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Imbalances, Inequality and Growth – Rethinking Growth Policies for Europe

Growth in industrialised countries has been relatively slow in recent decades. Some forecast that the economy will continue to stagnate in the medium to long-term, and a discourse on "secular stagnation" has intensified. Many worried by this development are seeking ways to rekindle growth. On the other hand, in the face of environmental problems and finite resources, others argue that continued growth is not desirable.

Therefore it is important to speak about what growth means and why it is important. We need to specify in what ways the European growth problems are special and how national and EU-level policies must change in order to foster better growth performance.

Growth in quantitative and qualitative terms

By growth we mean *economic growth measured in GDP*. This is a relatively recent method (just 80 years old) to aggregate economic activity. The limitations of GDP have been explored, though it continues to be widely used to measure performance.

Positive GDP growth is important, but how much GDP growth we need and how the growth of income should be distributed are equally important questions. This explains why (for reasons of distribution and environmental sustainability) a movement has developed over the last ten years to go "beyond GDP". Progress has been made in measuring the social and environmental impact of growth, which has helped in the development of EU objectives like achieving smart, sustainable and inclusive growth.

Since 2014 the work of Thomas Piketty on inequality has made a tremendous contribution to the understanding of our economic and social situation.[1] Beginning in the 1970s, income and wealth inequalities started to rapidly grow (again) – moving in the same direction, though with varying speeds, in various parts of the industrialised world.

There is a widely held view that this new inequality has been detrimental to economic growth in the industrialised (OECD) countries. There are various explanations for this, e.g. those who accumulate high incomes and wealth more often invest their resources in other parts of the world, and the broadening group of low-income people represent ever-weaker purchasing power in the consumer goods markets.

It is hard to define a natural rate of growth in historic terms. One can argue that it is not the current rate of growth (in the OECD average) which is too low, but rather that the post-war growth rates were exceptionally high. Average growth rates tended to drop:

- following the end of the post-war reconstruction period in the 1960s;
- following the rise of a new international division of labour in the 1970s;
- following self-inflicted pain from military adventures and financial market bubbles in the 1990s and 2000s;
- following the rise of extreme social inequalities throughout the last 30 years.

Today the literature on the limits of growth follows three main streams. The first is from the point of view of resource constraints, following in the footsteps of the Club of Rome. The second is from the point of view of demand constraints, in particular in the context of secular stagnation.[2] The third is from the point of view of supply constraints,[3] with a specific focus on technology and productivity.

In Europe, all three streams may be relevant in a complex analysis, but no single one of these factors appears to be dominant. Hence, we need to put our question into a specific EU context.

1 T. Piketty: Capital in the Twenty-First Century, Cambridge 2014, The Belknap Press of Harvard University Press.

2 L.H. Summers: The Age of Secular Stagnation: What It Is and What to Do About It, in: Foreign Affairs, Vol. 95, No. 2, 2016.

3 R.J. Gordon: The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War, Princeton 2016, Princeton University Press.

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What low (or lower) growth implies for Europe

Regardless of whether one deems zero-growth problematic or finds it desirable, there is a need to discuss *how the state and society can function without economic growth (or with low growth)*. What elements of our society depend on continued growth? How can they be made independent from economic growth?

Labour market policies, government debt and social security systems are only some examples of policies and institutions that seem to rely on the assumption of continued growth. In other words, *without growth, it is more difficult to reduce debts, unemployment and poverty*.

For a number of European countries, this is not just a theoretical point but the reality of recent years. While growth decreased in most EU countries in 2009, it was still negative throughout most of the eurozone in 2011-13, and in a few countries this reduction in growth lasted even longer.[4] In these countries, debt-to-GDP ratios have increased (by around 40-50% in Greece, Ireland, Portugal, Spain and Italy), unemployment has remained stubbornly high and poverty rates have also gone up (indeed, severe material deprivation has doubled in Greece). Inequality increased more in these adjusting countries than in the core of the eurozone.

Low growth does not necessarily mean increasing misery. It depends on institutional development and the adaptive capacity of societies. However, we can better understand the implications of low growth (or no growth) if we shift our focus from overall deceleration to relative growth rates. Based on recent experience, we can observe the following:

- growth rates of BRICs have been higher than in OECD countries;
- within the OECD, growth rates in the US have been higher than in Europe;
- within Europe, growth rates in the East have been higher than in the West;
- within Western Europe, growth rates in Germany have been higher than in France or Italy.

These trends can and should be analysed from the point of view of whether they are benign or malignant. For example, less developed countries or regions catching up with the higher income countries is largely benign, both for the "global South" and the "European East". On the other hand, slower growth in Europe as compared to the US economy since the 1990s can be seen as a matter of concern. And in particular, highly uneven growth rates within the eurozone – together with divergent social outcomes and resulting political polarisation – represent a malignant tendency which necessitates a closer look at the European context of growth.

European Union policies and economic growth

The promise of a contribution to improved economic growth has been used to justify a variety of policies in the EU. To list just a few:

- shifting resources towards research, development and innovation;
- improving the effectiveness of cohesion policy and industrial policy, and strengthening the link between the two for balanced growth;
- negotiating trade and investment agreements with other countries of the world;
- developing a social economy for inclusive growth;
- promoting a circular economy for resource (as well as energy) efficiency and environmental sustainability;
- developing a banking union, capital markets integration and fiscal risk-sharing for greater EMU resilience.

However, in order to see how exactly these actions contribute to economic performance, we need to break growth down into three smaller components. First, we must consider the long-term growth potential of the EU economy. In this respect, the EU is not much weaker than the US, and not necessarily weaker than Japan (which also suffers from low growth). Emerging economies (Asian tigers, BRICs, etc.) by definition experience higher rates of growth than OECD economies, in part due to the migration of industrial jobs and the hollowing out of labour markets in advanced economies.

Second, the short-term growth (recovery) capacity must be taken into account. In this respect, the EU (and especially the eurozone) is performing much worse than the US or Japan. Since 2011 the EU has decoupled from the

4 For a comprehensive analysis of the European economic crisis, see W. Dymarski, M. Frangakis, J. Leaman (eds.): The Deepening Crisis of the European Union: The Case for Radical Change, Poznan 2014, Poznan University Press.

rest of the OECD, arguably due to the lack of countercyclical capacity or strategy within the EMU.

Third, the capability of policies to foster balanced growth in the EU, i.e. the capacity to share prosperity among all participants of the single market, must be considered. This is a treaty objective in Europe, but the recent experience in regions belonging to the "eurozone periphery" has been primarily marked by booms and busts rather than balanced growth.

These aspects can be analysed according to their own logic, but they are also interconnected and can aggravate each other if not tackled through coordinated action. For example, intra-EU imbalances also damage the EU's recovery capacity and its long-term growth potential, and threaten the EMU with disintegration.[5]

While GDP growth in most EU countries has turned positive since 2013, the eurozone is still in an unsustainable situation. This is a specific European weakness that has delayed the recovery and keeps the EU in a more vulnerable position than either the US or Japan. While the challenge of low growth is shared with most OECD countries, the European growth problem is aggravated by the limitations of the EMU and the low speed of its reform.[6]

Of course, Europe cannot achieve very high growth rates comparable to those of the most dynamic emerging economies in the foreseeable future. But we cannot afford stagnation either. A Japanese-style decade-long deflationary period would entail the risk of EMU (and consequently EU) disintegration,[7] and along with it the destruction of the European social model.[8]

European societies, especially in the eurozone periphery, have already suffered immensely from the deep and long recession. While the harsh adjustment policies eventually resulted in some form of recovery, it also has to be recognised that an adjustment model based largely on internal devaluation (cuts in wages, pensions and public expenditures) undermines the capacity of convergence in terms of living and working conditions in the EU.

This also has repercussions in the more competitive European economies in terms of weak demand, financial instability and unwelcome migration. The eurozone North (i.e. the financially stronger core countries) can no longer remain ignorant about the crisis of the South, and it cannot rely solely on demand from dynamic emerging economies. Reflating the eurozone is a crucial unresolved problem of our time.

Europe's quest for growth through investment

The European Union has a framework for growth, but it is a cocktail of three loosely connected plans, rather than one integrated programme.

First, a long-term strategy for smart, sustainable and inclusive growth (Europe 2020) was adopted in 2010. An annual cycle of economic governance (European Semester) was built around Europe 2020, which also functioned as orientation for the budget negotiations. Unfortunately, rather than increasing the EU budget for investment, the European Semester ended up cutting it, thanks to the intransigence of four net contributing countries: Germany, UK, the Netherlands and Sweden.

Since 2012 the EU has also had a long-term vision for the reconstruction of the monetary union (the Four Presidents' Report and Commission Blueprint), which, together with ECB interventions, contributed to short-term market confidence, but in terms of EMU reconstruction only resulted in the creation of a modest version of the Banking Union. Also in 2012, shortly after the French presidential elections, the EU adopted the Compact for Growth and Jobs, which promoted a capital increase for the European Investment Bank (EIB) as well as innovative financial instruments like project bonds.

The assumption of this policy framework was that the rapid establishment of the Banking Union would make it possible to restore the flow of funds to the real economy, while the European Semester would help deliver crucial reforms for competitiveness. Thus, competitiveness would improve, enterprises would start investing again, and eventually growth and job creation would return.

In 2014 it had to be recognised that while the Banking Union is a vital reform, it was either not being implemented with the necessary speed or it did not lead to the right form of financing necessary for economic recovery. There is a definite need to go beyond the minimalist Banking Union but, at least at this stage, there is no political momentum to put the Fiscal Union on the agenda. The investment plan falls somewhere in between. It is an effort to overcome the economic depression through the more

5 A. Regan: The imbalance of capitalisms in the Eurozone: Can the north and south of Europe converge?, in: Comparative European Politics, 2015.

6 P. De Grauwe: Design Failures in the Eurozone: Can they be fixed?, LSE 'Europe in Question' Discussion Paper Series, No. 57/2013.

7 J.E. Stiglitz: The Euro: How a Common Currency Threatens the Future of Europe, New York 2016, W. W. Norton and Company.

8 J.E. Dolvik, A. Martin (eds.): European Social Models from Crisis to Crisis. Employment and Inequality in the Era of Monetary Integration, Oxford 2015, Oxford University Press.

intensive political coordination of investment activities, along with a kind of "credit rationing" of resources for this purpose, in the absence of a demand side stimulus.

In July 2014, investment was declared a priority by newly elected Commission President Jean-Claude Juncker. He designated one of the vice presidents as the investment chief of the EU and presented his investment plan to the European Parliament in November 2014.

According to the Juncker Plan,[9] the EU is to provide €16 billion from its own budget, supplemented by an additional €5 billion from the EIB. With this seed capital, the European Fund for Strategic Investment (EFSI) hopes to attract almost €300 billion in private sector investment. Member states are also encouraged to contribute. The potential upgrading of the programme has been often mentioned, especially since Juncker's 2016 State of the European Union address.

Moving towards a "Juncker II" should allow for the development of innovative ideas, like the establishment of a new vehicle (beyond or alongside EFSI), once the focus on equity support for enterprises is strengthened. In order to assist the growth of enterprises, identifying or creating a *public equity agency* at the European level could be a critical step forward. Such a public European investor would take minority equity stakes in medium-sized enterprises and thus help attract other investors to the market and improve companies' access to both equity and debt.

Crisis response and inequality dynamics

The sovereign debt crisis since 2010 and the fiscal consolidation strategies implemented in response to it have substantially weakened the welfare state in peripheral eurozone countries.[10] In particular, they have weakened the effectiveness of so-called automatic fiscal stabilisers at the national level,[11] constraining the ability of a state to immediately act in a countercyclical way as tax revenues drop and social expenditure increases.

Unemployment increased to 11% in the EU and 12% in the eurozone in 2013, but it grew to twice as high in the eurozone periphery. A quarter of the workforce in both Spain and Greece was unemployed in 2013, and youth unemployment rates peaked above 50% in both countries. Income inequality (as measured by the Gini index) was already higher than the EU average in these two countries before the crisis, and it continued to grow throughout the crisis years.

In adjusting countries, where economic growth was negative and unemployment was on the rise in 2011-13, poverty has also risen significantly. Demand for the services of food banks has grown and many young people lacking opportunities choose to emigrate, often to other continents, which by definition results in a loss of human capital for Europe as a whole.

Such developments resulted in the adoption of the European Commission's Communication on Strengthening the Social Dimension of the EMU in October 2013. In this document, a scoreboard of key employment and social indicators was proposed. The scoreboard demonstrated that EU member states showed significant and dangerous divergences during the crisis in terms of overall unemployment and youth unemployment and inactivity, along with income inequality and poverty, especially inside the euro area.[12]

These trends underline the importance of the debate on eurozone fiscal capacity.[13] Out of various possible instruments, unemployment insurance stands out with its potential to tackle asymmetric shocks, cyclicality and social dislocation. Two main directions for developing unemployment reinsurance have been explored: a partial pooling of national funds[14] and a reinsurance mechanism[15]. Both models can deliver three types of stabilisation.

First, they would contribute to *economic stabilisation* by shifting demand and purchasing power to countries and regions which otherwise need to implement fiscal "adjustment" and internal devaluation.[16]

9 L. Andor: Europe's Quest for Growth, www.primeeconomics.org, 23 March 2015.

10 See D. Vaughan-Whitehead (ed.): The European Social Model in Crisis: Is Europe losing its soul?, Cheltanham 2015, Edward Elgar Publishing.

11 L. Andor: Towards shared unemployment insurance in the euro area, in: IZA Journal of European Labor Studies, Vol. 5, No. 1, 2016.

12 European Commission: Employment and Social Developments in Europe 2013, European Commission, 2014.

13 P. Pasimeni: The Economic Rationale of an EMU Fiscal Capacity, Workshop "Towards a Genuine Economic and Monetary Union", Proceedings of the Oesterreichische Nationalbank, Vienna, 11 September 2015.

14 S. Dullien: A European Unemployment Benefit Scheme. How to Provide for More Stability in the Euro Zone, Gütersloh 2014, Bertelsmann Stiftung.

15 M. Beblavý, D. Gros, I. Maselli: Reinsurance of National Unemployment Benefit Schemes, CEPS Working Document No. 401, 2015.

16 The stabilisation capacity has been proven by several independent studies, including A. Brandolini, F. Carta, F. D'Amuri: A feasible unemployment-based shock absorber for the euro area, Questioni di Economia e Finanza (Occasional Papers), No. 254, Banca d'Italia, 2014; and M. Dolls, C. Fuest, D. Neumann, A. Peichl: An Unemployment Insurance Scheme for the Euro Area? A Comparison of Different Alternatives using Micro Data, ZEW Discussion Paper No. 14-095, 2014.

Second, *social stabilisation* would be enacted by directing the flow of funds towards more vulnerable groups and helping to tame the rise of poverty among the working age population (which has been a major trend in recent years in Europe).[17]

The third type is *institutional stabilisation*. EMU is based on rules, but the application of these rules has been the subject of academic and political debates. Member states agreed on tightening them, but pragmatic considerations often lead to more flexibility. While some experts simply recommend abandoning these rules entirely, it is more likely that a modus vivendi could be found through the creation of stabilisation tools that would allow the reconciliation of uniform fiscal rules with the need to maintain national welfare safety nets and social investment capacities.

Conclusion

For a variety of reasons, economic growth in Europe has been slower in the last three decades than in the quarter century following World War II. However, neither Europe nor the rest of the OECD world is destined to stagnation. Governments possess the policy tools to both improve the short-term recovery capacity and boost the long-term growth potential of their economies.

To increase their growth potentials, European countries have to invest more – and more intelligently – in education (including early childhood education), lifelong learning and active labour market policies. The EU's financial instruments should be increasingly focused on such objectives.

At the same time, governance at both the EU and national levels must pay more attention to the quality of growth. It is better to speak about the quality of growth than to simply reject growth as a concept. A participatory approach to developing economic policy helps to reconcile various objectives (quantitative and qualitative).

However, slower growth in Europe as compared to the US is only one of our concerns. A more important one is the lack of capacity to deal with substantial imbalances within the single market and the monetary union. Eurozone imbalances necessitate a broader and more substantial reconstruction of EMU that must include the creation of a fiscal capacity. Unemployment insurance is a possible countercyclical fiscal instrument with the potential to improve both economic performance and welfare state resilience at the same time. By improving economic and social outcomes, this would also help boost the overall legitimacy of the EU project.

17 L. Andor: Basic European Unemployment Insurance – The Best Way Forward in Strengthening the EMU's Resilience and Europe's Recovery, in: Intereconomics – Review of European Economic Policy, Vol. 49, No. 4, 2014, pp. 184-203.