

Economic Stagnation in the Euro Area

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Abstract

Output growth in countries that later formed the Euro Area has been slowing down secularly. The growth deceleration correlates with the tendency for the suppression of wages which set in after the demise of the Bretton Woods arrangements – amid the materializing economic paradigm change. Liberalizations of private capital flows were soon followed by more ominous internal policy changes including labor market flexibilizations and downsizing the welfare state institutions. Under the Maastricht Treaty (which sanctioned the re-emerging liberal paradigm, with the emphasis on fiscal continence) European economic integration, crowned by the introduction of the common currency, advanced strongly. However, economic performance has failed to improve. The monetary policy for the Euro Area, based on the “one-size-fits-all” principle, has perverse growth and inflation effects across the Area and facilitates the rise of cross-country trade (and payment) imbalances. The inability to nominally devalue the currency condemns the external deficit countries to protracted recessions. It is crucially important that wages in the Euro Area are kept depressed by the fierce competition imposed on its EA partners by Germany which abides by its long-term strategy of keeping wages trailing behind labor productivity. The “internal devaluation” which Germany’s partners are forced to follow assumes that the whole EA could become a “larger Germany”. But this is a mirage as it postulates the existence of a “rest-of-the-world” ready to keep indebted itself vs. EA indefinitely. Sooner or later the weak growth led by high and rising export surpluses must come to an end on account of the recurring protectionist sentiments in the net-importer countries, and/or on account of excessive debts accumulated by them. Eventually a robust output growth could only be sustained by robust growth of domestic demand. With the present trends governing the functional income distribution, robust growth in domestic demand can only come in the form of persistent fiscal deficit spending. But a radical change on fiscal matters is unlikely to happen anytime soon. The EU will thus remain a stagnant area convulsed by recurring economic (and then social and political) crises. Sooner or later these crises can give rise to further Exits or could even precipitate the dissolution of the Union.

Secular growth slowdown in the Euro Area: evidence

Under the provisions of the Maastricht Treaty (in force since 1992), European economic integration has been further advanced. The introduction of the Euro crowned the process of internal liberalization of trade and capital flows within the European Union’s Euro Area (EA). A huge area of ever freer movements of goods, capital, labor and services emerged. There are many possible measures of advances in economic integration. Perhaps the most unproblematic is the share of mutual trade in the EU’s aggregate GDP. The share of intra-EU exports of goods in the combined GDP of the original 12 Euro Area countries¹ was less than 7% in 1960, rising to close to 13% by 1989. Since 2003 that share has ranged between 20% and 23% .

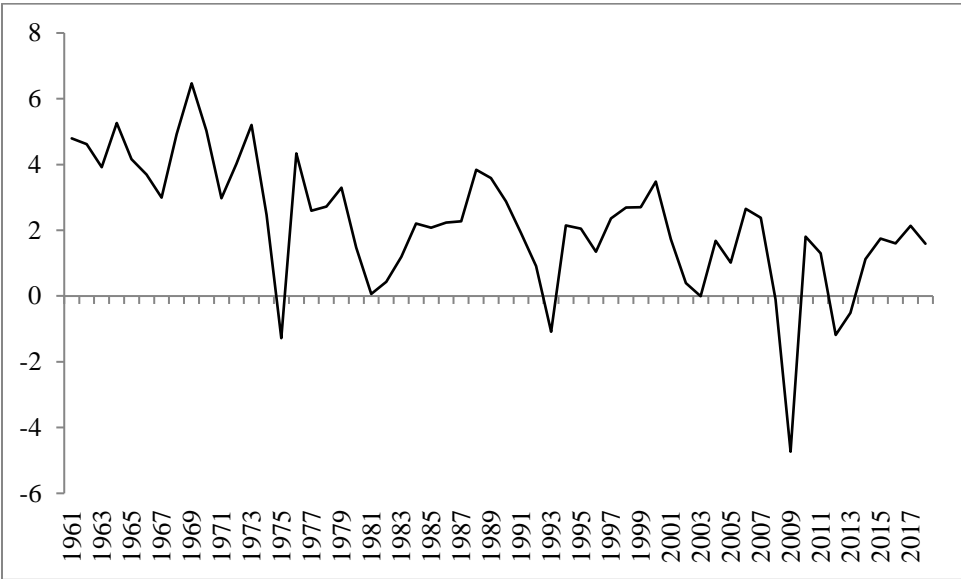
Just as internal economic liberalization, international integration is assumed to be conducive to economic growth (even if it is now often admitted that it may have unwelcome – supposedly transient – distributional effects). Closer integration is commonly expected to promote faster productivity growth – through increased competition and more

¹ Since 2006 seven more EU member states (predominantly small or very small East and South European) have joined the Euro Area, at different times. The essential macroeconomic indicators for the enlarged EA differ only marginally from those for the EA12 – but the available statistics for the former are much shorter. This justifies consideration, in this essay, of EA12 rather than of the whole Euro Area.

efficient utilization of scarce resources. Faster productivity growth is held a necessary condition for faster output growth.

European integration has failed to deliver on this promise. Output growth has been slowing down secularly, since around the mid-1970s (Figure 1). Thus, the slowdown cannot be considered to be a recent development that has occurred accidentally, following the 2007-9 global “events”. Prior to the final abandonment (in 1973) of the Bretton Woods arrangements the (per capita) GDP growth was quite high: on average 3.5% per annum for West Germany and 4.8% for the remaining 11 countries of the future Euro-Area group considered collectively. But growth slowed down already during the years 1974-1990 (with average growth rates at 2.2% and 2.3% respectively). During 1991-2019 the average yearly per capita growth rate for Germany is 1.3% and 1.1% for the remaining 11 countries². As can be seen the growth rates follow declining trends which – if continued – would push the EA into permanent recession. In addition, growth has become increasingly volatile, with violent ups and downs, and outright recessions around 1993, 2003, 2008-9 and 2012-13. One may bear in mind that the short-lived earlier recessions (in 1975 and 1981) could have been, at least partially, the aftermaths of the oil embargoes severely affecting the “supply side”. Beyond energy shortages materially affecting production, the oil shocks had negative consequences for inflation, income distribution and private investment, depressed on account of heightened uncertainties about the future energy supplies and prices.

**Figure 1 Growth rates of real per capita GDP
Euro Area (EA12), 1961- 2018**



Source: AMECO, own calculations.

The deep slumps in 1993 and 2008-9 cannot be viewed as “exogenous shocks”. These slumps were endogenous: consequences of malfunction of the economic “mechanisms” consciously designed by the European economic elites. The 1993 recession was primarily the consequence of the crash of the original Exchange Rate Mechanism (which had been expected to pave the way for the switchover to the Euro); in 2008-9 the recession was due to the near-collapse of the EU’s financial sector operating by the rules enacted by the EU policy-makers. The second-dip recession of 2012-13 was provoked by the fiscal consolidation hysteria gripping the Euro-Area decision-makers.³ The introduction of the

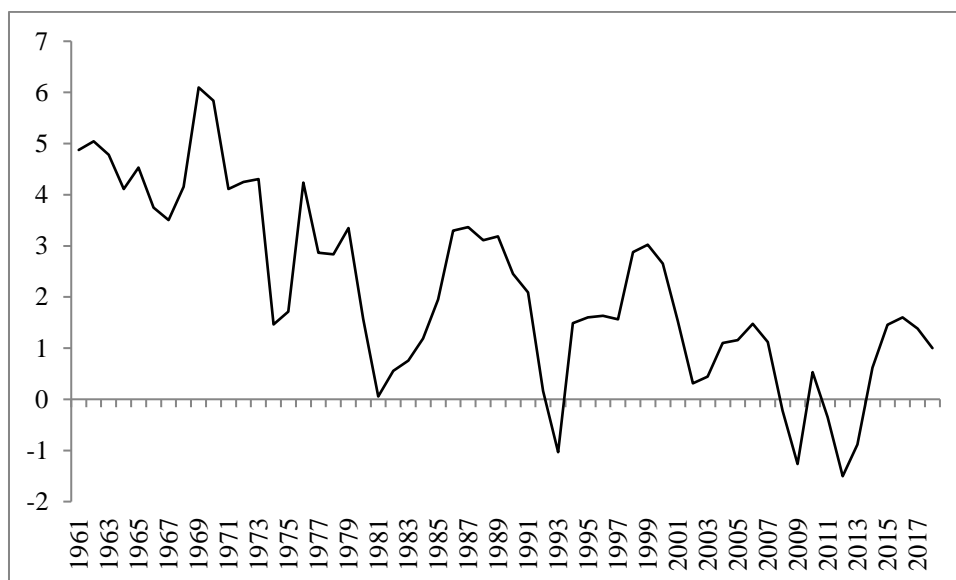
² The attention given to Germany is not only due to this country’s economic weight – about 30% of GDP of EA12. As will be shown later, since the early 2000s the German *internal* economic policies have played an important role in affecting growth in its EA partners.

³ The German unification (1991) was obviously an exogenous shock. However, the unification itself did not push Germany (and the rest of EA11) into recession. In 1991 the West German per capita GDP increased by 3.8%. Such a development was quite natural given East Germany’s urgent investment needs. However, the over-restrictive macroeconomic policy response to the unification-related fiscal

Euro (legal tender since 1998), the full internal trade liberalization (Single European Market, since 1993) and a plethora of other “agendas” and “programs” supposed to perfect the functioning of the Area have done nothing to smooth out (and accelerate) GDP growth.

The GDP growth slowdown is associated with a deceleration of growth of private consumption (Figure 2). That is not surprising – private consumption is the major GDP component. In the long (and medium) run fast GDP growth is hardly possible without fast growth of consumption. Private consumption tends to lead GDP: the slowdown of growth of consumption tends to be followed by a slowdown of GDP growth. Dynamic private consumption is essential for the overall output dynamism. In the last instance it is the secular slowdown of private consumption growth which is responsible for the secular weakening of output growth. As wages – the labor incomes – are the major determinant of private consumption, the examination of what has been happening to wages is necessary for the understanding of the secular slowdown of output growth.

**Figure 2 Growth rates of per capita private consumption
Euro Area (EA12), 1961- 2018**



Source: AMECO, own calculations.

A short digression: the slowdown of private consumption growth is linked to the slowdown of growth of fixed capital formation

For EA12 the slowdown of growth of private per capita consumption has been fairly closely associated with the slowdown of growth of per capita gross fixed capital formation. For the entire period 1961-2019 the coefficient of correlation between the yearly rates of growth of the two items is 0.75. The average growth rate of per capita gross fixed capital formation was 5.1% (years 1961-73), 1.5% (1974-90) and 1.02% (1991-2018). (Much the same tendencies prevail in Germany).

That a “strong” private consumption appears a precondition for strong capital formation cannot be a surprise. Perhaps it may be a surprise (at least to a more “mainstream-oriented” economist) that a weakening propensity to invest does not reflect the prevailing profitability of fixed assets. For EA12 the net return on net capital stock (AMECO item APNDK) was, on average, 11% larger for the years 1991-2018 than for 1961-74. Again, similar tendencies

deficits constituted another endogenous (and negative) shock contributing to the deep German recession in 1993 and slowing down Germany’s (and overall EA12) growth later on (see Bibow, 2001).

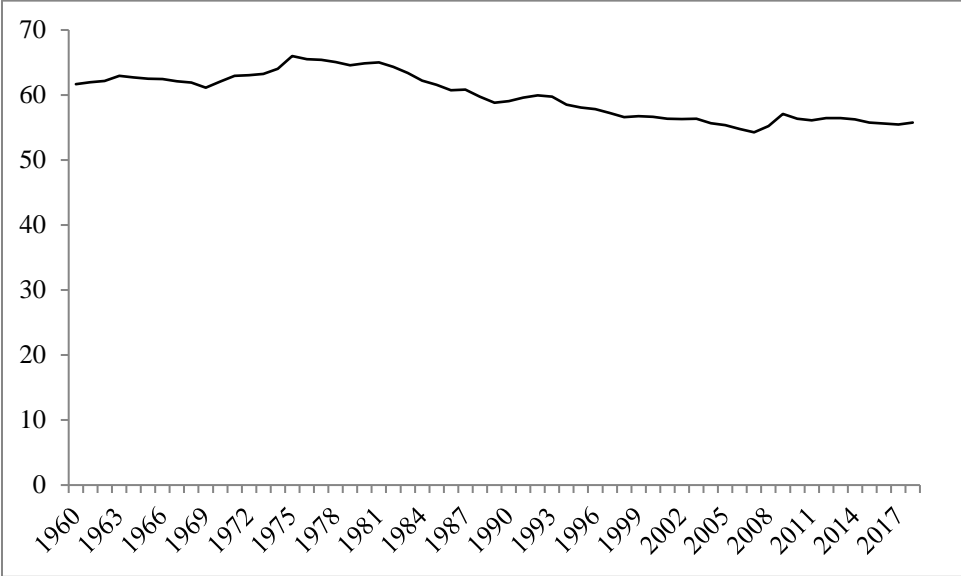
characterize Germany. *Ceteris paribus*, high profitability seems to have discouraged fixed capital formation. This “paradox” is easy to rationalize: high profitability emerges under repressed wages. But repressed wages mean weak consumer demand growth which, when rationally expected, must discourage fixed business investment.

Falling wage shares: not quite a “natural development”

After 1974 the monetary policies gave priority to combating high inflation which was ignited by the oil price shocks. Consequently, until approximately 2001 (and throughout much of the 1980s in particular) the interest rates were often quite high in the Euro Area. As such they may have played a role in slowing down the growth of consumption directly – by suppressing the demand for consumer credit and raising the attractiveness of depositing households’ idle monetary savings with the banks. But interest rates, quite low or even negative in real terms, could not have had much of a direct negative effect after 2001.

The deceleration of growth of private consumption has had more to do with the tendency which set in around the mid-1970s: the gradual change in the functional distribution of income. As can be seen (Figure 3) the GDP wage shares kept falling from 1975 through 2007 and have stabilized at depressed levels afterwards.

**Figure 3 The GDP wage share (adjusted)
Euro Area (EA12), 1960 - 2018**

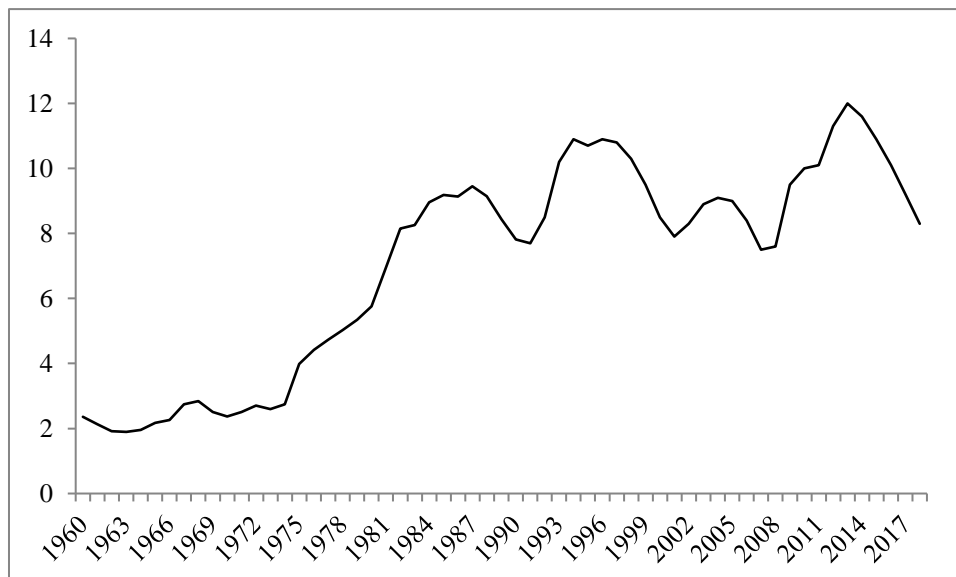


Source: AMECO.

The suppression of the wage shares (and thus the rise in the shares of non-wage incomes – and of profits in particular) has been one factor behind the expanding income inequality and, by implication, behind the suppressed consumption propensities. In addition, the consumption propensities have been suppressed by other, related, developments: high unemployment (Figure 4) and the ongoing, since the mid-1970s, evolution of the tax systems. “Flattening” of the personal income tax systems as well as falling taxation of profits have added to growing inequality in disposable incomes. The tendency for the substitution of indirect for direct taxation has additionally reduced the overall

progressivity of the national taxation systems – with obvious consequences for the overall income inequality levels and the private consumption propensities⁴.

**Figure 4 Unemployment rate
Euro Area (EA12), 1960 – 2018**



Source: AMECO.

It is certainly possible to claim that the secular decline in the wage share is a natural development reflecting diminishing “marginal productivity” of labor⁵. An alternative explanation is that labor started to lose to “capital” because the basic paradigms of the post-war economic systems were no longer generally accepted. The demise of the Bretton Woods arrangements was the first sign of the materializing paradigm change. Liberalizations of private capital flows and the flexibilization of the exchange rates were followed by more ominous *internal* policy changes initiated in the UK and the USA and then gradually emulated in the major continental European countries. Advancing external liberalizations (of trade and capital flows – also vs. the rest of the world) were thus synchronized with progressing internal liberalizations. The latter stipulated more or less wholesale privatizations and financialization of the sectors supplying public services, “unchaining” of the financial sectors, “taming” of the trade unions, labor market flexibilizations and successive rounds of reforms downsizing the welfare state institutions. Industrial policies were replaced by competition policies. The re-emerging liberal paradigm prescribing fiscal continence underlies e.g. the dynamics of final government consumption (Figure 5).

Labor was the primary “collateral casualty” of the war on inflation. High and rising unemployment “disciplined” employees and helped to beat them into submission over deteriorating conditions of pay and work.

Despite the eventual victory over high inflation (around 1990) the position of labor has not been improving since. High unemployment whose effective reduction through active fiscal policies is outlawed by the Maastricht Treaty⁶ (and the

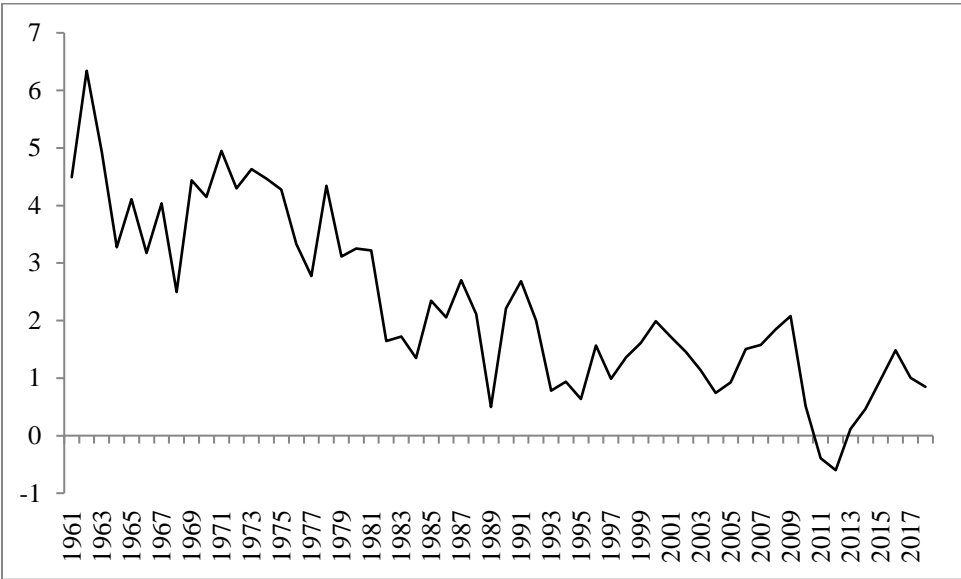
⁴ Growing internal income inequalities in individual member countries are associated with strongly increasing (since 2009) dispersion of per capita incomes *across* the EA12. The Area experiences “sigma divergence” rather than the conventionally expected “sigma convergence”.

⁵ In arithmetic terms the contraction of the GDP wage share means that the average labor productivity per employed person has been *outpacing* average labor compensation per employee. For the EA12 the real unit labor cost (the ratio of compensation per employee to nominal GDP per employee) fell by 23% from 1975 through 2007 (and remained essentially flat afterwards).

⁶ The Maastricht Treaty, signed in the early 1992, had been designed in the late 1980s and early 1990s. These were the heydays of neoliberal (and monetarist) revolutions whose ideas were reflected *also* in the “Washington Consensus”.

consecutive EU Fiscal “Pacts” reinforcing the Treaty) keeps wages on a short leash. The European Central Bank had played, until the Great Recession, an active role in the repression of wages, thus buttressing high unemployment. The ECB was long guided by paranoid fears of inflation in excess of 2% and repeatedly insisted on “wage moderation” (but not on “profit moderation”) as a precondition of price stability. (Price stability itself was proclaimed essential for fast and sustainable output growth.)

**Figure 5 growth rates of p.c. final government consumption
Euro Area (EA12), 1961 – 2018**



Source: AMECO, own calculations.

Of crucial importance is the fact that wages in the Euro Area have been kept depressed by the fierce competition imposed on its EA partners by Germany. The German long-term strategy has been to keep wages trailing behind labor productivity. This cannot be ignored by Germany’s partners who must adjust accordingly – or lose out on the competitive race. In an otherwise integrating economic area the internal policy by the dominant member country has far reaching consequences for everyone.

There can be little doubt that globalization (external liberalization vs. the rest of the world) contributes to the repression of wages in the Euro Area through outsourcing/offshoring of production activities to low-wage/low-tax destinations *outside* EA12⁷. But the internal Euro Area competition has been of central importance just because its participants, while structurally very different, are tightly bound together by geography and common EU regulations, share a common currency and are exposed to the same monetary policy.

A somewhat longer digression: supply-side developments unlikely to have underlain stagnating output growth

Labor productivity growth has followed a declining trend (see Figure 6). Given the rather undisputable acceleration of technological progress and the rather obvious advances in applied research and innovation activities, the labor productivity growth slowdown is considered a paradox. Some explanations of the paradox suggest that output (and

⁷ Credible threats of outsourcing/offshoring can achieve the required effect of moderating the domestic wage demands without actually relocating activities to remote places. Such threats also help extort tax (and subsidy) concessions from the fiscal authorities.

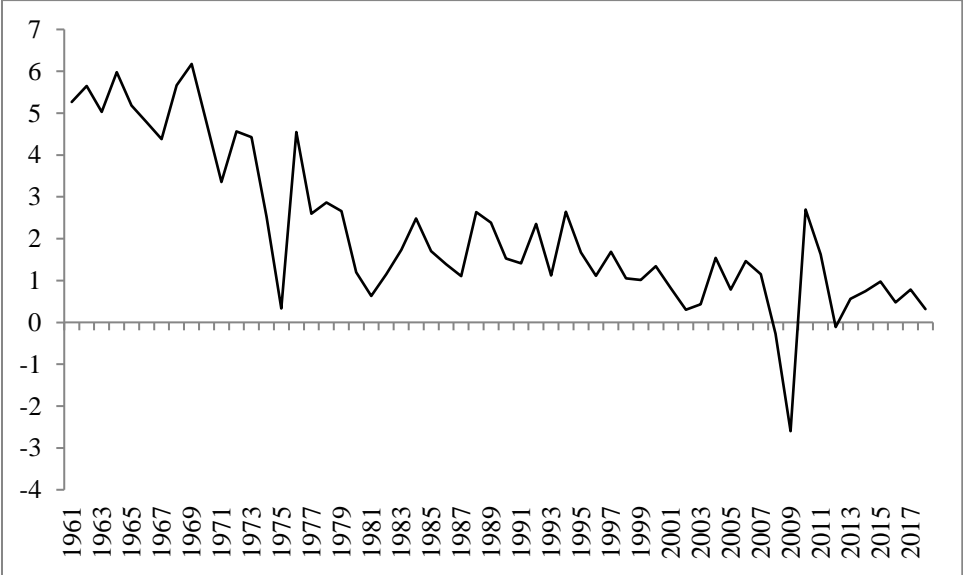
productivity) have been systematically underestimated by the statistics. Others tend to disagree with the mismeasurement thesis without yet offering a coherent explanation of the paradox.

Robert Gordon (2015) is the most vocal representative of the “supply-siders” who blames the post-2008 output stagnation itself on the slower growth (since 2004) in potential output “emanating from the behavior of productivity”. This seems to suggest that the supply side needs further “structural reforms”, stronger deregulation, more labor market flexibility, etc. so as to strengthen productivity growth and thus contribute to faster growth of output. By implication, the supply-side views on the roots of the secular stagnation (whether in the EU, USA, or at the global level) really ignore the possibility of stagnation emanating from the orientation of the macroeconomic policies followed, or from the prevalence of neoliberal maxims on e.g. the beneficial effects of labor market (de)regulation or of free international trade and capital flows.

However, the results of an econometric examination (Podkaminer, 2017) of the links between labor productivity and output growth for various groups of countries indicate that, generally, productivity growth does not “cause” growth of 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)⁸. This finding, though inconsistent with the mainstream ideas on the sources of long-term economic growth, is reminiscent of the classical Kaldor-Verdoorn Law. The progressing slowdown in output growth (also at the global level), initiated around the mid-1970s (amid the wholesale change of economic policy paradigms), has been mirrored – and followed – by the progressive slowdown in productivity growth (the indisputable acceleration of technological innovations notwithstanding).

It is also rather obvious that the growth slowdown cannot be attributed to intensified shortages of exhaustible natural resources. The secular decline in commodities’ terms-of-trade indicates that commodities are becoming less scarce, not more.

Figure 6 Growth rate of labor productivity (real GDP per employed person) for EA12 1961-2018 (%)



Source: AMECO.

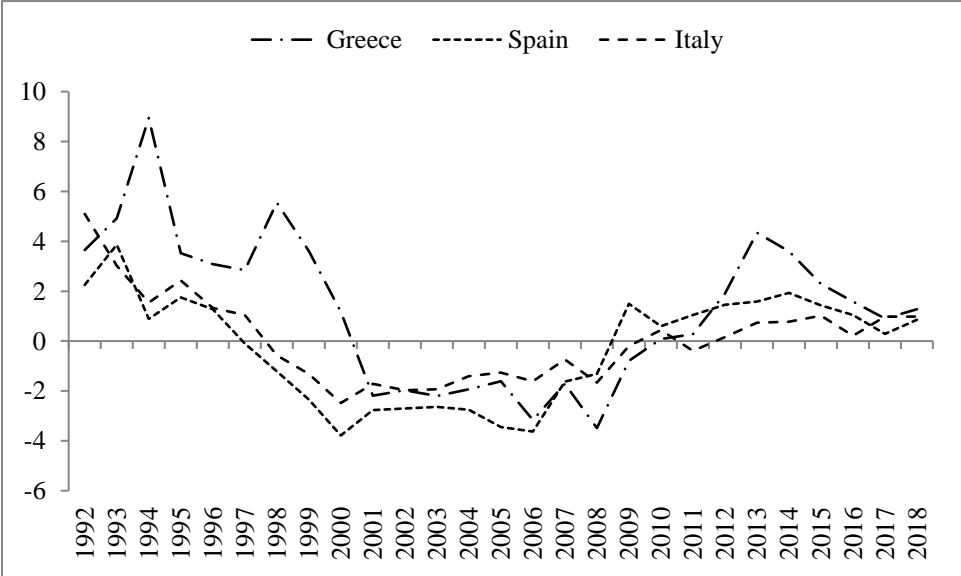
⁸ Only in two EA12 countries (Greece and Ireland) the productivity dynamics may have played a role in determining the dynamics of output.

The noxious of restrictive EU fiscal policy rules and the common monetary policy

For many authors the principles introduced by the Maastricht Treaty and later reiterated in a series of Fiscal Compacts or Pacts did not bode well for the future. In their opinion, these policies pave the ground for the eventual economic disintegration of the Euro Area and the whole European Union (see e.g. Laski and Podkaminer, 2012; de Grauwe, 2013; Podkaminer, 2015, 2016; Hein and Truger, 2017). Even if the EA has escaped disintegration so far (thanks to unconventional measures risked by Mario Draghi, the Italian chair of the European Central Bank) it is paying a high price – in the form of anemic, erratic and uneven (across the Euro Area) growth. Combined with the common currency (and the common monetary policy long embodying the tradition of German central banking), the Maastricht fiscal policy rules have additionally weakened economic performance of the Union (and of its EA core in particular).

The vicious dynamics behind the developing economic drama can be concisely described as follows. The first to consider is the set of fiscal rules setting very narrow limits for public sector deficits. The fiscal rules were to apply universally – without much regard for national specificities. Thus, a country (such as Germany) capable of producing output much in excess of the needs of its private sector (be it private consumption or private investment) cannot rely on the public sector for absorbing the potential excess private sector savings by means of deficit spending. Such a country is thus left with no other easy option than to attempt to run trade surpluses – to find abroad the outlet for its excess output. Trade surpluses become a way of supporting domestic growth (and of keeping its own unemployment in check). Of course, for a country to be 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 the accumulation of foreign debt – but also the suppression of domestic output growth and rising unemployment.

Figure 7 Real short-term interest rates for Greece, Spain and Italy (percentage-point differentials over Germany), 1992-2018



Source: AMECO, own calculations.

At this stage it is important to consider the way the common currency facilitated the rise of cross-country trade (and payment) imbalances. One currency, one monetary policy and one policy interest rate have very different economic implications for various members of the same country 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. However, in fact they have been very different.⁹ 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 7 shows, from the late 1990s (switchover to the common currency) until 2008 (the collapse of the real estate booms in the Southern Eurozone countries) the real short-term interest rates in Germany were consistently higher than in Spain and Italy. But the Southern periphery countries enjoyed lower real interest rates entirely on account of their inflations being much higher than in Germany. The same applied to other high-inflation countries (e.g. Ireland). As long as the governments of the Eurozone member states and their national banking systems enjoyed the same level of credibility, the cross-country differentials in short-term real interest rates on commercial loans were approximating also the differentials on the long-term government bonds. In other words, until 2008 credit to the German private as well as public sectors used to be much more expensive, in real terms, than elsewhere. Such differential developments favoring Germany's partners could not persist indefinitely. As soon as the boom supported by low real interest rates in the South collapsed (under the weight of accumulating internal and foreign debts) the nominal (and thus real) interest rates in countries that had had higher inflation became high (in many cases excessively high). It is at this stage that the initial boom fed by low interest rates turned into a (balance-sheet) recession initially engulfing the debtor countries and eventually also their creditors.

The moral to this story is that the principle “one size fits all” underlying the ECB's interest rate determination does not work in practice. The common monetary policy has been destabilizing output growth and inflation: fueling inflation (and pushing up growth, usually financed by accumulating debt and involving misallocation of real resources) in countries experiencing a boom and higher inflation, while suppressing inflation (and output growth) in countries experiencing deflation and stagnating output growth.

At this stage the existence of the common currency becomes crucially important. As a consequence of differential developments in real interest rates (and inflation), countries with traditionally low inflation (and weak growth in wages, such as Germany or Austria) have been gaining cost-competitiveness advantages vs. their higher-inflation partners. Of course, the shared currency precludes nominal depreciation (be it spontaneous or managed by the national authorities) by the higher-inflation partners. For countries fully in charge of their national currencies such depreciations are often the cheapest and most efficient way of responding to the erosion of external competitiveness. Italy's pre-Euro era experience is a case in point. After 1973 the Italian Lira kept steadily devaluing against the German Mark – from 182 Lira/DM in 1973 to 740 in 1988 (on average about 10% per year). That didn't affect Italy's output growth (which was fairly strong during that period) while securing sizeable current account surpluses all along.

Real effective exchange rate of Germany's EA partners: from relative appreciation to relative depreciation

As can be seen (Figure 8) in three major EA12 countries the real effective exchange rates (based on unit labor costs)¹⁰ declined initially (since 1995, i.e. during the “probationary” run-up to the switchover to the Euro). In Italy the same (albeit weaker) tendency came to the fore two years later. However, since 2000, upon the formal switchover to the Euro, real appreciation – driven primarily by rising unit labor costs – re-started in France, Spain and Italy – but was kept at bay in Germany. Since 2000-3 the German unit labor cost index has been virtually constant. That outcome was deliberately engineered by the German government under its “Agenda 2010” which was implemented since 2003. The

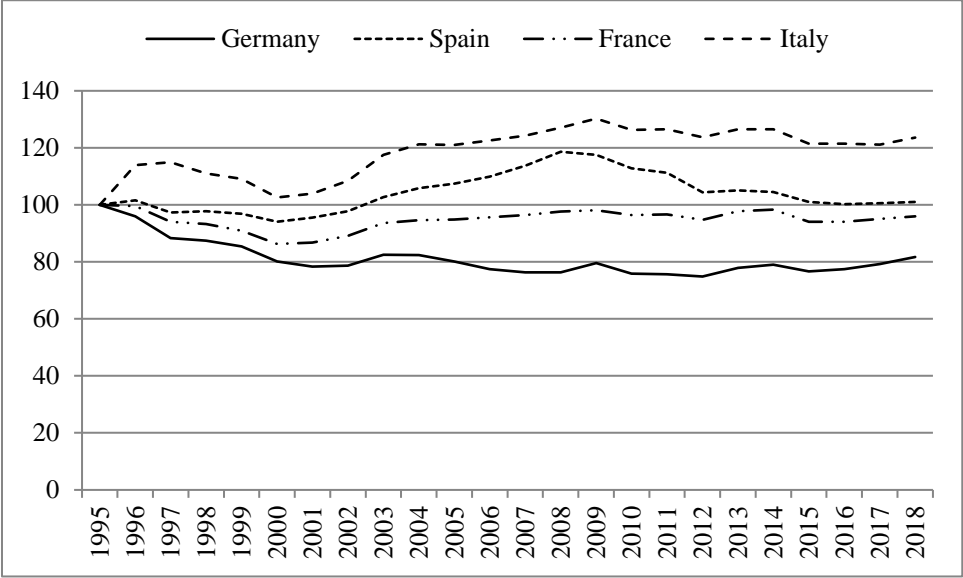
⁹ For many decades inflation used to be much higher in e.g. Italy than in Germany. As late as 1996 Italian inflation (measured as the GDP deflator) was still 4 percentage points higher than the German. Later on the differential narrowed – since 2010 the GDP deflator has been larger for Germany (not much, about 0.5 percentage points in 2018). Despite the convergence in the recorded inflation rates the Italian inflation qualitatively still differs rather radically from its German equivalent. The former has materialized under the prolonged stagnation, the latter under comparatively stable (if unimpressive) growth. An eventual return of faster growth in Italy is quite likely to involve the return to much higher, historically attested, rates of inflation.

¹⁰ The *nominal* effective exchange rates of individual EA countries can develop differently (because of eventual differences in the structure of trade with countries outside the EA and the eventual nominal exchange rate developments vs. the currencies of such extra-EA countries). Abstracting from such differences in the nominal effective exchange rates, the real effective exchange rates from Figure 8 primarily reflect the cross-country differences in the nominal unit labor costs developments.

Agenda stipulated far reaching reforms of the labor market institutions (including the unemployment insurance system and the Labor Codes). The purpose of the Agenda was to combat high unemployment – essentially by *increasing* the labor supply (through restricted access to unemployment benefits) and by suppressing growth in wages (starting in the public sector). Without the drastic measures introduced, the German real effective exchange rate could have joined the upward trend seen in other EA countries.

In the three major EA12 countries (but especially in Italy and Spain as well as in Portugal and Ireland) unit labor costs had grown vigorously until 2008-9 – with the predictable effects for their external competitiveness vs. Germany. Consequently, the private sectors of Germany’s trading partners ran external deficits and accumulated high debts to foreign and domestic parties¹¹. (In due time large portions of the excessive private sector debts accumulated had to be taken over by national governments seeking to rescue their commercial banking systems. That created the – misleading – impression of public sector profligacy and spurred the paroxysms of fiscal consolidation in 2011-3.)

Figure 8 Real effective exchange rates, 1995-2018 (1995=100)



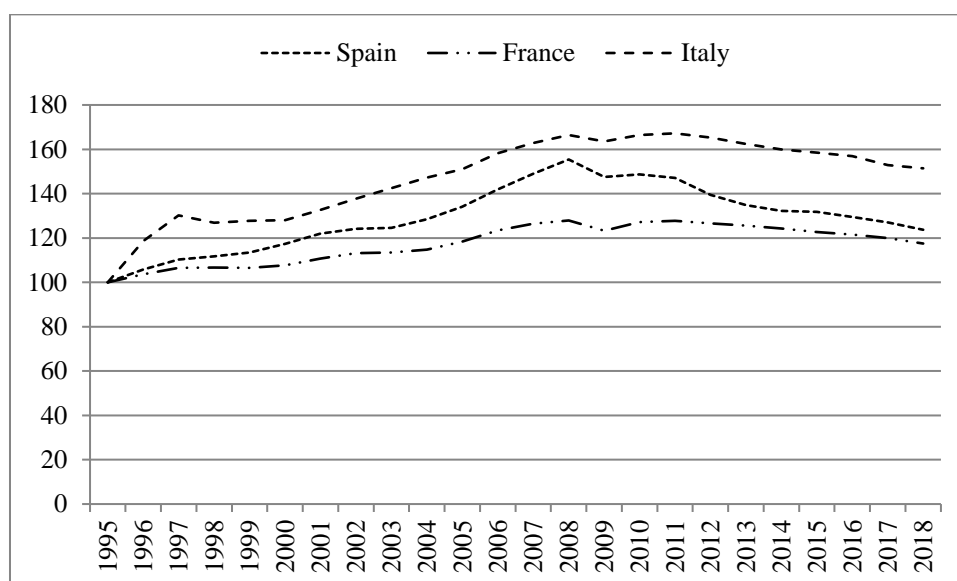
Source: AMECO, own calculations.

The debt and competitiveness consequences of the prolonged real appreciation inevitably stopped the appreciation itself. Relative to Germany the real effective exchange rates of EA12 countries peaked during the crisis. Afterwards they started to depreciate. The dynamics of relative (to Germany) real effective exchange rates for the three largest EA12 countries is shown in Figure 9.

The enforced post-crisis adjustments in real effective exchange rates have moved (still rather slowly) the individual EA countries to the conditions prevailing in Germany where wages have been engineered to fall far behind labor productivity. However, in Germany these conditions were consciously shaped as a central part of the national economic strategy seeking to run the highest trade and current account surpluses possible. For most EA partner countries, the adjustments are enforced by the necessity to regain competitiveness and to stop accumulation of debts.

¹¹ Actually, for an individual EA country *all* domestic debt (accumulated by private or public sector alike) constitutes *foreign* debt. The Euro may be a national legal tender – but in the last instance its issue is the sole prerogative of the sovereign “*extraterritorial*” European Central Bank.

Figure 9 Real effective exchange rates relative to Germany, 1995-2018



Source: Own calculations. The curves in Figure 9 are calculated as ratios of the curves in Figure 8 (for Spain, France and Italy) over the curve for Germany.

The adjustments prove very costly in terms of output foregone. During the post-crisis period (2010 through 2018) the average per capita GDP for EU11 grew by a miserable 0.8% per year, less than even in Germany (1%). The unemployment rate for EU11 fell rather moderately, from 11.1% in 2010 to 10.2% in 2018. German unemployment rates stood at 7% and 3.4% respectively. (In 2008 the unemployment rates for EU11 and Germany were almost equal, at about 7.6%). However, gains (in terms of falling nominal unit labor costs) have proved hard to achieve. The gaps between German and its EA11 partners' real effective exchange rate indices remain huge (Figure 9).

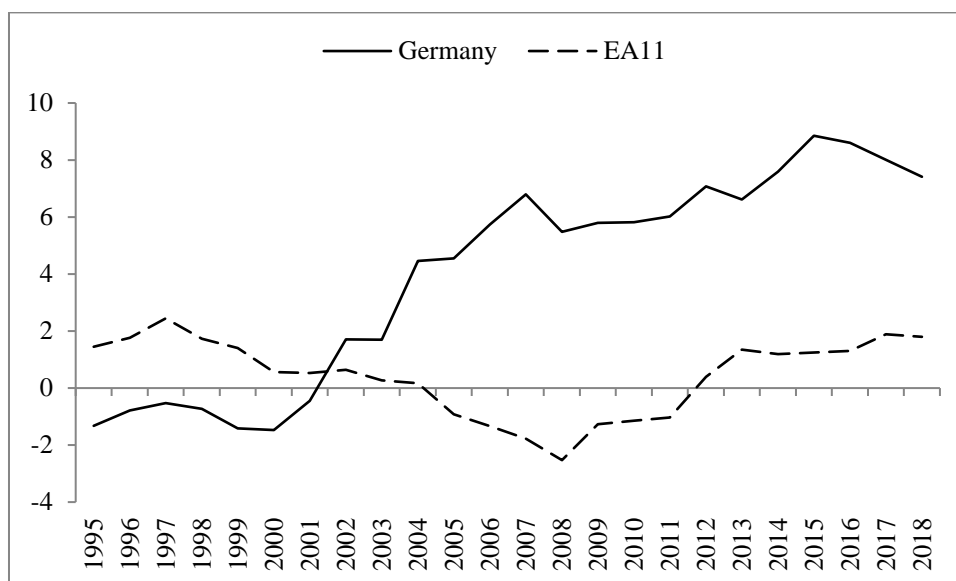
Nonetheless, in terms of external balance, the progress achieved on the real effective exchange rate is quite spectacular. After years of large foreign borrowing (2004-2011) the EA11 group considered collectively has become capable of working out large surpluses, thus emulating Germany in this respect (Figure 10).

The limits of “internal devaluation”

The concerns over cross-country trade and payment imbalances which are threatening the disintegration of the Euro Area and a collapse of the common currency (with some countries reintroducing national currencies) underlies many policy initiatives such as the *Euro Plus Pact* (European Council, 2011). The Pact prioritizes fostering competitiveness and convergence across the Euro Area in terms of unit labor costs. The same idea has been reiterated since (e.g. European Commission, 2015).

One specific policy strategy often considered to strengthen weaker Eurozone partners is “internal devaluation”. Internal devaluation involves a set of actions (including some labor market reforms) which would result in a sufficiently strong deflation in wages (and prices, in due course). Of course, the suppression of wages (and thus of domestic demand) is a bitter medicine if only because it is almost certain to provoke a recession – or at least stagnation – of unforeseeable depth and length. It took Portugal 10 years to regain the per capita real GDP level of 2007. Things are looking even worse for Greece and Italy where the current (2019) per capita GDP levels are still below (by 20% and 7% respectively) the peak values recorded in 2007. Internal devaluation of a sort has been actually taking place since 2008-9 (Figure 9). It has helped on the “external front” but has naturally failed to overcome the weakness of output growth.

**Figure 10 Net lending, total economy: Germany and the rest of the Euro Area (EA11)
Percent of GDP, 1995-2018**



Source: AMECO.

A more attractive alternative to internal devaluation is believed to involve the achievement of competitiveness gains through policies promoting much faster growth of labor productivity. Of course, faster growth of labor productivity (for example through a fast change in the structure of production and improved quality of exportable goods and services) cannot be a bad idea though it is not quite clear how this could be effectively engineered (without resorting to an industrial policy of a sort). The spectacular failure of the Lisbon Agenda (2000-10) and other such EU policy initiatives promising speedy structural change, technological breakthroughs and quality improvements – and thus advances in productivity – is a case in point. Besides, as already mentioned, the causality seems to be running from faster output growth to faster productivity growth rather than vice versa. A more concrete trouble with the “productivity alternative” is that in the long run the EA11 has on the whole performed *better* than Germany in terms of labor productivity growth. Ironically, from 2003 through 2010 (precisely when Germany was out-competing the rest of EA) productivity growth was much stronger in EA11 than in Germany.¹² Germany’s super-competitiveness cannot be squared with evidence on its relative productivity performance. It derives from its restrictive wage (and fiscal) policies which suppress economic growth not only in Germany.

As long as Germany firmly adheres to its restrictive wage and fiscal policies (and there is no indication these might appreciably soften anytime soon) other EA countries would have to follow suit¹³. That would doom them to slow growth secularly: Italy is the point in case. With depressed wages and stagnant consumption (and therefore stagnant investment in fixed assets) growth could rely only on expansion of trade surpluses. But EA11 has already become a

¹² The average yearly rate of growth of labor productivity in the whole EA11 was 5.4% and 4% for Germany (years 1961-1973), 2.1% vs. 1.7% (years 1974-90), 1.3% (years 1991-2003, both EA11 and Germany) and 0.7% vs. 0.5% (years 2003-10). Only after 2010 Germany performed better than EA11 (0.9% vs. 1%). But after 2010 the competitive position of EA11 has been improving vs. Germany (depreciating real effective exchange rates relative to Germany). Consequently, EA11 switched from being a current account deficit to a current account surplus area.

¹³ A meaningful relaxation of the wage policies in a country that has managed to “devalue internally” would reproduce the conditions that gradually led to the earlier crisis: from an eroding real effective exchange rate to diminishing external competitiveness, disappearing external surpluses and, finally, to the accumulation of debts sooner or later necessitating another “shock therapy” and more or less lengthy and painful recession.

huge rising-surplus country (and Germany has been such a rising-surplus country for 15 years now). Yet, this is not visibly helping to speed up growth.

The second trouble with the internal devaluation strategy is that it rests on the tacit assumption that the whole EA could become a “larger Germany” – on a *permanent* basis. But this postulates the existence of a “rest-of-the-world” ready to keep indebting itself vs. EA indefinitely (and at an accelerating speed which would have to be consistent with the positive EA output growth). Rather obviously, the “rest-of-the-world” is unlikely to obligingly serve the needs of EA permanently. Sooner or later growth led by high export surpluses must come to an end on account of the recurring protectionist sentiments in the net-importer countries, and/or on account of excessive debts accumulated by these countries.

Suppression of fiscal deficits critically contributing to stagnant EA output growth

The conventional wisdom underlying the fiscal policies in most high-income countries stresses the need to restrict public-sector financial deficits. This is particularly the case with the European Union. The EU Growth and Stability Pact “lays down the obligation for Member States to adhere to the medium-term objective for their budgetary positions of close to balance or in surplus” (European Council, 2005). The Fiscal Compact agreed upon by the majority of EU leaders is designed to strengthen “fiscal discipline” across the Euro Area (and beyond). It goes even further, imposing the obligation to reduce public sector debt/GDP ratios. Given the sluggish pace of nominal GDP growth, that requirement actually imposes the obligation to run budgetary *surpluses*. Thus, the taxation of the private sector (net of transfers to the same) should be persistently higher than the income earned by the private sector on sales of goods and services to the public sector. The private sector would then have to ‘bleed’ for many years to come – for the sake of “sound public finances”. The “sound public finances” are deemed indispensable for the long-term dynamism of the private sector itself.¹⁴

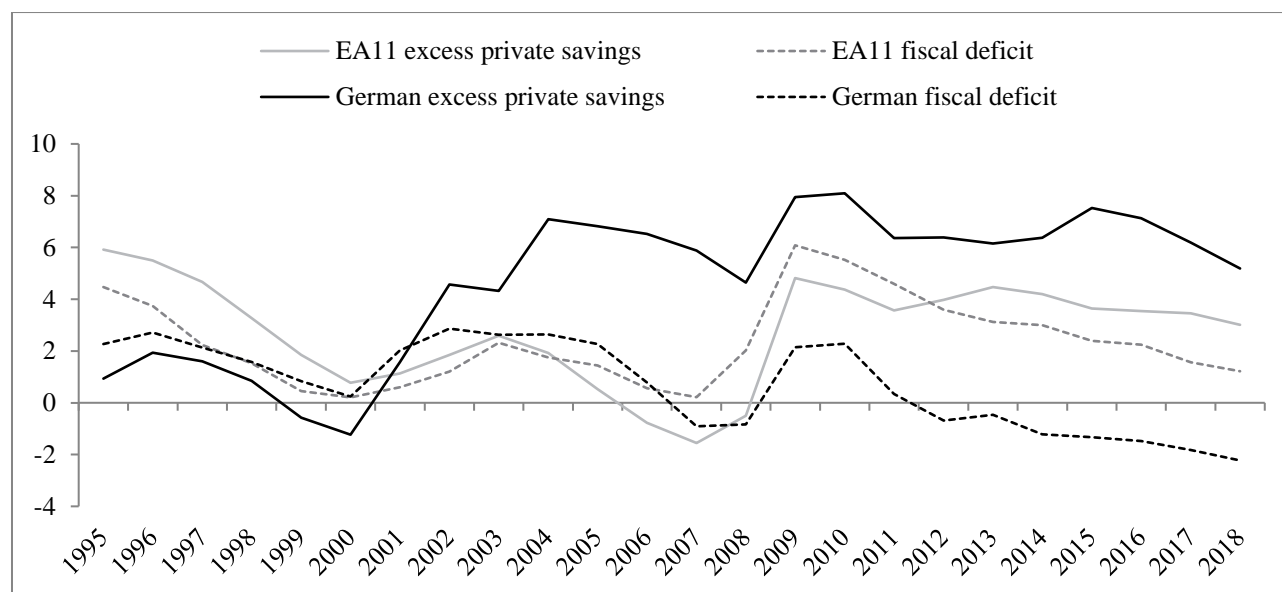
The fact that despite the best efforts of fiscal authorities around the world the public financial balances almost always and everywhere end up in deficits squares with the tendency of the private sectors to work out *positive* excess saving (i.e. saving in excess of capital formation). This is no accident: the fundamental macroeconomic identity states that the private sector’s excess saving equals the (national) net external lending plus the financial deficit of the public sector. Given the private sectors’ preference for running some positive excess savings (and the relative unimportance of external imbalances, at least in the longer run) the public sectors must run fiscal deficits secularly.

The policy aiming at balanced public finances enforced on EA implies that its private sector’s excess saving is not allowed to materialize. The excess savings are to be “pre-emptively” taxed away. Under confiscatory fiscal policies seeking to wipe out parts of the potential excess private saving, it is unreasonable to expect any faster rise in private investment (or even in private consumption). Of course, Germany has been able to run very large fiscal surpluses. But this outcome is due to Germany’s huge external surpluses. Since 2012 the EA11 has also been working out large external surpluses. But these have so far proved insufficient for absorbing the EA11 excess private savings. At 1.2% of GDP the fiscal deficit for EA11 was still (in 2018) far from being negligible.

Figure 11 shows the dynamics of the fiscal balances and the excess private savings for the Germany and the rest of EA (EA11) since 1995. As can be seen, in 2000 the fiscal balance for Germany (and for EA11 considered collectively) was close to zero. In 2007 the fiscal balance for EA11 was also close to zero (but Germany ran a sizeable fiscal surplus).

¹⁴ The consecutive German governments have been the most ardent adherents of the fiscal prudence gospel. There is a quasi-religious principle behind the German (and Swiss) economic policy. The German word for debt is “Schuld”, which also denotes “guilt”. Clearly, public debt is to be shunned by all means.

Figure 11 Private sector excess savings and government fiscal deficit as percentage of GDP: Germany and EA11, 1995-2018



Source: Own calculations based on AMECO.

Admittedly, the developments culminating in the years 2000 and 2007 were unsustainable. Much of the private investment went into risky (or speculative) activities (e.g. residential construction) that had failed to pay off, leaving large segments of the whole EA private sector (combined) deeply indebted to other segments of the same. Similarly, the expanding private consumption had been disproportionately driven by debt owed to other parts of the private sector (rather than being backed by rising wages and other regular household incomes). The *internal* private-sector debt/credit excesses were followed by the painful private sector “deleveraging” (and “balance-sheet recessions”) characterized by depressed private investment, increased private saving (depressed consumption out of the disposable income) and – consequently – increased excess savings of the private sector (the latter equal to the increased public sector fiscal deficits) reaching their local maxima in 2003 and 2010.

The recent (post-2010) developments are not all that different. Although the fiscal deficit for the entire EA11 combined is quite low almost all private excess saving takes the form of external surpluses – representing net lending to the rest of the world. For this reason, the post-2010 developments are also unsustainable. As soon as the net lending to the rest of the world (backing the EA11 and German external trade surpluses) comes to an end, the excess private saving could only be maintained by sufficiently large fiscal deficits – just as it was the case after the collapse (in 2000 and 2007) of previous booms.

The future remains uncertain

The deep (“systemic and structural”) tendencies underlying the behavior of private sector saving and investment are likely to be strengthening in the future. It is rather difficult to envision a decisive rise in the wage share, or a decline in income inequality. If anything, the combined effects of progressing globalization (outsourcing production to low-wage and low-tax countries) and technological change (expansion of “intelligent machines” reducing the demand for labor) will support falling wage and investment shares, rising income inequality and saving rates. Potential excess private saving would then increase in line with the progressing income concentration. Sufficiently relaxed fiscal policy would be an important countervailing force in such circumstances. By “deficit spending” it would supply the highly desired financial wealth (i.e. public debt) to the private sector (or rather to its rich segment).

Rejection of the fiscal consolidation provisions is vitally important for countries such as Germany whose private sectors have been induced to save much in excess of their investment. Without the ability to run trade surpluses (which can never be sustained indefinitely) such countries eventually either experience stagnation, or else allow public sector deficits which would be capable of generating (and absorbing) the excessive private savings.

The EU cannot prosper under self-imposed limitations that have little economic justification, theoretical and practical. The belief in the benefits of fiscal “prudence” is the backbone of these limitations. The ubiquitous acceptance of the “beggar thy neighbor” practices with respect to the national wage and tax policies also plays a destructive role. Unless the basic paradigms of economic policy are radically 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 could 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 European politicians – and economists – to voice their concerns over the overall orientation of the economic policies of the European Union – and of Germany in particular

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