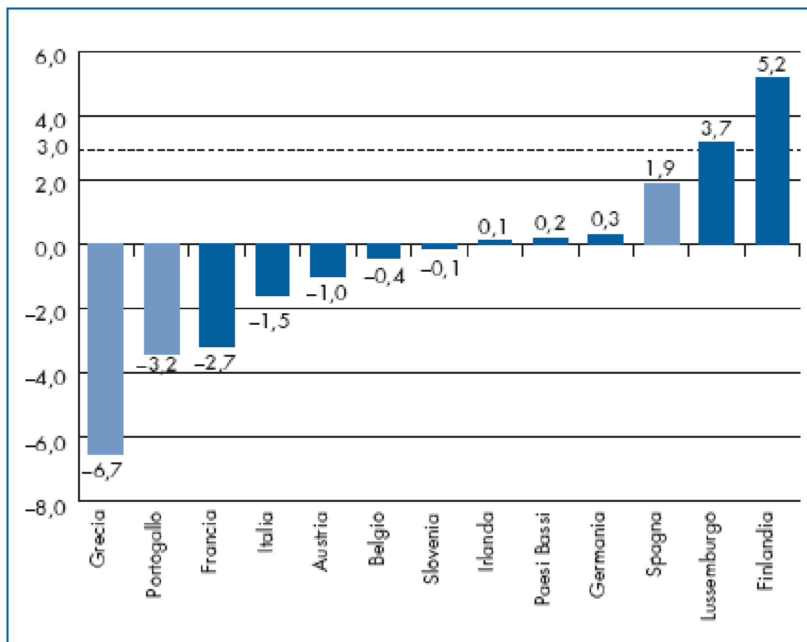
Curiously, the prevailing analysis in Europe has so far been almost exclusively focused on public deficits and the explosion of national debt. Yet if we closely observe the dynamics of national debt, it is truly difficult to identify this variable as being the element which triggered the crisis, nor as an explanation of the extremely difficult situation in which certain countries,

[1] Other, lesser turbulences, which had a knock-on effect on European interest tax rates due to the oscillations in the exchange rate between the German mark and the US dollar, had also demonstrated how the convergence process was not at all robust when it came to shockwaves from outside the European Union.

[2] P. De Grauwe, *The Economics of Monetary Integration*, Oxford University Press, Oxford 1992.

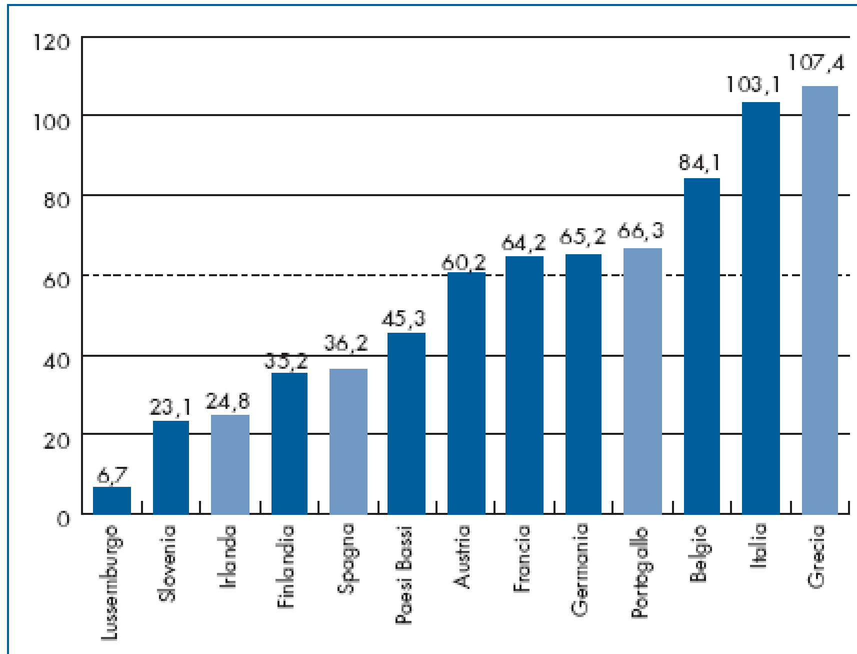
especially those in the Mediterranean area, currently find themselves. Indeed, the position of the euro area at the beginning of the crisis was anything but undermined, both at aggregate level (a deficit/GDP ratio of 1.5% and a debt/GDP ratio of 66.4%), and for individual member states (Figure 1). Even states which were traditionally considered weak in fiscal terms and with less credit from the international community, were all in the process of recovering and consolidating debt, with the exception of Greece, due to its notoriously fraudulent management of public finances. The other members of the so-called "PIGS" group – Portugal, Spain and Ireland – presented levels of indebtedness lower than the European average (Figure 2)

Figure 1. Public deficit/GDP ratio in EMU countries (2007).



Source: OECD, Economic Outlook*, n° 89, June 2011.*

Figure 2. Public debt/GNP ratio in EMU countries (2007).

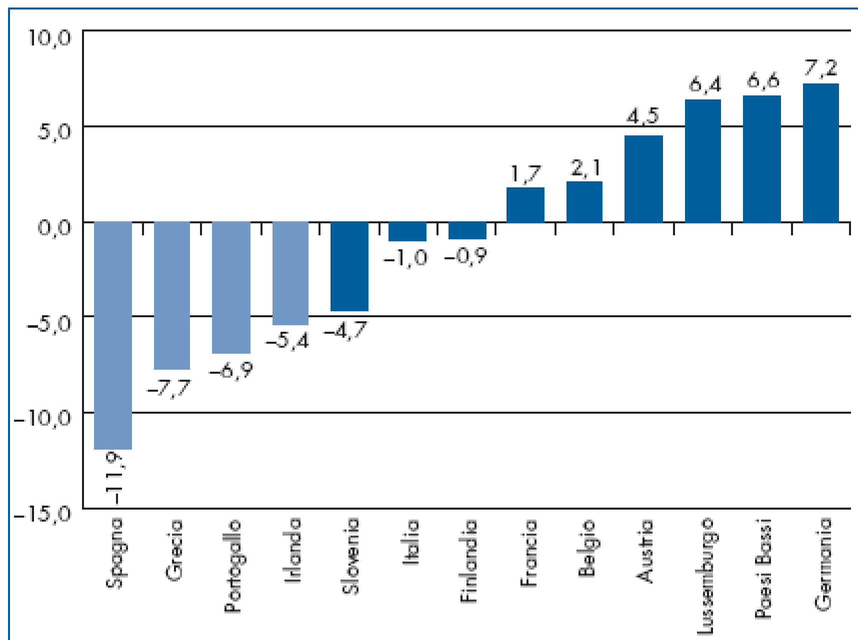


Source: Eurostat.

Rather than their public finance situation, what most draws together the countries which experienced the worst troubles after the crisis erupted is the high and systematic **private sector deficit**, which in all four cases was not only much greater than public deficit, but also completely lacking in any sort of monitoring by the European authorities (Figure 3). After having erected tall, robust firewalls against excesses in the public sector, Europe found itself unprepared when faced with a raging fire which began in the private sector and spread without encountering any obstacles or, subsequently, adequate political responses. The subsequent explosion of national

debt was, then, not the cause of the staggeringly large default in the private sector, but rather one of its effects. Indeed, member states' budgets were burdened with not only the subsidies provided to help floundering businesses and unemployed workers, but also vast expenditure to save the banking system, with astounding peaks in countries such as Germany and Greece itself. Merely curing the effect, rather than the cause, does not seem the best medicine if we are to avoid relapses in the future.[3]

Figure 3. Private sector deficit/GNP ratio in EMU countries (2007).



Source: OECD, op cit.

[3] De Grauwe, *Fighting the Wrong Enemy*, in "voxeu.org", 19 May 2010.

If, alongside the surveillance of public finances, equal attention had been paid to the dynamics of the private sector, it would have been possible to understand in good time many of the reasons behind the explosion of the vast differences between the countries being monitored since the single currency was created.

These differences concerned, among other things, the growth rate of money supply, real wages, economic growth and the balance of payments. Even after the crisis flared up, the only element even partially taken into consideration by the European institutions – namely, trade imbalances – was almost entirely attributed to competitiveness issues, to be resolved through "structural" reforms (liberalisation, decentralisation of bargaining in the labour market, reduction of rigidities, etc.) by the individual countries with deficits. The reform made by European governance, the Europlus Pact, the "six-pack", and the fiscal compact recently approved by the European Council, as well as the letter which several EU Prime Ministers sent to the Chairman of the European Commission last February, fit perfectly into this trend: balanced public budgets and reforms on the "supply side" are presented as being the two solutions for getting out of the crisis that the European Economic and Monetary Union (EMU) is in.

With the exception of interventions to strengthen the European Internal Market, these measures are at best ineffective,[4] if not downright damaging.[5]

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[4] Doubts as to the efficacy of the fiscal compact have also been expressed by the Scientific Committee of the German Finance Ministry, which underlined not only the objective difficulties of applying it, but also the severely negative impact it risks having on the European economy. On this matter, see *Fiskalpolitische Institutionen in der Eurozone. Gutachten des Wissenschaftlichen Beirats beim Bundesministerium der Finanzen*, 2/2012.

[5] Indeed, in addition to the commendable intention of paying more attention to the sustainability of debt came the much tougher rule of balanced budgets. If the final goal is economic growth, there are good reasons for wanting to cut national debt, especially in cases such as Italy. There are not, however, good reasons for imposing balanced budgets. See G. Pisauro, *Come funziona il fiscal compact*, in "lavoce.info", 31 January 2012.

As many authoritative Italian and international institutions have certified (Bank of Italy, International Monetary Fund), the restrictive economic policies adopted over the past year have made the European macroeconomic scenario even more uncertain than before, and have not managed to dispel tensions on the financial markets. Therefore, such measures risk being not just useless in containing profligate borrowing, but could even aggravate – rather than contain – the divergent, explosive dynamic between the economies of the various countries. Policies aimed at cutting input costs to increase competitiveness risk hurling the entire continent into a downwards, deflationary spiral with consequences that are difficult to imagine. The very existence of the euro and the single market would be put seriously at risk.

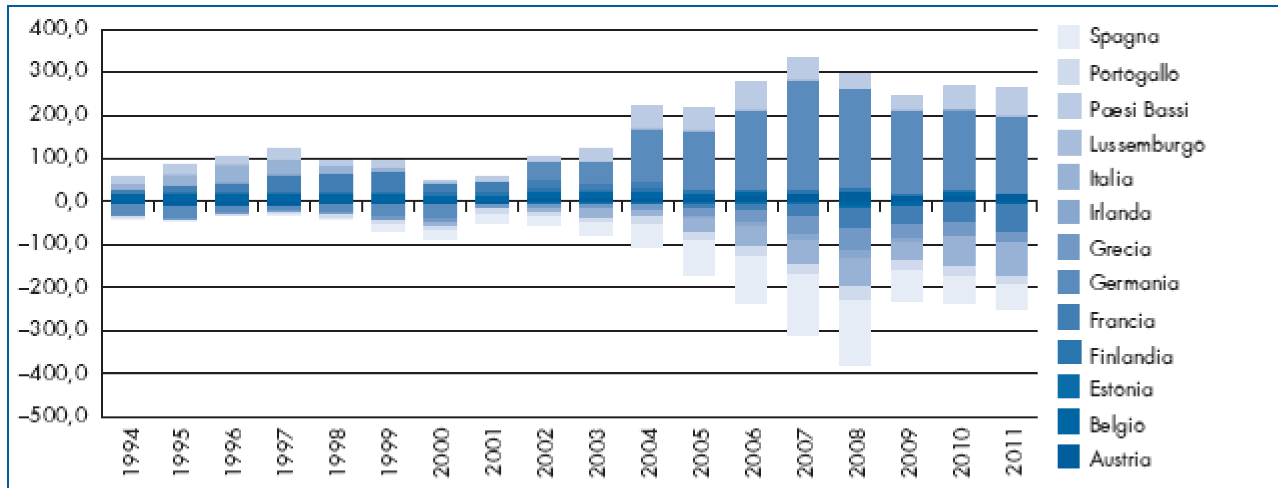
1. Twelve years of Monetary Union

Since the euro was introduced, growing financial and real imbalances have emerged within the EMU, in an institutional and political context which is seemingly unable to see the problem and, therefore, deal with it. Macroeconomic imbalances, rather than being the exception, have thus become the rule on our continent.

1.1. Capital flows and gaps in competitiveness

Firstly, in the 1998-2008 period we observed a considerable increase in the trade surplus of several countries, with the simultaneous increase in deficit in others. This divergent trend was only partially corrected by the crisis, from 2009 onwards, but nevertheless there has not been a structural change (Figure 4).

Figure 4. Trade balance of EMU countries in billions of USD (1993-2011).



Source: OECD, op cit.

Indeed, forecasts for the next few years look gloomy. For many years[6] it was thought that the widening of **trade imbalances** in the EMU was due to the growing financial integration of the member states: in other words, experts believed that countries with a lower GDP per capita would attract more capital than richer countries, and that this would allow an improvement in labour productivity, and therefore a greater growth rate in the future. So, the reasoning went, the increase in trade deficits should neither be a source of worry, nor a reason to request corrective policies; rather, it was a sign that the integration and efficiency of European member states' financial markets had been achieved. However, the way that trade imbalances developed over the subsequent few years led to severe doubts about this set-up (Figure 5).

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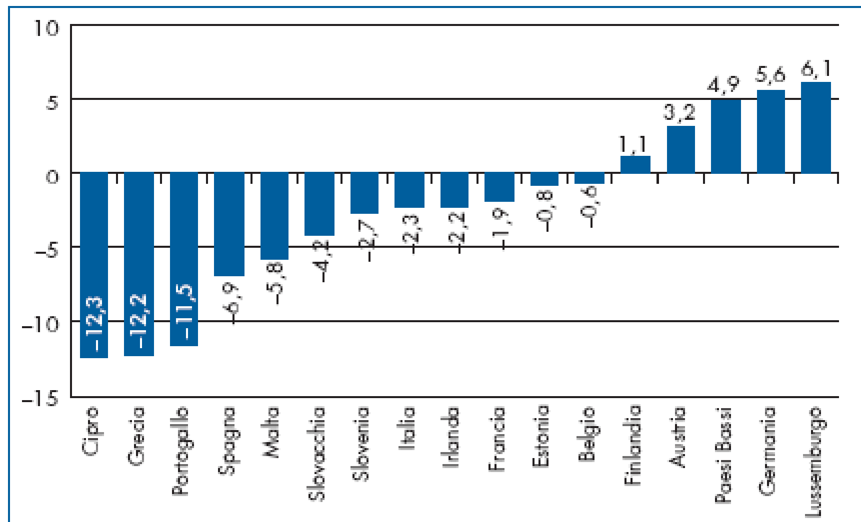
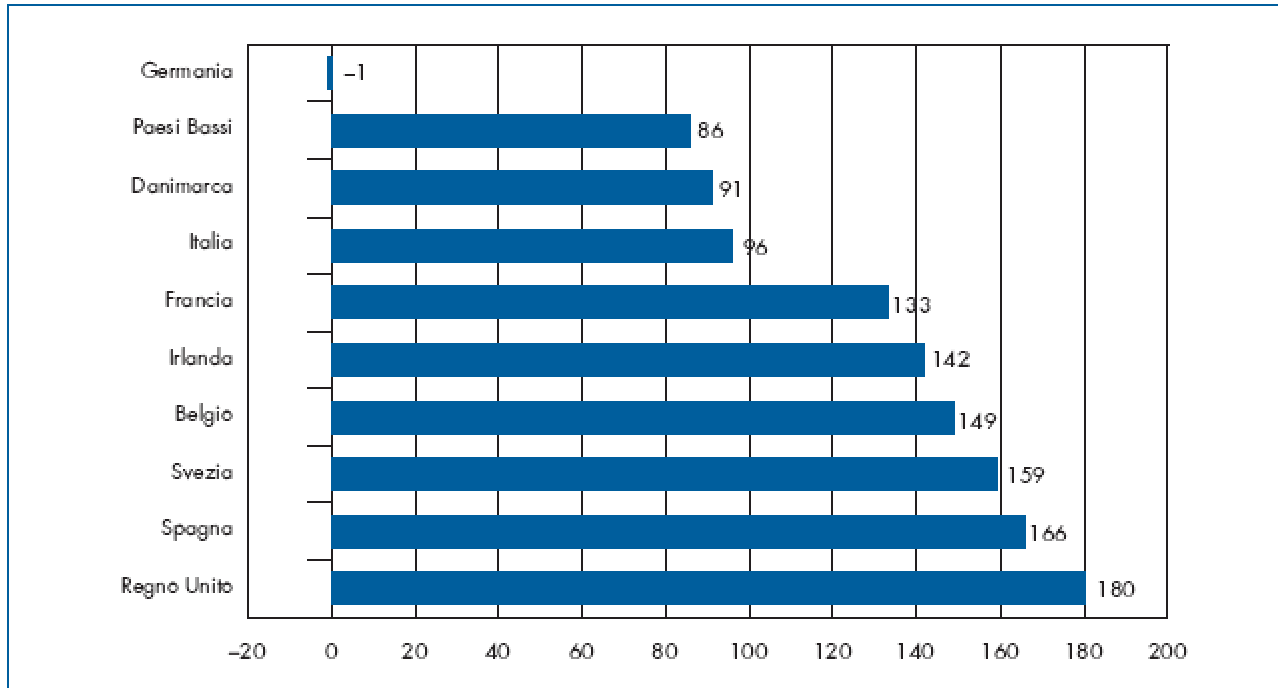
[6] O. Blanchard, F. Giavazzi, *Current Account Deficits in the Euro Area. The End of the Feldstein-Horioka Puzzle?*, Brookings Papers on Economic Activity, The Brookings Institution, 2/2002, pp. 147-210.

Figure 5. Trade balances of EMU countries in relation to GNP (2008-2010 average).



Source: European Commission.

Figure 6. House price variations (1997-2008).



Source: "The Economist".

The European Commission itself[7] admitted that the inflow of foreign capital was not always put to its most productive use, while private consumption was favoured, along with public current expenditure and the explosion of housing bubbles (Figure 6). None of these items would have been able to produce a stable rise in potential output. Many of the studies carried out on the

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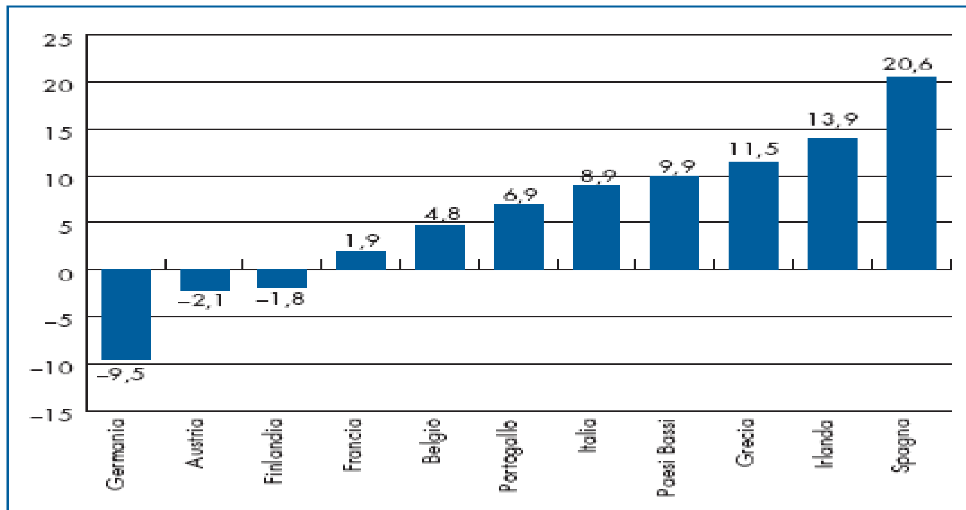
[7] European Commission, *Competitiveness Developments Within the Euro Area*, in "Quarterly Report on the Euro Area", 1/2009.

divergent dynamics of European economies following the introduction of the euro were based on the consideration that such trends reflected growing **competitive differentials** between the various countries. An indicator traditionally used to analyse an economy's competitiveness – its real exchange rate performance – highlighted how, from 1999 onwards, a restricted group of countries increased their competitiveness (Germany, Finland and Austria), while all the others gradually slid down the scale, with an outright crash in Ireland, Greece and Spain (Figure 7).

Behind the performance of the real exchange rate is the even more divergent performance of the unit labour cost (ULC). In the period 1999-2009, the annual variation of this indicator was 0.4% in Germany, while the so-called "PIIGS" recorded increases of around 3% (Figure 8).

Figure 7. Variation of real exchange rate[8] in the EMU (1999-2009).



Source: European Central Bank.

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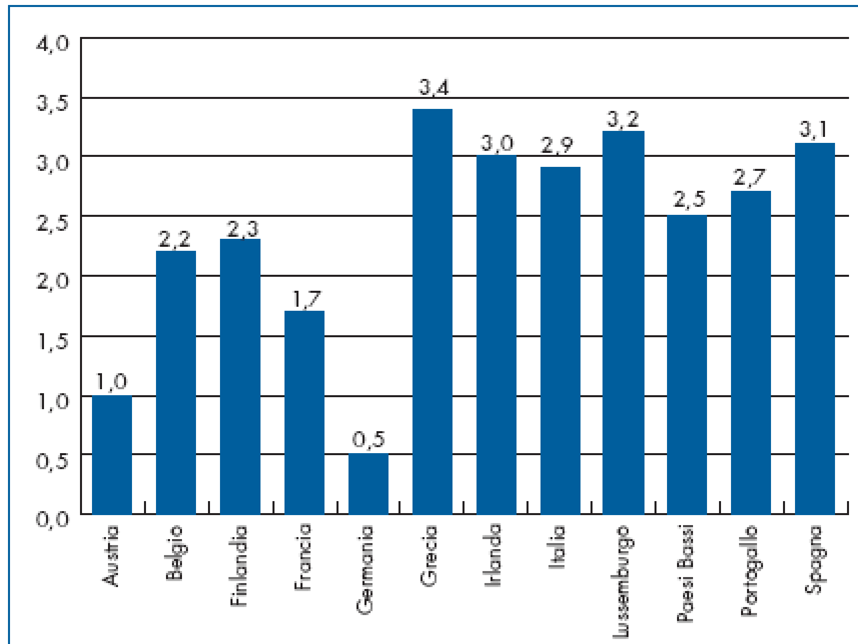
[8] The real exchange rate is calculated based on the GDP.

Figure 8. Unit labour cost (Average annual variations 1998-2008).



Source: OECD.

If we break down the ULC into its two components, we notice how nominal wages and productivity performed very differently in the various countries. The lack of a nominal exchange rate with the capacity to correct any imbalances in competitiveness meant that the variation of nominal wages bore the full weight of correcting asymmetrical shocks. Such a correction, however, did not take place. In fact, Table 1 shows a clear tendency for nominal wages to grow most in those countries which started with a very low level of wages in 1999, despite the stagnation or even reduction of real wages.

This trend should not be surprising: since the introduction of the single currency there has been greater integration (while far from perfect) between the input markets, and in some cases this has encouraged an initial convergence of wage levels. However, if the divergences in wage increases are not enough to make up for differences in growth in productivity, the result will be a variation in the competitiveness of euro area economies. While in the period considered, both Ireland and Greece performed well in terms of productivity, this positive dynamic was more than compensated for by the rise in nominal wages, causing a loss in competitiveness. Conversely, Germany presented wage growth that was systematically lower than productivity, with a marginal increase in unit labour cost.

Table 1. Evolution of nominal salaries, labour productivity and ULC in the euro area (1999-2010).

	Nominal wages 1999 in euros	Nominal wages 2010 1999=100	Productivity 2010 1999=100	ULC 2010 1999=100	Real wages 2010 1999=100
Austria	32.076	124,43	115,05	111,44	99,80
Belgium	36.932	130,60	105,58	123,70	102,64
Finland	29.843	139,06	110,91	125,19	114,69
France	33.690	128,96	113,19	118,46	106,62
Germany	30.690	111,37	112,89	105,99	93,54
Greece	16.479	173,93	129,43	137,88	118,65
Ireland	28.085	164,63	132,57	132,77	120,24
Italy	27.076	126,59	100,68	131,44	98,00
Luxembourg	39.465	135,83	100,62	134,99	104,24
Netherlands	28.978	137,64	112,66	127,28	107,73
Portugal	14.096	142,29	109,98	129,39	105,89
Spain	21.982	141,96	110,05	134,58	101,89

Source: calculated using OECD data.

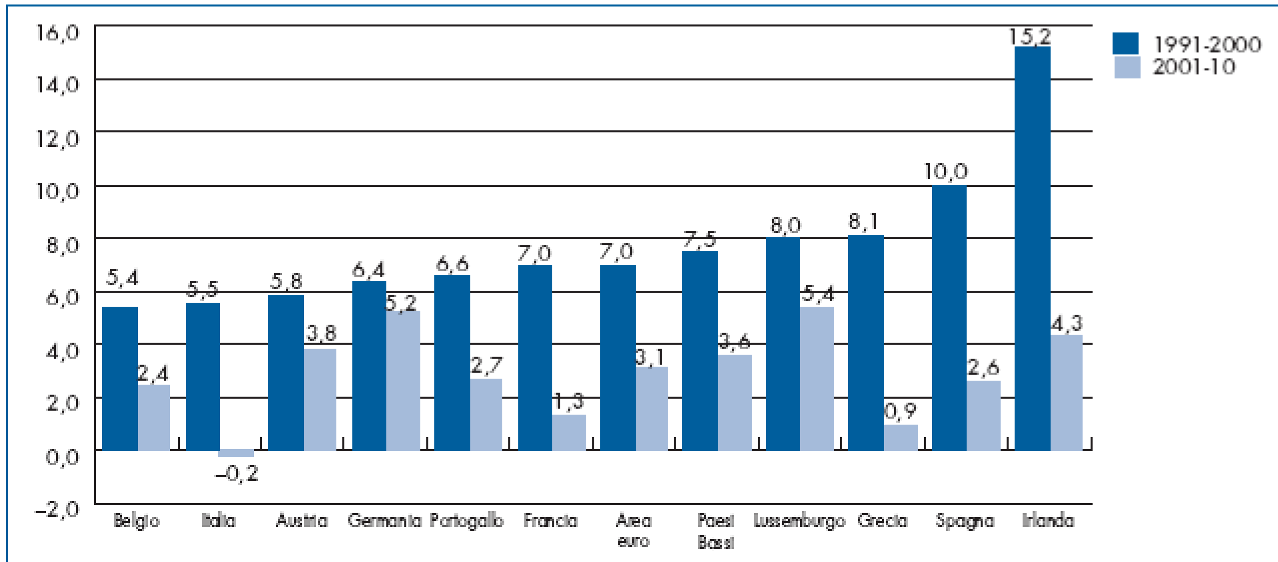
The divergence in competitiveness performance eventually caused a variation in the export shares of each country and, consequently, a growing imbalance between trade balances within the EMU. While there has been a general slowing of exports from all over the Eurozone, the countries which have recorded a more marked drop in annual average growth rates are indeed the PIIGS (Figure 9).

These imbalances are striking not only due to their magnitude (the greatest since 1970), but also due to their persistence over time; this highlights the lack of adjustment mechanisms capable of offsetting the fact that following the introduction of the single currency, competitive devaluations, as had been possible in the 1970s, the 1980s and up until the early 1990s, are no longer an option.

1.2. Who controls credit expansion?

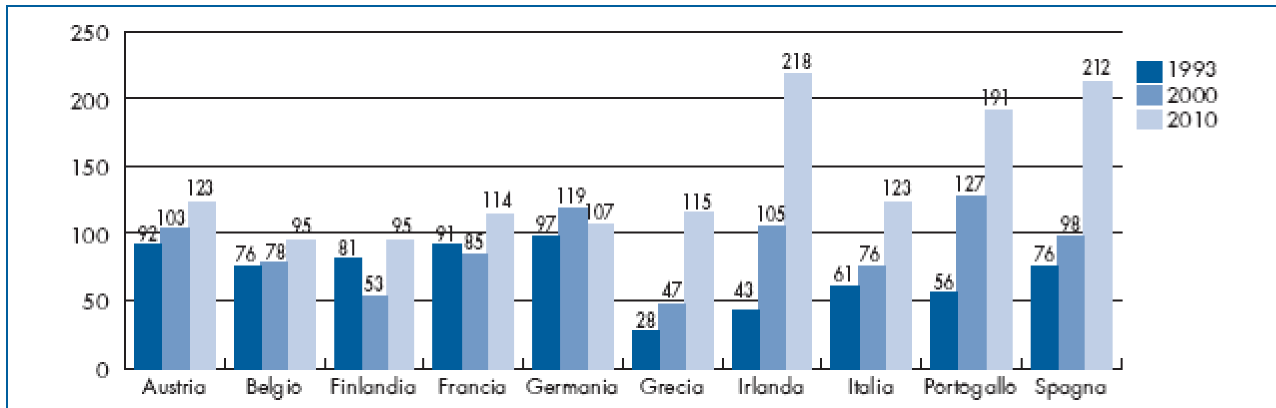
Competitiveness performance is not the sole factor determining a country's external position. Another important channel is the **banking and financial system**. It plays a key role in both generating and correcting macroeconomic imbalances. The rapid deregulation process, together with the introduction of new and increasingly sophisticated financial instruments, has meant that despite a common monetary policy, banking systems can determine credit dynamics that sometimes differ widely between countries in the Eurozone.

Figure 9. Average annual growth of goods and services exports in the periods 1991-2000 and 2001-10 (at steady prices 2000).



Source: European Commission, Statistical Annex of European Economy*, 2 May 2011.*

Figure 10. Ratio between domestic credit and GDP (1993-2010).



Source: World Bank, 2011.

Figure 10 shows how the ratio between domestic credit and GDP evolved in various EMU countries since the early Nineties. It stands out immediately that for the entire period considered, the growth of domestic credit was extremely asymmetrical. While Germany and France began with a ratio of around 100% of GDP and, after a slight increase, returned to just above that level in 2010, other countries experienced a much sharper dynamic. Italy's domestic credit more than doubled; Spain's, again in relation to the GDP, almost tripled, while those of Portugal, Greece and Ireland increased fourfold. Although right from the start, as the first pillar of its monetary policy the ECB established an annual growth rate of the broad monetary aggregate (M3) of 4.5% in the medium term, the average growth recorded in the last decade was actually more than 7%.

It is clear that the ECB's claim to have control over M3 does not stand up to reality: banks and other financial institutions in various countries have, indeed, been capable of creating liquidity quite independently of the stated intentions of the Central Bank, and sometimes even going against some of the ECB's restrictive policies. Given the single official interest rate set at Frankfurt,

such a pronounced divergence in credit availability across the various countries may have helped cause different price dynamics, generating a persistent inflation differential. Uncontrolled credit expansion has indeed caused a soft budget constraint for countries in deficit, leading to an increase in public and/or private consumption and therefore a rise in inflation above the European average. The inflationary gap between countries has thus caused, on the one hand, a more pronounced rise in nominal wages and, on the other, lower real interest rates in the peripheral countries, even if the nominal interest rates were practically identical throughout the whole Eurozone. The latter element has resulted in further reinforcing the knock-on effects on aggregate demand.

The result has been a further rise in the current account deficits of almost all countries in the Mediterranean area, and beyond. Conversely, countries with lower than average inflation have had to tackle a period of high real interest rates, which have reduced domestic demand and import flows, improving their trade balances.

1.3. There are multiple causes behind the imbalances

Therefore, as the European Commission itself has admitted, the common feature of almost all European countries is that the divergent performance of current accounts since the single currency was introduced has not depended solely on structural differences in competitiveness, but can be largely attributed to considerable and **persistent differences in the strength of domestic demand** among member states.[9] The European Commission itself suggests a precise timescale whereby – in countries such as Greece and Spain – domestic demand initially rose (due to a faster dynamic of nominal wages), with a consequent deterioration of current accounts, leading to weakened competitiveness, with damaging effects on their export capabilities.

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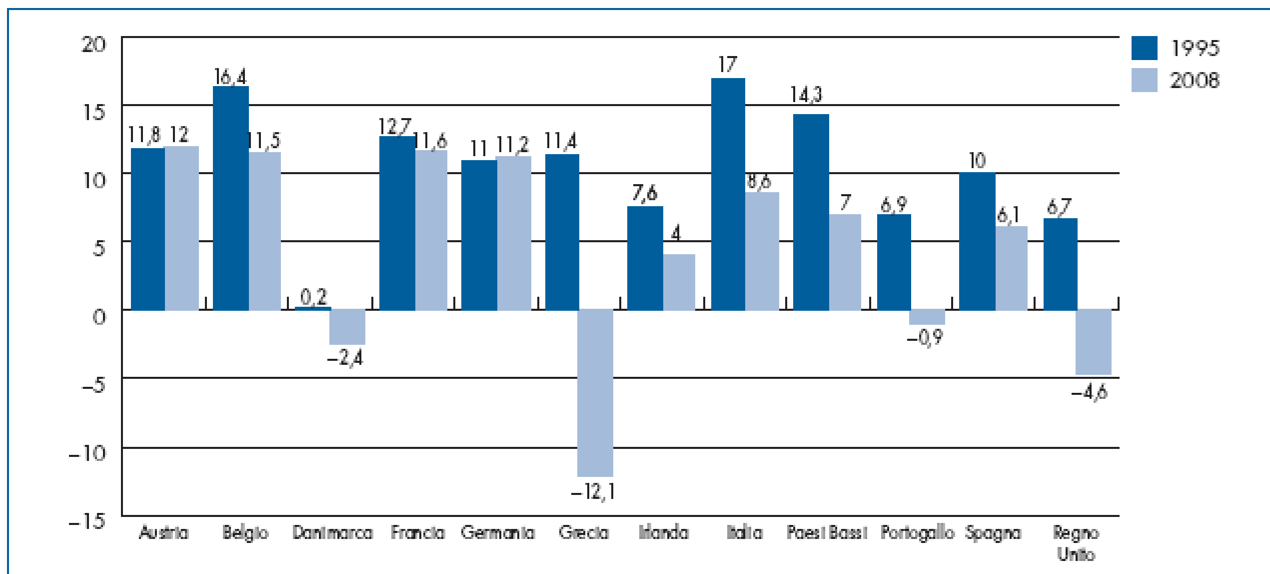
[9] European commission, *The Impact of the Global Crisis on Competitiveness and Current Account Divergences in the Euro Area*, in "Quarterly Report on the Euro Area", 1/2010.

Figure 11. Saving rate in relation to GDP (1995-2008).



Source: European Commission, AMECO.

This was further exacerbated by effects linked to **income distribution**. Even as far back as the 1980s, the countries of continental Europe also, although to a lesser extent than in the UK and US, began experiencing a drop in the wage share in the national income and, within this, a gradual widening of the gap between low and high incomes. But paradoxically, rather than dropping, the ratio of private consumption to GDP remained steady or in some cases, even increased. All this was possible, on the one hand, thanks to the considerable decline of tendency to save (Figure 11) and, on the other, due to consumers resorting heavily to indebtedness, helped along both by the so-called "wealth effect" on real estate and securities, as well as the emergence of new lending

instruments at decreasing costs (Figure 12). The presence of such profitable loans in the Mediterranean area, which were also protected from exchange risks, then stimulated cash flows from central European countries towards the periphery. Indeed, following the introduction of the single currency in countries such as Germany and Austria, saving rates rose slightly, despite the presence of a marked drop in wage shares.[10]

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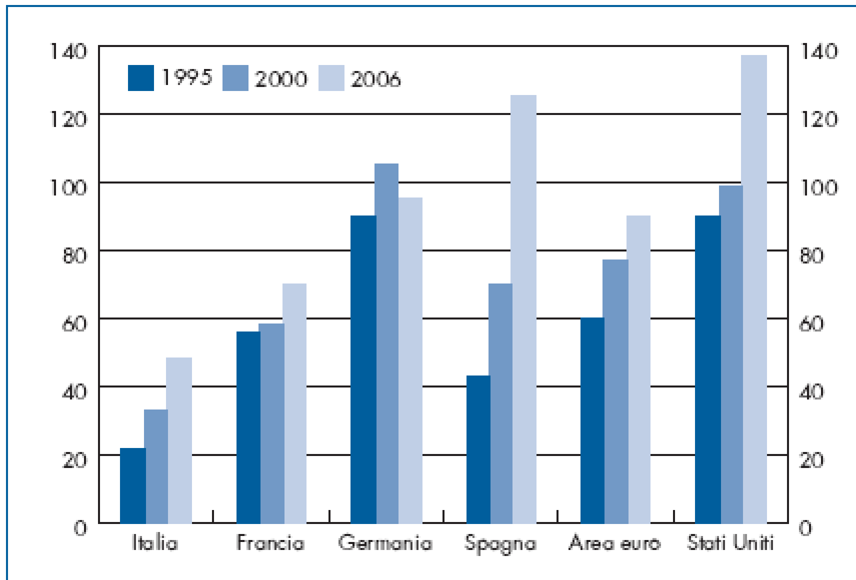
[10] The increase in the German saving rate seems to have partly been influenced by the "Hartz IV" social security reform: after falling steadily in the 1990s, savings in fact made a sharp turnaround starting precisely in the two-year period 2002-03.

Figure 12. Financial debts of families as percentage of disposable income.



Source: Banca d'Italia, Bollettino economico*, n. 52, 2008.*

In the light of these considerations, we can state that the problem of trade imbalances results from the combination of two factors: the **weakness of the European institutional structure** and the **economic policy choices** made both by deficit nations as well as those running a surplus. The Mediterranean nations, instead of directing the vast amounts of liquid assets created by the banking system into productive investments (both private and public), used these resources mainly to finance the housing bubble, credit consumption or current expenditure of the public sector; while these countries are at fault, responsibility also lies with surplus nations, where for years wages increases were lower than the growth in productivity. Moreover, let us not forget that Germany itself, dubbed the "engine of Europe" by the media, rather than driving growth across

the continent, let itself be driven for nearly a decade precisely by the demand for goods – financed by credit – of the PIIGS: without the "vices" of deficit nations, we would not have had the "virtues" of surplus nations. An analysis which only emphasises problems linked to the structural components of competitiveness therefore seems inadequate, as does the idea – which seems to have come out of the decisions made on European governance reform, the Europlus Pact and the Six-pack – that trade imbalances are a problem to be solved by devaluing labour in every deficit nation.

2. The emergency: the sustainability of sovereign debt

Starting in late 2008, the gaps between interest rates on government securities in the euro area – the so-called "spreads" – became very wide. These differentials, while they directly reflect the risk premium on national debt, seem to originate more from the structural conditions of the economies, which in turn determine whether there are satisfactory conditions for sustaining government finances. The evolution of external positions is incredibly important. Even before the crisis, many studies had proven the importance of external debt as an indicator of a country's probability for insolvency,[11] while others had highlighted that there is a very close link between current accounts and spread. More recently, new research showed how[12] the current account has a significant influence on risk premiums and that this is just as important as fiscal deficits as a predictor of differentials between credit default swaps.[13] This empirical evidence also applies to the Eurozone:[14] indeed, the correlation between current accounts and spread – which was tenuous and barely significant in the years immediately after the introduction of the single

[11] P. Manasse, N. Roubini, "*Rules of Thumb" for Sovereign Debt Crises*, IMF Working Paper, 42/2005.
[12] S. Barrios, P. Iversen, M. Lewandowska, R. Setzer, *Determinants of Intra-Eurozone Bond Spreads During the Financial Crisis*, European Economy, Economic Papers, 388/2009.
[13] International Monetary Fund, *Global Financial Stability Report*, April 2010.
[14] D. Gros, 2011, *External versus Domestic Debt in the Euro Crisis*, CEPS Policy Brief, n. 243, 25 May 2011.

currency – intensified from 2008 on. Moreover, deficit and national debt seem to influence spread performance much less than a country's external position does.[15] The same analyses show how the correlation between current account deficit and public deficit is rather weak, confirming that external indebtedness is not just due to deficits in government finances, but other factors also, not least the financial position of the private sector.

2.1. The indiscipline of the member states, or the institutional weakness of the Eurozone?

It is likely that market expectations are not just formed based on national budgets' risk of failure. Purchases of securities – whether public or private – are also influenced when situations of stagnation or external deficit arise. The markets seem to be driven by the suspicion that sooner or later, these countries will decide to tackle their problem of poor competitiveness on the international markets by abandoning the single currency and subsequently devaluing their national currencies. Until recently, this was considered a remote possibility by most economic commentators, but it has become more relevant especially with regard to Greece.

Alongside this there is an equally significant issue which, however, was deliberately ignored for far too long: the **institutional weakness of the euro area**. Indeed, both the Maastricht Treaty and the Stability and Growth Pact are founded on the conviction that the overall stability of the EU should depend upon the good behaviour of each member state. Therefore, a financial crisis must always be treated as a problem specific to the individual country affected, and should never be dealt by EU institutions. However, EMU is by its very nature a union between mutually supportive members: the government securities of each member state are issued in euro currency and can be purchased easily and without exchange risks by all other states. Yet no mechanism has yet been

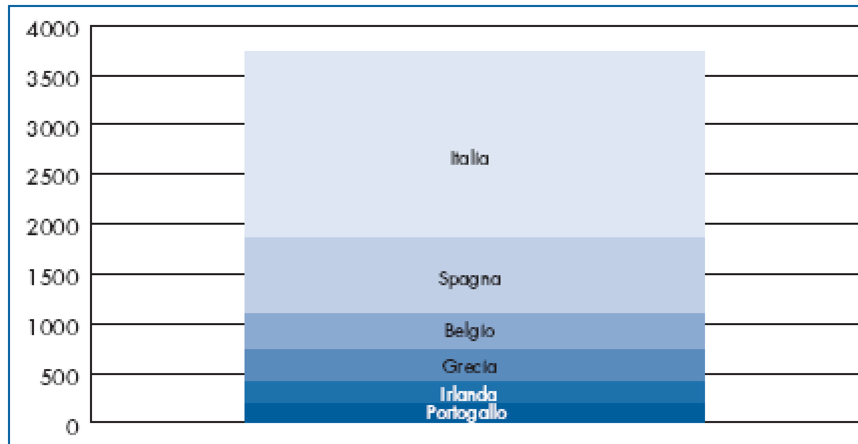
[15] E. Brancaccio, *Current Account Imbalances, the Eurozone Crisis and a Proposal for a European Wage Standard*, in "International Journal of Political Economy", forthcoming publication.

designed that is capable of internalising the debt problem of a specific member state. In other words, there is no way of organising transfers from robust national economies to countries with problems or imbalances. Such a basic form of solidarity is not only not provided for in European treaties, but is in fact forbidden. This shortcoming is one of the elements which in recent months have encouraged financial corporations to speculate against the member states which are struggling the most.

2.2. An insubstantial firewall

The **European Financial Stability Facility** (EFSF), even in its final version which comes into force in 2013 – namely the **European Stability Mechanism** (ESM), with capital of 500 billion euros – delivers neither the legal principles, nor the automated capabilities which would make it credible in the eyes of financial corporations. Even repeated announcements that the EFSF's capital would be doubled have not been enough to safeguard the euro area. An efficient expansion of the EFSF, capable of covering Italy and Belgium even partially, would have required increasing its capital to 1700 billion; this amount would be difficult to obtain for countries already grappling with tough tax restrictions introduced in a context of low growth and high unemployment (Figure 13). This weak point has also undermined the positive introduction of the EFSF's ability to purchase sovereign debt securities on the secondary market. This faculty, brought in to relieve the ECB from its direct interventions on the securities market as it had done thus far, immediately met with a reaction from the markets. They began to focus their pressure on Italy's sovereign debt, once again forcing the ECB to intervene both directly – by making direct purchases in secondary markets – and through non-conventional monetary policy measures such as lowering collateral requirements and granting fixed interest rate loans to commercial banks.

Figure 13. Overall debt in PIIGS nations.



Source: Eurostat.

However, the main problem with the EFSF, aside from its financing, is precisely its mechanism of pro-rata guarantees to raise capital. Faced with further pressures on the markets, the guarantees contributed by certain countries (Italy and Spain) could lose their value, forcing healthier nations – especially Germany – to take on the burden on their behalf. It has been calculated that, should Italy's sovereign debt be severely downgraded, Germany's guarantee commitments would have to increase to as much as 790 billion euros, i.e. one third of its GDP. If France were heavily downgraded in the same way, the guarantees required of Germany would exceed 54% of its GDP. This figure would be impossible to bear, even for our continent's leading economy.

Therefore, alternative solutions need to be found:

1. An initial step could be to **allow the ESM to self-finance itself directly on the market** through the issue of European bonds guaranteed jointly by all member states.

Retaining the pro-rata guarantee system despite the impossibility of resorting to securitisation would in fact mean that their rating would inevitably drop beneath that of the German Bund. Conversely, with a joint guarantee, the eurobonds' rating would approach the maximum, with minimal additional costs.

2. Secondly, the **ECB should be allowed to operate as a lender of last resort**, by modifying article 101 of the Maastricht Treaty, which forbids it to buy the debt securities of member states. While the non-conventional approach of monetary policy choices in recent months[16] leans towards encouraging private financial institutions to purchase public debt securities, this path risks being not only more onerous, but even less effective than a direct purchase on the primary or secondary market. Easing collateral requirements for loans to banks, and changing to a fixed rate system for the main refinancing operations have undoubtedly allowed a greater flow of liquid assets into the system. However, alongside this the strict criteria[17] established by the European Banking Association (EBA) with regard to the capitalisation of financial institutions risks totally nullifying the effects of the aforementioned measures. Vice versa, a direct intervention by the ECB would allow all these limits to be overcome, and would be much more effective. As the British experience of quantitative easing has shown, not only does such a policy on bond yields have a considerable effect, but the mere announcement of such a measure is

[16] Note that the decision made by ECB President Mario Draghi in late 2011 is a clear about-turn compared to the announcement in the monthly bulletin of December 2009 of a process of gradual recovery from non-conventional measures.

[17] The EBA ruled that state securities must be valued at market price, and not at nominal value. This decision had a two-fold effect, especially on Italian banks: on the one hand, having a considerable stock of national securities in the balance sheet, it forced them to carry out a heavy recapitalization; on the other, it discouraged lending institutions from buying securities from countries at risk or under the speculative attack of the markets, in order to avoid loss of assets.

enough to trigger a considerable drop in the risk premium of government securities.[18] Instead, the ECB's decision to announce neither the extent nor the methods of its operations on secondary markets made interventions more costly and less incisive.[19]

2.3. Sharing the risk: eurobonds

What is needed is to find a way of **relieving European countries of the mass of debt accumulated in the post-crisis phase** due to the bailouts for private banking and financial institutions. Most proposals on this matter,[20] as well as some of the studies conducted by the European Commission,[21] assume that a share of each Eurozone country's debt should be turned into eurobonds (stability bonds), jointly guaranteed by all countries. However, these proposals risk leaving individual countries in very different states of debt, with serious risks especially for the most indebted nations, which could be penalised by the markets. An alternative solution[22] could be to create stability bonds by using the amount corresponding to the increase in debt caused by the crisis or – conversely – that which exceeds 60% of each country's GDP. This solution would undoubtedly prove more useful than the events of recent months (consolidations, repudiations, Member States defaulting, financial repression and so on). Each nation should not only use its own budget to finance the service of both domestic debt and stability bonds debt, proportionately to

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[18] M. Joyce, M. Tong, R. Woods, *The United Kingdom's Quantitative Easing Policy: Design, Operation and Impact*, *Bank of England Quarterly Bulletin*, Q3 2011.

[19] It should also be noted that, from the start of this crisis, the ECB's active intervention appears rather limited compared to that of the world's other central bank: the ECB's balance sheet has risen by 77%, compared to an increase of 200% for the Bank of England and 226% for the US Federal Reserve.

[20] See, for example, De Grauwe, Moessen (2009), Juncker and Tremonti (2010), Delpla and Von Weiszaecher (2010) or Amato and Verhofstadt (2011).

[21] European Commission, *European Commission Green Paper on the Feasibility of Introducing Stability Bonds*, Memo/11/820, Brussels, 23 November 2011.

[22] V. Visco, *L'Europa e la crisi dei debiti sovrani. Una proposta*, in "Tamtàmdemocratico", 2/2011, pp. 77-81.

its own contribution, but should also compensate – through specific revenues – for the potentially greater burdens of virtuous nations, i.e. those to which the markets attribute a spread lower than that between the EFSF's issues and the German Bund. This would be a way of assuaging worries that the introduction of stability bonds would be a way of the virtuous nations financing the less virtuous nations.

3. Structural problems: financial and real imbalances

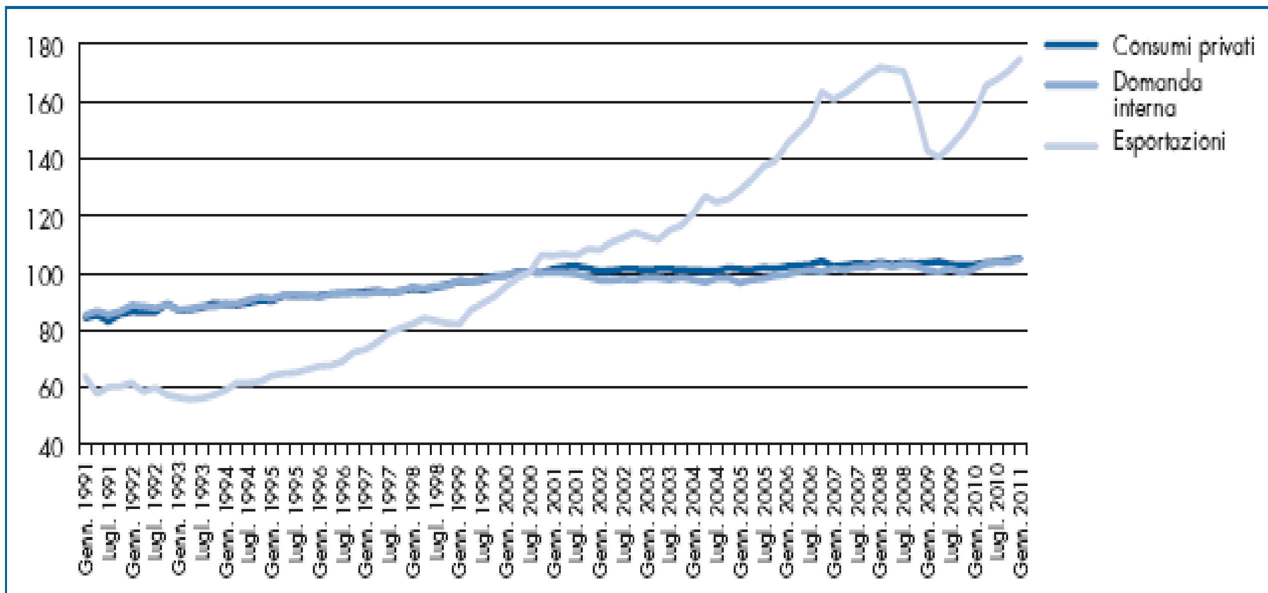
During the overhaul of European governance, both the Commission and the task force guided by Herman Van Rompuy made sure to include the introduction of a **system of macroeconomic surveillance of imbalances** in their proposals. The proposal adopted provides for a yearly examination of macroeconomic imbalances and divergences in terms of competitiveness, based on a limited number of indicators for which critical thresholds have been identified. Among these, it places particular emphasis upon measuring a country's external position; its price and cost competitiveness; the overall debt of each nation; sectoral employment, and productivity differentials.

The first report drawn up by the Commission and published on 14 February draws attention almost exclusively to competitiveness problems as being the sole source of trade imbalances, identifying an implicit causal relationship whereby the latter are an effect of the former. It completely ignores problems related to demand, which play a key role as mentioned previously. It continues by focusing almost entirely on the deficit states which should bear the cost of the adjustment, forgetting that the EU institutions themselves[23] had identified the policies of wage deflation and domestic demand compression implemented in some countries (Germany especially) as being one of the main factors for intra-European imbalances (Figure 14). Therefore, an attempt to correct imbalances within the EMU by imposing strict squeezes on wages in deficit

[23] European Commission, 2010, *op. cit*.

countries through so-called “structural reforms” of the labour market risks being not only useless, but also detrimental to the whole continent, as was sadly demonstrated by the events of the last century. The risk is that obsessively striving for competitiveness through the devaluation of labour, and the ensuing drop in domestic demand could lead the entire European economy to suffer from a structural lack of demand, triggering a deflationary spiral with results that are difficult to calculate.

Figure 14. Performance of consumer spending, domestic demand and exports in Germany between 1991 and 2011 (2000=100).



Source: Statistisches Bundesamt.

There also seems to be very little space for manoeuvre for cutting the cost of labour by acting upon the **tax wedge**. Tax cuts on labour should be carried out precisely in those countries which are currently grappling with tricky repayment plans for their excess debt; these countries should therefore make up for the loss of tax revenues on employment income and contributions with an increase in other taxes. There has been much talk about the idea of shifting the tax burden from labour income to consumption, to be achieved by increasing VAT; but its effects have probably been overestimated. Leaving aside questions regarding distribution, and the likelihood of the net advantage on wage purchasing power being negligible, the fact that many of the countries involved have ordinary tax rates of above 20% (the upper limited currently permitted by agreements is 25%) makes this solution difficult to put into practice.[24] Rather, we should not forget that competitiveness, as currently measured, is a relative concept, and if it improves in one country, it will worsen in others as a result. This symmetry is also reflected in the policies to be followed: a competitive rebalancing across the continent can be achieved not just by enforcing cuts on manufacturing costs and wages in deficit nations, but also by forcing countries that continue to have a current account in surplus to take on part of the burden of adjustment. In this sense, one possible lifeline could be the introduction of a **European wage standard**: through similar parameters to those used to deal with excessive public deficits, this would require all member states to guarantee on the one hand a growth rate of real wages that would be at least equal to the growth rate of labour productivity, and on other, to link wage dynamics to that of trade balances, with the aim of encouraging a rebalance between countries with a external surplus and those with a external deficit. In this way, countries with a structural trade surplus would be

[24] It has been demonstrated that shifting the tax burden from welfare contributions to VAT (a tax which has no effect on exports) would lead to a “domestic devaluation”, which would contribute to the reabsorption of the trade deficit. However, this effect would also be limited: for a country like Italy, faced with a competitiveness gap with Germany of around 30%, even if the VAT rate was raised to the maximum permitted level, this would only a achieve a drop of a few percentage points.

compelled to accelerate the wage dynamic so as to help absorb that surplus. This solution, considered “heresy” until not long ago, is put forward in the Paris Declaration of March 17 2012, prepared by the Foundation for European Progressive Studies and by Friedrich Ebert Stiftung (Germany), Fondation Jean Jaurès (France) and Fondazione Italianieuropei (Italy), the institutions which work with the SPD, PS and PD respectively. Conversely, countries with external deficits must align wage increases to productivity and, above all, implement policies to boost the latter.[25]

Measures are also required with regard to the financial and banking markets. Financial innovation and poor regulation not only led to the emergence of credit bubbles in some countries but, after the crisis exploded, also seriously undermined faith in interbank markets. Moreover, the use of excessive leverage should be restricted, while greater capitalisation should be encouraged with fairer and more rational criteria than those set forth in the requirements of Basel Accords and the European Banking Association. These choices could not only stimulate a more balanced growth of credit between the various areas, but could also reduce counterparty risk. Financial and banking surveillance also needs to be shifted from individual member states to community level, so as to prevent regulatory arbitrage. Lastly, the role afforded to **rating agencies** by national and European legislation should be scaled back, removing obligatory certification requirements both for marketable securities or securities for guarantee purposes, and for access to the interbank market and to operations with central banks.

4. There is no future without an alternative project for development

Alongside urgent interventions and the correction of real and financial imbalances, an effective strategy is required if the EU is to achieve satisfactory growth rates and guarantee sustainable development in the medium to long term. The European Council’s decisions and the documents produced by EU institutions in recent months continue to present a strategy that

[25] E. Brancaccio, *op. cit.*

focuses almost entirely on the competitiveness performance of European countries in relation to other areas of the world. Cutting costs, greater productivity, greater labour force participation, completion of the single market, liberalisations and other measures on the supply side: these were the key objectives of the Lisbon Strategy, and they are once again put forward in the Europe 2020 strategy, in the 2011 “Annual Growth Survey” and in the letter sent by twelve European prime ministers to the President of the European Commission in February 2012. Yet this kind of strategy can only be effective if there is an adequate demand dynamic, which neither the domestic market nor the rest of the world seem able to guarantee. Indeed, the effects of measures such as liberalisation of the goods and service markets are uncertain, and most likely insufficient to support demand, especially if we consider the poor reciprocity so far observed in key sectors such as energy, transport and telecommunications. Furthermore, continuous cuts to social services and welfare – schools, pensions, healthcare and benefits – risk pushing citizens to turn to precautionary forms of savings, resulting in additional downward pressure on domestic demand.

However, the situation outside Europe is hardly comforting: on the one hand, the United States seems unlikely to return to its previous role as engine for international development, while on the other, without serious reforms of the international monetary system it is hard to imagine that China will replace the United States, and give up its own growth model after such a short time. All this means that the EU can no longer rely on an engine for economic development outside its borders, and will have to equip itself with its own, autonomous locomotive.

Jacques Delors’ proposal for a **European development plan based upon public investments and manufacturing and consumption of consumer goods** should therefore be updated and developed; these two elements are necessary not only to generate sustainable development across the continent, but also to rebalance growth between the various areas of the Union. This plan could be financed using ad hoc bonds such as **project bonds**, or through the introduction of

specific fiscal instruments at European level, including the **financial transaction tax** and a bolstering of environmental taxation (partly through changes to the Emission Trading Scheme).

In addition to this, interventions are also needed from the European Investment Bank and the Marguerite infrastructure fund (made up of Deposit and Loan Banks in major European nations), which should be augmented both in terms of number of participating national institutions and endowment. Lastly, existing systems (such as structural funds) should be drastically improved in efficiency and effectiveness. Resources such as these should finance **investments** in infrastructures, training human capital, collective consumption and the reinforcement of a European industrial policy which encourages innovation, especially in the field of environmental sustainability and energy efficiency. The plan described above should not be designed purely to stem the current downturn, but should contribute to structurally increasing productivity, acting against the laissez-faire attitude taken by EU institutions in recent years, and which has resulted in worrying scenarios of the industrial desertification of entire areas, with serious consequences on employment levels too.

The other pillar on which lasting economic development for the Union must be founded is the pursuit of a **more balanced distribution of primary income** (earned on the labour market, especially in the more competitive countries) and **secondary income** (supported by fiscal measures and welfare), which would restore families' purchasing power and security. Competitive pressure due to the rapid globalisation of the markets, the high mobility of capital which has shifted the tax burden onto employment, the squeeze on social rights and the weakening of union organisations and collective bargaining have all helped to drastically weaken the bargaining power of the middle classes, and have made a significant contribution to lowering wage shares in the various member states. On the other hand, it should be considered that families' spending power is not merely a reflection of the net wage curve; it implies the need to guarantee everyone access to essential public services, especially healthcare and education, and to remedy market solutions

which are largely inefficient and inadequate for resolving problems related to protecting against social risks which are not privately insurable.

A mercantilist economic policy which instead focuses exclusively on competitive deflation, on containing public budgets and hence on the withdrawal of social protection systems, not only has serious repercussions on social equity and cohesion: it widens rather than narrows economic and social imbalances, and aggravates the burden of national debts themselves, with serious risks for the very survival of the European Union.

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