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The E.U. needs more than quick fixes

- In 2013, the EU's GDP will still be below that of 2008 with unemployment rising further. This recession differs from previous ones as, on top of the cyclical downturn, there is a structural cycle associated with globalization; moreover, superimposed on these cycles there are the effects on the economy from the lack of confidence as the measures proposed by the authorities seem yet again to be behind the curve.

- For over 100 years, the industrialized world enjoyed an economic rent. As the sole producer of medium to high technology products, they were sold at premium prices to the rest of the world, while at the same the oversupply of commodities from developing countries led to stagnant or even declining commodity prices for many decades.

- Globalization, which took a new turn with the emergence of China, sounded the death bell for the old international order around the middle of the last decade. Emerging Markets have been climbing the technological ladder rapidly with the result that the old industrial world is facing fierce competition in the medium technology segment, implying they can no longer sell their industrial products at premium prices. At the same time, the E.U. has been continuing to merrily provide significant wage rises without upgrading its production structure. Germany, reflecting its specialization in high value added products and having shown significant wage restraint, is coming out of the crisis relatively unscathed. Its cumulative growth in unit labour costs has been only 4% since 2000 compared with 23% in France, 28% in the U.K. and 30% in Spain and Italy, while there has been a surge in commodity and energy prices in the Eurozone (which have risen by some 80% since 2005). The consequent squeeze in profit margins in the latter countries has led to a sizeable cut in R&D expenditure and investments, thus eroding further their growth potential, especially in the medium technology product category. At the same time, these countries did not succeed in shifting production up the technology scale, with the result that the share of industrial production in GDP has fallen to very low levels. If high value added production is concentrated in a few countries with the rest lagging behind, this will be as important a destabilizing factor for the Eurozone as the fiscal irresponsibility of a few countries.

- Policy makers have failed to understand the multidimensional nature of the crisis that has hit the E.U. They have focused almost exclusively on correcting fiscal imbalances, hoping that easy monetary policy would revive growth while relegating structural reforms way down the scale of priorities. The loss of the economic rent and the impact of the rise in commodity prices have curbed the real national disposable income of the Eurozone, which, when added to the loss of income (and more importantly wealth) caused by the financial crisis and its aftermath, would bring the total loss in many countries to over 10% of GDP. In addition, the lack of confidence has a significant impact on GDP. In particular, investment is still almost 15% below the 2008 level. All these factors explain the prolonged crisis as piecemeal and half-hearted policies cannot be expected to bring growth back quickly and, the longer stagnation persists, the more hysteresis will embed making the exit even more difficult. There is no doubt that public expenditure in countries with fiscal imbalances has to be reduced (drastically in a few countries) but this by itself will deepen the recession or postpone countries' exit from it, even if easy monetary policy mitigates the deflationary effects. Only if this policy mix is accompanied by extensive structural reforms, which go much beyond the Lisbon agenda, can the needed restoration of confidence be triggered. Markets are sensitive to fiscal developments but they also pay close attention to the growth outlook.

- As in Germany, product and especially labor market reforms would help to reduce unemployment. Even if this is accompanied by stagnation in average wages over an extended period, or even a reduction, total household incomes will probably rise as the unemployed are brought back to employment, which in turn will improve markedly the fiscal situation. A new measure other than average real wage growth has to be conceived, which takes the loss (gain) of real incomes due to firing (recruitment) into account. Liberalization of professions and the break up of closed shops are also necessary, while the authorities should additionally use all means to channel extra resources to R&D at the level of production and to the educational system. Otherwise from a frontrunner the E.U. will fall to 5th place on the world technological scale with dire consequences for future generations and its geopolitical standing.

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