European Economists for an Alternative Economic Policy in Europe

- EuroMemo Group -

What future for the European Union – Stagnation and polarisation or new foundations?

– EuroMemorandum 2015 –

This EuroMemorandum draws on discussions and papers presented at the 20th Workshop on Alternative Economic Policy in Europe, organised by the EuroMemo Group, from 25-27 September 2014 in Rome. The text is based on written contributions from Marija Bartl, Joachim Becker, Ricardo Bellofiore, Gabriel Siles Brügge, Marcella Corsi, Judith Dellheim, Trevor Evans, Rodrigo Fernandez, Marica Frangakis, Carlo Giannone, John Grahl, Giulio Guarini, Peter Herrmann, Jeremy Leaman, Jacques Mazier, Mahmood Messkoub, Ronan O'Brien, Pascal Petit, Mario Pianta, Dominique Plihon, Oliver Prausmüller, Werner Raza, Malcolm Sawyer, Catherine Sifakis, Achim Truger and Frieder Otto Wolf.

Summary

1. Macroeconomic policies and the alternatives to stagnation

The economic recovery in Europe forecast for 2014 failed to occur and Europe is faced with the prospect of protracted slow growth, high unemployment and, at best, a minimal rise in real incomes. Although output in most countries ceased to decline, it remains well below the level in 2008 in Southern and many Eastern member states. Despite calls for greater budget flexibility by some governments, the European authorities insist on adhering rigidly to deeply restrictive policies. In place of the obsession with achieving balanced budgets, a coordinated fiscal expansion should focus on boosting employment through the promotion of environmentally desirable investments and an end to the attack on social spending.

The single currency must be complemented by an effective federal level fiscal policy which is able to cushion downturns at the federal, national and regional level and to provide for effective transfers between the richer and poorer regions. This should be based on a strongly progressive tax system and complemented by the development of a European wide system of unemployment insurance. A tax should be introduced on all financial transactions, and a uniform EU corporate tax rate should be introduced so as to end the bidding down of rates as states compete to attract inward investment. At the same time, off-shore financial centres must be strictly prohibited in order to avoid international tax avoidance.

While current account deficits have declined, this is due to policies of deflation which have reduced imports in deficit countries. In future, responsibility for eliminating imbalances must be shared between surplus countries, which should expand their demand, and deficit countries, which should invest in export industries. The regional and structural policies of the EU should be strengthened and expanded, in particular through a major programme of public and private investment, funded by the European Investment Bank, focussed in particular on deficit countries and, more generally, on lower income states.

2. Finance and the euro crisis

According to the ECB Banking Structures Report, the assets of the euro area financial sector have almost doubled over the past decade, to reach €57 trillion in 2013, nearly six times euro area GDP. Furthermore, the expansion of shadow banking – a network of credit intermediaries involving entities and activities outside the regular banking system, interacting across different jurisdictions – has outpaced that of the rest of the sector. Despite a series of financial policy reforms since 2009 the EU financial system has not been significantly transformed. It remains a system consisting of large, too-big-to-fail units, based on universal banks which combine investment banking and commercial banking activities under the same umbrella. Its banks and other financial units are highly leveraged, while shadow banking, plays an ever increasing role in the intermediation process.

The banking sector should be radically transformed, creating units of smaller size which specialise in a particular area of the financial services on the basis of clearly defined and generally applicable rules. At the same time an effective policy framework is required to address the European shadow banking system and its offshore dimension. So long as offshore centres are allowed to offer a safe haven where financial institutions can circumvent regulation and taxes, a dual market environment will persist. In order to overcome the vicious circle between bank losses and rising sovereign debt, there is a need for a mechanism for resolving the debt issue at the level of the euro area. In order to move towards a resolution of the euro area debt overhang, a conference of EU member states should be convened. The combination of the ill-conceived single currency together with financial deregulation and ineffective financial policy reform have contributed to the current entanglement, the cost of which is paid by large sections of the population in the EU.

3. Industrial policy and the reshaping of the economy

Post-crisis Europe cannot return to the forms of production of the past, much of which has in any case been lost during the prolonged years of stagnation. A new trajectory of ecologically sustainable and socially inclusive development is required and public policies will be crucial in shaping it. The new European industrial policy should focus on activities centred on the environment and energy; knowledge and information and communication technologies (ICTs); and health and welfare. These fields are characterised by labour intensive production processes and by a requirement for medium and high skills which have the potential to provide good jobs. Such activities should be developed with an expansion of activities in the public sector – including public research and development, and environmental protection – and with new private activities driven by public demand within the framework of regulation which supports the emergence of new dynamic markets. Policies should focus on the sustainable development of local economies, including the emergence of new public, non-profit and cooperative activities.

While EU structural funds and the European Investment Bank could play a role in financing such efforts, the implementation of a European industrial policy will require a new European Public Investment Bank or Agency, with similar organisations operating in each country. Such an organisation should be accountable to the European Parliament and have a substantial budget drawn from Europe-wide resources. Funding should be of the order of 2% of EU GDP over a period of 10 years, or about €260 billion per year. This could be financed in various ways, including the emission of Eurobonds; a new European Public Investment Bank which could borrow funds directly from the European Central Bank; while the ECB could also directly provide funds for industrial policy to the spending agencies concerned. These measures would make a major contribution to ending stagnation in Europe while at the same time reorienting investment – both public and private – towards a new model of sustainable development.

4. Social policy and combating inequality

The data produced by the European Commission itself provides incontrovertible evidence of the social distress resulting from austerity policies. Millions more Europeans are in poverty while the young people of the EU have been abandoned to mass unemployment. Because widening inequalities are becoming a key political issue, the social policy chapter of this year's memorandum focuses on inequality. Data from the Luxembourg Income Survey (LIS) show clearly a long-term rise in inequality across the EU. This can be traced to, firstly, a downward trend in the share of GDP going to labour and, secondly, increasing inequalities in wage incomes themselves. It is also necessary to consider inequalities among member states, which have been drastically aggravated by austerity policies and by a concentration of investment in Germany and a few of its neighbours.

Gender inequalities have also been worsened by austerity policies. Although, at the start of the recession, male workers were most affected by rising unemployment, subsequent cuts to public services have had a particularly heavy impact on female workers' employment and working conditions. Also, the reduction or withdrawal of public services – including child care and facilities for older people – has a disproportionate effect on women. Both the extremely adverse social consequences of austerity policies and the strong trend towards wider inequalities necessitate a major programme of social investment. However, an effective programme will require much greater budgetary resources and will have to be situated within a sustainable development strategy encompassing environmental, economic, social and cultural dimensions.

5. International trade and investment policy – the Transatlantic Trade and Investment Partnership (TTIP)

The EU has in recent years negotiated numerous bilateral trade agreements. This has been topped by the announcement in early 2013 that the EU and the US had agreed to enter into negotiations on a bilateral trade agreement, the so-called Transatlantic Trade and Investment Partnership (TTIP). The proposed agreement is not primarily intended to reduce the few remaining tariffs between the world economy's two biggest trading blocs; its central objective is to dismantle and/or harmonise regulations in areas such as agriculture, food safety, product and technical standards, financial services, the protection of intellectual property rights, and government procurement. Investment liberalisation and the protection of investors' rights will also be central issues. Protagonists of Atlanticism even herald TTIP as a new 'economic NATO', by means of which the Western powers will be able to curtail the rise of emerging powers like China or Russia. The European Commission, based upon commissioned studies, claims that the deal will boost growth and jobs in the EU.

The economic case for the TTIP is, however, unimpressive. Income gains are estimated at 0.5% of EU GDP, and will be phased in over a transition period of 10 years. Increased unemployment and adjustment costs due to trade liberalisation are downplayed or neglected altogether. The deregulation involved in the trade deal will threaten public health, labour rights and consumer protection. The proposed investor-to-state-dispute settlement will privilege investor rights over public policy autonomy. The TTIP is no less than a frontal attack on democratic decision-making in the EU. At the moment, it is highly dubious whether the trade agreement will deliver any net economic and social benefits to EU citizens. The prevailing approach to trade policy-making should be abandoned, and a fundamental rethink of EU trade policy needs to be put on the agenda. This includes as well other trade agreements such as CETA – the Canada-EU trade agreement, which in its current form should not be ratified by the EU parliament.

6. EU neighbourhood policies

The EU neighbourhood policies which are targeted at the post-Soviet space and the Mediterranean have contributed in 2013 and 2014 to the conflict in Ukraine. The Eastern Partnership has focused on the conclusion of Association Agreements with European successor states to the Soviet Union – except for Russia. These Association Agreements have a free trade component and a geo-political orientation. The partial transfer of the EU's *acquis communautaire* to the post-Soviet countries serves both ends. The Association Agreements are directed against the existing strong economic links between Russia and its neighbours and compete with the Russian initiative of a Eurasian Economic Union. In Ukraine, the population has been deeply divided on the issue of closer relations with the EU or Russia. When the then Ukrainian government decided against signing the Association Agreement with the EU due to both the dire economic situation and Russian pressure, a strong protest wave in the Western and Central parts of the country emerged and led to the downfall of the Ukrainian government. With Russian backing, there ensued a separation of Crimea and a military-political separatist movement in the Donbass region with particularly strong economic and cultural links with Russia.

Neither the Association Agreements with post-Soviet countries nor the free trade agreements with Mediterranean countries take the development asymmetries between the two sides into account. Trade liberalisation is likely to lead to de-industrialisation in the post-Soviet and Mediterranean countries while the partial transfer of the *acquis communautaire* drastically reduces the policy space for industrial policies. Asymmetries between the EU and neighbouring regions are therefore likely to increase. An alternative policy orientation is therefore necessary. First, the Deep and Comprehensive Free Trade Agreements should be replaced by mutually advantageous cooperation agreements that preserve policy spaces for the neighbouring countries. Second, energy issues loom large in both the Eastern Partnership and the Mediterranean policies; the EU should strive to reduce its dependence on energy imports by reducing the energy intensity of production and promoting renewable energies. Third, EU external policies are becoming militarised. The conflict in Ukraine has led to a closer interaction between EU and NATO structures. These tendencies should be reversed and capacities for peaceful conflict resolution should be strengthened.

Introduction

The proposals of the EuroMemorandum this year are being formulated in an exceptionally difficult context, which represents the virtually complete triumph of ideas and political forces to which the EuroMemo Group is fundamentally opposed. There is firstly the absolute licence conferred on the big corporations by the so-called 'four freedoms' and the European Union's (EU's) competition rules. The four freedoms map exactly onto the different phases of capital circulation as analysed by Marx: corporations can raise money capital, purchase labour power, equipment and other inputs, carry out production processes and market their output of goods and services anywhere in the 28 member states – so that for them the EU already constitutes a completely unified space.

The established judiciary of the EU powerfully reinforces this structure, giving the big firms justiciable rights which will be upheld not only in EU but also in member state courts. The consolidation of this economic space, however, has not supported any corresponding development of social or democratic rights at EU level. On the contrary, recent policies and court judgements have both sought to undermine the limited social gains that have been achieved, such as the rights of posted workers, and increasingly subordinated member state social models to the competition regime, opening up public services to predation from profit-seeking companies.

At the macroeconomic level, austerity policies, imposed by the strong states throughout the euro area, but especially on the weaker states, have reduced millions of EU citizens to poverty and impaired even basic levels of social protection and employment rights in the crisis-struck countries. As the EuroMemorandum in recent years has shown, these regressive policies and oppressive constraints on member state's social models have increasingly been given legal and even constitutional or quasi-constitutional force, making them extremely difficult to alter.

In such a context there is nothing surprising about the unprecedented hostility towards the EU and the European project which was expressed in the 2014 elections for the European Parliament, and nothing illogical in the increasingly widespread view that social progress has become impossible within the EU; that only its fragmentation and a reassertion of member state sovereignty offer a road out of the crisis for member states and the possibility of some measure of democratic control over economic life. The EuroMemo Group has not adopted such a position but this not because it underestimates the depth of the economic, political and institutional crisis in the EU. The fact that we continue to formulate alternatives in terms of the EU as a whole is based on two considerations.

Firstly, there is the extent of economic integration and interdependence which has already been brought about and which cannot be reversed without enormous material damage to existing productive structures and thus to the interests of European populations. There is no Aladdin's lamp with which to conjure these genies back into their bottles.

Secondly there is the possibility that the very success of corporate elites and of the political forces which serve them makes them vulnerable. Incalculable industrial, financial and commercial interests are tied up in the single market and in the single economic space which the integration project has brought about. It can therefore be conjectured that these interests, which benefit so largely from the EU as a unified economy, could, under a sufficiently great political challenge, be obliged to pay a high price to preserve that unity – a price in terms of social concessions, redistribution of income and the acceptance of socio-political constraints on markets and on business practice.

Could such a price for access to the unified European market be exacted? If only minor concessions are at stake the answer is almost certainly yes – the more intelligent of the corporate elites are aware that they might have won too great a victory and that some tactical acknowledgement of opposing interests could be advantageous. But could the price be raised substantially, enough to open up the economic development of the EU to democratic controls and to make a real difference to the working and living conditions of European people? The difficulties and uncertainties of such a policy perspective hardly need to be stated. However, we continue to advocate a common European response to today's multiple crises, not through an unreasoning optimism, but because of the conviction that such a response would most closely correspond to the needs and the values of a large majority of European citizens.

In several countries, most notably Greece and Spain, progressive political initiatives have gained impressive levels of support with platforms which clearly reject the current policies of austerity. If one of these were to gain a victory in national elections they would face an exceptionally stark and difficult challenge. Should the European Commission and the governments of the core states of the EU persist with their intransigent insistence on imposing deeply regressive policies, it would be legitimate for such a government to openly defy EU rules.

1 Macroeconomic policies and the alternatives to stagnation

1.1 'Recovery is weak, fragile and uneven'[1]

The economic recovery in Europe, widely forecast for 2014, failed to materialise. Instead, the European economy is faced with the prospect of a protracted period of low growth with only a very small decline in unemployment and, at best, a minimal rise in real incomes. The International Monetary Fund has even warned of the danger of a third recession since 2008.[2] Although most countries in the European Union (EU) registered some growth in 2014, output in many countries remained below the level of 2008.

In the countries of the euro area core (see Table 1.1) economic growth in 2014 was weak, especially in France, but output is higher than in 2008 everywhere except in Finland and the Netherlands. Nevertheless, in France, Finland and Belgium unemployment remained close to 10% and youth unemployment was over 20%. Unexpectedly, Germany, the largest economy in this group, registered a 4% decline in industrial output in the late summer as demand from key export markets weakened.

In the euro area periphery, everywhere except Italy registered some, if low, growth in 2014, but output remained well below the 2008 level, most notably in Greece where it has declined by some 23%. In Greece, but also in Italy and Portugal, output was only just above the level of 15 years earlier. Unemployment is much higher in this group of countries, and although it has declined slightly in Spain, both there and in Greece the rate is still close to 25%, with the rate for youth unemployment over 50%.

The new euro area countries recorded some growth in 2014, except in Cyprus, although in half this group output is still below that in 2008 and the unemployment rate is between 10% and 15%, with youth unemployment still higher.

In the Eastern European non-euro economies output in 2014 increased everywhere except Croatia, in most cases by 2.5% or even more. While output in some countries remained below the 2008 level, in Poland it was a full 18% higher. Unemployment is, except in the case of Croatia, generally below the EU average although there is extensive underemployment, especially in South-Eastern Europe, where many people have resorted to semi-subsistence activities in the agricultural sector. In Eastern Europe employment in manufacturing industries is higher, although several countries have become strongly integrated into German-led supply chains, and could be vulnerable to weaker growth in Germany.

The northern non-euro countries all registered growth in 2014 and in Sweden and Britain, but not Denmark, output was above the level in 2008. In all three countries, the unemployment rate was below the EU average, although youth unemployment was closer to the EU average, especially in Sweden.

[1] Mario Draghi, ECB president, 2 October 2014.
[2] International Monetary Fund, *World Economic Outlook,* October 2014.

Table 1.1: Indicators of EU output, unemployment and wage growth

		GDP growth 2013-14, % (1)	GDP growth peak-2014, % (1)	Unemployment August 2014, % (2)	Youth unemployment August 2014, % (2)	Real wage growth 2013-14, % (3)	Real wage growth 2009-14, % (3)
	Euro area (18)	0.8	-1.5	11.5	23.3	-	-
	European Union (28)	1.3	0.2	10.1	21.6	-	-
Euro area core	Austria	0.7	2.8	4.7	8.2	1.5	0.2
	Belgium	0.9	2.8	8.5	23.3	1.4	-0.5
	Finland	-0.4	-6.1	8.6	19.9	0.2	2.6
	France	0.3	2.0	10.5	24.0	0.2	1.5
	Germany	1.3	3.5	4.9	7.6	1.6	5.8
	Luxembourg	3.0	7.1	6.1	15.5	-	-
	Netherlands	0.9	-2.1	6.6	10.1	2.5	-2.1
Euro area periphery	Greece	0.6	-25.5	26.4	50.7	-1.6	-34.8
	Ireland	4.6	-2.4	11.4	23.2	-2.5	-10.3
	Italy	-0.4	-8.6	12.3	44.2	1.4	-5.4
	Portugal	0.9	-6.6	14.0	35.6	-0.4	-6.5
	Spain	1.2	-6.2	24.4	53.7	1.5	-12.1
New euro area	Cyprus	-2.8	-10.5	15.4	37.1	-4.0	-15.4
	Estonia	1.9	-2.9	7.4	12.7	4.2	8.7
	Latvia	2.6	-5.0	10.8	21.8	4.2	12.3
	Malta	3.0	11.2	5.9	12.7	-	-
	Slovakia	2.4	7.6	13.3	29.9	1.3	1.4
	Slovenia	2.4	-7.3	9.1	19.2	0.2	-4.7
Northern non-euro	Denmark	0.8	-3.2	6.7	12.5	0.1	2.9
	Sweden	2.0	5.9	8.0	21.6	3.4	15.1
	United Kingdom	3.1	4.3	6.0	15.8	1.8	3.4
Eastern non-euro	Bulgaria	1.2	0.2	11.3	22.2	-	-
	Croatia	-0.7	-12.6	16.5	43.9	-	-
	Czech Republic	2.5	0.2	6.3	16.6	0.8	-3.4
	Hungary	3.2	-1.0	7.8	20.9	0.9	-2.0
	Lithuania	2.7	1.2	11.4	21.5	-	-
	Poland	3.0	18.8	8.8	22.8	3.3	8.2
	Romania	2.0	-1.1	7.1	24.3	2.1	-2.0

Source: (1) Ameco, November 2014; (2) Eurostat, October 2014; (3) Ameco, May 2014. Peak is highest of 2007 or 2008.

Weak economic growth has led to policy tensions between euro area states. The German government, which prioritised achieving a zero fiscal deficit in 2014, insists that other countries should adhere rigidly to fiscal rules and reduce deficits below 3% of GDP. But governments in Italy and France, while promoting strongly pro-business policies, have called for greater budgetary flexibility. Matteo Renzi, the Italian premier, proposed a budget with tax cuts and increased investment which would raise the government deficit back to almost 3%; Manuel Valls, the French premier, proposed a budget for 2015 which, despite cuts in welfare spending, foresees a 4.3% deficit. Both have called for more investment in Europe, a call which has been echoed by Mario Draghi, the European Central Bank (ECB) president, who has urged member states with room to spend – a clear reference to Germany – to do more. Unexpectedly, the Polish finance minister, Mateusz Szczurek, called for a €700 billion investment programme which would focus on countries like Greece, Spain and Portugal, arguing that 'Europe is strangling itself unnecessarily'. In December, the EU's heads of government supported a proposal launched by the new president of the European Commission, Jean-Claude Junker, for a much touted €315 billion investment programme in public infrastructure but, in reality, this only involved €21 billion of guarantees by the EU and the rest, it was hoped, would be forthcoming from private investors.

Given the rigid constraints imposed on fiscal policy, many of the key policy initiatives in 2014 once again stemmed from the ECB. In June the key central bank lending rate was cut to 0.15% and, most unusually, in order to encourage lending the interest rate on banks' deposits at the ECB was cut below zero, to -0.05%. The ECB also announced the 'targeted long-term financing operation', a €400 billion programme of cheap four-year loans which banks could draw on to lend to small and medium businesses. But when the loans were offered, banks only took up €82 billion in September and €130 billion at a further round in December – in total only just over half the amount on offer.

In September, the ECB cut the lead interest rate again to reach an all-time low of 0.05%, while the deposit rate was reduced to -0.10%. At the same time, Draghi announced that the ECB would launch yet another programme to encourage bank lending, this time by taking bad loans off banks' books. Through extensive purchases of asset backed securities and other bonds, the ECB said it aimed to increase its lending to banks from €2 trillion to €3 trillion. However, despite the ECBs repeated attempts to support the banking sector, total bank loans to business in the euro area declined by some 8.5% between 2012 and 2014. Given the extremely gloomy outlook, businesses are not rushing to borrow and, when companies do seek a loan, banks are unlikely to lend.

1.2 EU policies trapped in wrong theories and bad institutions

The EU's – and especially the euro area's – disastrous economic performance since 2010 must clearly be blamed on completely inadequate macroeconomic policies. These policies have been shaped by the EU's institutional framework focusing on an independent ECB with a primary commitment to price-stability; on balanced government budgets as prescribed by the stability and growth pact; and on achieving deregulated labour markets and a dismantling of the welfare state. Fiscal policy in most euro area countries has been dominated by austerity measures implemented under the institutional setting of the Stability and Growth Pact and the so-called Fiscal Compact, which involved member states introducing deficit limits into national law, preferably as a constitutional measure. The degree of austerity was extraordinary. The so-called 'fiscal effort', i.e. the cumulative volume of discretionary measures taken to consolidate the budget was around 5% of GDP between 2010 and 2014 for the euro area as a whole, with the bulk of measures concentrated in the three years from 2011 to 2013. The largest reductions were in Greece (22% of GDP) and Portugal (10%). With some basic knowledge of the empirical estimates of the fiscal multiplier, the devastating economic, social and political consequences were clearly predictable. The serious risk of a vicious cycle, with consolidation efforts leading to higher deficits and debt levels and, in turn, to yet further consolidation efforts, has materialized for some countries.

It is increasingly difficult to ignore the failure of official macroeconomic policies, and the economic and social hardship caused by them, and even some official policy makers have recognised the necessity of a more expansionary or at least a less restrictive fiscal policy. In his now famous Jackson Hole speech Mario Draghi, the president of the ECB, called for a more expansionary fiscal stance for the euro area as a whole and a public investment programme at the European level.[3] The European Council at its meeting in June 2014 also saw the need to enhance growth. However, both Draghi and the European Council insisted that this be realised within the current institutional framework: 'The possibilities offered by the EU's existing fiscal framework to balance fiscal discipline with the need to support growth should be used.'[4]

With the help of a different interpretation of the existing fiscal framework, a substantial relaxation of fiscal policies and even an expansionary fiscal stance could be justified.[5] However, this is not what official EU policy has in mind. The Commission has, in fact, not changed its' overly ambitious consolidation targets, as can be derived from its assessment of the stability programmes and the 2014 country specific recommendations. If its recommendations were put into practice the fiscal stance for the euro area would again become substantially negative. It is highly unlikely that the EU economy would recover much under these circumstances. Even if the Commission and the Council were to agree to some national governments' requests to extend the deadlines for consolidation, this would only mean a slightly less restrictive fiscal policy, rather than the expansionary policy that is required. More seriously, national governments that obtain a slight relaxation of their consolidation targets will be required to pay a high price in terms of 'structural reforms', in particular a further dismantling of the welfare state and weakening of labour standards. In this way the threat of further austerity policies is used to promote a continuation of the neoliberal transformation of European economies and societies.

1.3 Alternative macroeconomic policies

The first requirement is for the replacement of the 'fiscal compact' and its obsession with the achievement of the ill-defined 'structural budget balance' with an agreement between the member states of the Economic and Monetary Union (which could also include other EU member states as the 'fiscal compact' does) on the objectives for fiscal policy to focus on the pursuit of high and sustainable levels of employment. It is recognised that whilst fiscal policy can aid the achievement of high levels of employment it has to be accompanied by a range of other policies. These include labour market and employment policies which are supportive of employment to replace the drive for 'structural reforms' which reduce wages, increase inequality and are often harmful for employment. Industrial and regional policies which address capacity building and current account imbalances are also needed alongside fiscal policy.

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[3] M. Draghi, 'Unemployment in the euro area', Speech by Mario Draghi, President of the ECB, Annual central bank symposium, Jackson Hole, 22 August 2014.

[4] European Council, European Council 26/27 June 2014, Conclusions, EUCO 79/14, CO EUR 4 CONCL 2, Brussels, p. 7.

[5] A. Truger, 'Austerity, cyclical adjustment and the remaining leeway for expansionary fiscal policies in the Euro area,' IMK Working Paper No. 140, October 2014, IMK in the Hans-Böckler-Stiftung, Düsseldorf.

The most pressing need is for the withdrawal of the drive for a balanced structural budget with its deflationary impact, and replacement by co-ordinated fiscal policies designed to boost demand and employment. Fiscal policy should be re-focused on the jobs deficit through enhanced public expenditure, including the promotion of environmentally friendly 'green investment' and an end to the attack on the social welfare spending, and through a re-orientation of tax policies for a much more progressive system (which would have itself tend to reduce budget deficits). A co-ordinated reflation rather than co-ordinated austerity must become the policy. It is important that the European Central Bank (and, for non-euro area countries, the national central bank) gives their full support to fiscal policies for prosperity and not to persist with its continual calls for fiscal consolidation.

It has long been argued that a single currency requires a Federal level fiscal policy with substantial tax raising powers, an appropriate level of public expenditure and an ability to run deficits and surpluses. A Federal fiscal policy would (if properly applied and not subject to balanced budget stipulations) act to cushion downturns at both the Federal level and at the national and regional levels, and would provide for fiscal transfers between the richer regions and the poorer regions. Federal taxation would replace some elements of national taxation, and should be designed in a progressive way which would aid its stabilisation properties. It is difficult to calculate with precision the scale of Federal taxation which would be needed for these stabilisation purposes but, in order to be effective, we envisage moving towards something of the order of 10%, rather than the current 1% of EU GDP. The construction of Federal fiscal policy is a very long term project but one which would be necessary for the successful functioning of a single currency. The development of a Federal budget is not only sought on the grounds that such a budget and the associated fiscal transfers are required to complement a currency union. The design of the tax policies and expenditure programmes, which would be appropriate for a Federal budget, should have an over-all progressivity for the stabilising features of such programmes and also for the contribution to reducing inequalities.

A fruitful area for development would be an EU wide social security system that would enhance social protection and labour mobility. One Commissioner has already raised this: 'The EMU governance, including its social dimension, would need to be sufficiently reinforced through the introduction of social standards and solidarity mechanisms that could provide more extensive support for preventing and addressing employment and social imbalances that affect the stability of the EMU. … I am convinced that, for economic, social and political reasons, EMU-level fiscal transfers with an automatic stabiliser function will also need to be developed, as foreseen in the Commission's Blueprint. For example, in the form of EMU level unemployment insurance, this would constitute direct expression of EU support to citizens in need. Possibilities of involving social partners in the governance of such stabilizer instruments should be explored'.[6]

There are numerous changes that could be proposed in tax policy, two of which are especially important. Firstly, a financial transaction tax should be applied in all the member states. Secondly, a uniform corporate profits tax should be introduced: in the context of a currency union with labour and capital mobility, this would help to address the bidding down of corporate tax rates between countries and limits the use of corporate tax rates to attract inward investment at the expense of other member countries.

[6] L. Andor, European Commissioner responsible for Employment, Social Affairs and Inclusion, argued that 'Europeans want and deserve a monetary union with a human face' speech at ETUC Madrid Conference, 'Celebrating the past, looking to the future', Madrid, 28 January 2013.

The European Investment Bank, whose activities are not constrained by the ‘fiscal compact', has a role to play in promoting investment in infrastructure and environmentally friendly investments. At a time of low interest rates and unused resources, this is the time for investment, and a shift towards a low carbon economy.

Current account deficits amongst EMU member countries have generally declined, often sharply, over the past few years. The driver of those declines has been the recession and the loss of productive capacity in weaker countries; any significant growth in these countries will soon lead to a renewed increase in the deficits as imports rise. The monetary union must put in place policies which will resolve the underlying weaknesses in productive structures which have given rise to the current account imbalances. These policies should start from the mutual recognition that surplus countries have as much responsibility as the deficit countries to resolve the imbalances, and that surplus countries can aid that resolution through policies of internal reflation. This will help expand export demand for the deficit countries and, through faster wage increases, reduce their export competitiveness.

Policies are required to rebuild productive capacity and to improve the competitiveness of the deficit countries. The regional and structural policies of the European Union should be strengthened and expanded, and a new industrial policy based on a major programme of public and private investment is required.[7] Programmes from the European Union to support and fund private investment in the deficit countries (and more generally in EU states with lower levels of income) are also required. These policies would facilitate the reduction of current account deficits without resorting to deflation. They would also through the stimulation of investment and net exports ease the reduction of budget deficits without austerity.

[7] For fuller details, see chapter 3.

2 Finance and the euro crisis

2.1 Current developments

According to the ECB Banking Structures Report, the assets of the euro area financial sector have almost doubled over the past decade, rising to €57 trillion in 2013, nearly six times euro area GDP. Furthermore, the expansion of shadow banking – a network of credit intermediaries involving entities and activities outside the regulated banking system – has outpaced that of the rest of the sector, as shown in Table 2.1.

Table 2.1: Euro area financial system assets

	2003		2013	
	Euro trillion	%	Euro trillion	%
Insurance companies and pension funds (ICPFs)	4	12.5	8	14.0
Banks	19	59.4	30	52.6
Shadow banks (OFIs)*	9	28.1	19	33.3
Total	32	100.0	57	100.0

Source: ECB, *Banking Structures Report*, October 2014. * Other Financial Institutions (non-monetary financial institutions other than insurance companies and pension funds).

Both Insurance Companies and Pension Funds (ICPFs) and Other Financial Institutions (OFIs) are extensively interconnected with the banking sector: ICPFs and OFIs have investments in debt securities issued by the banks and/or direct ownership links, while banks have equity investments or credit claims on ICPFs and OFIs. A high degree of interconnectedness is also present within the banking sector itself and banks are the largest investors in other banks: out of a capital increase of euro area banks of €630 billion between 2008 and 2013, €400 billion corresponded to an increase in interbank positions and only €230 billion to fresh capital injected from outside the banking system.[8] The total outstanding credit in the euro area in 2013 amounted to €119 trillion, but only 30% was provided to non-financial corporations and households, while more than 70% was directed to financial corporations (including banks, ICPFs and OFIs), largely in the shape of bonds.[9]

The interconnectedness within the euro area financial sector increases its fragility, since it increases the risk of contagion. This situation is further complicated by the significant and expanding presence of shadow banking. Here an important role is played by offshore financial sectors, in particular in the Netherlands, Luxembourg and Ireland, which act as conduit jurisdictions. The provision of credit by euro area shadow banks to other entities has increased over the past eight years and especially over the crisis period. At the end of 2013, shadow banks held on their balance sheets more than €4.7 trillion in loans, of which over €2 trillion were to the euro area non-financial sector, and more than

[8] European Commission, *European Financial Stability and Integration Report*, 2014, Table 1.4.1.
[9] Ibid, Tables 1.A.1, 1.A.2 and 1.A.3.

€4.2 trillion of debt securities.[10] While the bank-like functions of the shadow banks have partly made up for the declining role of the formal banking sector as it has been obliged to deleverage, shadow banks are a source of systemic risk due to their unregulated status and the strong interconnection with the regular banking system.

A number of financial policy reforms have been introduced since 2009 aimed at enhancing the stability of the EU financial system. The most recent of these is the creation of the banking union which involves more than five thousand banks in the euro area. The central objective of the banking union is to sever the feedback loop between sovereign debt and the banks, which has played a crucial role in the euro crisis.[11] Key features of the banking union came into effect in 2014:

- The Single Supervisory Mechanism under which the ECB assumes responsibility for the supervision of euro area banks became operative in November 2014.
- The Single Rulebook came into effect in January 2014, while the Single Resolution Mechanism will become operative in January 2015. The Single Resolution Fund will be established over a period of eight years starting in 2015, by the end of which it will have a total volume of €55 billion, corresponding to 1% of the insured deposits in the EU.
- The harmonized Deposit Guarantee Scheme, which will be established over a ten-year period, was initiated in 2014.

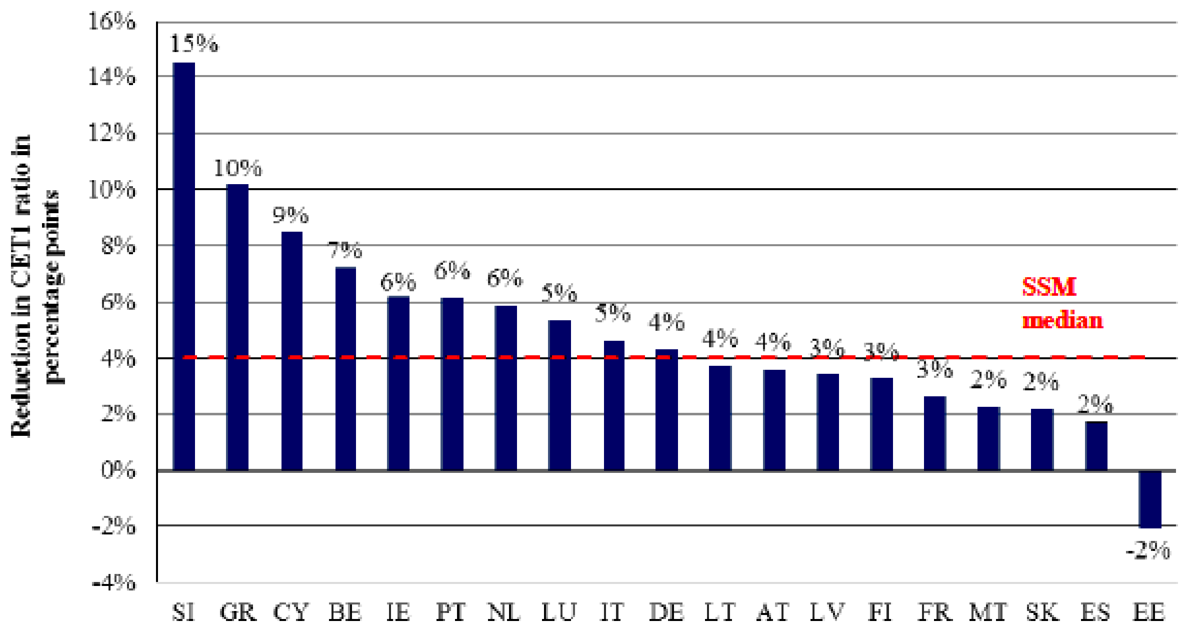
Both the framework and the mechanism for the resolution of banks under the Banking Union contain an 'escape' clause. Accordingly, if an otherwise solvent bank cannot fill a capital shortfall, as identified by the ECB, a member state may inject public money without first bailing in creditors, i.e. by cancelling or diluting the banks' shares and by reducing creditors' claims or converting them into equity. Furthermore, should the 'escape' clause be invoked, the injection of public funds must comply with State Aid rules on burden-sharing, introduced by the European Commission in 2013. However, a 'safeguard' clause in these rules allows creditors to be spared, should burden-sharing endanger financial stability through contagion.

Prior to assuming its supervisory responsibility, the ECB carried out a one-year comprehensive assessment of the 130 largest euro area banks, the results of which were announced in October 2014. This consisted of two different exercises: an Asset Quality Review of banks' balance sheets, including off-balance sheet positions, as at the end of December 2013; and Stress Tests, intended to assess the banks' capacity to absorb economic shocks, including a simulation of whether the banks' capital resources were adequate in the stress scenario.

The comprehensive assessment revealed a capital shortfall of €25 billion at 25 banks. As shown in Figure 2.1, in the adverse scenario, the median bank's CET1 ratio falls by 4% from 12.4% to 8.3%, and the fall is especially large in the highly indebted countries.[12] This points to the persisting debt overhang – including both private and public debt – which, in conjunction with the fiscal austerity policy pursued by the EU, is a significant source of financial and economic fragility.

[10] ECB, *Banking Structures Report*, October 2014, p. 32.
[11] See *EuroMemorandum 2014* for a more detailed analysis of the Banking Union.
[12] The CET1 ratio – also known as the Tier 1 capital ratio – measures the capacity of a bank to absorb losses arising in its operation in relation to its risk-weighted assets, where Tier 1 Capital is the sum of its equity capital and disclosed reserves.

Figure 2.1: Comprehensive assessment impact on CET1 ratio under the adverse scenario



Source: ECB, *Comprehensive Assessment Final Results*, 26 October 2014.

In summary, the financial sector of the euro area is growing in size and complexity. Extensive interconnectedness and the increasing role of shadow banking add to its complexity. Nearly six years after the 2007-08 financial crisis, EU financial policy is still evolving. Its most ambitious component – the banking union – is still far from being complete or crisis-proof.

2.2 Financial fragility and effectiveness of policy

Despite a series of financial reforms since 2009, the EU financial system has not been significantly transformed. It continues to consist of large, too-big-to-fail units, based on universal banks which combine investment banking and commercial banking activities under the same umbrella. Its banks and other financial units are highly leveraged, while shadow banking plays an ever increasing role in the intermediation process. Furthermore, the on-going negotiations between the US and the EU on the Transatlantic Trade and Investment Treaty (TTIP) are undermining existing financial regulation. These negotiations are being carried out in complete secrecy (see chapter 5), giving rise to concerns that the finance industry will gain new room for manoeuvre through the TTIP.

There are also major problems associated with the banking union, which is still far from being complete. Its various features will come into force over a lengthy period stretching to 2023, while the resources with which the Single Resolution Fund has been endowed (€55 billion) fall well short of the potential liquidity support required by large European financial institutions in the case of trouble. According to one study, the support that could be required by BNP Paribas has been estimated at €83 billion, by Deutsche Bank €74 billion, by Santander €51 billion, by ING Bank 36 billion and by Societé Générale €57 billion.[13] The volume of the Single Resolution Fund, even when it becomes fully

[13] F. Lindner, N. Soemer and T. Theobald, 'Opportunities and Risks of the European Banking Union', IMK Macroeconomic Policy Institute, May 2014.

operative, clearly will be quite insufficient to intervene effectively in the event that a major bank faces trouble.

It is, however, not only the logistics of the banking union that are inadequate. Equally important are the derogations provided by the 'escape' clause of the resolution framework and the 'safeguard' clause included in the European Commission's State Aid rules. In view of the complexity and interconnectedness of the EU financial system, the failure of any too-big-to-fail financial institution may trigger the application of both principles as a means of avoiding the risk of contagion and financial instability. As Lindner *et al.* have argued, 'A major bank in distress would very probably block the resolution mechanism because the resolution and deposit insurance fund sizes have been calculated too 'tightly'. As a last resort, the taxpayers' money would once again have to be employed in order to maintain financial stability'.[14]

The Single Rulebook, which came into effect in January 2014, includes the new capital requirements under Basle III, transposed into Community Law on the basis of the CRD IV package.[15] This sets banks' required capital ratio, reflecting the degree of credit risk of risk-weighted assets, at 8% rising to 10.5% by 2019. However, as the recent financial crisis demonstrated, capital requirements need to be assessed in relation to the total assets, rather than only the risk-weighted values. This is the 'leverage' ratio, which the Basle Committee has set at 3%, while in the US a bank is believed to be well or adequately capitalised if it has a leverage ratio of 5% or 4% respectively. In fact, the recent assessment of euro area banks by the ECB did not include the overall level of bank borrowing.

The fragility of the EU financial system is intensified by the expanding shadow banking sector. Following the G20 meetings in Seoul (2010) and Cannes (2011), the Financial Stability Board published an action plan in 2013 setting out a framework to constrain the risks generated by shadow banks. The European Commission also published a green paper on shadow banks in 2012 and its own action plan in 2013. Both policy processes, however, ignore the role and implications of off-shore centres, such as Luxembourg, the Netherlands and Ireland, which accounted for 40% of all shadow-banking transactions in the euro area in 2010.[16]

The demonisation of sovereign debt has diverted attention from the level of overall debt (private and public debt) prior to the crisis and the role of banks and shadow banks in fuelling the sharp rise in private debt. The major expansion of public debt following the onset of the crisis was necessary to fill the vacuum left by the collapse of the private 'liquidity factories'. Furthermore, it has always been 'naïve' of the current generation of EU policy-makers to consider it either appropriate or feasible to reduce sovereign debt to Maastricht-compliant levels as a primary macroeconomic goal. This is clearly demonstrated by the much longer period required to reduce sovereign debt ratios after 1945, when the growth of output, trade and state revenues was far more favourable. Lastly, recovery from high overall debt ratios is only conceivable through dynamic recovery in Europe or through a targeted but extensive forgiveness of debt.

[14] Ibid, p. 29.

[15] Capital Requirements Directive IV: Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

[16] European Commission, 'Non-bank financial institutions: assessment of their impact on the stability of the financial system', *Economic papers 427*, November 2012.

2.3 Alternative proposals

The banking sector should be radically transformed, creating units of smaller size which specialise in a particular area of the financial services on the basis of clearly defined and generally applicable rules. The so-called too-big-to-fail banks need to be broken into smaller units and their size constrained. This is best done through a complete separation between investment banking and commercial banking activities. So long as large universal banks are the norm in the EU, the danger of their becoming overstretched and vulnerable to failure is ever present. At the same time, the role of publically-owned and cooperative commercial banks should be strongly promoted.

The banking union currently under construction does not provide adequate provisions to contain the risk of contagion. It should therefore be strengthened, both in relation to supervision and to the powers of resolution. Furthermore, the Resolution Fund and the Deposit Guarantee Fund are insufficient to cover losses, should an institution be at risk. The funds therefore should be adequately funded on a pan-European basis by the banks themselves in proportion to the size of their assets. This is all the more urgent in view of the high volume of non-performing loans (obligations that are 90 days overdue, or that are impaired, or in default). The Asset Quality Review of November 2014 found banks' non-performing exposures to have reached a total of €879 billion, ranging from 10% to 30% of loans across the euro area member states.

An effective policy framework is required to address the European shadow banking system and its offshore dimension. So long as offshore centres are allowed to offer a safe haven where financial institutions can circumvent regulation and taxes, a dual market environment will persist. Tackling the issue of offshore centres is essential in relation to the supervision and regulation of global finance.

In order to overcome the vicious circle between bank losses and rising sovereign debt, there is a need for a mechanism for resolving the debt issue at the level of the euro area. Unsustainable levels of government debt must be resolved through some combination of cancellation and at least partial mutualisation. As the Third World debt crisis demonstrated in the 1980s, a 'debt overhang' leads to a downward spiral of low investment, low productivity and increased poverty. In order to move towards a resolution of the euro area debt overhang, a conference of EU member states should be convened. The mutualisation of government debt may be implemented in one of the following ways.

- *Restructuring government debt:* One of several proposals involves the creation of an agency that would acquire at face value 50% of existing public debt and swap it into zero-interest perpetuities.[17] This means that the corresponding debt is wiped out. To that effect, the agency borrows on the financial markets the amount needed to acquire that part of debt. The agency best suited for this task is the ECB because, like all major central banks, it has high credibility, it can sustain large losses, and it is the only institution which can mobilize large resources on the financial market.
- *Intervention by the ECB in government bond markets:* The ECB plays its role as a lender of last resort in a very restrictive way with respect to governments to the extent that it only intervenes in the secondary market and that its intervention is subject to the implementation of austerity measures. A change in its doctrine is necessary. The ECB should become an active player on the government bond market, including the primary market, as the Bank of England and the US Federal Reserve have done. Such a policy would have two positive effects. First, it would put a downward pressure on government bond rates and reduce the cost of debt. Secondly, it would

[17] Mutual Agreement for Public Debt Restructuring in the Eurozone, Madre Plan, CEPR, May 2014.

reduce the probability of a crisis in the bond market, thanks to the intervention of the ECB as a lender of last resort.

- *The common issue of Eurobonds:* The overall level of European debt is not high by comparison to that of the US and Japan. It is however distributed in an uneven way across the EU and the euro area. Different schemes have been proposed. One is to have Eurobonds issued jointly up to the value of 60% of the GDP of euro area member states. A more progressive solution would be to issue guaranteed debt above the 60% threshold, which the markets consider more risky and which is therefore more expensive. Eurobonds may also be a useful instrument to finance common policies at the European level.

One of the main structural problems of the euro area lies in its wide heterogeneity. Adjusting the real exchange rate through so-called internal devaluations (employment and wage cuts) involves unacceptable social costs and it has cumulative perverse effects. Other alternatives are complex to implement (coordinated fiscal and wage policies at the European level) or only with long term impact (large investment programmes and industrial policy).

Various alternative monetary regimes have been proposed. These include (i) a multi-euro zone whereby national euros are reintroduced at the national or regional level while a global euro acts as an international store of value in the financial markets; (ii) a return to the European Monetary System of the 1980s and 1990s; (iii) Germany leaving the euro area and letting its currency float while the remaining countries keep the euro, which would be either pegged to the German currency with a fixed, but adjustable, exchange rate or would float freely against the dollar; (iv) a euro-bancor model, which borrows from the experience of the European Monetary System, from Keynes' proposals on bancor and the International Clearing Union (ICU) and from the ECB and the Single European Payments Area. This last proposal is the most desirable. Unlike the present regime, it would make both debtor and creditor countries share the burden of the debt and, in this way, could help avoid any tendency towards a breakup of the euro area.

3 Industrial policy and the reshaping of the economy

3.1 The uneven decline of production

Since 2008 industrial production has declined throughout much of Europe and there has also been a process of polarisation. Other than Poland, where industrial output in 2013 had increased by 18% compared with 2008, only Germany, Austria, the Netherlands and Ireland had output levels that returned to pre-crisis levels. In most of Northern and Central Europe output failed to recover, with declines of 10% or more in France, Britain, Sweden, Denmark and Finland. The largest declines were in Southern Europe, with output down by 25% compared with 2008 in Italy, Spain and Greece. As a result of the prolonged European crisis, a permanent loss of production capacity is taking place in most industries and most countries, especially in the Southern 'periphery'. A parallel polarisation has emerged in unemployment and other economic variables.

Behind these figures lies a process of in which economic activities and power have become more concentrated in the 'centre' – Germany and few neighbouring countries which are integrated in its production system.[18] With a prolonged stagnation, Europe is likely to develop a more polarised industrial structure; 'weak' countries, regions, industries and firms are becoming weaker; the 'centre' may be negatively affected by lower demand; all countries will end up with a reduced ability to develop new technologies and economic activities. Without selective and sustainable areas of meaningful economic growth Europe as a whole could be stuck with sluggish markets, a heavy environmental burden, cosmetic attention to climate change, and growing inequality.

3.2 A rediscovery of industrial policy?

Since the 1980s, industrial policy has had a marginal role in Europe's agenda. European Union policies on the evolution of economic activities are now framed in the Europe 2020 strategy, approved in June 2010 by the European Council. There are several key policy tools.

- Structural Funds are the most important; they are intended to 'compensate the losers' in market competition and amount to 0.4% of EU GDP.
- Smart Specialisation,[19] recently adopted by EU policy, encourages regions to focus their 'horizontal' efforts in building a critical mass of R&D, innovative and investment capacity in highly specific activities, combining advanced technologies and local competences also in traditional industries.
- Project financing by the European Investment Bank; this amounted to €72 billion 2013 and funds a variety of private and public projects. The EIB, however, operates with a logic typical of financial markets.

With very modest resources, a focus on indirect measures and no questioning of market logic, the 'horizontal' approach of current EU policy has had a minimal impact on the development of

[18] Analyses of the recent evolution of European industries and production networks include WIIW, *European Competitiveness Report. A 'Manufacturing imperative' in the EU – Europe's position in global manufacturing and the role of industrial policy*, Vienna, 2013; A. Simonazzi, A. Ginsburg, and G. Novella, 'Economic relations between Germany and southern Europe', *Cambridge Journal of Economics*, vol. 37, no. 3, 2013, pp.653-675; K. Aiginger, 'Industrial Policy for a Sustainable Growth Path', *WIFO Working Papers*, no. 469, 2014.

[19] D. Foray, P. David and B. Hall, 'Smart specialisation: the concept', in European Union, *Knowledge for Growth: Prospects for science, technology and innovation*, EUR 24047, 2009.

production capacity. Moreover, present EU industrial policies have lacked an adequate governance mechanism, as industry lobbies exert a major influence.

Due to the depth of the crisis, however, the European Commission introduced a new policy initiative called the 'Industrial Compact' in January 2014. It also led the new Commission president, Jean-Claude Juncker, to propose a €315 billion investment plan in November 2014. The 'Industrial Compact' sets the target of returning industrial activities to 20% of GDP by 2020, against the present 16%. The only novelties compared to Europe 2020 include a call to support investment in fast growing, high value added initiatives such as energy efficiency, green industries and digital technologies. No additional funds, however, are on offer. All actions have to rely on existing EU initiatives, such as the Horizon 2020 R&D programme, the Competitiveness of Enterprises and Small and Medium-sized Enterprises (COSME), and Structural Funds (including national co-financing).[20]

The Juncker proposal calls for the creation of a European Fund for Strategic Investment (EFSI) with financing of €21 billion, €16 billion from existing EU funds and €5 billion from the European Investment Bank, which are then expected to 'leverage' private funds through the emission of EIB bonds and the mobilisation of private participation in investment projects, to reach a total of €315 billion over three years. National governments are invited to contribute additional funds that will be excluded from EU constraints on public expenditure, but they will have no control over the use of EFSI funds. The plan is unlikely to succeed in raising such large amounts of private investment in a context of continuing stagnation. Its impact in terms of additional demand will be modest and the type of profit-making investment that will be financed could be problematic from the social and environmental point of view.

The possibilities of an industrial policy are also seriously affected by the negotiations for the Transatlantic Trade and Investment Partnership (TTIP) with the US, discussed in chapter 5. If the TTIP were approved, the space for public action in the economy would be seriously reduced.

3.3 An alternative industrial policy for Europe

A fast growing policy debate is now rediscovering the importance of industrial policy. The German trade union confederation DGB has proposed 'A Marshall Plan for Europe', envisaging a public investment plan worth 2% of Europe's GDP per year over 10 years. Further proposals have been put forward by the ETUC, and Europe's Greens have proposed a plan for €750 billion of public investment over three years which is intended to mobilise additional private investments of around €400 billion, targeted at a green energy union, sustainable and inclusive local development together with and a green and social innovation union.[21] There are several reasons for developing a new industrial policy in Europe.

[20] European Commission, *For a European Industrial Renaissance*, COM (2014) 14/2, 2014; European Commission, *A policy framework for climate and energy in the period from 2020 to 2030,* COM (2014) 15, 2014.

[21] DGB, *A Marshall Plan for Europe*, 2012, http://www.dgb.de/themen/++co++d92f2d46-5590-11e2-8327-00188b4dc422/#; European Trade Union Confederation, *A new path for Europe,* 7 November 2013, http://www.etuc.org/sites/www.etuc.org/files/EN-A-new-path-for-europe_3.pdf; M. Pianta, 'Industrial and innovation policies in Europe', in A. Watt and A. Botsch (eds.), *After the crisis: towards a sustainable growth model*, Brussels, ETUI, 2010, pp.92-95; M. Pianta, 'An industrial policy for Europe', *Seoul Journal of Economics,* vol. 27, no. 3, 2014, pp.277-305; J. Dellheim and F.O. Wolf, 'Alternative European Economic Policy, Industrial Policy, and Socio-ecological Reconversion', Paper presented at the 19th EuroMemo Group Conference, London, 20-22 September 2013; J. Dellheim and F.O. Wolf, 'On Industrial Policy – A follow up and some suggestions', Paper presented at the 20th EuroMemo Group Conference, Rome, 25-27 September 2014; EuroMemo Group,

1. *Macroeconomic reactivation*: A Europe-wide investment plan driven by public policies could end the current stagnation by contributing a substantial increase in demand and support the rise of new environmentally sustainable, knowledge intensive, high skill and high wage economic activities.
2. *Public-private balance*: A new EU-wide industrial policy could reverse the massive privatisations of past decades. The new activities could directly produce public goods, such as knowledge, environmental quality, well-being, social integration and territorial cohesion.
3. *European cohesion*: A EU-wide industrial policy could reduce imbalances among EU countries and regions, concentrating initiatives in weaker areas.
4. *Countering the ecological crisis*: A new EU-wide industrial policy could become a major tool for addressing the ecological transformation of Europe, reducing the use of non renewable resources, developing renewable energy sources and energy efficiency, protecting ecological systems, landscapes and biodiversity, lowering carbon dioxice and other greenhouse gas emissions, reducing waste, generalising recycling and opposing current agribusiness strategies including land- and fish-grabbing. A combination is needed of direct public action with provision of environmental services, and appropriate regulations for private activities, including environmental taxation, incentives, public procurement and organisation of new markets.
5. *Disarming the economy*. In the context of increasing international tensions and the return to armed conflict in and around Europe – in the Ukraine, the Middle East, etc. – it is important that industrial policy does not take the road of militarisation. The way out of the Great Depression in the 1930s was marked in all countries by state intervention for building up military production, associated with preparations for the Second World War. The EU and the other European states, Russia included, have to build their security through political and not military means. Its industrial and technological policies have to take a different road from the one taken by US policies, which involve support for the military-industrial complex. A more balanced, sustainable and equitable production system in Europe is also one that does not need militarization.

An appropriate industrial policy is a crucial tool for addressing these priorities. The activities that could be developed include the following:

- *Environment and energy:* The current industrial model must be fundamentally transformed in the direction of environmental sustainability. The technological paradigm of the future could be based on 'green' products, processes and social organisations which use much less energy, resources and land, and have a qualitatively lighter effect on climate and eco-systems; they could move to renewable energy sources, organise transport systems beyond the dominance of cars with integrated mobility systems, rely on the repair and maintenance of existing goods and infrastructure, and protect nature and the Earth.
- *Knowledge and Information and Communication Technologies (ICTs):* Current change is dominated by the diffusion throughout the economy of the paradigm based on ICTs. Its potential for wider applications, higher productivity and lower prices should be supported. Moreover, ICTs and web-based activities are reshaping the boundaries between the economic and social spheres, as the success of open source software, copyleft, Wikipedia and peer-to-peer initiatives clearly show. Policies should encourage the practice of innovation as a social, cooperative and

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EuroMemorandum 2014, http://www.euromemo.eu/euromemorandum/euromemorandum_2014/index.html; The Greens-European Free Alliance, *A Green investment plan for Europe*, 13 November 2014.

open process, strengthening the intellectual commons, while easing the rules on the access and sharing of knowledge, rather than enforcing and restricting the intellectual property rules designed for a previous technological era.

- *Health and welfare:* Europe is an aging continent with the best health systems in the world, rooted in their nature as a public service outside the market. Advances in care systems, instrumentation, biotechnologies, genetics and drug research should be supported and regulated considering their ethical, ecological and social consequences (as in the cases of genetically modified organisms, cloning, access to drugs in developing countries, etc.). Social innovation may spread in welfare services with a greater role for citizens, users and non-profit organisations, renewed public provision and new forms of self-organisation of communities.

All these fields are characterised by labour intensive production processes and by a requirement for medium and high skills, with the potential to provide 'good' jobs. Building on previous experiences, the new European industrial policy could rely on three main tools in each of the targeted fields.

1. *Public R&D and innovation*: There is an urgent need for renewing this field of public policy, as public research in universities, public laboratories and agencies – sometimes also funded by EU R&D programmes – have always been a key factor in Europe's long term development.
2. *Public investment for developing production:* This type of public action is essential for expanding investment in environmental, ICT applications and health fields. Three cases have to be considered here. First, some of these activities are mainly carried out in the public sphere, as in the cases of cleaning up pollution, ICT education or public hospitals and caring services. There is a serious underproduction of these public goods, and EU industrial policy could allow existing public organisations to invest and expand the quantity and quality of their services. Second, markets dominate some other activities, as in the case of photovoltaic cells, software or medical machinery. Existing private firms, however, under-invest in these activities due to the uncertainty about technological and market developments. A European-wide agency or national public investment banks could offer long term loans to private firms, or take equity in them. Third, there may be a need to create new firms – either with a European-wide or with a local scope – which address specific innovation and production challenges, as in the case of the lack of strong European producers of photovoltaic panels. In these cases public investment banks could take the lead in the creation of new firms addressing the needs of emerging new markets.
3. *Mission-oriented innovation and procurement programmes:* A new industrial policy in Europe could identify specific goals for scientific and technological advancement – in fields such as energy efficiency, renewable energy, prevention and the cure of diseases – through 'mission oriented' policies and procurement programmes for developing new products and processes with a potentially large market. Policies of this type have long been adopted in science and technology efforts.[22]

The institutional arrangements for the new industrial policy should be set within the European Union, coordinated with other EU policies and linked to a renewal of the EU sustainability strategy. Major changes are required in current EU regulations, in particular the ones that prevent public action from supposedly 'distorting' the operation of markets. The EU level is crucial also for funding

[22] See M. Mazzucato, *The Entrepreneurial State*, London, Anthem Press, 2013, which includes a discussion of relevant experiences, such as ARPA-E in the US and the Brazilian Development Bank BNDES.

such policy. As it is likely to meet opposition from some EU countries, a 'variable geometry' EU policy could be envisaged, excluding the countries that do not wish to participate.

Existing institutions could be renewed and integrated in such a new industrial policy, including – at the EU level – Structural Funds and the European Investment Bank (EIB). However, their mode of operation should be radically changed. In the longer term there is a need for a dedicated institution – either a European Public Investment Bank, or a European Industrial Agency – coherent with the mandate of reshaping economic activities in Europe.

EU governments and the European Parliament should agree on guidelines and funding for industrial policy, and call on the European Commission to establish appropriate policy tools. In each country a specific institution could assume the role of coordinating the implementation of industrial policies at the national level. These institutions should identify the new public activities that are required, the projects to be developed, and the private firms to be supported – either with public procurement, with low interest loans, or with a share in ownership.

Financing for a Europe-wide industrial policy should come from Europe-wide resources. It is essential that troubled national public budgets are not burdened with the need to provide additional resources and that national public debt is not increased. Funding should be of the order suggested by the proposals referred to above – about 2% of EU GDP over a period of 10 years, equal to some €260 billion a year. Such an investment effort appears to be feasible. It would effectively end Europe's stagnation and the leverage of these investments could be used to reorient European investment – public and private – towards the requirements of an industrial reconstruction based on sustainable development.[23]

Various funding arrangements could be envisaged. As suggested by the DGB proposal, funds could be raised on financial markets by a new European Public Agency; funds also could come from the Europe-wide receipts of a once-for-all wealth tax and from the newly introduced Financial Transactions Tax. Such tax income could help cover interest payments for the projects that are not profitable in market terms.

An alternative may come from a deeper European fiscal reform, introducing an EU-wide tax on corporations, thus effectively eliminating fiscal competition between EU member states. Perhaps 15% of proceedings could go to fund industrial policy, public investment, knowledge generation and diffusion at the EU level; the rest could be transferred to member states' Treasuries.

In the case of countries in the euro area, euro bonds could be created to fund industrial policy. A new European Public Investment Bank could borrow funds directly from the ECB and the ECB could directly provide funds for industrial policy to the spending agencies concerned.

The governance of the system could be established through the creation of a European Public Investment Bank or Agency together with similar organisations in each country. The European institution should be accountable to the European Parliament, which would appoint a board that included representatives from business, research organisations, trade unions, and environmental and civil society organisations. The European institution should engage in consultation with EU political, economic and social actors to develop its proposed industrial policy and it should be subject to approval by the European Parliament. Funds would then be assigned to national institutions and

[23] By comparison, EU Structural Funds for the period 2007-2013 amounted to €347 billion while lending by the European Investment Bank was €72 billion in 2013.

specific targets and activities. Monitoring and evaluation procedures similar to those required by EU Structural Funds should be arranged

In order to reduce the scope for 'pork barrel politics', the countries and regions where such investments could be carried out should be defined in advance, with the explicit aim of reducing the polarisation that is weakening the industrial base of Europe's 'periphery'. For instance, 75% of funds could go to activities located in 'periphery' countries (Eastern and Southern Europe, plus Ireland) with at least 50% devoted to the poorer regions of such countries while 25% could go to the poorer regions of the countries of the 'centre'. Policies should not focus on export oriented production, but rather on the sustainable development of local economies, including the emergence of new public, non-profit and cooperative activities. Past collusion between industrial policy and economic and political power should be overcome through extensive public consultations and a democratic debate about what and how we produce.

4 Social policy and combating inequality

4.1 The widening inequalities in Europe

Data produced by the European Commission makes clear the deterioration of social conditions in the EU brought about by austerity policies.[24] The share of the population of the EU subject to 'severe material deprivation' after gradually falling to 8.2% in 2009 has risen to 9.9% in 2012, that is by about 8.5 million people. For children and young people below 18 the corresponding figures are 9.5% and 11.7%. On a broader definition of poverty the number of those 'at risk of poverty or exclusion' has risen from 23.2% to 24.28% of the population over the same period. The percentage of people in households with little or no employment has increased likewise from 9.1% to 10.3% over the same three year period; while the percentage of 'NEETS' – young people not in employment, education or training – has, as a consequence of recession then aggravated by austerity, risen from 10.9% to 13.1% between 2008 and 2012.

The impoverishment of millions accompanies severe and widening inequalities, which are attracting increasing attention and are becoming a central theme in the political debates on the EU and the euro area. For this reason the social policy section of this year's Memorandum concentrates on inequality.

Income differentials both within countries and between countries result in global inequalities, with the latter accounting for around three quarters of the total. They are increasing all over the world and in Europe threaten to return to the massive inequalities which prevailed two centuries ago.[25]

The Luxembourg Income Study (LIS) gives longer-term data on household income inequality for 21 EU countries over the last twenty to thirty years. The LIS data indicate that inequality tended to fall in three small countries where it was initially very high and in two Nordic countries where it was already low – Sweden and Denmark. In five of the most populous countries – Germany, Italy, Spain, Poland and, above all, the Britain – inequality increased substantially. Later estimates by the European Commission show a further marked deterioration in Spain and Greece.[26]

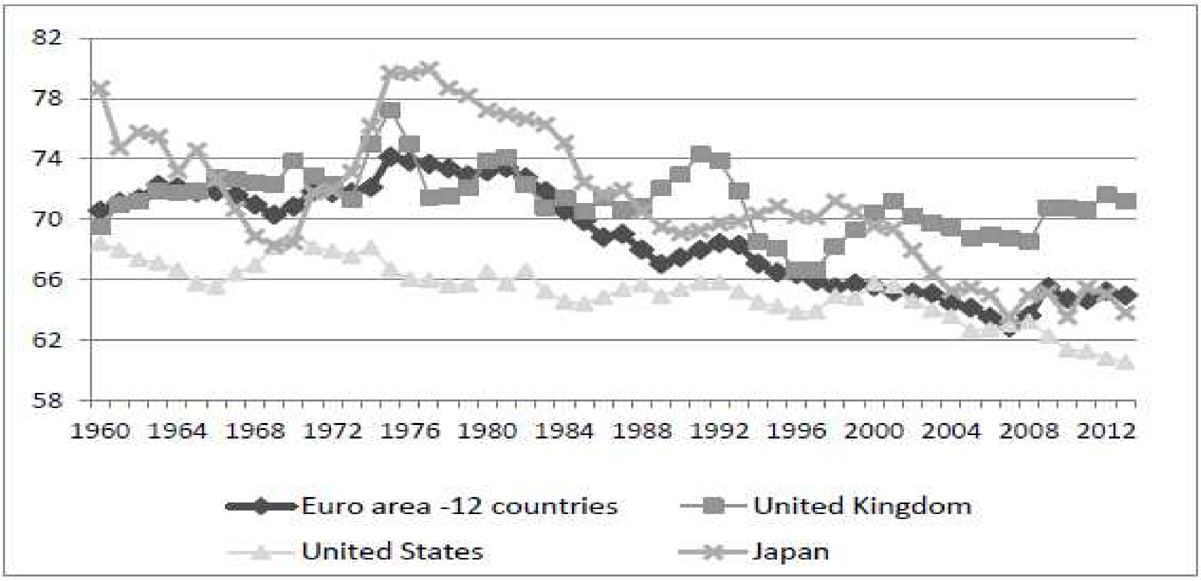
Behind the persistent long-term rise in income inequality there are two adverse trends. First, the share of income going to labour, shown in Figures 4.1, has been falling steeply and continuously for several decades. Second, within the share going to labour, wage incomes themselves have become very much more unequal. The OECD data shown in Figure 4.2 indicate a universal move to a larger share for the top 1% of earners (although the very highest such incomes, the 'compensation' of top management in the biggest firms are properly regarded not as payments for labour but as situational rents derived from the collective exploitation of dominant positions within corporate hierarchies). The inequalities in euro area countries are not as extreme as in the US or Britain but they have been widening rapidly.

The data referred to so far concern inequality within individual member states. However, inequalities among states, and household inequalities within the EU as a whole have also to be considered. If the integration process is to represent social progress then the well-being of EU citizens, rather than the functioning of national institutional structures must become the target of

[24] European Commission, *Employment and Social Developments in Europe*, 2013, pp. 463-4.
[25] F. Bourguignon and C. Morrisson, 'The Size Distribution of Income Among World Citizens, 1820-1990', *American Economic Review*, vol. 22, 2002, pp. 727-744; T. Piketty, *Capital in the 21st century*, Harvard, 2014.
[26] European Commission, *loc.cit*., pp. 474 & 475.

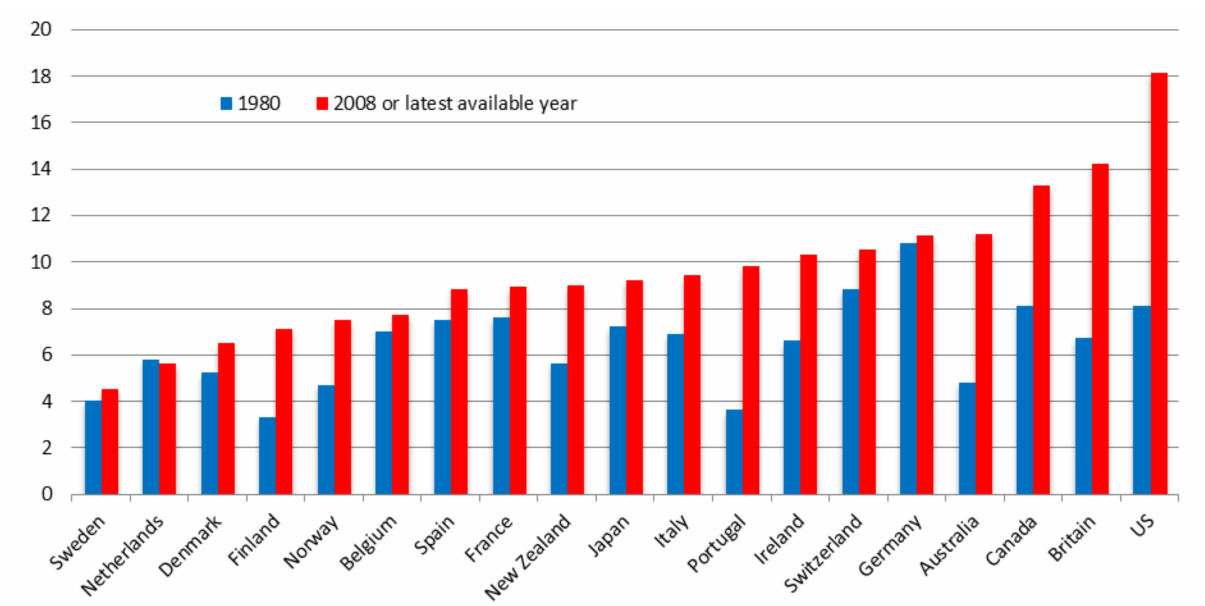
EU social policies. Moreover, tax-based transfer payments are, in the long run, more likely to be politically acceptable if they are seen as support for disadvantaged EU citizens rather than for specific member states.

Figure 4.1: Wage shares in developed economies, 1960-2013



Source: Thomas Goda, Özlem Onaran and Engelbert Stockhammer, 'A case for redistribution? Income inequality and wealth concentration in the recent crisis', University of Greenwich Business School, Working Paper, WERU9, 2014 (the authors used the AMECO data base).

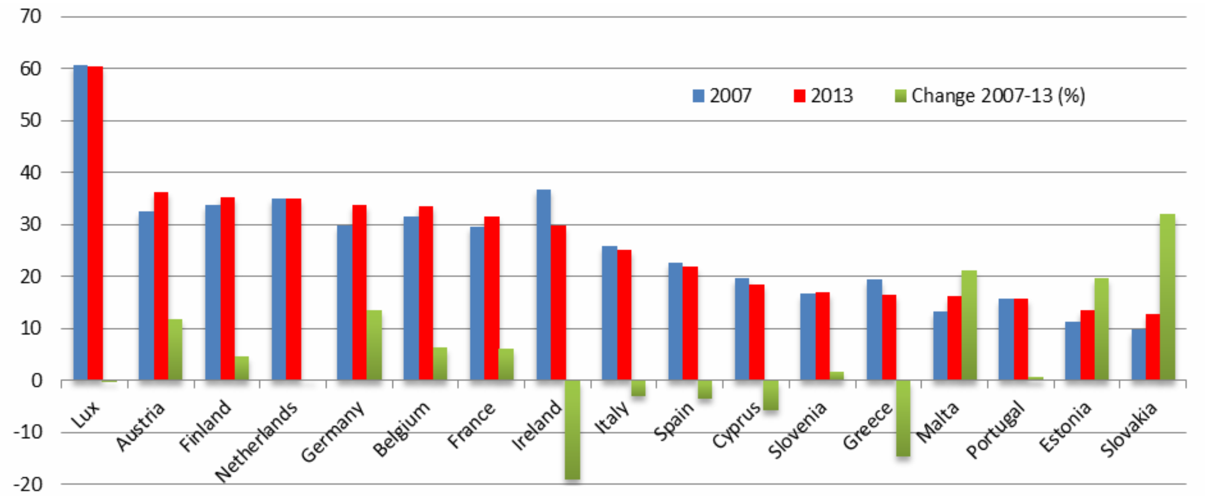
Figure 4.2: Share of the top 1% of earners in total taxable income, 1980 and 2008



Source: OECD, Statlink http://dx.doi.org/10.1787/888932566554

The fact that the Commission only presents data for individual countries is a tacit acknowledgement of how slow and inadequate the development of genuinely European social policies and social policy objectives has been. Although income and wealth distribution within individual member states tends to be lower than in the US, no disparity among US states approaches those found between the poorest and richest members of the EU. In fact inequality and social deprivation in the countries most struck by the crisis has direct spillover effects as many victims of unemployment, particularly the young, 'vote with their feet' and seek work in richer member states. This emergency migration, driven by social distress, weakens the development possibilities of the countries concerned.

Figure 4.3: Euro area national income per head (thousand euro)



Source: Eurostat 2014.

Figure 4.3 indicates that, even if the exceptional case of Luxembourg is ignored, the richest member states have a national income per head three times that of the poorest. Also, since the onset of crisis there has been in the euro area a strong process of concentration of capital, production and investment: for example R&D spending is increasingly concentrated on Germany and some of its neighbours: according to Eurostat data, Germany, the Netherlands and Austria accounted for 46.4% of euro area R&D in 2007; by 2012 this had risen to 49.2%.[27]

The apparent convergence in economic performance in the first years of monetary union has, therefore, proved to be a mirage; the crisis has led to very sharp divergence among the member states, aggravating the very adverse trends towards widening inequalities within each of them.

4.2 Gender inequalities in the crisis

The use of austerity measures in Europe is not gender-neutral. If women were initially spared from the worst effects of the crisis, they have not been able to avoid the effects of some of the proposed 'remedies'. The austerity measures and fiscal consolidation undertaken since 2010 have essentially taken the form of cuts in public spending for welfare and public employment, with an implicit prevalent recipient: women.[28]

Crises provide an opportunity to implement radical changes, including the ability to make significant progress on the issue of equality between women and men; at the same time they also pose a challenge where gender equality is regarded as a matter to be relegated to better times.

[27] Total intramural R&D expenditure (GERD) by sectors of performance [rd_e_gerdtot]

[28] Recent studies report a 'seesaw effect' in Spain, in Britain and in Denmark, that is a worsening of employment in female dominated sectors and an improvement in male dominated one. In Britain between 2011 and 2013 job loss in the public sector increased for women by 61,000 and fell for men by 31,000, while 73% of public sector pay freezes affected women threatening an expected widening of an already significant gender pay gap (20% in 2012). See A. Eydoux, A. Math and H. Périvier, 'European Labour Markets in Times of Crisis: A Gender Perspective', *Revue de l'OFCE – Debates and Policies*, no.133, 2014.

A recent report compiled by the ENEGE network of experts allows us to draw three main conclusions with respect to the gender impact of the crisis.[29]

1. During the crisis, we have seen a levelling down of gender inequality in employment, unemployment, wages and poverty. This, however, does not reflect progress in gender equality, since it is determined by a decline in employment rates, an increase in unemployment rates and a decrease in earnings for both men and women. Since the crisis, the segregation of the labour market has, in effect, protected women's employment, women's participation in the labour market and their wages. This segregation results in a major presence of women in the service sector (including the civil service) and an under-representation in the areas of manufacturing, construction and segments of the financial sector dominated by men. The overall level of segregation in a country is positively and significantly related to the difference in lost jobs for men and women. Men have suffered a loss of jobs higher than that of women in countries characterized by greater segregation. However, occupational segregation is likely to expose women at most where fiscal consolidation measures aim to cut jobs in the public sector.
2. The behaviour of women in the labour market during the crisis was similar to that of men. The traditional idea that women act as a labour reserve, called to work when demand increases and rejected again when demand contracts, had already been questioned during previous crises, and has been definitively refuted by this crisis. The 'reserves' of today are young men and women with precarious employment contracts, and migrant workers. In percentage terms, furthermore, men were more discouraged from seeking employment than women. The increase in the absolute number of involuntary part-time workers is, in fact, higher among women, but in percentage terms the increase was greater among men. The deterioration in employment conditions has affected men and women differently, rather than 'more' or 'less'. Some repercussions of the crisis relate specifically to women. The rights of pregnant women on maternity leave and allowances have been reduced and in at least four European countries it has been documented a clear discrimination against pregnant women.
3. While there is no evidence of a uniform scaling down of welfare benefits in the early years of the crisis, there is the threat that fiscal consolidation will eventually reduce both welfare benefits and employment in the service sector, with a consequent impact on gender equality. The consolidation measures that are likely to have the greatest impact on gender equality include the freezing or cutting of wages in the public sector; the hiring freeze or reduction of personnel in the public sector; pension reform; reductions and restrictions of benefits, allowances or facilities relating to the care of people; the reduction of housing allowances or family allowances; the restriction of the eligibility criteria for unemployment benefits or welfare or the reduction in the replacement rate of pensions; tax measures like VAT increases; and increases in tariffs for public services. The most recent data suggest that the specific impact of fiscal consolidation measures on gender equality varies greatly from one country to another.[30] While in some countries the impact is modest, in others the remarkable decline in employment, social benefits and social

[29] See F. Bettio, M. Corsi, C. D'Ippoliti, A. Lyberaki, M. Samek Lodovici and A. Verashchagina, 'The Impact of the Economic Crisis on the Situation of Women and Men and on Gender Equality Policies', 2012, available at http://ec.europa.eu/justice/gender-equality/files/documents/enege_crisis_report__dec_2012_final_en.pdf.
The report was produced by the network ENEGE (http://www.enege.eu). The reference period central to the analysis of the employment impact is (almost) four years from the second quarter of 2008 – when the recession began for the EU as a whole – and the first quarter of 2012. It covers 27 Member States, 3 EFTA countries (Iceland, Norway and Lichtenstein) and 3 candidate countries (Turkey, Croatia and Macedonia).
[30] See F. Bettio *et al, op cit.*

services is likely wiping out the gains recorded earlier. It is not excluded that differences in Europe in terms of equality may increase again as a 'side effect' of fiscal consolidation.

4.3 The need for an effective response to poverty and inequality

Both the extremely adverse social consequences of austerity policies and the strong trend towards wider inequalities necessitate a major programme of social investment. Although employment recovery in the short run would almost certainly require GDP growth there is no longer any convincing rationale for making GDP the central target of economic policy.[31] Economic considerations and considerations around 'societal development' both make for increasing scepticism when it comes to a one-sided orientation on growth.

An important strand of immediate political significance is the need to take social investment seriously. Although the theme has been addressed in debates on EU strategy since the beginning of the 2000s, the practical consequences have been very limited. The following points in particular were highlighted as arguments in favour of a social investment strategy: the lack of manageability of existing systems; a lack of monitoring and targeting, and the lack of synergies between different measures.[32] The European Commission claims that it is presenting a coherent strategy to combat such flaws. It states: 'the Europe 2020 Strategy for smart, sustainable and inclusive growth sets targets to lift at least 20 million people out of poverty and social exclusion and increase employment of the population aged 20-64 to 75%.'[33] However, as noted above, the drive for austerity is already putting many such targets beyond reach: between 2008 and 2012, for example, the employment rate actually fell from 70.2% to 68.0%.[34]

There are three major issues relating to social investment which must be addressed:

- Social investment can be seen as a major way of refocusing the current system. It permits an opening of policies towards issues that are of immediate significance for people's actual life.
- The major challenge is to make sure that the focus of social investment goes beyond a utilitarian consideration of 'enhancing manpower'. The Improvement of Living and Working Conditions[35] must be concerned with citizens' overall living conditions, and the improvement of the working conditions must answer the needs of people's lives and not the enhancement of economic growth.
- Demands relating to social investment policy should also be open to questions concerning the underlying understanding of growth. Despite frequent claims, in reality the way that economic growth is generally understood is far from being a means of achieving social progress.

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[31] For a mainstream approach, see the work undertaken by the Commission on the Measurement of Economic Performance and Social Progress, led by Joseph Stiglitz, Amartya Sen and Jean-Paul Fitoussi (http://www.stiglitz-sen-fitoussi.fr). More radical 'degrowth' approaches challenge the notion of growth as something which undermines wellbeing, both individually (for instance through 'overwork', economic dependency and consumerism) and for society (through the environmental impact and the consequences for social cohesion).
[32] See European Union, *Investing in Social Europe*, Publications Office of the European Union, Luxemburg, 2013, p. 7.
[33] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 2013: Towards Social Investment for Growth and Cohesion – including implementing the European Social Fund 2014-2020; COM(2013) 83 final: p2.
[34] *Employment and Social Developments in Europe*, p. 426.
[35] This is the title of an official European Union Agency charged with achieving improvements in the field.

Social investment strategy has to be understood in the light of a larger European and global project dealing with a restructuring of the European and the global economy. The understanding of growth must be linked with the question of distribution so as to address the challenge of increasing inequality. Social investment should not only address questions of investing in people (especially women) and their qualifications, so as to allow them to enter, or re-enter the labour market. Another, no less important goal is the redistribution of work so that employment is more widely spread, and so that people can work less without a loss of income and security. Three important points are crucial:

1. The budget is severely limited. The scope of the EU budget is completely inadequate failing, for example, to distinguish between economic, social and territorial cohesion. While the overall budget has been cut by 6% compared with the figure for 2013, cohesion policy is to be cut by 13.8% and asylum policies by 18.6%. By contrast, spending for the Connecting Europe Facility has been increased by 30.8%, justified by the dubious claim that it will create an additional 20 million jobs,[36] many of which will in any case not contribute to sustainable social growth since they will be oriented to people with high qualifications who are also prone to rapid relocation.

2. The intentions of the different social investment programme policies will be difficult to achieve. The various initiatives and programmes are not clearly coordinated and the concept of social investment serves rather as an ideological label. Part of this is a structural problem: the bulk of the EU social budget is spent on 'projects',[37] which amounts to providing financial support for individual measures. Securing an overall strategy remains highly problematic, something that is exacerbated by the fact that the share of 'community measures' and 'community initiatives' – the activities that are under the direct responsibility of EU bodies – is very limited.

3. The overall focus of the EU strategy is work and growth. There is not even a clear industrial policy, let alone a wider approach to what might be called a societal development strategy. A sustainable development strategy encompassing environmental, economic, social and cultural dimensions must stand at the core of any meaningful approach to social investment.

The future debate on social investment must move away from the underlying paradigm that is based in realisation of value in the market. The programmes that have been proposed are likely to maintain high levels of inequality since they focus at best on creating employment in peripheral areas instead of promoting the provision of stable and sustainable employment for the future. Social investment must be reoriented as to contribute to a wider process of transformation. Such a regime should include a system of basic security for all, and its provisions should be closely aligned with the development of a new strategy for industrial transformation.

The economic policies adopted in the EU over the last several decades have caused increasingly serious social distress accompanied by widening inequalities, which are, in the long run, destructive in both social and economic terms.[38] The austerity drive imposed throughout the EU but most relentlessly in the weakest economies has seriously aggravated both problems. As the recession provoked by financial crisis was followed by drastic cuts to public services, gender inequality has widened both in the sphere of employment and within households where it is predominantly women who struggle to compensate for the reduction in social provision.

[36] http://ec.europa.eu/digital-agenda/en/connecting-europe-facility (accessed 18 October 2014)

[37] European Union*, 2104 budget at a glance,* Publications Office of the European Union, Luxemburg, 2014, p. 3.

[38] On the corrosive consequences of inequality see R. Wilkinson and K. Pickett, *The Spirit Level: Why equality is better for everyone*, London, 2010.

It is no longer conceivable that minor policy adjustments could give a meaningful response to these problems. Only a complete change in priorities, subordinating the pursuit of corporate profits to social objectives, could begin to give the EU a positive meaning for European society and to address the deep disillusion of EU citizens with current policies. One key aspect of such a change is the introduction of a comprehensive programme of social investment. It will also be necessary to bring about fundamental changes in tax systems to challenge avoidance by powerful corporations and very wealthy individuals.[39]

[39] What is needed is certainly a 'fiscal revolution' as proposed in the French context by Landais, Piketty and Saez, *Pour une révolution fiscale*, Seuil, Paris 2011; Piketty, *op cit.,* has also put forward an interesting proposal for an EU-wide wealth tax. If levied at a rate of 2% on fortunes greater than €5 million, with a lower rate of 1% on wealth between €1 and 5 million, such a tax could generate revenues equal to 2% of EU GDP.

5 International trade and investment policy – the Transatlantic Trade and Investment Partnership (TTIP)

5.1 Recent developments: protests are on the rise

Intensified efforts to increase market access for EU companies at the international level have been an essential element of the EU crisis-resolution policies since 2008. Already with the communication 'Global Europe: Competing in the World', from October 2006, as well as the 2010 sequel 'Trade, Growth and World Affairs', the European Commission signalled a clear shift in the direction of its trade policy from multilateralism to an enforced use of bilateral agreements. The increasing number of EU bilateral initiatives during the last few years was topped by the announcement in early 2013 that the EU and the US had agreed to enter into negotiations on a bilateral free trade agreement, the so-called Transatlantic Trade and Investment Partnership (TTIP). Formal negotiations commenced in July 2013. The proposed agreement is intended not only to reduce tariffs between the world economy's two biggest trading blocs. Its primary aim is to focus on a very comprehensive set of regulatory issues and rules, with a view to dismantling and harmonizing these in areas such as agriculture, food safety, product and technical standards, sectoral regulations in services, intellectual property rights protection, as well as government procurement. In addition, investment liberalisation and the protection of investor rights are a central issue. With the WTO Doha round negotiations having been stalled since 2008,[40] and all major advanced industrialised as well as emerging countries resorting to bilateral agreements in order to secure their respective economic interests, the TTIP has to be seen as a project with a geopolitical ambition. It is both a reaction of the US and the EU to the growing economic and political influence of the BRICS countries, in particular China, and an attempt to construct new global rules for the regulation of trade and investment.

By October 2014, seven rounds of trade talks between the European Commission and the US Trade Representative had taken place. Overall, the pace of negotiations seems to be slow, and no significant breakthroughs have been achieved. The political as well as public discussion of TTIP in the EU has clearly gained momentum in 2014. After strong initial criticism on the proposed investment chapter, and in particular the investor-to-state-dispute-settlement mechanism (ISDS), the European Commission called for a public consultation on this issue. The three-month consultation ended on 17 July 2014 and received almost 150 thousand online-submissions.[41] The large number of replies is a result of forceful public campaigns orchestrated by NGO networks in Britain, Austria and Germany. Apart from the general discussion on the lack of transparency and accountability of the negotiations, apparently the topic that mobilised most of the support was the threatened liberalisation of public services. ISDS was specifically seen as a further instrument to propel the privatisation of public services, and in general as a mechanism to erode regulation in the public interest. These examples of strong mobilisation notwithstanding, one has to note the marked disparity between the national debates. Essentially, the debates were strongest in EU core countries, while it seems that in the Southern and Eastern periphery – with the notable exception of Spain and Hungary – a critical public debate did not generate sufficient momentum.

[40] The only exception to this is the agreement on trade facilitation approved in November 2014.

[41] European Commission, *Preliminary report (statistical overview). Online public consultation on investment protection and investor-to-state dispute settlement (ISDS) in the Transatlantic Trade and Investment Partnership Agreement (TTIP),* July 2014, http://trade.ec.europa.eu/doclib/docs/2014/july/tradoc_152693.pdf (accessed 26/10/2014).

The strong response to the public consultation notwithstanding, the battle on ISDS has not yet been decided. Though it appears that most national governments are in principle in favour of a trade agreement with the US, Member States are divided on the issue of ISDS. Particularly Germany, Austria, and France have voiced reservations, whereas in late October 2014 members of 14 other governments strongly supported ISDS in a letter to the in-coming Juncker-Commission.[42] Though some scepticism on ISDS was voiced by Jean-Claude Juncker himself, it is to be expected that the new Commission will be largely in favour of TTIP.

Recent events have clearly shown that TTIP has become a strongly contentious issue. Public resistance has been successful in slowing down the negotiating process. Mobilisation against TTIP however remains highly uneven across the EU. As of now, however, it seems likely that the initial schedule aiming at a conclusion of the negotiations by late 2015 will not be met.

5.2 Critique of official policies: minimal gains, substantial downside risks

The case for TTIP put forward by the European Commission and other supporters essentially rests upon two sets of arguments. The first relates to the claimed beneficial economic effects, the second to the geopolitical ambition of the agreement.

(a) The claimed economic effects of TTIP

The economic argument in favour of TTIP is basically built upon a series of economic assessments, which have been either commissioned by the EC or by other supporters of the agreement such as the German Bertelsmann Foundation.[43] All studies define various scenarios by comparing policy changes to a baseline that is a forecast on the assumption of unchanged policies. Policy changes are phased in over an implementation period of, typically, ten years. In Table 5.1, the 'limited scenario' in Ecorys (2009), the 'ambitious experiment' in CEPR (2013) and the 'reference scenario' in CEPII (2013) as major scenarios are considered. In all of these scenarios, a cut in trade costs of roughly 25% is assumed. In the Bertelsmann/ifo study, the 'comprehensive liberalization scenario' is regarded as the most important simulation. This experiment is also comparable to the 'NTB-scenario' in BMWT/ifo in which trade costs are also cut by 25%.[44] The basic similarities allow for a comparison of the results with regard to changes in real GDP, trade flows and distribution among sectors in the two economic areas of the EU and US, respectively. In addition, the implications for real wages and employment can be summarised. Table 5.1 provides an overview of the main findings.

[42] See the leaked letter at: http://blogs.ft.com/brusselsblog/files/2014/10/ISDSLetter.pdf (accessed 30/11/2014)

[43] The most widely cited studies are Ecorys (2009), CEPR (2013), CEPII (2013), as well as Bertelsmann/ifo (2013). For full references see footnotes 1 and 2 in W. Raza, J. Grumiller, L. Taylor, B. Tröster, and R. von Arnim, 'ASSESS_TTIP: Assessing the claimed benefits of the transatlantic trade and investment partnership', Final Report, Austrian Foundation for Development Research, Vienna, 31 March 2014.

[44] BMWT/ifo (2013) is a related study also by the ifo institute. The full reference for this study is G. J. Felbermayr, M. Larch, L. Flach, E. Yalcin and S. Benz, 'Dimensionen und Auswirkungen eines Freihandelsabkommens zwischen der EU und den USA', Report commissioned by the (former) German Federal Ministry for Economic Affairs and Technology, Berlin, 2013.

Table 5.1: Overview on results of pro-TTIP studies

	Ecorys (2009)*	CEPII (2013)	CEPR (2013)	Bertelsmann/ifo (2013)
Main Findings (different scenarios, percentage changes compared to baseline scenario within forecasting period)				
EU GDP	0.35-0.72	0.0-0.5	0.02-0.48	0.52-1.31++
US GDP	0.14-0.31	0.0-0.5	0.01-0.39	0.35-4.82++
EU bilateral exports	Not specified	49.0+	0.69-28.0	5.7-68.8++
EU total exports	0.91-2.07	7.6+	0.16-5.91 (extra-EU only)	not specified
EU real wages	0.34-0.78	N/A	0.29-0.51	not specified
Unemployment rate in EU-OECD countries (average)	unchanged (assumption)	unchanged (assumption)	unchanged (assumption)	-0.42 (deep liberalization)

* Findings for ambitious and limited scenarios only; + Reference scenario only; ++ Derived from BMWT/ifo (2013), aggregated to EU-27 level.

Source: own adaptation, taken from W. Raza, J. Grumiller, L. Taylor, B. Tröster and R. von Arnim, ASSESS_TTIP: Assessing the claimed benefits of the transatlantic trade and investment partnership, final report, Austrian Foundation for Development Research, Vienna, 31 March 2014

It should be stressed that the estimated numbers are positive, but small. GDP and real wage increases are estimated by most studies to range from 0.3% to 1.3%. Unemployment will either remain unchanged (by assumption), or in one case will be reduced by 124 thousand, i.e. 0.05% of the employed labour force in the EU. EU total exports will increase by 5% to 10%. If net exports are considered, changes are however much smaller. All of these changes concern the long run, which means that they will accrue over a transition period of 10 to 20 years. Put differently, annual effects during the transition period will be a fraction of these reported numbers.

These results are not surprising. With transatlantic trade being already very open – remaining tariffs are on average around 3%, and the bilateral stock of foreign direct investment standing at an impressive €2.4 trillion in 2011, economic activity between the EU and the US is already very intense. Most of the projected benefits of TTIP will thus not accrue from the removal of the few remaining tariffs, but are assumed to come from the elimination of diverging Non-Tariff-Measures (NTMs), i.e. the removal, mutual recognition or harmonization of regulations, administrative procedures or technical standards. NTM alignment is thus both a central issue to the negotiations and a key area of concern from a public policy perspective (see next section).

Besides, the results are still likely to overstate the case for TTIP, since they do not take into account two types of costs that are likely to emerge as a result of the agreement. These are macroeconomic adjustment costs and the total costs for society of regulatory change. Macroeconomic adjustments can come in diverse forms. Arguably the most relevant in the case of TTIP relate to (i) losses to public revenues, and (ii) changes to the level of unemployment.

(i) The elimination of all or most of the remaining tariffs due to TTIP will unavoidably lead to losses for the public budgets of the EU and its member states. During the transition period of 10 to 20 years the lower bound for these public revenue losses will be at close to 2% of the EU budget, i.e. €2.6 billion p.a. Thus, the EU will receive less income from its traditional own resources, a loss that only gradually might be compensated for by an increase of its GNI resources. A conservative estimate would arrive at cumulated income losses in the order of €20 billion over a period of 10 years, also depending on tariff exemptions and phase-in periods for sensitive goods.

(ii) All four pro-TTIP studies reject the idea that TTIP will lead to permanent unemployment. Either unemployment is assumed to remain constant (by three studies), or estimated to be reduced by TTIP. Any persons in import-competing sectors who lose their jobs because of TTIP are assumed to be reemployed instantaneously, i.e. with only negligible effects on their incomes and costs to the public budgets due to retraining expenses etc. According to one study (CEPR), between 430 thousand and 1.1 million workers will be temporarily displaced. The economics literature however suggests that (a) most displaced workers will earn lower wages in their new jobs, (b) retraining expenses particularly for less-skilled workers might be substantial, and (c) a fraction of the displaced workers, in particular older and less-skilled persons, will in all likelihood remain unemployed for a long time, thereby imposing substantial costs on national unemployment benefit schemes and social spending. These adjustment costs will be generally higher during times of economic crisis and low levels of labour mobility. Both of these conditions apply to the current situation in the EU. EU unemployment is at record heights. Labour mobility in the EU is generally low, though it has risen somewhat recently as a response to the economic crisis. A rough calculation yields annual expenses for unemployment benefits of between €0.5 and €1.4 billion during a TTIP implementation period of 10 years. Thus a cumulative €5 to €14 billion might be necessary to finance a part of the adjustment costs on the labour market, with additional costs for re-training and skills-acquisition not included in this amount. To this amount, a further loss of public revenue from foregone tax income and social security contributions between €4 to €10 billion has to be added.[45]

Another type of cost ignored by all of the pro-TTIP studies refers to the regulatory change resulting from TTIP. All studies, but particularly the Ecorys study, assume that a reduction of NTMs is welfare-enhancing. This ignores that NTMs such as laws, regulations and standards pursue public policy goals. They correct for market failures or safeguard the collective preferences of a society. As such they are themselves welfare-enhancing. The elimination of NTMs will result in a potential welfare loss to society, in so far as this elimination threatens public policy goals (e.g. consumer safety, public health, environmental safety), which are not taken care of by some other measure or policy. Economic analysis of the costs and benefits of regulations in the US finds that in aggregate the benefits outweigh the costs by a factor of six or more.[46] The analysis of NTMs in the Ecorys study completely ignores these problems. Instead, it is assumed that 25% to 50% of all existing NTMs between the EU und the US are actionable, i.e. can be eliminated or aligned, while CEPR assumes a 25% actionability level. This includes sensitive sectors such as foods & beverages, chemicals, pharmaceuticals and cosmetics or automotives. In order to arrive at its optimistic welfare estimations, strong reductions or alignments of NTMs in precisely those sectors are necessary, where the safeguarding of public

[45] See W. Raza, J. Grumiller, L. Taylor, B. Tröster and R. von Arnim, 'ASSESS_TTIP: Assessing the claimed benefits of the transatlantic trade and investment partnership', Final Report, Austrian Foundation for Development Research, Vienna, 31 March 2014, chapter 3.
[46] Office of Information and Regulatory Affairs, *2013 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities*, 2013.

policy goals is perhaps most crucial. It is highly doubtful that such high levels of actionability could be implemented without any losses to the quality of regulation in the public interest. Though subject to considerable uncertainty, the incurred social costs of TTIP regulatory change might be substantial, and require careful case-by-case analysis.

Though deeply ideological, the line of reasoning used to justify the TTIP, which puts regulation under the general suspicion of burdening the workings of a free market economy, unfortunately appears to be deeply entrenched into the design of the agreement. For under the euphemism of a 'living agreement', a permanent process for 'regulatory cooperation' between the EU and US will be included into TTIP. This will imply both the duty to inform the other party about new regulatory initiatives and changes to existing rules, respectively, and give the other party the formal right to be consulted at an early stage about any planned regulatory changes. The new competent body, the so-called 'Regulatory Cooperation Council', will have to evaluate whether a proposed regulation is the most efficient option to pursue a specific public policy goal. In other words it will discard those alternative regulatory options that are considered to infer an 'unnecessary' cost on trade. Thereby, the opinions of other stakeholders, in particular private regulatory bodies and affected businesses, will be heard. Put differently, business interests will be given preferential access to the body. Given the different regulatory approaches in the EU and the US, it is quite likely that regulatory cooperation will make future regulation not only much more complex and time-consuming, but will put EU regulatory initiatives under severe pressure from the US. The precautionary principle, which plays a key role in much EU regulation, would become very difficult to use in this context. In addition, it is arguably a further step to detach regulation from democratic debate, since either a regulatory proposal will not even be passed on for parliamentary ratification, or the EU Parliament will be confronted with a *fait accompli* at a very late stage in the policy-making process, giving it merely the option of a yes or no vote.[47] The European Commission has also proposed that the RCC would consider amendments to the sectoral annexes agreed in the TTIP and the addition 'of new ones', and that these would be done through 'a simplified mechanism not entailing domestic ratification procedures'.[48] The democratic role of parliaments and civil society, which play a major part in regulations through public debate and consultation, would appear to be drastically diminished in the technocratic structures and narrow objectives of TTIP.

(b) The geo-political agenda: TTIP as *'economic NATO'*

Lately, pundits of Atlanticism have emphasised the geo-political benefits of TTIP. Arguably, TTIP binds the EU to the US as a junior partner. At the same time the US strategic interest in Asia is growing rapidly. The concurrent negotiations on the Trans-Pacific Partnership agreement (TPP) have the explicit objective of curtailing the rising normative power of China. Nobody less than Hilary Clinton has therefore called TTIP an 'economic NATO'. [49] The general argument goes that in the context of intensifying rivalry between the allied Western powers, i.e. the US and the EU, and the emerging

[47] For a detailed analysis of the likely consequences of regulatory cooperation under TTIP see: Siles-Brügge, G.: 'Race to the bottom' or setting global standards? Assessing the regulatory impact of the Transatlantic Trade and Investment Agreement (TTIP), ARI 42/2014, Elcano Royal Institute, 19 September 2014; R. O'Brien, 'Regulatory cooperation at the core of TTIP and its likely consequences, unpublished manuscript', Brussels, revised October 2014, http://www2.euromemorandum.eu/uploads/regulatory_cooperation_obrien_rev_oct_2014_1.pdf.

[48] European Commission, 'EU-US Transatlantic Trade and Investment Partnership: Trade Cross-cutting & institutional provisions: Initial position paper', July 2013, p. 5.

[49] P. Van Ham, 'The Geopolitics of TTIP', *Clingendael Policy Brief,* no. 23, October 2013.

powers, in particular China, and more recently the EU conflict with Russia over Ukraine, there is a need for the US and the EU to close ranks and pool their economic and political strength. Thus Western liberal values are to be upheld against authoritarian rising powers. TTIP is presented as a crucial mechanism for achieving this goal. More specifically, TTIP is portrayed as a new global 'gold standard' for the regulation of an open and increasingly integrated global economy. It is argued that the harmonised bilateral standards to be produced under TTIP will sooner or later have to be taken over by the rest of the world without conferring a chance to negotiate over these on third countries. Obviously this argument rests upon the assumption that the US and the EU will agree upon harmonised standards. The history of transatlantic cooperation on standardisation would however suggest otherwise. Harmonisation of standards has proven to be costly, time-consuming and controversial.[50] Instead, the likely outcome of the TTIP negotiations on regulatory alignment will be mutual recognition. This is both less controversial in political terms, since no change to domestic regulation is required, and is favored by the corporate sector as not entailing any adjustment costs. Thus, very little in the way of regulatory gold standards are to be expected from TTIP.

A second argument advanced refers to the issue of energy. Given tense relations with Russia over Ukraine, and the high dependence of the EU upon imports of natural gas from Russia, it is hoped that TTIP will foster easier access to cheap US shale gas. Thus, energy dependence on Russia could be alleviated. At the moment, exports of shale gas are restricted and require approval by the US administration. But even if TTIP will facilitate gas exports, it remains doubtful whether sufficient quantities would be destined for exports. In addition, the gas exported to the EU would be significantly more expensive than the gas imported from Russia. For the US gas needs to be liquefied in order to be shipped to the EU, and then gasified again upon arrival in the EU. Both processes require costly investment in port infrastructure and shipping. With even out-going Commission President Barroso recently cautioning against premature hopes that US gas will solve the EU's energy problems, the case for ample and cheap US gas imports appears rather unconvincing.[51]

5.3 Alternatives: an EU trade agenda centred on democracy and international cooperation

Joseph Stiglitz is absolutely right in warning Europe against concluding TTIP in its currently proposed form.[52] The TTIP negotiations should be stopped and a fundamental rethink of EU trade policy should be put on the agenda. This is equally true of the Canada-EU Trade Agreement (CETA) negotiations, which have already been concluded. Much of what has been rightly criticised in the debate on TTIP has been implemented in CETA.[53] The most urgent task therefore is to stop the CETA agreement from being accepted by EU governments and ratified in the EU and national parliaments, respectively. An alternative EU approach to trade should be based upon the following principles:

1. Establishing full transparency of the negotiating process and the negotiating documents;

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[50] See R. O'Brien, op.cit.; G. Siles-Brügge and F. De Ville, 'The Transatlantic Trade and Investment Partnership and the Role of Computable General Equilibrium Modelling: An Exercise in 'Managing Fictional Expectations”', *New Political Economy*, DOI, 10.1080/13563467.2014.983059.

[51] 'US shale gas exports won't solve EU energy problems – Barroso', http://on.rt.com/xxs5rf, 5 July 2014, see also: F. W. Engdahl, 'Replacing Russian Gas Deliveries with US Shale Gas? Washington Lies to the EU', *Global Research*, 10 April 2014.

[52] See Il Manifesto, 25 September 2014, http://ilmanifesto.info/stiglitz-leta-della-depressione/ (accessed 26/10/14).

[53] See S. Sinclair, S. Trew and H. Mertins-Kirkwood (eds.), 'Making Sense of the CETA. An Analysis of the Final Text of the Canada-European Union Comprehensive Economic and Trade Agreement', Canadian Centre for Policy Alternatives, September 2014.

2. Holding regular and open consultations with the EU parliament and national parliaments during negotiations;
3. Safeguarding the policy space within the EU as well as vis-à-vis trading partners in order to regulate in the public interest. This entails in particular that regulatory competences must not be transferred to technocratic bodies or the private sector;
4. Applying an approach to trade liberalization that takes into account (i) the collective preferences of EU citizens with regard to, for example, the protection of public services, (ii) the lessons of the recent global and financial crisis with regard to the wholesale deregulation of financial services, and (iii) last but not least the development priorities of partner countries, in particular least-developed-countries;
5. Implementing binding provisions on the recognition of and adherence to basic human rights, in particular ILO core labour standards and international environmental standards;
6. Repudiating private systems of adjudication of claimed damages to investor rights, such as the proposed investor-to-state-dispute-settlement mechanism under TTIP. Instead, the EU should uphold the democratic prerogative of regulation in the public interest. Under a long-term horizon, the establishment of an international public court both for the arbitration of investor claims and the claims of parties negatively affected by those investments would appear desirable.

These principles might help to put EU trade policy on a different track. A track that makes a positive contribution to both the EU social model and an international economic order that is based on mutual respect and cooperation and not on domination.

6 EU neighbourhood policies

6.1 Enlarging the sphere of influence

The EU Neighbourhood Policy has two geographic vectors: East European post-Soviet countries (with the exception of Russia) and the Mediterranean. Lately, public attention has been focused on the so-called Eastern Partnership. In 2014, the latter made a major contribution to the massive conflict in Ukraine. The EU Association Agreement, which will export EU norms to Ukraine on a massive scale and will put the large East European country firmly into the EU sphere of influence, produced a sharp conflict within Ukraine and with Russia. The Ukraine is deeply divided on the question whether the country should seek closer alignment with the EU or with Russia. And Russia has formulated its own regional integration project, the Eurasian Union, which is competing with the EU Neighbourhood Policy in the post-Soviet space. The Ukrainian conflict has put the geo-political dimension of the EU Neighbourhood Policy into the limelight. The second dimension is the extension of neo-liberal governance through Free Trade Agreements both to the post-Soviet space and the Southern Rim of the Mediterranean. The two dimensions are intimately interlinked. The EU sphere of influence is expanded through the export of EU norms via very encompassing trade agreements.

The EU Association Agreement and the Ukrainian Conflict

In Ukraine, the key country of the region, the issue of the relations with the EU and Russia turned into an open conflict in late 2013. For Ukraine, economic relations with the EU and Russia are of almost equal importance. In 2012, 24.3% of Ukrainian exports had the EU as their destination whereas 24.1% went to Russia. In the case of imports, the EU share (40.7%) was higher than the Russian share (19.6%), but energy imports from Russia are essential for the Ukrainian economy. The composition of Ukrainian trade with the EU and Russia differs considerably. In 2012, 52% of Ukrainian exports to the EU consisted of raw materials, whereas exports of technologically more advanced products tend to go to the Russian market. Therefore, the Association Agreement was particularly in the interest of oligarchs in the Ukrainian agro-industrial business whereas heavy industry and the machinery industry could hardly hope to benefit from the agreement. The latter industries are rather concentrated in the East of the country. The Eastern Ukraine is more strongly linked to Russia than the West of the country. The Association Agreement goes beyond economic issues. It includes a political part with references to security co-operation. This illustrates the geo-political character of the agreement.

The Ukrainian population has been (regionally) deeply divided on the external orientation of the country. According to a poll conducted in November 2013, 64% of East Ukrainians, but only 16% of West Ukrainians were in favour of a customs union with Russia. In regard to closer relations with the EU, the opposite constellation could be observed – 66% of West Ukrainians favoured this option, but only 18% of East Ukrainians. This West-East-divide has many dimensions. The conception of the Ukrainian nation differs considerably between the two regions. In the West, an ethno-nationalist conception prevails. It emphasizes the linguistic aspect in defining the Ukrainian nation and the difference between the 'titular nation' and the 'national minorities' (especially the Russians).[54] In the East of the country a territorial concept of the nation is prevalent. It perceives Ukraine as a bi-ethnic and bi-lingual country and highlights the common historical roots. Political parties have been organised on regional lines and have highlighted the different concepts of the Ukrainian nation.

[54] M. Studenna-Skrukwa, *Ukraiński Donbas. Oblicza tożamości regionalnej*, Poznań, 2014.

Thus, the issue of the Association Agreement with the EU or eventual membership in the Eurasia Union was deeply divisive and potentially explosive. During the presidency of the pro-Western orientated Viktor Yushchenko the negotiations with the EU were commenced. His successor, Viktor Yanukovych who oscillated between the EU and Russia concluded the negotiations and initially defended the agreement. In view of the extremely precarious economic situation of Ukraine, the high costs of the agreement and Russian pressures, he decided against signing the Association Agreement shortly before the planned signing in autumn 2013.

Against the background of an extremely bad economic and social situation and discontent about the strong links between the government and heavy industry oligarchs, this decision led to protests, particularly in the West and the centre of the country. Initially, it was mainly the well-educated strata in the urban centres that provided the backbone of the protests. At first, they tried to keep a distance from the opposition parties. Nevertheless, these parties – ranging from neo-liberal nationalist oligarchic formations to the fascist Svoboda – joined the protests. They hoped to gain political terrain against the government. Some of the parties received considerable external support, notably from Germany and the US. Western embassies entertained contacts to the opposition, including Svoboda. After government repression, the protests turned more generally against the government and violence escalated.

A last minute attempt by the German, French and Polish foreign ministers to negotiate a gradual transition was aborted on 20-21 February 2014, and Yanukovych was toppled. A new coalition consisting of pro-Western nationalist neo-liberals and fascists assumed power. It changed the external orientation of the country, but not the oligarchic character of the state and the ordo-liberal orientation of the economic policies. The government rapidly signed the political-military part of the agreement on 21 March. The economic part was signed at the end of June. Both the European and Ukrainian Parliament ratified the agreement on 16 September. It is to come into effect at the beginning of 2016. Immediately after the change of government, the Ukrainian parliament adopted a highly controversial and symbolic language law. This step exacerbated the regional tensions and alienated the population in the South and the East of the country. With the escalation of the regional tension, the issue of a far-reaching regionalisation came onto the political agenda.

At a regional and local level, the conflict rapidly escalated. The Russian government stepped up pressure. Paramilitary forces occupied strategic positions on Crimea where a large Russian naval base is located. After a hastily convened referendum, Crimea seceded from Ukraine and was integrated into Russia in March 2014.

The conflict did not stop with Crimea. Paramilitary forces with an increasingly separatist orientation emerged in the Donbass region, a hub of heavy industry, in Eastern Ukraine. Though they have received Russian support, these forces have a local base as well. In Donbass, the conflict turned into war. A cease-fire was agreed in early September 2014. A lasting political solution is not on the horizon.

With the escalation of the conflict, the relations between the EU and Russia rapidly deteriorated. The US, Britain, Poland, Romania and the Baltic countries argued for a hard line towards Russia and sanctions. Other governments, such as those of Germany, Austria, Italy, the Czech Republic, Hungary and Slovakia, tended to be less inclined towards sanctions. The German foreign minister, Frank-Walter Steinmeier, even expressed doubts on the policy towards Ukraine pursued hitherto and argued that the Eastern neighbours should not be pushed towards 'either-or-decisions' regarding the

EU and Russia.[55] However, the hard line finally prevailed in the EU. NATO was a key forum for discussing and co-ordinating US and EU positions on Ukraine (though not all EU member states are members of NATO).

6.2 Association agreements deepen asymmetric relations

The conclusion of Deep and Comprehensive Trade Agreements is at the very heart of the EU Neighbourhood policy. Like traditional trade agreements, they liberalise goods trade. The goods trade clauses of the EU Association Agreement mirror the asymmetry in negotiating power of the two sides. Whereas there will be a long transition period for agriculture as a key sensitive sector for the EU, the treaty hardly provides for a gradual reduction of protection of vulnerable Ukraine sub-sectors (with the notable exception of the car industry). The Deep and Comprehensive Trade Agreements go, however, far beyond traditional trade agreements. They transfer key EU norms and economic governance structures to neighbouring states. For example, EU competition rules are transferred, rules for public tenders ensure full access for EU companies in the neighbouring countries, and capital flows are not to be subject to state controls.

Strong negative effects on the economies of the neighbouring countries whose productive structures suffer from significant weaknesses are foreseeable. Trade liberalisation will deepen already existing tendencies to de-industrialisation. The clauses on competition, tenders etc. take away industrial policy option that might at least partially compensate for the loss of protection. Thus, the agreements are not conducive to the development of productive sectors. This can be gauged from the experience of similar agreements with states in the post-Yugoslav space. In addition, the norms introduced through trade agreements are binding for future governments which might be in favour of a different direction of economic policies and strategies.

The Deep and Comprehensive Trade Agreements hollow out democracy though the preamble includes a reference to the 'respect for democratic principles' as a supposedly 'common value' of the contracting parties. Though the focus of the agreements is clearly on economic issues, the East European Association Agreements include a brief political part. In the controversial Ukraine case, references to military and security co-operation form part of the political section of the Association Agreement. This underlines its geo-political character.

Energy issues have been a key concern of the EU in both the post-Soviet space and the Mediterranean. Both regions are important for the transit of energy, and some Mediterranean countries, particularly Libya and Algeria, are important oil and gas producers. In regard to Eastern Europe, the EU has exported key elements of its *acquis communautaire* on the energy market through the Energy Community Treaty of 2005. The EU Association Agreement with Ukraine – a key transit country for Russian gas – contains a specific chapter on energy which inter alia establishes an independent regulatory authority for gas and electricity and phases out energy subsidies to households. The issues of energy regulation are extremely controversial between the EU and Russia.

In both areas of the Neighbourhood Policy, key EU member states have promoted indirectly or directly regime change in states where they disapproved of the geo-political and geo-economic orientation of the previous governments. The measures have ranged from support of opposition groups (often through NGOs or foundations), such as in the case of Ukraine, to outright military intervention in the case of Libya.

[55] *Frankfurter Allgemein Zeitung*, 30 March 2014

EU-Russian Competition in the Post-Soviet Space

The Eastern Partnership has been targeted at Armenia, Azerbaijan, Belarus, Georgia, Moldavia and Ukraine. Since the break-up of the Soviet Union, it has been an objective of the US (and Britain) to wean these countries, particularly Ukraine, away from Russia. This concern has been in particular shared by Poland, the Baltic countries and Romania whose relationship with Russia is overshadowed by a complicated and often painful past. EU countries such as Germany, Austria and Italy have long-standing economic relations with Russia, particularly in the gas sector, which usually stretch back into the times of the Soviet Union. In these countries, there has been a strong interest in further developing these economic relations and developing co-operative political links with Russia. Significant political sectors in the Czech Republic, Hungary and Slovakia likewise emphasized the importance of economic links and of a co-operative relationship with Russia. The relations between the EU and Russia experienced only a brief spring after the Iraq war when there was ephemeral coincidence between the multi-polar international orientation of the Russian government and of key governments in the EU (Chirac in France and Schröder in Germany). Those EU governments which have been in favour of co-operative relations with Russia did not question the strong focus of the EU on negotiating Association Agreements with the post-Soviet countries.

The countries of the Eastern Partnership were part of the Soviet Union and usually still have strong economic links with Russia. Only in the case of Azerbaijan and Moldavia, has the EU accounted occasionally for more than 50% of external trade. In the other countries, the EU share in external trade has oscillated between a quarter and a third and has usually shown a declining tendency since the beginning for the present crisis. The EU is usually an important, but not a dominant trading partner.

The Russian government countered the proposed EU Association Agreements with its own regional integration initiative, the Eurasian Economic Union. As Sadowski underlines, the two projects 'exclude each other'.[56] The Russian proposal provides a higher degree of protection to existing industries than the proposed EU agreements. The EU agreements with their focus on free trade do not take into account the lasting consequences of the post-transformation depression – real GDP was still 30% to 45% below the 1989 level in 2008 in Georgia, Moldavia and Ukraine – and the enormous gap between the per capital GDP in the EU and the post-Soviet countries. In Belarus the per capita GDP at Purchasing Power Parity reached 50% of the EU level in 2012. In oil producing Azerbaijan, it was 33%, in Ukraine 24%, in Armenia and Georgia 18% and in Moldavia a paltry 11%. In these countries, the (re-)construction of productive capacities should be a priority. This question is not seriously addressed in the EU Neighbourhood Policy.

Azerbaijan with its oil exporting economy has shown no interest in an Association Agreement with the EU and has maintained a distance to both projects. Belarus with its well-developed manufacturing was interested in technical and economic cooperation with the EU, but not in an Association Agreement. It has formed jointly with Russia and Kazakhstan the nucleus of the Eurasian Economic Union. Primarily for geo-political reasons – close political links with Moscow and extremely conflict-ridden relations with Azerbaijan – Armenia refrained from signing an Association Agreement with the EU and recently applied to join the Eurasian Economic Union. Likewise for geo-political reasons (in this case conflict-ridden relations with Russia), the Georgian government took a decision in the opposite direction – opting for an Association Agreement with the EU. In Moldavia and

[56] Rafal Sadowski, *Partnerstwo in czasach kryzysu. Wyzwania dła integracji europejskiej państw Europy Wschodniej, OSW Punkt Widzenia*,. Warsaw, 2013, p.13.

Ukraine, the decision on the Association Agreement has been particularly controversial. Moldavia signed the Agreement in late 2013.

Choosing (Dubious) Partners in the Mediterranean

The balance sheet of the Mediterranean vector of the EU Neighbourhood Policy is hardly better. On the Southern Rim of the Mediterranean, the EU initially banked on the governments in Egypt and Tunisia as pillars of its regional policy. It perceived the two governments as regional success stories of neo-liberal reforms. The perception of the local population was, however, different. Widespread discontent with the authoritarian character of the regimes, the crony character of local capitalism and the bad social situation erupted into broad protests that finally resulted in the toppling of the two governments in early 2011. The protests spread to other Arab countries as well.

The revolts could have been an occasion for the EU to rethink its Mediterranean Neighbourhood Policy. This has, however, hardly been the case. The EU has put a bit more emphasis on 'political reforms', but the focus on free trade and the export of EU economic regulations has been retained. At the end of 2011, it initiated steps towards the realisation of a Deep and Comprehensive Free Area with Egypt, Morocco, Tunisia and Jordan. Since the realisation of Deep and Comprehensive Free Trade Agreements is viewed as a rather long-term undertaking, the European Commission has embarked on more limited trade agreements as well. The aim of the Commission has been to remove protective barriers that hinder the expansion of West European companies in the region. For the ailing local industries, the EU approach will rather exacerbate existing problems. Even partisans of a free trade approach for the region, like Anna Maria and Eugenia Ferragina, see the need for modifying the EU approach: 'Europe can only regain credibility as a political and economic interlocutor by overcoming the euro-centric perspective, by putting the issue that the *acquis communautaire* represents the only way to an economic and political transition of the Southern and Eastern rim of the Sea into debate.'[57]

Key EU member states, however, were not passive in the face of social revolts in Arab countries. They perceived the chance to get rid of governments which they considered as not being sufficiently pro-Western in their external orientation. In Libya, the escalating internal conflict served as a pretext for direct military intervention by Britain and France (with Germany taking a more reserved position) which was officially justified by humanitarian concerns. As Moncef Djaziri observes, the humanitarian discourse concealed different concerns. 'As in Iraq, the war that was waged against the Khaddafi regime and for democracy was in reality a war for the control of energy sources in the context of increasing scarcity.'[58] France, Britain and the US aborted efforts of the African Union to negotiate a peaceful transition in Libya. As earlier in Iraq, the intervention has resulted in the de facto fragmentation of the state and permanent conflict among warring groups. The Libyan war spilled de facto over to Mali where a coalition ranging from Islamist extremist forces to Tuaregs took control of the country – provoking another external intervention led by France.

In Syria with its high geo-political significance for the whole (oil-rich) Middle East, Western governments were initially more cautious than in Libya. Eventually, they took side with those opposition groups that were inclined towards a military strategy against the deeply authoritarian

[57] Anna Marian Ferragina, and Eugenia Ferragina, 'Europa e Mediterraneo: le potenzialità di integrazione e le strategie di rilancio della politica euro mediterranea', in Eugenia Ferraginaand Paolo Malanima (eds.), *Rapporto sulle economie del Mediterraneo. Edizione 2014*. Bologna, p. 89.

[58] Moncef Djaziri, 'Natura e sfide della transizione democratica in Libia', in Massimo Campanini (ed.), *Le rivolte arabe e l'Islam. La transizione incompiuta*. Bologna, 2014, p. 88

regime. These groups belong overwhelmingly to those currents of Sunnite religious right which are regarded by Western liberal commentators as representatives of 'moderate' political Islam. Regional powers, such as Turkey, Qatar and Saudi-Arabia, became deeply involved by supporting oppositional (Sunnite) politico-military groups, whereas Iran and the Lebanese Hezbollah have sided with the government which had nurtured a long-standing close political and military cooperation with Russia (and earlier with the Soviet Union). An extremely violent war that has led to the de-facto fragmentation of the Syrian territory into parts that are controlled either by the government or right-wing religious forces or left-wing Kurds has ensued. Over time, very extremist Sunnite forces claiming to represent an 'Islamic State' (IS) have established control over parts of both Iraq and Syria. Alarmed by the unwanted consequences of their interventions, Western powers have stepped up their military involvement in Iraq and Syria in 2014. The US government decided to bomb IS positions, France and Britain followed suit.

6.3 The need for different neighbourhood policies

The Neighbourhood Policy of the EU is not suitable to strengthen the productive structures of the economies in the post-Soviet countries and the Mediterranean and to make the economic relations less asymmetrical. On the contrary, it will lead to partial de-industrialisation and even more profound structural asymmetries. In Ukraine, the Eastern Partnership Policy exacerbated pre-existing tensions over the external orientation of the country and regional antagonisms. Subordinate partial integration into the *acquis communautaire* has led to de facto national disintegration in Ukraine with Russia supporting separatist (or at least autonomist) tendencies of the Russian-speaking population. In Arab countries, such as Libya, Syria and Iraq, military intervention or at least strong support for specific political-denominational groups by the US, Britain and, partially, France (and some other EU member states) has led to lasting processes of national disintegration.

The dismal balance sheet of the EU Neighbourhood Policy underlines the need for a fundamental re-orientation of the EU approach. Three issues are of key importance:

1. The Deep and Comprehensive Free Trade Agreements reflect the general neo-mercantilist orientation of the EU. They should be abandoned in favour of a co-operation policy that renounces the transfer of EU norms to the neighbouring usually (semi-)peripheral economies, contributes to the strengthening of their productive structures and preserves policy space for the neighbouring countries. Such an approach would at least enable the building of productive capacities in the outer periphery of the EU and would reduce regional antagonisms. Such a re-orientation would be facilitated by a more inward-looking development strategy of the EU.
2. Energy – gas and oil – looms large in the expansionary approach of the EU and its member states. The production and consumption structures in the EU are highly energy-intensive and highly dependent on the import of fossil energies. This import-dependence should be systematically reduced by changing the energy mix in favour of renewable energies and by reducing the energy intensity of production and consumption, including by reducing the transport-intensity of the production systems. This would entail matching local production and consumption structures more closely.
3. The conflict in the Ukraine has led to a closer interaction of EU and NATO structures. There is a tendency towards the militarisation of external policies. This tendency needs to be reversed. Capacities and international institutional settings that contribute to peaceful conflict-resolution should be strengthened.

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