The Aftermath of the Global Crisis in the European Union

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INTRODUCTION

We cannot be completely certain about the ultimate end of the 2008 world-wide economic and fiscal crises; however, we can be assured that it has made permanent changes to the economic and financial systems. In this volume, monographs are selected to reflect on the long term impacts of these crises within the European Union (EU). Three main topics are covered: economic growth, EU fiscal and monetary policy issues, and special challenges for the new member and Mediterranean states (in the so-called cohesion countries).

Europe is being battered by multiple, interrelated crises. Economic and financial issues triggered the public financial and Euro crises, leading to political and social ones not only within some member states but also at the EU level. These crises add to a difficult long-term trajectory as Europe struggles to maintain its economic, social and environmental models in light of resilient challenges such as demographic change, resource scarcity, rising inequalities and the need to transform Europe's societies driven by climate change and increasing competition from emerging economies. *Fabian Zuleeg* analyses these processes and presents the conditions necessary to avoid stagnation in Europe during the next decade.

Matti Viren applies econometrical analysis to find explanations for the slowdown in European economic growth. He presents empirical analyses using European cross-country data. Special attention is paid to institutional and structural factors that are often assumed to affect aggregate growth: the functioning of labour markets, availability of labour and capital and the size of government. His results reinforce the notion that accelerating growth in Europe is not completely unrealistic. However, it is only possible through unpopular reforms.

The Japanese experience of struggling with decades of recession represents a real threat for Europe. *Masahiko Yoshii* examines what happened during the last twenty years in Japan. He studies what policies were implemented and why they were ineffective. He draws conclusions on lessons learnt and applies them to the current European crisis.

The common European Union budget is a special field of fiscal policy. *Gabriele Cipriani* provides insights on a particular aspect of national and union level budgeting. The economic and financial crisis creates the need for a more targeted and results-driven public expenditure policy a priority, demonstrating and acknowledging that EU actions add value to national policies and address individuals' concerns more effectively than "national" or "local" ones may provide an example of "best practices" for national spending. The opportunity is to identify and promote best practices in planning, management and reporting to achieve public objectives.

The euro-area has deep-rooted problems and, despite the various attempts to resolve the crisis, no solutions have been offered to the most pressing of these problems. *Zsolt Darvas* summarises ten major roots of the euro-crisis and assesses the policy responses to these issues. This is followed by a closer examination of the most pressing problem that also constitutes the most serious threat to the integrity of the euro-area: the dreary economic outlook of southern euro-area member states. He concludes that instead of exiting or breaking-up the euro, the common interest lies in finding ways to offer improved prospects for these countries. A substantial amount of measures need to be accomplished in these countries, but other euro-area partners, the so-called 'northern' members, as well as European institutions, will also have a decisive role in supporting the development process in Southern Europe. In the medium term, additional intuitional changes will be necessary to complement the currently planned overhaul of the euro-area's institutional framework.

Miklós Losoncz supplements the previous study and scrutinises the latest developments in the sovereign debt crisis and the experience of and the issues in crisis management in the European Monetary Union (EMU). He focuses on an analysis of the relationship between the institutional system and the operation of the EMU and the study of the sovereign debt crisis. He discusses the measures introduced thus far that have weakened the three pillars of the EMU and provides options for the EU to manage the unfolding sovereign debt crisis going forward.

One of the most important objectives of European integration is to reduce the economic gap between the more developed and less developed member states. European convergence is based on foreign capital inflows. *Beáta Farkas* demonstrates that this model provided substantial opportunities for Mediterranean and post-socialist member states; the success of convergence in the European integration process is unique. As a consequence of the crisis, the foreign capital inflows in Europe will decline and the convergence process will be slowed. Under these circumstances, it will be extremely important to promote the positive spill-over effects of foreign direct investment through economic policy. Both national and European policies should focus on the problems of the dual economies in the less developed member states and the development of an internationally competitive domestic economy to bridge the current productivity gap between foreign and domestic companies. The global crisis also necessitates some changes to the concept of integration.

The crisis that broke out and struck in waves brought to the surface, not only the consequences of the shift in the hub of world economic development, and the structural problems of the European economy, but also the differences in the capabilities, governance and approaches that existed between "Eastern Bloc" countries that joined the EU later (the "EU-10"), in addition to the differences that had already existed between this group and the older members of the European Union. From this perspective, *Árpád Kovács* reviews the common features of, approaches to, and differences in public finance among these nations.

Gábor Dávid Kiss and *Andreász Kosztopulosz* address the impacts of the crisis on monetary policy in three Central-East European countries, Poland, the Czech Republic, and Hungary. They analyse the euro-zone's daily bond and currency benchmark's impacts on their Czech, Hungarian and Polish counterparts between 2002 and 2010. They also examine the impact of monetary policy changes by the US Federal Reserve and the European Central Bank (ECB). Despite the fact that the Central-East European countries follow an ECB-compatible monetary policy; their fundamental differences resulted in increased risk premiums on extreme days. This risk premium represents increased losses given unfavourable events, while the ECB's and the Fed's monetary expansion has a limited impact on the Central-East European countries. As EU members, these countries are required to maintain the free movement of capital and allow the application of various financial innovations and will have to introduce the euro in the future. The authors conclude that they have to follow an inflation-targeting monetary policy but also need to improve their institutional capacities to substantially increase their focus on financial stability and regional cooperation.

The crisis in Greece remains the focus of the attention of researchers and analysts worldwide. Although several alternative explanations of the causes and implications of the crisis in Greece have been produced, the literature lacks a focused discussion on the role of fiscal policy in addressing the crisis. Against this background, *Anna Visvizi*'s objective is to dwell on the question of how the crisis in Greece was addressed and – in this context – how to conceive of the specific role that fiscal policy played in the process of addressing Greece's fiscal imbalance.

In recent years, Hungarian economic policy has been the focus of international interest. Having played a leading role in the 1990s, Hungary now lags behind due to public and private sector indebtedness, which is well documented in the literature. *Péter Mihályi*'s study analyses one other important, but less understood cause of the economic slowdown: the productivity of domestic enterprises remained low. The country lacks large-scale enterprises, which maximise worker output through economies of scale and scope. Thus, there is a need for a concentration of ownership in fixed capital, as well as in natural resources (e.g., agricultural land and forests). Such a strategy would require, first, a rapid consolidation of micro- and small enterprises into transparently functioning medium-sized and large firms.

These monographs present a comprehensive picture of the different aspects and levels of the crisis. The studies not only confront us with serious challenges but also offer potential solutions.

—The Editor

CHAPTER ONE

PERSPECTIVES OF GROWTH

Europe in Crisis: A Lost Decade or Stronger Future?

Fabian Zuleeg

1. Introduction

Europe has been battered by the global financial and economic crisis, which has turned into a sovereign debt crisis that is not only threatening the Economic and Monetary Union and the common currency of the 17 countries of the euro zone, but the whole European integration process. In this immediate climate of crisis, requiring ever-greater political and economic sacrifices to keep all countries within the euro zone, too little attention is being paid to the long-term challenges Europe faces.

Europe is facing a daunting set of challenges, which will require significant reforms to maintain Europe's economic and social model. Dealing with climate change, population ageing, increasing inequality, rising unemployment, resource scarcity and global competition will require a deeply rooted change in how Europeans live. Furthermore, these challenges are being aggravated by the crisis, and the sovereign debt crisis will limit what public money can do in future years. Europe will need to get used to a very different world, which is characterised by trade-offs and sacrifices.

2. Is the European model special?

To assess the threat posed by these long-term challenges, including the long-term impacts of the current crisis, we first have to determine what makes Europe special. What makes the European model uniquely European?

The first and striking issue that can be observed is, of course, that there is significant diversity. Even on a very broad macroeconomic level, many have classified Europe's economies and social systems into different categories, for example, into a Nordic, a Continental, an Anglo-Saxon and a Mediterranean model, all with separate characteristics (Sapir 2006). The accession of the formerly centrally planned Central and Eastern European countries has, if anything, made the diversity even wider[1], also adding countries with significantly lower Gross Domestic Product (GDP) per capita than in the previous European Union (EU).

However, even this broad categorisation can easily be called into question. For example, where do countries such as France, which arguably share some aspects of both the Mediterranean and the Continental model, belong? Do all Nordic countries share a similar economic policy approach? The euro crisis has also shown that rather than increasing convergence, which arguably was the case in the pre-crisis period for countries such as Poland, Ireland and Spain, we are facing a period of fragmentation, with some countries falling further and further behind.

Looking at this evidence of continuing diversity and divergence, it could be concluded that there is no such thing as a European model. There are, however, clear indications that such a European model exists. This is more apparent when looking at the situation from the outside and in comparison to the rest of the world.

A case in point is the size and role of government. Typically, the European model entails a larger government sector with comparatively high public spending. Government expenditure stood at 49.1% in the EU-27 in 2011 (Wahrig and Gancedo Vallina 2012), compared to the OECD average total outlays of 43.2% (OECD 2012). This level does not necessarily mean high public deficits: some countries with the highest levels of public spending have sound public finances, while other countries with low public spending have significant deficit problems.

There are typically two reasons for the high level of public spending: a relatively generous social net (social security) and the provision of universal public services (for example, health and education). This pattern of public spending reflects the values of Europeans: while there is a belief in the basic principle of a capitalist market economy, there is also a strong notion that the “US-style” free market capitalism has to be tempered by the state. In essence, the preference of Europeans is for what is termed the “social market economy” or the “welfare state.” In recent decades, Europeans' concern for social issues has been complemented by a strong emphasis on environmental concerns, including combating climate change.

The European model is thus closely aligned with the concept of sustainable development, with economic growth complemented by social and environmental protection. This concept is reflected in the debate at the European level about whether Europeans need and should forego a certain

[1] Beáta Farkas (2011) argues that there is a separate model for Central and Eastern Europe.

level of economic growth to maintain high levels of environmental protection (by reducing resource consumption) and social cohesion (by reducing incentives for profit-making through redistribution). This, in part, reflects the high standard of living that has already been reached across the EU. However, we should also note that for those countries where incomes are lower, more emphasis is generally put on economic growth and competition between individuals as an important driver for the economy.

The general concern for sustainable development is integrated into policy at the European level, which in turn reinforces a pan-European model. By emphasising the protection of the environment and of workers, the EU has created a pan-European standard, which in turn defines Europe's unique economic, social and environmental model. Because accession to the EU requires acceptance of the existing legal framework (the *acquis communautaire*), the EU also effectively transfers these values to new members.

3. Europe's long-term challenges

Over recent decades, the Member States of the EU have increasingly felt their economic, social and environmental model to be under threat by a range of global and European long-term challenges.

3.1. Globalisation

One of the key challenges arises from Europe's apparent ambivalence to the globalisation process. Europe is clearly one of the key beneficiaries of globalisation: European economies are among the world's greatest traders and have managed to raise their standards of living significantly through integration into the global economy.[2]

However, in recent years, for many Europeans the threats from globalisation have come more to the forefront, be it culturally, through the movement of people, or through intensified competition. Increasingly, there is a perception that Europe is not keeping up with its key competitors: neither with the more developed economies, such as the US, that manage to outpace European productivity developments through innovation and entrepreneurship, nor with the developing countries that have far lower wages. In both cases, the fear persists that higher European

[2] See for example the argument made by José Manuel Durão Barroso (2008), President of the European Commission, referring to Daniel Hamilton and Joseph Quinlan’s book “Globalization and Europe: Prospering in the New Whirled Order”.

taxes, as well as higher social and environmental standards, reduce the ability of Europeans to compete.

While this argument has to be taken with a large pinch of salt – after all, many European countries have competed very effectively for a long time, and the overall European trade position is close to balance – this poses a significant challenge to Europe's approach to globalisation.

First, global competition emphasises the need for quality of public spending. If public spending is simply an additional cost, the EU is unlikely to retain its competitive edge. If the spending helps to increase Europe's productivity and economic capacity, for example by increasing human capital and necessary infrastructure, it can add to the overall performance of an economy.

Second, there is a significant challenge for low-skilled jobs that can be outsourced to emerging economies. This threat is not for low-skilled jobs per se – there are many jobs that are difficult to outsource, for example in the area of personal care. However, in sectors where it is easy to transport the final product, such as basic manufacturing, labour-intensive industries tend to migrate to lower wage cost countries. This can create persistent long-term unemployment, especially for low-skilled workers.

Third, globalisation and especially global competition can put intense pressure on companies to consider their cost basis carefully, potentially relocating or investing in countries with lower taxes, reduced environmental and social standards, or a faster growing market. Companies that do not adjust to the reality of global competition will eventually have to close down.

Together, this adds up to a significant challenge to Europe's economic and social model. Economies characterised by high public spending without the resulting increase in productive capacity, long-term unemployment problems, a complex and bureaucratic business environment and low investment will struggle to maintain their highly valued lifestyles. While some European economies can concurrently maintain their economic and social model and retain their competitiveness, others struggle.[3]

3.2. Resource competition

Globalisation is also aggravating the global resource challenge. Economic progress still relies on increased consumption of natural

[3] In the global competitiveness index, Northern and Western European countries dominate the top 10 with Sweden (3rd), Finland (4th), Germany (6th), the Netherlands (7th), Denmark (8th) and the United Kingdom (10th). In contrast France is only 18th, and Greece is down to 90th (World Economic Forum 2012).

resources. The increased demand from the growing middle classes in countries such as India and China is creating a strong upward pressure on prices for all resources. While the economic crisis is, to some extent, reducing demand and thus the upward pressure on prices, this relief is only temporary.

This upward pressure on resources will most obviously affect energy, in particular oil, but will also affect energy sources such as coal that were less affected in the past. The types of price spikes observed just prior to the crisis, which were intensified by conflict, are likely to recur. This then affects all of the economy because input prices are higher, leading to inflation and lower growth, but also higher food prices. This development is mirrored by other resources, such as minerals, commodities or rare earths. In particular parts of the world, there will also be an increasing pressure on water resources.

For the EU countries, this resource competition will limit the growth potential and increase inflationary pressure. Given that growth rates are significantly lower than in emerging economies, the EU provides fewer economic opportunities, which will make it increasingly difficult to access the resources that are needed. While it is undoubtedly true that emerging and developing economies will be even more affected, this provides little comfort for the EU.

In addition to physical resources, there will be intensive competition for human resources, especially in relation to scarce, superior and soft skills (Collett and Zuleeg 2008). To attract these types of skills in the future, European countries can no longer rely on passively attracting immigrants and filtering out those that are considered desirable. Rather, European countries will have to actively compete for these migrants.

3.3. Increasing inequality and rising unemployment

Migration and the increasing diversity of Europe's societies have undoubtedly contributed to Europe's economic success in the post-World War II period. However, increasing diversity has also created longer-term issues that are difficult to resolve. In particular, the integration of some of the migrant communities has proven difficult, with many children from migrant backgrounds underperforming in education and, subsequently, being insufficiently integrated into the labour market. This deficiency perpetuates social integration problems for these communities.

However, the problem of inequality does not only affect migrant communities. While recent decades have led to an increase in living standards for many, there has also been a persistence of disadvantage for some groups. The impact of globalisation noted above can make it difficult to reintegrate the long-term unemployed into the labour market, frequently resulting in low aspirations being transmitted to future generations. In recent years, inequalities in Europe have been rising, a problem likely to be aggravated by the economic crisis (European Trade Union Institute 2012).

There is an on-going debate in Europe regarding how far inequality affects economic performance and imposes costs on all of society.[4] However, having groups in society that are permanently excluded clearly adds a burden to social protection systems. And given Europe's demographic profile, Europe cannot afford the long-term costs associated with under-utilised human resources.

3.4. Demographic change

Demographic change, in particular the combination of low fertility and increasing life expectancy, will have a profound impact on European societies. While the demographic projections differ significantly between countries, the common feature for European countries will be population ageing: “Population ageing is undoubtedly going to be a key demographic challenge in many European countries over the next fifty years” (Lanzieri 2011). This development will have a transformative impact on European society, which is hard to appreciate in its entirety.

Of course, migration can have a mitigating impact. However, the scale of migration that would be needed to reverse population ageing is very high: “In order to prevent a decline in the working-age population, the annual number of migrants would need to nearly double compared to recent experience” (UN 2001). In any case, it would only be a temporary fix because migrant populations also tend to age at similar rates once integrated.

There are clearly challenges from population ageing that affect the welfare state. There is increasing pressure on health, care and pension systems, while, at the same time, the ratio of those paying into the public system to those receiving support is reduced. The obvious way to address this issue is by altering public support systems, for example by increasing the retirement age. However, this in and of itself is not enough, even if it was widely accepted as a step in the right direction. It is crucial to ensure that changes to entitlement increase the propensity of individuals to stay in the labour market; for example, apart from a potentially small reduction in

[4] With significant debate triggered by the publication of Wilkinson and Pickett (2009).

public support costs, there is no gain if people, instead of retiring, become unemployed.

Keeping all groups engaged in the labour market (i.e., the elderly but also other groups with a tendency to drop out, such as those with caring responsibilities, a migration background or with health problems) is the key to addressing the impact of population ageing.[5]

Higher labour market participation also addresses the challenge of growth: an ageing population would automatically reduce the growth rate unless counteracted by such a development. But achieving higher labour market participation is a significant challenge, especially in light of the difficult labour market situation across Europe with unsustainably high unemployment in many countries. Once again, the current crisis is aggravating the long-term challenges Europe faces.

3.5. Climate change

One final challenge Europe faces is truly global in nature: how to mitigate climate change and how to limit global temperature increases. The challenge of dealing with climate change is, however, qualitatively different from the other challenges noted above, which makes finding a policy solution even more difficult.

Why is climate change different? The key reason is that whatever Europe does with regard to its own emissions will have little impact on the overall picture. The growth in the emission of greenhouse gases takes place clearly outside of Europe, with the biggest increases in countries such as China. While higher emissions in these countries are driven by an understandable desire to create economic growth in emerging economies, it does aggravate the climate change challenge: even a reduction of emissions in Europe is quickly outweighed by developments elsewhere. In addition, the other major historical perpetrator of emissions, the US, is showing little leadership or motivation on this issue.

These issues lead some to conclude that Europe should give up on attempting to combat climate change and just adapt to its effects while ignoring our global responsibilities. However, this is a very negative agenda with the obvious drawback that it could result in the destruction of the global climate system. A more positive approach is to develop Europe as a positive example of how environmental sustainability can be combined or even drive economic growth. Such a green growth scenario

[5] The European Policy Centre (EPC) has developed the Labour Market Adjusted Dependency Ration which clearly shows the combined impact of labour market participation rates and ageing populations (Guerzoni and Zuleeg 2011).

might well become the standard that other countries aspire to, but it is difficult to implement. It is a slow process because of significant political and economic transition costs, and it has yet to receive the genuine backing of member states. And once again, the crisis is also hindering this process, with many arguing that now is not the right time to be too ambitious and that we should rather focus on jobs, even if this means that the long-term transformation is delayed.

4. The crisis: from bad to worse

The economic and financial crisis, which has battered Europe over the last three years or so, has aggravated these long-term challenges and has added some new and pressing issues that need to be tackled, not least the unsustainable public debt situation in many European countries. The crisis should thus not be understood as a cyclical downturn from which Europe will emerge unscathed. Rather, it is a deep-seated structural crisis that will profoundly threaten Europe's economic and social model. While the overall impact will crucially depend on how policy reacts to the crisis, it is already clear that the on-going transformation will impose significant transition costs on all of Europe.

The first issue the EU will have to address is the aggregated growth crisis. The long-term challenges noted above have already tended to reduce Europe's growth rate. While policy can do much to reduce this impact, overall it remains a challenge to have strongly growing economies when faced with low-cost global competition and an ageing workforce. The unsustainable public debt situation in many countries further aggravates the situation: fiscal consolidation implies lower government spending, which will tend to reduce growth rates.

Dealing with Europe's aggregated growth crisis is tricky at the best of times. Even before the economic crisis hit, European attempts to reinvigorate the EU economy were less than convincing. At first, European worries were raised by competition from the US, driven by impressive increases in productivity, and, subsequently, by competition from the emerging economies, led by China. The Europeans responded with a European growth strategy, the Lisbon strategy, aiming to generate growth and jobs in Europe. However, despite some revisions over time, the strategy lacked decisive implementation tools. Consequently, while some countries in Europe made great advances, others continued to lag behind. Even before the crisis hit, it was clear that the Lisbon agenda had not significantly shifted the EU's growth performance.

The revised version of the Lisbon strategy, Europe 2020, contains some provisions that will, in principle, drive implementation more strongly, including, for example, provisions to link any European money to the strategic objectives in Europe 2020. There are also moves to develop the single market further, for example by creating a digital single market for Europe's citizens. There are also some attempts to address the impact of the crisis, for example by making credit or alternative financial instruments more widely available. While these are important initiatives, which, if implemented,[6] can have an impact on Europe's long-term growth rate, they are in themselves insufficient.

5. Divergence, not convergence

The solutions for the aggregated growth crisis also have the potential to aggravate Europe's other growth crisis: the increasing gap between the good performers and those lagging behind. The measures noted above, such as a better functioning single market, tend to benefit most those countries that have an economy geared towards trade. In a world of scarce and expensive capital, investments will go to the countries that are performing better.

In the pre-crisis environment, it looked easier: private capital would flow to the peripheral countries, often generated by high savings rates in countries such as Germany, and public spending could be financed cheaply. Now, however, neither of these routes is open to the countries in crisis. Global investors will avoid crisis countries, not least because of the political and economic uncertainty such a crisis brings. In the current climate, the risks outweigh the possibilities of making returns. The reality is that crisis countries will need to receive support from those performing better. True, there is already significant funding being provided to prop up banking systems and to help governments that struggle to finance their public debt at reasonable rates. However, the crisis countries will also need support to encourage private investment and enable public investment, for example in education (Zuleeg and Emmanouilidis 2011).

The need of the crisis countries for investment and growth also needs to be reflected in the reform programmes the crisis countries have to implement. One of the great paradoxes of the crisis is that fiscal consolidation tends to reduce growth, but without growth, fiscal consolidation becomes near impossible. Europe's approach to dealing with

[6] The EPC's (2012) Digital Single Market project estimates that completing only this aspect of the Single market would add at least 4% to EU GDP by 2020.

the euro crisis in the absence of positive external growth impulses is thus doomed to failure: not only is the fiscal consolidation not working, the political constituency for further reform is continually weakened. In the medium term, many electorates will question the purpose of reform: is it to help the weaker economies to improve, or is it just a means to preserve the euro? In either case, the perceived pain of reform is likely to outweigh the benefits.

The recent summit in Brussels made some moves in the right direction[7], for example by redirecting unused structural funds to the crisis countries and by enabling the European Investment Bank (EIB) to expand its lending operations. However, overcoming the growth divergence between the better performing countries and those in crisis will require significantly more action, for example by developing new financing mechanisms, providing guarantees for private sector investments and by redesigning the European budget (Zuleeg 2012).

There is, however, little apparent appetite in Brussels for continuing in this course of action. Providing the current help for the crisis countries is already observed as stretching what citizens can bear. There is also concern about the potential moral hazard involved. If the crisis countries receive this support, will they not just fall back into bad habits? Many also note that the countries most affected by the euro crisis are not the only ones that need support. Countries outside the euro zone are also suffering, and the Central and Eastern European accession countries are still relatively poor when compared to the EU average GDP.

6. Prospects: stagnation and imbalances?

Europe's long-term challenges, together with the impact of the crisis, are putting European countries in a very difficult situation. It can be argued that Europe is facing a “perfect storm” with all the negative impacts reinforcing each other, potentially destroying EU citizens' faith in their trusted system and, thus, potentially destabilising Europe's economic and social model and the European integration process. If no sustainable solutions can be found for the challenges arising from globalisation, population ageing, resource scarcity, rising inequalities and climate change, and if the aggregated growth crisis and the divergence of the crisis countries from the better performing ones continue, it is difficult to see how Europe could emerge from its current economic doldrums.

[7] See European Council (2012) which introduced a “Compact for Growth and Jobs.”

Europe might then be facing a situation similar to Japan, with a long-term decline. This does not necessarily imply a dramatic collapse, but the European economy would lose dynamism and be left behind. In the longer term, this would also mean falling standards of living and a state that can no longer play the role of providing public services and social protection for all.

However, the situation in Europe could turn out even worse, given Europe's complexity. Europe is not one country, but 27 (soon 28), with very different prospects and needs. A sluggish European economy also means that the catch-up process for the Central and Eastern Europeans would significantly slow down. There would be increasing imbalances within the euro zone. Some countries would try to shield their social market economy from the turmoil elsewhere, for example by limiting free movement of people, while others would struggle to provide even the most basic services. All in all, this does not look like a situation that would be to the benefit of Europe's citizens: disintegration and perpetual crisis. Indeed, the core fabric of the European model would be threatened.

So what can be done? Policy can still have a decisive role to play if it can activate Europe's assets. However, this cannot be accomplished with traditional policy approaches. Adapting to the long-term challenges and the crisis will require systemic change. To rescue Europe's economic, social and environmental model – the very essence of the European project – it will not only need to be altered but also reinvented. Only if public services are an asset to economic growth, for example by effectively activating all those outside the labour market, can the system become truly sustainable. Europe's economic and social model must be a competitive factor in our relations with the rest of the world, helping us to develop new growth and employment patterns and attracting the best talent from across the world. If this crisis is to be taken as an opportunity for fundamental reform, it might well lead to the eventual re-emergence of European strength.

This vision relies on an ability to carry it out. However, many countries in Europe have already lost this freedom of movement, or they never had the resources in the first place. So transforming Europe's economic, social and environmental model depends on joint EU action. Individual countries can do a great deal, but the high degree of interdependence and the need to show solidarity with those who do not have the means to carry out this process makes a pan-European approach a necessity. The crisis also aggravates the following need: solving the euro crisis must be an essential part of the way forward and can only be accomplished by moving forward together, towards a 'more Europe' solution.

Such fundamental change in Europe cannot happen without engaging Europe's citizens. We are no longer talking about some institutional change at the European level, which citizens hardly care about and are even less likely to understand. We are talking about the whole direction of the European integration process, and we are talking about the fundamental nature of the economic, social and environmental model and how it can be revitalised and preserved.

Europe's leaders must explain these fundamental choices to their citizens and sketch out a positive way forward. Without such an open debate around Europe’s future, we will face growing imbalances and economic stagnation. The technical resolution of the euro crisis and even the challenge of current youth unemployment are only elements of this wider question. The future of the EU's economic, social and environmental model should take central stage in the current debate.

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HOW TO ACCELERATE GROWTH IN EUROPE?

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1. Introduction

Most people would likely agree that Europe suffers from a growth slowdown. The GDP growth in Europe has lagged behind the GDP growth in the US and has been far worse than the GDP growth in the Newly Industrialized Countries, particularly China (cf. Figure 2-1 for the US-Europe comparison). Quite clearly, there is a declining trend in economic growth rates for Europe during the post-WWII period; although there are substantial growth differences among European countries, the overall trend is similar for all of the EU countries (Figure 2-2). During 1998–2011, GDP has grown by 1.7% annually in EU-27 and 1.5% annually in the euro-area. Moreover, these numbers are misleadingly high, given that in most EU/EMU countries, fiscal expansion exaggerates the true equilibrium growth rate.[1] The growth prospects appear no better for Europe; the estimates of annual GDP growth for the near future are in the one per cent range, and the long-term prospects are sometimes even worse due to poor demographic developments (see Figure 2-8 for several extreme examples).

However, what is the reason for slow or rapid economic growth? Growth theory does not provide us with a clear answer to this question. To phrase this conclusion in a different manner, the story is far from simple, as one may agree after consulting, for example, Acemoglu (2009). The classical Solow model states that it is (exogenous) technological progress that can keep output growing in the long run (in the short run, capital deepening can also produce output growth; however, diminishing returns will eventually make increased capital impotent). The new growth theory provides a somewhat more optimistic perspective for growth policies. However, alternative versions of this new growth theory generate different

[1] See, e.g., Snower et al. (2011) for an illustration of how to compute the impact of unsustainable fiscal policy on output growth and obtain an estimate of the corresponding equilibrium growth path.

recommendations. In particular, according to the AK model, the way to sustain high growth rates is to save a large fraction of GDP, a portion of which will find its way into financing a higher rate of technological progress and thereby stimulate faster growth. By contrast, the Schumpeterian view states that innovation and therefore productivity growth and convergence can be fostered by the following measures: better protection of (intellectual) property rights, which improves the extent to which successful innovators can appropriate the rents from their innovations; better financial development, which provides easier financing of new and innovative ideas; a higher stock of educated labour, which improves the ability of individuals either to imitate more advanced technologies or to innovate; and macroeconomic stability, which ensures low (risk-adjusted) equilibrium interest rates and encourages individuals to engage in long-term growth-enhancing investments (cf., e.g., Aghinon and Durlauf 2007). These recommendations are sensible, and to a certain extent, they are incorporated into the various programs that have been created to stimulate growth in Europe (cf., e.g., EU Commission 2010).[2] However, the recommendations are rather abstract, and it is not easy to quantify the importance of different factors for the growth process.

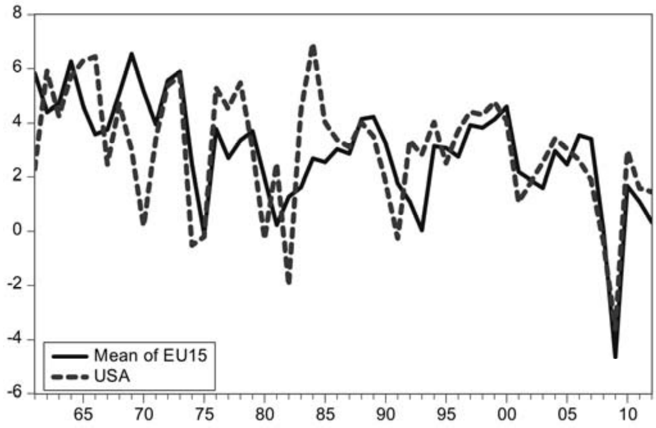

Fig. 2-1 GDP growth rates in the EU and in the US
Source: AMECO database

[2] The Commission program attempts to incorporate all possible issues, and therefore it produces results that are not very concrete but are instead a collection of aims and intentions.