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GROWTH SLOWDOWN ENDANGERS THE ECONOMIC COHESION OF THE EUROPEAN UNION[1]

Summary

It is argued that European integration has not fulfilled its chief economic promises. According to official documents and in compliance with post-Keynesian economic interpretation of major long-term trends characterizing the Euro area, the output growth has been increasingly weak and unstable. Productivity growth has been following a decreasing trend. Income inequalities, both within and between the EU Member States, have been rising. This sorry state of affairs is likely to continue – and likely to precipitate further exits, or eventually, the dissolution of the Union. However, this outcome is not unavoidable. A better integration in the EU is possible, at least in theory. Also the negative consequences implicit in the existence of the common currency could be neutralised. However, the basic paradigms of the economic policies to be followed in the EU would have to be radically changed. First, it follows from considerations presented that the unconditional fiscal consolidation provisions still in force would have to be repelled. Second, 'beggar-thy-neighbour' (or mercantilist) wage policies would have to be 'outlawed'.

***JEL codes**: F15, F43, E62*

***Key words**: European Union, integration, disintegration, economic growth, productivity, race to the bottom*

1. Economic integration has not fulfilled its promises

Under the provisions of the Maastricht Treaty, European economic integration has been further advanced. The introduction of the euro crowned the process of internal liberalisation of trade within the EU and facilitated the creation of an area of ever freer movements of capital,

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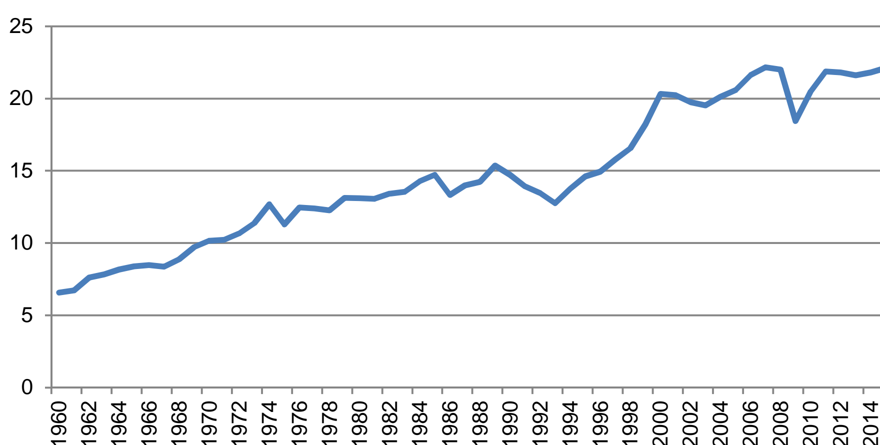
labour and services throughout the continent. There are many possible measures of advances in economic integration. Perhaps the most unproblematic of these measures is the share of mutual trade in the EU aggregate GDP. Figure 1 shows the mutual exports as a percentage of euro-area (EU-12) GDP since 1960.

Figure 1. Mutual exports as a percentage of EU-12 GDP



Source: AMECO.

Economic integration (just as internal economic liberalisation or globalisation) is generally assumed to be conducive to economic growth (even if it is now often admitted that it may have unwelcome – but transient – distributional effects). Tighter integration has been expected to promote faster overall productivity growth – for example through increased competition and more efficient utilisation of scarce resources.

The European integration has failed to deliver on these promises. In actual fact economic growth in the integrating Europe has been slowing down secularly, since approximately the mid-1970s (see Figure 2). Growth rates follow a declining trend which – if continued – would push the EU-12 into permanent recession. In addition, growth has become increasingly volatile, with violent ups and downs, and recessions climaxing around 1993, 2003, 2009 and 2012. One may bear in mind that the short-lived recessions in 1975 and 1981 could have been the aftermaths of the oil embargoes (1974, 1979) and the associated shortages severely affecting the 'supply side'. Beyond such shortages

materially affecting production, the oil shocks had negative consequences for inflation, income distribution and – especially – private investment[2].

The deep slumps in 1993 and 2009 cannot yet be viewed as 'exogenous shocks'. These slumps were 'endogenous'. They were the consequences of the economic 'architecture' consciously designed by the European economic elites. In 1993 the recession was the consequence of the crash of the Exchange Rate Mechanism; in 2009 it was the near-collapse of the EU's financial sector operating by the rules enacted by the EU policy-makers. It may be added that the second-dip recession of 2012 was provoked by the 'fiscal consolidation' hysteria gripping the euro-area decision-makers. Finally, it is worth observing that the introduction of the euro (since 1998) and the full internal trade liberalisation (Single European Market, since 1993) did nothing to accelerate and smooth out GDP growth.

Of course, the euro area consists of high-income countries. The neoclassical growth theory predicts that growth in such countries slows down 'naturally'. Is then the situation illustrated by Figure 2 fairly 'normal'? There are two arguments against such an interpretation. First, observe that until 1973 growth was very fast. The growth slowdown started abruptly, just as the Bretton Woods system was terminated (starting the era of liberalisation). That event seems decisive. For it is rather difficult to assume that in 1973 the West European countries suddenly reached the levels of developments beyond which they could no longer grow as fast as before. Secondly, the applicability of neoclassical growth theory to situation at hand is very problematic. The effects predicted by that theory are derived under many assumptions which are hardly satisfied here. For example, the neoclassical growth theory assumes full employment all along. But that assumption had been satisfied until 1973. Since then high (if variable) unemployment has persisted.

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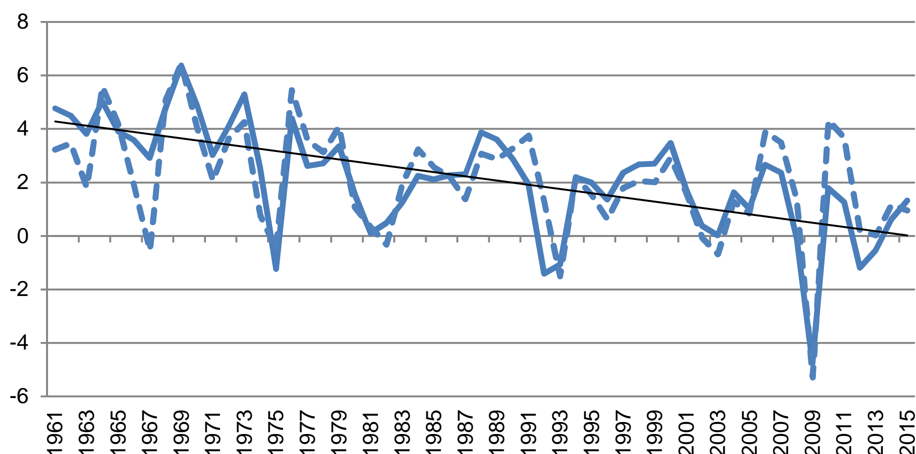
[2] Actions by the OPEC cartel produced fundamental *uncertainty*: would the energy prices/supplies be allowed to return to 'normal' levels, or would they rather stay at 'abnormal' levels more or less indefinitely? Under such uncertainty the best approach to taking (irreversible) investment decisions (involving technology choice: energy-saving, or traditional) could be of a *wait-and-see* sort.

Figure 2. Growth rates of real per capita GDP for EU-12 and Germany since 1961



Source: AMECO.

2. Is the weakening labour productivity growth responsible for the slowdown of output growth?

Labour productivity has also followed a declining trend (see Figure 3). This outcome is usually considered a paradox. A number of commentators and researchers have pondered on the ongoing productivity growth slowdown. Given the (apparent) acceleration of technological progress and the rather obvious advances in applied research and innovation activities, the labour productivity growth slowdown is considered a paradox. The solutions to the paradox sometimes forwarded suggest that output (and productivity) have been systematically underestimated by the statistics[3]. Others tend to disagree with the mismeasurement thesis without yet offering a coherent explanation of the paradox[4] (e.g. Byrne et al., 2016).

Robert Gordon (2015) is the most vocal representative of the 'supply-siders' who suggest that the technological progress has not

[3] See Mokyr, J. (2014), '*Secular Stagnation? Not in Your Life*', [in:] C. Teulings and R. Baldwin (eds.), *Secular Stagnation: Facts, Causes, and Cures*, VoxEU.org eBook or Feldstein, M. (2015), 'The U.S. *Underestimates Growth*', Wall Street Journal, 18 May.

[4] Byrne, D., Fernald. J.G. and Reinsdorf, M.B. (2016), *Does the United States have a productivity slowdown or a measurement problem?* Brookings Papers on Economic Activity, Conference Draft, 10-11 March.

prevented the weakening of labour productivity growth. He then goes as far as to blame the post-2008 stagnation itself on the slower growth (since 2004) in potential output '*emanating from the behaviour of productivity*'. The implication of this seems to be that the supply side needs further 'structural reforms', stronger deregulation, more labour market flexibility etc. so as to strengthen productivity growth and thus contribute to faster growth of output[5].

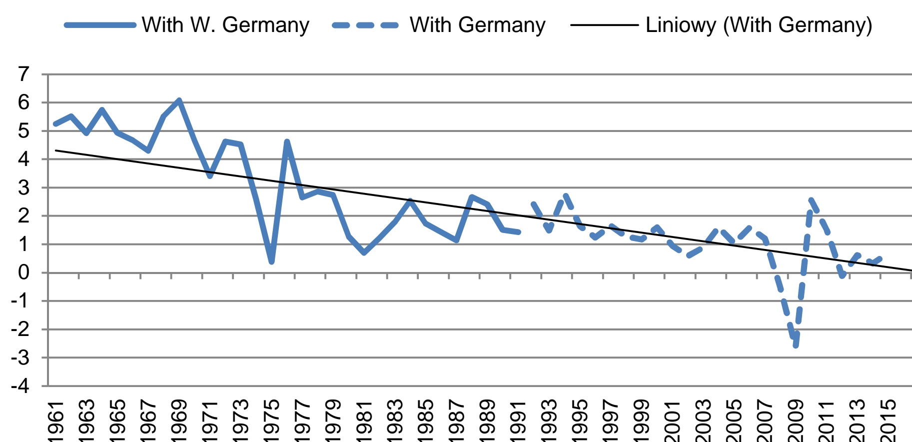
However, the results of an econometric examination[6] of the links between labour productivity and output growth for 22 countries (for which long-term data are available), for West Germany (years 1960 through 1991), for unified Germany (years 1991-2015) and also for a larger set of countries (years 1991, or 1995, through 2015) indicate that, generally, productivity does not 'cause' output. Much more often the causation seems to be running in the opposite direction: from output (or its growth rate) to productivity (or its growth rate). This finding, though inconsistent with the 'mainstream' ideas on the sources of long-term economic growth, is reminiscent of the classical Kaldor-Verdoorn Law[7]. The progressing slowdown in output growth at the global level, initiated in the mid-1970s (amid the wholesale change of economic policy paradigms), may have been mirrored – and followed – by the progressive slowdown in productivity growth (and that despite the indisputable acceleration of technological progress). Productivity growth slowdown cannot be the cause of the overall slowdown of output growth in the EU.

[5]The older economic literature was concerned with the concept called 'Baumol Disease' (Baumol 1967). The concept stipulates that the labour productivity in the service sector could be expected to grow at lower speed than in manufacturing. Because the GDP share of services increases with affluence it was concluded that the overall labour productivity growth had to slow down with rising income. However, empirical evidence does not support the concept (see e.g. Triplett and Bosworth, 2003). The 'disease has been cured' as the inter-sector links have been strengthening (with rising contents of services as intermediate inputs in the production of non-services and rising contents of non-services as intermediate inputs in the production of services).

[6] Podkaminer, L., *The slowdown in labor productivity growth is an effect of economic stagnation rather than its cause*, Acta Oeconomica, forthcoming.

[7] Kaldor, N., *Causes of the Slow Rate of Economic Growth in the United Kingdom*, Cambridge University Press, Cambridge.

Figure 3. Real productivity (GDP per employed person) growth rate for EU-12 since 1961



Source: AMECO.

3. Is an excessive degree of income redistribution the problem?

Can it be that productivity and output growth slowdown has been the price for increased income convergence – greater income equality? The answer is No. The dispersion of per capita incomes *across* the EU Member States has been increasing (see Figure 4). One observes sigma-divergence instead of sigma-convergence.

As can be seen in Figure 4, in terms of per capita income the 'old' EU has shown divergence rather than convergence (excluding a brief period of the recession-related income convergence in 2009). The same is true for the extended EU.

The increase in income inequality has been even more pronounced in individual EU Member States: 'It is the within-country, not the between-country dimension, which appears to be most important. Inequality in Europe has risen quite substantially since the mid 1980s[8].'

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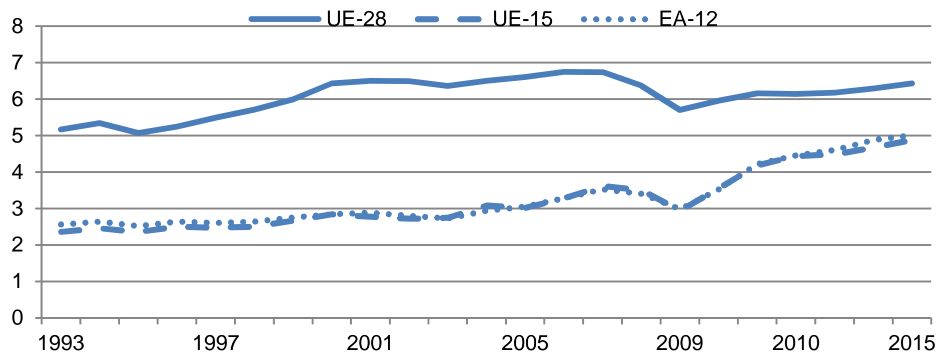
[8] Bonesmo Fredriksen, K., *Income Inequality in the European Union*, OECD Econ. Dept. Working Paper, No. 952, p. 2.
It is rather obvious that the growth slowdown cannot be attributed to the intensified shortages of labour: unemployment has been high since the early 1980s. Neither can it be attributed to intensified shortages of exhaustible natural resources. The continuing

Figure 4 Standard deviation of per capita national incomes (in 1000 PPS, population-weighted) since 1993



Note: EA = euro area.
Source: AMECO.

4. Central and East European new Member States: trapped in integration

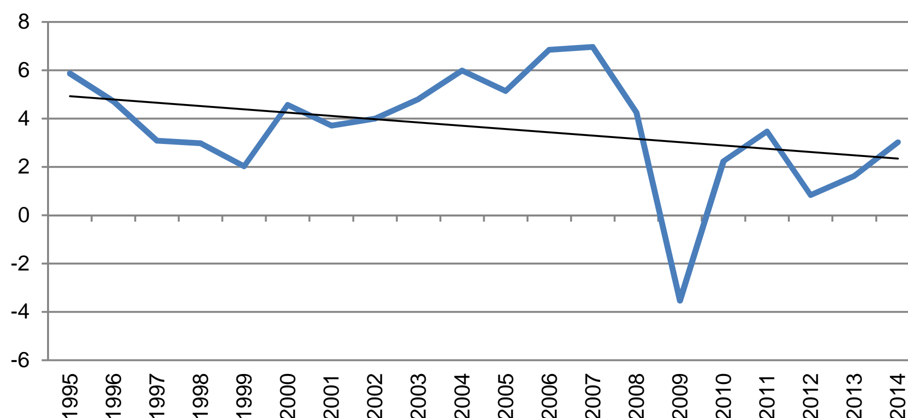
The economic history of the Central and East European new Member States of EU is still quite short. Nonetheless, economic growth of these countries – under progressing integration into the EU – is not really impressive. The post-accession boom (2003 through 2007) was fairly short – and ended in deep recession (see Figure 5). The post-recession growth has been anaemic. There are good reasons to expect their growth to be rather slow in the future[9]. These countries have come to depend, economically, on the West European core (primarily Germany). The pace (and sources) of their economic growth have been adjusting to those of Germany. In the medium term they will not grow much faster than Germany – and the German economy is very likely to stagnate[10].

secular decline in commodities' terms-of-trade indicates that commodities are becoming less scarce, not more (see e.g. Mollick et al. 2008).

[9] Podkaminer, L., *The euro area's secular stagnation and what can be done about it. A post-Keynesian perspective*, Real World Economics Review, Issue 70.

[10] The 2009 recession was certainly ignited by the global financial and economic crisis. But slow post-crisis growth in the Central and East European new EU Member States cannot be easily blamed on global developments. Unlike the euro area, the US – and many other (also high and middle-income) countries – experienced faster and more pronounced post-crisis recoveries.

Figure 5. Real rates of growth of output per capita for the 10 NMS



Source: AMECO.

5. The reasons of the failure

For some authors the economic failure of the EU can be directly attributed to the principles first introduced in the Maastricht Treaty and later reiterated in a series of Fiscal Compacts or Pacts. Combined with the common currency (and the common monetary policy embodying the tradition of German central banking) the Maastricht fiscal rules have eventually suppressed output growth, generated internal imbalances – and thus paved the ground for the internal economic disintegration of the Union[11].

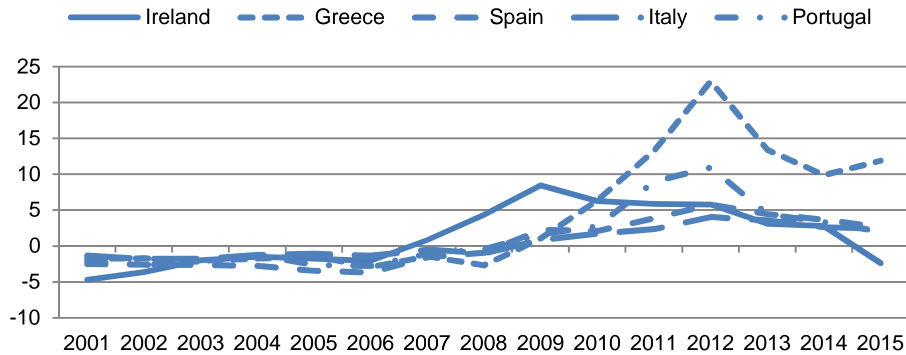
The vicious dynamics behind the developing economic drama can be concisely described as follows. First to come is the set of fiscal rules setting narrow limits for public sector deficits. The fiscal rules are to apply universally – without regard for national specificities. Thus a country (such as Germany) which is capable of producing output in excess of the needs of its private sector (be it private consumption or private investment) cannot rely on the public sector to absorb the excess private sector savings by means of deficit spending. It is thus left with no other easy option than to run trade surpluses. For such a country running trade surpluses becomes a way of supporting domestic growth (and of keeping its own unemployment in check). Of course, for a country to be

[11] Laski, K., Podkaminer, L., *The basic paradigms of EU economic policy making need to be changed*, Cambridge Journal of Economics, Vol. 36, No. 1.

capable of running trade surpluses there must be some countries capable of running trade deficits. It is understood that for countries running trade deficits this implies not only accumulation of foreign debt – but also the suppression of domestic output growth and additional unemployment (to be associated with persistent fiscal deficits).

At this stage it is important to consider the way the common currency facilitates the rise of cross-country imbalances. One currency, one monetary policy, and one policy interest rate have very different economic implications for various members of the same group. The policy interest rate has been tuned to the average inflation rate calculated for the whole area. That would be fine if inflation (and inflation histories) were similar across the whole area. But in fact they have been very different. In consequence, for countries with inflation persistently higher than the average the real interest rates have tended to be low (or even negative) while – at the same time – the real interest rates may be prohibitively high in countries with much lower inflation. As Figure 6 shows, until 2008 the real interest rates in Germany were consistently higher than elsewhere. Of course such differential developments favouring Germany's partners could not persist indefinitely. As soon as the boom supported by low real interest rates collapsed (under the weight of accumulated domestic and foreign debts) the real interest rates in countries that had had higher inflation become high (in many cases excessively high). It is at this stage that the initial boom turned into recession.

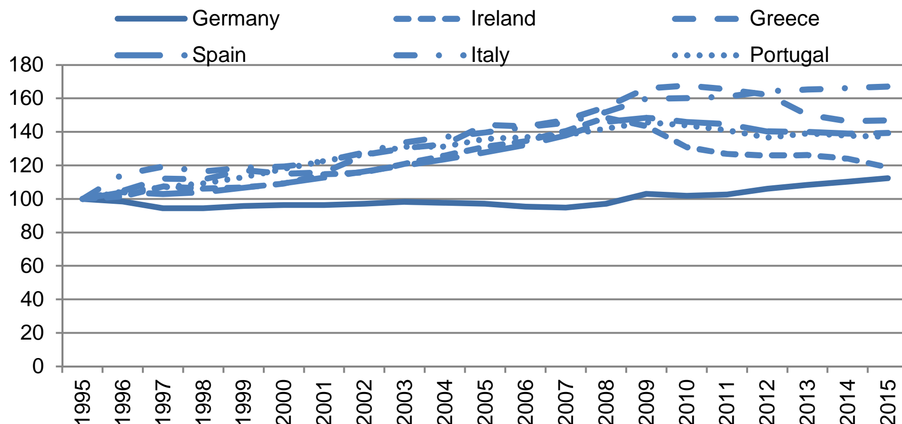
Figure 6. Real long-term interest rates (spread over Germany)



Source: AMECO.

The moral to this story is that the principle 'one size fits all' does not work in practice. The common monetary policy has been destabilising growth and inflation: strengthening inflation (and growth) in countries experiencing a boom while suppressing inflation (and growth) in countries experiencing deflation and output slump. Importantly, as the consequence of differential developments in real interest rates (and inflation), the countries with traditionally low inflation (and, consequently, weak growth in wages, such as Germany) have been gaining cost-competitiveness advantages vs. their higher-inflation partners (see Figure 7).

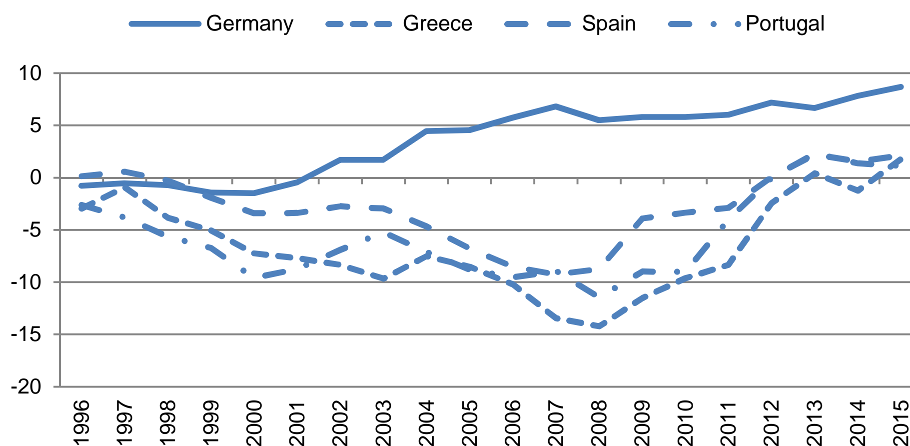
Figure 7. Nominal unit labour costs



Source: AMECO.

That way the low-inflation (and weak-growth) countries have become reliant on ever rising trade surpluses –while the higher-inflation countries that had earlier priced themselves out of international competition have been forced to reduce their trade deficits (see Figure 8) – as a rule hand in hand with persisting depression (or even recession).

Figure 8. Net external lending as a percentage of GDP



Source: AMECO.

6. A better integration in the EU is possible

A better integration in the EU is possible, at least in theory. Also the negative consequences implicit in the existence of the common currency could be neutralised. However, the basic paradigms of the economic policies to be followed in the EU would have to be radically changed[12].

Two, closely related aspects are of crucial importance: first, the rejection of the unconditional fiscal consolidation provisions still in force; second, the prohibition of 'beggar-thy-neighbour' (or mercantilist) wage policies.

The latter issue is obviously important because unduly restrictive wage policies which consequently lead to large trade surpluses not only suppress growth in countries which fail to follow suit (and thus run trade deficits and accumulate foreign debts) but also because the suppressed

[12] Laski, K., Podkaminer, L., *The basic paradigms*, op. cit.

wages (as e.g. in Germany or Austria) are responsible for overall weak growth in countries implementing the internal ‘wage moderation’ strategy. In practice, the ‘beggar-thy-neighbour’ policy is also a ‘beggar-thyself’ policy[13].

Rejection of the unconditional fiscal consolidation provisions is equally important for countries (again, such as Germany) whose private sector tends, on a permanent basis, to save much in excess of its own investment. Without the ability to run trade surpluses (but which never can be sustained indefinitely) such countries must either experience depression, or allow public sector deficits to absorb the excessive private savings[14] (Laski and Podkaminer, 2013).

7. Globalisation is not helpful

Sometimes there have been allusions to the possibility (and even desirability) of each and all EU Member States taking over the German economic policy of repressed wages, balanced public finances and sizeable trade surpluses (necessarily vs. the rest of the world). This proposition is an economic mirage if only because it stipulates the existence of a global economy capable of indebting itself to the EU indefinitely. Otherwise, the EU acting internationally as a much greater Germany is unlikely to be accepted by the United States. Very likely the latter country would retaliate in kind, or adopt protectionist measures. Besides, the economic strategy relying on repressed wages (and thus repressed domestic demand) guarantees weak overall output growth (as the bulk of GDP consists of non-tradable domestically produced goods and services).

Expectation that the outside world – especially in the conditions of advancing globalisation – is somehow capable of helping the European integration is not well grounded. In actual fact the whole global economy is suffering from a malaise that is not very much different from the one affecting Europe. Progressing globalisation turns out to have been

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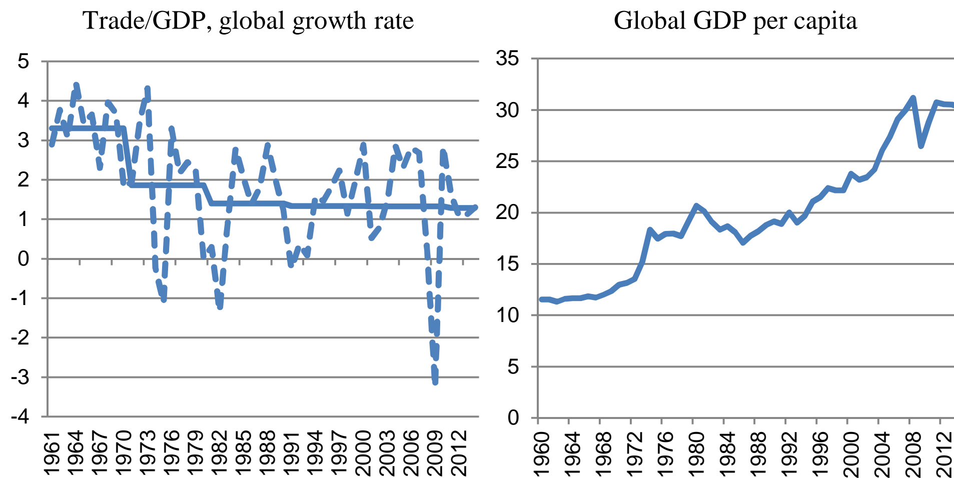
[13] Laski, K., Podkaminer, L., *Common monetary policy with uncommon wage policies: Centrifugal forces tearing the euro area apart*, Intervention. European Journal of Economics and Economic Policies, Vol. 8, No. 1.

[14] Laski, K.,Podkaminer, L., *Net private savings in relation to the government's financial balance: some basic principles of macroeconomics disregarded by the European Union's economic policy makers*,[in:] Ó. Dejuán, E. Febrero and J. Uxó (eds), Post-Keynesian Views of the Crisis and its Remedies, Routledge.

associated with the growth of global output becoming progressively weaker and more unstable (see Figure 9).

Figure 9. Global trade/GDP ratio and global per capita real GDP growth rate



Source: World Development Indicators.

Expanding world trade has failed to accelerate global growth. Rather, the expanding trade may be argued to have contributed to the output growth slowdown[15]. The possible reasons for the unexpected (but econometrically well-grounded) conclusions are partly similar as in the EU case. First, under progressing capital account liberalisation individual countries are quite likely to run trade surpluses (or deficits) much longer than would be possible under less free capital movements. This makes the growth process much more unstable. Second, under progressing trade liberalisation there is a tendency for countries to engage in wage and tax competition. Individual countries try to outsmart the competitors. But when all engage in the race to the bottom, no one is going to win – and all are likely to lose.

[15]Podkaminer, L., *Does trade drive global output growth?*, Bank & Credit, Vol. 45, No.4.

Concluding remarks

The existence of the European Union is of vital importance to the Europeans – and especially for the Central and East European nations. Without the EU these nations would once again find themselves, alone, in a grey zone between their all too mighty neighbours. Essentially, the Central and East European nations do not have a (good) alternative to staying in the UE. But, as the Brexit has proved, some of the ‘old’ EU members may well contemplate exiting. Whether they eventually choose to leave may depend on many factors. Continuing economic stagnation may well prove a decisive factor.

It must be understood that the EU cannot prosper within the confines of self-imposed limitations that have little economic justification, theoretical and practical. Unless the basic paradigms of economic policy for the EU are overhauled, the EU will remain a stagnant area convulsed by recurring economic (and then social and political) crises. Sooner or later these crises will give rise to further exits or would even precipitate the dissolution of the Union.

Whether the radical change happens before it is too late is of course highly uncertain. In any case it should be the duty of Central and East European politician – and also economists – to voice their concerns over the overall orientation of the economic policies of the Union.

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