The ‘one size fits all’ approach risks intensifying Europe’s North-South divide

Aidan Regan - 18 November 2013

The focus of adjustment to the crisis has been on structural reforms of Southern labour markets. Yet in the Northern economies, one of the core factors explaining their economic success is coordinated collective bargaining and high levels of investment in research, training and education. Can a narrow focus on labour market liberalization really improve the economic and employment performance of weaker member states?

The defining moment that led to the creation of the Economic and Monetary Union (EMU) in Europe was the publication of the Commissions 1990 study: “One market, one money”. This was based on the ‘new classical macroeconomic assumptions’ of rational expectations and denied the capacity of monetary and fiscal policy to affect real employment and economic outcomes in the long term. The core argument was that a single monetary policy would increase trade, equalise prices, enhance competition and discipline wage inflation across member-states. It was assumed that the EMU (a single currency with a single interest rate) in-itself would lead to macroeconomic convergence in policy outcomes across member-states with institutionally diverse capitalist democracies.

This has since proven to be a fundamental mistake, and recognised as such in the 2010 Commission report on “Intra-Euro-Area Competitiveness and Imbalances”. But instead of the rational expectations of market actors it is now assumed that economic convergence will come about through disciplined state action. It is the national executive of member-states that must now reduce welfare spending, liberalise collective bargaining and introduce structural supply-side reforms of the labour market. The 2010 report clearly outlined the new Euro governance regime and was soon followed up by the “Excessive Imbalance Procedure” which created two new regulations for the correction of macroeconomic imbalances (EU 1174 and 1176/2011). These new rules in addition to the ‘two pack’, ‘six pack’ and ‘fiscal compact’ all assume that a loss of competitiveness is the source of the Euro crisis. It is assumed that all member-states can converge on an export led growth model if national governments cut public spending and impose supply side reforms in the labour market.

This assumption of convergence, however, is not possible if we accept the core research finding of comparative political economy over the past thirty years, namely that there are different varieties of capitalism in Europe, with qualitatively distinct domestic institutions that cannot converge. The core empirical finding in this research is that what governments do is conditioned by the structure of the domestic economy. Within the Eurozone there are seventeen countries with qualitatively distinct national welfare states, fiscal policy regimes, wage-setting institutions and labour markets. In this perspective, imposing a one size fits all adjustment aimed at fiscal consolidation and structural reforms of the labour market will perpetuate rather than resolve the economic divergences in the north and south of Europe.

The Imbalance of Capitalisms within the Eurozone

In the Eurozone, one can argue that there are two variants of capitalism. Northern European countries; Germany, Austria, Netherlands and Finland are often described as coordinated market economies (CMEs). They have centralised and economically sophisticated employers and trade union associations with the capacity to autonomously coordinate and solve complex labour market problems. In addition, they have embedded welfare state traditions committed to social protection and income security. They have traditionally relied upon export-led growth as a mechanism to generate employment. Hence their macroeconomic structure supports a preference for stable fiscal policies and supply-side labour market reforms.

One the other hand, southern European countries in the Eurozone; Spain, Italy, Cyprus Greece and Portugal, are often described as mixed-market or Mediterranean varieties of capitalism. They have fragmented trade unions and employers with limited capacity to coordinate labour market outcomes. They have weak welfare states and a significant amount of social security occurs through family relations. Traditionally, they have generated economic and employment growth through domestic consumption. This gives priority to domestic demand over export-profits. Prior to EMU this structure lent itself to an accommodating monetary and fiscal policy, with governments regularly devaluing the currency to offset a loss of competitiveness and the inflationary impact of domestic prices.

The organisation of the political economy in southern Europe is conducive to a growth model based on domestic consumption. In contrast, the organisation of the political economy in northern Europe is conducive to a growth model based on export markets. Both of these regimes became systematically connected through the single currency and euro-financial markets. The strong export base of northern Europe depended on high-levels of domestic consumption in the south. The EMU is a semi-closed trading economy with less than ten per cent of trade leaving the Eurozone but predominately going to other EU countries. The EMU was designed as an unaccommodating currency regime that provided unprecedented autonomy to the European Central Bank (ECB). This primarily benefited the export driven model of northern Europe.

The conditions for competitiveness in comparative political economy

Membership of EMU compels member-states to pursue an internal devaluation as an instrument of adjustment. This is precisely what occurred in Germany from 2002 and underpins the EU's strategy in southern Europe today. The context specific conditions of the German political economy enabled unions and employers to institutionalise wage-restraint and facilitated government-led supply side reforms of the labour market (usually captured under the 'Hartz Reforms'). These were all aimed at enhancing export-led growth (even if it came at the cost of increased inequality and a growing low-wage economy). This is perhaps the proximate cause of Germany's capacity to internalise the monetary constraints of EMU. But it is certainly not the ultimate cause of Germany's competitiveness. The core insight from comparative political economy is that this can be traced to high levels of investment in research, training and education. These provide the conditions for a path dependent industrial infrastructure in highly specific niche export markets. This cannot be easily replicated.

Internal devaluation cannot, by definition, work in countries reliant upon domestic consumption for economic and employment growth. In southern Italy, Spain, Portugal and Greece, employment is predominately created by domestic demand. It should come as no surprise therefore that, despite successive labour market reforms and cuts in public expenditure, youth unemployment in these countries varies between a staggering 42 and 56 per cent. Many economists argue that Germany should reflate their domestic economy and

pursue a Keynesian response to the Euro crisis. That is, they should spend more, allow wages to rise, let banks fail, create inflation and encourage precisely what is occurring in the US. But this ignores the path dependent export model and the domestic political coalitions underpinning the German political economy. These are not likely to change anytime soon.

The attempt to join together different varieties of capitalism into the single currency is the real source of the Eurozone crisis. It is not a loss of competitiveness per se that is the core problem facing EMU but the heterogeneity of capitalisms within Europe, and the absence of a European wide problem-solving capacity to deal with this. The one size fits all adjustment, aimed at structural supply side reforms of the labour market, perpetuates the myth of economic convergence because it continues to assume that all member-states can generate the conditions for export-led growth. This, however, is systematically impossible is a semi-closed trading area such as the Eurozone. The structural effect of the single currency, therefore, is to exacerbate the imbalance of capitalisms within Europe.

The continued belief in the assumption of market convergence, implicit in the design of the EMU, is leading to a crisis of the democratic state in southern Europe. If European policymakers are serious about enhancing the competitiveness of these countries it will require huge levels of social investment in education, training and research, not to mention institutional capacity building. All of this expenditure implies that member-states should ignore the political and legal treaties of the European Union. Examining the empirical oriented research of comparative political economy, rather than following the hypothetical assumptions of rational expectations would better serve European decision-makers.

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