

# One Europe or Several? Causes and Consequences of the European Stagnation

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## Abstract

The European Economy is currently in a slump, the worst since the 1930s. Although this is often seen as a consequence of the financial crisis that hit the capitalist world in 2007-8, we argue that many of the problems that Europe faces today have long term roots to do with the fact that Europe consists of countries with quite different dynamics and capacities for adapting to changes in the global (and European) economic environment. We start by comparing Europe's growth performance to that of other parts of the world, and then consider some popular but arguably erroneous explanations of the present crisis. Subsequently, we delve into the development of the external balances of various European countries. This leads to the identification of three European "archetypes", characterized by different adaptability and performance, i.e., the North, the South and the East. We explore the consequences of globalization and European economic integration for the economic performance of these different country groups. The effects have been quite asymmetric; the Southern countries in particular have benefited little if at all. Finally, we summarise the lessons from the analysis and consider the implications for policy. What is needed is a European growth policy, properly adapted to the different capacities across Europe, that places the welfare of the European population as a whole at the center.

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## 1. Introduction

The European Economy is currently in a slump, the worst since the 1930s, with high and increasing unemployment and deteriorating welfare conditions for exposed segments of the population in several European countries, especially in the Southern part of the continent. Although this is often seen as a consequence of the financial crisis that hit the capitalist world in 2007-8, this is only part of the story. In this paper we aim to show the following:

1. Many of the problems that Europe faces today have long term roots and were apparent well before the crisis struck.
2. Far from being a homogenous set of countries, Europe consists of countries with quite different dynamics and capacities for adapting to changes in the global (and European) economic environment.
3. As a consequence of this heterogeneity, the “one size fits all” policies that have characterized European economic integration in the last few decades have had quite different effects in different parts of Europe. While some countries benefitted a lot, others have not.
4. The current austerity and “belt-tightening” in large parts of Europe is not helpful in reviving economic growth and reducing unemployment, and needs to be replaced by a Europe-wide growth policy, taking Europe’s heterogeneous character and the challenges it is facing properly into account.

We develop these arguments in several steps. In section two we place the European growth and stagnation in its global context. During the last few decades the global economy has gone through a dramatic transformation, most importantly perhaps as a result of industrialization in countries such as China, India, Vietnam etc., and their increasing presence in global markets that accompanied it. This process affected European countries in different ways depending on their capacities to adapt to these changes. Similarly, the dissolution of the Soviet empire and the gradual inclusion of the previously socialist economies in Eastern Europe in the global (and European) capitalist economy also affected European countries in different ways. In particular, there is a group of countries in Southern Europe that both in the decades leading up to the crisis and during the crisis underperformed compared to other countries at similar levels of development, while an opposite pattern may be observed in the Northern part of the continent. There is also a distinct Eastern growth pattern – quite different from the other two - associated with the previously Socialist economies in the East of Europe.

Using these categories, i.e., the North, the East and the South of Europe, we show in the sections that follow that much – albeit not all - of the heterogeneity in economic development across Europe can be summarized in this way. Section three considers the widespread - though as we will show largely erroneous - idea that the problems encountered by Southern Europe have to do with a deviant macro-economic stance characterized by excessive growth of wages and/or consumption, a so-called

“spending-spree”. The analysis shows that the relationships between the macro-economic aggregates of wages and productivity do not differ much between Southern Europe and the rest of Europe or other parts of the globe. What mainly characterizes Southern Europe in the decade leading up to the crisis is slow growth, i.e., stagnation, combined with deteriorating competitiveness, i.e., unusually slow growth of exports.

Having identified trade performance as a distinguishing feature between different parts of Europe, in section four we examine these developments in more detail, in the decades leading up to the crisis as well as in the years that followed. The distinction between the South, the North and the East fits the evidence quite well. The Southern countries combine unusually slow growth (or stagnation) with increasing deficits on their current accounts. The Northern countries do not grow very fast either but their current accounts improve year by year, i.e., quite the opposite of the Southern pattern. Hence, there appear to be important differences in the underlying dynamics. The Eastern countries again have a distinct pattern, combining relatively rapid growth in the years leading up to the crisis with large external deficits. These deficits, however, were primarily a consequence of high investment rates, not excessive wage (or consumption) growth, and should not necessarily be regarded as a matter of concern in a long-run perspective. Nevertheless, due to their increasing dependence on foreign capital, the Eastern countries were hit hard when the financial crisis struck.

In section five we delve deeper into the consequences of globalization and European economic integration for economic performance in the North, East and South of Europe. The “raison d’être” of European integration efforts during the last decades, such as the deepening of the “internal market” and the adoption of a common currency, has been that it would boost intra-European trade and growth all over Europe. We demonstrate, however, that the effects have been quite asymmetric. The major beneficiaries of increased European economic integration have been the previously socialist economies in the East, although also the Northern countries have benefitted substantially. However, the Southern countries have benefited little if at all from this process.

Finally, section six draws the lessons from the analysis and considers the implications for policy. We argue that the present insistence on austerity, with economic stagnation, high unemployment (especially among the young) and increasing poverty as some of its main consequences, only adds to the problems caused by inconsistent and inefficient policies in the past (and present). What is needed is a European growth policy, properly adapted to the different capacities across Europe, that places the welfare of the European population as a whole at the center.

## 2. Global transformations and Europe's role, 1995-2011

Europe's growth is intimately interconnected with that of the global economy. In this section we consider how different European countries have performed compared to other global players. However, to be able to assess the growth performance of various European countries, we need a theoretical perspective that helps us in the interpretation of the data. A useful approach, which will guide the analysis in this section, is the technology-gap theory of economic growth,<sup>1</sup> developed by economic historians such as Gershenkron (1962), Abramovitz (1986) and Maddison (1991).

The technology-gap theory emphasizes that the capitalist world economy consists of countries with very different levels of economic and technological development. According to the theory this provides countries with very different opportunities and challenges. For example, countries far behind technologically and economically – such as China and India today – face a potential for rapid economic growth through exploitation of technology already in use in the more advanced part of the world. Hence, provided that they manage to exploit this potential, we would expect China and India to grow faster than, say, the USA or Germany. Similarly, successfully tapping into this potential might allow the poorer countries in the East or South of Europe to grow faster than the richer ones in the Northern part of the continent.

However, historical evidence has shown that transforming potential growth into reality may be more challenging than some of the early advocates of the approach tended to believe. In fact, there have been big variations over time in the extent to which the potential for catching up – leading to convergence in productivity and income levels across countries - was exploited. Some periods witnessed a lot of catching up, such as the decades following the end of the 2<sup>nd</sup> World War, which led Abramovitz to call this period the “Catch up and convergence boom” (Abramovitz 1994a,b). However, in other periods catching up has been more or less absent. For example, very few developing countries managed to exploit the potential to reduce the gap with respect to the already developed part of the world during the 1980s and early 1990s, a period that has been characterized in the scholarly literature as “lost decades” for development (Easterly 2001). Hence, the capacity to exploit the potential cannot be taken as given and needs to be explored. Abramovitz (1986) used the concept “social capability” to characterize the different capacities of nations to exploit the opportunities for catching up economically and technologically. He also pointed out that the capabilities that are needed may differ depending on the technologies in question, what he called “technological congruence” (Abramovitz 1994a), and that this may lead the conditions for catching up to vary over time.

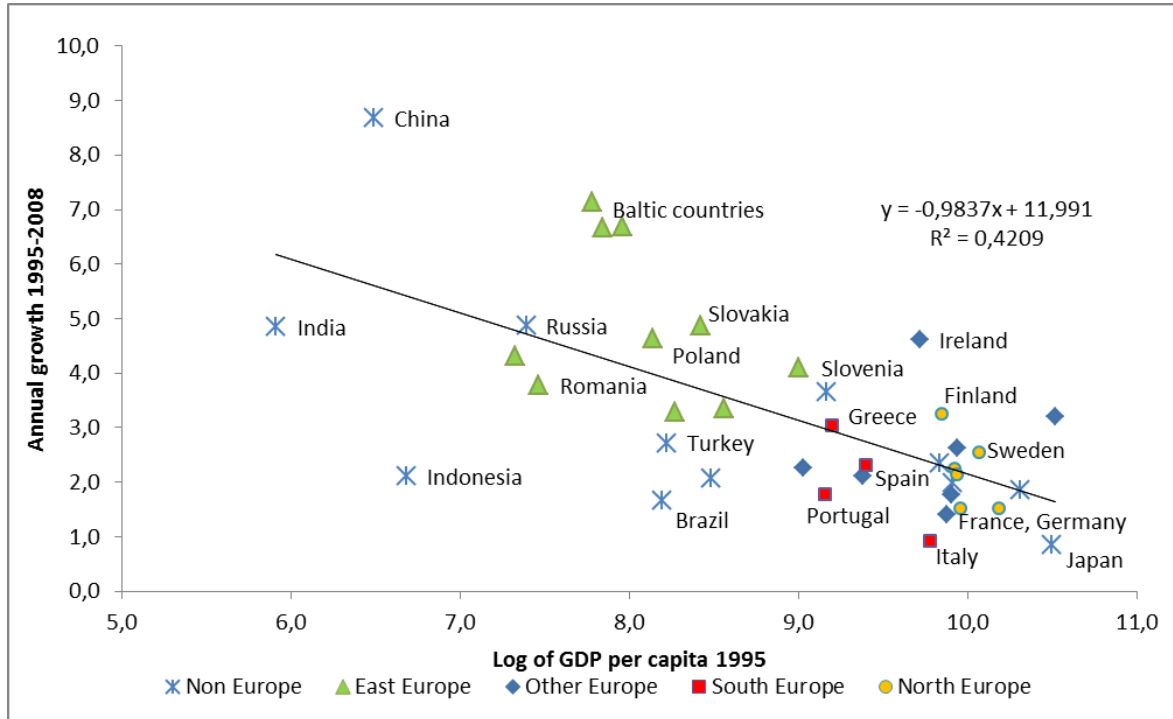
Nevertheless, during the period under consideration here, i.e., from the latter half of the 1990s until the financial crisis struck, the global economy once again entered a more dynamic state, characterized by rapid catch-up both globally and within Europe. To illustrate these developments, Figure 1 plots growth of GDP per capita between 1995 and 2008 against its level in 1995 for a selected number of countries at different levels of development. Although the main focus is on Europe and countries with which it may

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<sup>1</sup> For an overview see Fagerberg (1994)

be compared, the sample also includes some major players from the developing part of the world (such as Brazil, China, India and Indonesia). Thus, although a quite selective sample, the countries included represent a big share of world GDP.

**Figure 1 Growth and Convergence in the Global Economy, 1995-2008**



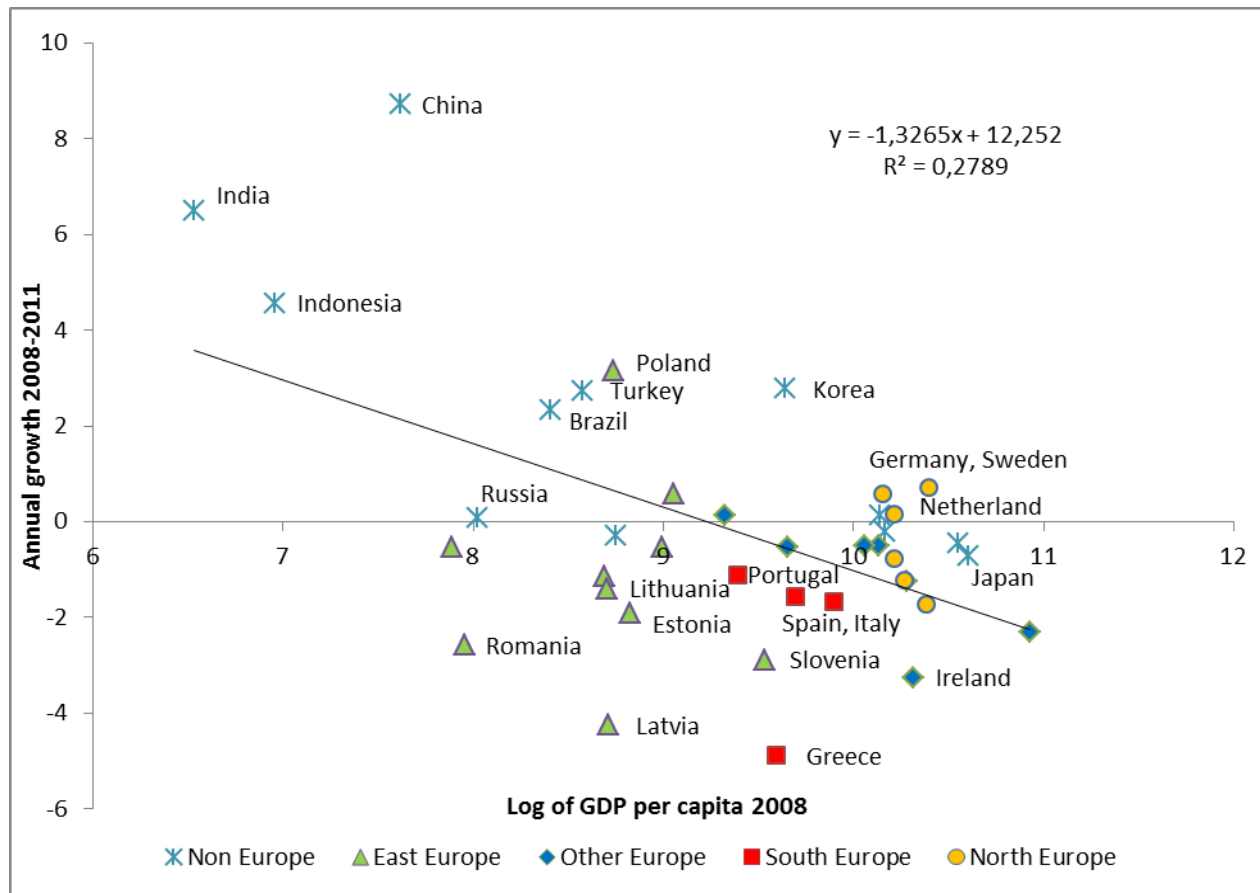
Source: Calculations by the authors using data from the World Bank (see appendix for details)

If poorer economies manage to exploit the potential for catch-up, as the Gershenkronian theory would suggest, growth rates should decline with rising GDP per capita levels. This is what is observed in the figure. If sustained over time such a process would lead to reduced differences in levels of economic development between the rich and the poor countries, what in the economics literature has been termed “convergence”. The convergence we observe in the period under study here stems from several sources. One of these is the much heralded rapid growth in the two largest developing nations in the world, China and India. This relatively new and arguably very important trend has contributed to lifting hundreds of millions of people out of poverty. Another source of convergence is rapid growth in a number of former Socialist economies in Europe, both in smaller countries such as the Baltics as well as larger economies such as Poland and Romania, and even Russia itself, to mention some important examples. Although, as expected from the theory, more developed countries tend to grow more slowly than average, there is also some variation between them. For example, given their initial level of development, Ireland and Finland grew relatively quickly, while the opposite was the case for France and Germany. Some of the Southern European countries (indicated with red squares in the figure), particularly Italy, also grew slowly.

The transformation of the global economy during this period was related to important technological, institutional and political changes. The ICT revolution, which had been underway for a long time, did start to have a major impact during these years. Gone were the days when computers, as Robert Solow once remarked, were visible everywhere except in the productivity statistics (Solow 1987). In particular ICT technology facilitated the coordination of economic activities across large distances (Hildrum et al 2011). Together with major advances in transport technology this presented firms – particularly larger ones - with new opportunities for combining economies of scope and scale, serving markets world-wide and sourcing labour and other resources globally. Political changes in China and its gradual inclusion in the capitalist world system from the 1980s onwards added hundreds of millions of workers and (potentially even more) consumers to the global capitalist economy, as did similar changes in other parts of Asia in the decades that followed, with rapid growth as the result. The collapse of the Soviet empire and the downfall of the Berlin wall opened up not only a new market but also a vast pool of relatively skilled labour. The gradual inclusion of many former Socialist countries into the European Union facilitated the transition and influenced the political, institutional and economic changes in these countries. After painful transition periods (of varying lengths) rapid growth followed, making the period from the early 1990s to the financial crisis in 2008 perhaps most dynamic in Europe's recent economic history.

The financial crisis had a major impact on the global economy and Europe in particular. Figure 2 repeats the exercise from Figure 1, plotting growth of GDP per capita against its initial level, but now for the period after 2008.

Figure 2 The Crisis Years, 2008-2011



Source: Calculations by the authors using data from the World Bank (see appendix for details)

The crisis did not reverse every trend from the previous decades, however. China still grew very fast, and India and Indonesia grew even faster than before. Turkey and Brazil also kept growing. So the major global transformation pointed to above was still unfolding. But Europe slid into recession. However, the effects of the crisis were far from uniform. Among the EU countries, only Poland did reasonably well during these years. Although six other European countries recorded positive growth rates of GDP per capita during this period, these were all in the 0-1 percent range, i.e., very low indeed. There was a dramatic reversal of fortune for previous high fliers such as Ireland, the Baltic countries and Romania, and the Greek economy almost collapsed. Moreover, the slow-growing countries in Southern Europe - Italy, Spain and Portugal - continued to underperform (with negative GDP per capita growth).

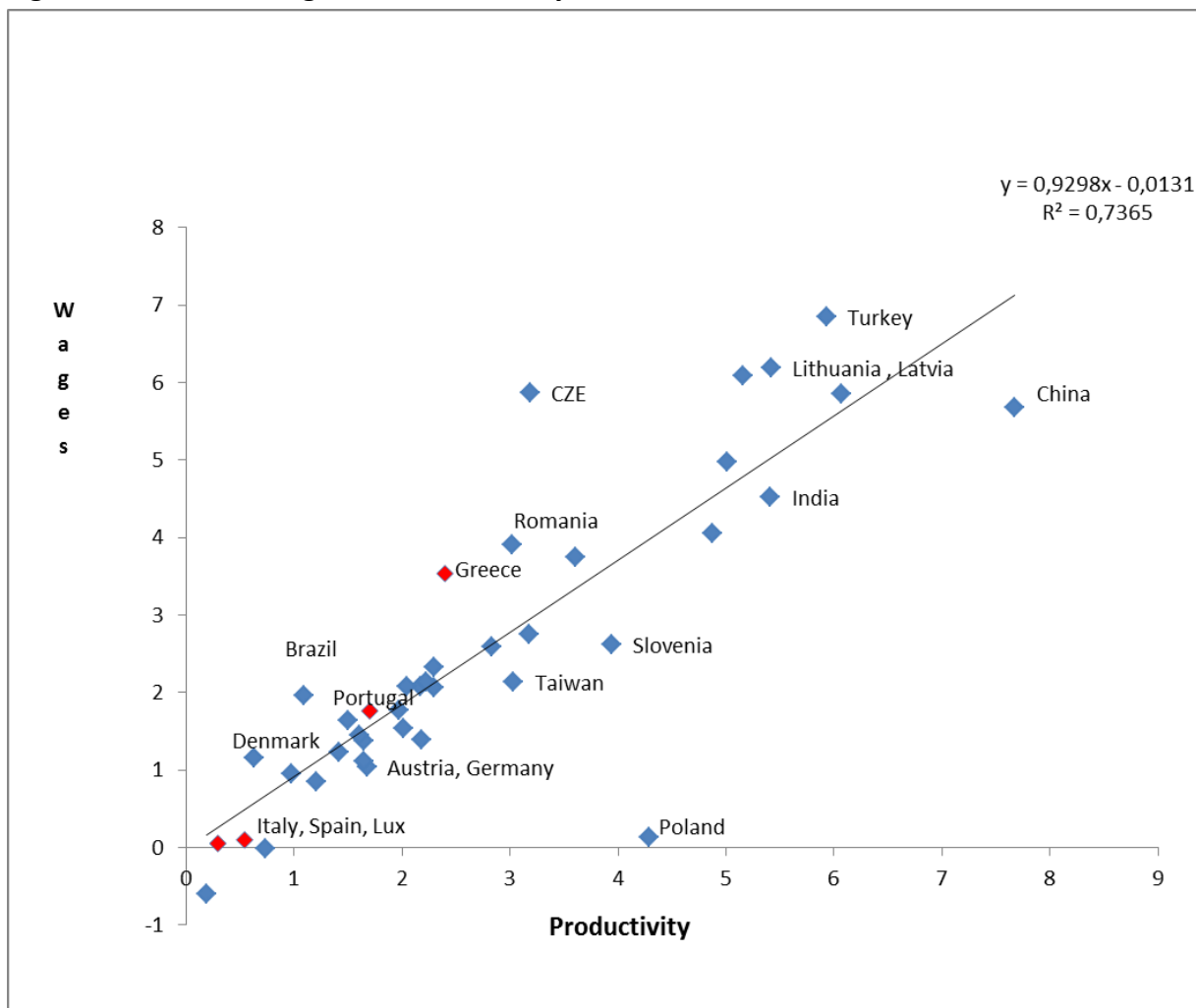
Thus, it seems that slow growth in Southern Europe compared to other countries (at a similar level of development) is not a new feature. In the next sections we will delve deeper into the causes of this phenomenon. The decade before the crisis was characterized by rapid growth, i.e., catching up, in the Eastern part of Europe but that this process ran into trouble when the crisis hit. In general, the countries in the North of Europe have been less affected by the crisis than their counterparts in the South and the East. We will return to some of the reasons for these observations in sections 5 and 6.

### 3. Southern exceptionalism?

As a first step towards understanding the causes for the stagnation in Southern Europe we will consider the widely shared – but as we shall show erroneous - view that that this has to do with a deviant macroeconomic stance in these countries, for example allowing wages to grow much faster than productivity, thereby hurting cost competitiveness, or allowing consumption to grow much faster than GDP. The discussion draws on data from the World Input Output Data Base (WIOD).<sup>2</sup>

Figure 3 plots growth of wages against growth of labour productivity – both in constant prices - from the mid-1990s to the financial crisis.

**Figure 3 Growth of Wages and Productivity, 1995-2008**



Source: Calculations by the authors based on data from WIOD (see appendix for details)

<sup>2</sup> See Appendix for details.



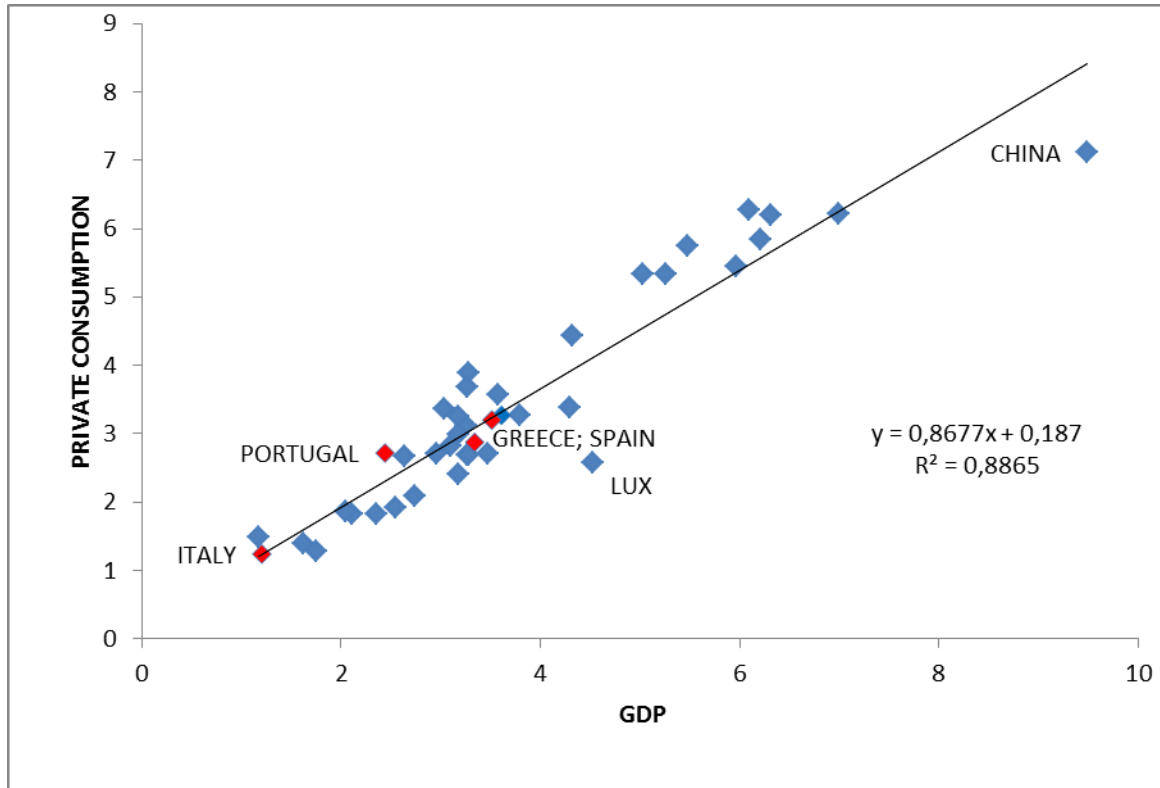
The figure confirms the prediction from growth theory that under capitalist conditions wages will have to grow in line with productivity (Pasinetti 1974). Overall the relationship is remarkably close, although there are some clear outliers, with the Czech Republic on the positive side (with wages growing markedly faster than productivity) and Poland<sup>3</sup> and China on the negative side as the most obvious examples. Thus, despite the communist rhetoric of its leadership, Chinese industrialization has gone hand in hand with a marked decline in the workers' share of value added. Some other European countries also had relatively slow wage growth. Germany is of course the economically most important case, but it also holds for some smaller countries (Austria, Slovenia and Luxembourg). In fact, after the turn of the millennium German wages grew very little if at all for a number of years, as a result of an effort by the government in accord with business and trade union leaders to boost the country's competitiveness in the years following its takeover of the former GDR. For the three slow growers in Southern Europe, wage growth was either in line with (Portugal) or below (Italy and Spain) productivity growth. Only for Greece, which grew more rapidly than the other three in the period leading up the crisis (Figure 1), is there is clear evidence of wage growth outstripping productivity growth, especially after the introduction of the Euro.

Figure 4 carries out a similar exercise for the relationship between GDP growth and private consumption. Again the relationship between the growth of the two aggregates is remarkably close (as indicated by the high R-square) with China and Luxembourg as the most obvious deviants (unusually slow growth of private consumption when compared to GDP growth). However, in Greece, Italy, Portugal and Spain (indicated by red) private consumption grew in line with GDP, as in most other countries.

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<sup>3</sup> Poland is an extreme outlier. According to the statistics, Polish wages hardly grew during the period under investigation here, while productivity grew more than 4 per cent per year on average.

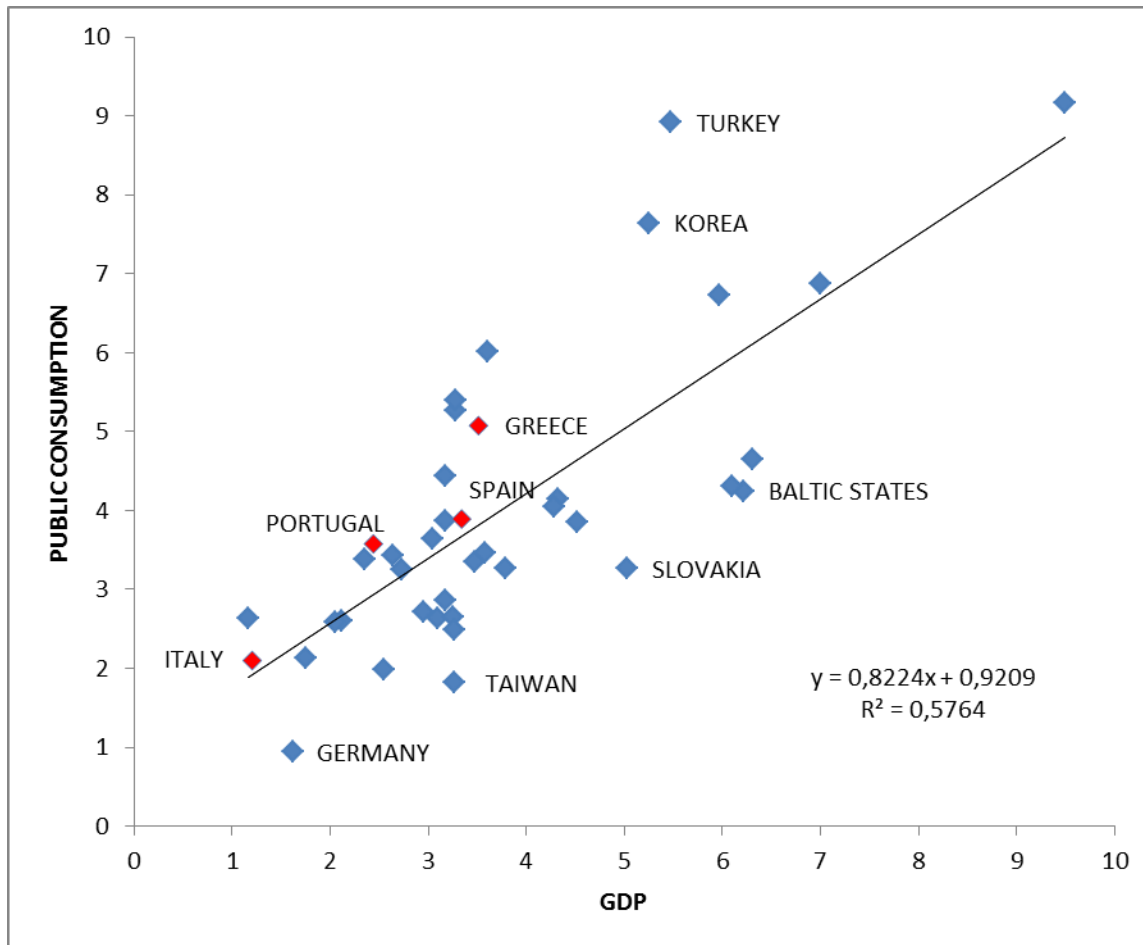
**Figure 4. Growth of Private Consumption and GDP, 1995-2008**



Source: Calculations by the authors based on data from WIOD (see appendix for details)

As Figure 5 indicates, there is more variation in public consumption, with economic success cases such as Turkey and Korea having much higher growth in public consumption than in GDP (or in private consumption for that matter), while the opposite is true for Germany, Slovenia and the Baltics. The Southern European countries tend to lie between the two extremes. However, in the Greek case, public consumption grew substantially faster than GDP.

**Figure 5. Growth of Public Consumption and GDP, 1995-2008**

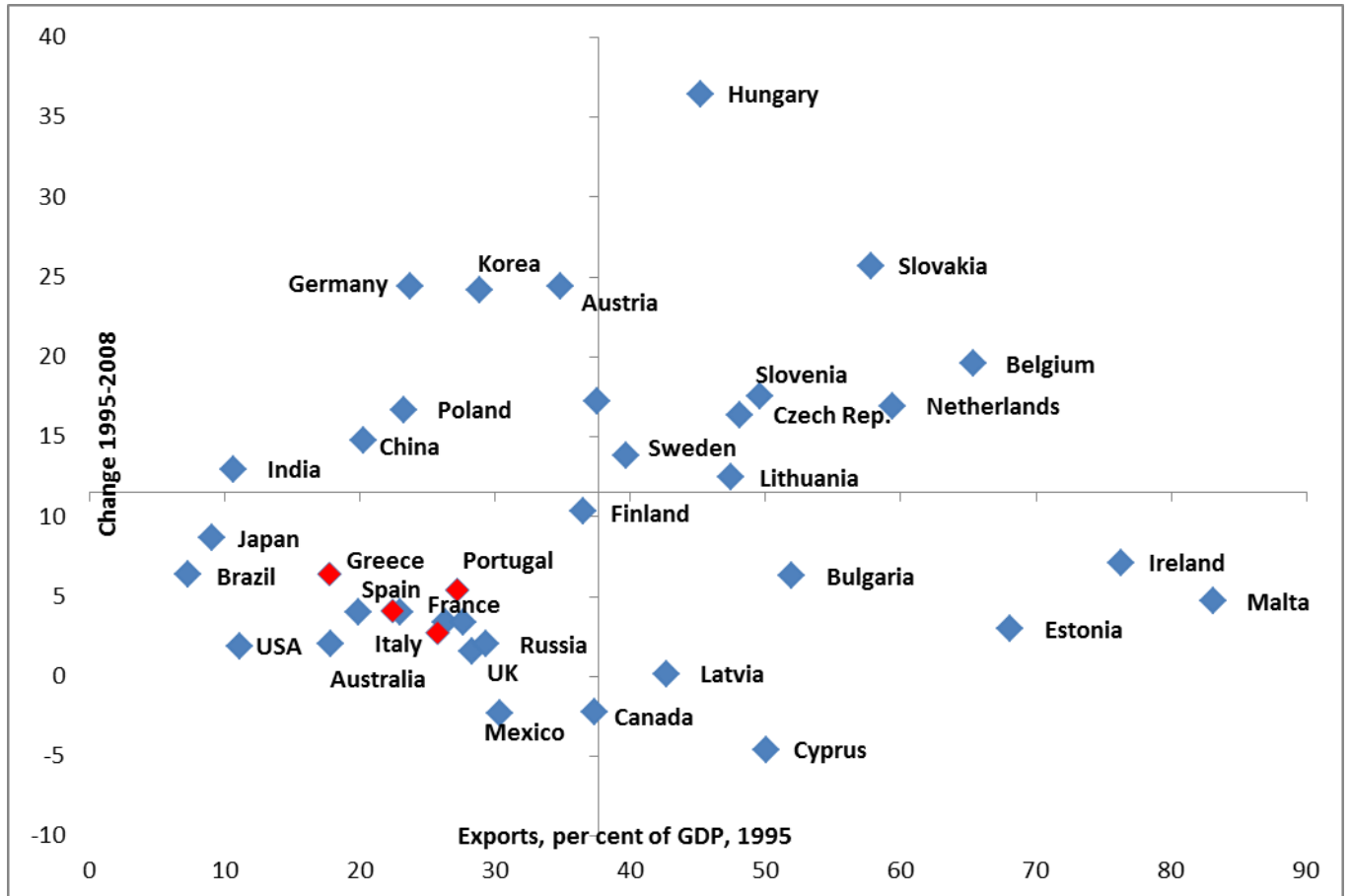


Source: Calculations by the authors based on data from WIOD (see appendix for details)

Thus, with a possible exception of Greece, the growth patterns of the Southern European countries do not deviate significantly from that of other countries. However, the three Southern slow growers and Greece have another feature in common, which may be of much greater relevance for the explanation of their performance. This has to do with their involvement in the global economy.

To examine this phenomenon, we look at the role of exports in GDP, using data from the World Bank. Figure 6 shows, on the horizontal axis, exports as a share of GDP. On the vertical axis, we plot the change of this share over 1995 – 2008. We see that, under the influence of globalization, the share of exports in GDP tends to increase in almost all countries (the average increase is close to 10 percentage points).

**Figure 6. Exports as a share of GDP, level versus change, 1995-2008**



Note: Luxembourg ( a major outlier) was excluded from the graph.

Source: Calculations by the authors using data from the World Bank (see appendix for details)

As the figure shows, Greece, Portugal, Spain and Italy cluster together in the bottom left quadrant,<sup>4</sup> this includes countries that are below average both with respect to their initial involvement in trade<sup>5</sup> and the increase in the share over time. In contrast, countries such as Germany, Korea and Austria, which did not differ much from the Southern European countries under study here with respect to the initial involvement in trade, recorded large increases in the share of exports in GDP. This also holds for several other countries that grew rapidly during this period. Hence, it appears that the Southern European countries under study here have not managed to tap into the combined potential entailed by

<sup>4</sup> This, it may be noted, does not hold for Ireland which is often lumped together with some of the Southern economies as “PIGS” countries. However, a detailed analysis of the Irish performance suggests that it has very little in common with the countries in the South of Europe (or other European economies), and therefore would warrant a separate analysis that we have chosen not to pursue here.

<sup>5</sup> The degree of involvement in international trade is also a function of country size. Very large economies, with vast domestic markets, trade less externally than other countries. This explains why the USA, India and China are to the left, while a very small country such as Malta is to the right in the figure. While this is to be expected, it is more surprising to find relatively small economies such as Greece and Portugal close to the US position. This tells us that, in relation to their size, the involvement of these countries in world trade is exceptionally low.

technological change and increasing globalization to the same extent as many other countries. In the following we will look more closely at the impact that this has had on the current accounts of these countries which increasingly have come into question.

#### 4. External balance: The European divide

In this section we analyze the development of the current accounts of selected European countries in the decades leading up to financial crisis based on statistics from the IMF. The aim is to document that there are three clearly distinguishable patterns, i.e., North, East and South. For this reason - and for the sake of space - the presentation will be limited to 21 European countries for which the division into these three groups is clearly relevant.<sup>6</sup>

A deficit on the current account means that a country's national debt increases. If sustained over several years a country may enter a vicious circle of increasing debt and rising interest-rates, and eventually face problems with respect to refinancing and servicing some of its debt. The development of the current account is therefore of immediate interest here. Changes in the current account may be caused by changes in transfers (for instance, support from the EU), factor income (profit and interest, for example) and trade. However, normally what drives the current account in the longer run is the trade balance.

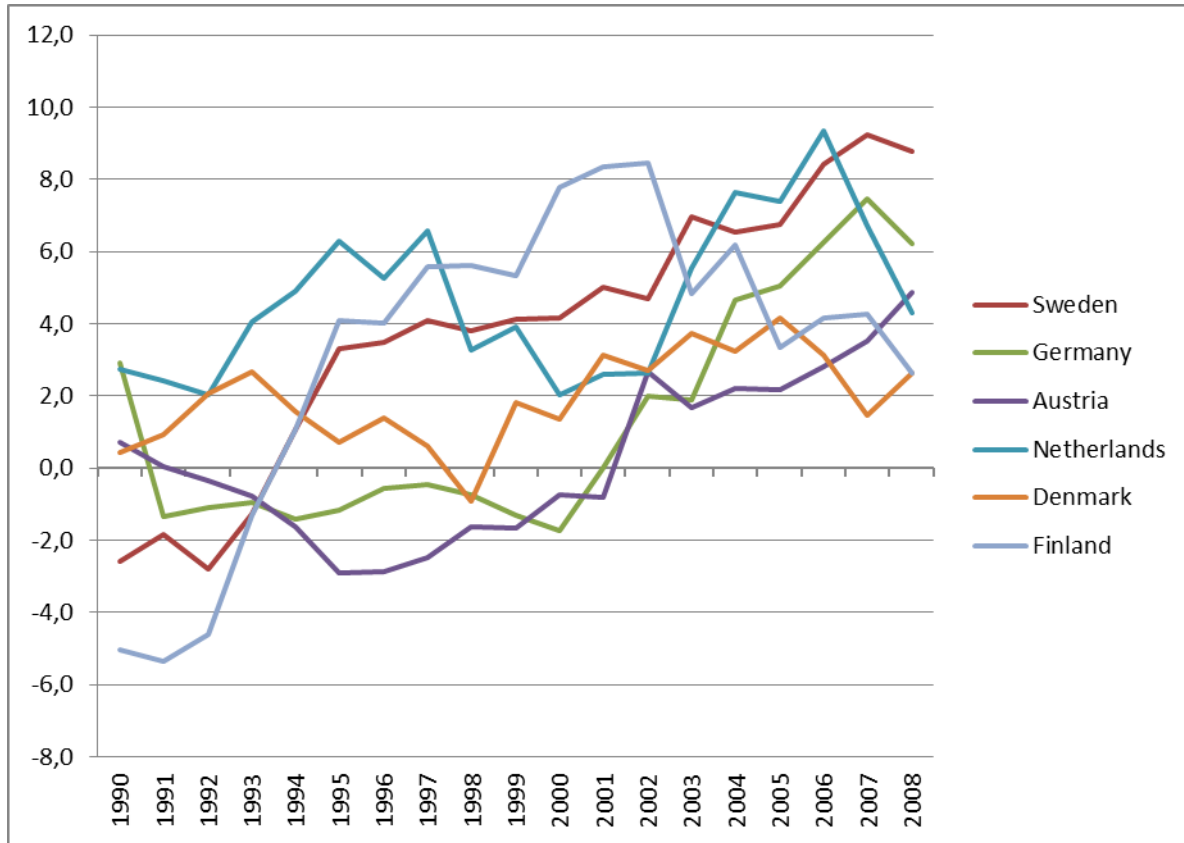
It should be noted, however, that having a current account deficit should not necessarily be regarded as a problem for a country. Rapidly growing countries often present foreign investors with favourable investment opportunities which they are eager to exploit. This makes it possible for a country to grow faster than it otherwise would have done, and will *ceteris paribus* lead to a deficit on its current account. Such deficits should not necessarily be regarded as a problem, however, because they are related to investments which will generate income in the future. Indeed this is a normal aspect of catching-up processes. When assessing the current accounts of European countries it is necessary to take such differences into account.

Figure 7 displays the current account as a percentage of GDP prior to the crisis for six Northern European countries, of which four are Euro-members and one pegs its currency to the Euro (Denmark). As the figure shows, there is a general upward trend in the external balance for these countries. This is particularly evident from the period after introduction of the Euro around the turn of the millennium. Consequently, prior to the crisis all six countries had substantial surpluses on their current accounts.

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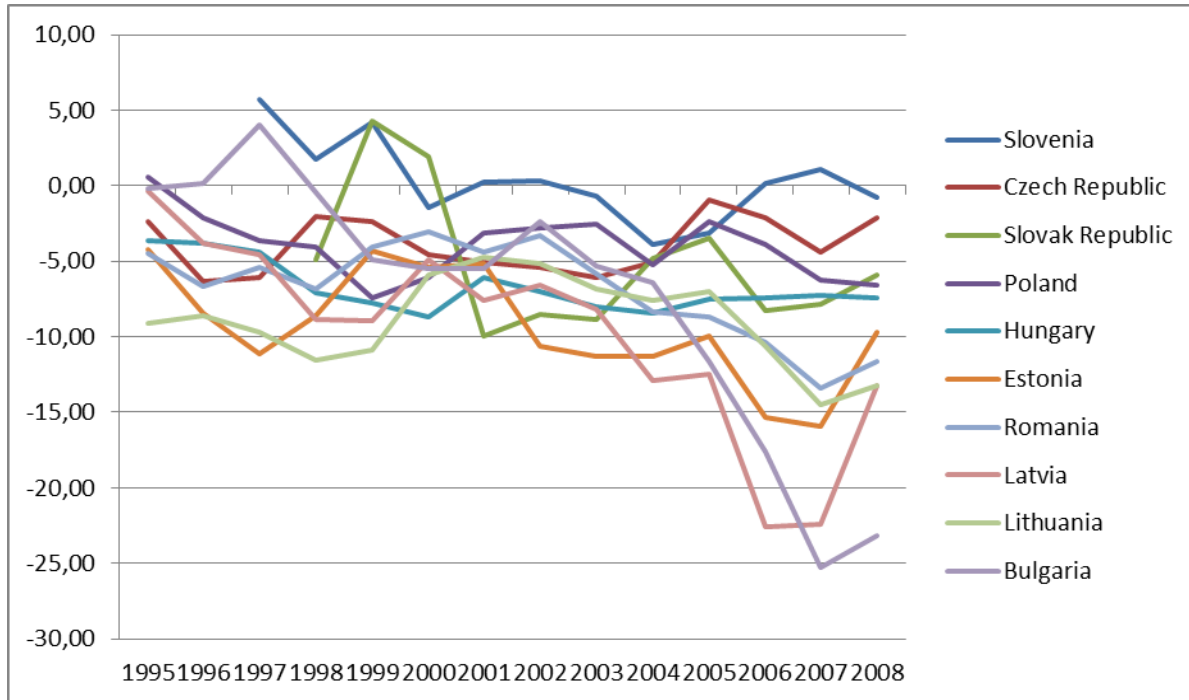
<sup>6</sup> Numbers for the countries not included here will be reported in a more aggregated fashion in the next section as "Other Europe". Belgium, Cyprus, France, Ireland, Luxembourg, Malta and the UK were included in this category. See also the discussion in section 6.

**Figure 7. Northern Europe: Current accounts, percent of GDP, 1990-2008**



Source: Calculations by the authors based on IMF data

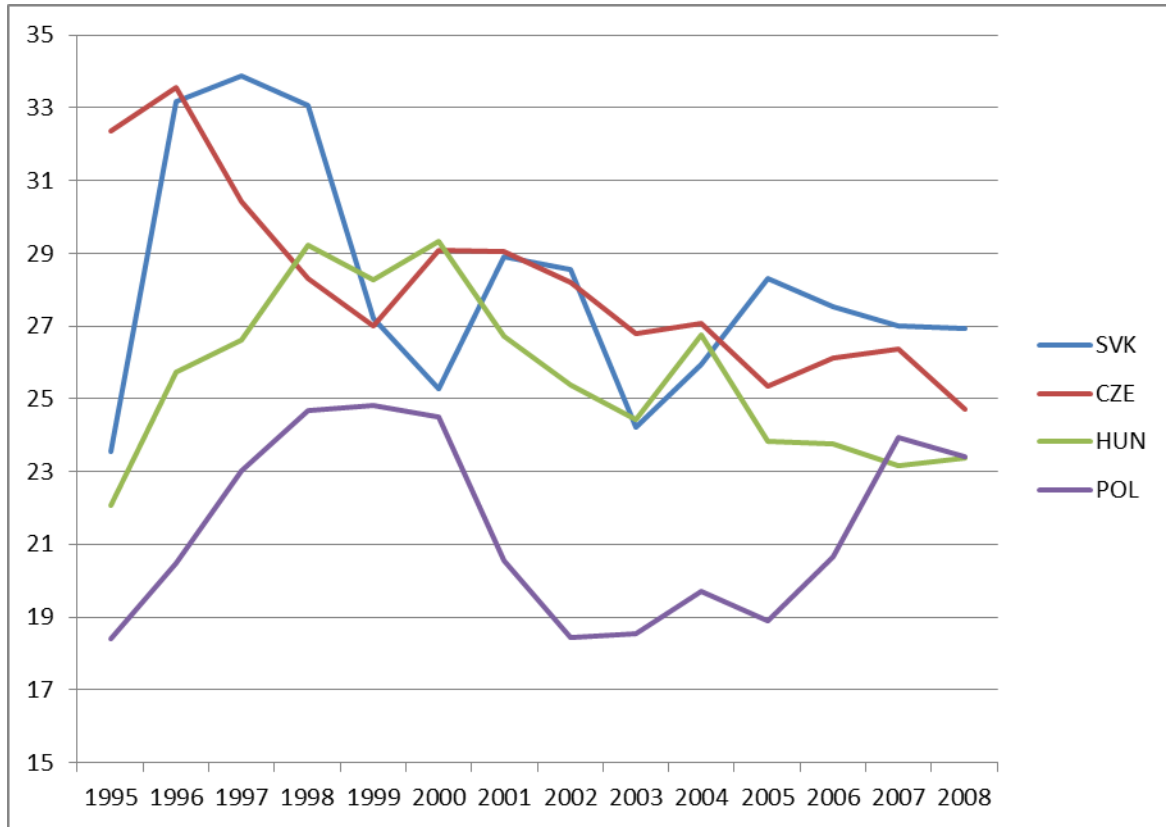
The situation is quite different in Eastern Europe as Figure 8 shows. Most countries in this group had deficits over the entire period, and these tended to increase, particularly after the introduction of the Euro. As the figure shows, there is a clear difference between the “Western” part of Eastern Europe, Slovenia, the Czech Republic, Slovakia, Poland and Hungary, which quickly became embraced by the Capitalist West, and the remaining countries, for which this process was slower. Among the former, although most countries in this category continued to run deficits, these did not deteriorate over time. This is different for the latter countries, for which the deficits continued to increase and eventually became very large (more than twenty percent of GDP in some cases).

**Figure 8 Current Accounts: Eastern & Central Europe, percent of GDP, 1995-2008**

Source: Calculations by the authors based on IMF data (see appendix)

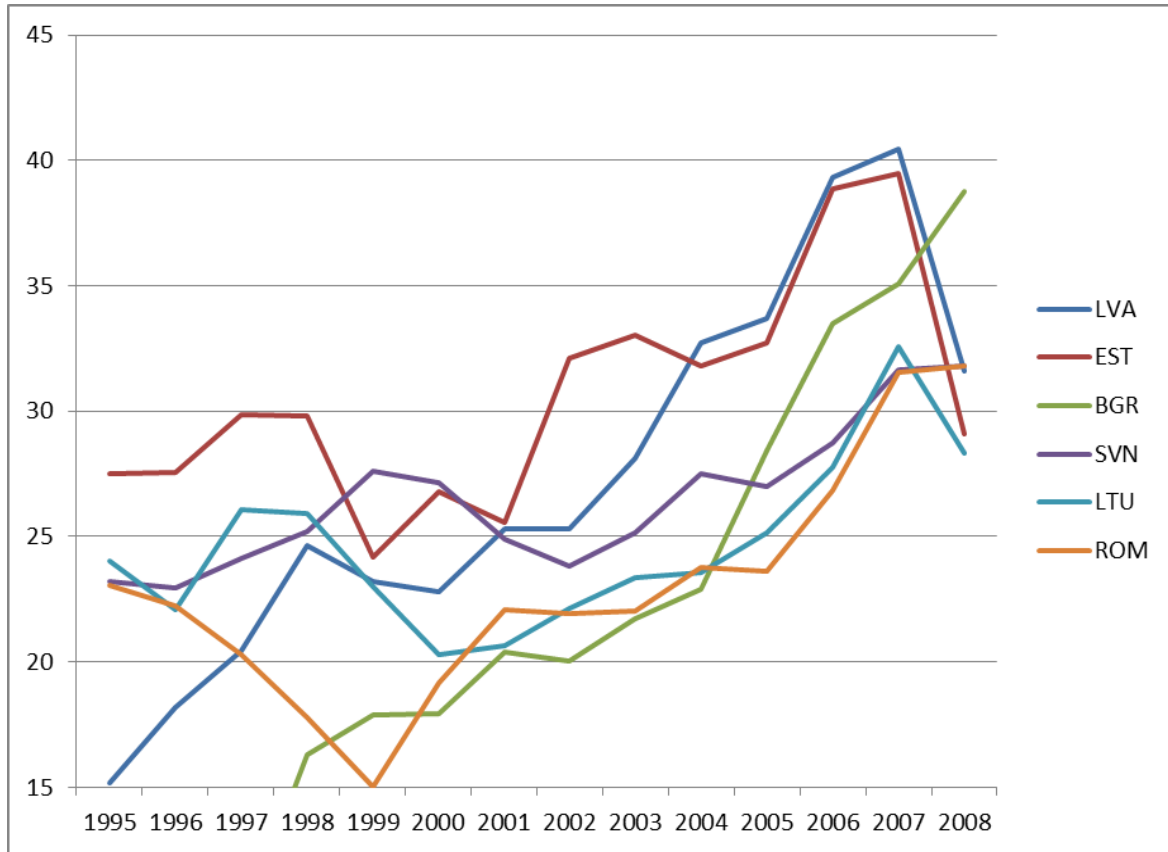
However, as noted above, these developments cannot be properly understood without taking into account the very high levels of investment in these countries during these years. As figure 9 shows, in the first group of countries investment was booming in the late 1990s, after which it leveled off. In contrast, for the second tier (the latecomers) investment only took off after the beginning of the millennium (Figure 10). A veritable investment-boom followed, with investment shares in GDP close to forty per cent for some countries and years. Hence, the large deficits that emerged on the current accounts for countries such as Latvia, Estonia and Bulgaria basically reflect an investment boom in which foreign investment played an important role. This does not mean that no domestic savings took place in these countries. In fact, the average domestic saving rate in these three countries between 2005 and 2008 was 18.5 % , and only for one country in one year did it slip below 15%.

Figure 9 Early Birds: Investment shares in GDP 1995-2008



Source: Calculations by the authors based on WIOD (see appendix)

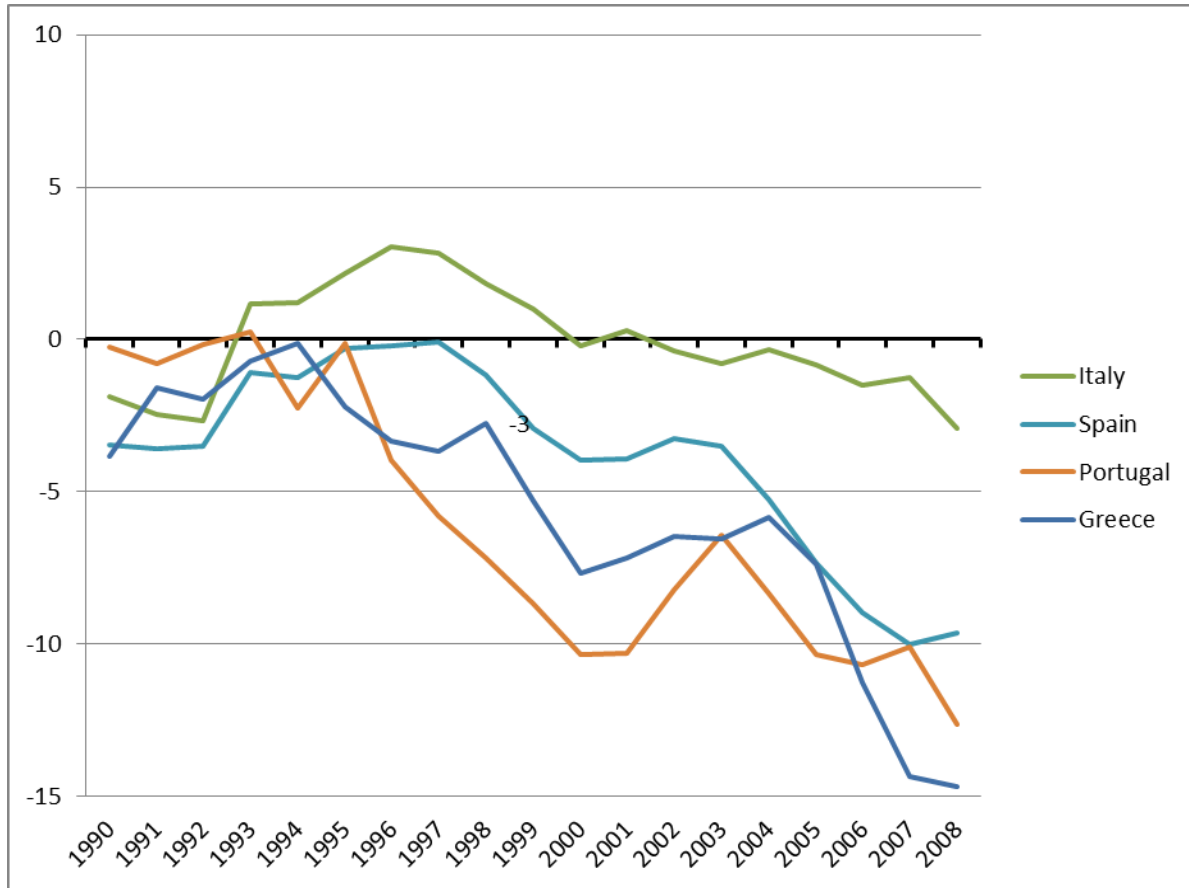


**Figure 10 Latecomers: Investment shares in GDP 1995-2008, per cent**

Source: Calculations by the authors based on WIOD (see appendix)

Figure 11 reports similar evidence for Southern Europe (Italy, Greece, Portugal and Spain). Around 1993-1995 the current accounts of these countries were roughly in balance. Then a divergence appeared between Greece, Portugal and Spain on the one hand, which moved into ever larger deficits from the mid/late 1990s onwards, and Italy on the other, which stayed in surplus for another 5-10 years, after which deficits started to emerge there too.<sup>7</sup>

<sup>7</sup> The somewhat better performance of Italy on this dimension should not be seen as an indication of superior competitiveness. It primarily reflects the fact that the rate of growth of GDP (see Figure 1), and hence imports, was slower in Italy than elsewhere.

**Figure 11. Southern Europe: Sliding into current account deficits (per cent of GDP)**

Source: Calculations by the authors based on IMF data (see appendix)

A relevant question may be ‘To what extent does this pattern mirror the investment cycle, as in Eastern Europe?’ The answer is much less so. There was something resembling an investment boom in Portugal around the turn of the century and again in Spain closer to the end of the period, and these developments clearly influenced the situation in these two countries. However, this does not explain why Portugal’s annual current account deficit continued to be close to 10 percent (or more) even after the investment boom had faded, or the large and increasing deficits during the same period in Greece. Nor does the level or fluctuation in investments explain the much more modest deficit that subsequently appeared in Italy.

Thus, slow growth and deteriorating current accounts over a number of years seem to be features that distinguish the countries in the South of Europe from those in the East or the North. What is the relationship between these trends and the process of European economic integration and changes in the global economy and from the early 1990s onwards? This is the question to which we now turn.

## 5. European growth (or lack of it): The impact of European economic integration and globalization

In this section we will delve deeper into the roles of European economic integration and globalization for Europe's growth. We focus in particular on the performance of the three groups of countries identified above; North, South and East Europe, and as before the analysis is based on WIOD data. For comparison, and as before, the analysis also includes a group of "other European countries", mostly from the central and western parts of Europe, and a group of Non-European countries, including some large and economically important developing countries (China for example).

We start by decomposing average annual GDP growth over the period 1995 – 2008 into two parts: one that is associated with trade (traded GDP<sup>8</sup>), and one that is associated with domestic sources. Figure 12 illustrates the contributions of the two categories of GDP to overall GDP growth for the 40 countries included in the data base.<sup>9</sup> The line stretching from the origin to the upper-right corner is the 45 degrees line. Below (above) this, the contribution of domestic (traded) GDP is largest. The lines stretching from the upper-left to bottom-right are iso-growth curves along which the GDP growth rate is constant. The further to the right these lines are, the higher the growth rate of GDP is.

The following patterns may be observed:

- The countries in Northern Europe cluster in the bottom left of the figure. They grew relatively slowly, and with the exception of the Netherlands the contribution from traded GDP trumped that from domestic sources. It may be noted that for Germany the contribution from domestic sources to growth was almost nil, reflecting the austerity policies pursued over a number of years.
- The countries in the South of Europe are to be found in the bottom right of the figure. Thus they also grew relatively slowly. However, with the exception of Portugal, all Southern European countries have a larger contribution from domestic sources to growth than from traded growth, which clearly distinguishes them from their Northern neighbors. Italian growth was particularly low.
- In contrast to stagnation elsewhere in Europe, many Eastern European countries grew quickly between 1995 and 2008, and in most cases they had a higher contribution from traded than from domestic GDP.<sup>10</sup> Their growth pattern thus does not resemble that of Southern Europe.
- The group of "other European countries" is a mixed bag. Several countries, France for example, are relatively similar to Southern Europe, in the sense of having slow growth and a high dependence on domestic sources. Ireland is different though, with high growth and a strong reliance on foreign sources. Its growth pattern is – if anything – closer to that of Eastern Europe.

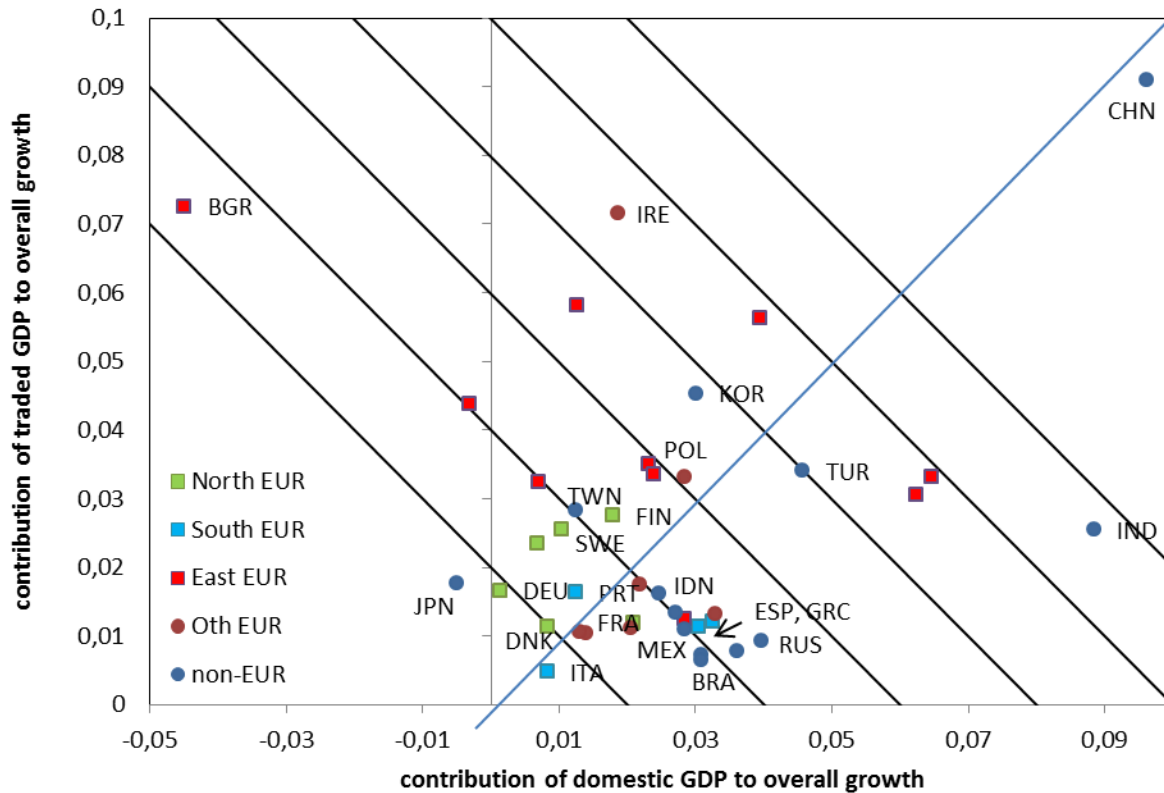
<sup>8</sup> See, e.g., Johnson and Noguera (2012) for an elaboration on this concept.

<sup>9</sup> The contribution of traded GDP to overall GDP growth was calculated as the growth rate of traded GDP in a country multiplied by the initial (1995) share of traded GDP in total GDP (and similarly for domestic GDP).

<sup>10</sup> This holds for all countries in this group except Lithuania, Latvia and Romania.

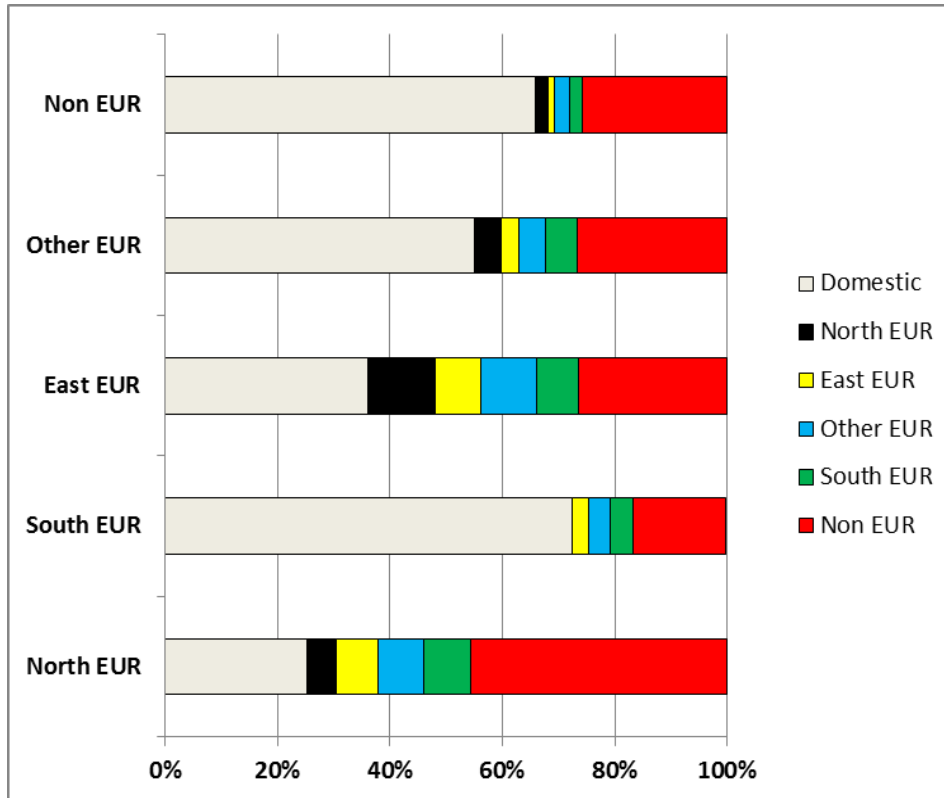
- With respect to the non-European countries, it is interesting to observe that most of them have a lower contribution from traded GDP to growth than from domestic sources. The exceptions to this rule are Japan, Korea and Taiwan.

**Figure 12. Contributions of domestic and foreign demand to growth of GDP, 1995-2008**



Source: Calculations by the authors based on WIOD data (see appendix)

The picture that emerges from this analysis of European growth is one of large differences across countries with respect their involvement in trade and the effects thereof. While some European countries are among the most internationalized in the world, in the sense of sourcing most of their growth abroad, other countries – notably those in Southern Europe – do not belong to this category. These differences may be seen as surprising given the efforts over the years to spur European growth and trade through the gradual elimination of barriers to trade (e.g., the internal market) and the introduction of a common currency, the Euro. To get a better understanding of the roles played by European economic integration and globalisation for different parts of Europe, Figure 13 presents a decomposition of the GDP growth of the country-groups identified above, which splits the foreign contribution according to the region where the final demand originated.

**Figure 13. Decomposition of GDP growth, 1995-2008**

Note: The regions to the left (vertical axis) are where the growth takes place, while the regions to the right (legends) are where final demand associated with this growth originates.

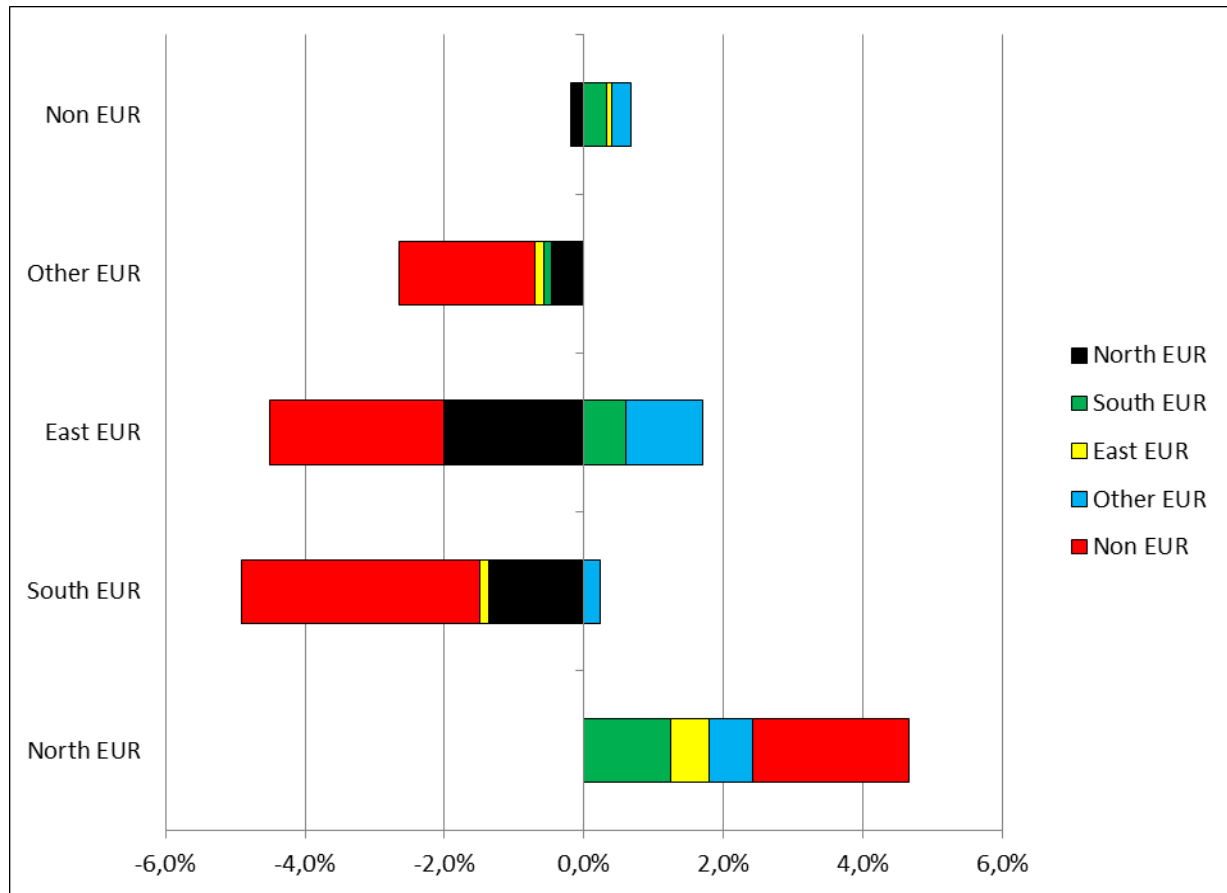
Source: Calculations by the authors based on WIOD data (see appendix)

First it may be noted that the effect on growth from trade with non-European countries (the area to the far right in the figure) exceeds that of intra-European trade for most country groups. The exception is Eastern Europe for which European demand has been very important indeed, supporting the rapid growth and “catch-up” there from the 1990s onwards. Intra-European traded GDP accounted for 37% of total GDP growth in these countries, which is about the same as the contribution from domestic sources. The countries in Northern Europe also received a substantial contribution from intra-European trade, 29% of their total growth, which is larger than the contribution from domestic sources. In contrast, for Southern Europe the contribution to growth from intra-European trade is very small, only 11%, and the largest part of this comes from intra-Southern European trade. In fact, the contribution to growth from trade with North Europe is essentially nil. Thus, although European integration has proven to be very fruitful for the rapid development of Eastern Europe from the early 1990s onwards, and also yielded substantial benefits for Northern Europe, the economic benefits for Southern Europe are much less obvious.

In the previous section, evidence on the development of the current accounts of European countries was discussed. It was shown that while these were roughly in balance for most countries in the early 1990s, since then a very unbalanced development took place with increasing surpluses in the North and

corresponding deficits in the South and the East. As pointed out there, the trade balance is an important part of the current account, and – at least in the longer run – determines the evolution of the current account and the country’s international debt. It is of interest, therefore, to explore how European economic integration and globalization influenced the trade performance of different parts of Europe. To link the discussion of this issue more closely to the main topic of this section, i.e., the effects on growth, we look at what may be called the “value added trade balance”, i.e. the difference between “exported GDP” and “imported GDP”.<sup>11</sup> Figure 14 illustrates the changes in the value added trade balance for various parts of Europe between 1995 and 2008, and how these changes were affected by trade with other parts of Europe and the rest of the world during this period.<sup>12</sup>

**Figure 14. Change in the value added trade balance (% of GDP), European regions, 1995-2008**



Source: Calculations by the authors based on WIOD data (see appendix)

<sup>11</sup> This builds on the same methodology of decomposing value added (growth) by sources of demand as was used in Figures 12 and 13. Exported GDP of country  $i$  is produced in  $i$  but used (due to final demand) in a different country. Imported GDP in country  $j$  is GDP used (due to final demand) in  $j$  but produced in a different country. The value added trade balance is then defined as exported GDP minus imported GDP. It is equal to the “normal” trade balance, but decomposes this in a different way.

<sup>12</sup> We use current prices to calculate this.

The imbalances that developed within Europe in the years leading up to outbreak of the financial crisis in 2008 are clearly visible in the Figure. While, as pointed out above, Northern Europe improves its (value added) trade balance with almost 5% of GDP, the other European country groups all see their balances deteriorate, particularly in Eastern and Southern Europe. The factors leading to this deterioration were the same, namely increased deficits vis-à-vis Northern Europe, a clear beneficiary of European economic integration, and the rest of the world. However, in the case of Eastern Europe these negative effects were to some degree counteracted by gains vis-à-vis Southern and Other Europe. The decline in the balance was particularly large for Southern Europe, for which increasing deficits in trade with the rest of the world were the largest contributing factor. An important part of this loss was no doubt due to increasing competition from China and other industrializing countries. The Southern countries, especially Italy and Portugal, were vulnerable to increasing Chinese competition because their manufacturing industries were specialized in relatively mature, low-skill products, such as leather products, footwear, textiles and clothing, which appeared as natural targets for producers in industrializing countries.<sup>13</sup>

This section has shown that during the years leading up to the crisis, deepening European economic integration and globalization had very asymmetric effects on different parts of Europe. While Eastern Europe clearly benefited (at least until the crisis struck), and Northern Europe as well, the benefits are much less obvious for the countries in Southern Europe. In the next and final section we will discuss the implications of these findings for the analysis of the current stagnation in Europe and possible solutions.

## 6. Conclusions

Much of the European economy is currently characterized by stagnation, high unemployment and increasing social problems, and this has been the situation for several years now. European policymakers are busy creating new regulations, especially in the financial and macroeconomic policy areas, with the hope that Europe's problems will eventually go away. We think it highly unlikely that such regulatory fixes, however sensible they may seem, will restore Europe's growth and lead to reduced differences between richer and poorer parts of the union. The root of the problem is that Europe is a heterogeneous economic entity. Although the challenges that different parts of Europe face may to some extent be related, their capacity to deal with such challenges, and therefore also the economic and social outcomes, varies a lot. Without taking such differences into account, any discussion of solutions to the present crisis run the risk of ending up with unrealistic and ineffective proposals that make the situation worse.

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<sup>13</sup> The increases in Chinese exports between 1995 and 2008 were concentrated in relatively mature, low skill industries. As an example, consider the sector "Leather, leather products and footwear". In this sector China had a gain of 25.3% of the global market (world traded GDP), the strongest Chinese gain in any sector, this amounted to 92% of total gains/losses in market shares. Italy and Portugal were among the top losers.

The evidence considered in this paper suggests that there are three broad categories of countries on the European continent: Northern, Eastern and Southern.

- The Northern countries are advanced economies with high levels of productivity but which grow relatively slowly. They have taken advantage of the opportunities offered by European economic integration and globalization and have internationalized their economies at a rapid rate. As a result they run surpluses in their trade with other European countries and the rest of the world. The financial crisis represented a serious challenge for these countries but not more than in other advanced economies.
- The Eastern countries for historical reasons have productivity and income levels well beyond the world frontier, but a relatively well educated labor force. They went through rapid economic, institutional and political change, attracted a lot foreign investment, and increased their trade with other European countries and the rest of the world. Some countries joined this process early, while others entered later. This resulted in rapid growth in this period but also external deficits and high dependence on international financial markets. These countries, and particularly the late entrants, were therefore hard hit by the financial crisis and the setback that followed, and their economies consequently contracted much more than Northern countries.
- The Southern countries have productivity and income levels comparable to the most advanced Eastern economies. But on average they grew much more slowly in the period up to the crisis. They are among the least internationalized economies in Europe, and have not managed to increase their presence in foreign markets to the same extent as many other European countries (or emerging economies from other parts of the world). A characteristic feature of several Southern countries is increasing external deficits and rising foreign debts over a number of years. As a result they were hard hit by the crisis and their economies contracted more than other European countries with rising unemployment as one of the results.

These categories are not carved in stone though, and some reservations may be in order. First, there is obviously a lot of variation within these categories as well, as countries differ in a number of respects. We are however not going to elaborate further on this issue here. Second, some countries have characteristics that would situate them between the “Northern” and “Southern” archetypes. This holds for example for some of the countries in the Center-West part of Europe such as the UK, France and Belgium. Thus, some of the challenges that the Southern countries face may to a varying degree be relevant for other European countries as well.

The research presented in this paper has shown that, because of Europe’s heterogeneous character, the effects of globalization and European economic integration have been very different for the three groups of countries considered above. For Northern Europe, the classic advantage of integration, i.e., a larger market for the products that these countries are specialized in (in many cases, advanced, high-value-added products), seems to have contributed to an improved external balance and higher economic growth. For Eastern Europe, integration into the European economy allowed these economies to tap into the advantages of global economic integration, benefitting for example from relocation of production from the Northern European countries. For Southern Europe, however, globalization and European economic integration appear to have been much less beneficial, mainly due to a lack of



competitiveness, which also made them vulnerable to increasing competition, both at home and abroad, from China and other developing countries. As shown in the preceding section, about three quarters of the increase in Southern Europe's trade deficit before the financial crisis struck came from trade with non-European countries, the remaining from increased deficits vis-à-vis the Northern countries.

The introduction of the Euro also had an asymmetric impact. For Germany it dampened the upward drift of its currency that otherwise might have resulted from the increasing external surpluses that gradually occurred as a consequence of the austerity policies of successive German governments from the 1990s onwards. This happened because Germany now shared a currency with a number of less competitive economies, such as the Southern countries and France. The German austerity policy, however sensible it might have looked from a national point of view, gradually became a problem for the less competitive countries of the Eurozone, because it effectively meant that there was hardly any growth for the demand of their exports in Northern markets. This naturally added to the increasing competitive challenge these countries were facing from rapidly industrializing economies outside Europe such as China. In effect, for the Southern European countries, the Euro mainly relieved them of a convenient mechanism to compensate for their lack of competitiveness without simultaneously hurting domestic demand and employment. For a while it allowed them to finance the external deficits that occurred at favorable interest rates but with hindsight this was a mixed blessing.

In the case of Southern Europe, being less competitive and characterized by slow productivity growth, policy makers were left with two primary choices. Either they could restrain growth of domestic demand, leading to low growth in GDP, increasing unemployment problems, especially for newcomers to the labor market, and exerting a downward pressure on wages. This policy, while leading to stagnation, had the advantage that, mainly by curbing imports, it would put a brake on the tendency towards increasing deficits in trade with other countries. Or they could allow domestic demand to grow sufficiently to compensate for low demand from abroad and lack of competitiveness, preventing unemployment problems from getting out of hand, but at the expense of increasing deficits in their trade with other countries. Among the Southern economies, Italy was for a long time close to the first scenario, while developments in the remaining countries were closer to the second. What happened after the financial crisis struck, however, was that the second scenario no longer represented an option. Thus, after a while, policy makers in all Eurozone countries increasingly faced pressures to adjust policy towards a more austere stance, i.e., mimicking the policy pioneered by Germany, leading to stagnation and high unemployment in the entire Eurozone and in the rest of Europe as well. The consequences have been most strongly felt among the economically and technologically least developed, and hence least internationally competitive, in the South and East of Europe but are visible in the North as well.

It is often suggested that the governments and populations in Southern Europe behaved irresponsibly in the years leading up to the crisis. Whatever the merits of this view, the creation of a common currency for an economically extremely diverse continent, without any mechanism to coordinate economic policies and prevent problems from getting out of hand, appears to have been a much more irresponsible policy. Sadly, the present insistence on austerity, with economic stagnation, high unemployment (especially among the young), increasing poverty and social unrest as some of its main consequences, only adds to the problems created by a flawed currency arrangement, inconsistent

macro-economic policies, lack of (constructive) policy coordination and leadership at the European level and the failure to take the heterogeneous character of Europe's economy sufficiently into account. What is needed at the European level is a growth policy, properly adapted to the different contexts and capacities across Europe, which puts the welfare of the European population as a whole at the center, and explicitly aims to diminish the large differences in productivity, income and living conditions across the union. Consistent with these aims, emphasis should also be placed on the important challenges Europe is facing with respect to climate change and energy, which, if taken seriously, would require large public and private investments (with important potential growth effects) as well as the possibility for new regulations promoting entrepreneurship, innovation, structural change and, hence, economic growth. Indeed, this is an area of public policy pioneered by Germany, which would be equally or even more relevant at a Europe-wide level.

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## Appendix.1. Data and Sources

Figures 1 and 2: GDP per capita (constant 2000 US\$)

GDP per capita is gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy (plus any product taxes and minus any subsidies not included in the value of the products). It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Figure 6: Exports of goods and services (% of GDP)

Exports of goods and services represent the value of all goods and other market services provided to the rest of the world. They include the value of merchandise, freight, insurance, transport, travel, royalties, license fees, and other services, such as communication, construction, financial, information, business, personal, and government services. They exclude compensation of employees and investment income (formerly called factor services) and transfer payments.

Source: World Development Indicators, The World Bank, 28 September 2012,  
<http://data.worldbank.org/products/wdi>

Figures 7, 8 and 11: Current account balance as a Per cent of GDP (current prices)

The current account is all transactions (between an economy and the rest of the world) other than those in financial and capital items. The major classifications are goods and services, income and current transfers.

Source: International Monetary Fund, World Economic Outlook Database, April 2012,  
<http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx>

Remaining figures: World Input-Output Database (WIOD)

The World Input-Output Database (WIOD) provides time-series of world input-output tables for forty countries worldwide and a model for the rest-of-the-world, covering the period from 1995 onwards. The database has been constructed on the basis of officially published input-output tables in conjunction with national accounts and international trade statistics. For more information see: Marcel P. Timmer (ed) (2012), "The World Input-Output Database (WIOD): Contents, Sources and Methods", WIOD Working Paper Number 10 (<http://www.wiod.org/publications/papers/wiod10.pdf>)

Source: [http://www.wiod.org/new\\_site/data.htm](http://www.wiod.org/new_site/data.htm)