

A downward-spiralling multi-speed Europe

Introduction

While the term ‘two-speed Europe’ was first coined simply to distinguish between the member states displaying a faster pace of integration and those managing to move forward only at a rather slower pace, the emphasis in this respect has recently shifted to a commitment to more integration. The new distinction became particularly apparent with the conclusion of the Euro-Plus Pact in March 2011 and the Fiscal Pact agreed at the EU Summit in December of the same year (European Council 2012). It is as a consequence of the eurozone crisis that the call for a closer degree of European integration has been reiterated, with the current focus being on economic governance and even fiscal union. Such deeper integration would, in the first instance, involve members of the Economic and Monetary Union (plus any non-EMU member states that join voluntarily) and would thus result in a two-speed Europe not in quantitative terms alone but in terms of a more qualitative form of political and institutional integration.

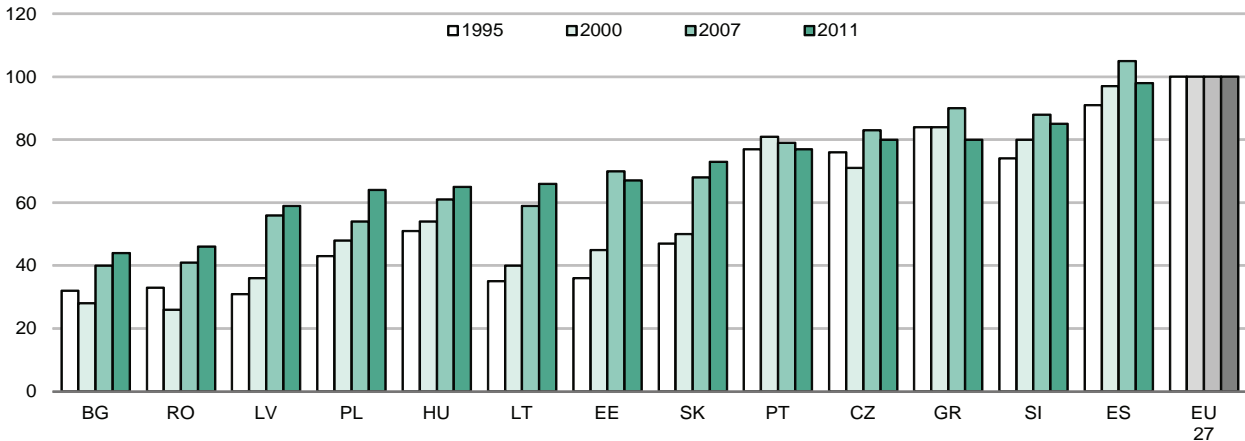
In this chapter, we examine various aspects of European economic integration in the specific fields of trade, finance and production regimes. Our focus, in so doing, will be on the prospects for growth and development of the European ‘periphery’ which encompasses the previously ‘converging’ countries of eastern and southern Europe that have been particularly harshly affected by the crisis of 2008 and its still ongoing consequences. Here it is a question not merely of different economic growth rates among member states but of differing economic models that were differently affected by the crisis of 2008. The adjustments that came in the wake of this crisis (including austerity policies and competitiveness-enhancing measures based predominantly on wage cuts) also had differing implications for individual economic models, so that what we see currently is a ‘patchwork Europe’ with fault lines zigzagging around among a variable combination of country groups. The practices imposed in the context of the adjustments are affecting the so-called ‘deficit countries’ asymmetrically, as these are the countries suffering a loss of national sovereignty as a result of interference from European institutions such that an accompanying feature of this development is a democratic deficit.

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Patchwork Europe: old and new divisions

Figure 2.1 Income gaps and convergence: GDP/capita as percentage of EU27 total for selected years and countries (based on market prices at PPS)



Source: Eurostat (2012).

Note: data for BG and RO: latest year 2010.

An end to convergence in Europe?

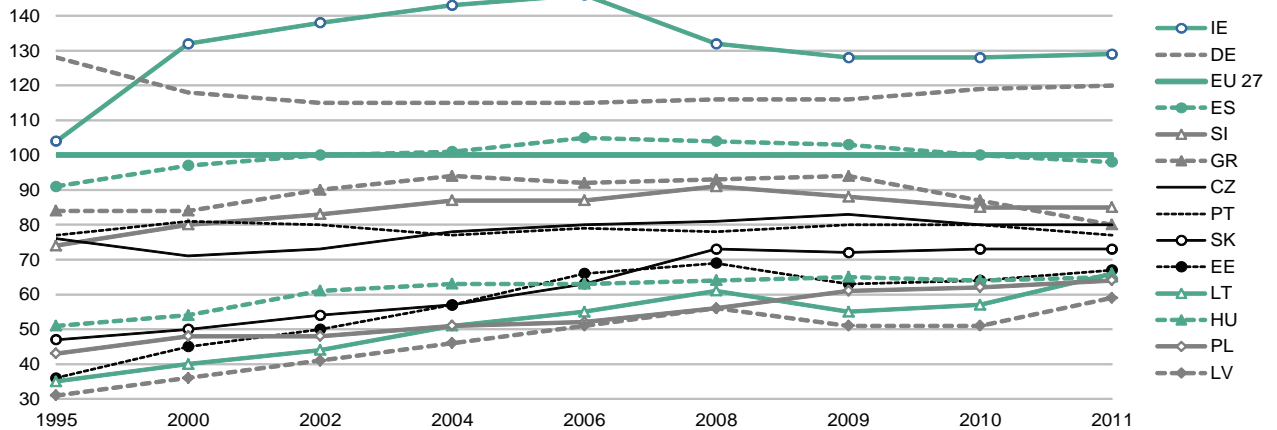
The promise of income convergence – between poorer and richer member states and among the poorer and richer regions within them – has been an underpinning feature of European integration from the outset. In this respect, a glance back over fifty years of EU history up to the crisis provides confirmation of an unprecedented feat. As stated in a recent World Bank (2012) report: ‘The European convergence in consumption levels in the last four decades is unmatched. Except for East Asia, the rest of the world has seen little or no convergence’. Indeed, already by the early 1990s the incomes of more than one hundred million people in the poor south – Greece, southern Italy, Portugal, and Spain – had grown and moved closer to those of the more prosperous areas of Europe. Similarly, between the late 1990s and the mid-2000s, the income levels of one hundred million people in Central Eastern Europe were dynamically converging towards levels in the richer part of the continent. Figure 2.1. offers a first historical glance at the economic divide in Europe, showing

that Central Eastern European countries still have substantially lower per capita GDP levels (at PPS) than the EU27 average. The data also indicate milestones in the last fifteen years, showing the varying convergence dynamics characteristic of individual countries in the different periods. Most of the convergence took place between 2000 and 2007, after which it lost momentum or even went into reverse. It is apparent also from the graph that Greece and Portugal stand out as having displayed no convergence whatsoever over the whole fifteen-year period. These are, what is more, the two EU15 countries that were subsequently overtaken by the most developed Central Eastern European member states.

The year 2008, with the onset of crisis, marked a halt in these processes of convergence achieved via a catching up of the less prosperous countries and regions, placing a question mark over the continuing sustainability of some of the progress achieved in the earlier phases of European integration (see also ETUC and ETUI 2012: 19).

Patchwork Europe: old and new divisions

Figure 2.2 Relative income levels: gross domestic product at market prices as a % of EU27 total (based on PPS per inhabitant)



Source: Eurostat (2012).

A case of 'reverse convergence'

The main trends observed in terms of GDP for the whole period 1995–2011 are shown in Figure 2.2. Although 2008 was a common point of fracture for both East and South, the experience of these two regions was significantly different. While convergence ground to a definite standstill in Southern Europe, in the Central Eastern European (CEE) countries the much stronger impetus towards convergence came to a more abrupt halt which, in some cases, nonetheless proved no more than temporary. Indeed, in most CEE countries – and particularly those with the lowest per capita GDP levels – a rapid process of catching up had been observable in the years before the crisis. In Southern Europe, however, the picture had been more mixed, even during the boom period, with Spain having achieved significant convergence, while Greece and Portugal had tended to stagnate. Latvia and Lithuania, the two countries which suffered the most dramatic falls in output in 2009 (17.7% and 14.8% respectively), nonetheless showed still impressive overall convergence for the 1995–2011 period as a whole, with per capita GDP levels relative to the EU27 rising

from 31% to 59% for Latvia and from 35% to 66% for Lithuania. What is also particularly noteworthy in relation to both these countries is that, after temporary drops in 2009 and 2010, they had by 2011 exceeded their pre-crisis relative income levels. Most other CEE countries also still preserved their pre-crisis relative income level in 2011, with Poland having significantly improved it (from 56% in 2008 to 64% by 2011).

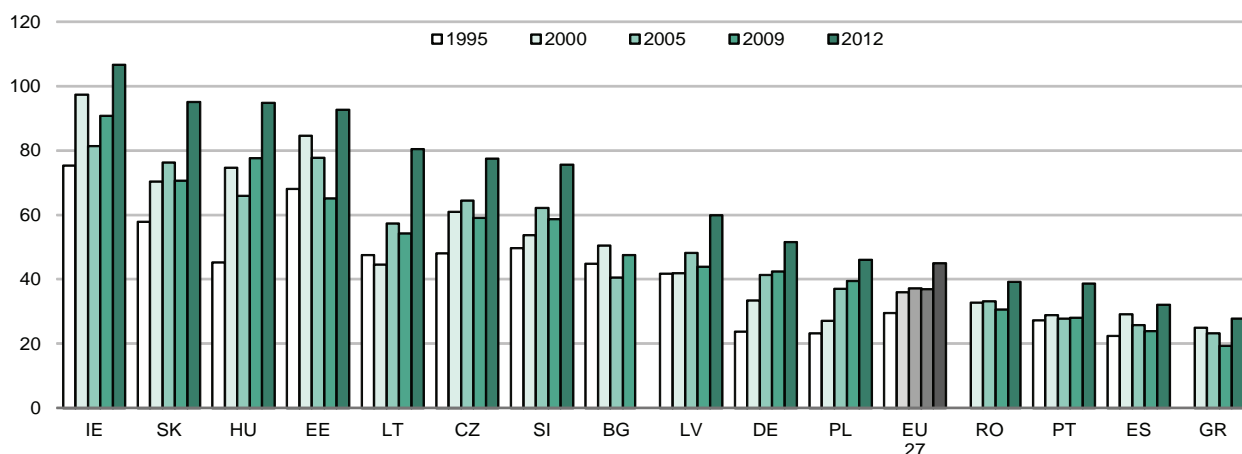
The picture for Southern Europe is much bleaker: between 1995 and 2011 the region showed no convergence – in the case of Greece and Portugal – or, in Spain, only limited convergence to EU27 levels. Thus, while Spain still achieved some convergence over these 16 years, from 91% to 98%, Portugal saw none over the entire period (77% in 1995 and still in 2011), while Greece actually suffered a loss of convergence (from 80% in 1995 to 77% in 2011). All three countries suffered significant setbacks in the wake of the crisis, most particularly Greece with a 14%-point drop in its relative income level between 2008 and 2011.

As a result of these setbacks, both Portugal and Greece have been overtaken by Slovenia in terms of per capita GDP expressed in purchasing power standards (PPS), while the Czech Republic has overtaken Portugal and very nearly caught up with Greece. Sadly, however, this apparent progress cannot be attributed to reinforced convergence for, although the

former EU15–EU12 gap has indeed narrowed, this result is attributable less to the catching up of poorer countries than to the deep recession suffered by Greece and Portugal. The development constitutes, in other words, what we might call a case of 'reverse convergence'.

Patterns of economic integration

Figure 2.3 Exports of goods and services (% GDP)



Source: Eurostat (2013).

New divisions on top of old ones

The two-speed experience in the catching-up process described in previous sections (see also ETUC and ETUI 2012: 19) is the result of a number of underlying structural differences among European countries that have affected their respective paths towards economic integration. In the following sections we examine four important drivers of economic integration: exports; the balance-of-payments situation and its structure; reliance on foreign direct investment (FDI); and the role of credit flows. The differences observed along these fault lines will be seen to be of relevance for understanding the differing degrees of vulnerability to external shocks that we have observed also since 2008.

The most pronounced division to appear recently is that between 'surplus' countries and 'deficit' countries, as determined by their balance-of-payments position (cf. Chapter 1) within the eurozone, with the core 'surplus countries' clustered around Germany and the 'deficit' ones around the Mediterranean. A similar distinction applies beyond the eurozone, with Eastern Central European countries belonging to the 'surplus'

core (e.g. the Czech Republic and Poland) and the more peripheral Eastern European crisis-ridden countries (e.g. the Baltic states) falling into the 'deficit' group. This division between surplus and deficit countries thus cuts across the historical and more traditional division between the East and the West of the continent characterised, on the one hand, by a substantial income gap between the old and the new member states and, on the other, by less established political institutions and economic structures to the East.

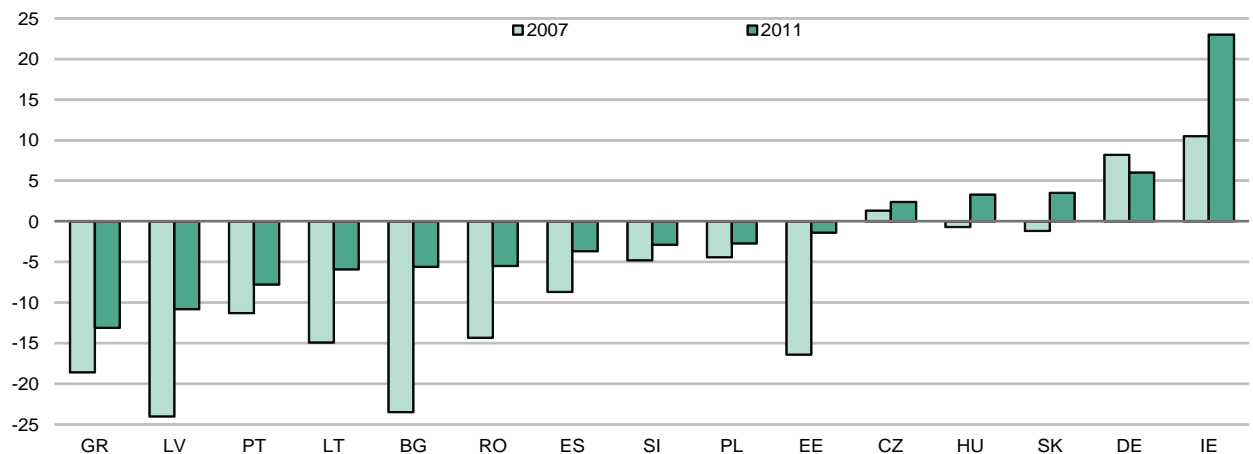
The countries dependent on exports and FDI (most prominently the Czech Republic, Slovakia and Hungary) suffered from the sharp drop in export demand in 2009, particularly in cyclical sectors such as the automotive and electronics industries. Exports of most CEE countries then recovered relatively rapidly, though their further growth remained sluggish given the overall condition of the eurozone. While FDI also dropped to some extent after the crisis, this did not appear to represent a major factor of instability. The major source of vulnerability was the reliance on private credit expansion (see Chapter 1), particularly when it was associated with the weak ability to adjust by balancing of the current account (see also Figure 2.8. in this chapter). While the terms of the East-West division in relation to income and wage levels overlap to some extent with another division in terms

of economic openness and the importance of export-oriented sectors, a new division is being created by the fact that Eastern European countries are among the most export-oriented economies in Europe, whereas the Southern European countries have failed to develop strong export-oriented sectors.

As shown in Figure 2.3, 2011 export shares in GDP amounted to over 90% of GDP in Estonia, Hungary and Slovakia, while they were as low as 27.8% in the case of Greece and only 38.6% in that of Portugal. Accordingly, openness and trade integration with the rest of Europe can be seen to be more pronounced in the case of CEE countries than of the Southern European crisis states. This situation is clearly visible from a glance at the export shares within output given in Figure 2.3.

Patterns of economic integration

Figure 2.4 Balance of payments component: trade in goods (% of GDP)



Source: Eurostat (2012).

Europe's new surplus-deficit faultline

The surplus-deficit divide refers to the different balance-of-payments situations across Europe. In the period preceding the crisis, balance-of-payments problems were a common factor of vulnerability not only in the South but also in a number of 'peripheral' Eastern European countries, including the Baltic States, Bulgaria and Romania. These peripheral countries were most heavily affected by the crisis as they were dependent on financial flows from abroad (mainly other EU member states) to finance their balance-of-payments deficits (for more details see Chapter 1 of this publication). Although the surplus-deficit divide cuts across the Eastern European region, the limited ability of the Southern countries to adjust to the crisis is a factor that sets these deficit countries apart from those in the East.

Figure 2.4 complements the balance-of-payments data presented in Chapter 1. The balance of payments includes all of a given country's financial flows with the outside world, including trade in goods and services, various

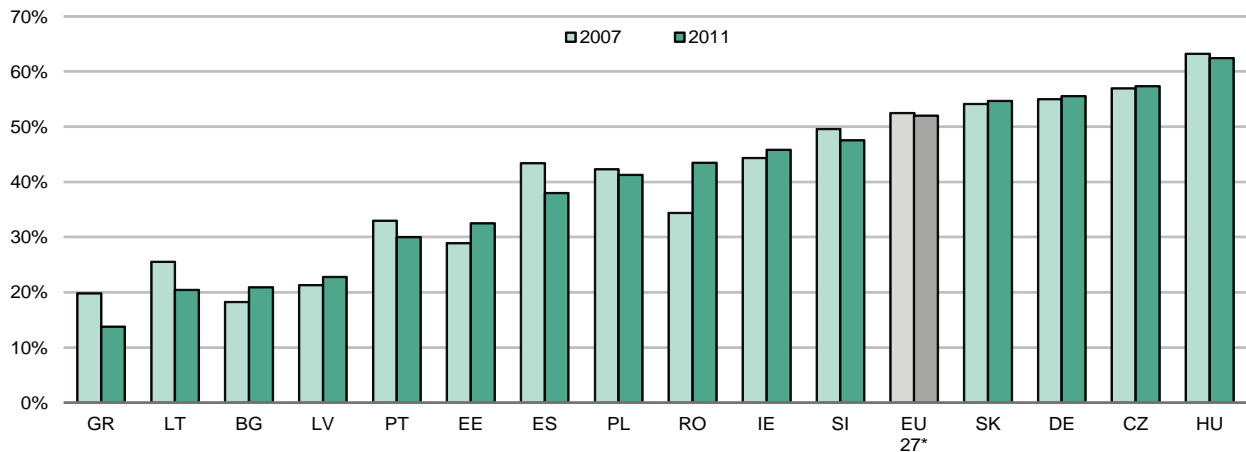
forms of capital, asset and income flows and credits. We present here two components that played a crucial role for deficit countries both before and during the crisis, namely, balance of trade in goods and services and, later, private credit flows. This section focuses on the balance in the trade of goods in 2007 and 2011 and reveals, in this respect, substantial differences between individual member states. A negative trade balance means that a country imports more than it exports and that the difference has to be financed. Persistent deficits not financed from other transactions within the balance of payments create debt, as happened in the cases of Latvia, Bulgaria and Greece, as shown in Figure 2.4. The data also allow assessment of the degree to which countries were able to adjust to the crisis of 2008. The Czech Republic, Hungary and Slovakia had broadly balanced trade even before the crisis, whereas Latvia, Bulgaria, Greece, Romania and Portugal were, during this period, having to contend with persistent and double-digit trade deficits. During the crisis most CEE countries were able to adjust by cutting their deficits substantially or by achieving a positive trade balance. In most cases, this happened through the decrease in imports that was a consequence of slowing growth or even recession. A balancing act achieved by the 'deep-freezing' of certain types of activity (such as, consumption, investments

and imports) can produce signs of fast adjustment, but cannot be regarded as a long-term solution. Moreover, it is still an open question to what extent adjustments in CEE deficit countries (for example, the Baltic States) have a longer-term structural impact. Greece and Portugal, in any case, even after having absorbed a large dose of measures for a 'deep-freeze', continued to show high trade deficits still in 2011, thereby revealing a much more limited ability to adjust in either of the abovementioned ways.

In an attempt to explore some of the reasons behind this divide, we examine, in the next sections, further structural features of the economies in question.

Patterns of economic integration

Figure 2.5 Share of complex sectors in the exports of individual member states (%)



Source: calculated from the COMTRADE database (<http://comtrade.un.org>). Complex sectors: (SITC 7, 54, 87, 88).
* EU27 exports to the rest of the world.

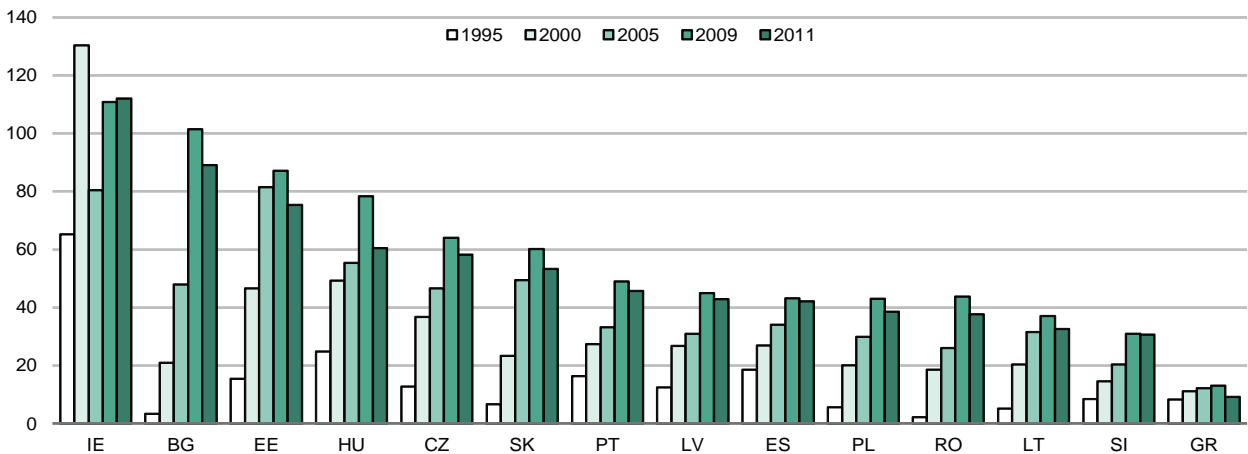
The structure of exports matters

The deficit-surplus divide roughly corresponds to the qualitative differences in export profiles of individual countries. Figure 2.5 shows the share of ‘complex sectors’ within the total exports of individual member states. The classification of export structures according to Standard International Trade Classification (SITC) categories corresponds roughly to the level of technological sophistication of the products being exported. Accordingly, the ‘complex sectors’ include machinery and transport equipment, pharmaceuticals, scientific instruments. The classification is merely indicative, insofar as it does not take into account the role of the country in the division of labour within the sector or its R&D or innovation content. In terms of sectoral composition, Hungary and the Czech Republic thus had a higher rate of export complexity than Germany with a share of complex sectors of around 60% of their total exports (with their high export share this corresponds to close to 50% of their GDP). Greece had the lowest share of complex sectors in its exports (13.8% in 2011), while Bulgaria, the Baltic States and Portugal also had comparably low

shares (between 20 and 30% in 2011). During the four years of the crisis a further downgrading of what were already, in terms of complexity, relatively low export profiles took place in Greece, Lithuania, Portugal, and Spain. By contrast, Romania, Estonia, Bulgaria, and Latvia were able to upgrade their export profiles during this period. Export complexity thus supplies a further indication of the role of countries in the division of labour in Europe, and small peripheral countries with scarce domestic capital – like most of the CEEs – can achieve high export complexity through foreign direct investment (FDI), as we will show in the following section.

Foreign direct investment (FDI)

Figure 2.6 Inward foreign direct investment stock in selected years within the period 1995-2011 (% of GDP)



Source: UNCTAD (2012) World Investment Report 2012, United Nations, New York and Geneva (available at: <http://www.unctad-docs.org/files/UNCTAD-WIR2012-Full-en.pdf>).

FDI as a driver of convergence?

Economic integration achieved by means of foreign direct investment (FDI) was the major driver of the process whereby lower-income regions and countries were able to begin to catch up economically with the more prosperous ones (Bijsterbosch and Kolasa 2009). FDI played a universally important role in both Southern and Eastern Europe, but there are important differences between countries in the two areas (see Figure 2.6). Five Eastern European countries (Bulgaria, Estonia, Hungary, the Czech Republic, and Slovakia) have accumulated the highest stock of FDI in Europe (between 90 and 55% of their GDP), second only to the exceptional case of Ireland. Greece, by contrast, has, over the years, accumulated less than 10% stock of FDI.

Foreign direct investment, if directed into the tradable sector (industry sectors whose output in terms of goods or services are traded internationally) of low- and medium-income countries, constitutes these countries' most valuable potential in terms of GDP and export generation. However, a large part of FDI stock in the Baltic States and Bulgaria was in the non-tradable sectors and

became associated with the unsustainable expansion of borrowing described in the next section (see Figure 2.8).

For CEE countries (especially for the Czech Republic, Hungary, Poland and Slovakia) high levels of intra-industrial trade (the share of which within total manufacturing trade grew from scratch to the level of the EU15 within the decade up to the mid-2000s), a high share of FDI inflow into manufacturing, and soaring manufacturing exports, were the main features characterising the qualitative shift in the structure of their economies from raw materials, semi-finished or agricultural products towards higher-value-added industrial goods, and these developments led to a new division of labour between the west and the east of Europe (Broadman 2005).

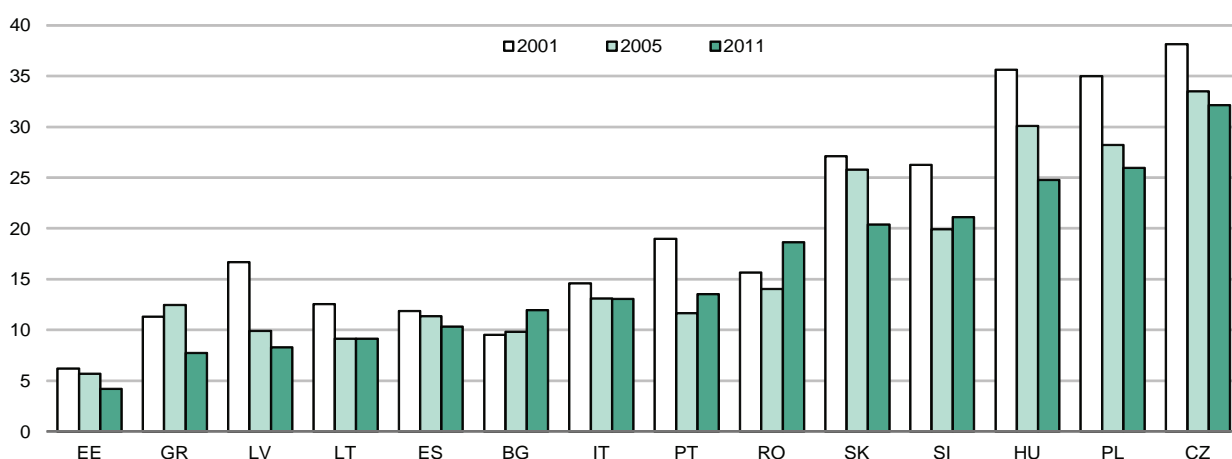
In Central Eastern European countries (CEE), a new automobile-industry-centred industrial core had been built up, offering opportunities for further upgrading in terms of value creation.

In CEE recipient countries the sustainability of this form of the division of labour and production model had not, before the crisis, been called into question. In recent years, however, the huge impacts of the crisis on Central Eastern Europe have raised some doubts as to the wisdom of this model. The nature of the new industrial landscape in Central Eastern Europe, which focuses on highly cyclical branches such as automobile

assembly and the production of electronic components, proved to be a risk factor at the time of a heavy downturn in 2009. As long as the German export machine in the world functions, CEE subcontracting deliveries also enjoy a safe background. Rebounding exports from 2010 and the crisis at the southern periphery of the eurozone showed that a solid FDI-based export sector is a factor more of strength than of vulnerability. At the same time, as the German export offensive was part of the problem in the eurozone imbalances and as CEE suppliers deliver a substantial part of its cheap inputs, CEE countries find themselves on the side of Germany rather than in the same position as the southern European deficit countries. This is one major aspect of a new division within Europe.

Geographical orientation of exports

Figure 2.7 Share of exports to Germany in total exports (%)



Source: calculated from International Trade Centre Trade Map, <http://www.trademap.org/>

Links with Germany: remaining on the safe side?

It is not just the size and composition of trade and foreign direct investment that matters but also the geographical orientation of exports, especially in the context of the current economic divisions across Europe. As Germany currently represents the economic core of Europe, it is worth looking here at the share taken by it in the exports of individual countries. This is shown in Figure 2.7.

Hungary, Poland and the Czech Republic have one quarter to one third of their exports directed to Germany, with a slightly decreasing trend over the years. Greece and the Baltic states, meanwhile, have values of below 10%. Three further CEE member states (Slovakia, Slovenia and Romania) had a German exports share of around 20%, while the rest of the countries examined (including Portugal and Spain) have values closer to 10%.

As regards foreign trade characteristics, the following trends emerge from the data: Central Eastern European exporters tend to have balanced

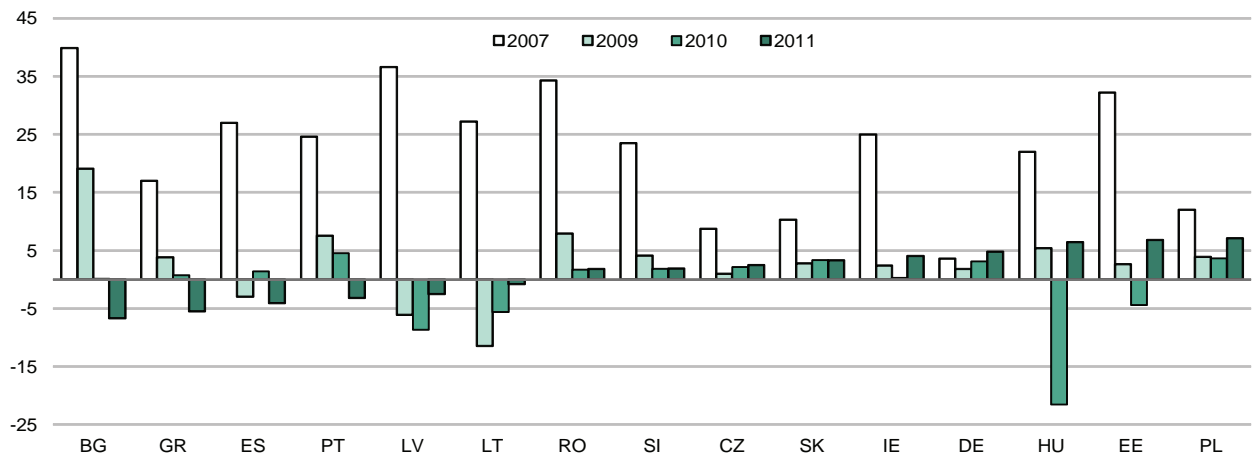
trade or even trade surpluses; they have a high share of their GDP generated by exports and, in the case of the Czech Republic, Slovakia and Hungary, a substantial part of their exports consists of complex products, while a high proportion of their exports is oriented to Germany. These countries also have high FDI penetration in their tradable sectors, with much of their manufacturing FDI originating from Germany (automobile, components and electronic sectors). On the other hand, the Baltic states and the Southern European states examined here show lower export shares, varying levels of trade deficit, low levels of export complexity and limited trade relations with Germany. All of this supports the view that, among the different fault lines in crisis-ridden Europe, one decisive division is between the surplus and the deficit countries, with core CEE countries (in this context the Czech Republic, Slovakia and Hungary) being part of the Germany-centred core region in terms of trade and investment patterns within the European division of labour.

Within this framework, Western (mostly German) multinationals have benefited from cheap sourcing from Central Eastern European locations and have used this to strengthen their market positions and competitiveness on a global level. The longer-term sustainability of this model poses serious questions, however. It can be maintained only if CEE

subcontracting activities become higher-value-added in terms of both R&D and local value-added content. Though signs of such a trend were apparent in the mid-2000s (see Broadman 2005), the process was interrupted by the crisis and nowadays (e.g. European semester) the mainstream adjustment strategy is focussed on low-wage competition. This is anything but promising for the future.

The role of cross-border lending

Figure 2.8 Expansion of bank credits: annual private credit flow in % of GDP (non-consolidated)



Source: Eurostat (2012).

Convergence cannot rely on credit expansion

One of the major areas of vulnerability during the crisis resulted from cross-border credit expansion in the private sector (business and household sectors) in many of the economies that enjoyed high growth and convergence before the crisis.

Subsidiaries of Western European banks in the CEE region (that make up the majority of the banking sector in those countries) were active in providing cheap credits to the population and the enterprise sector, often denominated in foreign currencies (EUR, CHF and even Japanese Yen). The final key distinction to be considered here is the one we see between countries that experienced credit bubbles in terms of huge credit expansion that was followed by credit crunch and recession and those which, having known such excesses, subsequently experienced a more balanced development. The credit expansion underpinned the current-account deficits in the South and in the deficit countries in the East. Foreign direct investment turned out to represent an alternative

means of balance-of-payments deficit financing (see previous sections).

Although, as mentioned above, the sustainability of FDI as a driver of convergence can in any case be questioned, the excessive credit expansion was clearly not sustainable. With the credit crunch and the accumulated high debt, short-term growth and convergence effects achieved through credit expansion evaporated all of a sudden and turned into their reverse, exposing the unsustainability – indeed the mirage! – of credit-driven convergence in Europe.

Figure 2.8 shows annual private-sector credit flow to the respective countries before and after the crisis. Only Germany shows a low and balanced level of credit flows over the years, followed by the Czech Republic, Slovakia and Poland, i.e. countries without excessive debt developments. All other countries show excesses with signs of credit bubbles that burst during the crisis. A credit expansion in Bulgaria of close to 40% of GDP in 2007 represents the peak, while the credit outflow from Hungary in 2010, amounting to 21.6% of GDP, constitutes, by contrast, the negative record. The Baltic States, Greece, Spain, and Portugal, were all heavily affected by both the pre-crisis credit expansion and, subsequently, by the credit crunch during the crisis. Credits also need to be paid back and this deleveraging process reduces economic demand and deepens

the recession. These observations allow the conclusion to be drawn that financial integration through uncontrolled cross-border lending can, if not managed and regulated, indeed result in turmoil. One significant division in Europe has definitely been between those countries that had credit bubbles before the crisis and those that did not.

Productivity and wage levels

Figure 2.9 Key indicators for selected central, eastern and southern European countries (Germany being the reference), 2010

Country	Gross yearly wage per employee, business sector (EUR, PPS)	Wage level in business sector at PPS in % of Germany	Labour productivity, total economy, Germany = 100	Real effective exchange rate, % difference from long-term average
Czech Rep	15,575	38.5	68.5	41.5
Hungary	16,737	41.4	67.1	13.0
Greece	31,784	78.7	93.6	12.8
Germany	40,364	100.0	100.0	-5.8
Portugal	20,371	50.4	70.7	8.7
Slovakia	16,316	40.4	75.2	54.2

Source: European Commission (2011); Eurostat (2012).

Cost competitiveness has its limits

Export dependence as a risk factor during the 2009 crisis in Central Eastern Europe had raised doubts about the sustainability of these countries' export-based and FDI-driven growth model, whereas the case of Southern European countries in the 2010 eurozone crisis showed that the lack of such an export potential leads to even bigger problems. Apart from the fiscal element of their difficulties (see Chapter 1), Greece and Portugal suffer from a longer-term lack of export competitiveness that is also apparent from the accumulating imbalances within the rest of the eurozone. During the last ten years these two countries were losing competitiveness vis-à-vis Germany, as their unit labour costs rose substantially higher than in Germany (with wages increasing faster than productivity). Chapters 1 and 3 illustrate this divergence, showing also that New member states (NMS) in Central Eastern Europe have seen even greater increases in their relative unit labour costs compared to Germany.

While some Southern European crisis states may have a long-term

competitiveness problem, this is not the case for most Central Eastern European countries. Figure 2.9 shows some key competitiveness indicators based on the European Commission's Annual Growth Survey (European Commission 2011) and on Eurostat data. It focuses on the relation between gross wages in the business sector and productivity at the level of the economy as a whole (both measured at purchasing power standards, PPS), and it sets these figures in relation to Germany. The figures reveal that wage levels relative to productivity are lower in all of the examined countries than in Germany (their relative wages are lower than their relative productivity).

The real effective exchange rate – the key indicator of competitiveness in the eyes of 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 and the Czech Republic seem to have lost cost competitiveness on the largest scale, followed by Hungary. Greece and Portugal, according to this indicator, also show a loss of competitiveness but to a smaller extent. All Commission analyses of competitiveness take only yearly changes into account with the underlying assumption that the year of reference (usually 2000) was a 'golden year of harmony' and equilibrium. In terms of yearly changes in the real

effective exchange rate (REER), both the Czech Republic and Slovakia indeed lost cost competitiveness to a certain degree, but this does not necessarily mean that they became non-competitive, given also that their wage levels – also in relative terms to productivity – are still low. Both their trade balances and growth in market shares show that this was not the case.

Southern European crisis states, on the other hand, appear to have an enduring competitiveness problem, as deficits in trade and market share losses show. This is not necessarily a cost-competitiveness problem, as shown by the comparison of wage and productivity levels in Figures 2.9 and 2.10 respectively.

Productivity and wage levels

Figure 2.10 Wage-adjusted productivity in manufacturing in selected countries, 2009

Country	Apparent labour productivity*	Average personnel costs	Wage-adjusted productivity (%)
(EUR 1000 per employed)			
EU27	46	34.5	132.1
Czech Republic	22	14.0	154.6
Hungary	23	11.7	199.6
Greece	42	28.0	150.6
Germany	57	47.2	120.7
Portugal	23	15.8	146.7
Slovakia	17	12.3	134.7
Spain	48	35.1	137.2

Source: Eurostat (2012) http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Manufacturing_statistics_-_NACE_Rev._2
 *apparent labour productivity is defined as value added at factor costs divided by the number of persons employed.

Is cost competitiveness indeed the issue?

Figure 2.10 offers an alternative indicator of wage-adjusted productivity across EU member states by taking the ratio of apparent labour productivity and average personnel costs in manufacturing in cross-country comparison. The first feature demonstrated by these data is that divergence in levels is much smaller here than what the evidence based solely on unit labour cost developments would suggest over time. The second interesting result is that Germany shows the lowest value in wage-adjusted productivity compared to the countries examined here. What this means in concrete terms is that in German manufacturing with 1000 EUR wage costs 1207 EUR value added was produced, while in Hungary the figure was 1996 EUR and in Greece 1506 EUR.

Combining these two factors into the wage-adjusted labour productivity ratio shows that value added per person employed was equivalent to 132.1 % of average personnel costs per employee in manufacturing in the EU27.

One of the lessons that can be drawn from the above evidence/data

is that, while these 'peripheral' countries were, due to increasing labour unit costs, gradually losing cost competitiveness over time, this does not necessarily mean that their competitiveness was dwindling to nothing; for they remain competitive by virtue of their relatively low income (and wage) levels, and this is particularly true of CEE countries. Though Slovakia has, in recent years, been losing cost competitiveness at a record level (see real effective exchange rate (REER) in Figure 2.9) within the EU, it retains, nonetheless, a reasonable level of competitiveness, as can be seen from its relative wage-adjusted productivity levels, but also from its trade surplus and its export performance. And if some Southern European countries do undoubtedly show signs of a lack of competitiveness, the data on relative wage and productivity levels at least suggest that underlying this shortcoming are a number of structural reasons (as seen in the previous sections), over and above any mere cost factor. Although tackling these structural problems through cost adjustment (wage and spending cuts) can deliver temporary results in cost competitiveness at the price of a dramatic increase in poverty and unemployment, in the end these inevitable side effects also jeopardize the success of the entire adjustment. Cost adjustment is simply not an adequate way of addressing the longer-term structural problems (such as

the share of manufacturing in the whole economy, export shares, qualitative composition of exports, place in the international division of labour, etc.). As we have seen above, these countries are not competing on export markets with Eastern Europe or Germany. The problem, to put it bluntly, was not that consumers in the surplus countries had been buying less olive oil and port wine due to rising unit labour costs in Greece or Portugal. In other words, the cure chosen to date is one that tackles the symptoms but not the causes of the problem.

Conclusions

What prospect of economic model convergence in Europe?

This chapter has analysed the changing dynamics of economic convergence trends in a 'multi-speed Europe'. The crisis of 2008 represented a break in the long-term convergence trends. In its wake we have witnessed a loss of the convergence dynamics and, in some cases, a reversal of convergence, seeing individual parts of Europe drifting away from each other as they experience differing effects of both the crisis and the ensuing adjustment policies. Is it then possible that convergence, a value believed until now to be inherent in the process of European integration, is ultimately turning out to be a myth, a dream or a lost opportunity?

The crisis has highlighted the diversity of economic models and of their sustainability during hard times and external shocks in the European 'peripheries'. While divergence in the economic catching-up processes, particularly after 2008, showed an East-South division, the multiple fault lines characterizing the diversity of political and economic structures can be shown to cut across historical and geographic country groups. The credit crunch of 2008 highlighted the division between the countries with current account surpluses, the European 'core' around Germany including also the Eastern Central European exporters, and the 'deficit' countries, including the Mediterranean countries, Ireland, and a number of countries in Eastern Europe. Given the lack of effective adjustment mechanisms in the eurozone, the surplus-deficit divide quickly turned into the difficult creditor-debtor relationship. The 'debtor' countries then experienced a prolonged agony of negotiated and imposed adjustments in the context of crisis-driven eurozone institution-building. Given the unequal power relations

between debtors and creditors, the concerns of the latter inevitably came to dominate the nature of the adjustment efforts made. This economic divide thus quickly translated into political tensions that may well place the process of European integration in severe jeopardy.

In Central Eastern Europe, the crisis has highlighted the fragility of the integration model that had previously helped countries to achieve a considerable degree of convergence towards Western Europe in the pre-crisis 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 appears to indicate a relative resilience of this economic model. The major challenge for these countries is to develop innovation and knowledge-intensive activities that would allow them to sustain the convergence trend in the long term. The complex exporters in Central Eastern Europe in particular cannot continue to rely on cost competitiveness, given, among other things, the competition from the large pool of cheap labour in the South-Eastern European countries. To overcome this challenge may require an 'institutional catch-up', by, for example, increased public investment in education and research and improvement in the quality of the institutional environment.

The eurozone crisis demonstrated also that, in the absence of competitive export sectors, Southern European crisis countries are in a more difficult situation. There are limits to what can be achieved by adjustment through wage costs alone in those countries where export demand and manufacturing in general play a much less important role. The weakness of the competitive position of crisis-ridden Southern European countries is primarily structural in nature and related to their position in the European division of labour (in terms of trade and investment). Moreover, finding a place for these countries in the international division of labour is particularly challenging, given the cost competition from Eastern Europe, the wider Mediterranean, and also China. The evidence presented above indicates that the root

cause of this weakness does not lie in cost factors (meaning relative wage and productivity levels) and that an exclusive focus on cost-cutting (predominantly via wage cuts) will therefore not deliver enduring results. Such a focus carries a high price, what is more, in terms of recession, unemployment and social tensions. Not only are we currently witnessing a social disaster in some of the Southern European countries, but we are in error if we regard the suffering that is being inflicted as the collateral damage of an otherwise promising correction. The therapy that has been applied so far addresses the symptoms – the current account deficit – but points in the direction of a rather unfortunate solution, one that would entail cutting imports on grounds of impoverishment. Such therapy will inevitably delay even further any prospect of a lasting solution based on higher exports, for such an outcome would be possible only with the development of competitive export structures.