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Alternative Economic Policies in Europe: An Introduction

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In a recent paper Anatole Kaletsky addressed Henry Kissinger's famous question about the Western alliance: "What is the phone number for Europe?" But observed that if Europe's phone number has a German dialling code, it goes through to an automated answer: "Nein zu Allem" (Kaletsky, 2016). One of us has addressed this in both historical and psychological terms, submitting that the Eurozone crisis is the first time since WW2 that Germany has been able to displace a darker past and project herself as a model of virtue that should be emulated by austerity from otherwise allegedly self-indulgent member states (Holland, 2015a, 2016).

After the crisis of 2007-2008 recession, the risk of depression and persistent unemployment and poverty in key member states and many European regions was mainly the consequence of European austerity policy whereas in other world regions and large economies policies have been able to achieve either investment-led recovery (East Asia) or demand-led recovery (the US). Austerity in Europe is not creating the conditions for recovery but "beggar-my-neighbour" deflation.

Structural reforms demanded of weak economies were used exclusively to obtain greater labour flexibility and a reduction of the income share distributed to employed workers (see the paper of Ginzburg and Simonazzi). By reducing the ratio of labour income and investment to GDP (Garofoli's paper in this issue) this has meant a reduction of aggregate effective demand, reinforcing the low disposition to invest (Keynes' marginal efficiency of capital) which is typical of a prolonged recession. Such findings for the case against austerity have been reinforced by parallel findings from the IMF Research Department (IMF, 2015), that Troika claims to weaken social protection of labour through *Structural Reforms* have no basis in any OECD country, which also has been critiqued in relation to the Lindbeck-Snower Insider-Outsider hypothesis by Holland and Oliveira paper in this issue.

As an outcome, there also have been negative investment, employment, income and fiscal multipliers. How policy makers estimate such multipliers has a crucial effect on what they expect the outcomes to be. Thus, if they assume a low multiplier, this minimises the presumed effect of austerity on economic growth which has been the case with the European Commission serially under-estimating negative multipliers in demanding cuts in investment and expenditure in the name of stability, and governments actively or reluctantly accepting this.

In October 2012, when Blanchard was chief economist of the IMF, both he and a colleague, Leigh, advertised in the IMF *World Economic Outlook* 2012 that negative multipliers from cutting debts and deficits had been under-estimated by a factor of up to three which was why the European economy was not recovering. In a further IMF paper in 2013 Blanchard and Leigh elaborated evidence for this. In parallel, in an NBER paper in 2011 Auerbach and Gorodnichenko found high negative fiscal multipliers in

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the Euro Area of some 2.5 since the onset of the Eurozone crisis which was five times more negative than the European Commission has presumed.

Yet a crucial factor in the Eurozone crisis not only is the lack of aggregate demand, but also failure to recognise how social investment can promote demand in a manner that sustains rather than drains the private sector (Fondation Robert Schumann, 2014; Abiad, Furceri, Topolova, 2015)[1]. This will depend on what the investment projects are, and how labour intensive since a key part of the GDP increase comes from the income they generate in new employment. Nonetheless, investment multipliers can average 2.5 to 3.0, as found by research into those generated by European Investment Bank projects (Holland, 2015a).

There is a German obsession with competitiveness and with export-led growth. But this not only displaces the commitment of the first revision of the Rome Treaty in the Single European Act to economic and social cohesion. In a large market such as that of the EU, internal demand is more important than external demand. EU member states trade mainly with themselves. The ratio of non-European exports to GDP was lower than 10% before the economic crisis and the EU as a whole is broadly in balance with the rest of the world (see Garofoli's paper in this issue).

German competitiveness is partly due to its strong manufacturing sector and its quality but also from undue wage restraint and containment of internal demand (Ginzburg and Simonazzi, in this issue). Besides, the growing shares of German imports of lower price and lower quality consumer goods from non-EU economies such as China (Simonazzi, Ginzburg, Nocella, 2013) has created problems for exporters of such traditional goods from the periphery of Europe to its centre.

Moreover, export-led models are not sufficient to get out of the crisis. German surpluses reflect other countries' deficits. Trade surpluses in the centre and deficits in the periphery have led to debt imbalances in the Union. Of which the main beneficiaries have been German and French financial investors, led by banks, and the main losers the Southern European countries. Even the expansion of domestic demand in core countries like Germany and Netherlands would be insufficient to assure the balanced growth that actually is an opening commitment of the Treaties on the Functioning of the European Union (see the paper by Ginzburg and Simonazzi in this issue).

Further, economic structure between countries cannot be eliminated by a one-size-fits all monetary policy but need structural, social and regional policies to offset asymmetries integral to the free working of the market mechanism, which was recognised in the 1955 Spaak report to the founding conference of the European Economic Community but has been displaced since agreement of the debt and deficit conditions of the Treaty of Maastricht.

Besides which, inequalities in long term trends in the distribution of income are not solely due to Piketty's analysis of reduced income and wealth taxation, though both count, but also a falling rate of profit. As Manera, Navinés and Franconneti submit through a long term comparison between USA and the main European countries, with only a few exceptions the rate of profit began to fall from the late 1960s, reaching values in the neoliberal phase that were half those of the Keynesian era.

The case for a bond funded European recovery programme, financed by both the European Investment Bank and European Investment Fund, had been recommended

[1] For a general reflection on the role of representation and communication of economic crisis and problems see Salles, Colletis, 2013.

by one of us to Jacques Delors (Holland, 1993) and was the cornerstone of his 1993 "full employment" White Paper, which was approved by the 1994 Essen European Council and endorsed by Mitterrand, Chirac, Prodi and other heads of government at successive European Councils thereafter. But opposed by Germany. With the displaced advantage that the European Investment Fund can counterpart the micro project based finance of the European Investment Bank by a macro role in recycling global surpluses. Which also was endorsed in 2012 by the social partners' Economic and Social Committee of the Union in their proposal *Restarting Growth* including, on its working party, unanimous support not only from trades unions but also employers' representatives, including the representatives of German employers.

By contrast, the wrongly vaunted Juncker plan is a deception in several senses. First, the lead commitments that Jean-Claude Juncker made to the European Parliament in July 2014 was that he would propose a €300 billion EIB bond backed recovery for Europe. By November, under pressure from German finance minister Wolfgang Schäuble, this had been reduced to only €5 billions from the EIB, a recycling of a share of the Commission's research budget and an absurd anticipated "leverage" of 15 which Jyrki Katainen, the Commissioner to draw up the "plan" promptly recognised was infeasible.

Second, a deception because it introduced a European Fund for Strategic Investments – EFSI – on the grounds that the similar sounding but different European Investment Fund (EIF), introduced by Jacques Delors, could not bond finance a European investment recovery rather than only offer support for small and medium firms. This was by reading the EIF's website rather than by reading its statutes, which could enable it to issue bonds recycling global surpluses as a macroeconomic instrument to complement the project focused bonds of its sister institution the European Investment Bank, and which had been its original design aim (Holland, 1993).

Third, because the European Fund for Strategic Investment as actually introduced was a travesty of its original design aims. It had been proposed by Mateusz Szczurek, at the time finance minister of Poland, in an address to the Bruegel Institute in September 2014. But he had proposed that it commit to a €600 to €800 billion bond funded recovery programme to offset the fall by a sixth of investment in the EU since the onset of the Eurozone crisis and was appalled by the downgrading of his proposals, other than in name, for a major bond backed European recovery (Szczurek, 2014; Holland, 2015b, 2016).

All of which has been compounded not only by German arrogance but by institutional ignorance and incompetence in the Juncker Commission and advisers to the European Council. Such as that, in December 2014 at a meeting in Brussels, neither the economic adviser to European Council President Donald Tusk, nor to Commission President Jean-Claude Juncker, nor to the Employment Commissioner Marianne Thyssen, nor to the Commissioner for Jobs, Growth, Investment and Competitiveness Jyrki Katainen, nor the senior economist to the Commission were aware that EIB borrowing does not count on national debt (Holland, 2016).

Whereas recognising rather than displacing this is vital both to the case for European economic recovery and for releasing fiscal resources to reinforce this without fiscal transfers between member states, however desirable this may be in the longer term. For, since investments through the EIB do not count on national debt, this enables the tax revenues that otherwise would service it at a national level to be allocated for other expenditures. Such as the more labour intensive employment in the social sphere which was endorsed by the 1994 Essen European Council and could mean more teachers and smaller classes, more health workers and shorter waiting lists and more care for the elderly in an ageing population.

Such a case for a bond funded European recovery programme is supported by the argument of Ginzburg and Simonazzi in this issue that the peripheral countries need European investment targeted to their economic and social needs to enable a sustained convergence with the European centre. This is especially important for Balkan countries aspiring to join the EU, because their production and export structure shows the presence of different stages of development in core and peripheral Europe (see Bartlett and Prica's paper and Meksi and Xhaja's paper, in this issue). Linear relationships between economic variables, as in the Solow convergence model, neglect such asymmetries, as well as the length of time that convergence could take, such as up to seventy years for Albania, even if the convergence is sustained (Meksi and Xhaja paper). Besides which the Solow model – based on Harrod-Domar premises - recognises that departure from an initial equilibrium convergence path could reverse it with disequilibrium outcomes. Not least since, whereas the Domar (1946) model is a technical coefficient relating growth to savings and capital-output ratios, the Harrod (1949) model includes expectations in his concept of warranted growth and since what firms deem to be warranted will be low or negative in a prolonged recession.

Moreover, structural differences between European countries and regions cannot be eliminated by "structural reforms" reducing wages to increase competitiveness nor by low level Structural Funds (Holland and Oliveira paper). They need a rediscovery and reframing of industrial, social and regional policies (Garofoli paper). While recovery need not depend on private sector confidence but, if driven by bond funded social and environment projects, can generate and sustain it. Regaining *effective* demand in the sense of Keynes is important. But there also is vast *latent* demand for social investments such as in health, education, urban regeneration and safeguarding the environment, which were criteria for cohesion and convergence agreed with the European Investment Bank by the European Council in 1997 in its Amsterdam Special Action Programme, and while realising such latent investment demand also would generate effective demand through positive rather than negative multipliers.

The fallacies of the case for austerity, and the outcome of "beggar my neighbour" deflation, have been widely recognised by many commentators. Keynesians, from both sides of the Atlantic, and Valli's paper in this special issue have argued that Europe needs to offset this by a common fiscal policy. Others such as Varoufakis and Holland (2011), also with James Galbraith (2014) have focused on what can be done now in policy terms with their "Modest Proposal" without fiscal transfers, without new institutions and without treaty revisions, including the degree to which decisions could be taken by the European Council on the basis of "enhanced cooperation". They have stressed that this procedure does not need unanimity, that Germany introduced to outflank David Cameron on a Financial Transaction Tax, and that other member states could do so to outflank Germany on austerity.

Such a case for recovery has been endorsed and extended in The Pavia Declaration which is reproduced in the Appendix and which was the outcome of two conferences organised by one of us - the first at Palma de Mallorca on 27th and 28th February 2015 and the second at Pavia on 24th and 25th April 2015.

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Appendix

The Pavia Declaration: A New Deal for a Social and Democratic Europe

Prologue

The Pavia Group's April 2015 meeting took place against the background of a deepening European economic crisis.

The Eurozone crisis has many causes and culprits. However only its citizens are being asked to pay the burden of its costs, especially those in the European periphery. Austerity in Greece and other member states has been submitted to dictates from a Troika of the European Central Bank (ECB), European Commission and International Monetary Fund (IMF) and is contributing to massive hardship which prejudices the commitment of the Rome Treaty to rising standards of living and of its first revision in the Single European Act to economic and social cohesion.

"Europe is not working" either in the sense of assuring high levels of employment or in terms of the commitment to democracy of its founders.

'Structural reforms' that induce austerity while reducing social protection cannot be the condition of any assistance to debt distressed countries. The IMF in its April 2015 World Economic Outlook recognizes that employment protection is not found to have any statistically significant negative effect on productivity. An obsession with reducing debt neglects that Europe could allocate surplus savings into productive investments especially because increased public investment raises output both in the short and long term, crowds in private investment, and reduces unemployment with limited effect on the public debt ratio, as supported by the IMF paper (written by A. Abiad, D. Furceri, and P. Topalova) of May 2015.

If the European Union is both to survive and flourish it needs to reassure its citizens that markets serve people rather than people serve markets, as well as that its institutions are working in their interest and adding value to what its member states otherwise cannot do as well by themselves. For some analysts this can only be achieved by new federal institutions, similar to those of the US. But Europe cannot wait for this. Without alternatives now it risks disintegration.

This is the main reason why this Declaration stresses feasible alternatives now. Europe already has the institutions and the decision-making procedures that could enable a recovery of investment and jobs. One of these is the European Investment Bank (EIB), whose lending for investments does not count on the debt of member states. Neither is there any need for national guarantees, for fiscal transfers, or for a "transfer union", since EIB bonds are serviced from project finance.

Those governments that want a recovery in employment have the power to act through the procedure of 'enhanced cooperation', which does not require unanimity, and which could by-pass entrenched opposition by a few member states to a bond-funded investment-led European recovery.

Supply side measures that reduce labour costs neglect the resulting reduction in aggregate demand, while in contrast supply side investment programmes can create aggregate demand.

Investment creating demand was the basis of the success of the Roosevelt New Deal in the 1930s, whereas after the crisis of 2007-2008 many EU member states have committed themselves to balanced budgets. Since then, the risk of depression and persistent unemployment and poverty in key member states and many European regions has mainly been the consequence of European austerity policy, whereas in other world regions and large economies policies have been either investment-led (East Asia) or demand-led (the USA).

The current trends in Europe are decreasing the ratios of labour income and investment to GDP. As an outcome, the crucial missing variable is the lack of aggregate demand. This reflects a private sector investment that still is a sixth below its pre-crisis level.

In European documents there is often an excessive emphasis on export-led growth. But in a large market such as that of the EU, internal demand is often more important than external demand. EU member states trade mainly with themselves. The ratio of extra-European exports to GDP was lower than 10% before the economic crisis and the EU as a whole is broadly in balance with the rest of the world. There is, instead, a vast latent demand for social investments and employment and income generated by these, such as in health, education, urban regeneration and safeguarding the environment.

Great structural economic differences among European countries and regions already existed at the time when the single European currency was introduced. These could not have been eliminated by uniform financial rules in Europe. Such differences increased during the crisis, and backward regions need specific productive investment programs. Structural differences between European countries and regions cannot be eliminated by reducing wages in an attempt to increase price competitiveness, nor by low level Structural Funds. They need a rediscovery of industrial, innovation and regional policies that foster structural competitiveness.

Quantitative easing has been necessary, but it is not sufficient for European economic recovery. This has been recognised by Mario Draghi who has stressed that it is governments that need to act to promote an investment-led recovery. Although bond finance of European investment is ruled out for the ECB, it has been the basis of EIB investment funding since 1958. This can be the key to recovery.

A Decalogue to resolve the European Crisis

The current crisis can be resolved without new financial institutions, without Treaty revisions, without fiscal transfers between member states and without national guarantees for bond-funded investments.

1. A "New Deal for Europe" is feasible through bond-financed social and environmental investments and development projects similar to the Roosevelt New Deal but not needing a fiscal union since bonds, as in the case of the EIB, can be serviced by revenues from national governments which will increase with a recovery of investment and employment.

2. Europe could and should recycle global surpluses. The BRICS made plain in Washington in September 2014 that they would invest in Eurobonds if the EU were to issue them to finance a recovery. Sovereign wealth funds – and pension funds – have vast surpluses for which they struggle to find adequate investment outlets.

3. There should be a major increase of direct European investment, based on borrowing from the EIB and its sister institution the European Investment Fund (EIF) with the under-recognised advantage that borrowing from them does not count on national debt. The proposal for a European Fund for Strategic Investment (EFSI) and to define investment criteria for this neglects that no new investment criteria are needed for a bond funded investment recovery since the criteria for the EIB already include Trans-European Transport and Communications Networks (the TENs) and support for small and medium firms as well as investments in health, education, urban regeneration, green technologies and protection of the environment (cf. Essen European Council, December 1994, and Amsterdam Special Action Programme of 1997).

4. There have been various proposals to mutualise national debt up to or in excess of the Maastricht debt limit of 60% of GDP. The proposal to do so above this level is subject to "moral hazard", whereas doing so up to the 60% limit is not. This could readily be converted into "Union Bonds" which, like the *Erblastentilgungsfond* of the Federal Republic on German reunification, are not traded nor used to leverage financial derivatives and speculation. The interest to service such bonds would be the liability of national governments from direct and indirect fiscal receipts generated by the recovery of investment, employment and incomes and would not need fiscal transfers between them.

5. The "golden rule" principle that, over an economic cycle, a government will borrow only to invest, rather than to finance current spending, should be adopted in interpretation of the Stability Pact. This should exclude public investment and national and regional co-financing of European financed projects from the Stability Pact's indicators.

6. An effective European Development Strategy was set out in the 1993 Delors White Paper on *Growth, Competitiveness and Employment*, which also proposed the European Investment Fund. Its vision of the future opportunities for European economy and society was unanimously endorsed by the Essen European Council of 1994 and needs to be recovered now. Bond finance from the EIB and EIF should enable synergies between research, development and restructuring of key sectors - green and alternative energy, green European transports, territory care, research on health, aerospace (as in the existing European Industrial Policy) - and should increase attention on the needs of European citizens. Public policy can help to extend, create and co-create markets and support business ecosystems and clusters, in mutually beneficial collaboration with the private sector, while respecting sustainability concerns, for the society and its own enlightened self interests.

7. There should be a resolution of insolvent banks through existing European procedures and institutions. The ECB and the European Stability Mechanism can restructure, recapitalise and resolve exposed banks on a case-by-case basis, without waiting for a fully-fledged Banking Union.

8. Existing financial resources at regional and local levels can be reinforced by issuing territorial and district bonds, creating stronger linkages between local

financial resources and investment needs, and between collective share capital at local levels and support for management and worker buy-out initiatives through a regionalised European venture capital fund financed by European Investment Fund (EIF) and EIB bonds.

9. The capabilities of local and regional actors should be reinforced through local development projects funded by joint EIB-EIF European bond finance. This would enable a "resurgence" of local and regional capabilities, responding to community needs on the basis of public and social entrepreneurship and trans-regional and trans-national co-operation programmes, which have already been accepted in principle by the EU since the launch of the RECITE (Regions and Cities of Europe) programme in 1988.

10. With gains in direct and indirect fiscal receipts from recovery of employment and output, resources would be generated for a European Solidarity Programme to offset extreme poverty by guaranteeing a minimum European citizenship social standard. In the short term this could be funded from the interests accumulated within the European system of central banks (TARGET2 - Trans-European Automated Real-Time Gross Settlement Express Transfer System).

None of this excludes an increase of the European budget and a transition in due course towards European fiscal policy financed by the introduction of European carbon taxes, a Financial Transaction Tax, and a fair European tax on the profits of Multinational Enterprises or the harmonisation of European taxes on profits, avoiding fiscal competition among state members. But none of it depends on this. While support in due course for such a common fiscal policy would be reinforced by European governments showing that they can recover high levels of investment, employment, trade and wellbeing.

The first group of signatories and their institutions in alphabetical order:

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