SUSTAINABLE ECONOMY

WINNING FOR REAL:

the Eurozone and the need for a paradigm shift

10 fundamental challenges

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WINNING FOR REAL:

10 fundamental challenges: the Eurozone and the need for a paradigm shift

1	A new Deal for Europe should be based on a better understanding of the origins and the historical "neoliberal" roots of the crisis.
2	Make a clear assessment of the European Single Market and its restrictive notion of solidarity.
3	Re-evaluate the limitations that the European Treaties have imposed on fiscal policies and the subsequent pressure of economic adjustments on the labour market.
4	Fiscal austerity will not succeed in promoting growth and creating jobs.
5	Fiscal policy should be seen as having the function of ensuring high-levels of aggregate demand, and the EU budget should be increased to act as a counter-cyclical mechanism.
6	A common labour policy and a shift away from wage repression are indispensable for Europe.
7	Focusing only on financial regulation misses out how finance is related to the rest of the economy.
8	Debt relief and consolidation should be discussed as part of a progressive policy package.
9	Supranational fiscal and labour authorities are required for increasing coordination across Europe.
10	The Stability and Growth Pact and the Six Pack have to be reformed so that fiscal policies are not reduced to a tool for simply balancing the budget.

INTRODUCTION

The crises (economic, financial, ecological, institutional and political) affecting the Eurozone have sparkled the debate on the need for a new deal on European economic and social policies. Words such as "responsibility", "solidarity", and "coordination" have entered the policy debate at European and national level among progressive political circles. To this end, it has been argued that the way out from the crises should combine budget consolidation and debt control with stronger growth, employment and social cohesion. In other words, fiscal responsibility should be combined with economic effectiveness and social fairness (Rasmussen and Schulz, 2010).

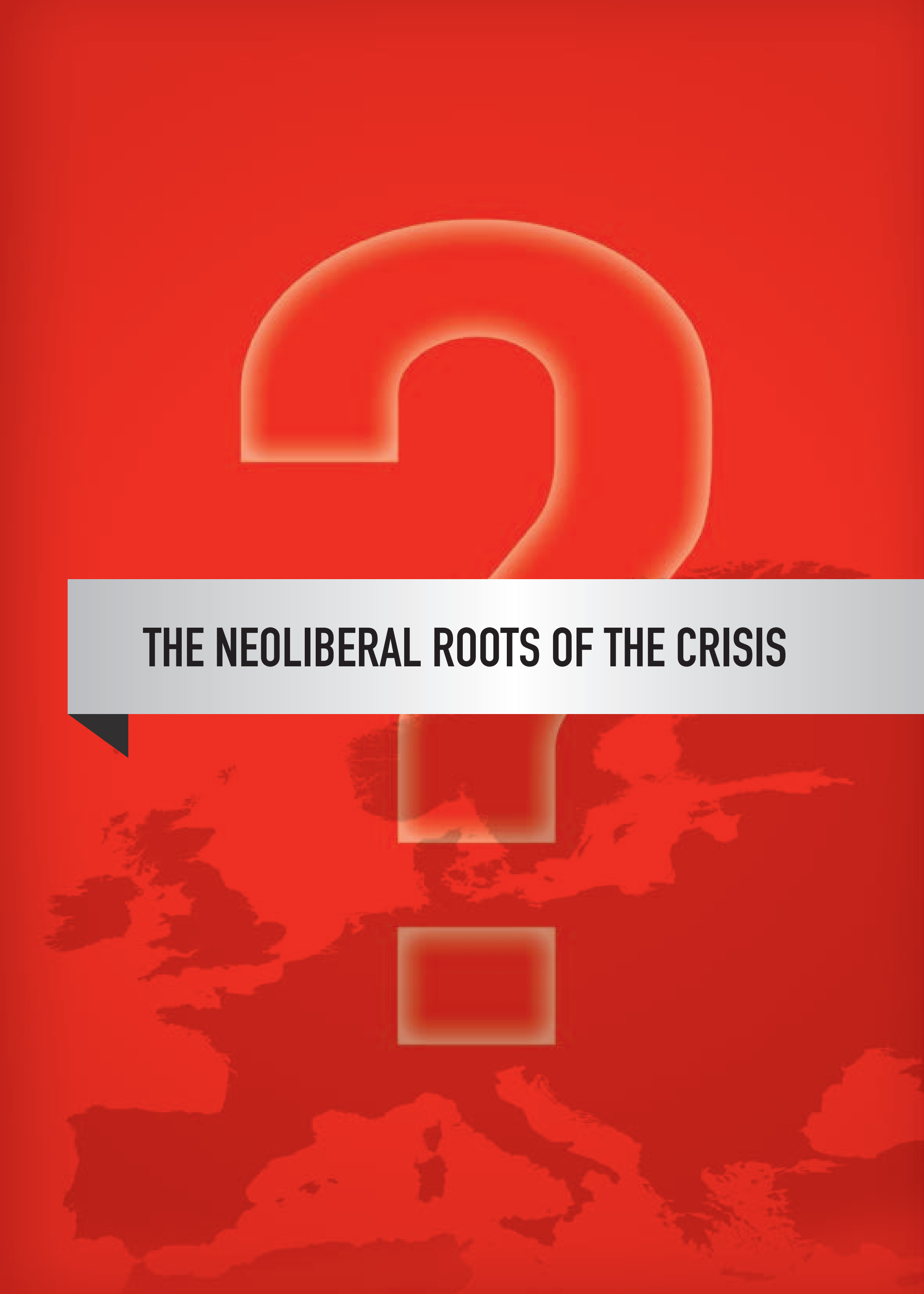
However, whilst highlighting the need to shift away from an exclusive focus on public deficit and debt reduction, it is questionable that the current progressive policy proposals are setting the foundations for a different model of development, let alone representing a real paradox shift from the current austerity policies.

This paper argues that in order to provide a concrete and real economic alternative for Europe it is important to gain a better understanding of the causes of the crises and their historical roots which can be traced back to the beginning of the neoliberal counter-revolution of the 1970s. Indeed, too often economic and financial crises have only been seen as a temporary displacement which requires emergency measures rather than being embedded in the structural development of the economic system.

The disregard of the systemic dimension of the crisis has limited the scope of alternative policy recommendations predominantly to “preventive” and “reactive” measures and has led to a neglect of those policies essential for building the institutional and economic foundations that would put Europe onto a different and more equitable developmental trajectory where solidarity (at least in terms of job creation and equitable growth) takes centre stage. Indeed, so far the ongoing crises has often been seen as a ‘crass exception that makes extraordinary measures necessary, only to return to normal once the crisis seems to have evaporated’ (Arestis and Sawyer, 2010 :331). In other words, most of the political decisions and discussions have amounted to the perpetuation of business as usual (Harvey, 2010), which translated into support of the current institutional and capitalist settings.

This paper begins by presenting a critical review of the causes and origins of the economic crisis and recession with a particular angle on Europe. This will be followed by a discussion of alternative economic and institutional policy proposals which could put Europe on a more sustainable economic trajectory.

THE NEOLIBERAL ROOTS OF THE CRISIS

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1 A new Deal for Europe should be based on a better understanding of the origins and the historical "neoliberal" roots of the crisis.

The systemic crisis which is affecting the Eurozone and other parts of the world has its roots in the neoliberal shift that took place in the 1970s-1980s and should be seen as the culmination of a pattern of financial and economic crises that has become more frequent and deeper over the past 30 years (Bellofiore, 2012, Harvey, 2010).

During the 1970s developed countries drastically changed their policy priorities from a commitment to full employment and towards fighting price inflation and increasing labour market flexibility. At the turn of the 1980s Keynesian policies and a strong role of the state in the economy were seen as the cause of the world's problems, while the *laissez-faire* of the economic liberalism was seen as the solution (Petit, 2012). In the name of inflation controls countries were urged to check and reduce government expenditure (especially on welfare), so that budget deficits would not fuel inflation. Governments were also encouraged to give political independence to the central banks, so that they '*could raise interest rates to high levels, if necessary against popular protests, which politicians would not be able to resist*' (Chang, 2010: 57).

In Europe the neoliberal shift significantly influences the creation of the European single market. The original idea behind the single market, which was reflected in the debate around the Single European Act (1986), had as a core objective the creation of a market that could be organized fairly and to the benefits of most of their stakeholders (consumers, producers, and workers among others) (Petit, 2012). However, it soon became evident that what could be done under the heading of 'common market' differed strongly among members and this impeded the development of rules of both coordination and solidarity (at least in terms of growth and employment). The restrictive notion of Common Market deeply rooted in the EU agreement of Germany prevailed, reinforcing a neoliberal Anglo-Saxon dynamic that made it clear that the market was strictly a rule of organisation[1], providing itself the solidarity that mattered (Petit, 2012).

However, at its completion in the early 1990s the single market did not produce the expected results. During the 1980s and 1990s several gains secured in the post-war era were reversed and instability significantly increased as a result of the free-market neoliberal policies. Price stability policies were supposed to lead to an increase in investment, growth, equity and employment across the globe but empirical evidence shows a very different picture.

2 Make a clear assessment of the European Single Market and its restrictive notion of solidarity.

During the neoliberal period the world economy grew much more slowly, compared to the period of 1960s and 1970s, not least because investment has fallen in most countries (Chang, 2010). Europe has been no exception to this trend. In West Europe and South Europe private investment as percentage of GDP declined from 24% in 1970 to 18% and 17% respectively by end of the 1980s, in the UK investment decreased from 18.9% in 1970 to 14% of GDP over the same period (figure 1).

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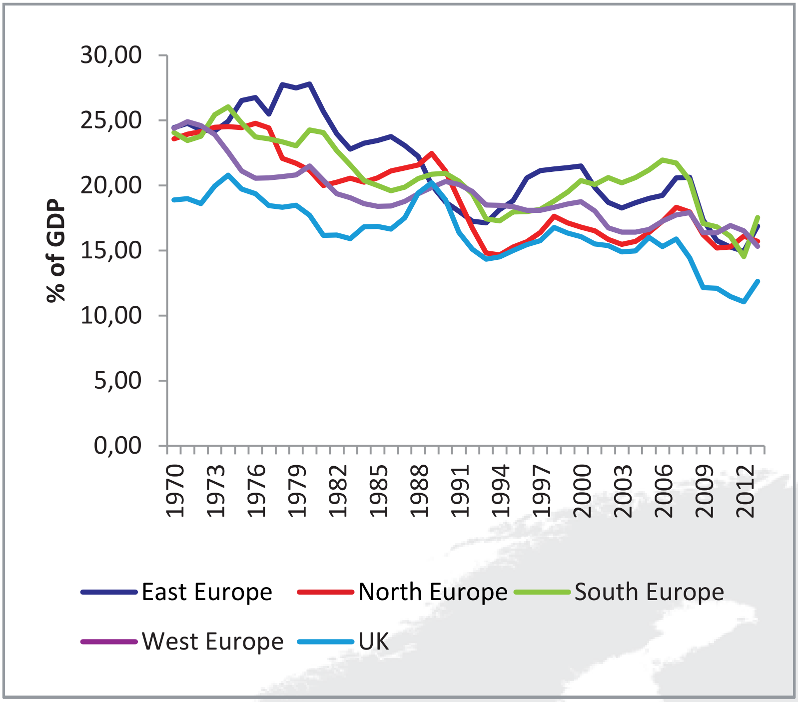
1 Organisations are here defined as '*entities that concentrate the operation of groups of people within narrowly defined common rules and purpose*' (Nissanke and Stein, 2003: 302)

Figure 1 - Private investment as % of GDP, European blocs[2], 1970 – 2012



Source: Alphametrics Co. Ltd

From the 1980s also the growth of average per capita income slowed down in many European areas. For instance, in South Europe average per capita income growth in the period 1970-1979 stood at around 5.6% whilst in the 1980s it reduced to 4.3% and in the 1990s to around 2.3%. In West Europe it declined from approximately 7% (1970-1979) to 2.3 percent by the end of the 1990s. Similar trends were also experienced in the UK and North Europe (table 1).

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2 European blocs are defined as follows: **West Europe**: Austria, Belgium-Luxemburg, Switzerland, Germany, France and the Netherlands; **South Europe**: Spain, Greece, Italy, Portugal and Ireland; **East Europe**: Albania, Bulgarian, Former Czechoslovakia, Hungary, Poland, Rumania, and former Yugoslavia; **North Europe**: Norway, Sweden Finland and Denmark.

Table 1 - Average Per Capita Income Growth, European Blocs, 1970 - 2009

	North Europe	South Europe	West Europe	UK
1970 – 1979	5.14	5.64	6.97	4.65
1980 – 1989	2.99	4.32	1.63	3.91
1990 – 1999	1.35	2.34	2.35	3.92
2000 – 2009	3.37	3.38	2.58	1.01

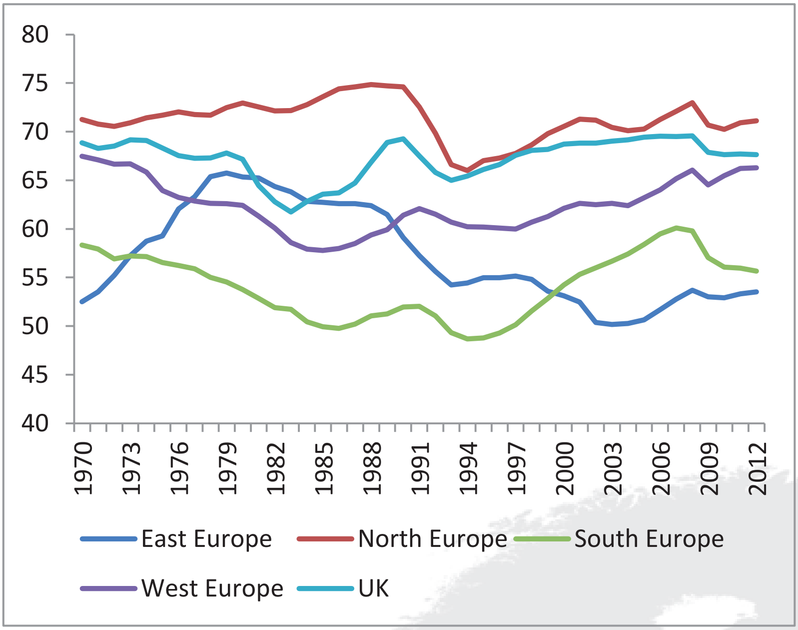
Source: adapted from Alphametrics Co. Ltd, calculations by the author

In several European countries inequality in household's gross disposable income also rose significantly. For instance, in the UK inequality increased by ten percentage points on the Gini scale from 0.25 to 0.35 (Irvin et al., 2009). In Germany the Gini coefficient increased from 0.25 in the mid-1980s to 0.30 in the mid-2000s and in Italy it raised from 0.30 to 0.35 over the same period.[3]

The fall in investment and growth was also accompanied by cut backs in the welfare state and a decline in consumption as wage stagnated (Bellofiore, 2012). Indeed, the restrictive macroeconomic policies which aimed at putting inflation under control also had negative effects on wages, employment and job security. In many countries during the 1980s job insecurity increased due to the decline in employment rate compared to the 1970s (figure 2). From the 1990s to the period prior to the crisis for several parts of Europe employment levels recovered, but job insecurity still rose as a result of so called "greater job flexibility" and the cutbacks in the welfare state since the 1980s (Chang, 2010).

3 Source : OECD (2009)

Figure 2 - Employment as % of working-age-population, European Blocs, 1970 - 2012



Source: Alphametrics Co. Ltd

At this stage the only way to boost aggregate demand in an environment where wages are repressed was to increase the borrowing opportunities of households. This was done through a process of financialisation which significantly changed the relationship between financial and real economy, and that ultimately led to the ongoing global financial and economic crisis (see e.g. Stockhammer, 2010, Orhangazi, 2011).

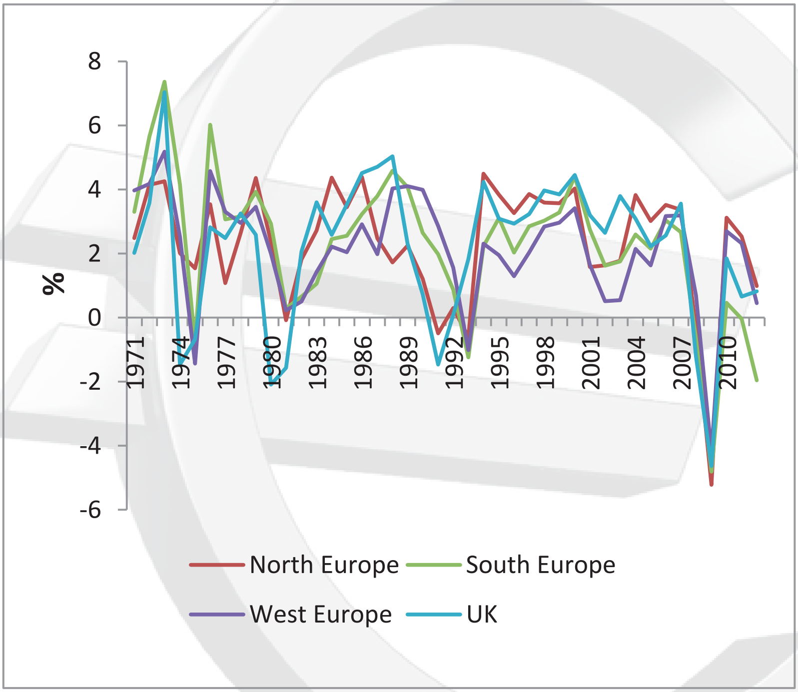
Financialisation has led to a significant slowdown in physical capital accumulation (thus reducing investment in productive activities further) and to a significant increase in financial assets. In addition, as a result of this process, the relationship between firms in the real side of the economy and the financial side has become more entangled as non-financial firms have started extending consumer credit to their own customers, and got involved in increasingly complicated financial deals to support profitability (Orhangazi, 2011).

THE DEVELOPMENT OF THE EUROZONE

3 Re-evaluate the limitations that the European Treaties have imposed on fiscal policies and the subsequent pressure of economic adjustment on the labour market.

The completion of the single market in 1992 coincided with a recession across Europe (figure 3) and with an increase in the speculative currency runs. These currency attacks, especially to the Italian Lira and the British Pound forced investors to stick to the stronger Deutsche Mark (Petit, 2012).

Figure 3 - Growth rate of Gross Domestic Product, European Blocs, 1971 - 2011



Source: Alphametrics Co. Ltd

In this context the Maastricht Treaty, which set up the basic principles for a common currency, represented a defensive reaction forced to rely on the German conception of social markets, insisting on the role of coordination and monetary criteria without any reference to solidarity rules. This clearly paved the way for the austerity plans as the only possible answer to any external challenge. Indeed, all the treaties and pacts that followed (e.g. Stability and Growth Pact, 'Six Pack' among others) merely specified conditions for the implementation of the common currency by imposing strict rules of behavior with few, if any, rules of solidarity (Petit, 2012).

Fiscal policy and budget deficits were seen as impotent in affecting the level of economic activity as the effects on aggregate demand of increases in government expenditure or decreases in tax rates would be exactly offset by changes in private demand. Fiscal policy was seen as a tool to encourage profligacy and budget deficits which would lead to unsustainable public debt (Arestis and Sawyer, 2010). A clear example of this is the intention of the Stability and Growth Pact for individual countries to have a budget position in balance or small surplus over the business cycle subject to a completely arbitrary 3 percent of Gross Domestic Product (GDP) limit in any year. It is also reflected in the 60 percent ratio of debt to GDP imposed by the Stability and Growth Pact (Arestis and Sawyer, 2010).

The Stability and Growth Pact, alongside the Maastricht Treaty, created four rules for economic policies. The four rules are that the ECB was granted independence from political influence, the rule of non-bail-out of national government deficits was introduced, the monetary financing of government deficits was prohibited, and member states must avoid excessive deficits. These rules were created in the belief that they would facilitate the European Central Bank's primary task of price stability (Arestis et al., 2001).

In addition another institutional arrangement set up in the 1990s in the EU is the complete separation between the monetary authorities and the fiscal authorities (in the shape of the national governments) and the absence of a European Treasury. Thus, there is not any significant fiscal policy operated at the European level. The size of the European budget is relatively small at less than 1-2% of combined EU member states' GDP in 1997 (Arestis et al., 2001), and still dominated by the needs of the Common Agricultural Policy (see e.g. Stetter, 2012).

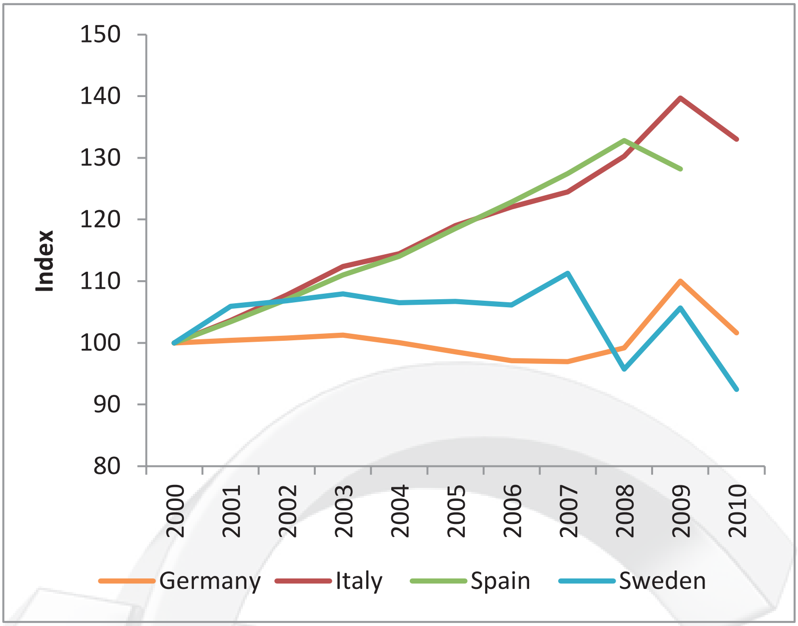
In addition the EU budget must be balanced, and the interaction between this and the limited size of the budget means that there is no scope for active fiscal policy, and that the EU budget is too small to operate as an effective stabilizer. It cannot be used as a counter-cyclical instrument either (Arestis et al., 2001). Apart from its small "structural funds", the budget cannot provide for significant transfers between rich and poor nations of the union (Irvin and Izurieta, 2011). The redistribution effect in the EU, in the forms of structural and cohesion funds, is estimated between 0.5% and 3% of the difference between national GDP per capita and the EU average (Arestis et al., 2001).

Furthermore, rules imposed by the EU which specify a fixed limit on government borrowing fail to recognize that it serves as a mechanism for distributing over the time the cost of adjustment to shocks for smoothing the tax burden associated with public investment. In addition, constraints on government borrowing reduce the flexibility of national governments' fiscal policy and make fiscal coordination very difficult (Arestis et al., 2001).

Thus the monetary union, by way of its specific design, has removed three essential policy instruments from the domain of national policy making: exchange rate management, monetary policy and fiscal policy. The latter became effectively dependent on the performance of the external sector the financial behaviour of the private sector (Irvin and Izurieta, 2011). At the same time the severe constraints on fiscal policy forced the pressure of economic adjustments onto the labor market (Lapavitsas et al., 2010).

Indeed, labour has lost out to capital across the Eurozone as both labour and wage policies were intrinsically weakened by the institutional design of the monetary union (Irvin and Izurieta, 2011). '*Guided by EU policies, Eurozone countries have entered a "race to the bottom" encouraging flexibility, wage restraint, and part-time work*' (Lapavitsas et al., 2010: 1). This race to the bottom has been won by Germany who succeeded in maintaining unit labour costs (i.e. average cost of labour per unit of output) lower than many other European countries (figure 4).

Figure 4 - Unit Labour Costs, index year 2000, Selected European Countries, 2000 – 2010

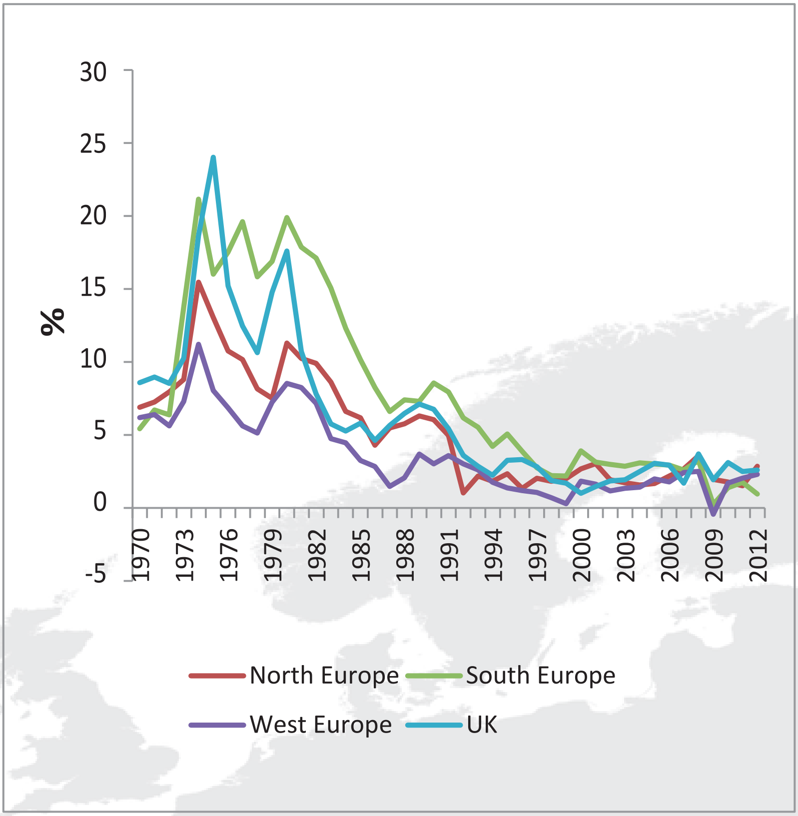


Source: OECD Data

The ability of Germany to keep unit labour costs lower than other countries did not result from the operation of free market forces. Instead, since the mid-1990s Germany has pursued policies promoting cuts in unit labour costs. These policies, aimed at enhancing labour market "flexibility" led to greater licenses to revoke workers' traditional rights and to downscale the labour codes that had safeguarded employees' living standards (Laski and Podkaminer, 2012). At the same time, high employment and the prospect of production being 'outsourced' to low-wage countries helped reduce wage aspiration. Thus, these policies contributed to suppressing the growth or real wages, despite the steady rise in labour productivity (Laski and Podkaminer, 2012).

Thus, is spite of a poor performance in terms of growth and productivity gains, the German economy (and West Europe as a whole) had been able to keep down inflation as well as the nominal remuneration of labour compared to the European peripheral countries. Although peripheral countries in Europe (e.g. South Europe) performed generally better in terms of growth (figure 3) their labour costs and inflation (figure 5) have remained higher than the core European countries.

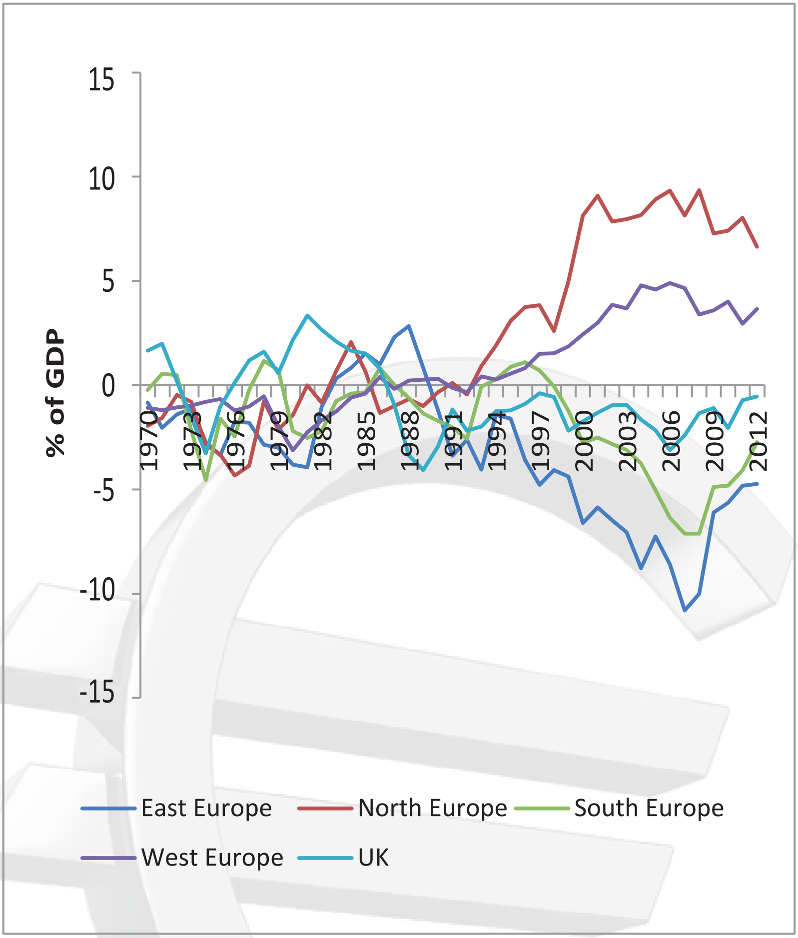
Figure 5 - Price Inflation, European Blocs, 1970 - 2012



Source: Alphametrics Co. Ltd

As a result of these institutional settings and economic policies the Eurozone has become an area of entrenched current account surpluses for West Europe, financed by current account deficits for the peripheral countries (figure 6).

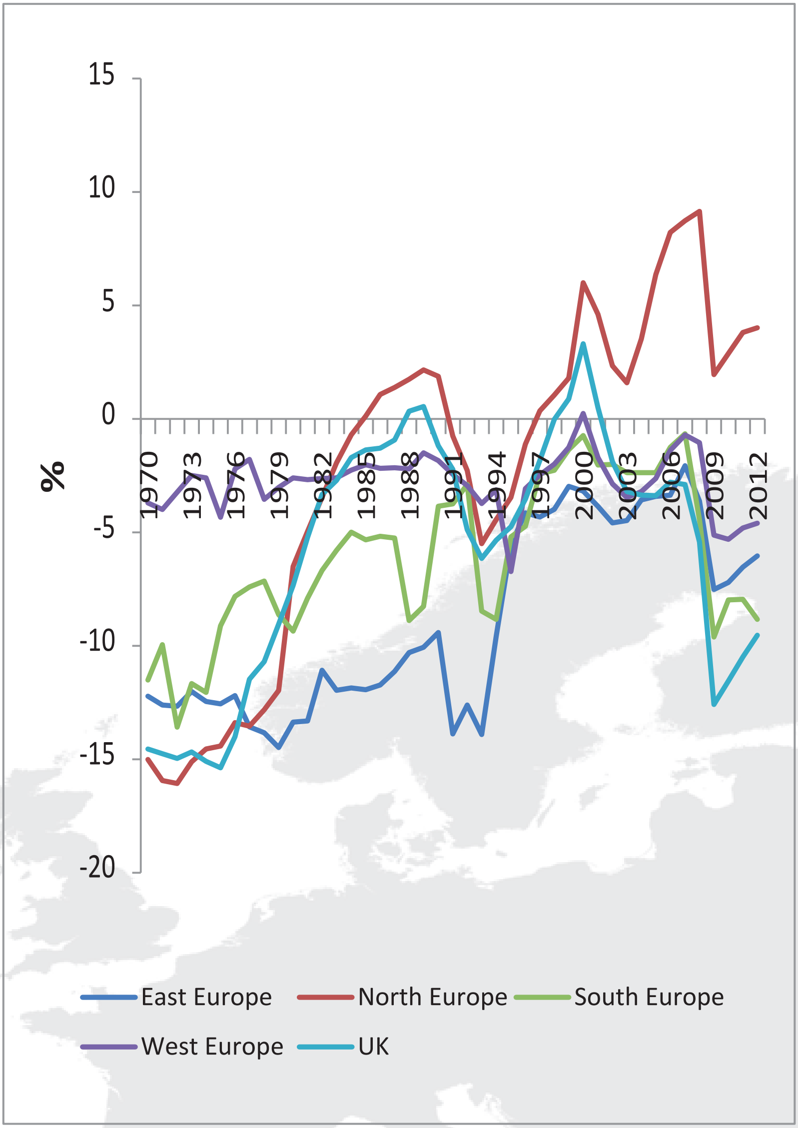
Figure 6 - Current Account as % of GDP, European Blocs, 1970 - 2012



Source: Alphametrics Co. Ltd

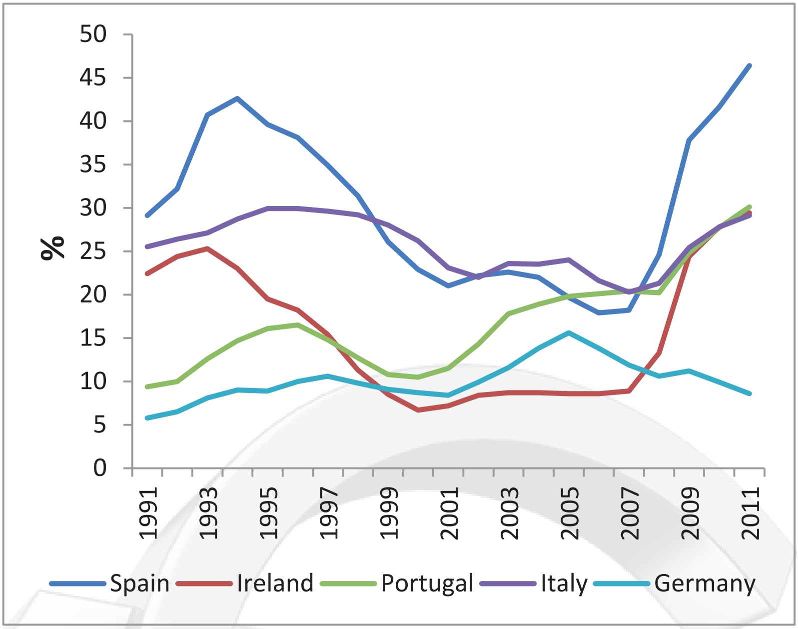
Confronted with a public debt crisis, increased budget deficits (figure 7) as a result of the ongoing global crisis, and increased level of unemployment, especially among the young (figure 8) peripheral countries have been asked to implement harsh fiscal austerity policies and to make their labour markets more flexible.

Figure 7 - Net Government Net Lending as % of GPD, European Blocs, 1970 – 2012



Source: Alphametrics Co. Ltd

Figure 8 - Unemployment rate less than 25 years, Selected European Countries, 1991 – 2011



However, austerity policies have not led to the promised recovery results. Six years on from the crisis it has now become evident that Europe needs to embark on a different developmental trajectory where equity, growth and job creation are at the fore.

PROGRESSIVE ECONOMIC AND INSTITUTIONAL POLICIES

4 Fiscal austerity will not succeed in promoting growth and creating jobs.

Fiscal austerity, which is intrinsically built in the various European treaties and pacts, is not achieving the expected results. A serious reconsideration of the institutional foundations and economic policies in Europe is needed in order for the Eurozone to embark on a new development trajectory where job creation, equity and growth is achieved across all areas of Europe (solidarity).

The response of the mainstream economists and policy makers to the current negative trends in employment and growth across Europe, and in particular across the peripheral countries, is that appropriately paced fiscal consolidation (*austerity*) should go hand in hand with growth-enhancing policies (Buti and Padoan, 2012). The suggested growth-enhancing policies focus once again on the bottleneck problems that the labour market is causing on growth.

To this end a series of initiatives promoting more labour market flexibility and wage adjustments, in particular for the peripheral countries (in terms of wage reductions), has been advocated as part of a structural reform package to achieve employment, growth and competitiveness whilst correcting current account deficits (European Commission, 2012). However, these policies fail to address the key institutional constraints imposed on fiscal policy and the impossibility to use this policy as a counter-cyclical tool to boost aggregate demand and as a transfer mechanism of resources between rich and poor nations of the Union, an important aspect of "solidarity".

The theme "solidarity" has been embraced by more progressive policy makers who highlight the unequal commitment to fighting unemployment and social exclusion and the need for more effective crisis prevention and crisis management mechanisms. To this end progressives have been calling for stability mechanisms, urgent financial regulation (e.g. financial transaction tax), an economic policy agenda of budgetary consolidation and jobs, and a European Employment and Social Progress Pact (Rasmussen and Schulz, 2010).

These policy proposals move away from seeing labour supply-side bottlenecks as one of the core impediments to growth and job creation in Europe and also recognize, to a greater extent, the role that financialisation played in the current crisis. However, the majority of the policy proposals so far have been preventive and reactive rather than building the institutional foundation of a European system that is, on the whole, more developmental and equitable.

The dominant policy stance rests on a somehow narrow view of the causes and the origins of the ongoing global crisis and recession. This crisis, as all the previous crises of the neoliberal period, has been seen as a temporary and "unpredictable" phenomenon which requires extraordinary measures to then return to normal once the crisis has subdued. However, the global crisis and recession was indeed "predicted". In 2002 with reference to the United States, Godley and Izurieta argued that they (the US) '*should now be prepared for one of the most severe and intractable recession of the post-World War II period, with no natural process of recovery in prospect unless a large and complex reorientation of policy occurs both here and in the rest of the world*'(2002: 27).

The crisis has also revealed some of the fundamental institutional and economic policy flaws within the Eurozone and these need to be immediately addressed if the objective is to create a more cohesive Euro area where solidarity (at least in terms of job creation, growth and equity) takes centre stage.

5 Fiscal policy should be seen as having the function of ensuring high-levels of aggregate demand and the EU budget should be increased to act as a counter-cyclical mechanism.

Fiscal policy should be seen as having the fundamental function of ensuring high-levels of aggregate demand. This implies that until investment strongly recovers from its long term decline and households are able to spend without incurring high levels of debt, budget deficits will have to continue (Arestis and Sawyer, 2010).

It follows, that a serious reconsideration of the role and size of the European budget has to be undertaken. The EU budget should be significantly increased in order to provide incentives for promoting investment and employment-focused growth policies, to act as a counter-cyclical mechanism, and to redistribute funds from rich to poor nations in Europe. Indeed, already in 1977, the MacDougall Report on the Role of Public Finance in European Integration highlighted the importance of having a federal budget of at least 5-7% of GDP of members' states in order for the monetary union to be viable (Commission of the European Communities, 1977).

6 A common labour policy and a shift away from wage repression are indispensable for Europe.

There is a need for a common labour policy and a shift away from the current system of wage repression (Irvin and Izurieta, 2011). A common labour policy and a progressive harmonization of labour rights and social protection could also lead to a reasonably egalitarian income distribution and to an end to the current and dysfunctional "wage flexibility" framework (Irvin and Izurieta, 2011, Petit, 2012).

7 Focusing only on financial regulation misses out how finance is related to the rest of the economy.

Progressive policy makers have also been focusing their attention to the deregulation of finance and the importance of adopting new financial regulations. However, an exclusive focus on financial regulation miss out how finance is related to the rest of the economy, in many contradictory ways (Orhangazi, 2011). Therefore, it is important that changes in financial markets and the adoption of new financial regulation is also accompanied by a reconsideration of the organizational structures in the firm (Stockhammer, 2004). In other words, '*regulation of financial markets and the empowerment of growth interested groups within the firm should go hand in hand*' (Stockhammer, 2004: 739).

8 Debt relief and consolidation should be discussed as part of a progressive policy package.

Furthermore, there is also a need to engage in a serious debate on the possibility to restructure and consolidate public debts (Bofinger et al., 2012) and provide some form of debt relief for countries with high levels of government debts. In many cases these debts increased as a result of the presence of significant current account imbalances and in order to support and bail-out financial institutions in crisis. Expansionary fiscal policies and growth alone might not be sufficient for South Europe to reduce debt significantly (McKinley and Cozzi, 2011).

Overall, economic policies and objectives need to be rearticulated so that Europe can move away from the constant obsession of price stability and concentrate much more on objectives such as full employment, equitable distribution of income and resources, sustained (and environmentally friendly) economic growth, and the creation of sufficient productive capacity through a process of re-industrialisation, among others.

9 Supranational fiscal and labour authorities are required for increasing coordination across Europe.

All of these objectives however call for institutional reforms that should enter into the agenda of European policy makers. Only through institutional reforms it will be possible to clearly redefine a set of economic policy objectives and bring Europe on a more equitable developmental trajectory where solidarity is at the core.

Europe still lacks supranational fiscal and labour authorities. Institutional arrangements for collective wage determination are currently undertaken on a decentralized and fragmented basis and have led to dramatic disparities across countries. However there is a need for a centralized supranational authority that pushes forward a common labour policy and coordinates wage policies. In addition, active fiscal policy and an enlarged European budget also require the creation of a supranational institution such as an EU Treasury. This can lead to increased coordination among union members by setting up common behavioural rules (Petit, 2012).

In order to revert the decline of private investment and to increase solidarity across Europe (by means of transfers from rich to poor nations of the Union) the lending scope of the European Investment Bank (EIB) should also be widened in order to make meaningful contribution to growth (Griffith-Jones et al., 2012) and to ensure high rates of capital formation, appropriately located across the EU (Arestis et al., 2001).

10 The Stability and Growth Pact and the Six Pack have to be reformed so that fiscal policies are not reduced to a tool for simply balancing the budget.

Finally, the Stability and Growth Pact and the 'six pack' are also in need of modification. The arbitrary 3% fiscal deficit to GDP rule prevents the efficient operation of automatic stabilisers and the use of fiscal policies for counter-cyclical operation, let alone stimulating aggregate demand (Laski and Podkaminer, 2012). There is a need for a Full Employment, Growth and Stability Pact and in this pact fiscal policy should be an active ingredient in achieving high levels of aggregate demand required to sustain high levels of economic activity (Arestis et al., 2001). In other words, fiscal policies should not be reduced anymore to a tool which aims for some balanced budget.

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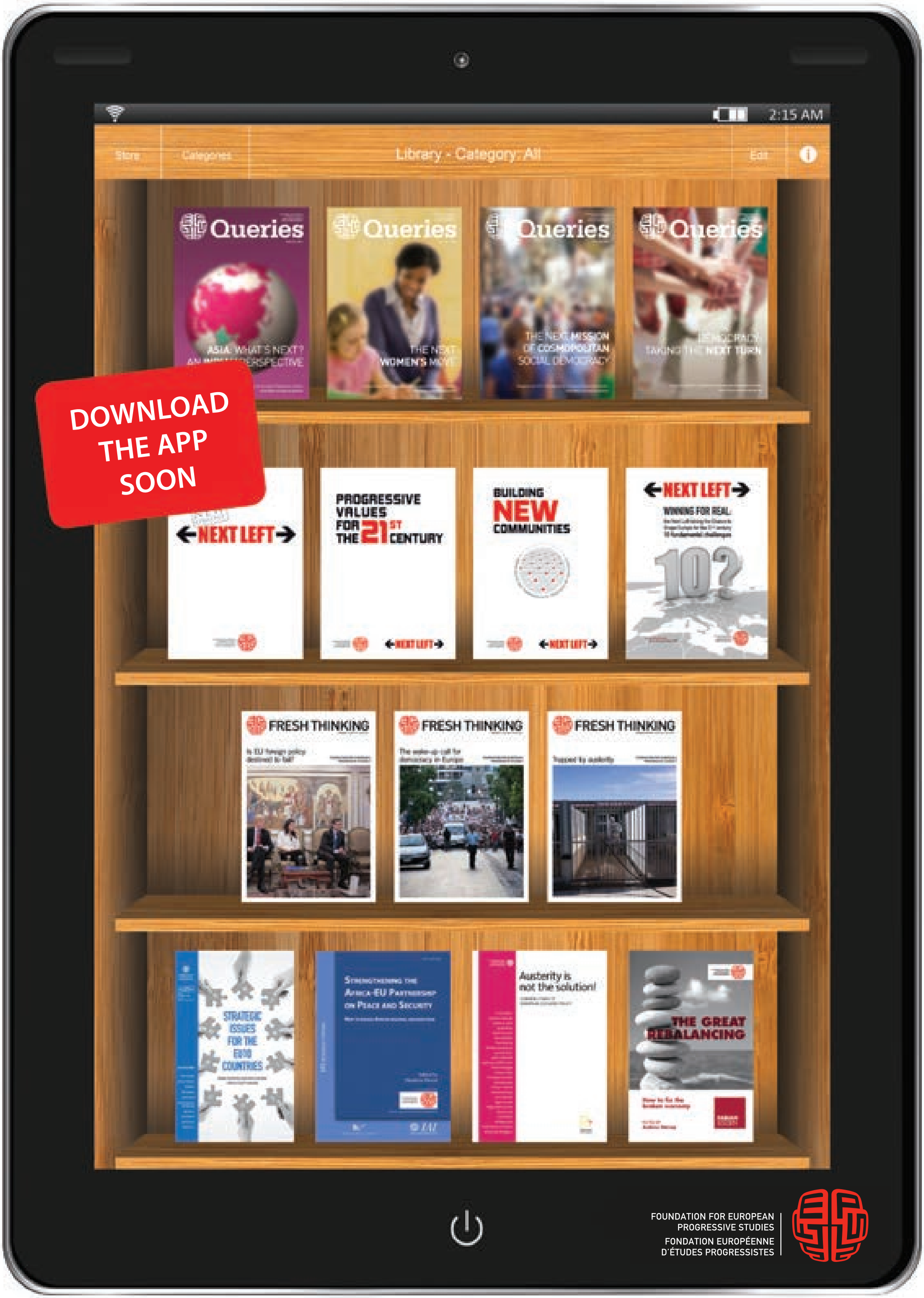
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