# How monetary union is sacrificed on the altar of competitiveness

European Economic & Monetary Union (EMU) is in permanent crisis. The economic strengths of the participating nations are drifting apart instead of converging. This creates great frustration among the governments of countries being left behind and fierce disputes between them and Brussels and governments of core countries.

The currency union was based on the premise that the economic structures and levels of prosperity among the members of the union would converge. The poorer countries would catch up. That didn't happen. On the contrary. Philipp Heimberger from the Vienna Institute for International Economic Studies (WIIW) warned in his analysis of October 2018:

> *"The most significant long-term risk of disintegration for the euro area is the existing polarisation in the production structures of 'core' countries and southern 'periphery' countries."*

While the German economy grew by 27 percent and the Austrian by as much as 33 percent between the beginning of monetary union in 1999 and 2017, Italy's grew by a modest six percent and Portugal's by 12 percent.  In Greece, gross domestic product in 2017, adjusted for inflation, was at the same level as 19 years earlier. While the share of German industry in value-added remained almost stable at a high level, it fell sharply in the periphery countries.

The EU and the International Monetary Fund (IMF) blame the governments of the southern nations for the decline of the periphery. This is what the European Central Bank (ECB) writes:

> *"Convergence is mainly the responsibility of the national governments."*

For them, the lack of convergence has to do with weak institutions, structural rigidities, poor productivity growth and insufficient measures against house price bubbles. Similarly, the International Monetary Fund writes:

> *"The main responsibility for reviving productivity growth rests at the national level."*

### Centrifugal forces

For Michael Landesmann and Roman Stöllinger from the WIIW, the ECB and IMF are being too simplistic. "One has to accept that institutional quality correlates with different development levels." " they argue. One cannot simply claim that economically less developed nations should develop institutions of the same quality as the most advanced.

In his analysis, Heimberger identifies "self-reinforcing processes" without compensating counterforces within the framework of monetary union as the cause of these centrifugal economic forces. That explains why Germany with its technological lead was able to press home its industrial advantage, while the periphery nations fell further behind.

The cause of this phenomenon, he says, is the advantage of mass production: something that is hardly ever mentioned by the European Commission, the ECB or the IMF in their reports, based as they are on neo-classical economic theory. When trade barriers are dismantled and the market expands as a result, the leading suppliers of high-quality, complex products are the ones that profit. That is because they are particularly reliant on large

markets, and achieving a high volume of production, to offset the high fixed costs arising from research and development. Where the average costs can be greatly reduced by an increase in production volume, the tendency for the market to concentrate on the leading suppliers is particularly strong. This effect, according to a gravity-based model of trade, favours companies at the centre of a trading area, as they have the lowest possible transport costs for the entire market. The further deepening of the common internal market, which the ECB strategy recommends as a means of convergence, will therefore, in the absence of f counter-measures, tend to produce the opposite of convergence.

Terms such as "centre" and "periphery" have long ceased to a appear in the analyses of convergence-issues by the EU, IMF, and the ECB. The same is true for the tendency towards market concentration because of high fixed costs. Heimberger criticises the European Commission's approach bluntly:

> *"A one-sided focus on 'structural reforms' and 'solid fiscal policies' is incompatible with a convergence process in the southern periphery"*

What is needed is an industrial policy at European level. Otherwise, the ever increasing polarisation between industrial winners and losers will lead to "toxic conflicts" that endanger monetary union.

Landesmann and Stöllinger note that for some years there has been a newly awakened interest of economists in industrial policy. However, they criticise the fact that this is very much focused on the needs of the leading industrialised countries and the promotion of the most advanced technologies and processes. On the other hand, an economic research direction linked to Harvard economist Philippe Aghion, among others, stresses that countries at the forefront of technological development need a different industrial policy than technologically less developed countries. According to the WIIW researchers, those needing to catch up must promote their capacity to use and upgrade the technologies and processes that they already posess.

### "Internal Colonialism"

The Norwegian economic historian Erik Reinert even talks about "internal colonialism" in the EU, because the community´s institutions ignore the obvious difference betwee*n the macroeconomic value of different industries and products – to the disadvantage of the periphery. The* more standardised the products, the higher the competitive pressure and the lower the value-added ratio. At the very bottom of the list are agriculture and simple services, while at the top are complex industrial products. Economic convergence would require the laggards to be given help to climb the complexity ladder. Instead, they are advised to become more competitive through cost reductions.

Reinert points to the change in the OECD´s definition of competitiveness. In 1992, when the Maastricht Treaty was signed, the club of industrialised nations defined competitiveness as "the extent to which a country **increases its domestic income**, and at the same time can produce goods and services, which are successful against foreign competitors". In 2015 competitiveness for the OECD, on the other hand, is "a measure of advantage or disadvantage of a country in selling its products in international markets, measured mainly in terms of unit labour costs."

Earlier, the economy was there to serve the people, later the people were there to make the economy competitive. In 1992, the goal of increasing competitiveness meant producing high quality products that allow for higher wages. In 2015 on the contrary, the goal was to reduce wages and thus unit labour costs. Such a strategy, Reinert argues, increases the competitive advantages of the laggards in low-value-added-production, and thus tends to exacerbate the divergence of economic structures.

***This English version of my German blogpost** was produced by and appeared first on *Brave New Europe*, a site worth exploring.

German Version