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Out of the Crisis.
A radical change of strategy for the Eurozone

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Abstract

The paper argues that the crisis, mistakenly interpreted as a standard fiscal/balance of payments problem, was generated by the incomplete nature of the European institutions and a disregard for the consequences of differences in the stages of development of the member countries. The ideological pre-conception that markets are self-equilibrating through price competition has been used to justify disastrous internal devaluation policies in the belief that an austerity regime associated with institutions close to those assumed to prevail in 'core' countries would create the 'right' environment for resuming growth in the periphery.

An analysis of the main phases of the development of European countries since the second post-war period provides evidence of wide differences in the productive structures of the countries of the centre and the southern periphery of Europe at the start of the Europeanization process. These differences entailed an asymmetric capacity of countries at differing levels of development to adjust to external shocks. This longer-term perspective helps us better to assess the limitations of the two alternatives that have been suggested to steer the EZ economy out of its present quagmire: internal devaluation (wage flexibility) in the deficit (Southern European) countries, or expansion of internal demand in 'core' countries (Germany).

Both measures, it is argued, do not go to the root of the development and debt sustainability problems of Southern European countries, which continue to lack a sufficiently broad and differentiated productive structure. Given the differences in the levels of development of the various EU countries and their varying capacities to cope with change, fiscal policy should be assigned two complementary targets: the role of actively promoting — through investment —the removal of development bottlenecks and the renewal of the productive base, and a redistributive and compensative function. This new strategy entails the assignment of a strategic importance to investment guidance by the State through industrial policies geared to diversifying, innovating and strengthening the economic structures of peripheral countries. The paper concludes that this change of strategy is even more important today, since the crisis marks another important structural break in world trade, similar to those of the 1970s and the first decade of the new millennium.

JEL Classifications: F15, O24, O25

Keywords: Eurocrisis, Southern Europe, Germany, Competitiveness, Industrial Policy.

1. Introduction

Three years ago, Shambaugh (2012) remarked that the Eurozone area was facing three interlocking crises: a banking crisis, a sovereign debt crisis, and a growth crisis. Banks were undercapitalized and faced liquidity problems in a number of countries; the rise in bond yields was associated with difficulties in funding public debt; and lastly, economic growth was low in the euro area as a whole and unequally distributed across countries. Shambaugh stressed the interconnection of these crises: "the problems of weak banks and high sovereign debt are mutually reinforcing, and both are exacerbated by weak growth but also in turn constrain growth". His conclusion was that "policy responses that fail to take into account the

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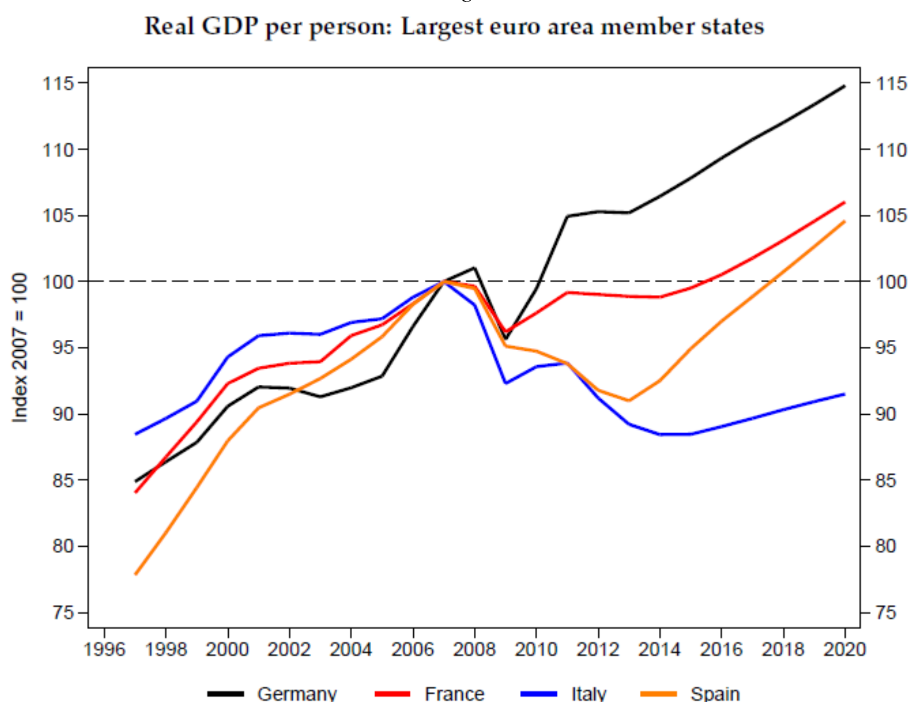
interdependent nature of the problems will likely be incomplete or even counterproductive”. It is not necessary to concur with all the stages of Shambaugh’s analysis to agree with his conclusion, which still remains valid today in a situation that, when compared with the state of affairs at the time he was writing, reveals – together with some positive changes – the persistence (if not a dramatic aggravation) of certain unresolved problems. The sovereign debt crisis has been averted by a rigorously deflationary fiscal policy that has been implemented without interruption since 2010. After July 2012, this was accompanied by a belated commitment on the part of the ECB to break the vicious circle of expectations that, in the absence of a debt-buyer of last resort, encouraged a massive liquidation of sovereign debt. Between 2010 and 2014, the Eurozone countries (EZ) implemented a huge contractionary policy “equal to four percentage points of the monetary union’s economy… The GIIPS [Greece, Ireland, Italy, Portugal and Spain] accounted for 48% of the fiscal swing, even though they accounted for only a third of Eurozone GDP. Eurozone core nations decided that they too had to embrace fiscal rectitude. As the monetary union’s largest economy, tightening by Germany accounted for 32% of the Eurozone’s overall fiscal tightening. France’s austerity amounted to 13 % of the Eurozone total” (CEPR, 2015, pp.10-11). Owing to these austerity policies, only a few Eurozone nations have recovered their pre-crisis growth and employment rates (Figure 1), while socio-economic conditions in the periphery have worsened dramatically.

Figure 1

Real GDP per person: Largest euro area member states



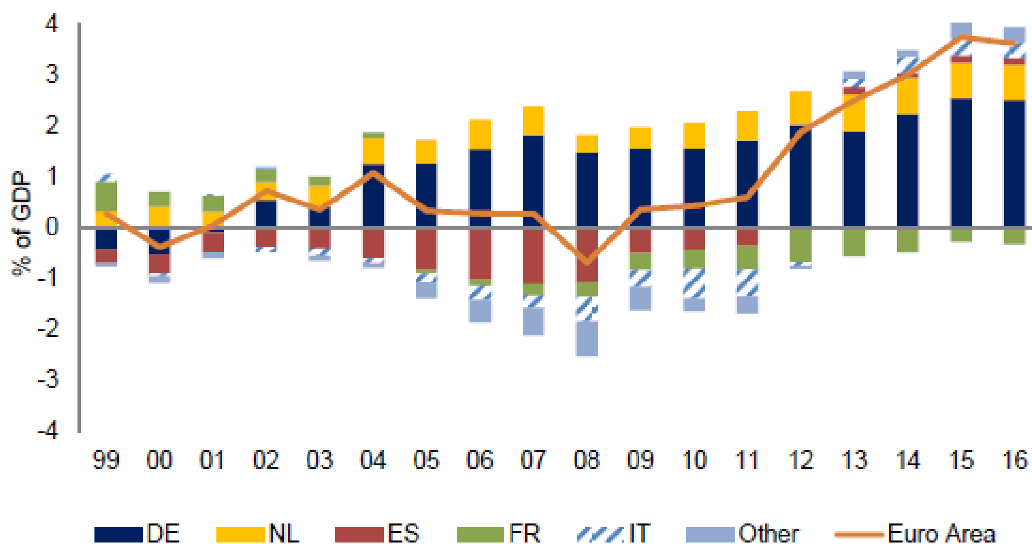
Notes: Annual data and projections from April 2015 World Economic Outlook. Index 2007=100.

Source: Orphanides 2015.

With households, corporations, and governments simultaneously reducing expenditure, income and production have dropped and unemployment has soared, with youth and long-term unemployment and inactivity rates at record levels. Several years of harsh austerity have also taken their toll in terms of inequality and poverty, and have cancelled a significant part of the gains in living standards achieved by low-income households over the past 20 years. Welfare provisions have been cut everywhere: the European Union's ambitious targets for combating poverty and achieving social inclusion are self-delusive because of the constraints faced by the Member States on the periphery, which were hardest hit during the crisis and are no longer in a position to ensure even a minimum level of social inclusion (Arpe et al. 2015). The destruction of productive capacity, skill capabilities, and welfare protection will take years to redress. Meanwhile, the euro area is churning out the world's largest current account surplus in value terms (approximately 3.0% of GDP in 2015) (Figure 2).

Figure 2.

The Euro area current account balances

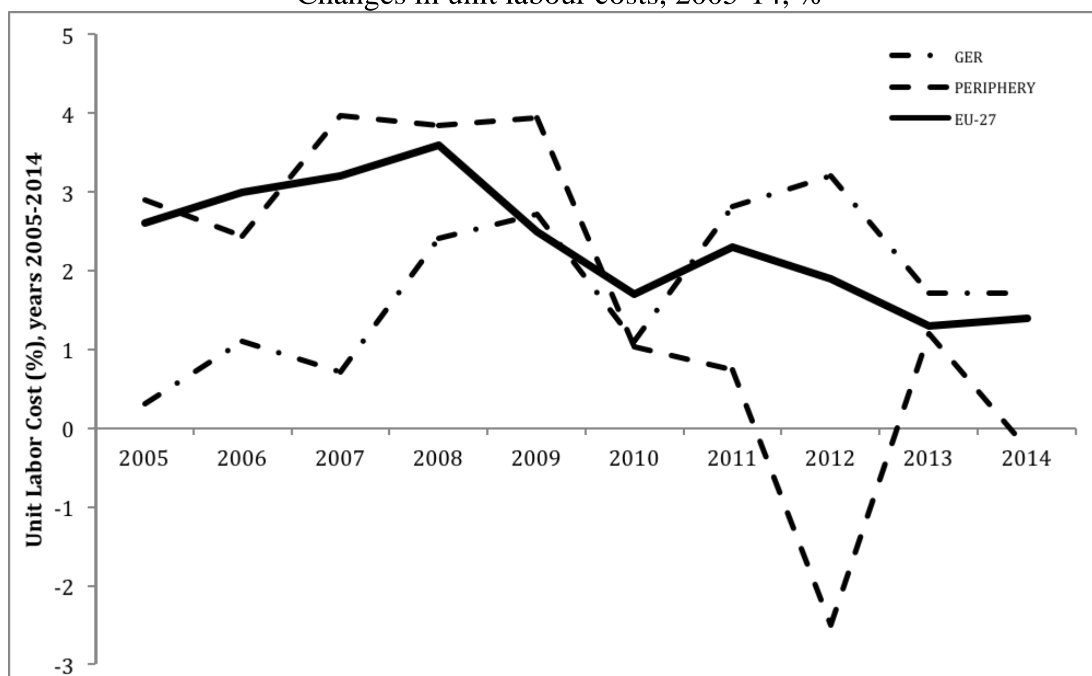


Source: European Commission, Alert Mechanism 2016, p. 9.

The bulk of this is accounted for by Germany (7.9% of GDP) and the Netherlands (10.6%), but also the former deficit countries are now recording balanced or surplus positions. The austerity measures opened up a process of alignment with Germany also for other economic indicators of the peripheral countries: since 2010, the European periphery has achieved a significant reduction in unit labour costs compared with Germany and EU27 (Cirillo and Guarascio, 2015 p. 5) (Figure 3).

Figure 3

Changes in unit labour costs, 2005-14, %



Source: Cirillo and Guarascio (2015).

After 2010, the government primary balances of countries across the Eurozone also reached a surplus, converging with Germany's (see Saraceno, 2015). At first glance, the recession has 'induced' (or forced) the adjustment of all those indicators whose misalignment, according to many commentators — but also the Troika and Germany's political representatives — had been at the origin of the crisis. If one adds that the ECB's quantitative easing (QE) is encouraging the devaluation of the euro against the dollar and that oil prices are subdued, it could be argued, to rephrase Chairman Mao, that "everything under heaven is in order, and the situation is excellent". Contrary to expectations, however, the recovery is very sluggish, and is exposed to the risk of being derailed: in fact, QE alone is at best ineffective, and at worst conducive to new bubbles. With the rest of Eurozone in enduring recession and the international economy losing momentum, the German export engine — which is offered as a model for all Eurozone countries — may also falter, dragging the other countries with it.

One may wonder whether the very idea of a model to be imitated is in fact the origin of a systematic flaw in current analyses of the crisis: the fallacy of composition (the idea that what is true of the parts must also be true of the whole). This fallacy is particularly evident in the limitations of the export-led model: as is often recalled (Whyte 2010, and Krugman and Saraceno on their blogs, among others), it is impossible for all countries to base their growth on exports. More generally, as in the case of the interlocking crises cited above, if the mutual, systemic relations of actors are not explicitly taken into consideration, the risk of a fallacy of composition will always loom. This warning should also be borne in mind if the nationalistic bias that results from taking a country as the unit of analysis is to be avoided: in fact, countries include actors with different destinies: banks, businesses,

workers, the unemployed, *rentiers*, pensioners, children, etc.). The unknown factor (the crucial object of the dispute) in every crisis is how the present and future costs of the crisis will be allocated, in particular between creditors and debtors. If we consider only countries, we neglect the internal distribution of the economic and social costs of the crisis. For reason of space, however, this aspect will be dealt with only briefly.

2. The limitations of a consensus narrative on "why the crisis became so bad and lasted so long"

In November 2015, a conspicuous number of prestigious economists[1] signed a document entitled *Rebooting the Eurozone: Step 1 - Agreeing a crisis narrative* (CEPR 2015). Although claiming to come from different backgrounds, the authors found it "surprisingly easy to agree upon a narrative and a list of the main causes of the EZ Crisis". The key terms in their account are "excessive intra-EZ capital flows" and "sudden stop". The crisis is interpreted as a standard balance of payments crisis that can be analysed using models previously applied to developing countries. A country's membership of a monetary union is considered irrelevant except for the greater opacity in signalling the risks involved in the formation of large capital flow imbalances. "EZ also mattered since the incomplete institutional infrastructure [no lender of last resort, impossibility of devaluation] *amplified* the initial loss of trust in the deficit nations" (italics added). The main message, which assigns blame and transmits recipes for the future, is that "All the nations stricken by the Crisis were running current account deficits. None of those running current account surpluses were hit".

Together with an important admission, to which we will return below, the paper contains two striking omissions and a number of unconvincing or contradictory statements. The first significant omission is the absence of any reference to the complementary relationship between the formation of a persistent, growing current account surplus by the core countries (in particular Germany) after 1999, and the corresponding deficit of the peripheral European countries with respect to Germany. Trade surpluses lead to debt imbalances. By definition, a current account deficit entails net capital inflows. Germany's large current account surpluses fuelled German banks' lending to southern Europe. The "consensus narrative" of the causes of the crisis tends to neglect the surplus aspect (which could have prompted expansionary fantasies or, even worse, criticisms of the export-led model), arguing that the crisis was triggered unilaterally by excessive foreign indebtedness on the part of peripheral countries: huge capital flows were drawn from the core to the periphery, facilitated by the monetary union and its regulatory framework.[2]

[1] They include R. Baldwin, T. Beck, A. Bénassy-Queré, O. Blanchard, G. Corsetti, P. de Grauwe, W. den Haan, F. Giavazzi, D. Gros, S. Kalemli-Ozcan, S. Micossi, E. Papaioannou, P. Pesenti, C. Pissarides, G. Tabellini and B. Weder di Mauro.

[2] Orphanides (2015, p. 11) observes: "The regulatory framework that had been created by the governments treated all euro area sovereigns as zero-risk-weight assets, from a capital requirement perspective, and exempted them from regulations regarding large exposures". The author suggests that these rules might have induced the financial markets to assume away the country risk.

The crisis started — we read in the CEPR document — with a “sudden stop” in cross-border lending: the EZ institutions and short-sighted government choices combined to trigger a vicious cycle between banks and their governments that amplified and spread the crisis. The term ‘sudden stop’ had previously been used in the literature to describe a sudden slowdown in private capital flows *to emerging market economies* after the formation of large current account deficits. It was usually followed by a sharp fall in demand, production, and employment, and by drastic exchange rate depreciation. The assignment of a central role in the EZ crisis to a phenomenon observed in emerging markets is interesting because the entire institutional architecture of the Monetary Union was based instead on the assumption that countries that met the Maastricht criteria for accession were all on a level playing field. This concern to stress that “the debt evolution was not a core-periphery story” is also found in the CEPR document: in fact, the private and public debt build-up included France. Even though house prices rose more in the GIIPS than in Germany, it is reaffirmed that “there was no simple core versus periphery distinction”. Somewhat contradictorily, the statement that “much of the bank lending went to the housing sector” is followed by the remark that in the pre-crisis period “banks from the ‘core’ (Germany, France, Austria, Belgium and the Netherlands) bought very large amounts of debt from the nations that would eventually get into trouble” (see Table 1, p. 7, showing total lending from core countries’ banks to the periphery between 1999 and 2009).

Now for the second important omission of the ‘consensus narrative’: what circumstances led to the ‘sudden stop’? The CEPR document accepts the conventional story that the trigger was the newly elected Greek government’s revelation that previous governments had masked the size of the budget deficit. However, by examining the data on foreign debts held by credit institutions published by the Bank for International Settlements (BIS), Lindner (2013) has been able to trace the dual role that German and French investors, particularly banks, played at the start of the Eurozone crisis. This dual role connects the subprime crisis in the US with the Eurozone crisis that hit the European periphery: a concatenation of events transforms what had previously appeared to be a *local* sudden stop narrative into a broader, worldwide narrative of contagion. Lindner shows that before the Lehman Brothers collapse (September 2008), French and German financial institutions held almost a quarter of the debt that the USA owed to foreign banks. European banks had accumulated speculative positions buying securitised US mortgages through off-balance-sheet Special Purpose Investment Vehicles. These lightly regulated ‘shadow banks’ need only a small amount of capital, and as a result are highly leveraged. In the middle of 2008, French and German financial institutions were also the largest creditors of the countries of the European periphery (not only governments but also the private sector): at the time, French and German financial institutions accounted for 60% of the amounts owed by Italy, 45% in the case of Spain, 42% in the case of Greece, 37% in the case of Ireland, and 33% in the case of Portugal[3]. As a consequence of the US subprime crisis, which began in 2007,

[3] Acharya and Steffen (2013) have shown that profits and losses of the EZ core countries’ banks may be understood as the outcome of a ‘carry trade’ strategy. With access to short term funding in the US wholesale financial markets, European banks have undertaken long peripheral sovereign bond positions. “On the upside, the trade would pocket the ‘carry’, the spread between the long term

German and French financial institutions suffered large losses. By August 2007, the French bank BNP Paribas had suspended two funds involved in the US mortgage market. Other French banks were having difficulty securing funds in the interbank markets. The German IKB, which had dealt substantially in US mortgage securities, also announced in July 2007 that it had been severely affected by the subprime crisis, and had to be rescued twice, in 2007 and 2008, through bailouts organized on the first occasion by KfW (Kreditanstalt für Wiederaufbau, a government-owned development bank) and on the second by the German Government itself. [4] In order to rebuild their capital, financial institutions called in the loans they had made to what we would consider today to be 'crisis countries'. As Lindner says, "In this way, through the banks, the subprime crisis contributed very significantly to the Euro crisis". The expansion of the bank crisis into a Eurozone crisis was helped — Lindner adds — by the instructions the European Commission gave in 2009 to all the banks that needed to be rescued by their national governments: they were obliged to reduce the credit they were providing. Between the second quarter of 2008 and the fourth quarter of 2012, the banks covered by the BIS survey reduced the debt held in the Euro-crisis countries by 42%, creating massive financing problems. French and German financial institutions accounted for half of this cut in lending. These events are recalled here to illustrate the context in which the first bailout of Greece took place in May 2010. Its failure is crucial because it lies at the origin of a chain of crises in Greece and a contagion effect in the other peripheral countries.

In the CEPR document, the figures documenting the financial exposure of 'core' countries *vis-à-vis* peripheral countries are followed by some important remarks that hint at mismanagement of the crisis. It is worth quoting them in full: "This interlinkage between core-nation banks and periphery-nation borrowers created one of the fragilities that made the Crisis politically difficult to manage. It meant that restructuring the debt of Crisis-stricken nations like Greece would have forced the problem back onto banks in nations leading the bailout. In other words, the obvious solution of writing down Greek debt might well have increased the risk of classic bank-solvency crises in France and Germany. Indeed, this is exactly what happened to Cyprus when investors were eventually forced to take a haircut on Greek debt" (*ibid.*, p. 7. See also pp. 13-14, where it is maintained that "political 'conflicts of interest'" inhibited "some natural solutions such as the writing down of Greek government debt in the early days of the Crisis"). The unusually outspoken tone of these sentences (and, indeed, the contrast between a 'natural' and a 'political'

peripheral sovereign bonds and banks' short -term funding costs. On the downside.,… the spreads between the two legs of the trade diverged even further resulting in significant losses for banks " and casting doubts on their solvency.(*ibid*., p.1). For evidence on core EZ banks' funding in foreign financial markets and re-loaning to the European periphery, see Hale and Obstfeld (2014). Shin (2011) pointed out that before the subprime crisis European global banks sustained the 'shadow banking system' (not subject to regulatory control) in the US by drawing on dollar funding in the wholesale markets to lend to US residents through the purchase of securitised claims on US borrowers.

[4] According to Mediobanca-R&S (2015, pp. 94-95), in the years 2008-2009 the Landesbanks (banks owned by the German Lånder) registered losses amounting to 14 billion euros, writing down more than one-third of their net worth. Large losses were due to speculation in financial derivatives.

solution of the crisis[5]) recall the analysis of the first Greek bailout carried out by Orphanides (2015), who served as Governor of the Central Bank of Cyprus between 2007 and 2012. He recalls that when Greece sought IMF assistance, one of the criteria for an IMF loan was that "a rigorous and systematic analysis indicates that there is a high probability that the member's debt would remain sustainable in the medium term". Since sustainability could not be proved, on the insistence of the German and French governments the IMF introduced an exemption to the established procedures and proceeded with a programme that by ruling out debt restructuring was doomed to failure. 'Systemic' reasons, namely the fear of contagion-induced losses associated with restructuring, were invoked to justify this exemption, which ended up with Greece having to bear additional costs. As Orphanides recalls, the risk that a restructuring might ignite contagion in the whole EZ area at the time could not be easily dismissed. "The banking system in a number of euro area member states, importantly Germany, remained fragile in the aftermath of the global financial crisis". As mentioned above, because Chancellor Merkel's government had bailed out several German banks since 2007, new losses would have put the Chancellor in a difficult political position.[6] This had a decisive influence on the Troika's decision to launch a rescue plan without debt restructuring, even though everyone knew it would fail. According to Orphanides, a solution should have been found that would compensate Greece for the higher costs associated with the decision to avoid restructuring. Instead, fiscal tightening pushed the Greek economy into deep recession, triggering a financial panic that soon engulfed the other debtor nations. "The result was unfortunate but predictable: massive destruction in some member states, and a considerably higher total cost for Europe as a whole." (Orphanides 2015, p. 3).

One merit of the CEPR document is its recognition that, with the exception of Greece, the crisis was not led by fiscal profligacy. Spain and Ireland had one of the lowest public debt to GDP ratios, and Italy had reduced its public debt by ten percentage points of GDP; by contrast, Germany and France had allowed their debt ratios to rise above the 60% Maastricht limit (CEPR 2015, p. 5). According to the authors' narrative, the crisis developed in three stages: a) "the capital inflows tended to drive up wages and costs, resulting in a loss of competitiveness that validated the current account deficits"; b) "much of the investment headed towards non-traded sectors like government consumption and housing" (*ibid.*, p. 4); and c) "the rigidity of factor and product markets made the process of restoring competitiveness slow and painful in terms of lost output" (*ibid.*, p.2).

As we shall show below, the data on real exchange rates do not confirm the idea of a general loss of *price* competitiveness of the peripheral countries *vis-à-vis* Germany. Further, the idea that investment directed towards tradable sectors makes it

[5] See also Orphanides (2014). In his research work, he argued against output-gap-based policy rules, favouring non-activist rules drawing on K. Wicksell and M. Friedman.

[6] Orphanides reports a "startling and controversial" statement given by the former Governor of the Bundesbank, Karl Otto Pöhl, in an interview published by *Der Spiegel* on May 18, 2010, just one week after the Troika programme had been decided: "It was about protecting German banks, but especially the French banks, from debt write-offs" (quoted in Reuters, 2010). On that occasion, he argued that Greek debt should have been restructured to reduce it by one-third.

easier to repay a country's debt is implicitly based on the assumption that both traded and non-traded products and services had only one final destination, thereby ignoring their frequent allocation to intermediate uses. Increasing quotas of services are entering the production of exportable goods and/or are becoming tradable. Yet is it possible to channel foreign resources into traded goods sectors without some sort of investment guidance? Lastly, given the (dubious) universal conviction that 'structural reforms' consist only in measures targeted to obtain greater labour flexibility, it is difficult to maintain that the blame for such a long and deep crisis should be laid on a lack of activism in this domain.

The exclusive focus on the ineffectiveness of monetary policy due to the zero-bound interest rate has diverted attention from the possibility of a high inelasticity of investment with respect to the rate of interest. In early 2015, the ECB at last implemented a policy of "quantitative easing", injecting large amounts of money into the economy. One year into this policy, however, we must conclude that, while it has been effective in depreciating the euro, thus providing some relief from exports, QE has been ineffective in making credit available to firms, stimulating investment and expenditure, and kick-starting the EZ economy. To be effective, monetary policy should be backed up by fiscal policy, but there is no corresponding party to the Central Bank, and no fiscal policy at a EU level responsible for EU-wide aggregate demand, while, at the country level, the indebted nations' fiscal policy is severely constrained by the Stability Pact. Thus, the excess liquidity that is created overflows into interest rates, the euro exchange rate, and Target2 balances.

To conclude, the creation of a Monetary Union without a fiscal and political union led to ignoring the problems of the transition to full integration and the crucial issue of who should eventually pay the cost of this incompleteness. As we argue in the following sections, this means that it ignored the problems originating from the differing stages of development of its member states. The crisis, which was mistakenly interpreted as a standard fiscal/balance of payments problem, actually required institutional corrections consistent with these basic flaws.

3. Alternative interpretations, alternative exit strategies

The discussion on how to steer the EZ economy out of its present quagmire has focused mainly on two alternatives: internal devaluation (wage flexibility) in the deficit (Southern European) countries, or expansion of internal demand in 'core' countries (Germany). In a recent paper written with Gianluigi Nocella (Simonazzi et al. 2013), we argued that the former solution is economically unsound, socially unfeasible and ultimately counter-productive, while the latter is politically unfeasible and probably insufficient. In fact, it is the first that has been put into practice until today.

The disappointing results obtained so far suggest that we should briefly review the theoretical and empirical bases of these interpretations. As is often the case in disputes among economists, the starting point is a national accounts identity: the difference between national savings and investment is identical to the current accounts balance (henceforth, for the sake of simplicity, we will refer to it as the difference between exports and imports: i.e. the trade balance). According to the first thesis (which is very close to the CEPR narrative, except perhaps in not acknowledging a possible autonomous role for intra-EZ flows), the origin of the

Southern European countries' trade imbalances lies in the excess of investment over national savings. Foreign capital bridges the gap, but pushes up wages and prices. The lack of price competiveness reveals itself in the excess of imports over exports. These persistent deficits find their counterpart in Germany's persistent surpluses, which reflect a 'virtuous' propensity to save that finds its expression in German competitiveness. This is the so-called 'culture of stability': in Southern Europe price and wages should adjust downwards, and fiscal consolidation is needed in order to obtain internal devaluation.

The empirical basis for this interpretation is traditionally entrusted to the trend of unit labour costs. The question is somewhat more complicated, however. As we read in a report by the Deutsche Bundesbank (1988, pp. 41-42)[7]: "labour cost only covers a part of the total costs of industry… this does not take into account the labour cost included indirectly in the intermediate products purchased from other domestic and from foreign sectors. In other words, the prices of intermediate goods (and the labour cost included therein) purchased from other domestic and from foreign sectors, capital cost and prices of imported energy and raw materials, taken together, have a far greater weight in the manufacturing sector's competitiveness in foreign trade than the labour cost incurred directly by industry…..if shifts occur in the relative cost structures of the countries involved, such unit labour cost comparisons, taken by themselves, permit only limited inferences to be drawn concerning the development of total unit costs and hence concerning industry's competitiveness". This has two implications. The first is that given the growing importance assumed by the outsourcing of stages of production in the last two decades,[8] an analysis of competitiveness must compare relative prices and not relative labour costs. The second implication is that the weakening of the link between (direct) labour costs and prices opens up the possibility to take account of changes in non-price competitiveness (based, for instance, on quality upgrading, product diversification, or pricing-to-market strategies). A comparison of four real effective exchange rate indicators based on Consumer Prices (CPI), Producer Prices (WPI), Unit Labour Costs in manufacturing (ULC), and Export Unit Values (XUV) induced Bayoumi et al. (2011, p.5) to conclude that this analysis, "for the peripheral countries give[s] only partial support to the much-discussed view that external competitiveness deteriorated significantly since the adoption of the euro became likely enough that interest rates started to narrow". When comparing the four indicators, Bayoumi et al. (2011) were able to find some divergences in the case of Portugal and Spain, but they were huge in the case of Italy, where indicators based on ULC and XUV have appreciated by about 50 and 110 per cent respectively, while those based on CPI and WPI have shown only modest appreciation since 1995.[9] A higher real appreciation

[7] For a late acknowledgement of the problem, see also Banca d'Italia, *Relazione annuale per il 2014* (2015, p.84).

[8] As we will discuss below, these processes had a major impact on the reorganization of the German economic system immediately before and after the start of the Monetary Union.

[9] As far as Italy is concerned, Felettigh et al. (2015) confirmed the findings of Bayoumi et al. These authors implemented a new methodology to assess the effective real exchange rates among selected member countries. Since the inception of the Monetary Union, France and Germany have gained about 6 and 9 percentage points in price competitiveness respectively, against a broad stability recorded by Italy and a loss of 11 points recorded by Spain.

was systematically found in the extra-euro area, in particular for XUV-based indicators, signalling the possible importance of higher quality, niche-type products or of pricing-to-market strategies.

If the standard labour cost indicators do not explain the persistent imbalances of peripheral countries, the internal devaluation policy, which is associated with the above-mentioned fallacy of composition, cannot be a viable way out of the crisis for the countries of the European periphery. One alternative explanation, based on the absorption approach, focuses on the implicit link existing between 'core' and periphery trade balances: if Germany were to succeed in maintaining an excess of production over aggregate demand (that is, an excess of national savings over investment) thanks to chronically low internal demand, it would have to be obtained through an excess of aggregate demand over output in the peripheral countries[10]. Insufficient demand addressed to the peripheral countries condemns them to production levels below their potential, and this shows up in an excess of imports, which in turn translates into insufficient national savings compared with investment. From this perspective, there is no place for moral judgment on the virtuousness of savers: in macroeconomic terms, savings are the difference between production and (private and public) consumption. As in the Keynesian paradox of thrift, the aggregate savings of core and periphery countries alike are largely determined by circumstances that are independent of an individual's choice, while they are affected in particular by all policies that induce wage – and thus consumption – restraint. Whyte (2010) observed that German competitiveness arises not from greater productivity increases but from wage restraint and containment of internal demand: "The way in which the savings-investment balance has evolved in recent years suggests that the scale of the trade and current account surpluses is as much a reflection of the economy's weakness as of its external strength" (Whyte 2010, pp. 3-4). The policy implications of this perspective are clear: German internal demand (and wages) should go up in order to induce the deficit countries' export increases required to absorb their imbalances.

While introducing important aspects of the problem, because of its aggregate level, this interpretation does not take into account the qualitative composition of trade and the possible creation of a mismatch between the quality of productive capacity available in the peripheral countries and that of demand. It disregards the significant changes undergone by the German economic model from the mid-1990s. These changes involved the relocation of important segments of German industry to Eastern Europe, a reorientation of exports and imports to the latter and to China (which developed strong demand for investment goods), and a strong increase in the import content of final demand. These changes occurred in the context of compressed domestic demand in Germany. In the case of investments, the internal containment that contributed to German excess savings is partly explained by the simultaneous increase in foreign direct investment (which is apparently not

[10] Gross capital flows are not directly associated with current account unbalances (see Borio and Disyatat 2011): in the short run it is possible to have capital exports from a country that exhibits an excess of investment over national savings. In the long run, however, current account surpluses can only be maintained if associated with net capital exports: otherwise, the currency revaluation will sooner or later undermine the surplus. For this reason, we can say that in the long run excess savings finance net capital exports.

complementary to, but rather a substitute for, domestic investment, see Herzer and Schrooten, 2008). As for consumption, low incomes gave rise to growing shares of imports of lower price and lower quality consumer goods. The reorientation of German trade along international supply chains located in Eastern Europe cut off Southern Europe, which had been unable to upgrade its production structure.

We conclude that it is doubtful whether fiscal expansion in Europe's core economies would suffice to boost sustained growth in the periphery, for two reasons. First, an increase in Germany's public investment would certainly stimulate its domestic demand in the short run and also raise its output over the long one. Its effects on the GDP of the peripheral countries would depend on a number of factors, among which are the stance of monetary policy (Blanchard et al 2014) and the import content of demand. However, the regional distribution of the spillovers associated with a programme such as this can prove to be quite different, for they are in fact much smaller for Southern European countries than they are for other European countries. In a recent study, Elekdag and Muir (2014) have estimated that a 1 per cent increase in government investment would increase German real GDP by 1.05 per cent, that of other (central) euro-area countries by 0.30 per cent, and that of the peripheral countries by 0.20 per cent; and the impact on current accounts is similarly differentiated: -0.57, 0.12 and 0.05 per cent respectively.

More importantly, however, we must consider that these spillover effects will reflect the core country's process of investment and restructuring as determined by its choices and priorities, not what is needed to sustain the autonomous development of its partner countries. What is good for Germany, for example, is not necessarily good for them: that is, an undifferentiated expansion of the core's internal demand, though helpful, will not be adequate to address the deep and growing development inequalities in the Eurozone. The peripheral countries need public investment targeted on their specific needs, able to envision and encourage the direction of change and innovation that best ensures the attainment of autonomous development. Only in this way can an increase in the peripheral countries' income prove sustainable in the long run. An independent strategic policy of industrial development, however, calls into question the institutional construction of the Eurozone, the fiscal compact, and the monetary policy rules.

Given the institutional constraints, there is little hope that this "third" alternative can prevail, at least in the short term. In spite of increasing consensus on the perverse effects of austerity policies implemented during a recession (Blanchard and Leigh, 2013), "readjustment" policies still rely solely on the "positive" effects of internal devaluations — a relative decline in domestic prices and wages, compared to the rest of the euro area — to regain competitiveness.[11] We argued that this is not

[11] The IMF itself, which was one of the first within the mainstream to warn against the perverse effects of implementing austerity policies in recession, has mixed feelings on the matter. A recent IMF publication (IMF 2015) concludes that wage moderation in the crisis-hit economies is deflationary. However, by reducing long-term interest rates, monetary policy can play a crucial role in mitigating the appreciable negative spillovers of this moderation on to other euro area economies: that is, a 'beggar-thy-neighbour' wage policy is indeed deflationary, but quantitative easing can work to offset its devastating effects (Janssen 2015). As in Blanchard et al. (2014), and in all the studies based on the neo-classical synthesis, this conclusion relies on the existence of a relationship between interest rates and investment, which has dubious theoretical (and empirical) validity.

only a slow and much painful process, but — as far as its primary objective, export promotion, is concerned — it is also in vain.

4. How did we get here? The structural causes of the crisis[12]

A longer-term perspective helps us better to assess the limitations embedded in the adjustment policies that have been imposed upon the debtor countries of the periphery. These policies are short-sighted in two respects: they do not help the economies to recover from the crisis in the short-term (the perverse effect of synchronized austerity), and, because they ignore the structural causes of the crisis – which is rooted in the peculiar problems faced by countries at different stages of development – they are inadequate to ensure long-term sustainability. In fact, the institutions of the EMU are based on the premise that all its members are on a level playing field, except for ‘less modern’ (‘anti-competition’) institutions, individual values and attitudes. The implicit assumption is that an austerity regime, associated with institutions close to those assumed to be prevailing in ‘core’ countries, would create in the periphery the ‘right’ environment for a persistently low cost of capital and ‘thus’ for a sustained flow of investment, which would occur automatically, especially from external sources (Foreign Direct Investment)[13].

This simplistic assumption, and its related prediction, is proved false by post-war European economic development experience. An analysis of the main phases of the development of European countries since the second post-war period provides evidence of wide differences in the productive structures of the countries of the centre and the southern periphery of Europe at the start of the Europeanization process. These differences entailed an asymmetric capacity of countries at differing levels of development to adjust to external shocks. In fact, the process of development, which consists in moving upwards towards more complex, less ubiquitous, products (Hausmann and Hidalgo 2011), is far from linear. Since it occurs through diversification into products that are “near” to those that are already being successfully produced and exported, a country’s ability to add new products to its production depends on having many near products and many capabilities that are being utilized in other, potentially more distant, products. Countries with a low diversity of capabilities can become stuck in “quiescence traps”, that make catching up more difficult. The existence of discontinuities in the product space and the need to develop and coordinate those capabilities demanded by growth industries prove to be a formidable obstacle to the process of development. This is why government policy is called upon to coordinate the dispersed actions of firms, to help them identify new opportunities for differentiation and upgrading, and to contribute to developing the capabilities required for the production of more complex products.

As argued in Berger (2013, p.13), in Germany (but this applies also to regional clusters in other countries, for example Italian industrial districts), proximity to suppliers with diverse capabilities enables the creation of new businesses not through start-ups – which is the US model – but through the transformation of old capabilities and their reapplication, repurposing and commercialization. The crisis of the 1970s,

[12] This part draws on Simonazzi and Ginzburg (2015).

[13] See, for instance, the European Commission’s last Annual Growth Survey (2015b).

which was associated with the saturation of the principal mass consumer goods in advanced countries and the start of globalization, led to a profound transformation in demand, production, and competition. Demand for substitution and quality competition (vertical diversification) favoured the passage from traditional price competition to markets dominated by product-led competition. These changes marked a profound break in the history of the relations between the centre and the periphery of Europe. The 'centre' succeeded in strengthening its ability to remain in the market thanks to processes of 'creative destruction' and reconstruction undertaken during the crisis with the support of industrial policies. The restructuring of the core deeply affected the countries of the periphery which, in reorganizing their economies, struggled to adapt to the new environment (which was dominated by deflation and quality competition). Faced with a situation that would have required innovation of the State's capabilities in order to facilitate selective guidance and the reorientation of investment to combat a rapidly weakening economic structure, they adopted across-the-board liberalization policies instead, implementing what might be called a 'plain destruction' of their capabilities to create new products, market niches, and markets. "Market fundamentalism" … the fallacious proposition that markets in general, and financial markets in particular, are capable of regulating themselves and therefore do not need public regulation" is "the most important policy failures underlying this crisis" (Padoa Schioppa 2011, p. 319-20). The author (a former Italian Minister of Economy and Finance and a former member of the Executive Board of the ECB) argues that by the end of the 1970s, this "radical idea" had conquered "universities, trading rooms, newspaper editorial boards, think tanks, central banks, treasury departments and parliamentary committees ... Policy makers became not only non-interventionists but also active deregulators".

Thus, partly as a consequence of their policies, growth in the peripheral countries fell behind in the 1980s, and the crisis associated with deregulation opened a gap in aggregate demand that was eventually filled by welfare and construction expenditure. This 'premature deindustrialization' — restructuring without industrialization — exposed the peripheral countries to stunted growth and persistent fragility with respect to external changes even before the formation of the Monetary Union.

Later on, the slow growth of the euro area did not sustain the capacity of Southern European countries to achieve a sufficient level of diversification and specialization of their productive structures; indeed, it may even have contributed to worsening it (as seems to be the case with Southern Italy). Conversely, the increasing integration of the Central and Eastern European economies into the supply chain of German industry speeded up their process of diversification- and specialization. The eastward integration of German industry, combined with the persistent containment of the internal demand of the major economies of the euro area, has gone hand-in-hand with an impoverishment of the productive matrix of those southern regions that are less connected with Germany and, more generally, with a general redirection of trade flows (Simonazzi et al. 2013, p. 664).

It follows from this analysis that austerity measures do not go to the root of the development and debt sustainability problems of Southern European countries, which continue to lack a sufficiently broad and differentiated productive structure. Given the differences in the levels of development of the various EU countries and

their varying capacities to cope with change, fiscal policy should have been assigned two complementary targets: a redistributive and compensative function, and the role of actively promoting — through investment — the removal of development bottlenecks and the renewal of the productive base. In the absence of this guidance, the forces protecting and freezing the status quo of institutions and productive specialization thus prevailed. “The way was open for a kind of bank-led ‘privatised Keynesianism’ (which in some countries took the form of a construction and consumption bubble) that concealed — until the outbreak of the global crisis — the existence in the European peripheral countries of a demand-and-supply constraint on development” (*ibid.*, p. 657).

5. After the 2007-8 crisis: the limits of export led-growth

Systemic crises determine major reorganizations of the main driving forces of development, specific productive specializations, and the peculiar institutional framework that had sought to provide — at least for a given time and space — stability to the system. These reorganizations deeply affect ‘core’ and peripheral countries and their interrelations. A few years before the formation of the Monetary Union, Germany commenced a new phase of reorganization of its economy. For the decade and a half following German reunification, its economic performance had been poor: between 1999 and 2005, the average growth rate of GDP was 1.15 per cent per year, but reorganization of production would lead to growing surpluses and to an export boom in the years between 2005 and 2008. While some authors attribute this performance exclusively to the effects of the Hartz reforms introduced in 2003 on wage moderation, Danninger and Joutz (2007) argue convincingly that the main determinants of the German export boom can be identified in four circumstances: 1) improved cost competitiveness through wage restraint and internal demand containment; 2) linkages with high-growth markets in emerging countries (especially China and India) through an appropriate mix of products or the use of previously-established links; 3) an increase in exports of capital goods in response to the increased investment in emerging countries; and 4) the formation of a regional pattern of supply by relocating part of its production abroad (off-shoring). Although these factors are not mutually exclusive, Danninger and Joutz attribute the majority of the explanatory contributions to export growth to the second and fourth items. To these four points, we would add a fifth: the increase in the incidence of temporary and part-time employment and of low- paid workers, especially in the lower-end, less-unionized segment of the service sector (which also indirectly contributes to exports). The fall in lower incomes explains the sharp increase in income inequality and relative poverty in Germany in the last ten years.[14] Data on poverty based on a socio-economic (SOEP) micro-census[15] show a continuously rising trend since the turn of millennium, and in 2013, 15.5% of Germans (12.5 million) were classified as being affected by poverty.

These five points establish a general framework that helps to explain — at an aggregate, national accounts level — the persistent accumulation of German current

[14] See Baldini (2012, p. 25) (elaborations on OECD Earnings Database) and Stadtfeld (2012a, p.1).

[15] See Stadtfeld (2012b). Poverty is defined as a living standard below 60% of the median income.

account surpluses since the introduction of the euro. Since 1999, the growth of the German economy has been driven not only by the quality of its exports and compression of internal demand, but also by imports. The latter consist mainly of parts and components linked to the relocation of supply chains abroad, but more recently a growing share has been accounted for by imports of consumption goods from emerging countries. More stringent income constraints on poorer German families explain both the reduction in demand for domestically-produced consumption goods and the substitution of consumption goods of intermediate quality imported from the European periphery with low price, lower-quality products imported from emerging countries, especially China.[16]

As mentioned above, an important reason for the rise of current account surpluses after 2001 was a sharp fall in domestic private investment as a share of GDP, accompanied by an increase in foreign direct investment driven by offshoring activities. In the meantime, savings increased due to increased corporate profits, low public expenditure and stagnating household disposable incomes. Imports from the Eastern European countries – which are characterized by lower labour costs and weaker currencies *vis-à-vis* the euro – sustain the profit rate and the competitiveness of German firms, but end up by substituting internal production and imports from Southern European countries. By also raising the import content of exports (the so-called Bazaar Effect), the increase in German imports leads to a growing difference between gross export flows and the value added associated with them.

Since the inception of the Monetary Union, Germany has been able to profit from a nominal exchange rate lower than the one which would have prevailed had it not belonged to the Euro system, and from an undervalued real effective exchange rate due to internal and 'external' wage moderation (that is, the cost effect embodied in its imports of intermediate and consumption goods from lower-wage countries). After 2008, during the years of the EZ crisis, German borrowers received a subsidy from Southern European countries through the lower rates of interest due to the 'flight to quality' effect (the other face of the increasing spreads in government bonds in the crisis countries). Thanks to this subsidy, during the years of the crisis, Germany was able to finance an increase in construction (the only investment to some extent responsive to low interest rates), which somewhat mitigated the slow-down of external demand.

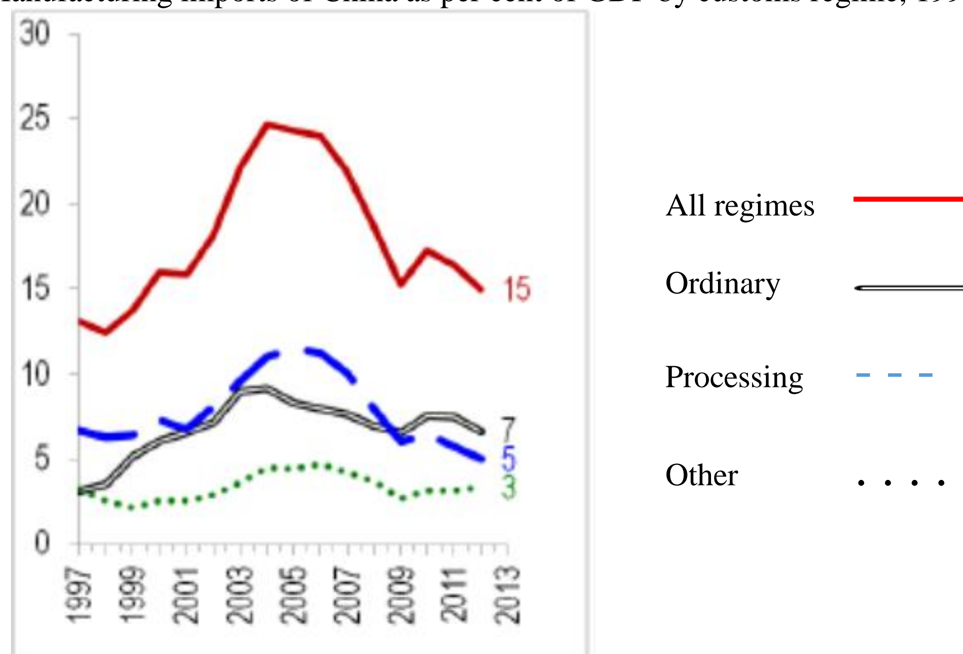
It is doubtful whether the conditions that favoured the success of German exports (and by implication of export-led models in general) will continue into the next decade. Contrary to the expectations built on supply-side models, recent experience shows that the tendency towards convergence in unit labour costs and current accounts, prompted by simultaneous austerity measures across European countries, is associated with a pronounced slow-down of the economies in the Eurozone, with negative effects on their debt/income ratios as well. Since 2008, the deflationary impulses originating from within the Eurozone have been added to the impulses from outside, particularly from China. Since Europe's biggest country is reliant on exports and it has been a particular beneficiary of China's sustained investment-led boom, the 'rebalancing strategy' carried out by China since 2007 creates growing uncertainty and concern that goes beyond Germany's borders. Since

[16] See Simonazzi et al. (2013, pp.667-669).

the 2007 subprime crisis, the Chinese government has been implementing measures targeted on the reduction of various imbalances (and at gaining greater strategic autonomy from external influences): the imbalance in domestic expenditure (an excessive share of investment relative to consumption), the urban-rural income divide, the cost-hinterland divide, asymmetries in access to credit, social security, housing, education, and use of emissions.[17] This inward reorientation (which is not free from the risk of derailment, given the high private debt/income ratio; see Pettis 2013) has already produced a reduction in the aggregate import/GDP ratio, as well as important changes in the composition of imports: a lower share of intermediate imports to be processed by foreign firms, and a higher share of luxury consumption goods, such as high-quality cars (see Figures 4 and 5).

Figure 4

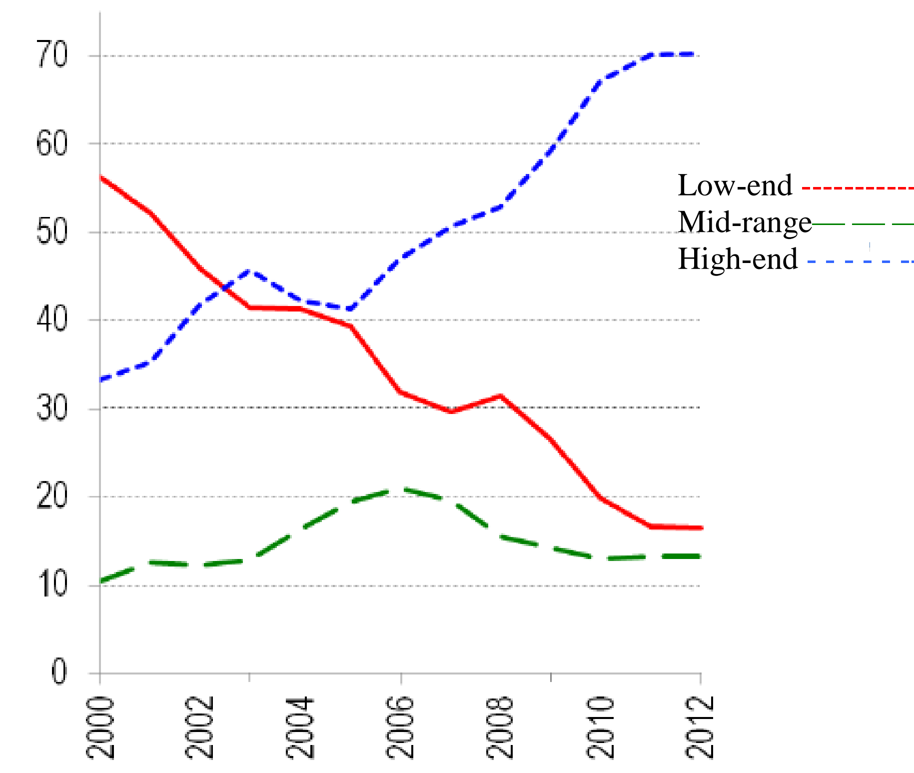
Manufacturing imports of China as per cent of GDP by customs regime, 1997-2013



Source: Lemoine et al. (2015).

[17] See Mc Kay H., L. Song L., eds, (2012); Lemoine F., Mayo G., Poncet S., Ünal, D., (2014), and Lemoine F. , Poncet S., Ünal D., (2015). On the likely effects of China's rebalancing on the slow-down of world economic growth, see Pettis (2013).

Figure 5
Structure of Chinese consumer goods imports by unit values segment (2000-2012)



Source: Lemoine F. et al. (2015).

This last feature, which helps explain the performance of German exports to China even after the subprime crisis, makes them vulnerable to developments in the political campaign addressed at reducing ostentatious consumption, and more generally to the policy aimed at reducing the greatest inequalities in income distribution, eliminating corruption and speculation, etc. (see Lemoine et al., 2015). The interdependence of the Chinese economy with the world economy suggests the urgency of countering the exogenous deflationary impulses by envisaging an international – and in particular a European – strategy targeted at reducing the major imbalances within and across European countries. Since the start of the Monetary Union, internal and external income inequalities have increased due to the combined effect of each European country's policy of promoting exports at the expense of domestic demand and synchronized austerity policies. While a few exporting firms in certain regions are able to reap the benefits of these policies, their effects, far from trickling down to the economy as a whole, increase the existing divergences and create new ones. As the Asian experience has shown, a successful development strategy has always been a combination of an import substitution policy geared to enlarging the internal market and an export promotion policy.[18] Export promotion has been used to support import substitution, which, sustained by a set of governmental and financial institutions, has been the key focus of the development strategy (see Zhu, 2006).

[18] See Ginzburg and Simonazzi (2005), pp. 1057-1058.

6. The strategic importance of investment guidance for European rebalancing

On 28 March 2012, the President of the Deutsche Bundesbank, Jens Weidmann delivered a speech at Chatham House in London titled "Rebalancing Europe" (Weidmann, 2012). He stated that Europe needed rebalancing, implying that it should address two problems, rebalancing current accounts and consolidating public budgets. He asked: Which countries would have to make the adjustment in the current account? Further, would the simultaneous correction of macroeconomic imbalances and of the public budget trigger a vicious circle of falling demand and slower economic growth? On the former issue he bluntly stated: "The typical German position could be described as follows: the deficit countries must adjust. *They must address their structural problems. They must reduce domestic demand.* They must become more competitive and they must increase their exports" (italics added). On the second issue, Weidmann reiterated the traditional view of "expansionary austerity": "consolidation might inspire confidence and actually help the economy to grow. In my view, the risks of consolidation are consequently been exaggerated". As mentioned above, three years of synchronized austerity policies succeeded in obtaining a re-balancing of the current account in the deficit countries, but at the cost of a lower and extremely fragile overall growth. After this failure, an investigation on the productive structure of peripheral countries in order to get a deeper insight of their 'structural problems' is required. We agree that Europe needs rebalancing, but we strongly disagree with the idea that the peripheral countries' structural problems may be reduced to a labour rigidity problem: in the era of production-led competition, there is a blatant contradiction between reducing investment and improving competitiveness.

Together with a macroeconomic policy targeted to a robust support of investments, the policy implications of this approach concern the assignment of a strategic importance to investment guidance by the State through industrial policies geared to diversifying, innovating and strengthening the economic structures of peripheral countries with a long-term perspective. These policies are currently implemented 'under the radar' – that is, discreetly – in the core countries, but are wholly excluded from the list of measures that the European institutions and the IMF recommend to peripheral countries in order to satisfy conditionality clauses (for these institutions, 'structural reforms' are simply another name for 'deregulation measures'). In the mainstream approach, the problem of development consists mostly in achieving static efficiency: allocating resources better by countering the market failures caused by monopolies, asymmetric information, and externalities.

More recently, "there has been a revival of the role that industrial policy can play. In this context, the issue is no longer the *whether* of industrial policy, but rather the *how*" (Landesmann 2015, quoting Rodrik 2008). The European Commission, too, has finally acknowledged the need for a European policy of public investment, though its conception of industrial policy is still confined within the narrow limits of acting as a catalyst of private capital without taking a systematic, long-term view. The much-publicized Juncker plan[19] – using a small amount of public money to

[19] Initiated in 2014, the European Fund for Strategic Investments (EFSI) – better known as the "Juncker Investment Plan" – is too strong on ambition. It "earmarked" almost €315bn to finance

leverage private capital, thereby encouraging private investment, growth, and job creation – is manifestly inadequate for the aim of kick-starting growth in the European Union and helping the peripheral countries towards sustainable long-term convergence. Leaving aside the trifling amount of money appropriated and uncertainties regarding its actual ability to attract a significant portion of private investment, its conception of industrial policy still places faith in the capacity of the market to ensure convergence, while reflecting scepticism about the ability of governments to manage their economies. This is still very far from a view of development as the result of the complex web of links connecting different institutions in a dynamic interaction, with the government acting as a long-term 'strategic organizer' rather than as a short-term 'market optimizer' (Mazzucato 2013). The attention paid to linking the inter-related elements of the productive structure marks the difference between capability-driven industrial policy and the creation of dependency.

Most importantly, a strategic industrial policy is not simply about developing competitive advantages for growth: it is also about characterizing the social needs that are consistent with sustainable prosperity. Modern capitalism faces a number of great societal challenges, including population ageing, youth unemployment, rising inequality, migration flows[20], nature protection and climate change. "These challenges have created a new agenda for innovation and growth policy that requires

European sustainable growth aimed at activating private funds for a total investment volume estimated at €1300bn in key sectors such as infrastructure, energy, innovation, education, and SMEs. "However, only €21bn from the EU budget and the European Investment Bank will go to replenish the EFSI as a financial guarantee", while it is doubtful whether private funds will produce the multiplier effect expected from the confidence boost (Bercault and Yeretzian, 2015).

[20] The U-turn in the German immigration policy, with Chancellor Angela Merkel's August 2015 resolution to accept refugee immigrants (soon to be reversed again), may be considered one of the few decisions taken by the German government that matches the responsibility of a "big country". It was estimated that the new policy, which also required additional government spending, would have had an immediate impact on Germany's economy similar to a small aggregate demand stimulus package. According to one estimate (Deutsche Bundesbank, December 2015, pp. 15-16), GDP was expected to increase by ¼, ½ and ¾ of GDP in the years 2015-17 compared with a baseline scenario without higher refugee immigration. In a statement issued on 16 September 2015, Bundesbank's president Jens Weidmann preferred to stress the supply side implications of the 'new' immigration policy, arguing that given the demographic change in Germany, with its rapidly ageing population, Europe's biggest economy "needs additional workers in order to maintain its prosperity". Some estimates have put the lack of qualified workers in Germany by 2020 at 1.8 million. The traditional German position, which is strongly opposed to the use of fiscal policy in Germany "in order to indirectly stimulate demand in other euro-area countries" has recently been reaffirmed (see Deutsche Bundesbank, November 2015, p. 60) with the statement that "it is likely that the scale of the fiscal loosening being contemplated would, in any case, have only a comparatively minor impact on demand". As far as aggregate demand coordination is concerned, however, no U-turn in Germany's traditional stance can be found: a few lines earlier, we read: "Looking at the European level as a whole, it seems that it would be worth considering a coordinated approach on a coordinated basis, at best, if there was a threat of an extensive crisis — such as a self-reinforcing deflationary spiral — which even monetary policy can do little to tackle. *However, this is currently not the case*. It does not seem appropriate…to put fiscal policy on a more expansionary course...in order to indirectly stimulate demand in other euro-countries, as this would amount to a U-turn on Germany's basic position, which is generally considered sensible"(italics added).

policymakers to ‘think big’ about what kind of technologies and socio-economic policies can fulfil visionary ambitions to make growth more smart, inclusive and sustainable” (Mazzucato 2014). The latter aim involves shaping sector strategies to provide for material and social consumption infrastructures. To play this ‘strategic role’, states must succeed in attracting the talent, expertise and intelligence needed to envision and address contemporary challenges.

Thus, simply investing in infrastructure is not the goal: it is necessary to align production and consumption infrastructures in ways that foster socially rational long-term growth (Best 2013). Positive complementarities between equity and efficiency suggest that ‘investing in people’ and targeting inequality more closely may respond to the urgent need to create employment while also favouring innovation and long-term sustainability. Higher employment is an indispensable prerequisite for the long-term sustainability of an inclusive system, while an increase in the supply of skilled capabilities needs to be matched by an increase in the creation of quality jobs. Capacitating public services can yield better long-term results than the neo-liberal deregulation of labour markets, which works by lowering labour costs and providing incentives for the unemployed to take on poorly-paid jobs. Accommodating critical life-course transitions reduces the likelihood that people will be trapped in inactivity and welfare dependency. This framework calls into question the whole adjustment agenda of the ECB and the EC. Austerity policies, constraining the spending capacity of governments, force reductions in social investment, while structural reforms interpreted solely as favouring more ‘flexible’ labour markets undermine long-term growth.

7. Concluding remarks

We have argued that the crisis, mistakenly interpreted as a standard fiscal/balance of payments problem, was generated by the incomplete nature of the European institutions and a disregard for the consequences of differences in the various members’ stages of development. The creation of a Monetary Union without a fiscal and political union has meant that both the problems of the transition to full integration and the crucial issue of who should eventually pay the costs of this incompleteness are ignored. When joining the euro, member states relinquished their national management tools without any supra-national governance to take their place. The ideological pre-conception that markets are self-equilibrating through price competition has been used to justify disastrous internal devaluation policies in the belief that an austerity regime associated with institutions close to those assumed to prevail in ‘core’ countries would create the ‘right’ environment for resuming growth in the periphery. The assumption of an equal level playing field has led to disregard of the need for industrial policies geared towards coping with the peculiar problems faced by countries at different stages of development.

A change of strategy is even more important today, since the crisis marks another important structural break in world trade similar to those we have described for the 1970s and the first decade of the new millennium. In the mid-1970s, saturation of the main mass consumer goods markets led to stiff product-led competition based on quality and product differentiation. The countries of the periphery, which failed to restructure their economic systems to meet this challenge, suffered a halt in their industrialization process and lost ground against those ‘core’

countries, which were able to implement the required macroeconomic and structural policies. In the first decade of the millennium, Germany once again succeeded in reorganizing its economy to meet the demand for investment goods sustained by the industrialization of emerging countries. On the cost side, it exploited the benefits of wage restraint, industrial outsourcing to Eastern European countries, and the 'exorbitant privilege' of belonging to the Monetary Union and having a dominant position within it. The crisis has shown not only an inability to replicate the German export-led model across Europe, but also the limitations of this model for Germany itself. In fact, the conditions that ensured the success of German exports in the years between 2005 and 2007 are no longer present. Since 2007, China has been embarking on a path of internal rebalancing that will have major repercussions on Europe's 'core' and 'periphery' alike because of its quantitative (slowdown in growth) and qualitative (changes in the composition of imports due to import substitution) effects. It is unfortunate that European leaders still have a tendency to tackle the problems they face in the same way as they did in the past, and expect to achieve the same outcome, even where the circumstances differ[21].

These premises give rise to a proposal for a radical change in policy: a long-term plan aimed at activating the interactions between firms and institutions and the interdependencies between aggregate demand and the supply of products and capabilities. A number of suggestions have been put forward: from a policy of public investment financed by euro-bonds, to a strategy of converting a part of the external debt obligations of the peripheral countries into a strategic plan for investment (with a public-private partnership) (Mazzucato 2013), to the consolidation of national government debts (budgetary union). All these proposals stress the benefits that would accrue to society from the opportunity to finance much-needed public investments virtually for free. A common fiscal authority that issues debt in a currency that is under its control – it is argued – would prevent destabilizing capital movements within the Eurozone and protect the member states from being forced into default by financial markets. This would restore the balance of power in favour of the sovereign and against the financial markets (De Grauwe 2015). Finally, by promoting the establishment of a sustainable development path, these policies could also create the foundation for the repayment of the loans associated with the investments.

There is still very little hope of a radical change of policies along these lines, which would require changing the EZ rules. A willingness to move in the direction of a budgetary and political union is non-existent in Europe today. This will not only continue to make the Eurozone a fragile institution, but justifies Orphanides' desolate conclusion that "In its current form, the euro poses a threat to the European project" (2015, p.2).

[21] We might recall that after the First World War, Keynes accused the leaders of the time of "attacking the problems of the post-war world with unmodified pre-war views and ideas" (Keynes, 2012, p. 337).

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