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Notes for Session 3 on: Europe's Periphery – longer-term consequences of the crisis

We define 'Europe's Periphery' as the set of lower- and medium-income economies including Southern Europe, Eastern and Southeastern Europe.

The crisis has revealed major problems in the 'pre-crisis growth model' of these economies (see also Becker et al, 2010): many of these economies relied heavily on massive capital inflows which often led to sustained (and in some cases explosive) current account deficits, real exchange rate appreciations beyond the predictions of the Balassa-Samuelson process, real estate bubbles (in some countries), sectoral distortions favouring non-tradable over tradable activities and the build-up of high – particularly private – debt levels.

The crisis brought these developments to an end: Net capital inflows came to an end or were seriously curtailed, current account deficits had to close (initially almost entirely through dramatic falls in GDP), banks' balance sheets deteriorated rapidly bringing about a squeeze on credit, unemployment levels rose (in some instances soared) and recoveries look very muted and protracted.

Longer-term consequences are the following: Europe's periphery will not be able to rely to the same extent on net capital imports which fuelled the growth process in the pre-crisis period. While in some countries such capital imports had distorting impacts, in others (mostly the Central European economies such as Czech Rep, Hungary, Slovakia, Poland) they were the strongest contributors to the build-up of a viable export industry, and to technological and organisational up-grading. Lower FDI flows will make it necessary to find policy substitutes for industrial and technological up-grading, essential for the build-up of export capacities to avoid structural balance-of-payments constraints. It is thus likely that countries will re-detect a stronger role for industrial, technology, regional, educational and training policies (by all means supported by European-wide policies, such as through EU, EIB, EBRD). Given the persistently high unemployment rates, there will also be scope for extending active labour market policies and learning from best-practices in this respect. Finally, the mal-functioning banking sector will have to be complemented by publicly-supported financing schemes for SMEs, to support new exporting firms etc.

The 'new convergence model' for Europe will thus have the following features:

- In general lower growth trajectories than in the decade before the crisis;
- some countries will succeed better than others to adjust to the new post-crisis environment;
- one cannot exclude that some countries in Europe's periphery will continue to suffer from weak enterprise activity, an unresolved debt legacy and chronic finance problems, insufficient export capacity so that growth will remain balance of payments constrained, drains of human capital through emigration; no adequate mechanisms to lead to necessary

real exchange rate adjustments to lead to sustainable development of external balances at satisfactory activity levels; social tensions and political instabilities;

- we shall see in some countries renewed interest in developing and using supply-side policy instruments such as various forms of industrial, regional, technology, educational policies, development finance; some of these policies will be executed in a complementary manner with EU- and European level schemes ('new' industrial policy, educational and training schemes, bank restructuring and debt resolution); there can also be changes in wage bargaining structures and incomes policy arrangements to deal with external imbalances, with uneven successes across different economies;
- agglomeration phenomena, particularly in the area of tradable activities are a stylized fact of industrial developments in the European economy as are cross-border production networks but these are not extending across the European periphery in its entirety; hence trade and industrial development processes will be uneven across the European economic space putting strain on external imbalances within the European Union and on the coherence of integration processes more widely (i.e. including the EU's neighbourhood). The EU will have to intensify its efforts for a development policy agenda both to deal with the 'North-South Divide' within the EU and in relation to its Neighbourhood.

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