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Nicholas Kaldor and Kazimierz Łaski on the pitfalls of the European integration process

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Nicholas Kaldor and Kazimierz Łaski have been two very prominent exponents of Keynesian thinking. They both contributed to the debate on European economic integration, one (Nicholas Kaldor) in the early 1970s, when there were fierce debates about the United Kingdom's entry to the European Communities, and the other (Kazimierz Łaski) in the wake of the financial and economic crisis of 2008–2012, when the European Union and its Economic and Monetary Union were seriously challenged by potential disintegration. Both exponents provided deep and complementary inputs into an understanding of the centrifugal forces at work when a region with a rudimentary federal structure (but an extremely weak 'central state') embarks on tight economic integration with an inadequate macroeconomic policy framework in place.

Keywords: *European integration, macroeconomic imbalances, balance-of-payments constraints, EU and EMU reforms, Nicholas Kaldor, Kazimierz Łaski*

JEL codes: *E12, E44, E60, E61, E65, F02, F15, F42, F43, F55*

1 INTRODUCTION

Nicholas Kaldor (1908–1986) and Kazimierz Łaski (1921–2015) were major representatives of Keynesian analysis, Kaldor a central figure of the Cambridge Keynesian school (particularly prominent in the 1950s up to the 1970s), and Łaski one of the main proponents developing Michał Kalecki's work.¹

Although Nicholas Kaldor wrote in the early 1970s, critically, about issues of European economic integration, while Kazimierz Łaski wrote in the wake of the financial crisis of 2008–2012 – that is, 40 years later – on the failures of the policy framework of the European Economic and Monetary Union (EMU), their analyses were largely consistent with each other and complementary.

Nicholas Kaldor made his contributions to the analysis of European economic integration in the course of the debates about the United Kingdom's decision to join the European Communities (EC, as it was at the time). Kaldor's approach to analysing the pitfalls of European integration followed from his own analytical background that was grounded in the analysis of economic growth which at that time had moved towards multi-sectoral (or at least two-sector) analysis (see Kaldor 1966). Łaski, on the other hand, together

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1. For biographical details, see Thirlwall (1987), Targetti (1992) and King (2009) on Kaldor, and Łaski (2006) and https://en.wikipedia.org/wiki/Kazimierz_%C5%81aski on Łaski.

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with his collaborator Leon Podkaminer (see Łaski/Podkaminer 2012a; 2012b) took a Keynesian stance with respect to the need of countries to be able to combat recessions by means of fiscal and monetary policy and they saw this possibility as being seriously constrained through the policy architecture in place in the EMU. Hence they questioned the rigid (and, in their view, misguided) construction of the Stability and Growth Pact (SGP), the difficulty to pursue a unified monetary policy in an integrated area in which wage developments were not subject to European-wide coordination, and – linked with this – problematised the premature entry of countries into a monetary union that did not allow individual countries to pursue an independent monetary policy. ‘Real exchange rates’ in such a scenario could become seriously misaligned and persistent external imbalances could build up, leading to unsustainable debt positions. These would at some point result in an unwinding in the form of severe austerity in some countries, could cause a prolonged period of sub-optimal growth in the eurozone as a whole, and asymmetric adjustment processes of creditor and debtor countries. This in turn could seriously challenge the European integration process as a whole. L&P (Łaski and Podkaminer) had the advantage of having witnessed the instability of integrated capital markets (after major moves towards liberalisation in the 1980s and 1990s); consequently financial markets and international capital flows played important roles in their analysis. This was much less the case in the analysis of Nicholas Kaldor as, at the time of his writing, the degree of liberalisation of financial markets and international capital markets integration were at much lower levels than when L&P pursued their analyses.

Nicholas Kaldor, on the other hand, focused on the inherent imbalances that are likely to emerge along with a high degree of trade integration amongst economies that are structurally (and, one might add, institutionally) heterogeneous and where differences in sectoral composition got accentuated through the process of integration itself. These differences in sectoral composition, in turn, affected relative productivity and unit labour cost developments and this caused a misalignment of real exchange rates in a monetary union, giving rise to what he termed ‘structural external imbalances’. The mechanism usually emphasised by neoclassical economists that would bring such a system back into ‘equilibrium’ (getting rid of external imbalances), that is, real exchange-rate adjustment, was perceived by Kaldor as too weak or dysfunctional to lead to a rapid return to ‘equilibrium’ and avoid severe economic and social costs.

What was common to both Kaldor and L&P was that they were severely concerned about the possibility of pursuing fiscal policy in the context of the EMU. Kaldor had emphasised already, in 1971 (!), that European integration required the build-up of fiscal arrangements that would allow fiscal transfers (both as cyclical stabilisers and to deal with ‘structural’, that is, persistent current-account problems). However, he also emphasised that this would be unrealistic in a Union that was not willing to share a high degree of political sovereignty (that is, ‘monetary union requires fiscal union and this required political union’).²

2. See his much quoted statement: ‘Some day the nations of Europe may be ready to merge their national identities and create a new European Union – the United States of Europe. If and when they do, a European Government will take over all the functions which the Federal government now provides in the U.S., or in Canada or Australia. This will involve the creation of a “full economic and monetary union”. But it is a dangerous error to believe that monetary and economic union can precede a political union or that it will act (in the words of the Werner report) “as a leaven for the evolution of a political union which in the long run it will in any case be unable to do without”. For if the creation of a monetary union and Community control over national budgets generates pressures which lead to a breakdown of the whole system it will prevent the development of a political union, not promote it’ (Kaldor 1971a [1980]: 192).

Łaski, on the other hand, employed his (theoretical and empirical) insights into the importance of fiscal spending as a counterweight to net savings of the private sector, which – in his view – had a cyclical as well as a secular dimension. His critique of the SGP (constraining the use of counter-cyclical fiscal policy, but also imposing a longer-term target aimed at a balanced budget over the cycle or remaining close to it) was based on these insights.

In the following we shall present the two different approaches by Nicholas Kaldor and Kazimierz Łaski (together with his collaborator Leon Podkaminer) and point out the complementarities in their approaches.

Considering Kaldor's rather pessimistic judgement regarding the prospects of monetary and economic union already in the early 1970s and Łaski's (and Podkaminer's) critique of the policy framework of the EMU, we shall – in a final section of this paper – consider which economic policy reforms in the European Union (EU) and specifically the eurozone (EZ) might be feasible to be achieved within the severe constraints of the current political-economic setting. That setting reflects in many ways the very 'hybrid' nature of the current stage of European integration, characterised by a very rudimentary state of 'federalisation' that the European Union currently represents. We believe that this state will continue to characterise the European Union for quite a few decades to come. We therefore advocate giving due attention to a 'positive political economy' approach when considering the formulation of reforms that would be feasible in the current political-economic context of European integration. In our view, this has not been given enough attention so far in the current discussions amongst economists and also in the valuable contributions made by Nicholas Kaldor and Kazimierz Łaski.

Section 2 will cover Nicholas Kaldor's contribution to the debate on European economic integration, Section 3 that of Kazimierz Łaski (with his collaborator Leon Podkaminer), and Section 4 will come back to a comparison of the two approaches and attempt to check on the feasibility of reforms suggested within the current political-economic European context.

2 NICHOLAS KALDOR ON THE PITFALLS OF EUROPEAN ECONOMIC INTEGRATION

As mentioned in the introduction, Nicholas Kaldor was already very engaged in the debates on European integration as far back as the early 1970s, particularly in the context of the question of whether the United Kingdom (UK) should join the European Communities (EC). There are three excellent intellectual biographies (Thirlwall 1987; Targetti 1992; King 2009) which all cover the historical context in which Kaldor made his contributions to the 'Common Market' debate in Britain. They also discuss the various analytical arguments behind his rather critical attitude towards Britain's entry into the EC and the problems in the construction of the EC more generally. This includes criticisms of the proposals made to go further in the direction of a European monetary union (at that time proposed in the so-called 'Werner Report' (1970)). We shall discuss these critical contributions by Nicholas Kaldor and further evaluate their relevance in the current context of the crisis of European integration.

The analytical contributions that Kaldor relied upon in his critical stance towards EC integration were manifold; they were coherent and comprised the following:

- a critical stance towards unqualified trade integration, including a careful discussion of the use of trade policy instruments which could improve the macroeconomic implications of economic integration;

- a careful examination of the likely emergence of ‘structural current-accounts disequilibria’ in an integrated market setting and the constraints these impose on economic growth (see the later contributions by Thirlwall 1979; 2011);
- an analysis of causes of divergent growth patterns (using Myrdal’s 1957 concept of ‘circular and cumulative causation’) which could emerge from international economic integration;
- an emphasis on the role of sectoral composition of economies (manufacturing, agriculture, services) in such growth processes and for current-account imbalances; Kaldor shifted in the period of his writings on European integration away from single-sector, aggregate growth models towards emphasising the sectoral composition of economies;
- an examination of terms-of-trade effects within two-sector models that can accentuate disequilibrium processes as these affect industrial costs, real incomes and growth;
- the role of exchange-rate regimes (in particular fixed vs flexible exchange rates) which might or might not provide an effective instrument to counter unbalanced growth patterns;
- the role of non-price factors in international trade and competitiveness which have to be taken into consideration when looking at the impact of ‘real exchange rate’ developments on competitiveness; and finally
- a far-sighted criticism of a move towards European monetary union if not accompanied by fiscal integration and a political union.

From the above list one can already see that these topics retain their relevance in the context of the current discussion of the crisis of the EU or of the European integration process more generally. In this sense one can say that Kaldor made important analytical contributions not only to the question of the UK joining the EC in the 1960s and 1970s but also to the current situation.

In sum, Kaldor’s analysis of the pitfalls of the Common Market comprises three components:

- the almost unavoidable processes leading to ‘structural external imbalances’;
- the detrimental impact of the Common Agricultural Policy (CAP), for a country like the UK;³
- the fact that external imbalances would result in a ‘deflationary bias’ in the deficit countries.⁴ This tendency would be strengthened in a fixed exchange-rate regime and, even more so, in a monetary union that would not be complemented by a fiscal union.

In the following we shall go over the main elements of his analysis. We start with the centrality of external imbalances in Kaldor’s analysis.

2.1 Structural external imbalances and cumulative causation: Kaldor on sectoral composition and the cumulative process of divergent growth trajectories

Kaldor’s analysis points to an issue that is of central importance in the set-up of the EC (and continues to be of great relevance in the EU): the likelihood of what he calls the

3. As the article had to be shortened in the published version, we excluded the section on Kaldor’s critique of the CAP. A longer version of this paper can be obtained upon request from the author.

4. For a more recent contribution to these issues, see Hein/Detzer (2015), Landesmann (2015; 2019) and Celi et al. (2019).

emergence of ‘structural (external) imbalances’. He refers in this respect to G. Myrdal’s ‘circular and cumulative causation’ processes (Kaldor 1971a [1980]: 192). Which are the cumulative processes that Kaldor alludes to when predicting that integrated groups of countries will experience ‘structural external imbalances’?

There are two interacting reasons for this: the ‘structure’ (or ‘sectoral composition’) of an economy⁵ – in particular the share of manufacturing compared to other sectors of the economy – and the development of the ‘real exchange rate’ or of ‘efficiency wages’ (that is, the real-wage-rate–productivity relationship) which Kaldor sees as the main determinant of ‘competitiveness’.⁶

In Kaldor’s view, the ‘cumulative process’ is, in the first instance, driven by relative productivity growth rates of different economies (or regions). These aggregate productivity growth rates in turn are driven by the differential sectoral output growth rates, particularly of manufacturing since manufacturing is ‘the’ ‘increasing returns’ sector of the economy (see Kaldor 1966, where he expands this argument).⁷

An economy thus has an advantage in terms of overall growth if it has a high share of manufacturing to begin with and the level of output expands at a faster rate than that of its partner economies in the EC. As output expands faster, it will experience a higher productivity growth rate (‘Verdoorn’s law’) (McCombie et al. 2002) and then Kaldor expects the ‘efficiency wage’ to decline in relative terms and its ‘real exchange rate’ to depreciate. Why is that? Because money wage rates – Kaldor refers here to a number of OECD studies – progress across economies/regions or sectors more evenly than productivity growth rates.⁸ Hence economies with a larger share of manufacturing will show faster overall productivity growth and will experience a fall in the relative efficiency wage, while economies with a smaller share of the manufacturing sector and with lower productivity growth will experience a rise in the relative ‘efficiency wage’.

Such relative movements in efficiency wage rates or in real exchange rates would in turn make the manufacturing sector more competitive in some economies/regions and less competitive in other countries/regions, which means the sector can expand at a faster

5. Nicholas Kaldor’s approach at the time was shaped by his own transition from having made seminal contributions to aggregate growth modelling towards recognising the importance of sectoral composition. The classic reference here is his Inaugural Lecture when he became full professor at the University of Cambridge (Kaldor 1966). Linking his analysis to the insights of the classical authors (Adam Smith and David Ricardo) and also following a line of research pioneered by Allyn Young (1928) and Verdoorn (1949; 1980) he emphasised the different scope for and mechanisms that drive productivity growth in manufacturing as compared to agriculture (and – although he did not cover this to the same extent – the services sector).

6. The focus on the ‘efficiency wage’ which Kaldor defined as unit labour costs – that is, the real wage adjusted for (labour) productivity levels – is one shot at the issue of international competitiveness; as a second shot – as we shall see below – he also emphasises non-cost factors such as relative product quality developments.

7. ‘Owing to the existence of economies of scale both comparative success and comparative failure tend to have self-reinforcing effects. Industrial areas tend to become more “competitive” when their growth of productivity is faster than average; but a higher rate of productivity growth is itself the reflection of the faster rate of growth of production made possible by the gain in “competitiveness”’ (Kaldor 1971a [1980]: 192).

8. ‘[T]he dispersion in the growth of money wages as between different industrial areas always tends to be smaller than the dispersion of productivity movements. It is for this reason that within a common currency area or under a system of convertible currencies with fixed exchange rates, relatively fast-growing areas tend to acquire a cumulative competitive advantage over relatively slow growing areas’ (Kaldor 1971a [1980]: 192).

rate (through its net exports) than in the countries with slower productivity growth. Hence, those economies/regions that have a high share of manufacturing to begin with, and experience higher output growth, will concentrate even more of the manufacturing capacities of the EC in their economies, while the other economies will lose manufacturing capacities. This also means (as manufacturing is the most dynamic tradable sector) that some economies will tend to have chronic trade surpluses and other economies chronic ('structural') trade deficits (Kaldor 1952 [1980]: 33–34).

In an economy with flexible exchange rates the 'structural deficit' country can alleviate its situation through frequent devaluations of its exchange rate, but this situation would not be possible if it has opted for a fixed exchange-rate regime.

However, while Kaldor (1971a [1980]) emphasises the 'efficiency wage' dynamics in his earlier contribution to the 'Common Market debate', he discusses in a later paper (Kaldor 1977 [1980]) that real exchange rates as traditionally measured (for example, through relative labour unit costs or relative export prices) do not correlate well (that is, inversely) with export performance (measured for example by changes in export market shares). In fact, he finds the opposite correlation: countries which over a longer period of time increase their export market share position also experience a (secular) real exchange-rate appreciation.⁹ In this context he discusses carefully the relevance of 'non-price factors' (such as product quality) in international competition, which can account for the 'perverse' relationship between 'efficiency wage' movements and export performance.¹⁰

But let us return to the impact of structural imbalances. Once we enter the 'cumulative process' of rising and falling competitiveness, it also means that countries with a 'structural deficit' in their trade account would require a continuous net inflow of capital in order to be able to sustain their domestic spending and thus keep growing. Should this inflow cease, the economies would be constrained to reduce their deficits in the current accounts and this would have to take place (given constraints on movements in the real exchange rates or in their effectiveness¹¹) through output or real income adjustment. Real income growth would have to be constrained through austerity policies so that countries or regions bring the trade deficit under control through a relative contraction of demand. Such output-constraining policies will (through the Kaldor–Verdoorn effect) have further detrimental effects on relative productivity growth. This negative effect would have to be compensated by sharp wage reductions or a further bout of devaluation if the country is not committed to fixed exchange rates. An economy with a 'structural trade deficit' will thus show an inbuilt 'deflationary bias' which gets accentuated under a regime of fixed exchange rates or a monetary union.

Kaldor also provides an interesting discussion regarding the 'terms-of-trade' between manufactured goods on the one hand, and raw materials and agricultural commodities

9. This positive relationship between (secular) real exchange-rate appreciation and improved competitiveness of economies was later coined the 'Kaldor paradox'; for a recent assessment, see Oblath (2016).

10. Kaldor (1977 [1980]: 106): 'the customary statistical measures of "competitiveness", whether they be unit labour costs or export prices, are arbitrary and not an indicator of a country's true competitive position. ... [A] rise in export unit values may ... signify no more than that a country is trading "up-market", i.e. selling machinery of higher quality, while the countries with falling export unit values are trading "down-market" selling machinery of the more primitive kind. There is a great deal of casual evidence that countries like Switzerland, Sweden and West Germany have concentrated on machine tools and precision machinery of the more advanced kind, whereas in the case of Britain, at any rate, exports became more concentrated on machinery of the more simple kind'.

11. See Kaldor's analysis of difficulties of 'real' exchange-rate adjustments (Kaldor 1965 [1980]).

on the other. Take as a starting point the empirically found longer-term positive relationship between real exchange-rate appreciation and specialisation in manufacturing (see footnote 9 on the ‘Kaldor paradox’). Then, a country which specialises in manufacturing will experience – through a real exchange-rate appreciation – a further boost to its economy as imported primary products (inputs to its industry) or agricultural goods (a component of its wage-goods basket) become cheaper. It can then produce again more cheaply and/or it can pass the lower food prices on to its workers in terms of real income gains, thus allowing domestic demand to further increase.¹² For the other economies that specialise on low-productivity growth activities (services, raw materials) the opposite would be true. A further cause for detrimental developments in inter-sectoral terms of trade could be a direct intervention into the price structure between the ‘processing sectors’ (manufacturing) and other sectors. This is the angle from which Kaldor attacks the Communities’ Common Agricultural Policy (CAP).¹³

Let us summarise Kaldor’s argument regarding why integrated economies such as the member countries of the EC are prone to ‘structural external imbalances’ and to disproportional growth patterns:

In general, tight trade integration of economies is likely to produce ‘structural surplus’ and ‘structural deficit’ economies. The reasons for this are cumulative causation processes whereby international trade and production specialisation patterns get entrenched. Since some industries are more conducive to high productivity growth than others and there is the operation of an output–productivity-growth loop (the Verdoorn effect) in some of the industries, differences in sectoral composition across economies will result in aggregate productivity-growth patterns across economies not to be balanced. If this is the case, there will also be a trend of some economies to improve their competitiveness as reflected by traditional measures of competitiveness (such as ‘efficiency wages’ or labour unit costs) and this will be reflected in the real exchange rate. Alternatively, the uneven competitiveness dynamic will show up in relative quality improvements, in which case the more competitive economies will experience both trend real appreciation of their currencies as well as a strengthened export performance. In the latter case there is a further benefit for these economies gaining from improved terms of trade that allows them to import relatively cheap raw materials and food products that have beneficial effects on unit costs and on the real incomes of workers. This in turn can boost real demand on the internal market.

12. ‘Currency devaluations invariably worsened the terms of trade of the industrial sectors, the extent of the deterioration being much greater in the case of Britain, whose imports of food and raw materials are relatively large On the other hand, Germany, and to a lesser extent perhaps Japan, were able to compensate for the effect of rising food, industrial materials and oil prices by the appreciation of their exchange rates, so that their terms of trade did not suffer so much deterioration. Even more important were the effects of revaluations and devaluations on domestic inflation. The revaluing countries, like Germany and Switzerland, managed to get rid of their inflation altogether or reduce it to very low levels, while inflation in both Britain and America has undoubtedly been much aggravated by the additional rise in commodity prices in terms of local currencies. ... The quantitative importance of these factors still remain to be investigated. At the moment we do not really know the reason why the currency realignments failed to produce the results that were expected of them, but if it turns out that the main effect of currency realignment is to redistribute the gains from international trade by giving an extra reward to the more successful and an extra penalty to the less successful, this will have far-reaching long-run implications on policies concerning international trade and payments’ (Kaldor 1977 [1980]: 112).

13. See particularly Kaldor (1970) and Kaldor (1971b), both reprinted in Kaldor (1980).

2.2 Three vicious circles

Following on from the discussion in the previous section of Kaldor's framework of analysis, one can discern that there are three different virtuous and vicious circles which act as centrifugal forces within the EC:

- (i) The impact of Verdoorn's law, which affects countries with different shares of increasing returns to scale sectors differently.
- (ii) The problematic impact of the balance-of-payments (BoP) constraint leading to the imposition of restrictive fiscal policy stances.
- (iii) The impact of exchange-rate devaluations on deteriorating terms of trade and inflationary pressures in deficit countries and to positive changes in industry-to-raw-materials/food terms of trade and reduced inflationary pressures in surplus countries.

Let us review these different vicious (and virtuous) circles and the relationships between them.

We start with (i). Trade (and production) specialisation means that countries differ with regard to the sectoral composition of their economies. Certain economies will be characterised by a stronger representation of economic activities (production sectors), which exhibit high static and dynamic economies of scale; other economies specialise in other directions.¹⁴ As global growth takes place, the first type of economies will benefit more in terms of productivity growth than the second type of economies. The differential productivity effect will be further accentuated if the specialisation of the first type of economies is also in the direction of products for which income elasticities are relatively high; this would boost these economies further in terms of relative output and then productivity growth compared to the other types of economies. Hence it would only be a fluke (that is, close to zero probability outcome) if international integration would lead to a balanced growth outcome across economies, just as it is across regions within a country. Because of the Kaldor–Verdoorn relationship, the differentiated productivity growth processes become cumulative.¹⁵

The next element of his analysis is the impact of uneven productivity growth on 'cost competitiveness' (the aforementioned likely effect that in the first type of economies the

14. 'There is a substantial amount of evidence in favour of the view that causes of high and low rates of productivity growth of various countries or regions are closely bound up with the rates of growth of manufacturing production. There are two main reasons for this. The first is that economies of large-scale production, due to ever-increasing differentiation and subdivision of processes, are peculiar to manufacturing ('processing activities') as distinct from either primary production (agriculture or mining) or tertiary production (transport, distribution and miscellaneous services). The second is that in the sectors other than manufacturing (chiefly in agriculture but also in services) there is in most countries a considerable surplus of labour (some kind of 'disguised unemployment') so that when the manufacturing sector expands and draws more labour from other sectors, these other sectors are not forced to curtail their output; on the contrary their output will also increase if they provided goods or services that are complementary (or ancillary) to manufacturing activities. Hence the faster manufacturing output expands, the faster productivity will rise, both in the manufacturing sector and in the non-manufacturing sectors' (Kaldor 1971a [1980]: 190–191). For a more elaborated analysis of this theme, see Kaldor (1966).

15. 'Owing to the existence of economies of scale both comparative success and comparative failure tend to have self-reinforcing effects. Industrial areas tend to become more 'competitive' when their growth of productivity is faster than average; but a higher rate of productivity growth is itself the reflection of the faster rate of growth of production made possible by the gain in "competitive-ness"' (Kaldor 1971a [1980]: 192).

relative gains in productivity across economies would not be fully compensated in the form of wage growth). These economies will gain in terms of relative export growth. They will become 'structural surplus' countries. Their overall growth performance will gain from 'export-led growth'. The second type of economies will reflect a 'mirror image' (lower productivity growth; loss in competitiveness) and become 'structural deficit' countries.

We then come to (ii), the second 'vicious circle': Structural external imbalances (where some countries are 'structural surplus' countries and others are 'structural deficit' countries) only persist if real exchange rates are misaligned, that is, are not at levels (or exert too weak an impact) to lead to a balancing of external accounts. This will develop over time into a precarious situation once capital inflows can no longer be relied upon to finance the deficits in a country's current account. Kaldor describes such a situation in the case of when the United Kingdom joined the Common Market with a misaligned real exchange rate. If this happens – Kaldor points out – the rules of the EC, which pointed at the time towards free capital mobility and also required fixed contributions to the EC budget, would push a country towards 'fiscal austerity':

If we failed to reduce the real wages initially (or failed to reduce them to the extent required) the 'dynamic effects' of membership would not be favourable but increasingly adverse. Industrial production and employment would fall, both on account of the deterioration of the trade balance, and on account of the restrictive policies we would be forced to adopt in order to restore the balance of payments and to finance our contribution to the Community. This would be aggravated by an increased capital outflow as domestic industrial investment became unprofitable owing to the fall in domestic demand, and full transferability of capital funds were introduced under E.E.C. rules; and this would necessitate further restrictive fiscal and monetary measures to avoid a balance of payments crisis. In those circumstances the U.K. would become the 'Northern Ireland' (or the Sicily) of Europe – an increasingly depressed industrial area, with mass emigration the only escape. (Kaldor 1971a [1980]: 201)¹⁶

The above quote describes very well the situation in which the Southern EU countries found themselves in the course of the recent financial and economic crisis. The scenario that Kaldor paints – while not applying to the United Kingdom, which stayed outside the EMU – quite accurately describes the developments that took place in 'Europe's periphery' close to 40 years later.

Kaldor – in a further foresightful passage, predicting something along the lines of the fiscal rules guiding the Stability and Growth Pact (SGP) – goes further in describing how an emerging fiscal framework of that type would contribute to such a vicious circle:

The Community will control each member country's fiscal balance – i.e. it will ensure that each country will raise enough in taxation to prevent it from getting into imbalance with other members on account of its fiscal deficit. To ensure this the taxes in the slow growing areas are bound to be increased faster, this in itself will generate a vicious circle, since with rising taxation they become less competitive and fall behind even more, thereby necessitating higher social expenditures (on unemployment benefits etc.) and more restrictive fiscal policies. A system on these lines

16. Obviously, the picture which Kaldor painted of the UK's destiny within the Common Market was overly pessimistic, as London and the Southeast UK became major attractors of international investment and Britain's strengths in tradable services (finance, accounting, legal services, etc.) benefited from the scope for agglomeration of such activities in the Common Market. However, his analysis was quite appropriate both at the regional level in the UK (rapid deindustrialisation in traditional manufacturing regions) as well as for a number of peripheral economies and regions in the rest of the EC.

would create rapidly growing inequalities between the different countries, and is bound to break down in a relatively short time. (Ibid.: 205)

Finally, let us come to the ‘vicious circle’ of type (iii): here we can see that Kaldor in no way suggested that a regime of flexible exchange rates was a panacea in which ‘structural external disequilibria’ could be avoided. Indeed, in certain circumstances exchange-rate dynamics could accentuate such disequilibria (see the quote in footnote 12 from Kaldor 1977 [1980]).¹⁷

The real income and terms-of-trade consequences of currency appreciations with respect to depreciations which can further benefit ‘structural surplus’ and harm ‘structural deficit’ countries in a regime of flexible exchange rates would not emerge in a regime of fixed exchange rates. However, what would still emerge is the build-up of (potentially) unsustainable debt positions of deficit countries that – in the context of delayed and/or very weak real exchange-rate adjustment – would finally end in the vicious circle of type (ii) discussed above.

Hence, Kaldor’s analysis points to problems of both types of exchange-rate regimes: of a flexible regime that adds vicious circle type (iii) and of a regime of fixed exchange rates which is unlikely to avoid ‘misalignments’ of real exchange rates and thus generates vicious circle type (ii). At a more basic level, both these vicious circles are the result of the longer-run patterns induced by vicious/virtuous circles of type (i).

2.3 Kaldor’s critique of a further move towards monetary union

The most far-reaching of Kaldor’s critiques of European integration pertains to his discussion of the centrifugal forces that would emerge if the EC embarked upon a type of monetary union without moving towards a fiscal union. His pessimistic position in this respect echoes the analysis made by many economists in the wake of the 2008–2012 financial and economic crisis that is still far from being resolved, especially at a political level.

[T]he objective of a full monetary and economic union is unattainable without a political union; and the latter pre-supposes fiscal integration, and not just fiscal harmonisation. It requires the creation of a Community Government and Parliament which takes over the responsibility for at least the major part of the expenditure now provided by national governments and finances it by taxes raised at uniform rates throughout the Community. With an integrated system of this kind, the prosperous areas automatically subsidise the poorer areas; and the areas whose exports are declining obtain automatic relief by paying in less, and receiving more, from the central Exchequer. The cumulative tendencies to progress and decline are thus held in check by a ‘built-in’ fiscal stabiliser which makes the ‘surplus’ areas provide automatic fiscal aid to the ‘deficit’ areas.

Monetary union and Community control over budgets will prevent a member country from pursuing full employment policies on its own – from taking steps to offset any sharp decline in the level of its production and employment, but without the benefit of a strong Community government which would shield its inhabitants from its worst consequences. (Kaldor 1971a [1980]: 206)

2.4 Kaldor’s analysis in the light of recent developments

Obviously, the historical context in which Kaldor wrote his critical analysis of Britain’s Common Market integration was quite different from the current situation. Nonetheless,

17. See also his detailed analysis of the difficulties encountered by different exchange-rate regimes (in Kaldor 1965 [1980]: 47–59).

he pointed his finger correctly towards major problems and weaknesses in the EC's construction that could lead to serious disequilibria and might lead to disintegration rather than integration.

In particular, Kaldor's analysis lends itself well to a discussion of the so-called 'North-South' problematic that has become so apparent in the course of the recent financial and economic crisis. Kaldor discusses many of the issues that fit well into the picture of explaining structural features leading up to and resulting in the recent crisis: growing current-account deficits and 'sudden stops'; interruptions of growth and 'convergence' processes; the importance of the unbalanced regional development of manufacturing (and other tradable activities) for 'structural external disequilibria'; these in turn are linked to strong agglomeration phenomena of export capacities in Europe; finally, his scepticism with respect to the power of real exchange-rate dynamics countering the emergence of unsustainable external disequilibria.

What Kaldor leaves out from today's perspective (without claiming that this amounts to an exhaustive list) are the following:

- The impact of full capital markets integration accentuating the problem of external disequilibria, that is, capital accounts driving (through real exchange-rate appreciation) trade accounts.
- The possible role of industrial and regional policies aimed at correcting weaknesses in economic sectoral composition (tradable/non-tradable sectors).
- A more detailed discussion of whether coordinated wages policies could substitute for the loss of exchange-rate flexibility.
- That growth and convergence do not just depend on Verdoorn's law (that is, output growth stimulating productivity growth) but also on 'technology transfer' (often transferred via foreign direct investment) which explains the phase of high East-West European convergence (that is, the Gerschenkron (1962) mechanism was insufficiently taken up by Kaldor).
- Kaldor also underestimated the ability of the UK through a very strong financial services hub to avoid a situation of being BoP-constrained from the 1990s onwards, although this went along with very striking regional imbalances.

Kaldor's analysis was overall very insightful regarding the pitfalls in the European integration process and he was in many ways correct on powerful centrifugal forces which could lead to the full political disintegration of the Union (or 'Communities' as was the case at the time he wrote). He ended up with a very pessimistic assessment of the future of such a European integration project (see footnote 2).

However, do we have to end here? Is there a way to – from an economic analytical standpoint – retain hope for the survival of the European integration project?

We shall return to this issue after introducing Professor Łaski's (and Leon Podkaminer's) critical analysis of the EMU policy framework.

3 KAZIMIERZ ŁASKI'S (AND LEON PODKAMINER'S) CRITIQUE OF THE EMU POLICY FRAMEWORK

Łaski (mostly jointly with Podkaminer) (henceforth L&P) wrote at an early stage of the unfolding of the impact of the financial and economic crisis of 2008–2012 (Łaski/Podkaminer 2011; 2012a; 2012b; Łaski 2012). They formulated a critique of the EMU policy framework that was extensive and also farsighted in a number of ways (see Łaski 2012; Łaski/Podkaminer 2012a; 2012b). We review their basic criticisms, which were well grounded in Keynesian analytical insights.

3.1 Łaski's critique of the EMU's economic policy framework: an overview

When L&P wrote their main articles on the EMU, they had observed the immediate impact of the financial crisis in 2008–2009, as well as the policy reactions that followed thereafter. The reference period for their contributions ended in 2011–2012. Hence, they could not include any information regarding the evolution of the eurozone in the years after that.

The main building blocks of their criticisms of the EMU policy structure consisted of the following:

- (i) Within the context of the EMU, countries lose independent instruments of monetary policy and the centralised monetary authority (the European Central Bank (ECB)) can no longer take account of differential monetary conditions (differential wage, price and productivity developments) in different economies. The central interest-rate setting and the control of inflation will thus no longer be optimal for the individual member countries of the EMU and this deficiency can have serious implications on real economic activity and divergences of performances. Furthermore, the self-imposed constitutional structure and the nature of policy-making at the ECB (in contrast to, say, the US Fed or the Bank of England) imposed further constraints on its activities that L&P considered counter-productive.
- (ii) A particular focus of L&P's analysis is the evolution of 'external accounts disequilibria' between members of the EMU.¹⁸ These arise from divergent wage-inflation developments (plus national trajectories of productivity) across economies. These are not simply the result of 'market forces' but also in parts explicitly the result of national wage and labour market policies which might result in 'beggar-thy-neighbour' policies. In this respect, they particularly refer to German labour market policies and wage developments that had a strong impact on diverging 'real exchange-rate' developments in the eurozone prior to the financial crisis, leading to sustained 'external accounts disequilibria' in many countries in Europe's periphery.
- (iii) Once the importance of diverging real exchange rates and of current-account developments are acknowledged – leading to the distinction between 'surplus' and 'deficit' countries, the question arises of whether the current EMU policy framework is equipped to deal with these. L&P think, and this position would be shared by most economists, that this is not the case. They enumerate a number of deficiencies of the EMU policy framework to deal with diverging current-account disequilibria:
 - first, there is a lack of coordination of wage policy and in quite a few countries productivity-oriented wage policies are not ingrained in labour market institutions or in the workings of labour markets;
 - second, the EMU moved into the crisis without a comprehensive EZ-wide regulatory and supervisory framework of the banking systems while banks themselves had become 'Europeanised' and some of them 'globalised'. This meant that there was insufficient control of cross-border credit expansion in parts because of the incomplete insights into the cross-border

18. The central concern about external accounts disequilibria is in line with Nicholas Kaldor's analysis. However, while Kaldor emphasised longer-term and structural issues, such as differences in the sectoral composition of different economies, L&P directly address the issue of 'real exchange-rate misalignments' putting strong emphasis on non-coordinated and (in important instances 'beggar-thy-neighbour') wage and labour market policies.

activities of banks and other financial institutions by national regulatory authorities. Furthermore, when banks were in trouble, national authorities became responsible to ‘pick up the pieces’, that is, to deal with possible recapitalisation or bankruptcies, even though the problems might have resulted from their cross-border operations which they could not properly supervise; and

- third, the fiscal policy framework (as enshrined in the Stability and Growth Pact, the SGP) was strongly constraining the pursuit of counter-cyclical fiscal policy and there were no EU-wide instruments taking the place of cross-regional ‘automatic fiscal stabilisers’ as there were in the United States. This leads L&P to a more general assessment of the EMU’s fiscal policy framework.

(iv) L&P’s critique of fiscal policy in the context of the EMU had two facets. One is: how to react to widening budget deficits when these appeared in periods of recession. Would the right policy response to the emergence of (even large) budget deficits in such circumstances be to move towards or the imposition of ‘austerity’, that is, to force the government in such circumstances to reduce their budget deficits in order to aim to alleviate an increase in the public debt-to-GDP ratio? The other, but linked, critique is to recognise the important role that government fiscal deficits had, not only in the short but also in the long run, to compensate for the positive net savings of the private sector as a whole. This is a core Keynesian element in L&P’s analysis and of their criticism of some of the main mistakes made in the EZ following the financial crisis of 2008–2009. The EMU fiscal policy position (enhanced by further tightening the fiscal rules during the crisis) was – according to L&P’s analysis – responsible for the unnecessary depth of the crisis in some member countries and a prolonged phase of stagnation and delayed recovery of the EZ as a whole (compared to, say, the US).

3.2 Łaski’s and Podkaminer’s critique of policy-making in the EMU in more detail

3.2.1 *L&P’s criticism of monetary policy in the EMU*

Let us start with L&P’s critique of the ECB’s monetary policy framework. In an article with the title ‘The basic paradigms of the EU economic policy-making need to be changed’ L&P (2012a) state the following:

Unlike the US central bank (the Fed) the ECB displays no sensitivity towards real-economy developments: it focuses on inflation; it adheres to an exotic and outdated monetarist criterion, etc. Furthermore, its policy lacks balance: it is very swift to tighten things up even if the signs of rising inflation are largely imagined, but is very slow to relax things if the threat of inflation is no longer seen. Moreover, the 2% upper limit for acceptable inflation seems too restrictive While rejecting any outside ‘interference’ in its goals or operating practices, the ECB feels obliged to censure fiscal, social, ‘structural’ or wage policies of individual member countries. Until recently the ECB did not care about the financial stability of the euro banking system. (Łaski/Podkaminer 2012a: 255)

In the above quote, L&P state a number of separate criticisms: (i) the target function of the ECB; (ii) the asymmetric response to inflation rising above target as compared to falling below target; (iii) the inflation target of 2 per cent being too low;¹⁹ (iv) the ECB did

19. See also O. Blanchard’s advocacy of a higher inflation target of the main central banks in advanced economies, which he stated around the same time as L&P, in Blanchard et al. (2010).

not care – until recently – about the financial stability of the banking system; and (v) the ECB pronounces on fiscal issues, wage and structural policies, but claims independence in the conduct of monetary policy.

In the following statement, L&P make a further point, (vi), concerning the use of ‘unorthodox’ monetary policy instruments as practised by the Fed:

The US Treasury Department spends in excess of its own financial resources by crediting bank accounts of private sector beneficiaries (and expanding its own debit accounts with banks). This amounts to the creation of funds that could force interest rates down to zero. It is only (shortly) afterwards that the US Treasury Department (in cooperation with the Fed) issues and floats its debt in quantities sufficient to keep interest rates at levels considered proper. (Łaski/Podkaminer 2012a: 255)

In further elaborations L&P take a more radical stance on monetary policy that would require a radical overhaul of EU treaties, which – as they acknowledge – would imply far-reaching commitments to further political integration.²⁰ We shall come back to these issues in Section 4 of this paper.

Before that, let L&P state what they consider to be the ‘original sin’ of centralised monetary policy in the EMU:²¹ they point to the difficulty of pursuing a ‘one size fits all’ monetary policy, as this gives rise to the development of basic disequilibria with consequent major costs to the overall growth dynamics of the EU economy as a whole, at times disastrous developments in some EMU member states and increasing tensions across the Union between ‘surplus’ and ‘deficit’ or ‘creditor’ and ‘debtor’ states.

L&P emphasised that underlying the difficulty of conducting a centralised monetary policy in the EMU is the heterogeneity of member countries, but differently from Kaldor’s emphasis on sectoral composition and growth dynamics, L&P observe in the first instance differential wage and price movements and they then point to the problem that this implies for the divergence of real interest rates in different economies that are members of the EMU. This in turn has the following consequences: ‘The common monetary policy acts pro-cyclically in weak growth/low inflation countries and accelerates growth-cum-inflation in countries that are close to a boom. Overall, the common monetary policy has the potential to enlarge the cross-country differentials in inflation and growth rates’; and: ‘[t]he reason for the difficulties of implementing fiscal consolidation in low-inflation countries is straightforward: fiscal austerity under overall stagnant growth/very

20. ‘Governments (acting in concert) should be given more power to create money without having to seek buyers for their debt in advance. ... Those modifications may necessitate revising some EU Treaties. Ultimately, the ECB should be allowed ... to “print money” with which the euro area governments (or the European Commission) could fund their legitimate and worthy “deficit spending” projects – without increasing the size of their interest-bearing public debts’ (Łaski/Podkaminer 2012a: 258). Thus, while some of L&P’s criticisms could be addressed without revising existing treaties, others do require this and some go much further in political commitments to European political integration: ‘[A]ddressing a fundamental flaw in the design of the ECB policy may require more far-fetched modification. Carrying through these modifications could well call for a more radical overhaul of the European politics, far beyond the monetary domain’ (ibid.).

21. ‘The original sin of the common monetary policy lies in its being defined as applying uniformly to a vast area comprising countries that had differed in many aspects before switching over to the common currency. The nominal convergence process ... did not eliminate the deeply rooted differences. Different national inflation rates (and the rates of growth of nominal wages and unit labour costs) refused to leave their entrenched paths and align themselves’ (Łaski/Podkaminer 2012a: 255–256).

low inflation is almost certain to have a negative impact on both real growth and the fiscal position' (Łaski/Podkaminer 2012a: 256).

It is interesting here that L&P emphasise the problem that centralised ECB monetary policy imposes a rather restrictive fiscal policy stance on low inflation countries (that is, because these countries face higher real interest rates on their public debt). However, there might be counter-acting forces that allow such countries to issue treasury bills at lower interest rates because of the lower risk of default. Given the historical experience, this would be the case when markets start to seriously assess default risks (or the risk of the country leaving the EMU). This they did once the financial crisis erupted: only then did (nominal) interest rates diverge. Before that, interest rates on treasury bills issued by different countries had been very close. Hence, one can argue here that – in normal times – low-inflation countries do in fact have to finance themselves at higher real interest rates. Once a financial crisis hits the EZ, risk assessment then suddenly shifts and interest rates may diverge quite dramatically, leading to a negative spiral in higher public debt countries that find it difficult to finance public spending and hence are forced to pursue pro-cyclical fiscal (that is, austerity) policies.

3.2.2 *The issue of 'external imbalances' and asymmetric adjustments within the EMU*

An interesting element in L&P's assessment of 'external imbalances' is that they emphasise policy factors in diverging 'competitiveness' across member countries of the EMU. They particularly mention various policies (and not just market forces) that impacted on German labour costs.

The tendency of Germany to outcompete others on unit labour costs has not been entirely due to the free operation of market forces. Since at least 1995 the successive German governments have pursued policies promoting cuts in unit labour costs. Germany has gone through successive waves of 'labour market reforms' aimed at enhancing the market's 'flexibility' ... a polite term for greater license to revoke workers' traditional rights and to 'downscale' the labour codes Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply In its capacity as the employer of a large segment of the workforce active in public service sectors, the German government has sought to economise on wages and employment levels. This had a direct influence on wage negotiations between the trade unions and private business ... (Łaski/Podkaminer 2012a: 257)

L&P then discuss the consequences of sustained current-account disequilibria: 'Sustained and rising external deficits are tantamount to accumulating net external debt A ... chronic deficit country cannot accumulate foreign debt indefinitely'. At a later point they say: 'The debt crisis of countries outcompeted by Germany backfires on Germany itself Ultimately, Germany may have to swallow some losses on these debts. More precisely, the German government may be forced to recapitalise German commercial banks and other financial market institutions owning large portions of bad foreign debt' (Łaski/Podkaminer 2012a: 258–259).

Hence there are two reasons for the EZ suffering a longer phase of growth below potential and a much slower recovery (than for example the US): (i) The impact on high-debt countries which can no longer finance their current-account deficits and also face high real interest rates to finance budget deficits and turn over their public debt; the result is austerity. (ii) The impact of the debt crisis in the deficit countries on the surplus countries. Again there are two channels: one is the trade multiplier effect of low GDP growth or recession in the deficit countries that have to bring their current account into balance, and the other is the likelihood that some outstanding debt will have to be written off.

And, of course, a monetary union committed to an overall low inflation target imposes a particularly arduous process of ‘rebalancing’: ‘Because of the impossibility of nominal exchange rate adjustments, “internal devaluation” – or deflation – remains the only route to regaining competitiveness. ... Massive (and/or long-lasting) deflation would throw the economy into a deep and prolonged depression associated with a drop in domestic consumption and investment’ (ibid.: 259–260).

They criticise the acceptance of the strongly asymmetric adjustment of ‘surplus’ and ‘creditor’ countries in the course of the crisis: ‘The Commission Report (2010) does not see anything wrong with the competitiveness gains achieved at the expense of domestic wages, consumption and investment’ (ibid.: 259).

Here one could add to the criticism of this asymmetric treatment of ‘surplus’ and ‘deficit’ countries in the EMU’s policy framework. Because ‘markets’ impose serious constraints on deficit countries and on the developments of external and public debt once certain thresholds are reached, it is all the more important that a policy framework intervenes *ex ante* with regard to sustained surpluses developing. This is because, in a monetary union, there are no market forces containing the build-up of such persistent surpluses. Outside a monetary union there are – potentially – ‘market forces’ that exert an appreciation pressure on a surplus country’s currency. Within a monetary union there is a unified currency and hence, in this respect, currency movements are the result of the position of the entire currency bloc’s relations to the rest of the world (RoW). L&P therefore come up with a strong proposal that attempts to compensate for the asymmetry of the *ex post* adjustment pressure on ‘deficit countries’ by calling for an ‘excessive external surplus procedure’.

In this context, L&P also criticise a premature entry into the EMU: ‘In the fixed exchange rate countries, the losses (or gains) in competitiveness appear to be accumulating over time, without ever (thus far) correcting themselves. The accompanying external imbalances also tend to accumulate over time’ (ibid.: 261).

Summarising, L&P come up with a set of ‘constructive proposals’ (ibid.: 262–263):

- implement ‘excessive external surplus procedures’ with ‘clearly defined penalties for misbehaviour’;
- ‘another modest proposal may require member states to enter into binding agreements on avoiding beggar-thy-neighbour tax/wage policies’;
- agree on broad guidelines for national wage policies (for example, stipulating that wages should be allowed to rise in line with labour productivity): ‘A labour-productivity-driven wage policy ... would result in national inflation rates approximating the common target inflation rate It would then be possible to run the ‘one size fits all’ monetary policy, without provoking centrifugal forces within the euro area’;
- L&P also advocate some radical proposals regarding ECB monetary policy which were mentioned in Section 3.2.1 and some of which require a substantive revision of EU Treaties, such as: ‘Ultimately, the ECB should be allowed ... to “print money” with which the euro area governments (or the European Commission) could fund their legitimate and worthy “deficit spending” projects – without increasing the size of their interest-bearing public debts’ (ibid.: 262–263);
- further possibilities are linked to a better design of fiscal policy, to which we now turn.

3.2.3 *L&P’s criticism of the fiscal policy framework within the EU/EMU*

Many commentators have criticised the design of current ‘fiscal targets’ in the Stability and Growth Pact (SGP), such as the uniformly applied 3 per cent fiscal deficit target or the target that national public budgets of member countries should be ‘close to balance

over the cycle' (De Grauwe 2011; 2015). However, L&P go further in analysing the role of fiscal policy and its interdependence with private-sector savings behaviour than standard criticisms of SGP rules. They allude to a misconception of the role of fiscal policy both in the shorter run as well as in the medium and longer run that underlies many standard proposals on 'fiscal targets'. Such misconceptions (or the analytical weakness of a traditional approach) lead to a policy framework that makes downturns more severe in the short run and also lead to economies moving along a below-potential trajectory in the longer run.

L&P reiterate the rather well-established Keynesian position on the role of governments to run fiscal deficits:

When the private sector's propensity to save is higher than its propensity to invest, a budget deficit provides the private sector with an opportunity for additional sales – and additional employment – above the level determined by the level of private investment. Without a budget deficit (and/or an export surplus), the private sector's efforts to achieve the desired level of savings would not succeed and thus would lead to a decline in GDP and employment down to the level determined by the volume of private investment and net exports. (Łaski/Podkaminer 2012a: 265–266)²²

The relationship is simply derived from well-known national accounting equations:

$$YD + T + M = CP + IP + G + X,$$

where YD denotes disposable income, T is the (disposable) income of the government (that is, all taxes net of transfers to the private sector), M is spending on imports, CP is spending by the private sector on consumption, IP that sector's gross investment spending, G spending by the government on goods and services and X spending by the RoW on the country's exports.

By rearrangement we get:

$$((YD - CP) - IP) = (G - T) + (X - M),$$

which is equivalent to:

$$(SP - IP) = (G - T) + (X - M),$$

where the first left-hand term amounts to net private-sector savings equivalent to the private sector's disposable income minus that sector's spending on consumption (SP) minus spending on investment, the second term to the budget deficit, and the right-hand term to the current-account surplus of the country concerned.

Private sector savings (SP) comprise household savings and profits retained by firms (PR). Regarding the latter item L&P add further interesting analysis on how fiscal policy that attempts to achieve a balanced budget or a primary surplus would depress corporate profits, reduce investment and could thus make the private-sector spending problem worse (see Łaski/Podkaminer 2012b: 453–454). This conjecture has been borne out during the recent financial crisis when positive savings were recorded by the corporate sector in quite a few EMU countries reflecting the depressing impact of a debt-burdened economy on investment.

22. This statement amounts to the basic insight of Keynes's analysis that the level of economic activity adjusts to the level of spending and in this way savings adjust (*ex post*) to the level of investment (plus net exports).

Coming to the longer run, L&P give a host of reasons why over the longer run (more recently these considerations got additional support from the 'secular stagnation' hypothesis strongly advocated by Lawrence Summers (2016)) private savings may further move towards exceeding private investments:

Deflationary tendencies may well be simultaneously responsible for too large a volume of savings and too low a volume of investments. [Furthermore,] the structure of private sector income may be conducive to high savings (e.g. via rising inequality in disposable income in the household sector). Alternatively, the downsizing or privatisation of services traditionally provided by the public sector (health and pensions) may also induce a higher propensity to save – without a requisite rise in the propensity to invest. Apart from this, some secular decline in the private propensity to invest can be expected, with some secular rise in the private propensity to save. The latter may derive from demographic changes (ageing). The former may be contingent on technological change ... (Łaski/Podkaminer 2012a: 266)

Consequently, L&P argue that: 'In the long-term, ... low private sector investment may need to be progressively supported by the investment of public funds (e.g. in infrastructure and environmental protection, as well as in human capital). ... [T]hat would imply appropriately high levels of secular fiscal deficits' (ibid.).

In this context, L&P emphasise the issue of rising income and wealth inequality on the savings behaviour of the private sector. In line with Piketty's (2014) analysis, they advocate a low-interest-rate policy in order to also reduce wealth inequality.

L&P rightly advocate not pursuing a policy of fiscal consolidation in a period of slow growth or even recession, even though fiscal consolidation might be necessary to be achieved in the longer run: 'The reduction of budget deficits is possible and, in many cases, necessary. However, it must wait until the economy has returned to normal growth. It is no accident that the rare periods of successful fiscal consolidation in the past were also periods of satisfactory or high growth ...' (Łaski/Podkaminer 2012a: 267)

In a growth phase, private investment activity picks up, and hence there is no need for the government to run fiscal deficits to 'mop up' excess private-sector savings. Nonetheless, one might wonder which provision L&P advocate to avoid pro-cyclical fiscal policies in an upswing that – as conservative critics would argue – led in quite a few countries post-World War II to continuously rising public-debt-to-GDP ratios. On this issue L&P do not propose policies which, however, in a monetary union have to be addressed. It is clear that this does require some form of fiscal rule that is oriented towards 'fiscal sustainability'. The details of how to conceptualise such a rule that, however, takes account of different countries' circumstances²³ and how to enforce it remains an unsolved issue.

4 A POLITICAL-ECONOMIC ASSESSMENT OF KALDOR'S AND ŁASKI'S ANALYSES AND THEIR SUGGESTIONS FOR REFORMING THE EU/EMU'S POLICY FRAMEWORK

In this section we shall attempt to assess Kaldor's and Łaski's contributions which pointed to the fragility and weaknesses of the policy framework that characterised the European

23. The issue of taking account of countries' individual circumstances is important, as demographics, deficits in infrastructural and human capital investment, and the prospect of social returns to these, as well as spillover effects on other countries, would all have to be taken into account in the designing of such 'fiscal rules'.

integration process at different points in time. We shall discuss these in the context of the political-economic constraints that the European Union faces today. I am motivated here by the issue that there is little value in advocating policies that have their rationale in an abstract setting without considering the specific historical and political-economic context in which the policy framework of the EU/EMU has to be further developed.

In this respect, we have to firstly recognise that the European Union is a hybrid construction: on the one hand, it is an attempt at political and economic integration amongst independent nation states of a depth that is unprecedented historically. On the other hand, it is still far away from a proper Federal State, such as the United States of America or Germany or India would constitute. The very shallow (non-deep) nature of the European state (its budget not bigger than 1 per cent of EU gross national income (GNI), there are no or extremely limited cross-European welfare arrangements, no fiscal stabilisation instruments, etc.) means that the relationship between European national states and 'the European state' is extremely unequal. However, the fact that the member states of the EU are economically highly integrated, that the 'four freedoms' that define the single market have led to a significant increase in the mobility of companies and people across the EU, to an integration of important research and educational programs, to a joint external trade policy agenda and the complete transfer of some central policy-making elements (such as competition policy and the conduct of monetary policy for EMU member countries) to the EU level, gives the EU construction much more prominence than the scale of the EU budget would suggest.

Nonetheless, a European polity emerges very slowly and we have to recognise that Europe's populations to a large degree see democratic participation as taking place mostly at the national level. In other words, they see the control mechanisms provided under representative democratic principles as being largely implemented at the national and not the European level. A big jump towards policy-making to be conducted at the EU level (either through councils of ministers or through the technocratic bodies of the European Commission) would not be seen by the European populations as subject to the same democratic control mechanisms they are used to at national levels. In particular, it is on the basis of a prolonged history of nation states that populations developed a willingness to have the entire population that live in a particular territory (the 'nation state') participate in (and pay for) a number of *insurance systems* (health, old age, unemployment, various assistance programs to deal with poverty). It is this necessary evolutionary precondition that currently prevents the development of a policy framework at the EU level which mimics the insurance systems that exist at national levels. The development of such insurance systems requires a significant time span and also positive experiences of mutual benefits, and this imposes constraints on the development of appropriate policies in a variety of areas. It accounts in large measure for the partial dysfunctionality of the policy frameworks currently in place at the EU level.

Thus, when we assess the policies and reforms pursued at the EU or EMU level and the policy frameworks that guide such policies, we have to take the nature of this 'hybrid' state of European integration into account. We cannot judge it by the same measure that policies of a unified Federal State would be judged by. Nonetheless, we can still explore whether – within the current historical state of 'hybridity' – the EU/EMU has a policy set-up that exploits its current 'potential' in terms of policy design. If it does not, one could and should suggest what could be better designed and which political forces could push towards such improvements.²⁴

24. See also the approach of 'positive political economy' (PPE) we take on European integration issues in Cardinale/Landesmann (2017; 2019).

Let us now assess Kaldor's and Łaski's (and Podkaminer's) contributions in the context of these considerations regarding the 'hybrid state' of European integration. We shall cover three different areas in this respect:

- External imbalances and 'structural' policies;
- The EMU, monetary policy and capital markets integration;
- The EMU and fiscal and social policies.

These areas are of course related to each other, but we shall discuss them in sequence over the final three subsections.

4.1 External imbalances and 'structural' policies

As regards external imbalances, both Kaldor and L&P consider these as central to their analysis of the 'centrifugal forces' of European integration: Nicholas Kaldor develops his analysis from an analytical background that emphasises multi-sectoral growth trajectories where the composition of economies in terms of sectoral structures matters for the aggregate growth and productivity dynamics. Differences in sectoral compositions (regarding the weights of high- and low-productivity growth industries or industries with a high and low export potential) across highly integrated economies are – in Kaldor's framework – the underlying cause of 'structural external imbalances'. L&P, on the other hand, emphasise wage (relative to productivity) dynamics as the principal causes of external imbalances. These can be strongly influenced by institutional features (such as those influencing wage bargaining) and by policies (wage and labour market policies). As a result, the policy implications for combating 'structural external imbalances' of these authors also differ: Kaldor's analysis would lead one to emphasise policies that impact on industrial composition, while L&P's analysis would lead one to consider policies that affect the wage–productivity relationship.

Let us shortly discuss which policies would suitably fit into the analytical frameworks with which Kaldor and L&P look at 'structural external imbalances'.

From the Kaldorian perspective, industrial and regional policies would be the appropriate policy tool, while from the L&P perspective some coordination of wage policies and also industrial (productivity-oriented) policies would be appropriate.

On the issue of industrial and regional policy first: it is clear that the uneven distribution and strength of tradable sector activities and strong recent tendencies of agglomeration of industrial activities in different EU economies have accentuated a core–periphery pattern across European economies and regions (see Landesmann/Hanzl-Weiss 2016; Landesmann 2019). What is required is the use of policies that acknowledge differences in the levels of economic development, allows for a degree of asymmetric uses of industrial and regional policies that are focused on the uneven development of capacities of the tradable sector in different EU economies and regions and that violate – to some extent – the 'level playing field' view that guides the rather strong arm of EU competition policy. Given the experiences of the very detrimental build-up of external imbalances prior to the recent financial and economic crisis and its serious aftermath, such a shift of policy should be high on the agenda and politically feasible. It is also very much in tune with Kaldor's analysis (see also Kaldor 1970 [2013]).

Next, on the issue of wage policies and wage coordination: From a political-economic perspective, it seems to me that one cannot end the analysis by advocating 'coordination' of national wage and labour market policies. A necessary ingredient has to be the strengthening of EU-level political and organisational set-ups that shape wage-bargaining processes

at the national, regional and sectoral levels. This cannot simply remain at the level of technocratic monitoring devices (such as the current design of the Macroeconomic Imbalances Procedure (European Commission 2016)). It requires the development and strengthening of social partnership (employers' organisations, trade unions) arrangements at the EU/EMU level and of cross-border bargaining structures. This is still very much in its infancy, but without it the likelihood of stronger coordination of wage and labour market policies will remain slim.

There is another issue to be considered: the current-account position of the EZ as a whole is the sum of the current-account position of its member states and hence if some countries show a very weak export performance this can be compensated by the stronger export performance of other members. It is not desirable that the EZ should have a chronic current-account deficit with the RoW, as the United States does. This would amount to another rich global region becoming a net capital importer. Hence if the relative strength of the German current-account position and of other 'Northern' EMU member countries is to be reduced, it should happen with other 'structural deficit' countries significantly improving their performance. This amounts to advocating policies that have been alluded to above, which would strengthen the exporting (tradable) sectors in countries that currently suffer from chronic current-account deficits. One misses more detailed policy proposals from L&P in this area (see Landesmann/Stoellinger 2019 on this).

4.2 The EMU, monetary policy and capital markets integration

It was one of the major institutional and policy failures in the construction of the EMU not to recognise that capital market integration (one of the basic pillars of the single market) could be a major source for the emergence of 'structural external disequilibria'. There cannot be a build-up of unsustainable BoP positions if capital markets are not willing to finance external deficits. In fact, capital flows can in many instances be the driving forces behind the development of sustained deficit and surplus positions of countries and thus of 'structural external imbalances'. This is due to self-enforcing loops (Myrdal's cumulative causation concept applies here as well): capital inflows might lead to credit expansion predominantly supporting spending on non-tradable activities (housing, retail and wholesale trade, other non-tradable service activities), thus putting pressure on price levels and real exchange rates, and thereby shifting sectoral structures away from building up capacities in the tradable sector. A recipe against such processes that lead to 'structural external imbalances' could be tighter capital market regulation and allowing those countries that suffer from such imbalances to impose controls on credit expansion that favour non-tradables. Policies could also incentivise capital flows (especially foreign direct investment (FDI)) into tradable activities. I can see no reason for strong political resistance against such moves, as it would assist 'structural deficit' countries to escape an external imbalance trap and current 'structural surplus' countries would themselves benefit from a move towards more balanced intra-EU trade flows. It would help to avoid current-account crises within the EMU which destroy trade flows and disrupt intra-EMU financial relationships between creditors and debtors.

As regards monetary policy, L&P's criticisms focus on three aspects of the policy framework of the ECB: (i) the 'one size fits all' constraint of its policy; (ii) the relatively conservative (that is, monetarist) nature of its policies (this refers both to its target function aimed solely at an inflation target, as compared to the US Fed, and also to being more conservative or a latecomer with respect to 'heterodox' monetary policy instruments, such as 'quantitative easing'); and (iii) that the relationship of monetary to fiscal policy

is quite different within the EMU framework as compared to, say, the functions of a central bank in a unitary state (that is, the ECB is not allowed to buy government bonds on the primary market).

Let us discuss these aspects in turn: to what extent are these criticisms justified and – when they are justified – are improvements feasible given the (previously discussed) ‘hybrid’ nature of the European integration process?

On the ‘one size fits all’ issue: the ECB has already enhanced its supervisory function following the financial crisis. In cooperation with national regulatory bodies it monitors more closely the level and structure of risk in the credit portfolio of banks. Furthermore, pro-cyclical reserve requirements oriented towards national and sectorally differentiated credit cycles would pave the way towards better tailored policies and interventions in EU financial markets and thus move away from a ‘one size fits all’ policy regime. Hence, while the core policy rate will continue to be set centrally by the ECB, the more complex financial supervisory structure (and of course the further development of the banking union) will allow the EMU to take account of differentiated conditions. Nonetheless, debates on this issue (see for example Pisani-Ferry/Zettelmeyer 2019) indicate that negative feedback processes (that is, tightening credit conditions in the most heavily hit parts of the EMU) are still likely to occur. Hence careful *ex ante* supervision is crucial.

On the conservative target function of the ECB with regard to the (slightly below) 2 per cent target rate: this is based on the well-founded argument that real exchange-rate adjustments should be easier when the overall target rate of inflation could be increased (see the Blanchard et al. 2010 recommendation). This should in principle be feasible for the ECB, but so far the more conservative position of central bankers in the EU – claiming that the ECB would give up a hard-won reputation to stick to its 2 per cent inflation target – prevent a move in this direction. Furthermore, regarding a faster reaction with more aggressive policy instruments such as quantitative easing: this has already been implemented by the ECB after initial reluctance. So, there is in principle no barrier for the ECB to use such ‘unorthodox’ methods of monetary expansion, in line with the Fed and other central banks. The issue here is the willingness of the board, depending on its constellation and the direction given to it by the ECB president. Finally, regarding the development of an EZ-wide ‘safe asset’: this would have to be introduced gradually, as creditor countries insist that legacy problems of the recent financial crisis will have to be overcome, and trust (and safeguards) are gradually built so that the insurance principle underlying a ‘safe asset’ or ‘eurobonds’ does not get undermined by a fear of significant moral hazard behaviour (some moral hazard has to be accepted as being a feature of any insurance system).

Let us now come to fiscal policy and the relationship between monetary and fiscal policy: this is the most sensitive issue, especially as there is monetary policy dominance because of the institutional structure of the current EMU policy set-up.

4.3 The EMU and fiscal and social policies

The unification (even coordination) of significant elements of fiscal policy is a big challenge for the ‘hybrid state’ in which the EU finds itself. The right of national states to decide on the level and structure of public spending and taxation is seen as the hallmark of national state decision-making (and these are legitimised by national parliamentary decision-making structures). The criticisms of L&P in the area of fiscal policy pertain to: (i) The constraints that the SGP imposes on counter-cyclical policy in European economies. (ii) The lack of

recognition of the important role of budget deficits to compensate for positive net savings by the private sector. As was analysed above, this is particularly detrimental in periods of recession and deleveraging of the private sector. In such circumstances, pursuing an austerity policy can lead to deep and long-lasting recessions and might make the public debt situation of countries worse. L&P also point to the long-run issue where a lack of the necessary compensatory role of state spending ill adapted to the net savings behaviour of the private sector can lead to growth trajectories remaining well below potential. L&P refer here to a number of secular forces at work in advanced economies which would indicate an increased role of government spending (on infrastructure, education, health, etc.) as the long-term savings rate of the private sector might increase (because of ageing, rising inequality and – possibly – a disruptive effect of technological change that might initially slow down investment). (iii) The neglect of the compensatory role of budget deficits to net private savings also leads some countries to shift towards a ‘beggar-thy-neighbour’ policy. They attempt to increase their external surpluses as an alternative to sustaining domestic demand. This then goes at the cost of other countries that take on the role of net capital importers and thus become net deficit countries on the external account.

L&P are correct to complain that the basic lessons of Keynesian economics have not been learnt with regard to the important role of state spending in periods of recession and deleveraging, as we have witnessed during the recent financial and economic crisis. They are also right to emphasise that, in a monetary union, a lack of consideration of the external impact of national fiscal policy behaviour on other economies can amount to ‘beggar-thy-neighbour’ behaviour and lead to sub-optimal growth and non-recovery of the EZ as a whole. Hence their emphasis on introducing an ‘excessive external surplus procedure’ is a justified one.

However, one can also make the point that there are no far-reaching (and more concrete) proposals regarding coordination of fiscal policy or the deepening of fiscal structures at the EU/EMU level in L&P: in which areas could joint spending programs be launched? What scale should these have? Do L&P envisage concrete plans regarding the establishment of rudimentary ‘automatic stabilisers’ across the EZ? It seems as if L&P stick to the prerogative of fiscal policies remaining fully national, and only the scale of national fiscal spending programs should be coordinated. My own view on this is that some common counter-cyclical spending programs and the development of embryonic ‘automatic stabilisers’ are an indispensable component of a gradual realisation by the European electorates that the EMU also operates in some areas as a ‘joint insurance system’. Such programs could come in the form of the widely debated EU component to an EU-wide unemployment insurance system (see for example Andor 2016) or to EU-level youth employment and training programs. Such initiatives seem to me to be vital for correcting the image of the EU/EMU as being solely a project of market integration and any social protection vis-à-vis instability and social degradation being confined to national insurance systems. EU reforms without tackling the issue of a significant development of the ‘Social Pillar’ are likely to increasingly lose political legitimacy.

Summing up, Kaldor’s pessimistic view that a monetary union cannot function without fiscal union, which in turn would be unfeasible without political union and would be rejected by the European population, has too much of a binary flavour to it. It is incumbent upon us economists to see all these dimensions of integration as a continuum in which complementarities are recognised, but where we examine our policy recommendations carefully in the evolutionary context of what is historically feasible and nonetheless lead to a sustainable outcome.

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