Béla Galgóczi

A ‘Europe of multiple speed’ in a downward spiral

Abstract

Central and east European new member states are being affected by the shockwaves of the Eurozone crisis, made manifest also in the presence of different stages, or ‘speeds’, of integration. In this article, we attempt to examine the different aspects of this picture of a multi-speed Europe, and the lessons of those regions and countries that have been affected by the crisis and by the implemented therapy, and we identify the major risks that this means for the future of Europe. New member states find themselves in a rather unique situation in the context of the enduring Eurozone crisis. On the one hand, as ‘junior partners’ they are more vulnerable (and are also in the eye of the financial markets); on the other hand, economically they are fully docked to the core of the EU, i.e. Germany, that results in ambiguous and sometimes contradictory consequences. One particular aspect will be to examine if ‘convergence’ – a basic and distinguishing idea behind European integration – would ultimately turn out to be a myth.

Keywords: *central east Europe, growth and employment, credit crunch, external financing, Eurozone crisis, Mediterranean crisis states, two-speed Europe, economic and trade integration, neo-liberal orthodoxy, social Europe, EU enlargement*

Introduction

It was Nicolas Sarkozy who brought the term ‘a Europe with two speeds’ into the debate, meaning member states with different ‘speeds’ of integration. The emphasis was laid here on a commitment to more integration in the sense of a ‘coalition of the willing’, as was the case with the Euro+ Pact in March 2011 (Euractiv, 2011) and with the Fiscal Pact agreed at the EU Summit in December 2011 (European Council, 2012). It is one of the consequences of the Eurozone crisis that the call has arisen for more European integration, including economic governance and even fiscal union. In the first instance, deeper integration would affect economic and monetary union members (plus those non-EMU member states that join voluntarily), thus creating a two-speed Europe in terms of integration.

The notion of ‘different speeds’ is, however, also used in terms of the growth and development perspectives of individual member states with a view to economic and social divergences within Europe, particularly within the Euro area. This is not simply a question of different growth rates among member states. The focus here is on how member states have been affected by the crisis and how they are being affected by the imposed adjustment that has followed (the austerity measures). In this regard, the line of division mostly appears between surplus and deficit countries within the Eurozone, with the ‘core countries’ around Germany on the one hand and the Mediterranean crisis countries on the other. The practices of the imposed adjustments are affecting ‘deficit

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countries' asymmetrically, as they are the ones that are subject to the resulting loss of national sovereignty through interference from European institutions, which is also revealing itself in terms of a democratic deficit. This would be a serious problem if the 'imposed adjustment' was rational and necessary; with the current ill-design of the measures, however, this might even become fatal or, as Paul Krugman has put it: 'Europe's Economic Suicide' (Krugman, 2012).

The crisis has also shown that new member states are far from a homogenous group. Even if they showed vulnerability during the first wave of the crisis, and some have continuing balance of payments problems, their situation is also greatly different from that of those countries on the Mediterranean periphery, as we will show.

We also show how new member states from central and eastern Europe are affected by the shockwaves of the Eurozone crisis, made manifest also in such different stages, or 'speeds', of integration. In this article, we attempt to examine the different aspects of a multi-speed Europe and identify the major risks that these mean for its future. One particular aspect will be to examine if 'convergence' – a basic and distinguishing idea behind European integration – would ultimately turn out to be a myth.

Divergent developments in pre-crisis Europe

There have already been two major lines of division in terms of the depth of political and institutional integration in Europe: the common currency; and the Schengen agreement.

For member states not having the Euro, there are also three sub-groups: member states who have a derogation (Denmark and the UK having free choice to join and who show no willingness to do so in the foreseeable future); for the other member states, adopting the Euro is mandatory once they meet the qualifying criteria, while Sweden keeps itself out by not fulfilling at least one of them. Five new member states (Slovenia, Cyprus, Malta, Slovakia and Estonia have already adopted the Euro; while most are also part of the Schengen agreement (with the exception of Bulgaria, Romania and Cyprus). The UK and Ireland are not part of the Schengen zone, although non-EU Norway and Iceland are members.

On top of that, there is still a substantial income gap between old and new member states, although this is becoming more blurred. Slovenia has already overtaken Portugal in terms of per capita GDP, while the Czech Republic is close to doing so. Currently, we are witnessing a 'reverse convergence', which means that crisis-ridden Portugal and Greece are to be overtaken by the Czech Republic and Slovenia respectively, as the latter have been less affected by the recent problems.

We will also show later that *de facto* economic integration (in terms of trade and investment flows) has been higher for central and east European new member states than it has been for the Mediterranean periphery of the EU. In the current crisis, this is manifesting itself in the paradoxical phenomenon that most countries from central and eastern Europe, due to their tight integration with the German economy, are part of the wider Germany-based economic 'core' of the EU and, in this respect, also the counterparts of the 'deficit countries' in the south. (It is ironic to see that both Slovakia and Estonia are keen to emphasise that, in the case of a splitting-up of the Eurozone, they would be part of the 'north Euro group' around Germany.)

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Now that we have flashed up the rather confusing multi-dimensional character of European diversity (the multi-speed Europe), we look next at the main developments in the central and east European region prior to the crisis, with special respect to wages and productivity. Then, we draw some of the lessons both from the 2009 crisis that hit the new member states particularly hard as well as from the 2010-2012 Eurozone crisis, of which the epicentre is located on the Mediterranean periphery.

Wage developments in central and eastern Europe prior to the crisis

This section provides an overview of wage developments and their drivers in central and eastern Europe in the period up to the crisis, and puts this into the context of the current Eurozone crisis and the applied adjustment strategy. The major question is whether the dynamic wage increases that were experienced before the crisis can be generally regarded as unsustainable processes that undermined competitiveness and which consequently require a major downwards adjustment. Would this be the case, then previous dreams about fast-track wage convergence would be deemed illusory.

The 1990-1991 systemic change and the subsequent economic integration of the region of central and eastern Europe into the European and world economy had far-reaching consequences for wage developments and wage-setting mechanisms. It is important to bear in mind that the *de facto* economic integration of the region (via free trade and free capital movement) took place right after the opening up of the early 1990s. The accession of central and east European countries to the EU (eight central and eastern European countries in 2004; Romania and Bulgaria in 2007) could be seen as a political-institutional act that completed this process by drawing these countries within the EU legislative framework. Mobility of goods and services was extended to the region at the time of EU accession, while free labour mobility has been granted in a gradual process (completed in 2011 for the 2004 accession countries while being partially available (with restrictions up to 2014) for the 2007 entrants).

The main trends in wage developments in CEE of the past decade

After an initial drop in wages due to the transformation crisis of the early 1990s, wages in central and eastern Europe started to grow dynamically from the mid-1990s onwards, but it still took a decade for wages to reach their level of 1990 in real terms.

The second decade (2000-2010) has brought a clear convergence between core western and central and east European countries in terms of real wages. Real wages practically stagnated in Germany over the decade as a whole but, in central and east European countries, they characteristically grew in a range between 35 % and 75 %, with Romania outpacing all other countries with an increase of 115 %, as Figure 1 shows.

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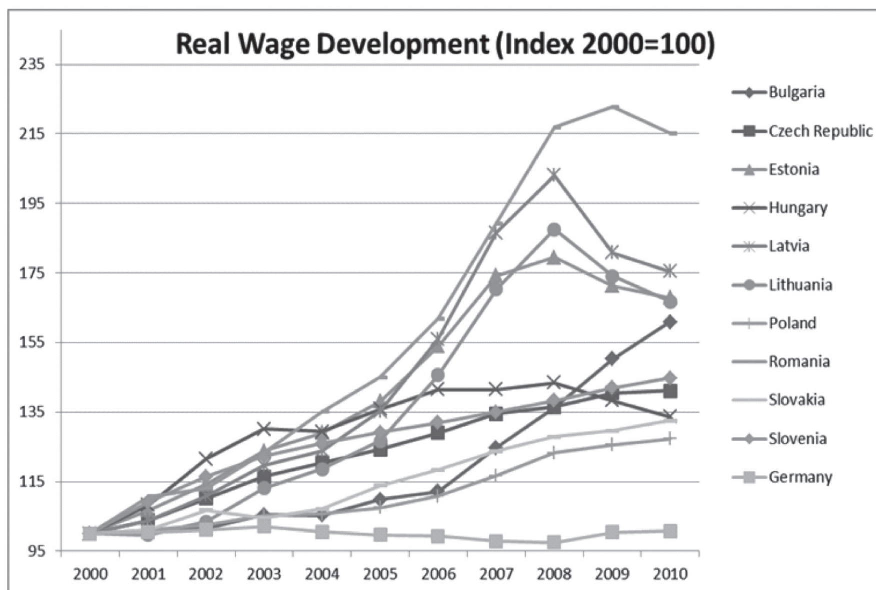
Figure 1 – Growth in real wages, 2000-2010



Source: AMECO database, 2011.

A considerable wage gap (of somewhere in the region of 1:3 to 1:5) has, however, still remained.

The catching-up process exhibited by wages is especially spectacular when expressed in Euros (instead of national currencies). Here, beside real wage increases we also have the effect of the appreciating exchange rate and higher inflation in central and eastern Europe. For the Czech Republic, this means an increase in its relative wage level (in Euros), in comparison to Germany, from 7.1 % in 1993 to 44 % in 2010.

What we can see in the context of longer-term developments is that economic integration between regions which demonstrate such huge income and wage differences has induced a levelling-out process. This has resulted in a strong drive for wage increases in central and eastern Europe through two major channels: foreign direct investment; and labour mobility.

Figure 2 shows the development of unit labour costs for selected central and east European countries as well as Germany and two crisis countries in the Eurozone, Greece and Portugal. Unit labour costs that include the effects of productivity are generally seen as a measure of competitiveness. In the current Eurozone crisis, it is argued that a divergence in nominal unit labour costs between Germany and countries like Greece and Portugal has both widened to unsustainable levels and contributed to the current crisis.

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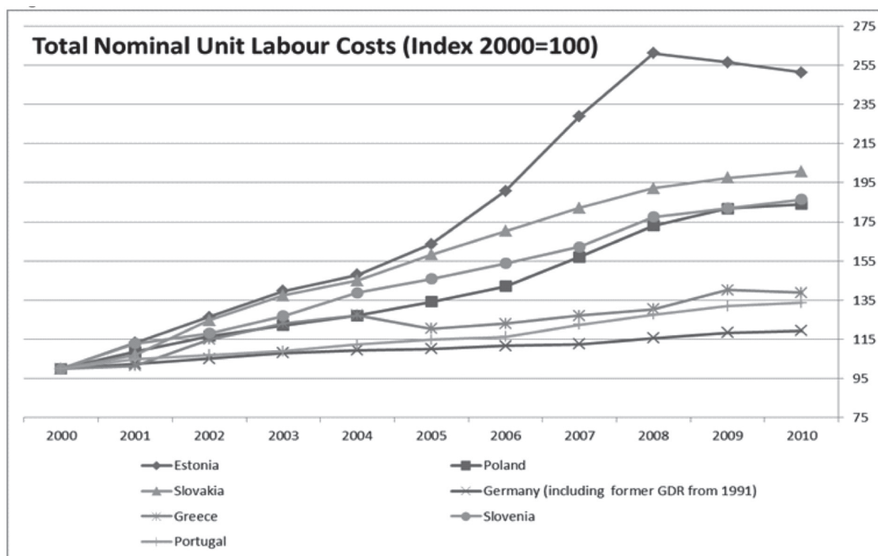
Nominal unit labour costs grew by around 35 % in Greece and Portugal, compared to just above 15 % in Germany, while in the core countries of central and eastern Europe they showed an increase of between 80 % and 90 % and, in the Baltic States, of between 150 % and 230 %.

Figure 2 – Unit labour costs, 2000-2010



Source: AMECO database, 2011.

Nevertheless, a comparable loss of competitiveness did not occur in central and east European countries as trade balances, export performance and gains in market share all show (see European Commission documents such as, for example, the *Annual Growth Survey* 2011). Part of the answer comes from the nature of catching up in transformation economies. Wage levels are still a fraction of that of the EU-15, but productivity increases, especially in export manufacturing branches, have provided a 'productivity reserve' and, therefore, some room for upwards wage convergence.

This does not mean that central and east European economies did not have balance of payments problems (to which we will refer) but at least this is not supported by evidence that wage dynamics have generally undermined their external competitiveness.

The crisis in central and eastern Europe (in 2009) and the Eurozone crisis (following 2010) have certainly both brought some common questions and lessons, but also caused certain confusions about the causes and possible therapies.

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The 2009 crisis and central and east European economies

The major factors that made central and east European economies particularly vulnerable to the shockwaves of the 2009 paralysis of the international financial system, which resulted in a sudden stop in foreign trade and investment, were as follows.

The high need for external financing (including various forms of FDI, bank loans and portfolio capital) experienced by under-capitalised catching-up economies was one of the central causes of their vulnerability to external shocks.

Core central and east European countries have a very high export dependence (the Czech Republic, Hungary, Slovakia and Slovenia realise over 80 % of their GDP through exports), which is also at least partially concentrated in cyclical branches (automobiles and electronics).

This high export dependence was, indeed, a major reason for the deep recession as these four countries suffered a drop of GDP of between five and seven per cent in 2009. This was then seen as a 'structural weakness', but soaring exports in the following years has since seen this diagnosis modified to one of 'export strength', although its concentration in cyclical sectors is still regarded as a risk factor.

FDI dependence was also questioned in the worst period of the crisis, but then a distinguishing conclusion had been drawn. What matters is the sort of FDI – one that was directed into the productive economy, creating export capacities (mostly in Czech Republic, Slovakia and Hungary); or investments that were directed to the non-tradable sector (e.g. retail trade, construction and land and property). The latter was the case in the Baltic States, which suffered the highest slump in economic performance in 2009 (17 to 19 per cent).

In terms of the expansion of credit, what has also proved to be decisive is for what the credit was used: consumption; or productive investment (in the Baltic States and Hungary, the former was the case, causing serious turbulences during the crisis).

Even if central and eastern European countries were affected by the crisis in a differentiated way, one common feature was characteristic: a loss of competitiveness was not among the main causes. Even the case of Hungary supports this. The country has had massive balance of payments problems, partially because of irresponsible fiscal policies in the past (in this regard, a similar feature to Greece) and partially because of a credit bubble that had fuelled consumption. The only healthy segment of the Hungarian economy that remained was its competitive export sector which kept the country afloat.

The 2010-2012 crisis in the Eurozone

With the exception of Greece, the root cause of the crisis was not a debt problem. We can see that there is a manifest debt financing problem on the surface, but this is more due to a lack of confidence in a determined European crisis management policy. The Eurozone crisis is much more due to the economic imbalances that have accumulated over a decade. The case is much more complex than the usual explanations of excessive wage increases and fiscal profligacy.

At the same time as increasing the level of inequality, the depressed position of wages saw these substituted either by credit-based consumption (above all, in the UK,

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Ireland and Spain), or export-driven growth (Germany) in which exports were largely financed through debt taken on by deficit countries. The main causes of this were the accumulated inequalities and a failure of capital allocation, demonstrating also that inequality was not only unjust and socially devastating, but economically detrimental. It was this that was actually the root cause of the crisis.

Country cases are largely different. In Spain and Ireland, a credit bubble in consumption and the construction sector led to an unsustainable situation, whereas in Greece state government over-spending and a lack of competitiveness were the main reasons. In Portugal, all of these distortions played a certain role. An adjustment is needed, but a singular focus on wage correction and austerity as a 'one-size-fits all' strategy does more harm than good.

If the case of central and east European economies during the 2009 crisis delivers some lessons for the present context, then it is that wage dynamics themselves did not lead to imbalances or a loss of competitiveness.

Why central and east European countries are different to the Mediterranean countries most hit by the Eurozone crisis

In central and east European countries, the new automobile industry has created around half a million jobs and offers opportunities for the further upgrading of the capacities which have been established there.

High levels of intra-industrial trade (the share of which within total manufacturing trade grew from scratch to the level of the EU-15 within a short period), a high share of FDI inflow into manufacturing and soaring manufacturing exports were, however, the main features that characterised the qualitative shift that has taken place in European industry and led to a new division of labour between the west and the east of Europe. At the same time, the previous target of such investments, such as Portugal and Spain, have suffered a setback in their positions. Even with this qualitative shift in trade and investment patterns, EU core countries (especially Germany) have continued to benefit from market expansion. Within this framework, western (mostly German) multinationals have benefited from cheap sourcing from central and east European locations and have used this to strengthen their market positions and competitiveness on a global level.

Questions over the sustainability of this form of the division of labour and production model had not been raised before the crisis. The huge impacts of the crisis on central and eastern Europe have, however, raised some doubts. The mono-industrial nature of the new industrial landscape in central and eastern Europe, that focuses on highly-cyclical branches such as automobile assembly and the production of electronic components, has proven to be a risk factor at the time of a heavy downturn. A high dependence on export demand, and one that is concentrated on cyclical industries at that, became a factor of vulnerability and this added to the intensity of the downturn in the region.

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Lessons from the Eurozone crisis for central and eastern Europe

Export dependence as a risk factor during the 2009 crisis in central and eastern Europe had raised doubts about the sustainability of export-based and FDI-driven growth, whereas the case of south European countries in the 2010 Eurozone crisis delivers the opposite arguments. Apart from the fiscal part of their difficulties, Greece and Portugal suffer from a longer-term lack of export competitiveness that also appears in the accumulating imbalances within the rest of the Eurozone. They were losing competitiveness *vis-à-vis* Germany, as their unit labour costs rose substantially higher than in Germany (with wages increasing faster than productivity). Figure 2 illustrated this divergence, showing also that new member states in central and eastern Europe have seen even greater increases in their relative unit labour costs compared to Germany.

The paradoxical situation is that, even though some south European crisis states have a long-term competitiveness problem, this is not the case for core central and east European countries. Table 1 shows some key competitiveness indicators based on the European Commission's *Annual Growth Survey* (European Commission, 2011). The real effective exchange rate – the key indicator for competitiveness for the Commission – shows the combined effect of exchange rate, inflation, nominal wages and developments in productivity (a higher positive figure shows a loss of competitiveness). What we see here is that Slovakia seems to have lost competitiveness on the largest scale, followed by the Czech Republic and Hungary. Greece and Portugal, according to this indicator, also show a loss of competitiveness but to a smaller extent.

Table 1 – Key indicators for selected central, eastern and south European countries (Germany being the reference)

Country	GDP/capita, EU27= 100, 2009, exchange rate parity	Labour productivity level, EU27= 100	Real effective exchange rate, % difference from long-term average
Slovakia	30	78.7	54.2
Czech Republic	38	71.8	41.5
Hungary	30	70.2	13.0
Greece	78	98	12.8
Portugal	61	74.1	8.7
Germany	129	104.7	-5.8

Source: European Commission, 2011

The data also reveal that economies in central and eastern Europe have a substantially higher level of productivity than would be reflected by their income levels (measured in terms of GDP/capita). Even if these countries are losing cost competitiveness, their low income (and wage) levels still make them competitive. Slovakia is losing

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competitiveness at a record level in the EU in the last few years, but it still maintains a trade surplus and has no fundamental problem in its economic balances.

Moreover, it is true for central and east European countries that have an FDI-driven export-based economy that productivity and, therefore, unit labour cost levels in their export sectors (mostly the manufacturing sector) are significantly higher than their national average values. This duality of their economies (otherwise a source of other tensions) allows them to maintain export competitiveness even if unit labour costs (or real effective exchange rate) are increasing.

This is a major difference compared to the south European countries now in crisis. The lesson is that Greece and Portugal are precisely lacking that FDI-based manufacturing export basis that Slovakia and the Czech Republic have.

On the other hand, this also shows how important such a competitive export sector is for these central and east European countries, even if this did expose them to cyclical downturn during the 2009 crisis.

Even if individual countries have different vulnerabilities, a parallel between the two countries most exposed to the crisis delivers some lessons. Table 2 indicates that both Hungary and Greece have serious fiscal problems due to over-spending in their government sector, but Greece also has a competitiveness problem.

Table 2 – Key indicators for Hungary and Greece

	Current account balance			Government deficit		
	2004	2007	2010	2004	2006	2010
Greece	-10.2	-14.5	-8	-7.8	-3	-12.5
Hungary	-9	-6.5	-2	-6.2	-9.2	-3.8

Source: European Commission, 2011

The result of the 2010 Eurozone crisis is that European economic governance now aims at 'restoring' competitiveness and at a rebalancing in line with the key indicators of nominal unit labour costs and change in export market share.

For nominal unit labour cost, a three-year average is being taken into account. For economic and monetary union members, a 9 per cent deviation (and, for non-EMU members, a 12 per cent deviation) is regarded as the limit. Meanwhile, for a change in export market share, a threshold of a 6 per cent decrease is still seen as sustainable. If 'alarm bells ring', then intervention would follow.

What does this have to say about central and east European countries? What happens if nominal unit labour cost increases exceed the maximum value (as happened before the crisis), but no loss of market share took place?

The rigid application of these criteria to catching-up economies would also mean that any correction in the relative level of labour productivity to wages is deemed to be unsustainable.

This raises serious doubts as to whether attempts at breaking out of an economic model based on low wages is still a viable option in Europe, and whether the promise

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of wage and economic convergence with richer member states was any more than an illusion.

Looking at this in the wider European context, it is clear that adjustment is needed, but that the current singular focus on austerity measures and wage adjustment is not only missing the goal but that its time horizon is also mistaken. This therapy is not addressing the root causes of the crisis – accumulating inequalities, failures in capital allocation and the gaps in financial supervision which might otherwise have prevented credit bubbles from forming. Instead, it is creating harmful side-effects that are resulting in enduring recession.

Conclusions

We have shown the different dimensions of a 'multi-speed' Europe, in the sense of how different member states have been affected by the crisis and by the therapy imposed in its aftermath.

The 2009 crisis has highlighted the fragility of the integration model that helped countries in central and eastern Europe manage a considerable degree of convergence towards western Europe in the previous period. FDI-driven export-based growth, concentrated in cyclical industries, did indeed prove to be a risk factor during the downturn, but the quick rebound in exports following the crisis also showed the strength of such an economic structure. The Eurozone crisis after 2010 demonstrated also that, without a competitive export sector, south European crisis countries are in a more difficult situation.

The case of south European crisis countries and the emergence of central and east European economies from the downturn also shows that having a competitive, export-oriented industry based on productive FDI is perhaps not the ideal solution but, for small catching-up countries with scarce domestic capital, there does not seem to be a viable alternative.

The 2009 crisis experience in central and eastern Europe also showed us that wage dynamics themselves do not create an unsustainable situation and that the use of wages as a main instrument of adjustment is not the way ahead for Europe.

We have identified a series of factors that give us a picture of a multi-speed Europe with different depths of integration and also in terms of the regions and individual countries that have been affected by the crisis and by the implemented therapy.

The new member states find themselves in a rather unique situation in the context of an enduring Eurozone crisis that also raises questions about the future of the entire EU. On the one hand as 'junior partners' they are more vulnerable (and are also in the eye of the financial markets); on the other hand, in economic terms they are fully docked to the core of the EU, i.e. Germany. This may result in ambiguous and sometimes contradictory consequences.

One of the main questions arising from this chaotic diversity is whether a Europe that was founded on the basis of solidarity and social and democratic values, and with a promise of convergence, still has a future.

It is not necessarily a problem that we see a 'multi-speed' Europe: the real danger is that the direction points at a downwards spiral.

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