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Why Europe is in a trap

1. Introduction: the trap

This paper deals with the economic and social situation in Europe at the end of the year 2014, after the great international financial and economic crisis of 2008-2009 and the following European crisis. It deals mainly with the consequences of both crisis and of the economic policy enacted in the European Union (EU), on European society and economy. The causes of the crisis and the detailed features of the economic policy measures undertaken in the EU and Eurozone (EZ) will be briefly recalled in paragraph 2. However, the goal of this paper is neither to investigate and discuss why the crisis started and continued, nor to present and suggest a wayout. Its focus in between the start and the likely economic recession end-date. Its key message is that the consequences of the crisis are such not to allow any easy or foreseeable end, with the current economic policy and with the current social and economic dynamics. Europe is in a trap. A radical change of the economic policies that are currently pursued is needed; with no change, Europe could continue to stay in a situation of social and economic depression for years until a shock will dramatically change the course of its future.

Europe is not in a trap because it is an integrated area: both commercial integration (started in the 1960s) and the single market of the 1980s proved to be very successful. The single currency, for most of its Member States (MS), is not per se the origin of the current state of the economy: even if history has shown, contrary to the overly optimistic predictions, that it is quite difficult to have an «optimal currency area» as large as Europe, without having a federal government such as in the US. Europe is not in a trap simply because of the profligacy of fiscal policies of some of its Member States (MS). The making of the trap, instead, comes from both private and public disequilibria that started at the beginning of the new century plus, with a decisive role, the economic policies of austerity that began in 2010; and the asymmetric effects, among MS, that they created. In a context in which the European institutional design has proved to be too incomplete to cope with such a development.

So why the «trap»? For three main reasons that will be analyzed in the next paragraphs: *a*) because European macroeconomic policies are unable to put an end to the crisis, even in the long run: worse, they basically transformed a deep international recession in a permanent state of depression of the European economy (paragraph 2); *b*) austerity is producing a sharp reduction of public and private investment, and of R&D and education expenditures: exactly what is needed more to re-launch depressed economies and reinforce their competitiveness. Austerity is as well reducing those social expenditures and policies needed to keep European societies together (paragraph 3); *c*) the extraordinary length of the depression is producing new fractures within Europe (and exacerbating older ones), creating a very unequal distribution of the adjustment cost. So, while some Europeans are hit, others benefit from the current situation and strongly support the continuation of the austerity. In this scenario, the trust of the European citizens in the UE and its institutions is decreasing fast to record-low level. In this situation, for both economic and political reasons the possibility of a shock, such as new governments of some MS being against the euro or the whole European construction, increased. With the potential risk of destroying what has been built in decades of cooperation in Europe. Quoting former German Foreign Minister Joschka Fischer (2015), «observing the EU from outside is like watching a train collision in slow motion – and one that was announced at the station».

2. The trap I: permanent imbalances and the self-defeating austerity

The current macroeconomic policies followed in the EU are not contrasting the causes of the economic depression.

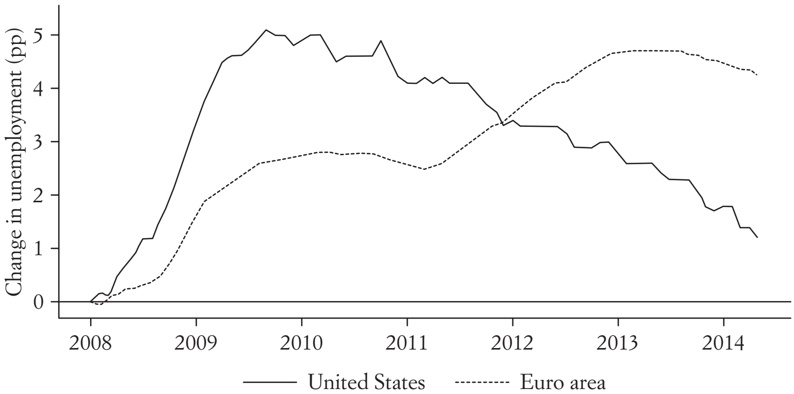

FIG. 1. Change in unemployment rate since 2008. The euro area and the US. *Source*: Draghi 2014.

Instead, they are aggravating its effects. In addition, in the EZ periphery (EZP), that includes Ireland, Portugal, Spain, Italy and Greece, restrictive fiscal policies are not improving the conditions of public finances.

It is possible to compare the current EU economic situation only with the 1930's. For Italy, De Nardis (2014) shows that the GDP trend in the years 2007-2014 is perfectly comparable to the years going from 1929 to 1936; current forecast of 2015-2016 is worse than what actually happened in 1936-1938. From the start of the recession, the Greek performance (2008-2014) is worse than the one recorded in the US at the times of the Great Depression (1929-35). As well known, the economic trends are now much better in the US than in the EZ; in his summer 2014 speech at the Jackson Hole meeting Mario Draghi (2014) showed a simple chart (Figure 1) comparing the change in unemployment rate since 2008; it increased much more in the US than in the Eurozone in 2008-2010. Thereafter, the US unemployment rate started to decrease; on the contrary, unemployment in Europe had a new, fast, rise starting in mid-2011. As of end 2014, the unemployment rate in the US has returned to its pre-crisis levels, while in the euro area has remained at much higher levels.

There has been a very extensive debate on the origins of the new European crisis. It is not at all in the goal of this paper to review that debate; the interested reader can refer

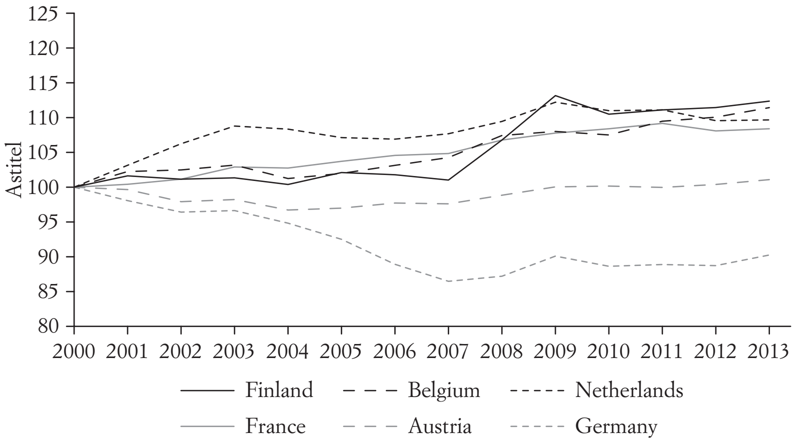

FIG. 2. Relative unit labour costs Eurozone: creditor nations.
Source: De Grauwe 2014, tab. 3.

to Legrain (2014) for a detailed chronicle of the economic events and policy decision. Paul De Grauwe is among the economists that provided (De Grauwe and Ji 2013; De Grauwe 2014) the more convincing explanations. What matters here is to underline two main facts. First, that the origin of the new European crisis is not linked to imbalances in public finances (except for the case of Greece): Spain and Ireland, in particular, were among the EZ countries with the best record of public finances. Second, that the EZ was hit by what the theory of optimal currency areas calls «asymmetric shock». From the turn of the century, the price competitiveness of German goods improved vis-à-vis the products of all the other Eurozone member states, due to the impressive wage moderation in Germany (Duval 2013; Dustmann *et al.* 2014; Legrain 2014b) (Figure 2), that was parallel to a productivity growth. German unit labour costs decreased almost 15% between 2000 and 2007 (De Grauwe 2014).

This produced, since 2002, a growing German current account surplus, that reached 5% of GDP in 2004 and remained between 5% and 7% of GDP until 2014 (Figure 3). In the same years other EZ MS had growing, large current account deficits; e.g. the Spanish one went up to 10% of GDP (Tilford 2014).

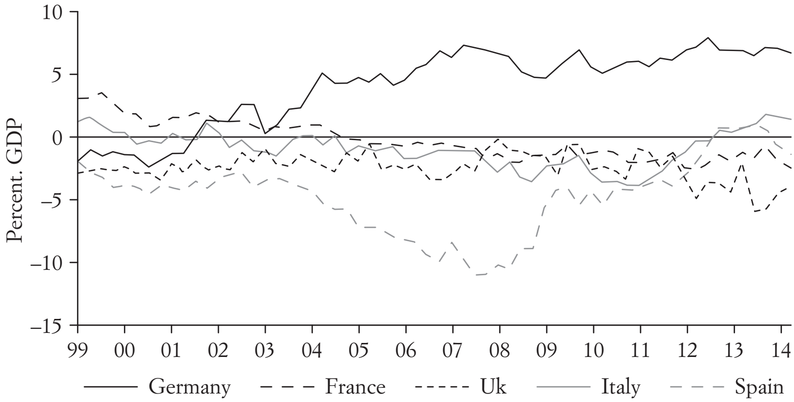

FIG. 3. Current account balance 1999-2014.
Source: Tilford 2014.

It is important to underline the fact that this happened because of the common currency; if the D-Mark had remained, the very large current account surplus would have led to a substantial appreciation of the German currency, progressively reducing the surplus. Flexible exchange rates help in adjusting trade balances because of the supply/demand of currency due to trading needs, leading to variation of the parities, especially when the gap between supply and demand is so large as in this case; in turn, currency devaluation/re-evaluation influences the international price competitiveness of goods, impacting on current account balance. This did not happen. The current account surplus/deficit became permanent. The trading surplus was matched by a large outflow of German investments, especially in the EZP countries. Germany lent capital to EZP countries to let them buy her goods.

Following the theory of optimal currency areas, that deals with the equilibrium in an area that shares the same currency, there are two main adjustment mechanisms to absorb an asymmetric shock and the permanent disequilibrium in the current accounts: price and wage flexibility (to substitute for exchange rate flexibility); migrations. Price and wage flexibility at the center of the stage: an important part of the policy prescriptions of the so-called «Troika» (the European Commission, the European Central Bank and the International Monetary Fund) is aimed at reducing total production costs (and in particular labour costs) in the EZP countries, so to regain export price competitiveness, and reduce trade imbalances and the inflow of foreign capital. This strategy has not proved satisfactory: and this is one of the main reasons why Europe is in a trap.

Why? First of all, the European inflation is particularly low, and the risk of deflation (decrease of prices) materialized in 2014. The hope, in Europe, is that non-conventional monetary policies announced by the ECB in January 2015 will contrast deflation. Otherwise, it will remain very difficult to improve price competitiveness: with a zero inflation in Germany, the prices of good in the EZ periphery have to decrease in nominal terms for a long time; but with decreasing prices, the situation of public debts gets worse and worse. A higher inflation would be needed in Germany (and, generally speaking, in Northern Europe) in order to help the adjustment process in the periphery; but German authorities are strongly contrasting this perspective. But this is not the only reason why trade adjustment is not happening. In the last twenty years many German firms created international value chains (IMF 2013), particularly in Poland, Czech Republic, Slovakia, Hungary to import cheaper components. This means that German exports now incorporates a notable percentage of parts proceeded abroad (percentage that is higher than in Italy), whose production costs are related to Slovak, not German, wages: for EZ periphery to compete on prices with Germany (with a decrease in imports and an increase in exports) is therefore more difficult. This is not enough. There is a clear «fallacy of composition» (De Grauwe 2014; In't Veld 2013): all European countries, including Germany, are trying to push exports while following restrictive fiscal policies at home (and this results in a decrease in imports). With restrictive policies «abroad», especially in larger and closer markets, it is very difficult to increase export. However, trade competitiveness is not due to wages and prices: non-price factors, such as innovation content of products, product differentiation, economies of scale and of scope are powerful determinants of the export performance, as is well known to the international economists (see e.g. Altomonte *et al.* 2013); such factors are the result of decades of investment and industrial development. For countries like Spain (much more for Greece) it is very hard to compete with the German industry, one of the strongest in the world. Finally, all European countries could try to solve, at least partially, their external imbalances exporting in the rest of the world. Actually, this is exactly what is happening. The EZ surplus with the rest of the world is very large; in 2014, it was more than € 400 billion (more than 2% of GDP), the double than the Chinese one; needless to say, this is an important factor of imbalance in the international scenario.

Notwithstanding the strong decrease in unit labour cost in most of the countries of the periphery, the external adjustment is not happening at a satisfactory pace: in some EZ countries current account did improve, but mainly due to import contraction linked to recession (De Grauwe 2014).

European Southerners (and Irish) should migrate to Germany to decrease unemployment (and wages) at home, and increase wages abroad. This is happening. CEPS (2014) presents data showing an increase in net migrations to Germany (as well as to other destinations, such as the United Kingdom) from the European periphery, especially for Greece and Ireland. But the magnitude of the flows is not at all comparable with the stock of the unemployed. Millions and millions of Greek and Spanish should live in Germany to have a sizeable effect on labour markets of both countries to help reducing imbalances.

The impact of the «Troika» on the domestic front was still worse. Fiscal consolidation is producing, as expected, recession and unemployment: there is a clear, and expected relationship between the restrictive mood of fiscal policies and GDP. But there is much more: the austerity is worsening, not improving, the situation of the public finances in the Periphery (Figure 4).

As argued first, among others, by De Grauwe and Ji (2013), and then authoritatively confirmed by the International Monetary Fund (Blanchard and Leigh 2013) austerity is increasing the debt/GDP ratio, in all periphery countries. There is a clear vicious circle: if the debt/GDP ratio increases, more austerity is needed; but with more austerity, the debt/DGP ratio increases more. This is another, powerful, reason why Europe is in a trap: austerity policy, while producing lasting negative effects (see next paragraphs) are not delivering in terms of improving public finances. They could last forever: the IMF (2014) suggests htat eventually debt will decline, but at a very low rate; De Grauwe (2014) for example calculates that even with a primary surplus of 4% of GDP, Greece will need 22 years to half its debt and Italy 16. The IMF (Blanchard and

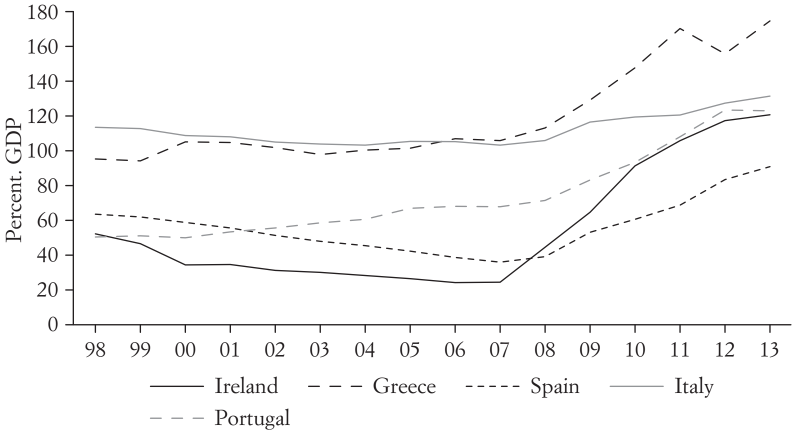

FIG. 4. Gross government debt to GDP ratio.
Source: De Grauwe 2014.

Leigh 2013) explained why there was such a policy mistake: there were different expectations regarding the functioning of the economy, in particular regarding the «multiplier» effect of fiscal consolidation on income. As very well documented by Blyth (2013) this was due to the growing political strength, since the 1980s, of an extreme, very ideological vision of the economy, in which public policies and the size of the public sector are the evil; and the reduction of public expenditures the cure for all ills. The «Austerians», in the definition of the Nobel laureate Paul Krugman, were very influential. The Italian economist Alberto Alesina was invited at the Ecofin meeting in Madrid in April 2010, an important step in the design of the austerity path (Legrain 2014). He told European Ministers that, according to his research, «many, even sharp, reductions of budget deficits have been accompanied and immediately followed by sustained growth rather than recession, even in the very short run». This was the idea of «expansionary austerity»: that proved to be not realistic in the European economy, as well as highly questionable on both grounds of theory and empirical evidence. For sure, in the most recent period there is some evidence of improved economic conditions in countries such as Ireland, Spain and Greece. However, one must assess those data considering the

TAB. 1. *Macroeconomic imbalances (selected EU countries), 2013 (% of GDP)*

	Current account balance[1]	Net financial position[2]	Private sector debt[3]	Public sector debt[4]
Germany	+7.3	48	107	78
Netherlands	+9.8	46	219	74
Sweden	+6.1	–5	210	40
Ireland	4	–105	306	124
Greece	–3.8	–119	129	175
Spain	–1.4	–98	195	94
Italy	–0.7	–29	126	133
Portugal	–2.8	–119	218	129

[1] Between –4% and +6% of GDP.
[2] No more than –35% of GDP.
[3] No more than 133% of GDP.
[4] No more than 60% of GDP.

Source: European Commission.

fall of the economies that occurred in the last years, and the effect of positive exogenous factors (such as oil prices). The point is not assessing that GDP is not falling any more: it is about comparing most recent levels of income and employment with the values of 2007 or 2010; otherwise it may look like a «medieval barber saying that a blood letting is working, because the patient has not died yet» (Stiglitz 2014). Moreover, one must consider that such a prolonged depression have already caused important structural effects in the economy and in the society of peripheral countries.

Unfortunately, the imbalances are still there. Thanks to the European Central Bank, and in particular to the announcement of the OMT (outright monetary transaction) a crucial imbalance was reduced: the interest rates spreads are substantially reduced, as of end-2014, in comparison with the situation in 2011-2012. But others are still there (Table 1).

The EU Commission report on macroeconomic imbalances, shows that as of end 2013, the current account balance (as % of GDP) was still –3.8 for Greece, –2.8 for Portugal and –1.4 for Spain, while being +9.8, +7.3 and +6.1 respectively for the Netherlands, Germany and Sweden. Since 2009 Germany has increased its exports in the extra-EU markets, but it still records a large surplus (almost 2% of its GDP) with EU28 partners. In any case, for the European rules, total surplus should not exceed +6%. The Irish case (+4), is very peculiar: in a very small open economy in which the role of export-oriented multinational firms is crucial, the surge of export is not surprising, but it is not necessarily linked to an improvement of the well-being in the average citizen, also given the high values of public and private debt. The net financial position of both Greece and Portugal was –119% of GDP, of Ireland –105%, of Spain –98%, compared to the value of –35% not to be exceeded. In the same time both Germany and the Netherlands showed a positive net financial position around half of their GDP. The stock of private debt is a very important indicator, given the role of private indebtness in creating the financial crisis. The UE macroeconomic imbalances rules state that it should not be larger than 133% of GDP. It was 306% in Ireland, 218% in Portugal and 195% in Spain. It is very interesting to note that it stand around 210% of GDP in both Sweden and the Netherlands. Finally, public debt were well above the 60% of GDP threshold: an unsustainable 175% of GDP in Greece; around 130% in Italy, Ireland and Portugal, 94% in Spain. The data on both private and public debt clearly show that their service (payment of interests) still subtracts substantial resources from private and public consumption and investment.

Current EU rules allow to assess the existence of imbalances, but do not have any impact, in terms of obligations, for their reduction. In particular, the Commission is not really pushing Germany to reduce its huge current account surplus, or to ease the adjustment of peripheral countries. The problem is not to ask Germany to artificially reduce her exports, as some politicians and economists have stated; the point is asking Germany to increase its level of activity, to induce, inter alia, larger imports. Is this permanent and immense trading surplus (that is there also because of the common currency that impedes adjustment via exchange rates movements) politically and economically compatible with the membership of a single market with a common currency? This is a huge, hidden, question. There are reasons to believe that it is not.

As is well known, if EU rules regarding macroeconomic imbalances are of very limited, if any, effect, the rules regarding public finances have been sharply strengthened after 2010. What counts in Brussels is contrasting only the profligacy of fiscal policies, no matter what happens for external and internal disequilibria, especially in the labour market. Emerson and

Giovannini (2013) has very well shown how the architecture of European governance changed dramatically in the last years, with the introduction of new procedures such as the European Semester, and new rules, such as those of the new version of the Stability and Growth Pact, the Treaty on Stability, Coordination and Governance (including the Fiscal Compact) and the provisions of the Six Pack and the Two Pack. This is another important reason why Europe is in a trap: its rules are written following the ideological approach of «austerians». They are not only incredibly baroque, so to be very far from the comprehension of average European citizen. They do not allow any margin of adaptation to take into account the real dynamics of the economy in the worst recession of last 80 or more years. As Tommaso Padoa Schioppa warned many years ago, given its incomplete level of political integration, Europe introduced and «automatic pilot» for its economic policies. Nowhere in the world fiscal policy is managed sticking to numerical parameters alone. What happened in 2010-2014 was not enough to convince European rulers, first of all the Germans and their closer allies, to change their minds. For the first time in post-war Europe, ideology is much stronger than reality.

Finally, one has to mention the fact that the EU Commission has kept interpreting the rules of the treaties in the most «austerian» mood. First, she dismantled operationally the modest «investment clause» that was introduced in 2011 to allow investments to grow (Prota and Viesti 2013). Then she interpreted the rules to calculate the public «structural deficit» (that is what counts for respecting the treaties) in the strictest ways possible, estimating potential production and structural unemployment in the most conservative way possible, with numbers that are much worse for MS that those produced by the OECD and the IMF (CER 2014).

3. The trap II: austerity is not only reducing growth, but also growth potential

The goal of the second part of this paper is to show that austerity is not reducing symmetrically all public policies, but it is reducing much more the ones aiming at maintaining social cohesion and creating the conditions for future growth. We

TAB. 2. *General Government Expenditure by function, % change 2009-2012, current prices*

	EU-24	GR, IRL, POR	ITA, SPA	9 others EU-15	BALTICS	7 others CEE
Health, recreation	4	–20	–7	8	–6	12
Education	2	–14	–10	5	–7	8
Family and children	0	–19	–10	3	–14	1
Total	4	–12	1	6	–3	7

Source: Bruegel 2014b, tab. 1.

start with an analysis of the change (2009-2012) of general government expenditures by function, following Darvas and Wolff (2014) and comparing five groupings of countries: Greece, Portugal and Ireland (GPI); Spain and Italy (SI); the other EU15 (O15); the Baltics (BAL); the other EU10 (O10) (Table 2).

As expected, the total expenditures of government decreased in currents prices in GPI (–12%) and BAL, remained stable in SI while increasing in the other countries and EU average. But if one takes «health and recreation» the picture changes; the decrease in GPI, BAL and SI is much larger than their average, as well as it is much larger the difference with the other MS. Exactly the same happens for «family and children», with a strong decrease in GPI, BAL and SI. The data for Baltics are important. They remind us that the problems in Europe are not only in the five EZP countries; the crisis impacted several MS and regions. What is the price that the Baltics did pay, and are still paying, while returning to a positive dynamic of GDP?

A more general analysis of public expenditures performed by in the Sixth Report on Economic, Social and Territorial Cohesion (European Commission 2014b), defines those categories of general government expenditures that may be considered more «growth-friendly», and confirms that they decreased in the EU (and more particularly in several MS) proportionally more than the rest of public expenditures. As expected (Ball *et al.* 2013), those cuts have had large distributional effects (see below).

Education is crucial for long-term, sustainable, growth. Education expenditures dramatically fell in GPI; BAL and SI in 2009-2012, while strongly increasing especially in O10 (Darvas and Wolff 2014). OECD data, though still limited to 2008-11, could give us a larger perspective. They confirm that education expenditures decreased in Ireland, Spain, Italy, as well as in Iceland (affected by the financial crisis), and some Eastern European MS, such as Slovenia and Hungary. This has happened nowhere else in the world. More recent data (European Commission 2014) show a particularly critical situation in Italy, where the decrease of education expenditure (that were already well below the EU and OECD average as a percentage of GDP) was stronger, for both schools and universities. It is worth recalling that Italy is, together with Romania, the Member States with the lowest percentage of graduates of those aged 30 to 34 years: percentage that is one key indicator of the EU2020 strategy. Recent very negative trends was also recorded in Ireland, Spain, Hungary and Greece (Grove 2014).

Public investment is the main victim of austerity. When public budgets suffer from tighter constraint, it is easier to reduce capital than current expenditures. As for example Italy: from 2009 to 2013, interest payments grew 13% (current euros) and other current expenditures 4%, while capital expenditures decreased 29% (Servizio Studi BNL 2014). If this happens for one or very few year, its effect can be managed relatively easily: the creation of public capital via new investment can be resumed at an higher level when the conditions of public finance improve. If this happens for a longer period, its effects can become much more important: without new investment, public capital may become obsolete; this, in turn, may reduce the competitiveness of private firms: think of road (or port, or railway) maintenance, and of the construction of new, transport infrastructures. A vicious cycle in the economy can start, going back and forth from reduced public investment to reduced firms' competitiveness, profit and investment. As stated by a recent ECB working paper (Clancy *et al.* 2014), «government investment, by raising productive public capital, improves external competitiveness and counteracts external imbalances». In the EZ, public sector investment started to decline dramatically in 2008-2009, going from around 2.5% of GDP to 2% of GDP in 2012-2013. «While the long-term decline in EU government gross fixed capital formation is broadly in line with developments in other advanced economies», more recent data «were strikingly different», quoting a very detailed Bruegel report (Barbiero and

TAB. 3. *Public gross capital formation (euro per inhabitant)*

	2009	2013	Diff.
EU-28	692	571	–17.5
Germany	509	521	+2.4
Ireland	1338	610	–54.4
Greece	650	319	–50.9
Spain	1018	330	–67.6
Italy	637	444	–30.3
Portugal	478	227	–52.5
Finland	914	1003	+9.7
Sweden	1110	1464	+31.9
UK	694	591	–14.8
France	1002	982	–2.0

Source: Own calculations, EUROSTAT data.

Darvas 2014). According to their calculations public capital expenditures (2009-2013) decreased 51% in Greece, Ireland, Portugal and Spain taken together, 24% in Italy, and 1% in the 10 other EU 15, while increasing 14% in Switzerland and 20% in the USA. Barbiero and Darvas (2014) argue that this is due to the EU fiscal framework. Public investment in the EZ, as a percentage of GDP, stands well below the US level (Valla *et al.* 2014). Taking EUROSTAT data on public gross capital formation (Table 3), one can see that it lowered from 692 euro per inhabitant in 2009 to 571 euro in 2013, that is –17.5%. Only European cohesion policies were at work to reduce the impact of austerity on public investment: they financed as much as one fifth of public investment in the EU28 in 2013 (European Commission 2014b), being the only pro-growth EU policy.

As one can expect, a much stronger decrease is in the Periphery: the decline was as large as –67.6% in Spain. Spain had in 2009 an investment effort that was much greater than the EU average, with the figure being more than one thousand euro; in 2013 she fell at 330. The same happened in Ireland, where a particularly high investment effort in the recent past, and a 2009-2013 decline of –54.4%. In Greece and in Italy investment per capita was already in 2009 a little below the EU average, and it fell, respectively –50.9% and –30.3% in the period. Portugal was already well below, and declined 52.5%. As a comparison, in the Scandinavian MS investment was already higher than average and increased in the period.

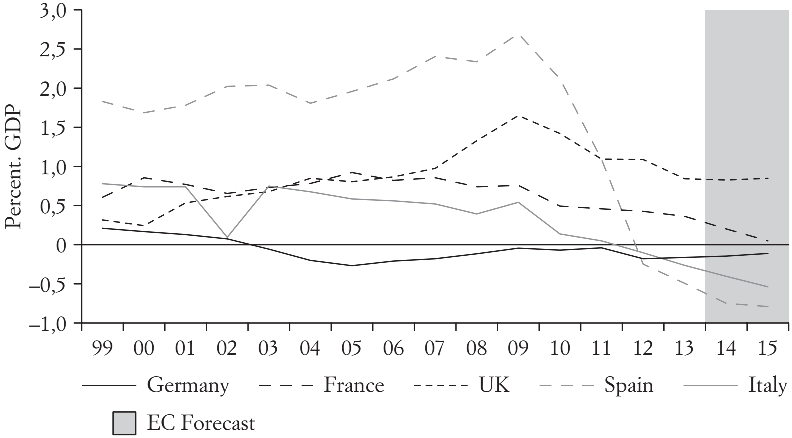

FIG. 5. Net public investment, 1999-2015.
Source: Tilford 2014.

In the other large MS there were minor changes, with a limited decline both in France and the UK. The situation in Germany is of particular interest: there was a minor increase; but what counts more is that public gross capital formation per capita remains well below the EU average. Data on gross flows, by definition, do not take into account the depreciation (obsolescence) of existing public capital stock. To measure net increase/decrease of public capital stock, one can refer to net (public investment) data. Tilford (2014) shows (Figure 5) that the decrease of gross flow has determined a negative public investment in both Spain and Italy: the Spanish data are impressive, because the country was having a very large net addition to its stock (around 2% of GDP) until 2009: an overall enlargement and modernization of her public capital.

Now Spain is reducing its amount. Germany, again, emerges as a very interesting case, because the net data show that, contrary to other large EU member states, she has been reducing, due to a minor investment effort, her public capital since 2002. The point was made very clearly by Fratzscher (2014): Germany is suffering from many years of public underinvestment, so that her infrastructures are getting more and more obsolete, creating the conditions to reduce her competitiveness. According to Fratzscher (2014) the German investment shortfall between 1999 and 2012 amounted to about 3% of GDP, increasing in 2010-12; the government and the business would have to spend 103 billion more each year, to avoid the country to live «from its reserves», and, while exporting high quality automobiles, having the plaster crumbling in the elementary school and parents raising to hire painter. According to a recent report, for example, «the Kaiser Wilhelm Canal in Kiel is crumbling. Last years the authorities had to close the 60-mile shortcut from the Baltic to the North Sea for two weeks, something that had never happened through two world wars. The locks had failed» (Evans-Pritchard 2014).

This is a crucial point: austerity is destroying the economies of Ireland, Portugal, Spain, Italy and Greece also because much lower levels of public investment are reducing the chances to increase their competitiveness in the long run. But austerity appears to be self-defeating also for Germany: to achieve a balanced public budget (as was the rule in the XIX century), Germany is strongly under-investing in her public capital. Even the International Monetary Fund (IMF 2014) has authoritatively stated that now, especially in Europe, «the time is right for an infrastructure push»; that, contrary to the Austerians' belief, «debt-financed projects could have large output effect without increasing the debt-to-GDP ratios». But the suggestions coming from Washington were and are disregarded in Brussels. After the so-called growth strategy, that proved to be a fiasco (Prota and Viesti 2012), the much-heralded Juncker Plan will not have any real growth impulse according to almost all analysts, including cautious economists such as Gros (2014), who spoke of «smoke and mirrors».

Data regarding research and development (R&D) expenditures are also interesting (Veugelers 2014). Increasing the R&D/GDP ratio is another key goal of the Europe 2020 strategy; the goal is to get, summing public and private efforts, a 3% ratio, in the EU average, for the end of the decade. Government expenditures in research and innovation are actually falling, albeit slightly. They are decreasing in nominal terms; as a ratio of GDP (from 1.5% to 1.4% notwithstanding the limited, if any, increase of the GDP); and as a percentage of total government expenditures. The latter data show that, also in this case, pro-growth expenditures such as research and innovation (R&I) public investment, are decreasing more than total public expenditure. Also in this case austerity is causing

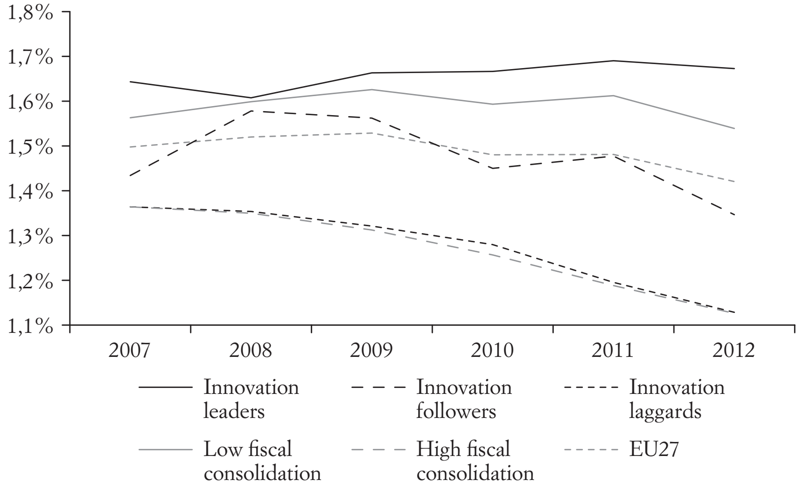

FIG. 6. Trend in government R&I expenditure, 2007-2012 (GBORD as % of government expenditure).

Innovation leaders (Denmark, Finland, Germany, Sweden and the UK), innovation followers (Austria, France, Ireland, Luxembourg and the Netherlands) and the rest (innovation laggards).

High fiscal consideration countries (Bulgaria, Cyprus, the Czech Republic, Estonia, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Poland, Portugal, Romania, Slovakia and Spain) versus the rest (low fiscal consideration).

Source: Bruegel calculation on the basis of EUROSTAT and AMECO.

an adverse selection. But, again and as expected, the picture at the national level is very different. Veugelers (2014) clearly shows that dividing MS in three groups (innovation leaders, followers and laggards) one can see the trend in government R&I expenditure (as a percentage of total government spending, 2008-2012) respectively being constant in the first group and decreasing fast in the other two (Figure 6).

This is creating the conditions for a future enlargement of disparities within the EU. Not surprisingly she also shows the correlation between austerity and a decreasing research effort. Dividing MS in two different groups (low and high fiscal consolidation, with the latter including Bulgaria, Cyprus, the Czech Republic, Estonia, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Poland, Portugal, Romania, Slovakia and Spain), the picture for the groups is completely different. In the former one, R&I public expenditures remain around 1.6%

of the total; in the latter one they go from around 1.35% to slightly more than 1.1%. Spain cut its public R&I budget substantially, down to 1.25% of government expenditures in 2012, from 1.95% in 2007. Italy reduced the figure to an historic low. 1,1% in 2012, while in Greece it went to 0.7 in the same years. Only in Portugal the share of R&I over public spending remained relatively high (Veugelers 2014).

Needless to say, private investment in the EU as a whole is decreasing since the crisis erupted. It is worth noting that, after a major collapse in 2008-2009 private investment in the US resumed vigorously. So the overall picture is as follows: in the last five years the UE is strongly under-investing in its future; both public and private investment is decreasing, reaching historically-low level, and being both much less than in the US. It has been estimated (Claeys *et al.* 2014) that in 2014 EU-15 investment is € 260 billion below the long term trend (€ 160 billion excluding construction). In this framework, «Italy offers the most worrying picture, with continuous and broad-based decline in investment since the beginning of the crisis».

Firms also invest in people. One of the several ways of so doing is by hiring new employees with tertiary education. If one takes the data regarding the employment rate of recent graduates may have an indirect measure of this phenomenon. In 2008 the employment rate of recent graduates was very close in Germany, Ireland, Portugal and Spain, around 85%, while already being much lower, around 65%, in Greece and in Italy. In 2013 in Germany the rate slightly increased, while falling to 73% in Ireland, 68% in Spain, 60% in Portugal, 46% in Italy and an astonishing 40% in Greece. Those numbers do not only show the problems that the crisis has created for the younger generation (see below); they can be read as another indicator of the investment effort of the private sector, and of the society at large.

In its conclusions of the 27th-28th June 2013 meeting, the European Council recognized «the vital importance of a strong European industrial base as an essential building block of the EU's growth and competitiveness agenda». Unfortunately, as for several European statements of the most recent period, those were only empty words. Industry value added/GDP ratio and industry/total employment have historically tended to decrease, especially in the most advanced countries, well

TAB. 4. *Employment in industry (except construction, 000)*

	2008	2013	Diff.%
EU-28	42.226	37.717	–10.7
Germany	8.746	8.502	–2.8
– Eastern Germany	1.336	1.279	–4.3
Ireland	286	240	–16.1
Greece	627	384	–38.8
Spain	3237	2.355	–27.2
– Southern Spain	415	290	–30.1
France	4.071	3.702	–9.1
Italy	5.001	4.519	–9.6
– Southern Italy	905	777	–14.1
Poland	3.802	3.568	–6.2
Portugal	944	761	–19.4
United Kingdom	3.820	3.433	–10.1

Source: Own calculations, EUROSTAT data.

before the crisis, for a number of reasons. They have to do with different factors going from international competition to productivity dynamics, to statistical problems, such as counting as «services» activities that are still there, but that were counted as «industry» before. With this caution in mind, one can nevertheless measure, cross countries, the change 2008-2013 of the number of industrial jobs (employment is updated before value added data: Table 4).

In the UE average there was a 10.7% decrease. In Germany, the decline in the number of industrial jobs was much smaller, being –2.8%. Data for the UK, France and Italy are similar to the European average. What happened in the other periphery countries is as follows: –16% in Ireland, –19% in Portugal, –27% in Spain, –39% in Greece. On the one hand, this decline can be due to emerging countries' competition, or to process innovation. On the other hand, the magnitude of the change is so large to let one think that a substantial part of the losses are due to the lack on internal demand. As mentioned before, the theory of optimal currency areas states that trading imbalances in a currency area can be reduced via price and wage flexibility improving the current account balance. Now the question is: how can Greece or Portugal substantially increase their export while their industrial capacity is shrinking so fast? In Europe, manufacturing accounts for most of export. Even for a country like Greece, with a very large service export of services (tourism) it is now more difficult.

Austerity is reducing growth potential. A growing literature finds that deep recessions have a highly persistent effect on output (hysteresis), inter alia because it damages economy's labor force and productivity, thereby reducing its potential output. According to Ball (2014) calculations, the loss of potential output is over 30% for countries such as Greece, Hungary and Ireland.

Would «structural reforms» solve the problems of the EU, and in particular of the EZP, as many European leaders, and the European Commission, strongly advocate? In general terms, the answer is: no. The problems for Europe, and in particular for the EZ, are on the demand side, much more than on the supply side. However, they can help. But this crucially depends upon the meaning of «structural reforms». In several areas, Europe and in particular EZP can increase its growth potential: this means investing more in education and R&I; reinforcing industrial policies to increase investment, industrial productivity and competitiveness; increasing external economies thanks to better and improved infrastructures. But those are exactly the policies that have been reduced, due to fiscal consolidation, without raising any concern in many European leaders. With «structural reforms» the EU Commission usually refers to labor markets (keeping wages as low as possible) as well as to a new wave of privatizations and liberalizations, in a sort of «Berlin Consensus» Decalogue, with many similarities to the well-known «Washington Consensus». What counts, for EZP, is «internal deflation»: reduce import, increase export via compression of the internal demand and wage moderation (decrease); balance the budget. Those are exactly the policy prescription that were familiar in the XIXth century, at the time of the gold standard (Viesti 2013).

4. The trap III: dangerous fractures are growing

The crisis is not the same for everybody: the recession is impacting very differently not only in terms of different MS, but also in terms of regions, and of different social groups. The last set of reasons why Euro is in a trap has to do with growing disparities and fractures within Europeans. Those fractures produce, from an economic point of view, a new framework, in which some citizens continue to benefit from the EU (as happened in the past for most of them), while others are excluded.

The first fracture has to do with nations and regions. The economic, social and territorial cohesion is one of the pillars of European Treaties: most, if not all, European policies in the past decades were aimed at increasing cohesion. As Mario Monti stated in his authoritative report on the future of the Single Market (2010), in line with the tradition of EU reports and political decisions, growth and cohesion, efficiency and equity, must necessarily go hand in hand. Inter alia, this is the only way to mantain and reinforce the political consensus of the majority of the European citizens for the common institutions. Not surprisingly, this consensus is falling sharply, and the danger of anti-European movements is much stronger now than in the past.

As very well known, the year 2010 marks a profound discontinuity in European economic trends. Also due to the very high level of economic integration, the economic cycle in the EU countries have been synchronized since a long time: when times were good for one MS they normally were good as well for the others; when the international recession hit Europe in 2009, GDP decreased everywhere. From 2010 on, this was not happening any more: some of the MS, those most affected by the austerity policies, started recording very bad results, while the others performed better. As of end 2014, among major MS, both Italy and Spain were well below the GDP levels of 2008, while France, Germany and the United Kingdom were above. But it is not only a matter of comparison among those countries. Even among Eastern Europe MS the performance were widely different, which much better results for Poland, for example, than Croatia or Slovenia.

When the Single Market was created in the late 1980's, the then-President of the European Commission Jacques Delors launched the European Cohesion policy. The reason was simple: with the single market and the free circulation of goods, services, capital and people, the economic development may become more polarized. Growth can be stronger in some of the European regions, because of a number of factors (such as economies of scale and dynamic economies of learning, but also geography, infrastructures and public capital), leading to growing disparities among European regions. According to Delors, and to the rationale of the EU cohesion policies that

TAB. 5. *Coefficient of variation of employment rates (15-64) across regions (NUTS 2 level) within countries*

	2005	2008	2011	2013
Austria	0,036	0,034	0,031	0,037
Belgium	0,080	0,081	0,085	0,090
Germany	0,055	0,045	0,039	0,040
Greece	0,061	0,052	0,058	0,079
Spain	0,095	0,099	0,103	0,115
Finland	0,083	0,090	0,081	0,078
France	0,132	0,118	0,109	0,110
Italy	0,149	0,157	0,168	0,183
Portugal	0,038	0,036	0,027	0,052
Sweden	0,029	0,029	0,025	0,024
United Kingdom	0,053	0,054	0,054	0,053

Source: Own calculations, EUROSTAT data.

started in 1989 (and is still there, being the most important common policy in terms of magnitude of the EU budget), this is not acceptable from a political point of view: European Union has to deliver its benefits to all the EU citizens, independently of where they live. Even from a purely economical point of view, it is highly questionable that spatial concentration of production is the first best for the Union to grow. Since then, reducing disparities among regions has been a priority. Results in terms of convergence of income have been mixed, especially following the enlargement; but for sure cohesion policies has at least contrasted the increase of regional disparities. Now, take the data for UE15: in the pre-crisis period, regional (as well as national) disparities were largely stable; not decreasing, but not increasing. Things changed dramatically after the crisis erupted: divergence among nations was accompanied by a divergence trend among regions within each nation. The coefficient of variation of both GDP per capita and employment rates within countries show clearly this trend. In particular, there was a new, notable, trend of increasing regional disparities within the peripheral countries (Table 5).

The coefficient of variation of the employment rate, between 2008 and 2013, increased substantially in Greece (0.52 to 0.79), Spain (0.99 to 1.15), Italy (1.57 to 1.83) and Portugal (0.36 to 0.52), while remaining constant in all the other MS. This is to say that looking only at the growing disparities among MS is only a part of the story; fractures are larger. Within

TAB. 6. *Youth unemployment rate*

	2008	2013
EU Average	15,2	26,2
Greece	22,1	58,3
Spain	24,5	55,5
Portugal	16,4	37,7
Ireland	12,7	26,8
Italy	21,3	40,0

Source: EUROSTAT.

worst performing countries, the gap between relatively richer and poorer regions increased substantially, changing the previous trends. Citizens of the relatively poorer regions of the EU periphery are the most affected by the crisis. This is due to the structure of their economies, having a lower export/GDP ratio not allowing to compensate abroad the weakness of the internal demand (Viesti 2013). But may also be due to the effects of the austerity policies: recent analysis of the Italian case (Banca d'Italia 2014) clearly show that tax increases and expenditure cuts were both, simultaneously, stronger in the Italian Mezzogiorno than in the rest of the country, inducing much worse results in terms of GDP per capita and employment.

The second fracture has to do with the young and the old. Unemployment increased in the EU as a whole, and much more in the peripheral countries. Youth unemployment rate in the EU went from 15.2% (2008) to 26.2% (2013), being larger and increasing more than overall rate, in the EU (Table 6).

In Greece and Spain it skyrocketed, starting form 22-24% in 2008 it went as high as 55-58% in 2013; and the same happened in other countries. In Italy there was a decrease of 1.6 million in the number of young (25-34 years old) employed between 2007 and 2014 (CSC 2015). Now, one always has to keep in mind that the growth of unemployment is not due to a «normal» recession, but to a lasting depression. This means that the average duration of the unemployment (in many cases the time to get the first job in the life) increased. The long term unemployment rate more than doubled in the UE average (2008-2013) up to 5.4%; but it increased five times in Greece up to 18.6%, and more than six times in Spain, from 2% to 13%. In the South of the EZ, those who had been unemployed for longer than one year constituted 25% of the

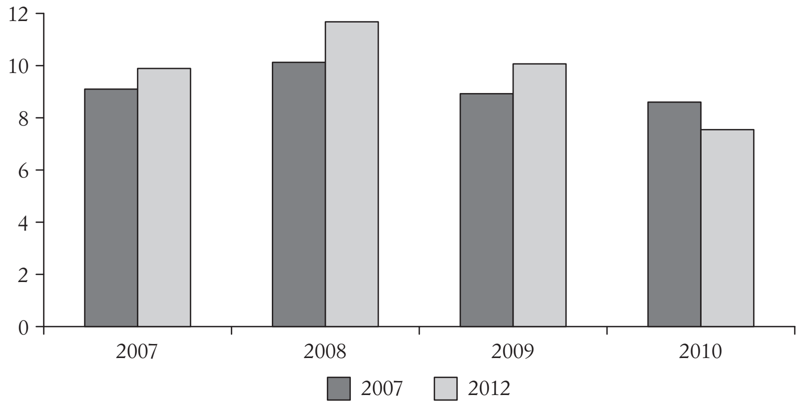

FIG. 7. Severe material deprivation rate in the EU27, 2007 vs 2012.

Note: Children: below 18 years; working age: 18 to 64 years; elderly: over 65 years.

Source: Bruegel 2014b based on EUROSTAT.

total unemployed in 2007 and 45% in 2013 (Merler 2015). A longer unemployment period may have lasting consequences for future employability; the more you remain unemployed the lower are the possibilities to get hired in the future: employers tend to prefer systematically those who have been unemployed for a shorter period (Merler 2015). The very life of millions and millions of young Europeans may be compromised by what is happening in these years (Tschekassin 2014); this may have trickle-down effects: «when children grow up in families in which parents do not work for long periods or work irregularly, their opportunities are curtailed compared to children whose parents work» (Darvas and Wolff 2014a).

But it is not only a matter of jobs: a recent Bruegel report (Darvas and Wolff 2014) assesses that, in the framework of overall increase of the percentage of Europeans that in a condition of severe material deprivation, the increase was larger, and the level reached much higher, for European children (up to 18 years old). In the case of the elderly (more than 64) it actually decreased (Figure 7).

Those numbers drive us to another key fracture: the one between the rich and the poor. While reducing poverty in the Union was one of the key target of Europe 2020 strategy, poverty and inequality in Europe increased in the most recent

TAB. 7. *Population «At risk of poverty or exclusion» or «severely materially deprived» (% of total population), selected countries*

	% At risk of poverty or exclusion			% Severely materially deprived		
	2008	2013	Diff.	2008	2013	Diff.
Greece	28.1	35.7	+7.6	11.2	20.3	+9.1
Hungary	28.2	33.5	+5.3	17.9	26.8	+8.9
Italy	25.3	28.4	+3.1	7.5	12.4	+4.9
Spain	24.5	27.3	+2.8	3.6	6.2	+2.6
United Kingdom	23.2	24.8	+1.6	4.5	8.3	+3.8
Portugal	26.0	27.4	+1.4	9.7	10.9	+1.2
Netherlands	14.9	15.9	+1.0	1.5	2.5	+1.0
EU-28	23.8	24.5	+0.7	8.5	9.6	+1.1
Germany	20.1	20.3	+0.2	5.5	5.4	–0.1
France	18.5	18.1	–0.4	5.4	5.1	–0.3
Finland	17.4	16.0	–1.4	3.5	2.5	–1.0
Poland	30.5	25.8	–4.7	17.7	11.9	–5.8

Source: EUROSTAT (Newsrelease 168/2014).

period. All the indexes that are normally used to assess the magnitude of poverty give the same indication.

As far as the larger concept of «percentage of people at risk of poverty or exclusion» is concerned, the average index for EU28 went from 23.8% (2008) to 24.5% (2013). This is to say that, in one of the richest part of the world, one citizen out of four is at risk of being poor or excluded from society. As one may expect, there are very large differences among MS in terms of both levels (in 2013) and change (2008-2013) (Table 7).

In 2013 one citizen out of three was in this situation in Greece (as well as in Hungary), with an increase, in the five years, of 7.8% in the former and 6.3% in the latter. Both levels and increase were smaller in Italy, and even smaller in the Iberian countries; but nonetheless, in all cases, much larger than the UE average. It is worth noting that the percentage of people at risk also increased in some of the Northern countries, such as the Netherlands (+1%) and the United Kingdom (+1.9%), while remaining similar to the 2008 levels in both France and Germany: those number shed some light on the social effects of the crisis also in countries out of the EU periphery. Finally, one has to mention the very large decrease of people at risk in Poland: starting in 2008 with levels larger than the Mediterranean countries, Poland was able to reduce the percentage of almost 5 point, with the best results in the Union. Comparing Hungary and Poland helps to understand again how the new fractures are not limited to the comparison of the well-being of the average Greek with the average German; several social groups all over Europe have seen their situation worsening in the last five years.

Using the more stringent definition of people «severely materially deprived» does not change the picture. However, the increase in the percentage of European severely materially deprived was higher than in the case of people «at risk», with the percentage going up 1.1% to 9.8%; this implies that the situation worsened relatively more for the most disadvantaged people in Europe. In 2013 one citizen out of four was severely materially deprived in Hungary, one out of four in Greece, one out of seven in Italy, a country that is a member of the G8. Again, more detailed analysis, comparing the national differences, is useful: both Spain and Portugal were able to record milder increase and lower levels of poverty than Italy and Greece.Quoting Nobel laureate Josephx E. Stiglitz (2015), «behind the cold statistics, lives are being ruined, dreams are being dashed, and families are falling apart (or not being formed) as stagnation-depression in some places-runs on year after year».

As for as inequality of income is concerned, since the crisis broke out there is a large spread in the variation of the Gini coefficient (one of the measures of inequality), from 2008 to 2013, throughout Europe (OFCE-ECLM-IMK 2014).There are large increases in several countries, notably Cyprus, Spain, Hungary, Italy and Greece, as well as in France and Denmark, while income inequality decreased in Portugal (where top income were hurt even more than low-income) as well as in countries such as the Netherlands, Belgium and Poland. It is not at all only a matter of equity. Among many others, also the OECD (2014) recently assessed that «when income inequality rises, economic growth falls. One reasons is that poorer members of society are less able to invest in their education». This seems to be what is happening in several European MS.

The last fracture can be seen as a result of the previous ones: the trust of European citizens in the European Union and the European institutions dramatically fell (European Commission 2014a). The EU Eurobarometer regularly measures,

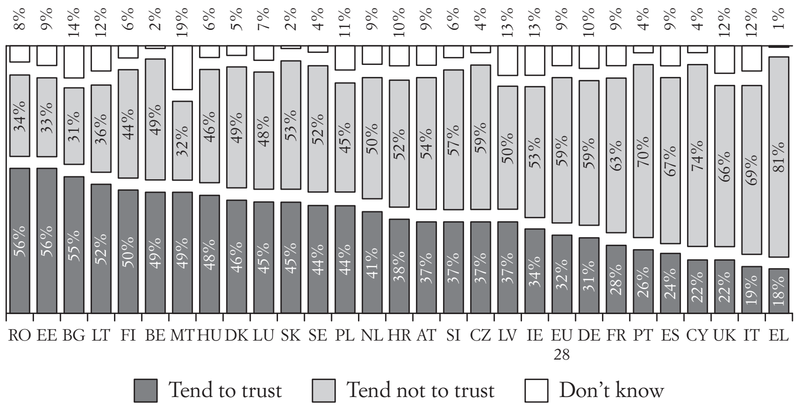

FIG. 8. Trust in the European Union, 2014.

QA7.4: I would like to ask you a question about how much trust you have in certain institutions. For each of the following institutions, please tell me if you tend to trust it or tend not to trust it.

Special Eurobaromenter: Europeana in 2014.

via opinion polls, the share of Europeans that states that they tend to trust the European Union. In 2014 the percentage of Europeans who tend to trust the EU is 32%, against 59% who do not (9% don't know). The percentage of citizen tending to trust the EU is 18% in Greece and 19% in Italy (both below the United Kingdom), 22% in Cyprus, 24% in Spain and 26% in Portugal (Figure 8).

Only in 7 out of 28 MS, all of them new member States except for Finland, the percentage of citizens tending to trust the EU is larger than the opposite. The percentage of Europeans tending to trust the EU was 57% in September 2007, and still 50% in September 2008; it decreased almost 20 percentage points because of the crisis (and the austerity). The same happens if considering the trust in specific institutions, such as the European Commission, the ECB, the Parliament (European Commission 2014a).

A survey of October 2014 (European Commission 2014c) showed very interesting difference, among EZP countries, in the trust their citizen have in the single currency (Table 8). In the Euro area, 57% of people think that the euro is «a good thing», against 33% that think that it is «a bad thing», with a balance of +22% (the rest can't decide). In Ireland and in

TAB. 8. *Public opinion: the euro, 2014 (%)*

	Is a good thing	Is a bad thing	Can't decide
Cyprus	42	46	9
Italy	43	47	9
Portugal	50	38	9
Spain	56	34	6
Euro Area	57	33	8
Greece	59	28	11
Ireland	76	17	5

Source: European Commission, Flash Eurobarometer 405, October 2014.

Greece the balance of opinion is much more favourable for the euro, being as high as +59% in Ireland, and +30% in Greece. In Spain and Portugal the numbers are similar to the EU average. This indicates that the majority of people in those countries still think that the problem is not the euro per se.

Italy is different. It is the only EZ country, together with Cyprus, in which people who think that the euro is a bad thing are more than those considering it a good thing. In Italy, one of the founders of the EEC, with a population that was traditionally pro-Europe, the public opinion seems to have changed dramatically its views.

For the reasons explained in the whole paper, the probability of a substantial improvement of the economic conditions in the EU, given the current austerity policies, is very low. Given the data regarding European citizens' opinion, the probability of a «political shock» in the EU is very high; at the time of writing (end-January 2015) it is not clear if this is going to mean anti-Europe, nationalistic parties and movements or pro-Europe, anti-austerity parties.

Notwithstanding this the European leadership is insisting to stick to austerity as long as possible, accepting the risks of «political shocks», up to the breakup of the EZ and, in the worst scenario, of the very EU. The risk of dismantling decades of integration, bringing peace and prosperity to the Europeans. It is not at all an ambition of this paper to explain why it is happening; why ECB President Trichet stated that «it is an error to think that fiscal austerity is a threat to growth and job creation» (July 8th, 2010), European Council President Van Rompuy that «the most is over (February 6th, 2012) and Chancellor Merkel that «what we have done, everyone else can do» (September 25th, 2013) (Legrain 2014). If it depends more upon radical, ideological liberism or upon a more pragmatic evaluation of the differential benefits accruing to some EU MS in this situation. And it is neither the goal of this paper to discuss the different possible, roads to drive the EU out of self-defeating austerity and depression. In nutshell, the message of this paper is sample: the future of the EU is at risk, because Europe is in a trap.

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Why Europe is in a trap

Summary: This paper deals with the economic and social situation in Europe at the end of the year 2014, after the great international financial and economic crisis of 2008-2009 and the following European crisis. It deals mainly with the consequences of both crisis and of the economic policy enacted in the European Union (EU), on European society and economy. The goal of this paper is neither to investigate and discuss why the crisis started and continued, nor to present and suggest a possible way out. Its focus is in between the start and the possible end of the economic recession and of the social difficulties. Its key message is that the consequences of the crisis are such not to allow any easy or foreseeable end, with the current economic policy and with the current social and economic dynamics. Europe is in a trap. For three main reasons: *a*) because European macroeconomic policies are unable to put an end to present crisis, even in a longer run: worse, they basically transformed a deep international recession into a permanent state of depression of the European economy; *b*) austerity is producing a sharp reduction of public and private investment, and of R&D and education expenditures: exactly what is needed more to re-launch depressed economies and reinforce their competitiveness. Austerity is as well reducing those social expenditures and policies needed to keep European societies together; *c*) the extraordinary length of the depression is producing new fractures within Europe (and exacerbating older ones), creating a very unequal distribution of the adjustment cost. So, while some Europeans are hit, others benefit from the current situation and strongly support the continuation of the austerity measures. A radical change of the economic policies that are currently pursued is needed; with no change, Europe could continue to stay for years in a situation of social and economic depression, until a shock will dramatically change the course of its future.

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