Engines of growth and paths of development in the Euro-area

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Outline

- A very brief review of the historical evolution of the theory of development
- the factors behind the interruption of the process of industrialization in the Southern European members of the Eurozone
- implications for the policies required to sustain the periphery's growth and development

- This paper draws on Simonazzi et al (2013), Simonazzi and Ginzburg (2015) and Ginzburg and Simonazzi (2016).

The rise and fall of development economics

Hirschmann (1981, p. 3):

“The development ideas that were put forward in the forties and fifties shared two basic ingredients in the area of economics”:

- the rejection of the *monoeconomics* claim

  (Rostow’s stages of development vs. Gerschenkron’s latecomer countries)

- the mutual benefit claim

  (but unequal exchange (Prebisch and Singer), cumulative causation and polarization (Myrdal and Hirschman)

Washington consensus

- development is not “smoothly linear”: errors, retrogressions… disenchantment
- Two criticisms
    - Dependency theory
    - Neoclassical market economics
- Public intervention is justified only:
    - Externalities
    - Cost benefit analysis of intervention
- ‘Governments cannot pick winners, but losers can pick governments’” (Wade 2012, p. 225).

European industrial policy

- Conceived mostly in terms of market selection mechanisms, obtained by enforcing competition: One market, one money
- reinstated the monoeconomics claim.

  - problems faced by countries at different stages of development ignored

  - the institutions of the EU were based “on the premise that all its members are on a level playing field, except for ‘less modern’ (‘anti-competition’) institutions, individual values and attitudes.

  - The implicit assumption is that competition, and an austerity regime, associated with institutions close to those assumed to be prevailing in ‘core’ countries, would create in the periphery the ‘right’ environment for growth”

Core-periphery relations

- Divergent trajectories of core and periphery interpreted as **interdependent** economies with different levels of capabilities
- Three concepts:
  - distinction of countries between first-comer industrializers (the ‘center’) and latecomers (Italy) and late-latecomers (Spain, Portugal and Greece) in the periphery
  - level (quality) of productive structure;
  - distinction between price and product competition.

Stages of development and differing capabilities

- wide differences in the productive structures of the centre and the southern periphery of Europe at the start of the Europeanization process. These differences entailed an asymmetric capacity of countries at differing levels of development to adjust to external shocks.
- The process of development consists in moving upwards towards more complex, less ubiquitous, products (Hausmann and Hidalgo 2011), but it is far from linear:
  - it occurs through diversification into products that are “near” to those that are already being successfully produced and exported
  - Because of the existence of discontinuities in the product space countries with a low diversity of capabilities can become stuck in “quiescence traps”, that make catching up more difficult.
  - The existence of discontinuities in the product space and the need to develop and coordinate those capabilities demanded by growth industries prove to be a formidable obstacle to the process of development.

Need for government policy

The interruption of industrialization

- The countries in the periphery started from different levels of industrial development, but they all recorded high income growth, led first by investment and consumption, and then by export.
- They all placed special emphasis on basic industry, deemed necessary for the creation of an industrial sector. The state supported accumulation either directly, through public owned companies, or indirectly, through subsidies and incentives to domestic and foreign capital.
- differences in the production structure initially very large were reduced until the beginning of the seventies,
- but re-opened again in the subsequent years, and especially after the crisis of 2008.

The 1970s crisis

- Saturation of mass consumer goods in advanced countries and the start of globalization led to a profound transformation in demand, production, and competition.
- Demand for substitution and quality competition (vertical diversification) favoured the passage from traditional price competition to markets dominated by product-led competition.
- a profound break in the history of the relations between the centre and the periphery of Europe.

- The ‘centre’ succeeds in strengthening its ability to remain in the market thanks to processes of ‘creative destruction’ and reconstruction undertaken during the crisis with the support of industrial policies.

Market fundamentalism

- The restructuring of the core deeply affected the countries of the periphery which, in reorganizing their economies, struggled to adapt to the new environment (which was dominated by deflation and quality competition).
- Faced with a situation that would have required innovation of the State's capabilities in order to facilitate selective guidance and the reorientation of investment to combat a rapidly weakening economic structure, they adopted across-the-board liberalization policies instead, implementing what might be called a 'plain destruction' of their capabilities to create new products, market niches, and markets.

Premature de-industrialization

- Partly as a consequence of their policies, growth in the peripheral countries fell behind in the 1980s, and the crisis associated with deregulation opened a gap in aggregate demand that was eventually filled by welfare and construction expenditure. This ‘premature deindustrialization’ — restructuring without industrialization — exposed the peripheral countries to stunted growth and persistent fragility with respect to external changes even before the formation of the Monetary Union.
- Over the thirty years of European integration since the early eighties, the Southern peripheral countries were exposed to macroeconomic and industrial policy measures that, though apparently neutral, generated increasing regional disparities, both between center and periphery and within countries

Core and periphery

- increasing integration of the Central and Eastern European economies into the supply chain of German industry speeded up their process of diversification- and specialization.
- Wage restraint and price containment
- The eastward integration of German industry, combined with the persistent containment of the internal demand ➔ impoverishment of the productive matrix of those southern regions that are less connected with Germany and, more generally, with a general redirection of trade flows.
- Since the 1970s, the international market regime is increasingly dominated by the competition of differentiated products. In the current Eurozone crisis, in a context of fixed exchange rates, austerity measures in the periphery are assigned the task to pursue a “flex-price” policy through domestic devaluation.

Summing up

- the effects of the crisis differ for first and latecomers:
- It calls for an overhaul of the production systems: obsolete capacity needs to be scrapped, declining sectors have to be abandoned.
- Thanks to a stronger and broader productive capacity, core countries succeed in implementing a deep internal restructuring over a wide range of industries and services, strengthening their position in the product markets with the help of industrial policies
- The process of restructuring of the core affects the periphery: here, their basic industries and “mature” production face the competition from developing countries, calling for drastic cuts in production.
- Just when the State should have taken up new tasks to ease the process of restructuring, diversification and quality upgrading, 'early liberalization' policies prevented public investment guidance: industrial policies were redefined as policies for the guarantee of competition.

The return of industrial policy

- two tenets of the “new” theory of development:
  - innovation occurs through contiguity (Hausmann e Hidalgo 2011)
  - innovation is hindered by lack of demand (Rodrik 2004).
- Changes in a country’s productive structure can be understood as a combination of 2 processes:
  - that by which countries find new products as yet unexplored combinations of the capabilities they already have,
  - the process by which countries accumulate new capabilities and combine them with other previously available capabilities to develop yet more products.

Innovative firms

- innovative businesses compete on the basis of new products or processes and/or more effective use of new technologies and not primarily on the basis of price.
- Firms' performance crucially depends on both the structured interrelationships (the linkages) that it can establish upstream and downstream, and the support received from the material and immaterial infrastructures, development agencies and financial institutions that sustain the process of innovation in the long term
- market prices cannot reveal the profitability of products that do not exist yet, and dynamic externalities can limit firms' readiness to take up risky projects,
- without public incentive and support, promising innovations may not be taken up by firms

Cost discovery vs innovation

- State intervention is needed not because “the government officials [are] omniscient or cleverer than businessmen but because they [can] look at things from a national and long-term point of view, rather than sectional, short-term point of view”
- Self-discovery: “What is involved is not [only] coming up with new products or processes, but “discovering” that a certain good, already well established in world markets, can be produced at home at low cost” (Rodrik 2004, 7-8).
- Imports can signal the existence of unexploited opportunities - final demand for products or bottlenecks to development - that a well-integrated policy action can help to seize.

Domestic demand and macroeconomic policies

- Industrial policy can encounter insurmountable obstacles if it is inconsistent with the main directions of macroeconomic policy. A strong and expanding domestic market is essential even for the most successful exporting firms.
- The European institutions are sending contradictory signals and advocating conflicting policies: the recent endorsement of an “industrial compact”, coexists with their strong advocacy for “structural reforms”, aimed at making the labor market more flexible, which are likely to encourage firms to move in the opposite direction. Fiscal consolidation and the strength of pro-liberal advocates, finding support in international institutions and treaties, hinder the implementation of a more comprehensive developmental approach at the national level.
- A strategic policy of industrial development is incompatible with cuts in public budgets, and more generally in aggregate demand.

Conclusion

- A more balanced European economic integration requires a common undertaking to stop chasing emerging economies on low wages: this requires production upgrading, diversification and structural change. To this end, peripheral countries need a developmental state capable of broadening their productive capacity and increase their capabilities (to reduce the gaps between and within countries). This strategy is desperately lacking in the present economic program, which reiterates its willingness to conjugate financial stability and growth, but is too concentrated on (needed) supply side, efficiency-enhancing measures in a void of strategic vision.