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Charting Ways Out of Europe's Impasse – A Policy Memorandum

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The European Union has reached a critical juncture in dealing with the fallout from the 2008 financial meltdown that started in the USA and spread to engulf banks and the financial markets of Europe. The ensuing recession or stagnation in many member countries was compounded by austerity programs undertaken by national governments, in some cases as a pre-condition for rescue from potential bankruptcy. Europe's leaders took initiatives to strengthen financial systems but have been unable to secure a significant recovery of the European economy or avert growing divergences between member states in GDP per capita, unemployment rates and external-account balances.

This memorandum written by participants of a 3-year research project on Europe and the world's socio-economic future to 2030 (the AUGUR project) discusses possible ways out of prolonged stagnation and low growth. The current trajectory can trigger renewed crises of political-economic sclerosis in Europe and progressively undermine social standards and well-being. Such an outcome would strengthen the forces that aim to dismantle European integration. An overriding priority must be given to rebalancing the distribution of growth between different parts of Europe. Policies in R&D, competition and external trade must be reassessed with these objectives in view. EU finance for social programmes in lower-income countries is needed to support improvements in education, health and other public services that benefit social cohesion thereby securing the foundation for higher productivity and competitiveness.

Keywords: policy memorandum, Europe, European integration, location policies

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Foreword[1]

The European Union is a new form of internationalism whose successes and failures are important to all parts of the world. Having evolved step by step over decades, the European Union now includes nearly all European countries and provides a framework of legislation, institutions and policies covering a wide range of economic, financial and social issues.

But in recent years the Union has reached a critical juncture in dealing with the fallout from the 2008 financial meltdown that started in the United States and spread to engulf banks and the financial markets of Europe. The ensuing recession or stagnation in many member countries has been compounded by austerity programmes undertaken by national governments, in some cases as a precondition for rescue from potential bankruptcy. Europe's leaders took initiatives to strengthen financial systems and provide safety nets but have been unable to secure a recovery of the European economy or avert growing divergences between Member States in GDP per capita, unemployment rates and external-account balances.

This Memorandum, following a three-year research project on Europe and the world's socio-economic future to 2030 (the AUGUR project, see footnote 1), discusses the economic and political problems and possible ways out of prolonged stagnation and low growth. In the following pages we review the present impasse and long-term consequences in order to explain policy choices that could re-launch Europe on a mutually beneficial sustainable development path.[2]

[1] The authors of this Memorandum cooperated in the AUGUR project (Grant No. 244565) funded by the European Union's FP7 programme which brought together six research groups in Europe and associates in China, India, South Africa and Brazil to examine prospects for Europe and other parts of the world under alternative hypotheses about patterns of governance in Europe and the world as a whole. The project covered many fields including economic growth, demography, migration and employment, finance, trade, energy, climate change and indicators of well-being using the CAM global macro-model to review developments since 1970 and construct scenarios to 2030 under different assumptions about governance systems and policies in Europe and other parts of the world. Tables in this paper use updated CAM estimates and scenarios with additional country-level breakdown for Europe. A book entitled *Challenges for Europe in the World, 2030* (published by Ashgate, May 2014) presents a set of synthetic research papers from the AUGUR project. For further research output see also www.augurproject.eu.

[2] Our thanks are due to Summerhall at Edinburgh for hosting a three-day meeting in July 2013 at which we began the work on this Memorandum.

The impasse

Economic stagnation is now endemic in Europe in the aftermath of the recession that followed the 2008 financial crisis. Responses to the crisis have thus far focused on financial issues. European leaders averted the collapse of banks and bankruptcy of member governments by organising emergency financial support. New frameworks for regulation of banks and other financial institutions were introduced in parallel with efforts in the United States and other high-income countries. But measures to bolster financial stability have not been adequate to launch a general recovery of growth and investment in Europe. Unemployment remains high while government services and social benefits are being cut in most countries. Budget cuts have depressed spending without achieving long-term reforms in public finances, nor have they been effective thus far in reducing government debt relative to GDP. Debt ratios can be expected to fall gradually but the adjustment will be a long painful process and countries in Europe will share the cost directly via depression of their trade and investment.

AUSTERITY PROGRAMMES

In 2009, recalling the experience of the 1930s, governments of the G7 agreed to implement spending increases and tax cuts to stimulate the global economy in the aftermath of the 2008 financial crisis. Many middle- and high-income countries around the world responded to this call. The concerted fiscal stimulus was successful in limiting the extent and duration of the fall in world trade, and exports and output started to grow again in most countries in the second half of 2009. However, stimulus measures added to the cost of bank rescues, pushing up government debt suddenly and by large amounts. Subsequently, in 2010-2012, as a sovereign debt crisis emerged, economic growth faltered, and borrowing costs for several euro area governments increased dramatically. Some governments were plunged into funding crises from which they required immediate rescue. Others introduced austerity programmes in order to reduce the risk that they would incur high borrowing costs in future.

The switch from stimulus to austerity in the United States and Europe dampened recovery of consumer spending, investment and trade on both sides of the Atlantic. In this process the lessons of the 1930s were, it seemed, put on one side. The determination of leading governments to prevent further financial crises in Europe, evidenced by the establishment of the European Stability Mechanism (ESM), has calmed financial markets but has not generated a general recovery of investment and economic growth in Europe.

Between 2010 and 2012 growing exports to other parts of the world helped Germany and other countries in the North and East of Europe escape, to some degree, the stagnation that gripped the indebted countries in South and West Europe. Lately these more successful countries have been affected by the malaise gripping the rest of Europe, where GDP has fallen substantially. Imbalances between the more successful and less successful countries have increased based on widening gaps in income and productive potential. Meanwhile, within many European countries, there has been a rise in income inequalities, which had begun with the liberalisation of economies in the early 1980s. In this Memorandum, we do not deal directly with this latter issue.

FINANCING THE SOCIAL STATE

One of the main pillars of economic and social development in Europe has been what may be termed the social state, which provides health and education services, social security benefits and pensions to support an inclusive pattern of economic development and improved living standards. Austerity policies have reduced funding for government services and benefits, raising doubts about the future of the social state in many parts of Europe.

For highly competitive countries with growing exports, balanced budgets can be a safe option. Export-led growth increases tax revenue and can maintain budget balance without the need for cuts in expenditure. In a growing export economy, governments, banks and businesses typically improve their balance sheets together. But in the context of an integrated European economic zone with unequally competitive trading partners, a balanced budget rule applied by all will perpetuate stagnation. Budget cuts in less successful countries cause reductions in production and income not only in countries where they are implemented but also in other countries within the region. When many countries pursue austerity policies, the internal market of the entire zone will remain depressed.

THE PROBLEM OF STAGNATION IS INTERNAL TO EUROPE, NOT EXTERNAL

In the two decades before the 2009 recession, there was substantial convergence of GDP per capita and living standards within Europe (Table 1). This trend relied in part on imbalances in trade financed by capital flows. But trends of competitiveness already began to diverge in the late 1990s and this divergence became more pronounced after 2000, especially for euro area member countries.

Table 1 / Per capita GDP relative to the European average (100)

	2000	2008	2013 est
Nordic countries	134	136	138
Germany	121	116	124
Other Western Europe	138	133	135
UK	117	119	118
France	121	113	113
Italy	113	100	94
Spain	101	102	94
Other Southern Europe	91	94	83
Poland	48	58	66
Other Eastern Europe	39	51	50

Note: ‘Other Western Europe’ includes countries such as the Netherlands, Belgium and Luxembourg and ‘Other Southern Europe’ includes countries such as Greece and Portugal.
Source: CAM estimate, October 2013. – The CAM model, which is the source for the historical data and projections in this table and others in this Memorandum, employs a simplified representation of Europe and other world regions, with small countries combined into groups. Europe as defined here excludes countries in the former USSR. A further limitation is that non-members of the EU (Norway, Switzerland, Albania and most of former Yugoslavia) are not identified separately in these tables.

Germany, having absorbed the costs of integrating the former East Germany using a special investment fund and having transformed its labour market through an increase in lower-paid jobs, held its position in export markets within and outside Europe despite a rise in the euro exchange rate against external currencies. The long-term strength of Germany's competitive position has much to do with its specialisation in capital goods and development of production networks linking to itself neighbouring countries to the East. Countries in other parts of Europe, including the United Kingdom, France, Italy and Spain, lost ground not only to Germany but also to Poland and other new entrants in the East.

Given the size of its economy, strong competitive position and current account surplus, Germany now sets the growth trend in Europe. Other countries might grow faster with deficits financed by capital inflows but their rising debt levels will limit the period over which this can happen. When the time comes to correct deficits, other countries will typically have to grow at a slower pace than Germany. Hence, if Germany grows at 1% or 1.5% per year, there will be little scope for them to improve their employment rates and output per person employed.

MAASTRICHT AND THE TREATY ON STABILITY

The euro area started life with requirements for conservative budgeting (deficits not to exceed 3% of GDP, debt not to exceed 60%), which were not generally respected by euro area governments after they had satisfied initial conditions for entry. By 2009-2010 rising levels of government debt across Europe and financial crises in Greece, Ireland and several other countries as well as the risk of a similar crisis in Spain made it obvious that a new approach was needed.

In 2012 the Treaty on Stability[3], signed by all members except the United Kingdom and the Czech Republic, reinforced the provisions of the Stability and Growth Pact. According to this Treaty, structural budget deficits (i.e., those adjusted for the cycle) should follow a defined convergence path towards a level not exceeding 0.5% of GDP (or 1% for countries with debt below 60% of GDP). This provision and other requirements such as a debt-brake rule and an automatic correction mechanism will likely be difficult to enforce in practice.

A 'macroeconomic imbalance' procedure has been instituted with annual reviews of the economies of Member States for which statistical indicators suggest problems. Under this procedure, France, Italy and the UK were all found to exhibit significant imbalances in 2012 and 2013 along with inadequate competitiveness and export performance. No proposals have been made by the Commission or the Council as to how such imbalances affecting the three largest EU economies after Germany should be remedied although their performance is being 'monitored'.

Another aspect of government responses to the 2008-2009 financial crisis and its continued impact is the introduction of new regulatory systems for banks and other financial institutions at the global level (e.g., Basel III guidelines and the Financial Stability Board) and European level (e.g., the Banking Union and Systemic Risk Board).

These regulatory systems are intended to reduce the risk of bankruptcy of financial institutions but will not provide any general stimulus to the European economy and thus might not contribute significantly to

[3] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG). The Treaty does provide an opt-out for countries that are not members of the euro area. All Member States are in principle bound by the rules of the Stability and Growth Pact whether or not they are in the euro area or have opted into the TSCG.

a recovery of investment. Tighter regulation might reduce the risk of crisis but might also tend to reduce the supply of loans and other forms of credit, or raise their cost.

It is apparent in the aftermath of the 2008 crisis that EU Structural Funds are insufficient to counteract divergent trends of competitiveness in the euro area. The primary driver of imbalances in trade and income is unequal performance in exports of manufactures, which in Europe today account for 50% of all cross-border income flows (a ratio as high now as 30 years ago). A larger share of income and jobs generated in exporting region is now taken by many types of service industries, but the main determinant of the distribution of income and employment between countries remains, in fact, the production and export of manufactures. Services and cross-border income transfers (such as profits and remittances) each account for 20% of the total while food, raw materials and fuels account for the remaining 10%.

Current trends in industrial trade favour Germany and some of its neighbouring countries as well as Eastern Europe while other countries in West Europe and in South Europe are experiencing a relative decline in competitiveness. The challenge is how to balance the needs of different parts of Europe in a context of economic and monetary union.

Table 2 / EU policies that are insufficient to generate recovery

Objective	Institution / policy	Benefit	Deficiency
Financial stability	ESM: credit to support governments or banking systems facing financial crisis	Averts bankruptcies of governments and banks	Imposes austerity packages as a condition for assistance
	ESRB and ESFS: macro and micro regulation of banks and other financial institutions and markets	Reduce the risk of financial crises that could badly affect consumer and investor confidence	These measures do not stimulate expansion of credit and investment
	EU: Treaty on Stability	Anchor for the ESM	Highly-restrictive rules for government finance
Economic growth in Europe as a whole	ECB: low interest rates and monetary easing	Reduce the cost of investment and government borrowing	Small impact on investment and consumer spending; minimum benefit to government spending constrained by the Stability and Growth Pact and Treaty on Stability
Rebalancing	EU Structural Funds	Improve infrastructure and capabilities and encourage growth of industries and services in lower-income regions	Limited budget and objectives; allocations not always taken up by national and local governments
Social protection	EU: Social Investment Package EU: Employment Package	Recommendations to national governments to focus spending priorities and policies on critical social needs	No support to help governments and partners implement the recommended policies

Similar issues confront politicians and policy-makers in every large federal system. Table 2 provides a brief overview of the policies and new institutions of the European Union in response to the crisis as well their goals and deficiencies. The rest of this Memorandum will discuss these issues more thoroughly.

WILL RECOVERY COME FROM GROWTH ELSEWHERE?

European countries experiencing stagnation might hope that recovery of the US economy and growth of emerging market economies will help stimulate faster growth. The problems are that such a trend would not resolve internal differences in competitiveness nor even provide much benefit to the EU's main exporters (such as Germany and the Nordic countries) since such benefits would lead to increased current account surpluses and a stronger euro. And such a trend would certainly not solve the problems of weaker trading partners in other parts of Europe.

OR FROM ADJUSTMENT OF COSTS?

Costs in different parts of Europe might be expected to adjust in a manner that evens up the competitive positions and market shares of each country or region. In an abstract economic model this could be assumed to happen spontaneously as wages fall in declining regions and increase in prosperous regions until there are movements of labour from low-pay to higher-pay regions and movements of production facilities from high-cost to low-cost locations that will eventually restore balance. However, cost adjustments of this kind do not occur readily or on a sufficient scale in the real world to compensate gains or losses in competitiveness because firms, employees and families have long-term mutual dependencies that contribute to high productivity but also inhibit rapid adjustment of production locations and employment.

Monetary policy might target inflation in the euro area as a whole but it cannot contribute significantly to the adjustment of relative inflation rates in different member countries. It is sometimes suggested that national policies can adjust cost trends. For example, if Germany targeted a 2% inflation rate, countries such as France and Italy should target a rate below 1%. The German government would encourage employers and unions to implement higher wage increases, pushing inflation in Germany up to 2%, while governments in other countries pressure employers and unions to limit pay increases and thus keep inflation below 1%.

There are several problems with this kind of proposal. First, leverage of governments on earnings and costs outside the state sector is at best weak, as productivity and earnings at firm and industry level are strongly affected by growth of output and restructuring. Second, wage rates are only one element in the cost-competitiveness equation. Third, widespread pay cuts in less competitive countries have negative effects on both household and government incomes that compound financial problems and stagnation of demand. Thus, it is exceedingly unlikely or impossible for current problems of imbalance and divergent competitiveness in the euro area to be resolved by wage and salary adjustments alone even if these trends do play a part.

SUBDIVIDING THE EURO AREA – ANOTHER WAY OUT?

A possible recourse that can be imagined in the event of prolonged failure of the EU to generate economic recovery in member countries is a break-up of the euro area into multiple currency areas with a 'strong' euro in the more successful countries (Germany and some neighbours) and weaker euros or new national currencies in less successful countries (other core countries in Europe and most of the periphery).

In a variant of this scenario, Germany and some partners could introduce their own ‘super euro’ in order to maintain a low rate of inflation and fiscal discipline in their own economies without insisting that the same discipline be accepted by other euro area countries. If carefully managed, this approach might reduce the degree of disruption and costs to weaker countries.

Such a managed break-up of the euro area could give greater fiscal and monetary autonomy to individual countries or groups of countries and thus provide them with the opportunity to devalue their currencies once or repeatedly in order to improve the market shares of their industries and support faster economic growth. However, there could be some clear disadvantages to such an approach, since there could be considerable short-term disruption and individual countries or blocs that devalue their currencies would have to carefully manage the movement of capital (such as through capital controls). While a managed break-up of the euro area might represent a workable option, it should probably only be considered as an alternative when a break-up of the currency union becomes an imminent likelihood.

LONG-TERM CONSEQUENCES OF STAGNATION IN EUROPE

If the European economy suffers continued stagnation over a period of one or two decades, per capita GDP might increase in Germany, the Nordic countries, Poland and some other Western and Eastern European countries, but it would grow very slowly in the UK, France, Italy, Spain, Greece and Portugal. Table 3 below provides an illustrative projection using the CAM model on the unrealistic and unattractive assumption that current policies and institutions including the Stability and Growth Pact and the Treaty on Stability are maintained unchanged through the current decade and into the 2020s. Without any major initiative to stimulate growth and investment in the European economy as a whole or provide stronger support to countries experiencing relative decline, income levels in the worst affected countries are not likely to fully recover to levels achieved before the 2009 recession. The gap between successful and unsuccessful countries would continue to widen. By 2030 the level of per capita GDP in Greece and Portugal could be half that in Germany and the level in the UK, France, Spain and Italy could have declined to around 60% of the German level.

In other words, some core EU members such as France, Italy and Spain as well as peripheral countries in Europe risk falling living standards for the majority of their population, reduced public services and social benefits, long-term unemployment and under-employment and growing social division, while the incomes and employment opportunities in Germany, Nordic countries and Poland continue to improve, albeit at a moderate pace, and accompanied by rising inequalities.

Table 3 / Per capita GDP relative to the European average without new policies

	estimate	projections	
	2013	2020	2030
Nordic countries	138	155	181
Germany	124	134	153
Other Western Europe	135	133	133
United Kingdom	118	111	92
France	113	102	86
Italy	94	92	82
Spain	94	87	81
Other Southern Europe	83	79	72
Poland	66	68	85
Other Eastern Europe	50	53	58

Source: CAM scenario N2, January 2014.

ARE THE SGP AND TSCG VIABLE IN THE LONG RUN?

The majority of EU Member States are now highly indebted in the sense that their ratio of government debt to GDP exceeds the 60% ceiling set by the Stability and Growth Pact (SGP) and their budget deficits are far in excess of the 0.5-1.0% objective prescribed by the Treaty on Stability, Coordination and Governance (TSCG). With budget cuts perpetuating stagnation, it is very difficult for governments to bring deficits down to the prescribed level and debt-to-GDP ratios will remain high or even increase for a long time to come (because of slow growth of GDP). Table 4 shows projected outcome under 'no change' assumptions. Debt ratios in most countries would remain at around their present level or increase in the period up to 2020 and decline gradually thereafter. Budget deficits would fall in the next few years in response to cuts but stabilise or increase slowly in the 2020s.

Table 4 / Government debt and deficits without new policies

	Government debt as % ratio to GDP			Government surplus or deficit as % ratio to GDP		
	2013	2020	2030	2013	2020	2030
Europe	87	86	76	-4.5	-1.6	-1.9
Nordic countries	44	49	60	1.5	1.4	0.7
Germany	80	66	60	-1.0	0.0	-0.8
Other Western Europe	74	81	77	-4.3	-2.5	-2.7
United Kingdom	93	86	80	-6.1	-1.4	-2.2
France	93	101	103	-5.0	-2.9	-3.2
Italy	131	119	100	-6.4	-2.9	-3.4
Spain	91	114	96	-9.6	-3.1	-2.6
Other Southern Europe	151	164	133	-9.8	-3.2	-2.5
Poland	67	62	45	-5.0	-1.5	-2.6
Other Eastern Europe	51	57	51	-3.7	-1.4	-1.6

Source: CAM scenario N2, January 2014.

Policies for recovery

Economic integration within Europe and more especially within the euro area has gone too far for national governments to be able to find solutions on their own. Even countries which have not joined the EU or retain their own currencies, such as the UK, Norway, Switzerland, Sweden and many Eastern European states, are too strongly linked to the European economy and financial markets to have effective independence. There has to be a European solution. But it is not so easy to conceive of one given the complexity of institutions and political relationships and wide variation in economic circumstances in different parts of the Union.

CENTRALISATION AND SUBSIDIARITY

The EU has developed step-by-step on a functional basis with Member States ceding the minimum power necessary at each step. As the number of Member States and variety of circumstances have increased, treaty provisions have become more flexible, with opt-outs and transitional arrangements for Member States that are not ready to apply new rules and policies immediately. The principle of 'subsidiarity' and an 'open method of coordination' are defining characteristics of a European approach to federalism. Ethnic, linguistic and cultural diversity, which is a strength of Europe in many respects, leads to caution regarding centralisation of power and executive decision-making.

The implication is that to recover from present difficulties and establish a robust and sustainable pattern of future development, the EU must be strengthened at the centre while differences in national priorities and institutions are recognised and stronger support for countries in difficulty is provided. Another important point is that Europe needs central institutions with effective, though limited, supranational powers in some areas. In the absence of such powers European institutions can monitor but cannot regulate the actions of member governments answerable to national electorates and parliaments.

Several new arrangements have been put in place following the 2008 financial crisis with little controversy. These include the Systemic Risk Board (bringing together central banks), the System for Financial Supervision (linking national regulators) and procedures for annual submission of budget plans and analysis of macroeconomic imbalances that provide a framework for coordinating ministries of finance. These arrangements seemed to have calmed financial markets for a while but have not made it possible for the EU institutions or member governments to stimulate economic growth and promote long-term convergence.

SUSTAINABLE DEVELOPMENT

The issue is how the European economy can recover from stagnation and establish a pattern of sustainable development in which all parts of Europe share. To make investment, high employment and the social state sustainable across Europe in the longer term it will be essential to boost aggregate spending and growth of the internal market as a whole and find ways to rebalance competitive positions in such a way that all countries share in growth of production and improvements in productivity, living standards and environmental sustainability.

The single market and currency union were justified in economic terms by an expectation that a large market and stable currency would provide the foundation for sustainable development, long-term convergence and high levels of employment. Such gains, it was assumed, would make it possible for Europe to hold its place in world markets through innovation and technical progress. It was recognised that less-developed regions and new Member States would need assistance in order to take advantage of these initiatives and catch up with more advanced Member States.

The assumption was that support from the EU's Structural Funds, plus the Cohesion Fund, would be sufficient to help countries achieve long-term convergence of productivity and living standards. Risks of transitional losses of income and employment as loss-making firms and industries closed down were recognised and it was accepted that convergence of the lowest-income countries would take several decades to achieve. But it was not anticipated that the European economy could become mired in a long period of stagnation along with divergent trends in the ability of member countries to compete, as well as rising inequalities within countries.

The immediate problem now facing the EU is that the focus on financial stability and containing government debt-to-GDP ratios makes it difficult for governments to stimulate public or private spending while the EU has no institution that can perform this task for Europe as a whole. The other longer-term problem is divergent growth trends, particularly within the euro area. Some parts of Europe are losing their place in internal and external markets. Many individual countries or regions are suffering relative or absolute decline while other parts of Europe are able to maintain or improve their position.

Sustainable recovery requires solutions for both these problems. Such solutions are not going to be generated spontaneously but will require new policies and new or increased powers of action by EU institutions and governments of Member States.

CONDITIONS FOR EUROPE'S RECOVERY

To summarise the argument so far, a development perspective in which all parts of Europe share requires:

› growth of aggregate demand (consumption, public and private investment and government services) in Europe as a whole in order to keep up with rising productivity growth and generate employment for all those who want to work;

› rebalancing of growth trends in different parts of Europe in order to provide a more acceptable distribution of employment and income across countries;

› assistance for highly indebted governments to facilitate a long-term return to normal levels of deficits and debt without imposing immediate and damaging cuts in spending.

To the above we add a fourth requirement:

› a viable pattern of trade, investment and finance vis-à-vis the rest of the world as well as within Europe itself.

The remaining pages of this Memorandum outline policies which could help to achieve these objectives in a stronger and more flexible version of the EU. The focus is on indicating the kinds of policy which are called for rather than considering in detail the precise form that they should take or how they should be implemented in practice. These are thorny questions in some of the policy areas, especially with regard to the division of responsibility between the EU and national authorities. There is also no consideration of how to overcome deficiencies in governance that could impede the practical implementation of some of the measures required in a number of Member States.

GDP GROWTH AND CONVERGENCE

How much economic growth is needed to provide adequate employment and allow lower-income regions of Europe to catch up over the next two decades? Table 5 shows a rough estimate for Europe as a whole, with a breakdown by country or country group in Table 6.

Table 5 / Average growth rates of employment, productivity and GDP

Europe, all countries (% p.a.)

	1998-2007 actual	2008-2013 estimated	2014-2030 for convergence
Labour supply	0.6	0.3	0.6
Employment	0.9	-0.4	0.9
Productivity	1.3	0.2	1.8
GDP	2.2	-0.2	2.7

Source: CAM scenario N1, January 2014.

These calculations interpret convergence in terms of

› increased labour force participation along with improved opportunities for women and the elderly to work;

› unemployment coming down to a range between 5% and 8% in each country; and

› productivity in all countries below Germany's level catching up to it.

Productivity is measured here by aggregate output per person employed (full or part-time). This indicator reflects the pattern of business, work organisation, resources and infrastructure as well as technical efficiency and production methods.

In order to satisfy convergence objectives, Europe needs to achieve aggregate GDP growth of at least 2.5% per year. Labour supply will increase primarily on the basis of the rising participation of women and the elderly. Employment needs to increase by nearly 1% per year to accommodate the increase in labour supply and bring unemployment down to pre-crisis levels. The average level of output per person employed in Europe as a whole needs to increase by nearly 2% per year to lay the basis for convergence of productivity.

Table 6 shows indicative GDP growth rates by country or country group and the implied pattern of output per person relative to Germany, where productivity growth is assumed to average 1.5% per year and a very small increase in employment is assumed.

Table 6 / GDP growth and convergence

	2013	2014-2030 average growth rates		2030
	Productivity	Employment	GDP	GDP per capita
	% of level in Germany	% p.a.	% p.a.	% of European average
Europe	93	0.9	2.7	100
Nordic countries	112	0.3	1.2	104
Germany	100	0.1	1.7	108
Other Western Europe	112	0.6	1.4	106
United Kingdom	98	0.5	2.2	104
France	108	1.2	2.4	102
Italy	99	1.6	3.3	105
Spain	98	2.1	3.9	107
Other Southern Europe	84	1.4	4.1	106
Poland	62	0.7	4.4	89 [a]
Other Eastern Europe	54	1.0	4.7	76 [a]

[a] The convergence path illustrated in these countries limits productivity growth to a maximum rate of 4% per year, implying some remaining shortfalls in income per capita and output per person employed in 2030.
Source: CAM scenario N1, January 2014.

Countries in the North and West of Europe together with Spain and Italy in the South already have levels of output per person employed similar to the level in Germany. The difference is that the UK, France, Italy and Spain need faster GDP growth in order to absorb increases in labour supply and reduce unemployment. Emigration might reduce this problem to some extent but it has to be recognised that long-term cross-border emigration from core European countries to other parts of Europe has been low while opportunities to emigrate to other parts of the world are increasingly restricted.

Other countries in Southern and Eastern Europe start with lower productivity, lower labour force participation and higher unemployment. To achieve a reasonable measure of convergence by 2030, they would need GDP growth averaging 4% or more per year.

REBALANCING

The growth path in Table 6 requires a sustained stimulus to the growth of demand, trade and investment in Europe as a whole along with a more balanced distribution among countries than was achieved in the past couple of decades. A stimulus to growth without rebalancing is not likely to be workable as it would generate fast growth in some of the countries in the North and West of Europe where the level of income is already high and unemployment relatively low. But, such a stimulus might not accord with the economic priorities in these countries. Also, such a trend would not generate a strong recovery in other parts of Europe and is more likely to result in continued divergence of productivity and income.

Thus, location and industrial policies have to play a major role in counteracting divergent trends and limiting imbalances across Europe.

Although several Eastern European countries benefited from external direct investment and capital inflows before the crisis, investments were concentrated in border areas and capital cities, and it is unclear if such trends can resume in the future. More peripheral regions with trade deficits prior to the crisis experienced shrinkage of their export capacity and de-industrialisation. Moreover, as already explained, imbalances of trade and investment have begun to affect large, higher-income countries such as France, Italy and Spain, causing a negative impact on growth of the European economy as a whole.

Thus, the major objective must be to maintain or restore sufficient critical size of the tradable sector in each country to support improvements in competiveness in all regions of Europe.

EU INVESTMENT PROGRAMMES

Investment is essential to any solution to problems of stagnation and unbalanced development but investment currently remains mired at historically low levels in almost all EU countries.

In the past, EU Structural Funds and the European Investment Bank (EIB) contributed to important investments in Spain, Greece and Portugal and provided much-needed assistance to Eastern European countries. But both systems have been limited. Since Structural Funds, together with the Cohesion Fund, involve transfers from net contributor countries, these countries experience a net reduction of resources while recipient countries experience a net increase.

Moreover, the scale of funding relative to population covered has declined considerably in the 2007-2013 EU budget period compared to the previous period. Furthermore, there will be an additional reduction in the new seven-year period starting in 2014. In fact, the current reduction is much larger in less developed regions such as in Eastern Europe where GDP per person is below 75% of the EU average.

EIB provides finance in the form of loans that must be shown to be financially viable. This means its lending operations do not greatly increase resources for investment although they may help institutions that cannot easily raise credit from banks or financial markets.

Hence, new policies and funding arrangements are needed to achieve results beyond what can now be done by Structural Funds and the EIB.

We propose two methods to provide more funding. One is to enlarge the EU budget by increasing the existing value-added tax element or introducing new sources of revenue such as a carbon tax or tax on financial transactions. Such initiatives could increase the size and rebalancing effect of Structural Funds. But, since the cost is paid by Member States, it is doubtful whether the expanded budget would contribute, in aggregate, the necessary stimulus to the European economy as a whole.

The other method for increasing financial resources is issuance of euro bonds by the EU in its own name, ultimately backed by the European Central Bank. Provided banks and investors accept this approach, it is not difficult to raise large amounts of financing at low cost. EU bond issues will not impose a burden on national governments or taxpayers and can be used to finance projects in the EU's own name as well as EU participation in projects by national or local governments, state agencies and other public bodies.[4]

The vital condition for EU action to promote investment, whether via the budget or issuance of euro bonds, is political legitimacy. Voters will not support higher funding of EU programmes unless they believe the investment programmes respond to significant needs and that action at the EU level is justified.

Public investment programmes typically focus on long-term projects that cannot be readily financed on commercial terms, such as infrastructure in transport and communications, energy-saving, environmental protection, and improvement in health, education and other social facilities.

In current circumstances the principal objective at the EU level is to promote economic recovery and convergence of productivity. This implies that an EU investment programme must have a specific focus on rebalancing the pattern of growth of GDP and productivity across member countries. A programme to satisfy this overriding need on the basis of projects in areas such as those outlined above can be politically acceptable. A good example, in fact, is the investment programme in Germany after reunification.

Table 7 illustrates the scale of increases in investment as a share of GDP that might be achieved by a programme combining EU participation in a wide range of public investment programmes with location policies offering benefits to enterprises locating new or expanded production facilities in priority areas.

Table 7 / Investment as % ratio to GDP [a]

	Actual			With new policies			
	2008	2013	2009-13 change	2020	2014-20 change	2030	2021-30 change
Europe	18.6	15.6	-3.0	20.1	4.5	22.3	2.2
Nordic countries	18.1	15.7	-2.3	17.1	1.4	16.2	-1.0
Germany	17.0	16.6	-0.5	19.8	3.2	19.7	0.0
Other Western Europe	19.1	16.8	-2.3	19.2	2.4	19.2	-0.1
United Kingdom	14.5	13.5	-1.0	16.6	3.1	19.5	2.9
France	18.1	16.6	-1.6	19.7	3.2	22.0	2.3
Italy	18.9	15.6	-3.3	21.9	6.3	26.0	4.1
Spain	24.7	15.5	-9.1	22.3	6.8	27.7	5.4
Other Southern Europe	18.4	9.0	-9.4	17.2	8.3	25.0	7.7
Poland	17.7	15.0	-2.7	21.6	6.6	19.2	-2.4
Other Eastern Europe	23.5	17.9	-5.6	26.8	8.9	30.4	3.5

[a] Non-government fixed investment expenditure (including investment by state enterprises)
Source: CAM scenario N3, January 2014.

4 Jorg Bibow, 'Lost at Sea: The Euro Needs a Euro Treasury', Levy Institute, November 2013. See also the proposal for the issue of interest-bearing carbon certificates to finance investment in low carbon projects in Michel Aglietta and Jean-Charles Hourcade, 'Can indebted Europe afford climate policy? Can it bail out its debt without climate policy?', Intereconomics, Vol. 47, No. 3, May/June 2012.

By 2020, the investment rate in Europe as a whole would be higher than before the crisis and experience a further increase through the 2020s. The improvement would be largest in the convergence countries of South and East Europe as well as in the UK and France. A major change in trend in these countries, including in Italy and Spain, is needed to recover from stagnation and avert future decline.

The estimated annual cost of a programme financed by EU bond issues rises to around 1.0% of EU GDP in the 2020s, implying a cumulative total debt issue amounting to about 11% of European GDP in 2030 (Table 8). Figures for individual countries range up to 2.8% per annum or a cumulative 24% of national GDP by 2030.

The benefits to aggregate investment and GDP will be much larger than the cost of EU participation after enterprises and households see prospects in European and national markets improve and higher government revenues and private sector income generate further spending increases. The full impact on investment is estimated to be between 3 and 10 times the cost of EU participation, and the GDP benefit rises to between 10 and 20 times the cost in most countries.

The benefit would be smaller in countries of North Europe, where the positive impact of higher investment across the EU is partially offset by location policies favouring other parts of Europe.

Table 8 / Financial cost of an EU investment programme (% of GDP)

	Annual cost		Cumulative cost	
	2020	2030	2015-20	2015-30
Europe	1.0	1.0	3.8	11.2
Nordic countries [a]	0.4	0.1	1.7	2.8
Germany	0.4	0.1	2.0	3.5
Other Western Europe [a]	0.5	0.1	2.5	4.2
United Kingdom	0.6	1.4	2.8	13.2
France	1.5	1.5	5.1	17.9
Italy	1.5	1.8	5.5	19.6
Spain	1.5	2.0	5.6	17.8
Other Southern Europe	1.7	2.4	5.3	22.3
Poland	1.7	0.1	6.6	8.3
Other Eastern Europe [a]	2.8	1.7	8.7	24.4

[a] No adjustment has been made to exclude countries not currently EU members.
Source: CAM scenario N3, January 2014.

LOCATION POLICY

National and local governments have significant influence on location decisions by local, European and global firms because planning permissions, infrastructure and utilities, social services and other amenities are a vital consideration for investors. Without EU coordination, negotiation between public bodies and firms is an open competition in which high-income regions with substantial clusters of export industries have many advantages.

Structural policies alone, as they now stand, cannot influence the trend of increasing concentration of investments in strong manufacturing regions or in low-cost regions outside the euro area. Supported by Horizon 2020, structural policies can be reinforced in new fields, such as the green economy, life-science applications or agro-food initiatives. This would require the EU to enhance investments through channelling resources from existing instruments such as the employment fund and the R&TD funds. Such a change of policy implies an interpretation of the subsidiarity principle that acknowledges local supply policies in weak areas with high unemployment cannot curb polarisation of investments and growth within a globalised context of competition.

The purpose of location policy at EU level should be to improve distribution of trade and investment by promoting development in countries and regions with weak or declining competitiveness. Ideally the aim is to establish diversified linkages in each country or region, giving local economies sufficient flexibility to cope with innovation and change in both European and global markets.

In the context of a major EU investment programme targeting economic recovery and convergence, EU sponsorship of investment projects could provide new leverage for location policy if effectively coordinated with national governments and other public bodies in each Member State.

Member governments need to reach a consensus on a larger role for location policy based on the recognition that future prosperity and well-being of Europe as a whole will rely on patterns of local development contributing to an improved balance of trade and investment among European countries. The EU policy framework will have to give attention to countries as well as regions, according priority, for example, to reversal of declining competitiveness in higher-income countries as well as convergence of low-income countries. Development agencies need to be designated at national and sub-national level to negotiate projects and programmes consistent with EU guidelines.

To make location policy effective and give more space for development agencies to perform their role, it will be necessary to adjust single market rules and other EU policies such as support for research and development and external trade policy. Competition policy rules need to be revised to support new entrants and diversification rather than having a bias in favour of incumbents and must be differentiated by country to support rebalancing. Innovation and technology policies, which have been biased towards the high-tech end, must focus in future on productivity improvement in regions and industries at all levels of the technology ladder.

Other areas for action to assist balanced development include programmes to improve standards of education in lower-income regions and assistance for labour mobility between countries.

Finally, the EU needs to ensure that its negotiating position in relation to external trade agreements gives firm support to location policies that are essential to balanced national and regional development. Given the level of concern in the United States and other high-income countries about their longer-term ability to maintain growth of exports and stimulate recovery of declining regions, interest in location policy can be expected from all sides.[5]

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[5] R. H. Wade, 'Return of industrial policy?', International Review of Applied Economics, Vol. 26, No. 2, 2012, pp. 223-239.

SOCIAL POLICIES

Economic growth in itself will not necessarily achieve social objectives unless accompanied by policies to ensure it benefits all sections of society. There is no conflict between pursuit of social objectives and growth but social priorities affect the form growth takes and how competitiveness of the EU economy is maintained. The principles of 'Social Europe' are particularly important in periods of economic difficulty when governments are under pressure to cut spending by reducing transfers and social services and to promote employment growth by cutting social contributions or corporate taxation.

Employment is one of the most important factors for well-being and the one most severely affected by the economic crisis. Increased efforts are needed in programmes to help the unemployed and under-employed people to find new jobs and acquire new skills and simultaneously to help young people make a successful transition from education to work as recovery in economic growth improves job opportunities.

Even after the crisis, European countries continue to enjoy a level of well-being that is among the highest in the world, a result in part of improvements and extensions of social welfare systems over many years in conjunction with economic growth. The contribution of social welfare systems to well-being and quality of life is a distinctive feature of Europe. The importance of their role is explicitly recognised in the Treaty of the European Union.[6]

EU legislation established common principles and standards and a framework in which each national government is responsible for establishing institutions and policies for achieving them. In this way, the EU succeeded in integrating different cultures and traditions into a system in which prosperity, social cohesion and well-being are mutually inter-dependent. EU policies improved access to health, education and care for children and the elderly in low-income regions by providing additional funding for social infrastructure as well as strengthening these regions' competitiveness and ability to deliver these services.

Over the past five years or so, however, these policies came under increasing pressure as high levels of social-welfare spending were targeted for fiscal consolidation. Even before the crisis, the need to support an ageing population by providing both adequate retirement pensions and satisfactory levels of health and social services led to growing concern for the sustainability of existing systems of social protection. In many countries, in Northern and Western Europe especially, these pressures led to reforms of pension arrangements, increases in pensionable age and changes in provision of care services.

In other countries, in the South of Europe in particular, reforms were delayed when the break-up of traditional family structures intensified demand for social support provisions. Governments in some of these countries are now being obliged to make deep spending cuts to systems already failing to cope adequately in current circumstances and without sufficient time to consider the incidence and long-run effects of cuts.

In the context of a European recovery programme there is a strong case for EU support to increase resources for social programmes in Member States with relatively low per capita income, just as there is for support to help them improve competitiveness. Table 9 shows resources for government services,

[6] The Treaty of Amsterdam states that one of the tasks of the EU is to promote 'a high level … of social protection', Article 3(3).

adjusted for demographic differences between countries in relation to children, young persons and the elderly who are most in need of welfare support.

The levels today are distinctly lower in Southern and Eastern Europe than in the North and West. This implies competitive disadvantage if the result is lower educational and health standards. Our table also illustrates the potential impact of divergent economic performance in the absence of new policies with declining resources in the United Kingdom and France as well as Southern Europe.

Table 9 / Resources for social programmes.
Government spending on goods and services per dependent [a]
(2013 European average = 100)

	2013	2020	2030	2020	2030	2020	2030
	estimated	without new policies		with EU financial support [b]		policy effect [b]	
Europe	100	95	104	106	139	11	35
Nordic countries	159	180	221	182	242	2	21
Germany	112	125	157	126	173	2	16
Other Western Europe	132	123	132	124	143	1	11
United Kingdom	114	97	87	106	126	9	39
France	125	110	101	116	144	5	43
Italy	93	80	78	92	119	12	42
Spain	98	77	75	91	122	14	47
Other Southern Europe	82	68	65	80	111	13	46
Poland	67	67	97	91	135	24	38
Other Eastern Europe	48	51	62	80	111	28	49

[a] Children, young persons and the elderly plus adults aged 25-64 counted at 50%.
[b] Reflects gains from the EU investment programme discussed above as well as higher spending made possible by financial support for social programmes
Source: CAM scenarios N2 and N4, January 2014.

The Social Investment Package (SIP) proposed by the EU Commission recommends more focused policies to address current and future needs and argues that improvements can be achieved without new funding. It will be difficult or impossible, however, to avoid deterioration in service provision standards in the context of budget cuts where those providing services fear for their jobs. Moreover, while the Commission's proposed package identifies areas where spending must be maintained or increased to favour economic growth, it stops short of identifying where reductions can be made without damage to growth and social well-being.

Governments in lower-income Member States need to undertake reforms to raise incomes of particular groups and improve health services, education and care for children and the elderly. They need the help of EU funding to be able to achieve necessary levels for the well-being of all of the population and ensure a social environment conducive to improved competitiveness. Social programmes can make investment and location policies more effective. The best way to provide EU support for investment programmes is euro bond issuance by the EU without increasing contributions from higher-income countries.

Table 10 illustrates the cost of a programme to make resources available to achieve a common standard, taking account of demographics and income levels in each country. Up to 2020, the main need is augmenting resources for government services in Southern and Eastern Europe. The annual cost would be around 0.9% of European GDP and up to 8% of national GDP in parts of Eastern Europe. In the 2020s, the United Kingdom and France are likely to join the group of countries with a deficit of resources for government services while countries in Southern and Eastern Europe will require less support than before. Overall the annual cost would not change much and the cumulative cost could reach 10% of European GDP by 2030.

Table 10 / Financial cost of social programmes (% ratio to GDP)

	Annual cost		Cumulative cost	
	2020	2030	2015-20	2015-30
Europe	0.9	0.9	3.8	9.7
Nordic countries	-	-	-	-
Germany	-	-	-	-
Other Western Europe	-	-	-	-
United Kingdom	-	0.9	-	2.7
France	0.1	1.1	0.1	5.5
Italy	0.4	0.3	2.0	4.5
Spain	1.1	0.5	4.9	8.8
Other Southern Europe	2.5	1.3	10.5	23.0
Poland	4.2	1.9	20.2	36.9
Other Eastern Europe [a]	8.1	5.7	37.3	84.3

[a] No adjustment has been made to exclude countries that are not currently EU members.
Source: CAM scenario N4, January 2014.

THE ROLE OF THE ECB AND BANKS

As we have said already, it is unlikely that highly indebted governments, including those of the UK, France, Italy, Spain and other countries in Southern Europe, will reduce national debt to the EU's target ceiling of 60% ratio to GDP by 2020 or even 2030. It is also necessary to re-examine how sovereign debt can be financed to reduce risks of further economic disruption.

Targets for government debt can reassure investors, lower the borrowing costs, and keep debt servicing burdens on budgets, and ultimately on taxpayers, affordable. The 60% ratio to GDP ceiling is not in itself unreasonable. An economic recovery programme to generate higher GDP with convergence of productivity would in the long run make it possible for most or all European governments to reduce their debt-to-GDP ratios close to or below the 60% ratio. But, for the most highly indebted countries, the long run may be one or two decades away and new cyclical downturns will cause spikes in government debt in some or many Member States, as has repeatedly happened in the past.

Management of government debt and budgets has to take account of financial and economic conditions in each country, including levels of household and corporate debt, the balance of private savings and investment, and the basic balance of payments (current account plus long-term capital flows). An active lender of last resort will be required for many years to come.

Table 11 / Lender of last resort. Levels of debt (% of GDP)

	2013 estimated			2020 with new policies			
	Total	Domestic banks	Market	Total	Domestic banks [a]	Market [b]	ECB [b]
Europe	86	27	60	76	22	47	8
Nordic countries	44	5	40	46	9	37	0
Germany	80	25	55	61	12	49	0
Other Western Europe	74	17	57	77	27	50	0
United Kingdom	93	47	47	81	30	50	1
France	93	23	69	89	30	50	9
Italy	131	40	91	106	30	50	26
Spain	91	33	59	95	30	50	15
Other Southern Europe	151	34	117	137	30	50	57
Poland	67	14	53	48	10	39	0
Other Eastern Europe	51	15	36	37	7	29	0

[a] Compulsory reserve equal to 30% of GDP or 20% of outstanding government debt, whichever is the lower.
[b] Market debt includes borrowing from non-residents and international institutions; under new policies the ECB would take over debt in excess of 50% of GDP.
Source: CAM estimates and scenario N4, January 2014.

The existing European Stability Mechanism is too limited or inflexible to play this role even if conditions for assistance are adjusted to make them more realistic. One way or another, the EU's lender of last resort is and will remain the ECB, the Union's leading monetary institution. Domestic banks can reasonably be expected to hold a substantial portion of government debt as a normal rule, but in the current situation outstanding debt in several countries is too high to be funded in this way.

Table 11 gives some idea of the scale of need for bank finance and ECB support up to 2020. For example, ECB support would amount to 8% of EU GDP by 2020. But in the context of an economic recovery, the ECB's contribution might, in fact, fall away and by 2030 it could be confined to a residual holding of debt of the worst-affected Southern European countries.

EXTERNAL TRADE AND FINANCIAL FLOWS

The final issue to be considered in this Memorandum is the balance of payments between Europe and the rest of the world and the pattern of such payments within Europe. Moderate current account deficits have been financed by capital inflows and banking inflows without much difficulty and Europe as a whole usually has had a balance or small surplus. But economic recovery might change this picture, particularly if it is stimulated by domestic spending and EU bond issues.

In 2008, when the crisis hit, Europe as a whole had a current account deficit equal to 0.9% of its GDP, with very much higher figures in Southern and Eastern European countries, which were financed by capital inflows (see Table 12). The subsequent debt crisis and large reductions in spending and GDP in the deficit countries have by 2013 reduced their current account deficits to normal levels while countries in Western and Northern Europe other than the UK and France have shown large surpluses, leaving

Europe as a whole with an external surplus of around 1% of GDP. This level is near the top of the range over the past 30 years. This contrasts with that for the United States, which had very large trade deficits before the crisis and continues to run deficits (around 3% of GDP in 2013).

Even with an economic recovery led by domestic spending, the projected pattern for Europe in 2020 remains much the same as now. As the UK, France and Southern Europe continue to struggle to reduce their debt, countries in Eastern Europe will grow fast with rising imports financed by capital inflows, and other countries in the North and West of Europe will continue to maintain strong trade surpluses.[7]

Eventually, convergence policies will reduce the trading advantage of countries in North and West Europe. And continued growth of domestic spending may push the balance for Europe as a whole into deficit, increasing to 2% of GDP or possibly more by 2030. This trend would create a new situation since Europe would become dependent on net capital inflows while continuing to be a large exporter of capital to the rest of the world.

Table 12 / Balance of payments within Europe and with the rest of the world

Current account as % of GDP

	2000	2008	2013	2020
	actual		estimated	with new policies
Europe	0.5	-0.9	1.2	1.4
Nordic countries	7.6	8.0	6.0	6.4
Germany	-1.0	5.7	4.6	5.3
Other Western Europe	6.6	2.7	6.5	6.3
United Kingdom	-1.3	-0.5	-3.4	-2.7
France	2.0	-1.9	-2.6	-1.7
Italy	0.0	-3.4	-0.7	-1.0
Spain	-3.5	-10.3	0.7	0.8
Other Southern Europe	-6.7	-13.5	-1.2	0.1
Poland	-5.8	-6.4	-3.6	-4.5
Other Eastern Europe	-4.0	-10.8	-2.5	-5.5

Source: CAM estimates and scenario N4, January 2014.

The prospect of sustained economic growth on the basis of improved profitability and some increase in interest rates and bond yields could stimulate investor demand for euro assets and result in a stronger euro rather than a weaker one. Such an outcome would be welcomed by trading partners, including many developing countries. Europe would make a positive contribution to the global economy and to development in neighbouring regions rather than acting as a brake on trade and investment in the rest of the world, as it is currently doing.

[7] Since EU programmes financed by bond issues are assumed to generate capital flows, they will not directly affect current account estimates in this table.

Summing up

Without new policies, the European economy will remain mired in a state of stagnation or very low growth for many years to come. This can potentially trigger renewed crises of political-economic sclerosis in Europe and progressively undermine social standards and well-being. Such an outcome would strengthen the forces that aim to dismantle European integration.

To avoid this, it is essential to adopt concerted policies to move beyond austerity to stimulate growth of the European economy with a strong and renewed emphasis on rebalancing the distribution of growth between different parts of Europe. Table 13 summarises the various major policy initiatives that we recommend.

To stimulate employment and productivity growth, and financial rebalancing between Member States, the EU needs new financial support along the lines we recommend to be covered by EU bond issuance rising to 1.5% of GDP per year in the 2020s. This is critical to supplement what is achievable by framework policy recommendations and related actions financed by the EU budget paid currently only by direct contributions from Member States.

Table 13 / Policy innovations necessary for Europe's recovery

Objective	Policy innovation	Benefit
Growth of spending and output in Europe as a whole	EU debt issuance financing investment programmes across Europe	Higher investment spending by EU and national institutions
Rebalancing	EU location policy providing a framework for development agencies to leverage EU participation in investment programmes in regions with weak or declining competitiveness	Improve the distribution of trade, investment and GDP growth within Europe
	EU social programmes to improve standards of education, health and other public services in lower-income countries	Improve well-being, social cohesion and competitiveness
Assistance for highly indebted governments	The ECB to act as lender of last resort; domestic banks required to hold substantial reserves in the form of government debt	Enable highly indebted governments to maintain services and sustain domestic GDP while making long-term adjustments to budgets and debt positions
External trade and financial flows	Strong euro policy: acceptance of net capital inflows and moderate current account deficits	Contribute to global growth of trade and investment; improved economic conditions and security in neighbouring regions

EU participation in investment projects must be conditioned by an over-riding priority given to rebalancing, and providing leverage to development agencies, for countries with weak or declining competitiveness. Policies in R&D, competition and external trade must be reassessed with these objectives in view. EU finance for social programmes in lower-income countries is needed to support improvements in education, health and other public services that benefit well-being and social cohesion thereby securing the foundation for higher productivity and competitiveness.

The final element in a sustainable long-term programme for improving the European economy is explicit recognition that the ECB has to act as lender of last resort and that domestic banks in European countries should hold a substantial level of government debt of each country where they operate. These reforms will make financing national and local governments less dependent on volatile financial markets.

The full weight of policy recommendations in this Memorandum should have the effect on employment, productivity and GDP summarised in Table 14. Between 2014 and 2030, employment is projected to increase by 0.8% per annum and productivity by 1.8%. GDP would increase by 2.6% per annum.

Table 14 / From recession to recovery in Europe: employment, productivity and GDP

Europe, all countries (% p.a.)

	1998-2007 actual	2008-2013 estimated	2014-2030 new policies
Labour supply	0.6	0.3	0.5
Employment	0.9	-0.4	0.8
Productivity	1.3	0.2	1.8
GDP	2.2	-0.2	2.6

Source: CAM scenario N4, January 2014.

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› The elasticity of the new EU Member States’ imports: implications for external rebalancing in Europe
› State aid and export competitiveness in the EU – first results
› European financial policy, as if banking mattered (Further notes on the crisis in the euro area)
› Statistical Annex: Selected monthly data on the economic situation in Central, East and Southeast Europe

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