

The impact of the crises on European unemployment and the need for new policies

ENRICO MARELLI*

Abstract

In this chapter, we analyse the impact of the recent crises in the Eurozone – the global financial crisis with the consequent Great Recession (2007-09) and the sovereign debt crisis (causing the second recession in 2012-13) – followed by a weak recovery. Thus, many EU countries are experiencing a long period of stagnation. We provide new empirical evidence on the fall of aggregate demand and its components, with particular reference to the collapse of investment. The dramatic impact on unemployment, especially youth unemployment, is also discussed. This depressed situation has been aggravated, in our opinion, by the delayed, uncertain or wrong policies adopted by the EU institutions and by the individual countries; in particular, the austerity measures undertaken in the area, especially in the peripheral countries, have been too deep and pervasive, not accompanied by effective growth policies. In addition to the urgent changes needed in current macroeconomic policies, we also discuss the long-run radical reforms in the EU institutions and governance, necessary to guarantee a “genuine” and viable “economic and monetary” union.

Keywords: *Eurozone’s crisis, unemployment, austerity, aggregate demand, EU’s governance*

* University of Brescia, Department of Economics and Management (enrico.marelli@unibs.it).

1. Introduction

The Global financial crisis (2007-08), with the consequent Great Recession (2008-09), and the following sovereign debt crisis (2010-14) not only caused a “double-dip” recession in many Eurozone countries, but also produced a long-lasting impact on real economies, especially because of the rising and persistent unemployment. In particular, youth unemployment has risen to unacceptable levels. The crises already had social and political consequences, including the rise of nationalist and populist movements in many European countries.

The European monetary union has proved to be “fragile” after the recent economic shocks and the policies followed in the Eurozone have been wrong or inadequate. As for fiscal policies, the austerity measures undertaken to face the sovereign debt crisis, especially in the peripheral countries, have prolonged the recession. Monetary policy has become progressively more accommodative, but although it has been adequate, so far, to save the euro, it has not been able to contrast deflation and favour stronger economic growth. Policymakers should understand that the euro area, especially the peripheral countries, have suffered a dramatic fall in aggregate demand; thus, structural reforms are insufficient to reinforce economic growth.

In the longer run, there is a need to complete the monetary union with a “genuine” economic union, otherwise the euro will not survive. The EU’s budget should be expanded, with an adequate section specific for the Eurozone. Fiscal transfers will be required not only to contrast asymmetric shocks but also to favour real convergence between the economies, thus giving substance to “Europe 2020” and similar plans. Although politically unfeasible at present, the economic union should be completed with a fiscal union, including the possibility to issue common debt (such as the Eurobonds).

The structure of the chapter is as follows. In section 2 we discuss the events following the crises in the Eurozone and we provide new empirical evidence on the fall of aggregate demand and its components. The dramatic impact on unemployment, especially youth unemployment, is presented in section 3. Section 4 critically evaluates the macroeconomic policies that have been followed at the EU and national levels and emphasizes the radical reforms required at the European level for a viable “economic and monetary union”. Section 5 concludes.

2. The double crises in the Eurozone

The recent financial crisis originated outside Europe, in the United States, but then reached the worst and lasting consequences in the Eurozone. The credit

crunch, the negative wealth effects, adverse expectations and systemic uncertainty caused sudden real effects in 2008-09. The so-called “Great Recession” has been the deepest contraction in economic activity since the Great Depression of the ‘30s; in 2009, there was a decrease of 3% to 6% in real GDP of major countries (Table 1).¹

The subsequent recovery, in 2009-10, was facilitated by the economic policy response in many world countries: (i) wide rescue plans of banks; (ii) accommodating monetary policies (interest rates were lowered to almost zero and were accompanied by “unconventional” operations of liquidity management, e.g. the “quantitative easing”); (iii) expansionary fiscal policies (in addition to the working of automatic stabilizers).

In Europe, however, we had a second crisis, the “sovereign debt crisis”.² The situation precipitated because of some news coming from Greece.³ This, in addition to the real deterioration of the fiscal stance in many Eurozone countries (deficit/GDP and debt/GDP ratios were increasing since 2009), caused a drop in confidence in the financial markets. The “spread” in the rate of interest on public debt, compared to the German bonds, began to increase, initially in Greece and subsequently in the other peripheral countries, the so-called “Pigis” (Portugal, Ireland, Italy, Greece and Spain). The high spread levels were due not only to the perception of the risk of default, but also to the possibility of some countries abandoning the Eurozone or even the very dissolution of the euro: the so-called “redenomination” risk. For the first time since its birth, markets were questioning the irreversibility of the euro.

The uncertain, delayed and inadequate economic policy response also contributed to the contagion in the Eurozone (Marelli and Signorelli, 2016a). Speculative attacks were also partly determined by the EU Council decision to make private owners responsible for the losses in case of default or restructuring of the debt.⁴ The “save-State” funds (the European Financial Stability Facility, EFSF, and the European Stability Mechanism, ESM), that were used

¹ In this and the following tables, data are reported for the four largest EU economies, for the four countries most affected by the sovereign debt crisis as well as (for comparison) for the United States and Japan.

² On the development of the new crisis, see Reinhart and Rogoff (2011), Coenen et al. (2012), Blankenburg et al. (2013).

³ In October 2009 the new Greek government (Papandreou) revealed that the true deficit/GDP ratio was equal to 12%, double than previously announced, then further revised upward by Eurostat.

⁴ This “private sector involvement” is reasonable (e.g. to avoid problems of moral hazard), but, when made at the height of the crisis, it accelerated the contagion effect.

Table 1. Real GDP growth rates

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016*
Germany	3.3	1.1	-5.6	4.1	3.6	0.4	0.3	1.6	1.7	1.6
France	2.4	0.2	-2.9	2.0	2.1	0.2	0.7	0.2	1.2	1.3
United Kingdom	2.6	-0.5	-4.2	1.5	2.0	1.2	2.2	2.9	2.3	1.8
Italy	1.5	-1.1	-5.5	1.7	0.6	-2.8	-1.7	-0.3	0.8	1.1
Spain	3.8	1.1	-3.6	0.0	-1.0	-2.6	-1.7	1.4	3.2	2.6
Greece	3.3	-0.3	-4.3	-5.5	-9.1	-7.3	-3.2	0.7	-0.2	-0.3
Ireland	5.5	-2.2	-5.6	0.4	2.6	0.2	1.4	5.2	7.8	4.9
Portugal	2.5	0.2	-3.0	1.9	-1.8	-4.0	-1.1	0.9	1.5	1.5
Eurozone	3.1	0.5	-4.5	2.0	1.6	-0.9	-0.3	0.9	1.7	1.6
European Union	3.1	0.5	-4.4	2.1	1.7	-0.5	0.2	1.4	2.0	1.8
United States	1.8	-0.3	-2.8	2.5	1.6	2.2	1.5	2.4	2.4	2.3
Japan	2.2	-1.0	-5.5	4.7	-0.5	1.7	1.4	0.0	0.5	0.8

Source: Eurostat data (2007-2015) and European Commission (European Economic Forecast, Spring 2016)

to assist Greece, Ireland, Portugal⁵, would not be sufficient to bail out big countries such as Italy or Spain. Nevertheless, neither these funds nor the new stricter rules⁶ on public accounts – the reformed Stability and Growth Pact (SGP) and the Fiscal Compact – were sufficient to improve the situation. Only after the adoption of the Outright Monetary Transactions (OMT) plan by the ECB, in Autumn 2012, following President Draghi’s declaration “we shall save euro whatever it takes”, the financial situation partially improved and the systemic risk (as well as the spreads) reached lower levels in the following years.

However, the strict austerity measures, added to the uncertainty created by the sovereign debt crisis itself, have resulted in a new recession, that in most Eurozone countries occurred in 2012-13, but in some of them continued up to 2014; even the subsequent recovery has been very weak, compared for instance to the US case.

The severity of the double recession and weak recovery is confirmed by the fact that at the end of 2015, the Eurozone real GDP level was still below

⁵ As well as, later, also the banks in Spain and Cyprus.

⁶ Even stricter rules were imposed by the “troika” (EU Commission, ECB, IMF) on the assisted countries.

the pre-crisis (2007) maximum level; in some Eurozone's countries it was still significantly lower (Table 2). The most dramatic case is Greece, with a 2016 real GDP still around 30% lower than the 2007 level; dire performances are also recorded by Italy, Portugal and Spain.

Reinhart and Rogoff (2014) showed that – among 12 advanced economies hit by the financial crisis in 2007-08 – only two had regained in 2013 the pre-crisis levels: the United States and Germany. By computing a “severity index” – which is the sum of the depth of the crisis and its length (number of years required to return to pre-crisis levels) – they also showed that, out of 100

Table 2. GDP and aggregate demand during recession and recovery (index 2005=100)

	Germany	France	U.K.	Italy	Spain	Greece	Ireland	Portugal	Eurozone	EU
GDP										
<i>max.</i>	109,2	106	106,7	104,2	110	110,1	114,6	105,2	107,8	108,1
<i>min.</i>	101,6	101,8	100,2	94	99,8	80	101	95,1	101,7	102
<i>2015Q3</i>	115	108,5	113,2	94,9	104,9	80,3	125,7	98,4	107,4	109,8
qtr. recess.	4	4	5	27	20	26	8	19	5	5
Export										
<i>max.</i>	127,9	112,6	114,5	116,1	115,8	126,5	119,2	125,5	119,8	120,5
<i>min.</i>	104,6	96,5	100,7	88,5	97,7	93,8	113,8	102,7	100,8	101,9
<i>2015Q3</i>	153,4	127,8	124,9	117,9	140,3	105	172,1	151,7	140,1	140,3
Consumption										
<i>max.</i>	102,9	103,8	106,8	102,8	108,9	110,9	120,6	105,7	n.a.	n.a.
<i>min.</i>	101,8	106,7	99,9	94,2	93,4	80,8	102,3	93,5	n.a.	n.a.
<i>2015Q3</i>	108,9	116,6	111,1	95,9	98,2	82,1	110,1	99,6	n.a.	n.a.
Investment										
<i>max.</i>	115,8	113	111,8	106,1	113	154,8	117,3	105,3	112,6	113,9
<i>min.</i>	102	99,5	84,6	72,5	71	42,5	55,6	64,2	92,2	94,5
<i>2015Q3</i>	119,5	102,8	109,9	73,1	79,6	42,5	103,4	69,1	96,5	101,2

Source: elaborations on Eurostat data

episodes of financial crises occurred in 150 years, the severity of the recent financial crisis was similar to that of the '30s; in Europe, the most affected countries have been Greece, Ireland⁷ and Italy.

Considering again Table 2, it shows the real GDP's fall from the maximum level in 2007 or 2008 (according to the country) to the following (absolute) minimum and the subsequent increase from the minimum to the end of 2015.⁸ So, it is clear that Eurozone's performance has been slightly worse (despite the exception of Germany and other countries) than that of the EU. Italy's performance has been better only of the Greek one; in fact, the overall fall of GDP in the full period (-9%) has been worse than those in Portugal and Spain (-7% and -5% respectively).⁹ Furthermore, Italy exhibited the longest recession period (from the pre-crisis maximum to the absolute minimum): 27 quarters.

Table 2 presents similar figures for the main aggregate demand components: exports, (household) consumption and total investment (i.e. gross fixed capital formation). Concerning exports, they quickly recovered after the huge decline in 2009 and returned in 2015 to pre-crisis levels in all countries, including the "Piigs" (except for Greece). In fact, the latter countries, also thanks to internal devaluations, were partly able to reduce the competitiveness gap; nevertheless, in order to completely eliminate the mentioned gap with Germany, at least one decade of pain would be required, unless unit labour costs are mainly reduced through productivity increases, which requires strong innovations and investments. Moreover, net exports improved to a greater extent due to the fall in imports (related to the GDP decreases), rather than a significant improvement in export capacity. A first important conclusion is that it was the internal demand's dynamics that exclusively explains the fall of GDP since 2008 (apart from 2009). As regards households' consumption¹⁰, only in the three big economies (Germany, France, the UK) were the 2015 consumption levels partly higher than the pre-crisis levels; in all the Piigs, they were lower in real terms (by about 30% in Greece and 10% in the other Piigs).

The greatest collapse in aggregate demand refers to gross fixed capital formation, i.e. investment expenditure: a collapse that has been equal to $\frac{3}{4}$ in real terms in Greece, around or above 30% in Italy, Spain and Portugal (it was

⁷ However, the strong recovery in this country since 2014 allowed Ireland's GDP to overtake the pre-crisis levels.

⁸ Data on the third quarter of 2015 were the latest available when elaborations were made.

⁹ On the other hand, since 2014 Ireland has returned to its high pre-crisis GDP growth rates.

¹⁰ Similar trends can be observed for public expenditure (not shown in the table), which – apart from the three big EU countries – has not been able to play an effective counter-cyclical role, because of the austerity approach.

even larger in Ireland until 2011, but later a good recovery followed). The cumulated loss in the 2008-15 period in the Eurozone was -15%; thus, total investment in 2015 was still lower than the pre-crisis levels in both France and the UK, while in Germany it was a little higher. Particular sectors, such as construction, exhibited even greater declines.¹¹

Also public investment has been slashed during the crisis period.¹² Most of economic theories suggest the importance of public investment (e.g., on material and immaterial infrastructure) in sustaining recoveries and reinforcing economic growth, with a significant demand side impact in the short run and positive supply side effects in the long run. The empirical evidence shows that this public expenditure is paradoxically pro-cyclical; the key reason is that during recessions it is politically less costly to postpone public investment than to reduce current expenditures. However, a collapse as great as the one recorded in the recent years was never recorded.

3. The impact on unemployment

In normal recessions, unemployment reaches the top value 18 months after the start of the recession; however, the lag is even longer in case of financial crises (see IMF, 2010). Also after the Great Recession, the labour market impact has been delayed in many countries, but with huge differentiation across countries (Table 3). In 2009 and the following years, unemployment rate rapidly increased in the most flexible countries, e.g. in the US, UK, Ireland, the Baltic states and Spain (in the latter case because of the high incidence of temporary contracts). In countries characterised by less flexible labour markets or by “internal” flexibilities (such as working hour adjustments or other instances of labour hoarding), such as Germany, the increase has been narrow or null. In Italy, the increase has been smoothly distributed over time and has been amplified by the second recession following the sovereign debt crisis, similarly to what happened in many other Eurozone’s countries. Greece and Spain are

¹¹ For example, by 90% in Greece, 70% in Ireland, 50% in Spain: see Deutsche Bundesbank (2016). This report observes that some recovery in investment took place since 2014 in the Eurozone, but it was extremely feeble, also because of the high levels of private debt (financial resources have been used to reduce the debt of firms and families rather than to start new investment projects).

¹² The fall (not shown in the table) was about one fifth in the Eurozone, concentrated in the years 2010-14; as a consequence, the share of public investment over GDP decreased from 3.6% in 2009 to 2.7% in 2014 (then this share remained unchanged until 2016). It should be added that the share has been slightly declining in Germany, in the 2008-15 period, but remaining significantly below Eurozone’s and EU averages (about 2.2% of GDP).

Table 3. Unemployment rates

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016*
Germany	8.5	7.4	7.6	7.0	5.8	5.4	5.2	5.0	4.6	4.6
France	8.0	7.4	9.1	9.3	9.2	9.8	10.3	10.3	10.4	10.2
United Kingdom	5.3	5.6	7.6	7.8	8.1	7.9	7.6	6.1	5.3	5.0
Italy	6.1	6.7	7.8	8.4	8.4	10.7	12.1	12.7	11.9	11.4
Spain	8.2	11.3	17.9	19.9	21.4	24.8	26.1	24.5	22.1	20.0
Greece	8.4	7.8	9.6	12.7	17.9	24.5	27.5	26.5	24.9	24.7
Ireland	4.7	6.4	12.0	13.9	14.7	14.7	13.1	11.3	9.4	8.2
Portugal	9.1	8.8	10.7	12.0	12.9	15.8	16.4	14.1	12.6	11.6
Eurozone	7.5	7.6	9.6	10.2	10.2	11.4	12.0	11.6	10.9	10.3
European Union	7.2	7.0	9.0	9.6	9.7	10.5	10.9	10.2	9.4	8.9
United States	4.6	5.8	9.3	9.6	8.9	8.1	7.4	6.2	5.3	4.8
Japan	3.9	4.0	5.1	5.1	4.6	4.3	4.0	3.6	3.4	3.4
* The 2014- 2016 data are forecasts										

Source: European Commission (European Economic Forecast, Spring 2016)

the most dramatic cases, with unemployment rates persistently above 20% in the recent years, but several other countries still have two-digit rates, mainly due to the hysteresis effects, i.e. a significant part of cyclical unemployment has become structural.

In the Eurozone as a whole, the current unemployment rate is still approximately 50 per cent higher than the pre-crisis levels. This deterioration can be observed for most countries, with partial exceptions in Germany and the UK. Huge changes are detected, as already mentioned, in Greece and Spain, but also in Italy the current figure is almost double that of 2007. As a consequence, social pain has been soaring, and citizens, especially in the Piigs, feel that sacrifices do not deliver the promised results (Wyplosz, 2012). From this point of view, we can say that the long crisis will be concluded only when unemployment levels have returned to pre-crisis levels: it will take much longer for this to happen (with respect to the time taken by real GDP to return to pre-crisis levels). In fact, we should consider both the positive labour productivity dynamics and the likely behaviour of participation rates, which for example in many countries of Southern Europe are extremely low and in the future should return to a satisfactory growth path.

Of course, also employment rates have been affected by the crises and are significantly below both the pre-crisis levels and the “Europe 2020” targets (the target for the EU as a whole is 75%, defined on the population aged 20-64 years). The Eurozone’s value is still (in 2015) below the 2008 pre-crisis level: 69% vs. 70.2%. Greece and Spain are to a large extent (more than 10 percentage points) below their 2020 national targets, but also Italy, Portugal and France are significantly below them (around 6 percentage points).

The double crisis had more profound effects concerning: (i) long-term unemployment, i.e. that of unemployed persons seeking jobs for more than one year (this indicator more than doubled in the Eurozone)¹³ and (ii) youth unemployment. As for the youth unemployment rate, Table 4 highlights both the worsening after the crises and the great differences across countries. Regarding the latter point, we should consider, in particular, the structural determinants of youth unemployment; among them, a specific role is played by all types of policies and institutions (see Marelli and Signorelli, 2016b).

On the other hand, the literature examines the various reasons why youth unemployment rates are more sensitive to the business cycle than adult unemployment rates.¹⁴ One reason relates to the greater frequency of temporary contracts among the young, thus the young workers are generally among the first to lose their jobs; moreover, during economic crises, labour-hoarding practices can further reduce the labour demand for young people. School-leavers compete with more jobseekers for fewer vacancies. The risk of youth unemployment becoming structural, thus leading to a “lost generation”, is high (Scarpetta et al., 2010).

After the recent crises, the youth unemployment rate increased from 15% in 2007 to a top figure of 24.2% in 2013; then it partly declined to 22.4% in 2015 (Table 4). In the final year, particularly high figures are found in Greece, Spain and Italy (more than 40%), but also in Portugal (higher than 30%), France and Ireland (more than 20%).¹⁵

Also considering a different indicator, increasingly used in empirical investigations, i.e. the NEET (not in employment, education or training), Table 5 shows that it increased in the Eurozone from 10.8% in 2007 to a maximum of 13.1% in 2013 (then it partly declined to 12.3% in 2015). In the last year, dramatically high values are found in Italy and Greece.

¹³ From 2.9% in 2008 to 6.0% in 2014, with a slight reduction to 5.5% in 2015.

¹⁴ See, for example, Marelli et al. (2013). More specifically, for an econometric investigation of the higher sensitivity of youth unemployment to financial crises, see Choudhry et al. (2012).

¹⁵ Only Germany showed a decline for the entire period (until 7.2% in 2015).

Table 4. Youth unemployment rates (15-24)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Germany	11.9	10.6	11.2	9.8	8.5	8.0	7.8	7.7	7.2
France	18.8	18.3	22.9	22.5	21.9	23.6	24.0	24.2	24.7
United Kingdom	14.3	15.0	19.1	19.9	21.3	21.2	20.7	16.9	14.6
Italy	20.4	21.2	25.3	27.9	29.2	35.3	40.0	42.7	40.3
Spain	18.1	24.5	37.7	41.5	46.2	52.9	55.5	53.2	48.3
Greece	22.7	21.9	25.7	33.0	44.7	55.3	58.3	52.4	49.8
Ireland	9.1	13.3	24.0	27.6	29.1	30.4	26.8	23.9	20.9
Portugal	16.7	16.7	20.3	22.8	30.3	37.9	38.1	34.8	32.0
Eurozone	15.0	15.5	20.0	20.9	21.2	23.4	24.2	23.8	22.4
European Union	15.5	15.6	19.9	21.0	21.7	23.2	23.6	22.2	20.4
United States	4.6	5.8	9.3	9.6	8.9	8.1	7.4	6.2	5.3
Japan	3.9	4.0	5.1	5.1	4.6	4.3	4.0	3.6	3.4
NOTE: calculated on 15-24 labour force (employment plus unemployment)									

Source: Eurostat database

Table 5. NEET indicator (15-24)

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Germany	8.9	8.4	8.8	8.3	7.5	7.1	6.3	6.4	6.2
France	10.7	10.5	12.7	12.7	12.3	12.5	11.2	11.4	11.9
United Kingdom	11.9	12.1	13.2	13.6	14.2	13.9	13.2	11.9	11.1
Italy	16.1	16.6	17.6	19.0	19.7	21.0	22.2	22.1	21.4
Spain	12.0	14.3	18.1	17.8	18.2	18.6	18.6	17.1	15.6
Greece	11.3	11.4	12.4	14.8	17.4	20.2	20.4	19.1	17.2
Ireland	10.8	15.0	18.6	19.2	18.8	18.7	16.1	15.2	14.3
Portugal	11.2	10.2	11.2	11.4	12.6	13.9	14.1	12.3	11.3
Eurozone (17)	10.8	11.0	12.5	12.7	12.7	13.1	12.9	12.6	12.3
European Union	11.0	10.9	12.4	12.8	12.9	13.2	13.0	12.5	12.0
NOTE: calculated on 15-24 population									

Source: Eurostat database

We observe that, while Table 5 refers to the most commonly used 15-24 age cohort, the NEET rate would be significantly higher in the age class 25-29 years (not shown in the table). In fact, it is less likely that young people in the latter group are in education or training, so youngsters not working are more likely in the NEET group; furthermore, in this particular segment the female rate is much higher.¹⁶ The corresponding waste of human resources has become a big social problem, especially after the recent crises.

Moreover, the relative position of young people in the labour market depends not only on the probability to find a job and on the length of the unemployment condition, but also on the type of work and its remuneration. Even excluding the more extreme situations (there is a growing literature on the “working poor”), the evidence shows that young people exhibit a disproportionately larger incidence of “temporary” jobs, especially in countries that have adopted a “flexibility strategy” oriented to remove restrictions to the entry into the labour market. In Europe, the highest incidences of temporary employment¹⁷ are found in Slovenia, Poland, Spain, and Portugal.

4. The need for new economic policies in the EU

The recent EU policies can be criticized on different grounds. First of all, the management of the “sovereign debt” crisis has been delayed and inadequate: the well-known, “too little too late” approach. In some cases, macroeconomic policies have been clearly wrong: for instance, the miraculous virtues of the so-called “expansionary austerity” have not been found. Policymakers overlooked that high public deficits and debts were not the cause of the financial crisis, but rather its consequence.

Austerity has been self-defeating also because of wrong assumptions about the size of the relevant parameters such as the fiscal multipliers. While the supporters of tough austerity measures argued that fiscal multipliers are rather low and consequently restrictive fiscal policies do not cause large falls in income and production, the size of the fiscal multipliers has been found large in the recent situation of the Eurozone. In fact some specific elements must be considered: (i) the short-run impact of fiscal consolidation is mostly nega-

¹⁶ See Marelli and Signorelli (2016b). In the age class 25-29 years, the NEET rates reach top figures as high as 39.5% in Greece, 33.8% in Italy, 29.6% in Bulgaria, 27.1% in Slovakia, 26.7% in Spain, 26.2% in Croatia, with the female rates even higher

¹⁷ On the contrary, it is well known that part-time employment is more diffused in Northern European countries (such as the Netherlands, Denmark, Sweden, and Ireland). On these comparisons, see again Marelli and Signorelli (2016b).

tive; (ii) multipliers are higher in recession periods rather than recoveries; (iii) multipliers can be very large when the “zero lower bound” of interest rates is reached; (iv) their size increases when many trade partners consolidate at the same time.¹⁸ Notice that even the financial markets now seem to penalize countries for the feeble growth prospects rather than for temporary deviations from positions of a balanced budget (Shambaugh, 2012).

Thus, GDP is still below the pre-crisis levels in many Eurozone countries (see the previous section); the long and repeated recessions have led to a decrease of potential output too. The paradox is that this is causing further austerity, since the SGP requires the consideration of deficit/GDP ratios in terms of potential output (at least regarding the medium-term objective), reducing again GDP and potential output. Furthermore, the EU Commission estimates of the output gaps have been criticized because very low, with a corresponding high value of “natural unemployment” (Cottarelli et al., 2014) and greater importance attached to structural reforms compared to support of aggregate demand.

The monetary policy of the ECB has finally become accommodative. Interest rates reached in 2016 the zero level (and the rate on overnight deposits the negative value of -0.40%). Many unconventional measures were introduced in the recent years. We have already mentioned the crucial OMT plan. The new measures adopted in 2015 and 2016 – in particular the Quantitative easing and the “Targeted long term refinancing operations” – have been introduced to support the real economy and to contrast deflation (zero inflation or an inflation much below the 2% ECB’s target has persisted since the end of 2014). However, also the new measures are not probably sufficient to stimulate in a decisive way the real economy and to raise the inflation rate. The liquidity created by the ECB does not properly flow to families and firms, also because of the situation of the banking system (penalized in some countries by the excessive weight of non-performing loans) and the incompleteness of the banking union. Not only is the ECB’s direct supervision limited to the biggest banks, but we are still waiting for the “European Deposit Insurance Scheme”, the third pillar of the banking union. In any case, for economic growth monetary policy is not sufficient by itself.¹⁹

¹⁸ We also notice that although a coordination between member states was required by the Maastricht Treaty, it has not been realized at all and we have assisted to a wrong structure of macroeconomic adjustment: tight austerity imposed on the debtor (Southern) countries while the creditor (Northern) countries continued to follow balanced-budget policies (De Grauwe, 2013; Blanchard et al. 2015). Furthermore, internal devaluations in debtor countries, without rising inflation in the creditor ones, i.e. an asymmetric adjustment, is unsustainable on economic and political grounds (O’Rourke and Taylor, 2013).

¹⁹ Already in the Jackson Hole speech (ECB, 2014), President Draghi admitted that monetary policy is not sufficient to reinforce the feeble economic recovery in the Eurozone. He even

Regarding fiscal policies, notice that even the IMF, already in 2012 (IMF, 2012), advocated a smoothing of the fiscal adjustments. Many critics advocate that fiscal discipline should be assessed in a medium-term horizon, differently from the current SGP and Fiscal Compact rules, also because structural reforms can have a positive impact on growth and on debt sustainability only in the long run. Moreover, the reduction of the debt/GDP ratio is practically impossible in presence of zero (or almost zero) growth and deflation. For the future, the request to exclude public investment from the deficit definition, within the SGP rules (the so-called “golden rule”), should be properly considered. Which critical suggestions have been accepted so far? Until now, only some “flexibilities” have been introduced by the EU Commission in 2015, concerning the assessment of convergence toward the “medium-term objective” of the SGP.

On the contrary, as discussed in the previous sections, it is fundamental to adopt expansionary macroeconomic policies to support aggregate demand. In particular, investments – public and private – should fill the enormous gap procured in the crisis’ period. Notice that an increase of public investment expenditure would allow an immediate relief for the economy (demand side effect); in addition, investment in infrastructure, transport, communications (Digital Agenda), higher education and research would sustain long-run growth (supply side effect). Unfortunately, the so-called “Juncker Plan” (worth 310 billion euro of public and private investments in three years) is too limited and has proved slow in its implementation. Thus, it should be extended²⁰ – in both time and size – and possibly financed by new credit lines from the ECB to the European Investment Bank (waiting for the future “Project Eurobonds”).

Rather than big projects, for instance on massive public works (characterised by long delays in their approval and subsequent construction, and sometimes by corruption episodes), many “micro” investment projects should be preferred.²¹ Afterwards, a big effort to relaunch public investment is more feasible than adopting too innovative measures, such as the different versions of “helicopter money” recently discussed in the literature. On the other hand, private investment should benefit by a change in expectations and more ef-

accepted that structural reforms are fundamental for economic growth, but should be accompanied by policies to sustain aggregate demand.

²⁰ In September 2016 President Juncker talked of a possible increase of the plan in size (a double amount is mentioned) and time (up to 2022); but the dreadful economic situation requires more prompt and radical decisions.

²¹ For example, in local transport, school building/renovation and social housing, energy efficiency, environmental protection, health, tourism, sports infrastructure, museums and cultural resources, social welfare (see Marelli, 2015).

fective transmission of monetary policy. Both public and private investment, including many projects concerning the regions and the urban areas, should also be supported by new industrial policies, putting R&D and innovation processes at the core (Mazzucato, 2013).

A further point is that the cost of the adjustment after the recent shocks fell mainly on labour (Pasimeni, 2014); in fact, the economic crises abruptly ended the gradual decline in global unemployment rates recorded before 2007 (ILO, 2014). Social pain has spread in the continent and poverty indices have reached unprecedented levels (Darvas and Tschekassin, 2015). Thus, an urgent action should be taken to fight the huge unemployment, in particular the unacceptable (in some countries) level of youth unemployment.

The key solution would be to adopt more expansionary macroeconomic policies. However, since the long period of stagnation and feeble recovery has caused the cyclical unemployment to become structural and persistent in some countries, there is also a need for new active labour market policies. In fact, along with more effective “passive” labour policies²², active labour policies are fundamental. Already in 2012, ILO advocated different types of policies: (i) expansionary macroeconomic and growth policies; (ii) active labour market measures, including development of public employment services, wage and training subsidies or tax cuts on labour; (iii) programmes to offset the mismatch of technical skills among youth. The latter include, for example, vocational training programmes, re-training of unemployed or discouraged youth, workplace training schemes, the creation or improvement of apprenticeship systems, entrepreneurship training programmes, soft and life skills training programmes for disadvantaged youth.

In the EU, the “Youth Guarantee” Recommendation, launched in 2013, requires that Member States should put in place measures to ensure that young people receive a good quality offer of employment, continued education, an apprenticeship or a traineeship within four months of leaving school or becoming unemployed. However, the experiences so far made are heterogeneous between countries and also within countries. Considering that the “youth experience gap” harms the employability of young people, despite their generally high level of human capital, structural policies should include reforms of the school-to-work transition processes and also of the education systems, if necessary (Pastore, 2015). New school-to-work transition institutions, should include innovative educational, placement and training schemes.

Moving now to longer run issues, it is necessary to overcome the weaknesses of EMU’s construction and governance. In particular, the international

²² On this point, there are some interesting proposals for a euro-wide system of unemployment insurance, to be adopted at least in the medium run.

financial crisis abruptly revealed the complete absence of an “economic axis” (Delors, 2013; De Grauwe, 2016). It is urgent to surmount the complete asymmetry between the two key macroeconomic policies. While monetary policy has been centralized, fiscal policy is still assigned to national governments (Obstfeld, 2013; Mody, 2015). While the EU’s budget is a tiny 1% of aggregate GDP, the Eurozone needs a proper budget of an adequate size, both for countercyclical purposes – as maintained by OCA’s theories – and for sustaining long-run real convergence across European countries and regions. As a matter of fact, in the past the emphasis placed on monetary and financial stability has triggered a neglect of effective mechanisms favouring long-run convergence among the economies. A common currency cannot be maintained in a group of countries characterized by huge differences in competitiveness and current account balances (Micossi, 2016). The “Europe 2020” plan is not a bad plan, but it could effectively work only with adequate resources.²³

The long-run endurance of EMU will also require some shock absorption mechanisms and innovative crisis management instruments, more effective than the “save-States” funds (EFSF and ESM): for instance, the Eurobonds.²⁴ Risk reduction should be accompanied by risk sharing and an authentic solidarity, among the Eurozone countries, should go hand in hand with stronger supra-national controls on all members (to face the “moral hazard” dilemma).²⁵ A more effective power allocated to the EU Commission might be a solution, including a Eurozone Finance Minister, a European Fiscal Institute or similar proposals (Baldwin and Giavazzi, 2016; Resilience Authors, 2016). The key point is that the Eurozone should soon dispose of a fiscal capacity, at least to stabilize aggregate demand or to grant emergency lending; a fiscal union is a pre-requisite to realize a complete economic union. The recent “five Presidents” Report (presented in 2015 and similar to the previous “four Presidents” document presented in 2012: see EC, 2015) has been disappointing. For instance, for the long term, this document does not exclude a “stabilisation function” for the euro area, but it is more clear on what such a “function” must not do than on its characteristics and funding.

It is also important that the transfer of budget and economic policy power from national countries to the Eurozone level should be accompanied by ade-

²³ The resources of structural and cohesion funds (now about 0.4% of EU’s GDP) should be significantly increased, in order to support investment, infrastructure, R&D, human capital, etc. Of course, with mandatory controls on the timing and efficiency of the financed works.

²⁴ For a review of the different proposals, including various partial mutualisation schemes, see Marelli and Signorelli (2016a).

²⁵ It is chiefly a lack of trust that renders Germany and “Northern” countries resistant, at present, to more integration in the Eurozone.

quate innovations in the democratic and institutional setting. An improvement in the “quality of institutions”, also at the national level (especially in some peripheral countries), is important for favouring the general acceptance and rapid accomplishment of closer integration in the Eurozone.

Besides the need for institutional reforms and greater support of economic growth, there is a problem of a more equitable income distribution, not only between countries but also within them. In some European countries and regions, well-being has deteriorated in absolute terms (because of the crises) but even more in relative ones, compared with the richest areas and segments of the population in each country; this is naturally also the effect of more general trends in globalization processes and technical progress. Not only have poverty indices risen to unprecedented levels and exhibit high persistence, but in many cases even the “median voters” have been affected.²⁶ Because of the public budgets’ constraints, the benefits of the Welfare State have been progressively limited and the “equality of opportunities”, characterizing the “European social model”, has somewhat vanished.

5. Conclusions

We have provided, in this chapter, new evidence regarding the profound impact of the “double crises” suffered by the Eurozone, especially the peripheral countries. Output and income are in some cases well below the pre-crisis (2008) levels. Unemployment rates are still much higher, affecting in particular the most vulnerable segments, that – as previously discussed – deserve specific attention and policies; targeted labour market policies are therefore valuable. Nevertheless, the key aim of current European policies should be to strengthen economic growth.

Regarding supply-side measures, typically advocated to reinforce growth, it should be noted that “structural reforms” (liberalisations, reduction of the fiscal pressure, pro-market legislation, etc.), although suitable in some instances, are not enough, since their effects can be grasped only in the long run. Moreover, even from this perspective, they should be accompanied by innovative industrial policies, putting R&D and innovation processes at the core of the reforms.

In any case, we repeat that the key problem of the European economy is currently the lack of aggregate demand. So, there is an urgent need to adopt

²⁶ The spread of populist and anti-Europe movements is particularly pervasive in the areas most hurt by the crises, where social discontent has been mounting (the result of the Brexit referendum in the UK is an example of trends that are clear in other countries as well).

expansionary macroeconomic policies. The monetary policy conducted by the ECB has become sufficiently accommodative, including different “unconventional” measures, but we have illustrated their limited success in strengthening economic recovery and contrasting deflation. Monetary policy should be integrated by a coordinated and expansionary fiscal policy. The real issue is not to contest the austerity approach *per se* or to encourage the spendthrift behaviour of governments (before the EU Commission the markets themselves would punish the opportunistic behaviour of national governments), but *how* to reduce the debt/GDP ratio. The most sensible way is to support GDP growth (and inflation).

In the medium and long run, there is also a need for indispensable reforms in EU’s governance and the working of the monetary union, that should be completed with a genuine “economic union”. For the survival of the euro, or even the EU as a whole, “more” integration is not a choice. This process might be followed in a flexible way, in which the further deepening may involve a subgroup of countries²⁷; a “feral union” should be the final outcome, even if realized with a strategy of “small steps”²⁸. Otherwise, in a globalized world, where the economic and political power is shifting to other world regions (in America, Asia and other continents), a fragmented Europe would be certainly fading.

To sum up, in order to boost the feeble recovery, a real “aggregate demand shock” is urgently needed. A big investment plan, financed either through Project Eurobonds or by the European Investment Bank, would be a proper solution. At the end, following a factual improvement in the labour markets – as well as in the general economic and social conditions – a virtuous circle could initiate: the progress in the well-being of the European citizens could make them more sympathetic toward further integration steps, thus allowing to take on the full benefits of a “complete and genuine” EMU.²⁹ Anyhow, within the Eurozone, key reforms are needed to ensure the long run survival of the euro and guarantee the continuation of the European economic and social progress; or, to be more precise, the return to an acceptable growth path after the violent impact of the recent crises.

²⁷ A European institutional framework with “concentric circles” of more or less integrated members cannot be excluded.

²⁸ As suggested by De Grauwe and Ji (2016) for moving in the direction of a “political union”. Closer integration would be appropriate also regarding non-economic issues; for example, by adopting a common position on policies for defense (also in response to the terrorist attacks in 2015-16) and migration flows.

²⁹ The “Brexit” (June 2016 referendum in the UK), may be a first step towards the EU’s dramatic disintegration; or conversely it could be an opportunity to redesign the functioning and policies of the EU’s institutions. The second outcome requires, of course, wise and far-sighted policymakers.

References

- Baldwin R. and F. Giavazzi (eds.) (2016), *How to fix Europe's monetary union: Views of leading economists*, VoxEU eBook, CEPR Press, London.
- Blanchard O., Erceg G. and Lindé J., (2015), "Jump starting the euro area recovery: would a rise in core spending help the periphery?", *NBER Working Paper* 21426.
- Blankenburg S., L. King, S. Konzelmann and F. Wilkinson (2013), "Prospects for the Eurozone", *Cambridge Journal of Economics*, 37, 463-477.
- Choudhry M.T., Marelli E., and Signorelli M. (2012), "Youth Unemployment Rate and Impact of Financial Crises", *International Journal of Manpower*, 33, 1, 76-95.
- Coenen G., Straub R., Trabandt M. (2012), "Fiscal Policy and the Great Recession in the Euro Area". *American Economic Review - Papers & Proceedings*, 102, 3: 71-76.
- Cottarelli C., Giammusso F. e Porello C. (2014), "Perché la crisi complica la stima del Pil potenziale", www.lavoce.info, 11.11.2014.
- Darvas Z. and O. Tschekassin (2015), "Poor and under Pressure: the Social Impact of Europe's Fiscal Consolidation", *Bruegel Working Paper* No. 2015/04.
- De Grauwe P. (2013), "Design Failures in the Eurozone: Can they be fixed?", *LSE 'Europe in Question' Discussion Paper Series*.
- De Grauwe P. (2016), "The legacy of the Eurozone crisis and how to overcome it", *Journal of Empirical Finance* (online 3 Feb. 2016).
- De Grauwe, P. and Ji Y. (2016). "How to reboot the Eurozone and ensure its long-term survival", in Baldwin R. and F. Giavazzi (eds.) (2016).
- Delors J. (2013), "Economic Governance in the European Union: Past, Present and Future", *Journal of Common Market Studies*, 51(2), 169-178.
- Deutsche Bundesbank (2016), "Investment in the euro area", Monthly Report, January.
- EC (2015) "*Completing Europe's Economic and Monetary Union*", European Commission, Report by J C Juncker, D Tusk, J Dijsselbloem, M Draghi and M Schulz.
- ECB (2014), *Unemployment in the Euro area*, European Central Bank, Speech by Mario Draghi, President of the ECB, Annual central bank symposium in Jackson Hole, 22 Aug 2014.
- ILO (2012), *Global Employment Trends*, International Labour Organization, Geneva.
- ILO (2014), *Global Employment Trends 2014: Risks of a Jobless Recovery?*, International Labour Organization, Geneva.
- IMF (2010), "Rebalancing Growth", *World Economic Outlook*, Washington: International Monetary Fund, April.
- IMF (2012), "Coping with High Debt and Sluggish Growth", *World Economic Outlook*, International Monetary Fund, October.

- Marelli E. (2015), "Investimenti per uscire dalla crisi" in R. Cappellin, M. Baravelli, M. Bellandi, R. Camagni, E. Ciciotti, E. Marelli (a cura di), *Investimenti, innovazione e città: Una nuova politica industriale per la crescita*, EGEA, Milano, 2015, 101-110.
- Marelli E., M.T. Choudhry e M. Signorelli (2013), "Youth and the total unemployment rate: The impact of policies and institutions", *Rivista internazionale di Scienze Sociali*, 121, 1, 63-86.
- Marelli E. and Signorelli M. (2015), "Convergence, crisis and unemployment in Europe: the need for innovative policies", *Croatian Economic Survey*, 17, 2, 5-56.
- Marelli E. and Signorelli M. (2016a), *Europe and the Euro: Integration, Crisis and Policies*, Palgrave Macmillan, London and New York (forthcoming).
- Marelli E. and Signorelli M. (2016b), "Youth unemployment and the disadvantages of the young in the labour market", in Fadda S. and Tridico P. (eds.), *Varieties of Economic Inequality*, Oxon and New York, Routledge.
- Mazzucato M. (2013), *The Entrepreneurial State: debunking public vs. private sector myths*, Anthem.
- Micossi S. (2016), "Balance-of-payment adjustment in the Eurozone", in Baldwin R. and F. Giavazzi (eds.) (2016).
- Mody A. (2015), "Living (Dangerously) without a Fiscal Union", *Bruegel Working Paper* No. 2015/03.
- Obstfeld M. (2013), "Finance at Center Stage: Some Lessons of the Euro Crisis", *CEPR Discussion Papers* 9415.
- O'Rourke K. H. and Taylor A.M. (2013), "Cross of Euros", *Journal of Economic Perspectives*, 27 (3), 167-92.
- Pasimeni P. (2014), "An Optimum Currency Crisis", *The European Journal of Comparative Economics*, 11, 2, 173-204.
- Pastore F. (2015), *The Youth Experience Gap. Explaining National Differences in the School-to-Work Transition*, Springer, Heidelberg.
- Reinhart C.M., Rogoff K.S. (2011), "From Financial Crash to Debt Crisis". *American Economic Review*, 101, August: 1676-1706.
- Reinhart C.M. and Rogoff K.S. (2014), "Recovery from Financial Crises: Evidence from 100 Episodes", *American Economic Review*, 104 (5), 50-55.
- Resiliency Authors (2016), *Making the Eurozone more resilient: What is needed now and what can wait?*, VoxEU.org, 25 June 2016.
- Scarpetta S., Sonnet A. and Manfredi T. (2010). "Rising Youth Unemployment During the Crisis: How to Prevent Negative Long-term Consequences on a Generation?". *OECD Social, Employment and Migration Working Papers*, 6.
- Shambaugh J.C. (2012) "The Euro's Three Crises", in D. Acemoglu, J. Parker and M. Woodford (eds.), *NBER Macroeconomics Annual 2012*, 27: 157-231.
- Wyplosz C. (2012), "The coming revolt against austerity", VoxEU.org, 2 May.