Economic relations between Germany and southern Europe

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Two interpretations have been advanced to account for persistent German current account surpluses that translate into equally persistent deficits of countries in the European periphery. According to the first, the German surplus is the expression of a 'virtuous' savings behaviour, to be extended to the periphery. The second maintains that the increase in net exports reflects the stagnation of German domestic demand. The paper argues that differences in price competitiveness are only part of the explanation of the disequilibria and that an expansion of German internal demand, albeit necessary, would not suffice to provide a viable response to the long-term sustainability of the euro area. Adopting a multilevel perspective, the paper argues that to understand the persistence of deficits in the European periphery, the main features of the reorganisation of the German economic system, including its income redistribution and demand implications, should be considered. Three elements are singled out: the effects of eastward enlargement, the impoverishment of the productive matrix of peripheral countries and the quality composition of trade flows. This analysis, it is argued, is a crucial premise for devising trade and industrial policies targeted on redressing the increasing skewness of EU trade, especially through greater trade among the deficit countries.

Key words: Eurocrisis, Southern Europe, Competitiveness, Industrial policy, Network of trade
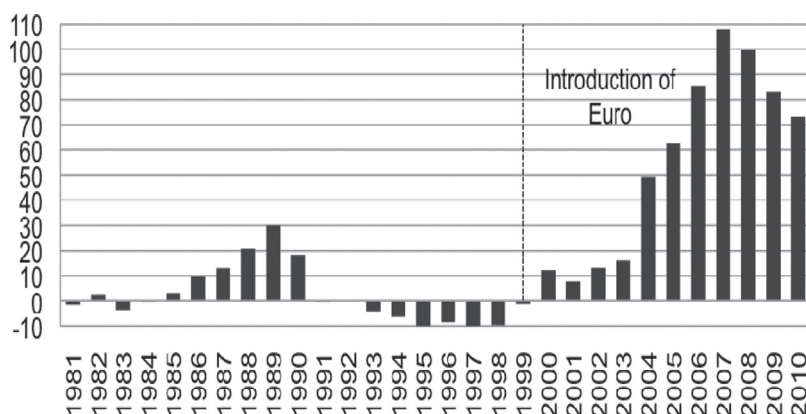*JEL classifications:* F15, O24, O25

1. Introduction

The origin of the euro crisis is commonly attributed to a balance-of-payments problem: persistent German current account surpluses translate into equally persistent deficits of countries in the European periphery (Figure 1). This interpretation hides an important ambiguity that perhaps helps to explain its popularity. These imbalances are, by definition, evidence of a difference between output and demand that is open to different causal explanations. Although there is agreement on the idea that these regional disequilibria straightforwardly reflect a standard balance-of-payments problem, two

Fig. 1. *Germany's current accounts with the euro-area countries (€ billions).*
Source: Lehndorff (2012).

different interpretations of these regional disequilibria have been advanced. They focus on relative prices and income effects, respectively.

According to the first, which we can label the 'culture of stability' view, the German surplus is the expression of a 'virtuous' savings behaviour to be extended to the periphery: restrictive fiscal policies would both reduce the debt/GDP ratio and restore competitiveness through 'fiscal devaluation' and real wage reduction. In this view, the surplus reflects the price competitiveness of German industry in world markets and the loss of competitiveness of peripheral countries. The narrative about the latter's lack of competitiveness is generally as follows: the fall in borrowing costs on entry into the euro area led to unsustainable booms in borrowing and domestic demand in those countries, fuelling inflation and raising relative prices within the currency union (Bayoumi *et al.*, 2011). Although the surplus countries benefited from higher exports, the model pursued by the deficit countries was unsustainable and must now be reformed. Two possible roads to adjustment have been discussed: a reduction of wages and prices in the periphery, possibly leading to a Japan-like deflationary stagnation, or inflation substantially higher in the core countries than in the periphery. The latter can only be achieved if EU-wide inflation rates are well above the ECB's inflation target. The policy implications of this proposal are that German wages must grow in excess of productivity growth and that the inflation target must be revised upward (Stockhammer, 2011, p. 14).

The second interpretation (Whyte, 2010) argues that this approach not only suffers from an obvious 'fallacy of composition'—since it ignores the 'impossible mission' of a universal replication of the export-led growth model—but it also disregards the fact that the increase in net exports reflects the stagnation of domestic demand due to wage compression and high domestic savings. Germany has been able to run an economy with chronically weak demand and large external surpluses because other economies have been the polar opposite. In fact, current account positions reflect the difference between domestic savings and investment (or between aggregate spending and output). Germany has been running a current account surplus because it has been saving more than it has been investing (or, which amounts to the same thing, because it has been spending less than it earns). Moreover, the above argument confuses productivity with

competitiveness (achieved by wage-cost restraint). German competitiveness reflects 'the heroic discipline of the country's workers, not the world-beating efficiency of its economy. Pay restraint in Germany since the introduction of the euro has been quite exceptional. In real terms, German wages are barely higher now than when the euro was launched in 1999 … It is deeply misleading, therefore, to look at Germany's external surpluses through the prism of the country's "competitiveness". The way in which the savings–investment balance has evolved in recent years suggests that the scale of the trade and current account surpluses is as much a reflection of the economy's domestic weakness as of its external strength' (Whyte, 2010, pp. 3–4). From this it follows that it will be very difficult, if not impossible, for peripheral countries to balance their books unless there is also a change in the core countries. Given disinflationary pressures in the core countries, restoring competitiveness through domestic cost compression within the euro area will not only be extremely difficult, but it will further exacerbate adverse debt dynamics by limiting nominal GDP growth over coming years.

Whilst we agree with Whyte's position on the impossibility of replicating the German model in the European peripheral countries and on the cumulative dangers of the simultaneous adoption of austerity measures, we doubt that reflationary measures in Germany will suffice to bring about an increase in exports and income in the peripheral countries large enough to redress the disequilibria and start a sustainable recovery. In Section 2 we argue that in a monetary union there cannot be a standard balance-of-payments problem—calling for equally standard measures of intervention. Extending our perspective beyond the short term, we shall contend that the euro crisis shows some evidence of the effects of a balance-of-payments crisis, but largely stems from different causes. In particular we contend that persistent deficits are not explained by standard indicators of price competitiveness, such as the real exchange rate. Adopting a multilevel perspective (MLP) that allows analysis of individual situations without losing sight of the systemic dimension, we argue that a preliminary assessment of the main changes of the German economic model (Section 3.1) is important in order to explain the emergence and persistence of these imbalances in the European periphery. To account for them, we single out three elements: the effects of eastward enlargement on southern Europe's trade flows with Germany (Section 3.2); the pattern of specialisation and the impoverishment of the productive matrix of peripheral countries (Section 4); and the change in the quality composition of German trade flows, with particular regard to the relation between imports and income distribution (Section 5). The importance of these elements can be traced back to the reorganisation of the German economic system, which started in the mid-1990s, within the general framework of a globalisation addressed in Europe under the constraints of the Maastricht criteria. These elements are also responsible for the increasing skewness in the network of trade within the eurozone, as presented in Section 6. Section 7 concludes by highlighting the need for an industrial policy able to upgrade the productive structures and rebalance the trade flows within the eurozone.

2. Current account imbalances in a monetary union: a multilevel and multidimensional perspective

The interpretations of the euro crisis outlined above raise two broad questions: the issue of external constraints (which will be discussed in Section 4) and the problem of competitiveness. In different ways, both of them fail clearly to distinguish an

'effective demand constraint' from an 'external financing constraint'.[1] According to Whyte, whilst Germany has been suffering from a lack of *internal* demand, the peripheral European countries have suffered from insufficient *external* demand. Since the eurozone current account is approximately in equilibrium, the major role assigned here to external demand may derive from two different assumptions. The first relates to the strict enforcement of Maastricht criteria in the case of the peripheral European countries: this leaves only net exports to compensate for a persistent weakening of private internal demand. According to the second assumption, instead, the insufficient external demand derives from an implicit 'external finance constraint' for individual eurozone countries, a constraint that a well-functioning monetary union would a priori exclude.

In the late 1980s, with the formation of a European central bank and the integration of European banking, it was expected that the creation of a 'truly European network payments … [would] make the re-cycling of balances much easier and much more casual among European countries'.[2] The conclusion was that 'intra-European balance of payments could thus become just a statistical curiosity'. If this prediction may appear overhasty today, so does the position of those who tend to liken the present euro crisis to a standard balance-of-payments crisis. According to this view, excess supply of credit in the countries of the European periphery resulted in real appreciation and current account deficits.

Standard balance-of-payments analysis focuses on a single dimension of competitiveness—price competitiveness—and on the atomistic behaviour of each single country. Arguably, this approach ignores the complexity of changes involved in the present crisis, which can be better analysed within an MLP.[3] From this viewpoint, at least three aspects qualify the euro crisis *as different* from a standard balance-of-payments crisis: (i) the presence of global uncertainty stemming from the unresolved 2007–08 crisis; (ii) the absence of international reserves as a 'binding constraint' on European peripheral countries; and (iii) the loss of credibility due to faulty construction of European institutions. From this point of view, it is not of crucial importance whether this loss derives from the falling value of public debt held by banks, from the difficulty of selling state bonds or from the sudden stops (Merler and Pisani-Ferry, 2012) in intra-European bank transactions with deficit countries. These events are obviously intertwined, with mutual cumulative effects. Any intervention that does not address, at the proper level, the institutional failure that generates this credibility loss is bound to prolong the crisis rather than resolve it.

The same 'atomistic ontology' inspired the foundation of the EMU. Assuming that the countries participating in the monetary union differed only in their preferences regarding inflation, it was deemed possible, given self-regulating markets, for the European periphery to import disinflation from the more 'virtuous' countries at no social costs. The belief in the existence of a vertical Phillips curve provided academic justification for the (politically originated) idea that a viable monetary union could be built on the weak foundations of a (partial) centralisation of the single currency, with a

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[1] See on this frequent confusion, Medeiros and Serrano (2001) and Palumbo (2009).
[2] See Giovannini and De Cecco (1989, p. 11) for a summary of these positions.
[3] The MLP was originally advanced to study the transitions of social systems towards sustainability with respect to substantive environmental problems such as climate change, biodiversity and resource depletion (see Rip and Kemp, 1998; Geels, 2010, 2011).

very limited degree of fiscal centralisation.[4] As noted by Pivetti (1998, p. 8), in a paper that builds on Italy's experience with the 'new EMS' before 1992, 'without *prior* constitution of a unified polity and a common balance of payments, there is no monetary regime, established among the potential participants in EMU, that could be regarded as irrevocable'. He warns[5] that 'monetary policy integration, unaccompanied by a joint authority over a joint budgetary power and a joint balance of payments, would hamper rather than enhance the cohesion of the union, due to the differential real impact of a single monetary policy on the individual economies' (a differential impact that the neutrality of money assumed in the monetarist approach excludes a priori). Thus, an interruption of the smooth economic integration of goods and capitals (with sudden halts in interstate interbank lending due to a lack of confidence and fears of default) can occur even without the binding constraint of the loss of international reserves. This is what recently occurred within the USA, usually considered an optimal currency area. Unlike the eurozone, however, the US government has been able to react with (relatively) vigorous discretionary policies.

We can conclude that although the euro crisis may resemble the models of the balance-of-payments crisis of the first and third generation (based, respectively, on excessive budget deficits and excessive private debt, though, in our case without immediate exchange risk), its causes must be traced mainly to the faulty construction of European institutions, supported by inadequate economic theory. Sooner or later this institutional failure would have inevitably attracted speculative attacks, with one-way riskless bets. Compounded by domino effects, the occurrence of crises described by second-generation models (based on self-fulfilling prophecies in which the so-called 'fundamentals' may have no role[6]) becomes much more likely. Without institutional reforms in the direction suggested by the MacDougall report (Commission of the European Communities, 1977), these crises cannot be avoided.[7]

Given the differences in the level of development of the various EU countries, fiscal policy should have been assigned two complementary targets: a redistributive and compensative function, and the role of actively promoting—through investment—the removal of development bottlenecks and renewal of the productive base. In the peripheral countries, the productive base was too narrow, in quantitative and qualitative terms, to respond effectively to external demand, the only dynamic demand component, given the deflationary effect of the Stability Pact on internal demand. Lacking this guidance, the forces protecting and freezing the status quo from the point of view of both institutions and

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[4] As Eichengreen wrote in 1993, instead of transferring control over national budgetary policies to the European Community, which would entail full completion of the process of political integration, the Delors report of 1989, which anticipated the provisions of the 1992 Treaty of Maastricht, 'proposed rules that would firstly impose effective upper limits on budget deficits of individual member countries of the Community … [and] secondly, exclude direct access to central bank credit and other forms of monetary financing' (see Eichengreen, 1993, quoted in Pivetti, 1998, p. 13).

[5] But see also the warnings of Minford (1992), Walters (1992), Cohen (1993) and Simonazzi and Vianello (1998). Apparently similar critical positions on these matters conceal widely different theoretical conceptions and policy implications (see Goodhart, 2003).

[6] As Keynes (1972, p. 157) wrote in 1931, 'there is a degree of deflation that no bank can stand', which means that in those situations it would be impossible to distinguish a liquidity crisis from a solvency crisis.

[7] This was the prevailing opinion among European economists until the late 1970s, before the monetarist counter-revolution: only with the full centralisation of monetary and fiscal functions would the transfer of funds required by intraunion surplus and deficits take place in the same way as it did between different areas within the same country.

productive specialisation thus prevailed. The way was open for a kind of bank-led 'privatised Keynesianism' (which in some countries took the form of a construction and consumption bubble) that concealed—until the outbreak of the global crisis—the existence in the European peripheral countries of a demand-and-supply constraint on development.

Similarly, the emphasis on price competitiveness, with its monodimensional character, seems incompatible with the multidimensional complexity of change. In fact, as Schumpeter[8] strongly emphasised, innovation processes involve changes in product, production process, markets, supplies/inputs and organisation.

The MLP that we propose deals with system changes. It is labelled 'socio-technical' because it encompasses, besides new technologies, changes in markets, user practices, policy and cultural patterns (Geels, 2004, 2010, 2011). It views transitions as non-linear processes that result from the interplay of developments at three analytical levels, each comprising heterogeneous configurations: niches (the loci of radical innovations), socio-technical regimes (the loci of established business practices and associated rules that stabilise existing systems) and a (partly) exogenous socio-technical landscape (the wider context that influences niche and regime dynamics). A crucial aspect of the MLP is that transitions—i.e. regime shifts—come about through interacting processes within and between these levels (on this, see also Lane, 2005, 2011). In the case of the euro crisis, a great deal of discussion arises from the failure to recognise the diversity of the underlying ontology: 'atomistic' ontology is unable to communicate with multilevel ontology (which, in this case, includes productive systems, regions, states and interstate institutions).

3. The reorganisation of the German economic system and the reorientation of trade flows

3.1

For the decade and a half following German unification, Germany's economic performance was poor (in particular, between 1999 and 2005 the average growth rate was 1.1%). In this period, as Carlin and Soskice (2009, p. 68) point out, the debate among domestic and international analysts focused on labour rigidities and the need for reforms 'with the objective of creating labour market flexibility in line with Anglo-American norms'. These authors show that in fact two different supply-side reforms were implemented, eventually leading to an increase in labour market segmentation. In the core, advanced industries, the supply-side restructuring was carried out by the private sector 'using institutions of Germany's coordinated economy, including unions,

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[8] Cf. Schumpeter (1992, p. 84, emphasis added): 'Economists are at long last emerging from the stage in which price competition was all they saw. As soon as quality competition and sales effort are admitted into the sacred precincts of theory, the price variable is ousted from its dominant position. However, it is still competition within a rigid pattern of invariant conditions, methods of production and forms of industrial organization in particular, that practically monopolizes attention. *But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control, for instance—competition which commands a decisive cost or quality advantage and which strikes not at the profit margins and outputs of the existing firms but at their foundations and their very lives.* This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly; the powerful lever that in the long term expands output and brings down prices is in any case made of other stuff'.

work councils and blockholders owners'. While the continued role played by those institutions may help account for the strong performance of exports from the late 1990s onwards, 'orthodox' labour market and welfare state reforms created labour market flexibility especially in the lower-end, less-unionised, segment of the market (e.g. services). The combination of these two supply-side developments resulted in an increase of wage dispersion and of the incidence of low-paid workers. Carlin and Soskice's conclusion on this point, however, is that low long-term GDP growth,[9] high unemployment and low real wage growth with respect to productivity until 2005 is hard 'to reconcile with a supply-side causal mechanism' and 'points towards the role of persistent domestic aggregate demand weakness' in explaining, along with these developments, an overall pressure towards wage restraint and profit share increase.

The export boom after 2005—not fully accounted for by the traditional costs determinants of price competiveness (Stahn, 2006)—opened the way for interpretations of the long-term reorganisation of the German economy that (as in Carlin and Soskice's essay) consider the supply and demand sides jointly. Danninger and Joutz (2007) convincingly show that the main determinants of the German export boom can be identified in four circumstances: (i) improved cost competitiveness through wage restraint; (ii) linkages with high-growth markets of emerging countries (especially China and India) through an appropriate mix of products or the use of previous established links; (iii) an increase in exports of capital goods in response to the increased investment in emerging countries; and (iv) formation of a regionalised pattern of supply by relocating abroad (offshoring) part of the production. Although these explanations are not mutually exclusive, Danninger and Joutz attribute the majority of the explanatory contribution of export growth to the second and fourth items. These four points, to which we add, as a fifth point, the above-mentioned evolution of German income distribution, set a general framework helpful in explaining—at an aggregate, national account level—the persistent accumulation of German current account surpluses after the introduction of the euro. Since 1999 the growth of the German economy has been driven not only by exports but also by imports, in particular of parts and components linked to the relocation abroad of supply chains.[10] However, the primary reason for the rise of current account surpluses after 2001 was a sharp fall of domestic private investment as a share of GDP, accompanied by a growth of foreign direct investment driven by offshoring activities. In the meantime, savings increased due to increased corporate profits, stagnating disposable income and, possibly, precautionary behaviour by households.[11] At the more disaggregate level of German trade flows, the above-mentioned five points highlight the impact of the reorganisation of German industry on Europe in its three spatial dimensions: east, west and south.

3.2

In the past decade, German trade has undergone substantial changes in its geographical breakdown and composition, with the eastern European[12] region and emerging

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[9] It should be recalled that in a large economy such as Germany's, internal demand, given its bigger relative size, is much more influential on growth than external demand (see Carlin and Soskice, 2009, p. 87 ff.).

[10] In Section 5, the attention will focus on consumption goods imports.

[11] See Traa et al. (2006, pp. 10–12).

[12] By 'eastern Europe' we mean the group of central and eastern European countries that are members of the EU.

Table 1. *Germany: exports, imports and trade balance by area (absolute values and percentage of total)—1999 and 2008*

	German exports to		German imports from		German trade balance			
	Percentage		Percentage		Absolute values		Percentage[a]	
	1999	2008	1999	2008	1999	2008	1999	2008
Southern EU	14.8	13.5	12.6	9.7	*16,788*	*73,751*	*39.1*	*30.8*
EC	8.3	12.6	8.5	13.6	*2,999*	*19,339*	*7.0*	*8.1*
Eurozone	48.9	46.2	52.4	49.5	*4,911*	*74,129*	*11.4*	*30.9*
EU27	69.4	68.4	70.6	69.5	24,358	152,585	56.8	63.7
RoW	30.6	31.6	29.4	30.5	18,560	87,064	43.2	36.3
Total	100.0	100.0	100.0	100.0	42,918	239,648	100.0	100.0

Notes: EC, Eastern countries; RoW, rest of world.
Southern EU: Greece, Italy, Portugal and Spain.
EU eastern countries: Estonia, Latvia, Lithuania, Czech Republic, Slovenia, Slovak Republic, Hungary, Poland, Bulgaria and Romania.
Eurozone: to avoid distortive effects, data for 1999 include the countries entering EMU after that date (Greece, 2001; Slovenia, 2007; Cyprus and Malta, 2008; Slovak Republic, 2009; and Estonia, 2011). The same applies for EU27.
[a]The values in the first three rows show each group of countries' share in the total trade balance. Only the last two rows add up to 100.
Source: Eurostat.

Asia, especially China, becoming important partners (see Table 1). Most of the eastern European countries have been given an opportunity to integrate into the supply chains of EU countries, especially Austria and Germany. This is reflected in the composition of trade: intermediate goods have been the most dynamic element of trade, with imports and exports of intermediate goods exceeding the equally dynamic expansion of trade in final goods (Simonazzi and Boris, 2010).

The eastward expansion of European industry has not been equally shared by all the old EU members. Austria and Germany have been swift to take advantage of cultural ties and closer borders, though Italian firms have also been very active in creating supply chains in south-eastern countries. German industry in particular has invested heavily in the neighbouring countries, integrating the new industries into its value chain (the 'bazaar' economy). The progressive elimination of barriers to trade and investment, but not labour, has generated incentives to outsource only parts of manufacturing activity. According to some authors (Coricelli and Wörgötter, 2012), it has been mainly activities biased in favour of low- and high-skill requirements that have been relocated, while activities requiring medium skills have remained in the country. The delocalisation of manufacturing to emerging Europe has actually helped to create jobs in the home country by sustaining productivity in manufacturing, while contributing to the sharp fall in Germany's relative unit labour costs (Marin, 2010B).[13] The pattern of German delocalisation, based

[13] According to Marin (2010A), outsourcing some activities to CEE countries has helped Austrian and German firms to save between 65% and 80% of their labour costs, helping them to stay competitive in an increasingly competitive environment.

on keeping the final stages of production in the home country, seems to differ from the Italian one (Deutsche Bundesbank, 2011B), which is based on the delocalisation of the entire process,[14] with obvious consequences on demand and growth.

Have Germany's closer ties with the east entailed a diversion of trade and a weakening of ties with the rest of Europe and, in particular, the southern European periphery? And has this impoverished the matrix of production and the trade network of southern Europe? Table 1 presents the share of Germany's external trade with Europe's two peripheries: southern and central-eastern Europe. Apparent from the table is a redirection of trade away from the southern periphery towards the eastern one. The change is larger for imports than for exports: consequently, not only does the south continue to account for one-third of Germany's total trade surplus, but in 2008 it still accounted—although to a lesser extent compared with 1999—for the near totality of the German surplus *vis-à-vis* the eurozone (see the last column of Table 1), substantially offsetting Germany's deficits with the Netherlands and Belgium.

The changing role of the various areas of the enlarged EU in the division of labour has been stressed by the Bundesbank (Deutsche Bundesbank, 2011A). On investigating who benefits most from a German expansion, it observes that a German rebound spills over to its neighbouring countries to different extents that mirror both their diverse specialisation patterns as well as the pattern of growth in Germany. The demand for intermediate goods, which the German economy normally covers through imports, especially favours the neighbouring countries of central and eastern Europe, which rely on the export of intermediate goods, although the link with the east is strong for capital goods as well.[15] Conversely, 'only with the Mediterranean countries is the interlinkage of the supply chains not very advanced so far … The spill-over effects of German business activity tend to be weaker in countries which mainly deliver consumer goods to Germany and/or which are holiday destinations' (Deutsche Bundesbank, 2011A, p. 22). This holds particularly for the Mediterranean countries. Conversely, the imports of intermediate goods from other European countries have been boosted because many suppliers located there participate in the strong sales performances of German exporters, especially in the rapidly expanding Asian markets. Far from demonstrating a low activation potential of German growth, however, the Bundesbank's analysis illustrates the importance of which component of demand is mainly supporting growth: export-led growth is more intermediate inputs-intensive, thus resulting in imports from both the east and the west, and much less from the south. Conversely, domestic demand gives greater impetus to more broadly geographically based imports of consumption goods. We can conclude that, on purely quantitative grounds and leaving to Section 4 an examination of qualitative aspects of trade, the spillover of demand on neighbouring countries depends on the pattern of German growth.

More buoyant internal demand in Germany would certainly help economic rebalancing in deficit countries through the direct and indirect effects of an increase in German consumer

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[14] The extent of delocalisation along the production chain is generally lower the more complex, exclusive or customised the product. In Italy, offshoring processes were mainly associated with large firms producing standardised, low- or medium-quality consumption goods (including cars), whilst they did not affect firms serving the highest segment of the 'made in Italy' and small- and medium-sized firms, often located in industrial districts, producing customised products (e.g. in the mechanical sector).

[15] In the case of capital goods, the regional structure is more concentrated. Switzerland and the Czech Republic specialise in supplying machinery and other equipment to German customers. The Slovak Republic has greater weight in motor vehicles and motor vehicle parts, followed some way behind by other central and eastern European countries and Spain.

goods imports. The full operation of the international multiplier is obviously greater, the larger the share of exports to Germany in GDP. As Table 2 suggests, since growth is relatively more affected by external demand, it follows that small countries with close linkages with the German economic system (Austria, Finland and Sweden, but also the Netherlands, not shown in the table) will tend to exhibit higher growth, smaller public deficits and current accounts surpluses. In the past 10 years, taking the eurozone as a closed area, there has been a reduction in the southern peripheral countries' share of exports to Germany in their total trade with the euro area, accompanied by an increase (with the exception of Portugal) in their share of imports from Germany (see Table 3). Whilst disentangling the composition, price and income effects lying behind the growing deficits of the various peripheral eurozone countries would require further investigation, it seems evident that their export base is at the moment too narrow to sustain development driven only by external demand.

To conclude, the reorganisation of the German economic system, based on internal demand compression and eastward reorientation of German trade, is partly responsible for the accumulation of deficits in southern European countries, which have continued to import from Germany without finding alternative outlets for their exports within and outside the eurozone (as shown by the increasing overall current accounts deficit of peripheral countries).

4. Patterns of specialisation: divergence or convergence?

We claim that even if surplus countries expanded their imports, this by itself would only marginally help their fellow euro-area countries to increase their exports. To address this problem, investigation is required of the convergence or divergence of

Table 2. *Exports to and imports from Germany as a percentage of a country's GDP, 2008*

	Export to Germany/GDP	Imports to Germany/GDP
Austria	12.92	18.56
Ireland	3.72	3.12
Denmark	5.82	6.42
Sweden	3.71	5.93
Finland	3.76	5.34
Portugal	2.70	4.73
France	3.17	4.71
Spain	1.89	4.28
Italy	2.92	3.94
UK	1.80	3.41
Greece	0.85	3.28
Czech Republic	21.24	19.53
Hungary	18.36	16.41
Slovak Republic	16.72	15.31
Poland	8.38	10.57
Slovenia	10.84	11.07
Romania	4.08	6.67
Bulgaria	4.18	7.92
Lithuania	4.10	7.97
Estonia	3.01	9.26
Latvia	2.71	7.35

Source: UN Comtrade.

Table 3. *Share of southern EU countries (plus France) trade with Germany in their total trade with the euro area, 1999 and 2008*

	Country's exports to Germany as a share of its exports to euro area		Country's imports from Germany as a share of its imports from euro area	
	1999	2008	1999	2008
Greece	32.7	24.3	33.3	36.6
Italy	33.1	28.9	49.4	54
Portugal	29.1	20.6	25.2	24.9
Spain	21.5	19.1	33.5	38.8
France	31.1	29.2	53.4	54.7

Source: UN Comtrade.

specialisation models across eurozone countries before and after the formation of the monetary union. In a bilateral comparison of selected European countries with Germany, we obtain for each country the Spearman rank correlation coefficients of revealed comparative advantages of exports to the euro area (measured by the Balassa index[16] at the SITC two-digit level of disaggregation) (see Table 4). We find a widening divergence in the specialisation models of Spain, Portugal and Greece. France and (increasingly) Austria appear to have specialisation models close to Germany's, while Italy, which started as rather divergent, is reducing its divergence.

Whilst the rank correlation coefficient provides a synthetic measure of the divergence/convergence of patterns of specialisation, a comparison of the Balassa indices of exports to the eurozone can provide evidence on the heterogeneity of the various production structures and of their evolution over time. We observe (see Table 5) that Germany and Italy (and to a lesser extent France) are characterised by specialisation indices generally slightly higher than unity, but spread across a wide range of products.[17]

Table 4. *Exports to the euro area: Spearman rank correlation coefficients of Balassa indices (bilateral comparisons with Germany)*

Country	1999	2008	Increase in convergence (+)
Austria	0.03	0.33	0.30
Netherlands	−0.17	−0.22	−0.05
France	0.35	0.34	−0.01
Greece	−0.31	−0.33	−0.02
Italy	−0.19	−0.03	0.16
Portugal	−0.30	−0.37	−0.07
Spain	−0.30	−0.35	−0.05

Source: Elaborations on UNCTAD database, SITC two digits.

[16] The Balassa export specialisation index is defined as $(X_{ij}/X_j)/(X_{iT}/X_T) \geq 1$, where X_{ij} and X_j are the exports of product i and total exports from country j, while X_{iT} and X_T are exports of product i and total exports from the whole reference area.

[17] Since Balassa export indexes measure relative specialisation, the lower the number of sectors with values greater than unity, the higher the degree of specialisation and the less diversified the productive structure for exports.

Table 5. *Balassa export specialisation index: number of sectors*

	Germany		France		Italy		Greece		Portugal		Spain	
	1999	2008	1999	2008	1999	2008	1999	2008	1999	2008	1999	2008
Chemicals and related products	8	8	7	6	3	4	3	6		2	4	5
Manufactured goods by material	5	5	5	6	6	7	3	4	6	6	6	7
Machinery and transport equipment	6	7	4	3	3	5		1	2	2	2	3
Manufactured goods	2	4	2	4	6	7	1	1	4	4	3	4
Total	21	24	18	19	18	23	7	12	12	14	15	19

Notes: Trade with world.
Total number of sectors: 34.
Source: UNCTAD.

As for the other peripheral countries, although Greece and Spain have increased their diversification even more than Germany in the decade 1999–2008, they are still characterised by very few products of specialisation, with extremely high values of the indices. In 2008, Greece and Portugal show *import* specialisation in the same products for which they appear to have *export* specialisation.[18] This result is compatible with an increase in the delocalisation/fragmentation of productive processes, and a consequent reduction in value added, which is particularly alarming given the limited number of specialisation products.

We conclude that the slow growth of the euro area did not sustain the capacity of southern European countries to achieve a sufficient level of diversification and specialisation of their productive structures; or it even contributed to worsening it (as seems to be the case of southern Italy). Conversely, the increasing integration of the central and eastern European economies within the supply chain of German industry speeded up their process of diversification-cum-specialisation. The eastward integration of German industry, combined with the persistent containment of internal demand of the major economies of the euro area, has gone hand in hand with an impoverishment of the productive matrix of those southern regions less connected with Germany and, more generally, with the general redirection of trade flows.

5. The quality of trade flows and price competitiveness indicators

Regional disequilibria within the euro area have been interpreted as indicating the loss of price competitiveness (often defined in terms of comparative unit labour costs). Whence derives the requirement to implement structural labour-market reforms and across-the-board austerity programmes to achieve an internal devaluation. With respect to unit labour

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[18] Data are available upon request.

costs, and in particular to productivity, however, we also find the problem of the plurality of levels of analysis and the difficulty of extrapolating at the aggregate level concepts and observations based on individual elementary units, as outlined in Section 2. As noted by Syverson (2011), the determinants of productivity can be divided into two groups: (i) those that operate primarily within the company under the control of the management and (ii) factors external to the company and involving the level of demand, productivity spillovers, competition, deregulation and regulation, and flexible inputs markets. When moving from the enterprise to higher levels, not only the determinants but also the *measuring* of productivity escape the control of the company, since it requires the use of an *aggregate* price deflator. At the level of a country, unit labour costs are equal to the labour share in total nominal value added multiplied by an aggregate price deflator.[19] Between 1980 and 2007, observe Felipe and Kumar (2011, p. 12), given the general decline in the share of labour in the value added, in all European countries except Greece[20] the increase in unit labour cost was due solely to the increase of the price deflator. This result has important implications, because it transfers, at least in part, the problem of productivity increases from the rarefied field of technology to the much more confrontational and mundane arena of income distribution.

It may also help explain, at least in part, a conclusion that Bayoumi *et al.* (2011) drew from an investigation of several measures of price competitiveness across European countries. They observed 'surprisingly wide divergences across alternative relative price measures' based in particular on wholesale prices, consumer prices, unit labour cost and export unit values for intra- and extra-euro trade. An interesting case is that of Italy (and to a lesser extent Spain). In a graph (2011, p. 7), Bayoumi *et al.* show the trend of four indicators of the real exchange rate between 1995 and 2009. What emerges is an enormous loss of competitiveness with regard to the indicator based on the unit values of exports and, to a lesser extent, with regard to the indicator of unit labour costs.[21] Instead, the two indicators based on consumer prices and wholesale prices have a completely different trend, both showing only a slight appreciation over the period. This surprising divergence between the two groups of indicators (ranging between 70 and 30 percentage points by the end of the period) stems from the fact that Italy (and Spain) used the unit values of exports (an index that is affected by changes in the quality of products and 'pricing-to-market' strategies widespread especially in the luxury goods industry) instead of an export price index,[22] as the other countries do, in the calculation of the value added price deflator, which is also used in the calculation of productivity. Whence derived an apparent deterioration in competitiveness measured by the first two indicators that was not reflected in the other two. Since the indicators of the real exchange are measures of *relative* competitiveness, an overvaluation of the

[19] The unit labour cost (ULC) can be written as (Felipe and Kumar, 2011, p. 11):

$$ULC = \frac{w_n}{(VA_n / P)/L} = \left(\frac{w_n L}{VA_n} \right) P = \left(\frac{Total\ labor\ Compensation}{VA_n} \right) P$$

where W_n is the average money wage, VA_n is the value added in money terms, L is the number of workers and P is the value added deflator.

[20] As Felipe and Kumar (2011) observe, in 1980 Greece had the lowest share of wages on value added.

[21] There is indeed a potential circularity in the measurement of indicators of real exchange rate based on unit labour costs: insofar as the deflator used for the measurement of productivity coincides with or approximates the one adopted in another indicator of relative prices, we will find a spurious correlation between indicators that is implicit, by construction, in the use of the same price index in both the indicators.

[22] See Banca d'Italia (2009, pp. 107–8) and Deutsche Bundesbank (2011B, p. 17). On the so-called 'Spanish paradox', i.e. a divergence between standard competitiveness indicators and Spanish export performance, see Banco de España (2012, p. 104).

deterioration in competitiveness of one country is an overestimation of the improvement in competitiveness of the countries with which the comparison is made.

The monodimensional approach to competitiveness finds a commonly accepted expression in the real exchange rate, since this indicator assumes the homogeneity of the baskets of products that are compared. This approach is challenged by studies that, in pointing out the analytical weakness of aggregate indicators of 'competitiveness', have focused on the structure and composition of production and trade. When disaggregated data are used—observe Felipe and Kumar (2011, p. 27)—'the comparison with Germany is, at least for some countries, misplaced … Germany is not the correct comparator as its export basket is very different from that of the southern European countries and of Ireland. What would an across-the-board reduction in nominal wages of 20%–30% achieve? The most obvious effect would be a very significant compression of demand. But would this measure restore competitiveness? We argue that it would not allow many firms to compete with German firms, which have a different export basket, and in all likelihood it will not be enough to be able to compete with China's wages.' Using an indicator of product complexity,[23] Felipe and Kumar argue that the peripheral countries' 'lack of competitiveness vis-à-vis Germany is not due to the fact that they are expensive (their wage rates in fact are substantially lower), or that labour productivity has not increased. The problem is that they are stuck at middle levels of technology'—as we have shown in Table 5—'and they are caught in a trap. Reducing wages would not solve the problem' (ibid., p. 11).

The increasing attention paid in the international trade literature to product quality, often approximated by unit values of exports, originates from the observation that economic development is associated not with producing more of the same thing (as a naive interpretation of GDP evolution might suggest) but with diversification. The expansion of the range of products and services may happen either horizontally (across product categories) or vertically (within product categories). Whilst both patterns of diversification appear to be correlated with the per capita income of the countries, implying that they are interlinked and not mutually exclusive, an important finding is that 'as the number of categories rises … the dominant form of diversification is the expansion of production of different varieties within the same category'.[24] Since countries diversify not by selecting new goods at random but by choosing new goods that are likely to be more exclusive,[25] the upgrading of exports corresponds to specialisation in products that are at the same time less common (since they are considered more 'complex') and sold at higher unit values. While richer countries trade mainly differentiated, high-unit-value production, often based on smaller production runs, 'most of the mass production is left to poorer nations' (UN-ESCAP, 2012, p. 158).

[23] This indicator is the result of an iterative process that interacts two characteristics of the export basket—diversification and ubiquity—the former relating to the country structure of exports and the latter to the complexity of the product. See Abdon *et al.* (2010) for a detailed analysis and Aiginger (2000) for an early analysis based on quality of exports indicators.

[24] See UN-ESCAP (2012, p. 158). Across-product diversification is defined as the number of categories of products exported by each country, while within-product diversification is defined as the average number of products of different unit prices per category of product. The data refer to 2009. See also Kellman and Shachmurove (2011).

[25] Closeness in the product space is another important aspect of the selection process (which may be dealt with by strategic state intervention).

From this perspective, southern European countries may envisage a long-term diversification strategy geared to the upgrading of their productive structure. The 'upgrading' of exports has become a somewhat compulsory route (opinions diverge, if at all, only on the means of getting to it) and German reorganisation may appear to be a successful example in this regard. Less attention, though, has to date been paid to the widespread tendency towards the *downgrading* of imports, especially in the consumption goods sphere. Germany is a case in point. As we mentioned before, the remarkable fall of the wage share was associated with modest average nominal wage increases (in 2010 real wages were 4% lower with respect to 2000). This outcome is generally explained by the labour market reforms introduced around 2003 (the Hartz reforms),[26] together with sluggish internal aggregate demand since 2000. As noted in Section 3, this average outcome conceals an increased segmentation of the labour market. The trend of employee compensations at the lower end of the dual market was associated with a negative wage drift,[27] an increased share of low-paid full-time workers,[28] a sharp increase in temporary and part-time employment,[29] and lower labour costs in the private sector services relative to manufacturing.[30] While the fall of lower incomes explains the sharp increase of income inequality in Germany in the past 10 years,[31] data on poverty based on the socio-economic (SOEP) microcensus[32] show a continuously rising trend since the turn of millennium, with only a brief decline in 2007. In 2010, more than 15% of Germans were affected by poverty (see n. 32), up by more than three percentage points since the mid 2000s (see Figure 2, based on OECD data). What was the contribution of these developments to the German external surpluses?

On the export side, the contribution of the Hartz reforms is usually associated with the direct and indirect effects of cheaper services. From the perspective of export price setting, the German export success was the result of integration of the dual internal labour market with the 'third' labour market created by offshoring practices, which contributed heavily—through lower wages and prices—to the German supply chain of intermediate commodities. On the import side, the rise of low-paid jobs and unemployment resulted in a lower expansion of consumption expenditure[33] and hence of imports of consumption goods. Between 1999 and 2008, German imports of consumption goods from China saw a 4-fold increase, compared with a less than 2-fold increase in imports from the southern European countries.

However, the sharp decline in the real incomes of lower-bracket households and the decade-long containment of median incomes suggest that distressed households were also driven to make 'forced purchases' of lower quality, imported consumption goods. 'The globalization helps the poor and mitigates inequality', triumphantly announced an economist[34] in the USA, mixing up causes and effects and disregarding the direct and indirect effects of changes in demand associated with consumption downgrading on income and employment. In our case, more-stringent income constraints on poorer German families explain both the reduction in demand for domestically produced

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[26] See, e.g., Bornhorst and Mody (2012, p. 12) and Carlin and Soskice (2009).
[27] See Bispinck (2011, p. 2 ff.).
[28] See Bosch and Weinkopf (2008, pp. 37–9).
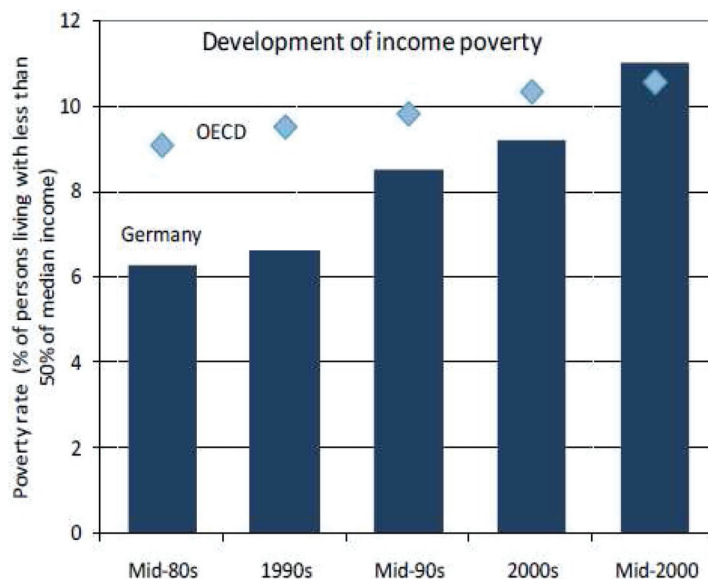[29] See King and Rueda (2008).
[30] See Bosch and Weinkopf (2008, p. 60).
[31] See Baldini (2012, p. 25; elaborations on OECD Earnings Database) and Stadtfeld (2012A, p. 1).
[32] See Stadtfeld (2012B). Poverty is defined as a living standard below 60% of the median income.
[33] See Bosch and Weinkopf (2008, p. 57).
[34] Broda, as quoted by Heather (2008) and Broda and Romalis (2008).

Fig. 2. *Poverty rate: Germany.*
Source: OECD (2008).

consumption goods and the substitution of consumption goods of intermediate quality imported from the European periphery with lower-quality products imported from emerging countries, especially China. We provide an example of this substitution process based on apparel and clothing imports (Table 6[35]). We used the UN Comtrade four-digit classification to attribute the apparel and clothing imports to Germany from six eurozone countries plus China to three price segments. Between 1999 and 2008 there was a polarisation of German imports classified by price segments,[36] with a sharp increase in low-price imports (from China) displacing middle- and higher-price products from the eurozone countries.

From a more general perspective, income deflation generates 'forced purchases of inferior goods imports'. This process adds a new perverse loop to the current self-defeating, synchronised European austerity measures. When deflationary measures adopted to balance the budget generate higher unemployment and widen the area of lower-income households, we witness not only a vicious spiral of a fall in tax revenues eventually requiring new cuts to achieve the targets, but also a change in the consumption bundle. The increased importing of lower-quality consumption goods will involve, together with a worsening of living standards not captured by the consumption index, a reduction in growth spillovers and a new spiral of cumulative income reductions in the eurozone.

[35] For each four-digit product we obtained the three unit-value benchmarks by taking one-third and two-thirds of the highest unit-value price (within our sample of countries). We thus obtained a classification of import flows associated with each price segment and country; we then aggregated them into the two-digit classification employed in Table 6.

[36] From international trade data we obviously cannot draw any inference on the nature of buyer/supplier relationships. For a description of the main sourcing strategies in the textile and apparel global value chains, see Lane and Probert (2009, p. 156 ff.).

Table 6. *Apparel and clothing: German import share on total imports, by price segment*

1999			
	Low-end	**Mid-range**	**High-end**	**Total**
China	678.48	39.01	0.00	45.80
France	0.02	4.78	4.78	9.58
Italy	1.18	3.93	27.81	32.91
Greece	0.18	3.45	0.02	3.65
Portugal	0.09	2.16	4.56	6.82
Spain	0.01	0.33	0.92	1.25
Total	8.26	53.66	38.09	100.00
2008			
	Low-end	**Mid-range**	**High-end**	**Total**
China	78.63	5.46	0.00	84.09
France	0.16	1.20	2.46	3.82
Italy	0.00	1.37	8.98	10.36
Greece	0.02	0.16	0.00	0.18
Portugal	0.00	0.16	0.66	0.82
Spain	0.02	0.66	0.05	0.73
Total	78.82	9.03	12.15	100.00

Source: UN Comtrade.

6. The network of trade within the eurozone: 1999 and 2008

In 1947, Frisch addressed the issue of the accumulation of external imbalances between countries in a way that can still be fruitful today. He investigated the skewness of the trade matrix, measured as the ratio of the sum of the surpluses to total trade. The relative skewness, ranging from 0 (complete multilateral balance) to 100, is at the same time an indicator of the limit that deficit countries encounter in providing a 'paying' outlet for their exports ('payment effect') and 'also an expression for the amount of liquid transfers or international lending that is needed'. If 'the trade skewness is not compensated in a reasonable time by a movement in the opposite direction, the tension is, through the credit system, allowed to accumulate, intensifying thus the difficulties'.[37] Frisch's purpose was to devise a policy designed to prevent a vicious circle from developing, whereby, starting from unbalanced trade, each country would be forced to reduce its imports *proportionally* to the level of its exports. He showed that this way of accomplishing balanced trade would go along with a substantial reduction of total trade. If the policy objective is to reduce the skewness with *minimum* reduction (and possible increase) in the total value of transactions, a better solution would be for deficit countries to intensify their import and export flows reciprocally. This is not an easy task, but it would have the double advantage of sustaining aggregate demand and income and reducing total financial liabilities in the long term.

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[37] Cf. Frisch (1947, pp. 542–3).

According to Frisch it was illusory to believe that lower tariffs (prices) would auto-matically lead to a trading system both multilateral and able to eliminate the bottleneck of the 'payment effect'. More than 10 years of monetary union and the single market appear to confirm Frisch's conviction: in fact the relative skewness of the trade matrix restricted to the six major countries of the eurozone doubled in the years 1999–2008 (from 0.08 to 0.16). Even cursory inspection of Figure 3 (where the arrows point to deficit countries and the thickness is proportional to the deficit size) shows that net trade flows among Italy, Spain, Greece and Portugal were less intense in 2008 than in 1999, while a larger part of net balances are now absorbed by bilateral relation-ships between Germany and France, Italy and Spain. At the same time, imbalances increased sharply. This emerging 'hub-and-spokes' pattern of trade balances shows that, with the help of a similarly skewed financial system, a departure from multilater-alism is possible even without trade preferential agreements.

7. Policies for growth: rebalancing trade flows within the eurozone

The late recognition (IMF, 2012, pp. 41–3) that the size of the income multiplier had been greatly underestimated by international and national institutions—because the synchronisation effects of the austerity measures had been overlooked—is a clear indi-cation of the problems generated by the pervasive adoption of an 'atomistic' ontology that, we argued, seems inadequate, on both analytical and policy grounds, to cope with the current crisis. It also suggests that a coordinated expansion driven by the leading country in Europe could be an important pillar in a multidimensional strategy targeted on overcoming the crisis.
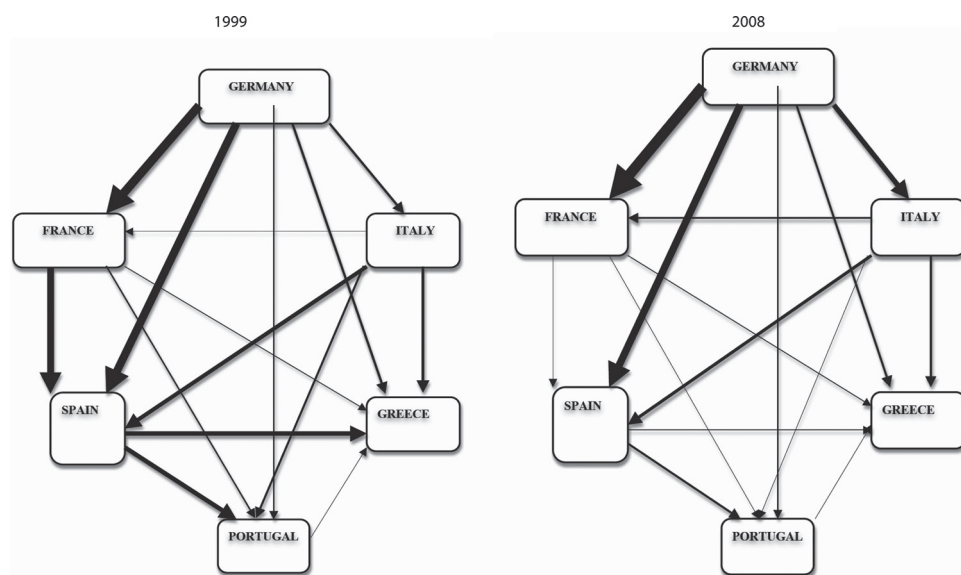
Fig. 3. *Eurozone: the network of trade.*
Note: Bilateral trade balances. The arrows point to deficit countries; the thickness is proportional to the deficit.
Source: UN Comtrade.

We have argued in this paper that a substantial German expansion of domestic demand, though necessary, would be unable to provide, by itself, a viable response to the long-term sustainability of the euro area. To this end, a rebalance in trade flows within the EU is also required: the present unbalanced pattern of trade (with all EU countries increasing their import dependence on Germany while reducing their export dependence and, at the same time, with a still too low degree of intraperiphery trade) needs to be replaced with a truly multilateral network of trade flows.

Differences in price competitiveness, it has been argued, are only part of the explanation of the disequilibria, with a much greater role being played by the composition (and direction) of exports and the underlying organisation of production: it is the quality of exports that needs to be improved. In fact the discussion in the previous sections suggests that the southern European countries' problems originate from their failure to diversify towards more complex products: this has left them exposed to the increasing competition of low-cost countries in their main export markets and especially in Germany. As we noted, the shift towards low-priced consumption goods imported from China has been reinforced by the increase in German income inequality and poverty.

Whilst the low growth of the EU economy, combined with the Maastricht conditions, may have played a role in the low path of structural change of the less developed southern European economies, there is no doubt that, based on market forces alone, they will not be able to diversify along a path that will take them to sustainability. 'Transitions do not come about easily,' warns Geels, 'because existing regimes are characterized by lock-in and path dependence, and oriented towards incremental innovation along predictable trajectories … Struggles between niches and regimes, and possible replacement, take place on multiple dimensions (e.g., markets, regulations, cultural meanings, infrastructure) and are enacted by interpretive actors that fight, negotiate, search, learn and build coalitions as they navigate transitions' (Geels, 2010, p. 495).

A more balanced European economic integration requires a common undertaking to stop chasing emerging economies on low wages. However, a 'high-road' strategy[38] requires a multilevel activism; one that is capable of supporting, through an industrial policy, production upgrading, diversification and structural change. Its success or failure should be measured in terms of the fulfilment of these targets, and not in terms of sector performance and profitability, growth of total factor productivity and exports (Wade. 2012, pp. 236–7). An effective industrial policy does not necessarily require hard instruments (such as subsidies or protection): 'soft' instruments of interaction—between public officials, firms, financiers and universities—at the 'meso' level can effectively support networks of firms in targeted sectors.[39]

As we argued in Section 4, the southern European economies are very different—both between and within themselves—in levels of development and product complexity. They will thus require different supportive policies, incentive structures and institutional arrangements to bridge the gap. The Italian SMEs of the industrial districts, for example, especially in the consumer goods and mechanical industries, have been even more successful than the German firms in finding new product niches

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[38] See Aiginger (2012, p. 6).
[39] As Sebastiano Brusco stressed in his contributions to the design of industrial district policies, 'a multiplicity of forms of industrial organisation could be efficient if properly embedded in supporting social and institutional structures' (see Natali and Russo, 2009, p. 211).

and new markets (Foresti and Trenti, 2012, pp. 82–7). However, their export strategy seems more fragmented and uncoordinated than the more structured, strategic behaviour of their German counterparts. Their export performance seems to rely more on the uncoordinated efforts of a plurality of firms, whilst the Germany's export strength seems to rely more on tightly organised value chains offering a complete range of products and backed by the full power of their 'country system' (what was once called 'Germany Inc.').

The south of Italy, instead, shares many of the problems of the poorest parts of the southern countries. In this regard, a policy of appropriate, targeted investments will be required, while avoiding the past waste of public and private resources. Public investment could play a pro-active role in infrastructure development and act as the catalyst for public–private partnerships by creating a virtuous cycle of investment (ESCAP, 2011, pp. 175–6). Health, welfare, climate change and the environment have all been at the centre of targeted industrial policies by the more advanced economies (see on this the German Federal Ministry of Economics and Technology, 2010). Government policy needs to coordinate the dispersed actions of firms and help them identify new opportunities for differentiation and upgrading. Imported products, for example, signal the existence of demand and they could guide domestic firms in discovering new opportunities.

An effective industrial policy requires strong and well-integrated industrial development agencies operating on a regional level and with close knowledge of the warp and weft of the economic structure. Competition clusters and innovation networks involving companies, universities, research centres, technology service providers, educational institutions and business networks all help to strengthen value chains. Innovative clusters and networks should be developed in a more targeted way to ensure that knowledge transfer, research, infrastructure and further training are promoted in a coordinated manner. This has long been acknowledged and tacitly done in all advanced countries. Recent research shows that for three decades at least, the US government, at federal, state and local levels, has implemented a type of 'below the radar' industrial policy that previous research overlooked (Wade, 2012). The same applies to Scandinavian countries (Aiginger, 2012, p. 9). These examples (but still others could be quoted from Asian emerging countries) show that the initial lack of capabilities required to implement these policies—the most binding bottleneck in a plurality of situations—can be overcome, not by 'across-the-board formalisation and enforcement' of 'impersonal rules', but through a sort of 'learning by doing': i.e. by '*raising* the state's capacity to coordinate a selected set of economic agents', to 'stabilize their confidence in the state's behavior and establish national development as an urgent overarching project' (Wade, 2010, p. 157).[40]

We are aware that a large proportion of the current account deficits and surpluses of the eurozone countries result from trade with countries outside the euro area. In this paper we have mainly focused on intraeurozone trade flows because we believe that intra-European integration can make it possible to reduce the costs and reap the benefits of a monetary union, while facilitating the creation of a political union. To this end, redressing the increasing eastward skewness of EU (German) trade should take priority. Industrial and commercial policies in support of import substitution, product

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[40] For a discussion of the key design features of industrial policy needed to maximise its contribution and minimise its potential adverse effects, see also Rodrik (2008, p. 25 ff.).

upgrading and export expansion should target a European re-equilibrium and should be associated with the promotion of external relations with the non-EU countries of the Mediterranean basin. Indeed, all southern countries have more intense economic relations with western and central Europe than they have with each other. However, the south is the bridge to many of the neighbouring regions: Greece is important to Europe as the former Yugoslavian countries strive to become EU members and as Europe endeavours to build bridges towards Asia; Italy and Spain are essential for cooperation with North Africa; and Spain and Portugal play a role in Europe's cooperation with South America. Finally, a targeted industrial policy is urgently necessary to rebalance the internal trade among the regions within each country, to reverse the trend that has seen the backward non-exporting regions fall behind, with hysteresis resulting in reductions in productive capacity, the creation of bottlenecks and lower long-term actual and potential growth rates.

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