

European Economists for an Alternative Economic Policy in Europe

- EuroMemo Group -

The deepening crisis in the European Union: The need for a fundamental change

– EuroMemorandum 2013 –

To the memory of Tadeusz Kowalik (1925-2012), distinguished Polish political economist and indefatigable advocate of the welfare and democratic rights of workers and their families.

Summary

Introduction

The crisis which began in 2007 and deepened dramatically in 2008 has exposed deep rifts in the architecture of the European monetary union. Harsh austerity policies which were first imposed on countries in Eastern Europe, and subsequently on the countries in the euro area periphery, are now beginning to be implemented in countries of the European core. The crisis is highlighting the deeply undemocratic construction of the EU, as the Commission assumes ever greater powers to control national budgets, without any serious oversight by the European Parliament. At the same time, the position of the core countries of the North, and in particular Germany, has been strengthened in relation to the countries of the periphery. But Germany's economy, which has depended on stagnant wages and a rising export surplus, cannot be a model for the whole EU. In the face of global climate change, the EU's approach to the Rio+20 conference in July 2012 contributed to its failure to reach any serious agreement.

1. Economic and Financial Policy

Economic expansion came to an end in the EU in 2012 with output still below that in 2008. There were recessions throughout the euro area periphery, and output fell during the year by a further 3% in Portugal and 6% in Greece. In Eastern Europe most countries registered some growth in 2012, but output is still down on pre-crisis levels, except in Poland and Slovakia. Countries in the euro area core registered some growth but it was low, and even Germany, which grew strongly in 2010 and 2011, was affected as many of its trading partners in Europe were subjected to austerity programmes.

In early 2012, 25 member states acted, primarily at German insistence, to introduce the so-called Fiscal Compact, a legal limit restricting each country's structural budget deficit to 0.5% of GDP, a measure which will effectively prevent countries pursuing an active fiscal policy in the future. Meanwhile, as the interaction of the debt crisis and the banking crisis threatened to deepen dangerously, the European Central bank (ECB) launched its Long Term Refinancing Operation. It provided commercial banks with some €1tn of three-year loans at 1% interest between December 2011 and February 2012; despite this, bank lending to households and firms actually declined slightly in the course of 2012. After speculation against Spanish and Italian bonds intensified in mid-2012, the ECB also announced its programme of Outright Monetary Transactions. This promises unlimited central bank intervention to support government bonds in the secondary market – but only if countries first agree to an approved programme of policies with the EU's rescue fund, the European Stability Mechanism. Although the ECB has yet to act, the announcement secured a fragile financial stability in the second half of the year.

Estimates of the combined impact of the various fiscal rules being introduced in the euro area suggest that between 2013 and 2016 GDP could decline by as much as 3.5% in the euro area as a whole,

some 5-8% in Italy, Portugal and Spain and 10% in Greece and Ireland. The European Summit in July 2012 proposed to create a European Banking Union, which will involve a common supervision by the ECB; a common deposit insurance; and a common resolution authority. But with some 6,000 banks there are unresolved issues about which banks the ECB will supervise directly, and some Northern countries have indicated an unwillingness to proceed with the common deposit insurance and resolution authority.

Fiscal policy should, in place of austerity, focus on reducing unemployment. Public spending should promote socially and environmentally desirable investment projects. A European currency requires a European fiscal policy, with expenditure in the order of 10% so as to cushion downturns and to ensure an effective transfer of resources between richer and poorer regions. Regional and industrial policies should be strengthened and the European Investment Bank, which is empowered to issue euro bonds, should facilitate a major programme of investments, especially in the most crisis stricken countries in Southern and Eastern Europe. In order to eliminate the large current account imbalances, surplus countries should also be required to expand demand. Employment policy should seek to promote skilled, well paid jobs since competition based on low pay will always be undercut elsewhere in the world. The normal working week should be reduced to 30 hours, both in order to combat unemployment and as part of a shift to a society where people's lives are not dominated by waged work.

The overexpansion of the financial sector should be radically reversed. Commercial and investment banking should be completely separated, and public and cooperative commercial banks should be promoted to provide finance for sustainable investment projects. Investment banks, hedge funds and private equity funds should be tightly curtailed. All securities should be traded on approved public platforms, new securities should be subject to strict testing, and a public European ratings agency should be established. All financial transactions should be subject to a transactions tax. The ECB should be brought under effective democratic control, and its main focus should be on ensuring financial stability through the establishment of a comprehensive, anti-cyclical, system-wide European stability framework.

2. Governance in the EU

A wide range of governance changes have been introduced in the EU in response to the crisis of government debt: new legislation, such as the 'six-pack', which tightens the rules of the stability and growth pact; new treaties and intergovernmental agreements, such as the Treaty on Coordination and Governance, involving tighter constraints on member state budgets; and new procedures, such as the 'European Semester' which reinforces the annual cycle in which the Commission and Council inspect member state macroeconomic policies and 'reform programmes.' The common theme of these changes is to subject the economically weaker countries to a comprehensive system of tutelage with unremitting pressure for expenditure cuts, erosion of labour standards and privatisation of public assets. For those member states which have received 'bailout' funds the controls and restraints are even more oppressive, amounting, in the case of Greece, to a virtually colonial system.

The unavoidable consequence of these developments is to intensify the longstanding legitimacy crisis of the EU. The democratic deficit widens as key decisions are shielded from democratic pressures; as the big corporations dictate EU policies and the content of EU legislation; as the powerful European Central Bank takes critical decisions for which it is not democratically accountable and as national social models are disorganised and dismantled in the name of the single market or of fiscal consolidation.

Although detailed proposals could be put forward to change present governance procedures, they will be futile without a complete change in the direction of EU policy with priority for decent employment and social justice. It has to be recognised that the EU's legitimacy crisis is now so severe that potential challenges to the existing regime at member state level will increasingly be seen as legitimate.

3. Restructuring the social agenda

Austerity policies are also blighting the lives of millions of Europeans, most especially in the Southern and Eastern countries of the periphery. In the EU the official unemployment rate in 2012 was 10.6% but in Spain and Greece it was to 25%, and while the youth unemployment rate for the EU was 22.7%, in Spain and Greece it was over 50%. In place of closing tax loopholes, austerity policies have focussed on expenditure cuts, resulting in the postponement or cancellation of infrastructure projects as well as reductions in recurrent expenditure in healthcare, education, social provision and welfare benefits. Public employment has been reduced significantly in many countries and, due to the recession and the impact of austerity policies, there has been a significant increase in the proportion of the population at risk of poverty. The poorest sectors have been hit worst but, in the crisis stricken countries, many middle-class citizens have also been affected.

Historically, social policies in Europe have been provided by managing or removing the market in the provision of services, through food subsidies or the free provision of health services and certain levels of education. Now the de-commodification of public services is being reversed through the introduction of vouchers and user fees for health and education services. At the same time, the EU Commission advocates increasing the flexibility of labour markets, but pay freezes, cuts in pensions and increased retirement ages, together with an easing of restrictions on layoffs and limits on unemployment benefits all represent a further weakening of the provisions of Europe's vaunted social model.

The failure of the EU and leading member states to achieve any significant harmonisation of direct taxation has allowed tax competition to flourish, as states offer favourable rates to existing or potential investors, and exposed the vulnerabilities of states with low taxation. All member states should commit themselves to the principal of progressive taxation and an approximate harmonisation of scales. Corporation and other tax rates should be close to avoid profit shifting, and all member states should commit themselves to transparency and a full exchange of information about incomes. Tax avoidance facilities in Europe and the use of tax havens must be eliminated, and there should be a greater taxation of wealth. The shift from direct taxes towards more regressive indirect taxes should be reversed and the destructive dynamic of tax competition must be eliminated.

4. A development strategy for the European periphery

The centre-periphery divide pre-dates the European integration process, but the neo-liberal design of the integration process has widened the divide. In the Mediterranean countries (Greece, Spain and Portugal), accession to the EU was followed by a partial de-industrialisation as governments lost the ability to pursue national industrial policies and, upon entry to the euro, also lost their ability to protect domestic industry through devaluations. Exacerbated by wage deflation in Germany and other Northern European countries, current account deficits grew strongly. In the Baltic and South-East European countries, growth was strongly dependent on an expansion of loans, largely in foreign currencies. Inflows of foreign capital fuelled real estate booms, but overvalued exchange rates were detrimental to industrial development, leading to current account deficits even larger than in the Mediterranean countries. In the Visegrad countries (The Czech Republic, Hungary, Poland and Slovakia) industrial sectors became closely linked to German export industries and, except in the case of Hungary, their current account deficits were smaller.

The Baltic and South-East European countries were affected by the crisis in autumn 2008 as a dwindling or even reversal of capital inflows hit the heart of their growth models. Hungary, Latvia and Romania were the first countries to apply for rescue programmes to the International Monetary Fund and the EU; the programmes' main aim was to stabilise exchange rates, which was the priority of the West European banks that had lent extensively to the countries. The impact of the programmes led to a plummeting of living standards, especially in Latvia. The Mediterranean countries faced the full weight of dwindling capital flows, capital flight and speculative attack in 2010, beginning in Greece. The reaction of the core euro area governments was very slow, and strict austerity

programmes focussed on cutting the government deficits, but also aimed at reducing current account deficits. These programmes have bought time for West European banks to disengage from the Mediterranean countries, but austerity policies have not addressed the problem of de-industrialisation and these countries are in a developmental cul-de-sac. The East European countries were primarily affected by a severe contraction of exports in late 2008 and early 2009, and their subsequent recovery was linked to the recovery of German exports – prospects for which dimmed in 2012 due to the impact of austerity policies in Europe and the growth slowdown in key markets such as China.

EU regional policies have focussed on infrastructural development, and not on building viable productive structures. The new EU budget for 2014-2020, due to be agreed in early 2013, is proposing to reduce spending on cohesion policies by some 5% from the current level, and to redistribute its allocation to the benefit of richer and middling ('transition') countries at the expense of poorer countries. The so-called 'Friends of Better Spending' in Northern Europe are also calling for macroeconomic conditions to be attached to cohesion spending, and this appears likely to be agreed. EU peripheral countries have succeeded in reducing their current account deficits, but this has been the result of suppressing domestic demand through strict austerity programmes, and has had disastrous social consequences. EU leaders claim that the structural reforms required by EU/IMF programmes – privatisation and the deregulation of labour markets – will enhance competitiveness, but pro-active industrial policies are completely absent from the programmes. EU policies also fail to address the current account surpluses generated by Germany and other Northern countries as a result of pursuing neo-mercantilist policies.

The current level of public debt in Greece and other peripheral countries is clearly unsustainable. Such debt should be subject to a debt audit to determine which parts are legitimate, and remaining debt should be written down to a sustainable level. The ECB's role as lender of last resort in the government bond market should be extended, and decoupled from demands for strict austerity policies. The EU budget should be raised from the current 1% of EU GDP towards 10%, in order to facilitate macroeconomic stabilisation, and in order to facilitate a major investment and development programme in the southern and eastern periphery of the EU. Active industrial and regional policies are required to promote the process of development in the peripheral countries, since development does not occur only as a result of market processes. Current EU regional and cohesion policy has mainly promoted metropolitan areas, but support for poorer areas is important to increase employment and output. Regional policy has focussed on the regional and urban level, but this is to the detriment of the national level, which is often more appropriate for promoting development. The full use of resources requires democratic participation and not elite planning. In particular, the 'Smart Specialisation' proposed by the EU whereby every region should be a world leader in some area cannot work as there are not sufficient products to go round and over-specialisation is likely. Furthermore while intra-regional trade is important, there should be greater attention to promoting more ecologically sustainable forms of production by using local resources for local consumption, for example in the case of food or energy generation. Economic policy in the EU must be rebalanced, and whereas the newly instituted procedure in the EU applies to countries with external deficits, countries with external surpluses should also be required to adopt more expansionary policies so as to increase their imports.

5. The Crisis in Global Governance

Two overwhelming failures characterise the field of global governance in 2012. Firstly, no substantial progress has been made on financial reform or economic coordination. The unresolved euro area crisis represents a growing threat to the global economy which is slowing down. Despite numerous declarations about the need to address global challenges, the root causes of the global financial crisis – massive current account imbalances, inequality of income and wealth and unregulated and volatile financial markets – still remain unsolved. Current account imbalances remain well above sustainable levels. The implementation of new financial regulation has lagged far behind declarations of intent.

The too-big-to-fail problem is far from being resolved and financial institutions are becoming even larger and more concentrated; risky activities are still being transferred, perhaps on an increasing scale, to the non-regulated shadow banking system.

Secondly, the environmental dimension of global governance combines situations of extreme and growing urgency – e.g. climate change and biodiversity destruction – with a decreasing political capacity to act. The Rio+20 summit in 2012 proved incapable of renewing the global agenda of sustainability politics. Environmental governance has been pushed to the side-lines, reduced to lip-service in the main fields of economic development, and to fragmented and inadequate measures in the field of nature protection.

Currently, there is no global institution or set of institutions effectively overseeing and controlling global and systemic risks, such as global current account imbalances, asset bubbles, excessive exchange rates fluctuations, large swings in capital flows, levels of international reserves or harmful tax competition and tax evasion. Institutions that are currently supposed to assume (part of) these tasks – the International Monetary Fund (IMF), the Group of 20 (G20), the Financial Stability Forum, the Bank of International Settlements, the Organisation for Economic Cooperation and Development (OECD) – are currently not effective in carrying them out in practice. In the field of global environmental governance, the EU's official policy seems to have retreated since the onset of the financial and economic crisis and, in so far as it exists, it is woefully deficient.

Reform of global financial governance must be based on the imperatives of equity and of economic and financial stability and must be organised in a representative and transparent manner. Instead of the G20, a self-appointed group of countries, objective and explicit selection criteria should be employed to establish a 'Global Economic Council', as proposed by the UN Commission chaired by Joseph Stiglitz. The IMF needs to be subjected to substantial reforms in its governance, mandate and policy recommendations. If there is the political will more transparency in tax issues is quite achievable. As the UN is currently the most representative coordination forum, the EU and other OECD members should transfer resources and the mandate from the OECD to a high-level UN tax institution and provide it with sufficient expertise and power to effectively combat tax evasion and tax avoidance, and to reduce tax competition.

Any meaningful alternative political strategy in the field of global environmental governance must reject the privatisation of water, energy and, generally speaking, of the Commons, must contest the monetisation of nature, and refuse the weakening or replacement of binding regulation by mere market mechanisms. The EU could promote its own capacity to develop long-term sustainability by engaging in a new type of multilateralism. Instead of trying to always claim the leading role for itself – or for its leading member countries – and instead of addressing all the others as subordinates that need to be led, the EU and its member states should practise a kind of open diplomacy, in which those who are most advanced in a specific field take the lead.

The full text of the EuroMemorandum draws on discussions and papers presented at the 18th Workshop on Alternative Economic Policy in Europe, organised by the EuroMemo Group, from 28-30 September 2012 in Poznan, Poland. If you wish to receive the full text of the **EuroMemorandum 2013**

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