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THE EUROPEAN

The European View

The EU needs more, not less investment, to get out of its current economic predicament

Is there any faith left in the eurozone leaders?

Trade is the best way out for the EU economy

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Contents

The European View 3
Petros Fassoulas, Chairman, European Movement UK

The EU needs more, not less investment, to get out of its current economic predicament 4
Mariana Mazzucato, Professor of Economics and RM Phillips Chair in Science and Technology Policy, University of Sussex

Is there any faith left in the eurozone leaders? 9
Vicky Pryce, City Economist and former senior UK Government economic adviser

Trade is the best way out for the EU economy 10
Dr Rebecca Harding, CEO, Delta Economics

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The European View

As the debate about how to amend the eurozone's governance architecture and at the same time deal with the sovereign debt problems of some eurozone and non-eurozone member states rages, the issue of growth and how to re-engineer the EU economy has not received the attention it deserves. With austerity and spending cuts being the main focus in the effort to consolidate public finances, investment as a growth-inducing instrument has been ignored.

Reducing sovereign debt is indeed necessary for the medium and long term health of the EU economy and that of its members, but more and more voices are arguing that short term policies must focus more on growth, since austerity seems to have a counter-productive effect on the EU economy. Even the International Monetary Fund has recognised that, and, at a recent meeting in Japan, signalled a change in its pro-austerity discourse.

Resistance though remains, especially from centre-right governments currently in power in most EU member states. Either due to ideological reasons or driven by fear of the 'markets', most EU states remain reluctant to pursue expansionary policies.

But the EU itself can provide opportunities. The pooling of debt issuing will remove market pressure for individual member states, while reducing the cost of servicing current debt, releasing financial resources for both fiscal consolidation and investment programmes. The EU has been taking bold steps towards closer eurozone governance and budget co-ordination, which will reduce the risk of 'moral hazard'. The sooner such steps are coupled with the mutualisation of eurozone debt, the better it will be for both the more and the less affluent member states.

The EU budget is a vehicle that can help EU states achieve economies of scale. By combining spending at the EU level we can avoid duplication of expenditure at the national level, delivering this way saving for individual member states. The EU budget currently stands at about 1% of GDP, while member states are locked in negations on the next seven year budget (or Multiannual Financial Framework as it is affectionately called in EU circles) less attention should be given on capping it and more on how to target its spending towards areas with growth-generating potential. EU member states should even contemplate increasing the size of the EU budget, if spending is to go towards research and development, green technologies, telecommunications and the digitisation of the EU economy.

Unleashing the potential of the single market is also very important. Building on the free movement of goods, services, capital and people, measures must be put in place to enhance labour mobility while also deepening the services side of the single market. Much has also been said about e-commerce and the EU has still a long way to go before cross-border on-line trade achieves its full potential. Proposals on how to unleash the digital potential of the single market are already being put forward and this is an area that can help the single market deliver more for consumers and businesses alike.

Last but not least is trade. The EU is the biggest market in the world and that affords its members huge advantages when negotiating trade agreements with third parties. The growth potential of such agreements is enormous and the benefits for all EU member states are numerous. The recently signed South Korea Free Trade Agreement alone is expected to save European exporters £1.35 billion annually in tariff reductions. It is expected to benefit the UK economy alone by about £500 million per annum. The EU is currently negotiating Free Trade Agreements

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with India, Canada and Singapore, among others. Completing all the bilateral trade deals now on the table could add £75 billion to Europe's GDP.

Despite the economic and debt crisis in some eurozone and non-eurozone EU member states, the means to assist the EU and its members to exit the current economic stalemate reside within the Union itself. It is up to EU leaders to look beyond their immediate challenges, assume a more holistic approach and take full advantage of the most successful project of economic and political integration European history has seen. The benefits are many for all those involved, not least the revitalisation of the project of European integration.

Petros Fassoulas
Chairman, European Movement UK

The EU needs more, not less investment, to get out of its current economic predicament

When the financial crisis hit in 2007, European countries were struck by it in different ways and to different degrees. Those that had failed to invest, for decades, in key areas that increase economic growth – such as human capital formation, adaptation to new technologies, and Research and Development (R&D) – experienced the hardest knock. And as the financial crisis has become a full-blown economic crisis, it is these countries that are experiencing the worst sovereign debt crisis. Figure 1 below shows that indeed the hardest hit countries in the eurozone, those which Goldman Sachs has infamously called the PIIGS, stand out clearly as the lowest investors in R&D – widely recognised by both macro and micro-economists as being important to economic growth.

Indeed, one of the biggest myths propagated during the 'eurozone crisis' has been that the 'periphery' countries such as Greece and Italy, have been too 'profligate'. While the more responsible 'core' has known when and how to 'tighten its belt'. The figures above suggest the opposite: the periphery did not spend enough on key expensive areas, like R&D, that cause growth.

The myth is repeated not only by the conservative media but even by respected authorities like the International Monetary Fund (IMF) President Christine Lagarde – not least in her comment (which sounded more like comments one hears from taxi drivers) that an innocent African child deserves the IMF's attention more than a Greek citizen who has been the source of his/her own destruction. The emphasis on 'profligacy' ignores the fact that in many of the weakest countries deficits had indeed been low. Italy's deficit, for example until 2007 had been a modest 4%. Yet because its growth rate was so much lower than the interest it paid on its debt, Italy's debt/GDP ratio climbed to rates as high as 105% in 2007, climbing to 120% in 2011. And the great mission of today's painful austerity programme in Italy is simply to bring this figure back to what it was in 2007. When things were hardly good.

Worldwide austerity is in fact proving self-defeating in trying to get debt/GDP levels down, since austerity is hurting both consumer demand (due to falling wages and crippling public services), and eroding the confidence of businesses to invest. This is deepening social fabric of countries – hurting their ability to get out of the current rut and at the same time making them less resilient to future crises to come. With protests in the streets on the rise for the foreseeable future.

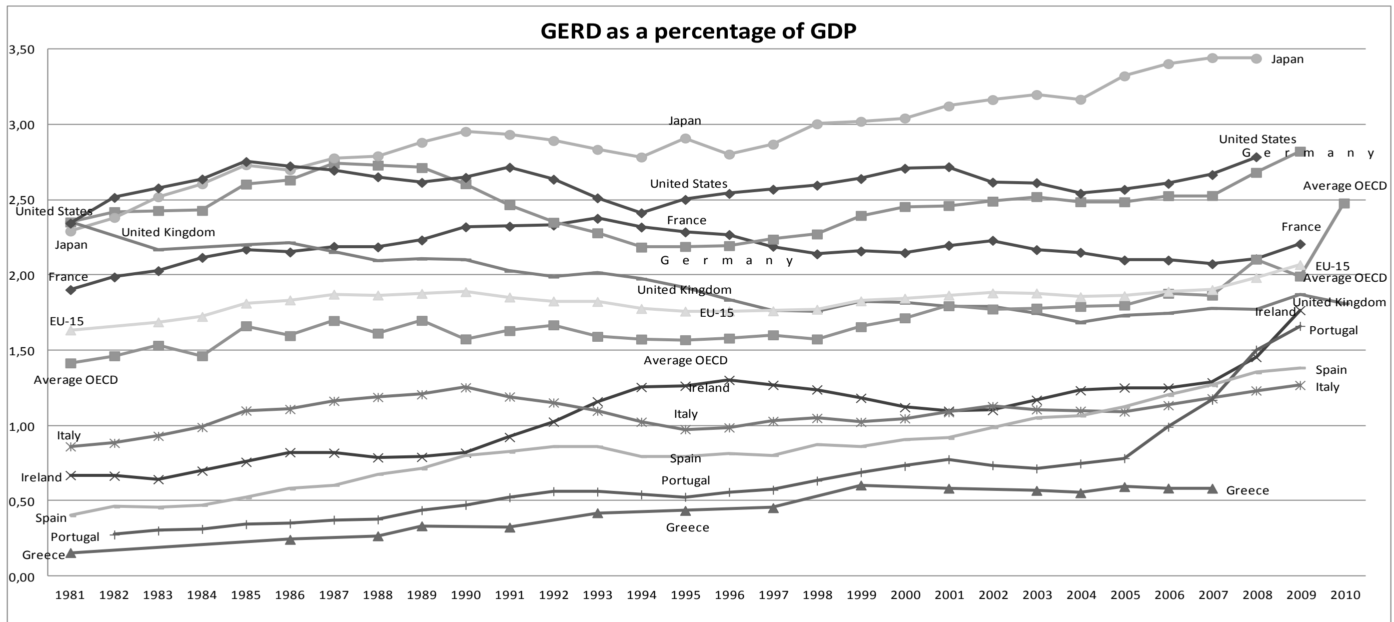

Figure 1: Source: Author's calculations using OECD 2010 figures on GERD (gross expenditure on research and development)

recessions, and thus hurting the denominator: GDP growth. Different governments are also embarking on 'structural' reforms, aimed at loosening rigidities in the labour market, battling corruption and nepotism, and increasing transparency, important to the 'ease of doing business' indicators. So the big question is: will the different types of 'structural reforms' and spending cuts induce growth of the periphery, the PIIGS? My answer is that, without investment in key areas, NO they won't. Austerity will be pain with no gain, and structural reforms won't be enough. Indeed, when Italy 'liberalised' Telecom Italia in the early 90s, the first thing Telecom Italia did was cut its R&D. This will very likely be the fate of Italy's leading microelectronics company Finmeccanica, unless the upcoming liberalisation is accompanied by an investment strategy. Currently absent. And since many of the structural reforms are also implying cuts to public services, and public sector wages, hitting the weakest elements of society the most, it is likely that many such reforms will also hurt demand and the

Indeed, many attribute Germany's 'surplus' status to the 'Schroder' reforms in Germany, which saw productivity increasing much faster than wages. And thus the immediate recipe for the 'deficit' countries has been to ask them to do the same. Cut wages, especially in the 'profligate' public sector, free up labour markets from 'rigidities', 'liberalise' markets in areas as different as pharmacies, taxis and energy supply, and this will cause growth.

These recipes ignore that there is no country that has ever grown without major investments in key areas, such as education, research and human capital formation. These investments along with institutional 'systems' of innovation which promote horizontal linkages between areas like science and industry are core to a country's competitiveness. Indeed, Germany, one of the winners in Europe, with a high

R&D spend (close to Japan and the USA in Fig. 1), has recently been directing this spend on the 'green growth' challenge and has over decades build a variety of institutions which support patient finance, growth and innovation. This, not low wages, is the reason its companies, like Siemens, win procurement contracts all over Europe, such as the recent procurement to build 'fast, green' trains for the UK's Thames Valley service. Successful German firms are the product of a variety of factors such as A – the KfW State investment bank, which provides 'patient' finance to innovative firms whose lead times in long run investments cannot perform over the short 3-5 year period which impatient banks and venture capital want, and B – the well-funded Fraunhofer institutes that support science-industry links in a systematic and coherent way. It is such investments and institutions that are lacking in Greece, not lower wages. Indeed, in Italy, a school teacher earns € 1200 per month. If education is important for growth, is this figure too much or too little?

As I have argued in The Entrepreneurial State (Mazzucato, 2011), the Silicon Valley miracle that so many European countries aspire to, is a result of heavy, yet decentralized, state led investments. Without them, the most innovative US companies like Apple and Google would not be what they are. Indeed, most revolutionary elements behind the iPhone (Siri, GPS, internet, touchscreen display) owe their funding to public investments. If Europe is to get off the ground again, it needs to create a common vision around innovation led growth, understand the role of both public and private sector actors and investments, and set up the institutional frameworks which allow dynamic links between the two.

The irony of the 'fiscal compact' is that it has very little 'fiscal' in it in terms of actual (fiscal) spending. It is in the end about cuts and some reforms. We need a similar change to that which occurred with the Maastricht Treaty, which was initially only about 'stability', and later (in 1997), with pressure from the French Prime Minister Jospin, re-named to a treaty for stability and growth. But even there the growth component remained idiosyncratic, with the growth vision not embodied in the details of the treaties. We need to rename the fiscal compact a growth compact and make sure that it is well represented in the remedies (and conditions for bailouts and loans) that are being given to countries. If not, when the next crisis comes (and these do inescapably occur every 10-15 years), EU countries will again be hit in very different ways and degrees, causing a new round of scepticism, lack of solidarity, austerity, and lack of confidence in the European project.

So if structural reforms without investment do not lead to growth (and vice versa), the question facing Europe is where will the funds come from in a period in which the economic crisis has wiped government budgets dry. The answer must of course be partly from private EU firms themselves. Indeed, the GERD figure above (which includes both public and private R&D) is also driven by the fact that many firms in Europe spend too little on innovation (BERD, business level R&D): Fiat is one of Italy's problems and must become one of its solutions. It must invest more in innovation, whether this is in the search for new engines (part of China's new industrial policy) or other types of energy saving innovations.

The answer must also be at the national level, with investments in areas that cause growth not burdening debt figures: European wide agreements should make spending on areas like R&D to be counted as capital expenditures not spending. Education, research and human capital formation must be priorities for national budgets: without these, European countries will be forced to compete with low wage nations, which the EU cannot and should not do. And we must also consider how to steer investments productively

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at the European level, using specific European instruments.

A key player at the European level must of course be the European Investment Bank (EIB). Indeed, when the financial crisis hit, it increased approved loans from €890m in 2007 to €4.2bn in 2009. This declined dramatically by 2011 to €703m, mainly due to worries about the bank's AAA credit rating, as well as lack of consensus between European Union countries on how active the EIB should be. If the EIB is to play an active role today, it must be recapitalized, using unused structural funds, as well as co-financing of EIB bonds with European Central Bank (ECB) bonds. But this requires the EIB to be viewed as an important instrument to get productive investment happening in the periphery countries especially. And this will only happen when the diagnosis of the problems in those countries is no longer seen as one of simple corruption and rigidities, but also one of lack of investment. EIB investments, managed properly, have indeed earned high returns. But as with the structural funds, they must also be managed properly on the ground. National ministries and national firms receiving the loans must be governed in ways that meet common European standards. It is these types of standards and 'conditions' that should govern both the bailouts and loans, not conditions based on austerity, which cause only a vicious cycle of no growth->bailout->austerity conditions->no growth->bailout.

In this sense, the fear in Germany that allowing the ECB to be a lender of last resort will create a permanent siphon from Germany's Treasury to the PIIGS and become a self-fulfilling prophecy: by not getting the institutional set up right, by not allowing productive investments to happen (e.g. creating more synergy between the ECB and EIB), growth will not occur, so bailouts will indeed need to occur continuously. A waste for all. Especially for the EU citizens involved – lost investment, lost growth, lost opportunities, especially but not only for the young and the most vulnerable.

In sum, I believe Europe would be well served by reforming its post-crisis agenda in the following ways:

INVEST: We must find ways to allow the weakest countries in Europe to make the necessary productive investments in those factors that cause growth. Spending on such investments should not increase debt figures. These investments, especially those on innovation, should be recognised in terms of capital expenditure, distinguished from simple 'spending'. And when the funds are not available internally, they can be provided by the EIB. EIB loans should go to 'viable' projects and be managed locally by people with sectoral, technological and financial expertise. The EIB should be recapitalized with unused structural funds as well as through contributions from member states which do not have to be very large since private sector co-financing can lead to a very large multiplier effect.

GOVERNANCE AND CONDITIONALITY: Instead of only complaining about governance problems in the periphery, Europe must think of concrete ways to monitor governance structures in those institutions which will be directing the investments (above). Indeed, it should be easier to impose technocratic leaders of the core agencies that steer productive investments than to impose them at the presidential level (which is being done overnight). In the end it is these agencies and institutions that will make the difference. Throwing money at them without reforming them will not work. Indeed, while the bailouts have been associated with austerity driven 'conditions', we should begin to consider conditions for the bailouts that are more linked to the investments and governance issues. Countries should provide detailed plans on how they plan to steer funds

towards the productive investments that cause long run growth and provide clear and transparent criteria for how expertise and performance will be used to man the top leadership positions in the agencies administering funds. And plans must be developed to build the type of dynamic institutions that support an innovation eco-system.

STIGMA: The current bailouts are received only if a country asks for it. This creates an unnecessary stigma for that country which then sets a vicious cycle that leads the market to react badly. If European leaders understand growth they should pre-empt the problems by knowing which countries are in most dire need rather than ask for the countries to come begging. And set in place a plan for that country which is not only about the 'bailout' but also about how to steer investments productively in the areas discussed above, such as education, research, human capital formation and science-industry links.

LENDER OF LAST RESORT: In the end, speculation has been driven principally from the bond markets' worry of loans not being paid back. The UK, with a very low growth rate, has until now been spared attacks by the markets simply because it has a central bank that will step in as a lender of last resort (which has not defaulted since the 15th century). Until the ECB confidently assumes this role, even when the issues above are sorted, speculation will not stop.

Having said that, it must also be remembered that quantitative easing, whether by national central banks or by the ECB, have not been very successful in getting spending and investment going in Europe because the money created has been hoarded in the banks as well as in firms' coffers (with massive net financial surpluses in most countries). Confidence and investors' animal spirits will only rise when productive investments get going again, making Europe an exciting hub of competitiveness, in a wide array of areas, with each country understanding its links to the others. But this can only be done if there is a common vision of what causes competitiveness: low wages or key investments? So the short-run issue is to get the ECB to back the euro in every way necessary to stop speculation. In itself, this will provide a symbolic show of confidence of Europe for Europe. The medium-term issue is to recapitalize the EIB to get productive investments going in the periphery countries as well as allowing member states to make the necessary productive investments without burdening their debt levels. The long-run issue is to transform the local agencies and institutions which administer and plan the productive investments, in member states, in a way that meets European standards, increasing the confidence of all in the short run, medium run, and long run mechanisms required for growth.

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Is there any faith left in the eurozone leaders?

We just witnessed an inconclusive EU summit in mid October. So what's new? Time and time again we have seen the disagreements that have generally meant that the EU is not moving in unison towards solving the problems of the eurozone. What is more we see decisions supposedly made and then announced to the world as great steps forward in fact being reversed when individual country leaders go back home and face their cabinets, coalition partners, their parliament and in the case, repeatedly in Germany, their constitutional courts. What is legal and what is illegal? Is the European Central Bank (ECB) within its rights to intervene in the secondary sovereign bond markets when it believes that the money transmission mechanism does not work and we might end with deflation in the region? Are the bailouts legal given the no-bailout clause in the Maastricht treaty? And does it matter? Hiding behind legality as a reason for obfuscation has in fact led to a loss rather than an increase in trust in European institutions. Indeed there are now doubts about the prospects for a speedy move to the proposed banking union that will bring the eurozone's banks under a single supervisory authority on the basis that it is also 'illegal'. And in the meantime there has been no disbursement from the €130 billion second bailout for Greece agreed in February and the country still had to raise short term debt locally to repay outstanding loans to the ECB!

Not a pretty sight. But what it demonstrates is that EU leaders do not get the urgency of the situation as economies are shrinking. And nowhere is this more urgent than in Greece. There have recently been some positive signs. On the political front there is less of the unsettling talk about Greece being forced out of the euro as even the Germans – at least Angela Merkel – seem to have realised that the Greek problems, though extreme, are not unique as Spain and Italy have demonstrated; and numerous studies are now suggesting that a Greek exit would lead to massive costs through a serious contagion far and beyond what we have witnessed already. In addition the geopolitical importance of Greece has risen in awareness with the rise in the extreme parties of the left and right.

On the economic front Greek industrial production and exports are showing some signs of improvement, tax collections is tax collection, and the public sector is likely to move to primary surplus next year. But the Greeks have seen a major cut in living standards as pensions and other benefits have been slashed and wages cut by some 20-30%. The Greeks, both individuals and the government, basically stopped spending. The country is still waiting for the €6 billion or so of the bail out money which was the only part of the huge package due to go into the real economy to pay overdue contractors' bills rather than to recapitalise the banks or used to service and /or repay outstanding loans. The latest €11.6 billion austerity package would mean even more significant pay and benefit cuts alongside extra revenues from tax and from privatisations. These will push Greece even further into recession, after a fall of GDP of some 6-7% in 2012, 2013 will be the 4th year of decline.

So what next? Some agreement will be reached to lengthen the period Greece needs to achieve the reduction in its deficit (from the 9% last year) to 3%, as required by the fiscal compact. Some of the debt will be written off. There is no doubt that Greece needs to modernise and also open up its economy to real competition, ease bureaucracy and reduce massively the size of the public sectors, improve tax collection and reduce corruption. But, even if the will were there, the problem with Greece is hampered by a hugely inefficient public administration system

which is open to manipulation and control. The implementation record of the Greeks has been abysmal overall, with some small exceptions.

So the Greeks need to change but it is now accepted that it will take time, even with the best will in the world, financial and technical assistance as well as modernisation of a public administration system that needs bringing up to the 20th, let alone the 21st century standards. At least that is finally recognised. On the positive side for the eurozone as a whole, the Greeks have done everyone else a favour as they have probably been the catalysts in the International Monetary Fund (IMF)'s very recent change of heart – admitting finally that austerity measures may in fact lead to such massive cuts in GDP that they end up being counterproductive, thus worsening rather than improving deficits and debt levels. The policy conclusions should be simple; stop worrying about legality of actions and ensure that the markets are convinced that the leaders are serious about setting up a proper institutional framework for the eurozone's survival. At the member state level, push structural reform aggressively but readjust the timeframe for fiscal consolidation, write off unsustainable debt and use the ECB and structural funds to inject money into the economies and get growth moving again. Let's hope the EU leaders read the IMF report and that the message is understood and acted upon.

Vicky Pryce
City Economist and former senior UK Government economic adviser. She is also the author of 'Greekonomics', just published by Biteback Publishing.

Trade is the best way out for the EU economy

When President Obama was awarded the Nobel Peace Prize in 2009, the world collectively raised its eyebrows. Here was a man who had been in office for too short a time to have had much impact being recognised by one of the most illustrious awarding bodies in the world, in effect, for not being his predecessor. Similarly, when the EU was awarded the Nobel Peace Prize in October this year, there was a ripple of collective bafflement that went around the chattering classes: can an institution be awarded the price and, given that the answer was clearly yes, what has it done to deserve it?

The real reason it was given the prize of course was to recognize, albeit in a time of economic crisis, that the real, political, purpose of the Treaty of Rome was to make the wars that had destroyed Europe in the first half of the 20th century could never happen again. This was to be done by giving European nations, particularly France and Germany, a shared perspective about their future. Thus far, job done.

Any commentary that has questioned the worthiness of the EU to receive the prize has focused on the current economic crisis, however. It has pointed out that the potential for a Greek exit from the eurozone has evoked the spirit of war time heroes in Athens and beyond as Southern Europeans have fought against the economic imperatives of drastic austerity measures which they regard as the imposition of an over-dominant Germany.

The images are not attractive and it does little good to dwell on them. But what this does is turn the mirror back to policy-makers to look at the other reason for the Treaty of Rome: to establish a European Economic Community by reducing progressively the customs duties on trade between its members. The ultimate

goal was, of course, to create a Customs Union with free trade and a single market across the whole of Europe. It is ironic, perhaps, that when the single market was nominally completed in 1993, the Maastricht Treaty of the same year amended the Treaty of Rome by taking out the reference to "Economic" – hence establishing the European Community. The rest, as they say, is history.

With the whole eurozone suffering the strains of the sovereign debt crisis and with debates around Greek exit, eurobonds and Spanish bank bail-outs reaching fever-pitch, it is really easy to forget that Europe is ultimately a trading bloc. Free trade between its member states is a *sine qua non* of 21st century Europe. Shared economic interests were the means by which a common purpose amongst European countries would be created hence preventing future war. In the end, it is this political underpin to an economic project that is the main reason why the European project will succeed: because the benefits to Europe's businesses of unrestricted access to the 27 individual markets of the European Union and the 4 markets of the European Free Trade Area far outweigh the costs of trade barriers were Europe to trade as separate nations.

These benefits are not just the economies of scale that a wider market offers. The idea behind the internal market was that it would also make Europe's businesses more competitive in international markets. If British companies have to compete in Germany on the same terms as German businesses, or vice versa, it raises the performance bar so that all businesses improve. With the difficulties that Europe has faced since the financial crisis, the underlying business reasons for expanding and growing the internal market are often forgotten.

In June, the European Union reported an 'unexpectedly large' trade surplus – a timely reminder that Europe is an economic powerhouse because of its business base. Eurostat reported a trade surplus of €14.9bn, the largest since the organisation started collecting trade statistics and noted that the surplus had increased because of increased trade with Asia and emerging markets (notably Russia, South Korea and Brazil). Germany, Ireland and the Netherlands lead the way, with Germany playing the biggest part in ensuring that, while trade within Europe is relatively static, trade outside of Europe is growing and growing fast. EU businesses are using the single market as the springboard to expand beyond EU borders and preferential EU trade deals with emerging powers afford them better access to markets that would otherwise be more reluctant to open up if EU nations negotiated individually.

Delta Economics forecast predicts that Europe's external trade will grow by more than 4% annually over the next five years. Since we are forecasting that its trade overall will grow by 2.1% annually to 2016, this suggests that external trade is becoming increasingly important to the region as businesses build on their strong 'home' markets in Europe and make inroads outside of the region. Particularly fast growing export trade routes, as Eurostat suggests, will be Brazil, which we forecast will grow by 6.4% annually to 2016 and India and China which will grow respectively by around 6% to 2016. Expanding trade sectors include cars, biopharmaceuticals, printing and machinery infrastructure and equipment and telecommunications.

By definition the Nobel Peace Prize is for peace and not for economics. Economists will always have the ultimate get out: that politicians mess up their theories – had politicians studied the models more carefully and stuck to the theory to create a perfect single market that included fiscal union from the outset, then maybe we wouldn't be in the situation we are currently in. But we are where we are and the

persistent strength of Europe’s businesses even in peripheral Europe manifests itself through trade and tells us this is a project worth fighting for: a Nobel Prize for applied economics in fifty years’ time maybe?

Dr Rebecca Harding
CEO, Delta Economics

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