The process of European integration can be described as the increasing interdependence between economies at different levels of development and with different productive capabilities. It evolved from a pre-eminently political project to a ‘de-politicised’ management based on the automatism of rules and on the assumption that market forces could promote convergence and harmonisation between and within countries. ‘Early liberalisation’ policies led to a ‘premature deindustrialisation’ – restructuring without industrialisation – which exposed the peripheral countries to stunted growth and persistent fragility with respect to external changes even before the forma-

tion of the Monetary Union. The developments within and outside the euro area – emergence of the Central European Manufacturing Core (CEMC),\(^2\) globalisation and exponential growth of low-cost competitors – put further pressure on the productive structure of peripheral countries. Germany’s growth model, based on wage moderation and reliance on exports, proved unsustainable for the whole area. When the crisis finally exposed the mounting disequilibria, austerity was relied upon to restore convergence with severe consequences for the long-term viability of the Union.

Austerity policies carried out in both deficit and surplus countries weakened growth and further increased inequality and poverty, fed anxiety and resentment in creditor and debtor countries alike, which in turn fueled anti-European sentiment and populist political movements across the entire European Union. The comparison of the growth rate in the euro area and the US illustrates the failure of the Eurozone growth model (Figure 1). This paper briefly reviews the factors responsible for the increasing divergence between and within the core and peripheral countries of the EMU, describes the economic and political consequences of the crisis which began in 2008 and still grips the southern periphery, and discusses the possible paths to a sustainable EMU.

At the root of the crisis

The crisis that began in 2008 has distant roots. In Celi et al., we argue that the institutions of the EU and the EMU were based on the premise that all members were on a level playing field, excluding the ‘less modern’ (anti-competition) institutions, individual values and attitudes.\(^3\) The implicit assumption was that market forces, associated with institutions close to those assumed to be prevailing in ‘core’ countries, would create the ‘right’ environment for a sustained flow of investment and a smooth process of convergence in the periphery. Two role models – German disinflation and US financialisation– shaped the process of European integration. The ‘German model’ made price stability the fundamental objective of the EMU and its Central Bank. The ‘US model’ commended widespread market liberalisation and states’ renunciation of economic and financial interventionism.

Because of these choices, the Southern peripheral countries (SP, hereafter) were exposed to macroeconomic and industrial policy measures over decades of European integration that, though apparently neutral, generated increasing regional disparities both between the EMU core and periphery and within countries themselves. The structural crisis of the seventies (and the liberalisation policies of the eighties) represented a turning point in the modalities of international competition. The crisis raised the standards of global competition and the saturation of demand for consumer durables shifted the field of competition from price to product differentiation based on quality and innovation. While the countries of the core (epitomised by Germany) managed to adapt to the changing regime by innovating the industrial structure, the late-comer countries in Southern Europe struggled to adjust. Their premature deindustrialisation made peripheral countries more fragile with respect to external change even before the inception of the euro. Thus, the different trajectories of peripheral and core countries reflect the interdependence between economies with different product capabilities.

The external imbalances are the more prominent evidence of the diverging pattern of the core and the periphery. A huge German current account surplus was countered by equally large deficits in the periphery. Various factors have been indicated to explain these imbalances: from wage moderation and off-shoring to Central-Eastern European countries, to the quality of German industry and its ability to penetrate high-growth markets.\(^4\) Wage moderation, a traditional feature of the German labour model, was reinforced by the dualisation of its labour market. Since the mid-1990s, the share of low-paid work-

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3 G. Celi et al., op. cit.
Forums and working poors increase rapidly having a dual effect on the German trade surplus. By curbing the costs of services, the real wage of ‘insiders’ increased (the workers employed in the export sector), supporting wage moderation and export competitiveness. By reducing the level and the quality of imported consumption goods, German imports were redirected away from the more expensive, higher quality goods exported by Southern European countries towards the cheaper goods exported by China. This effect was compounded by the creation of the CEMC, which led to a partial crowding out of Southern European suppliers (see Figures 2 and 3). The desynchronisation of the German housing market acted as an additional factor of misalignment, contributing to wage moderation and a relative decline in residential investments in Germany, while fueling the bubble in peripheral countries.\(^5\) The interaction of widening within-country and between-country inequalities produced asymmetric effects in the core and periphery. More specialised in capital goods, the core was able to offset the deterioration of income conditions of part of its population through imports of low price/low quality consumer goods. Conversely, the SP, specialised in medium-high quality consumption goods, suffered a double displacement: i) the import penetration of low quality (Chinese) consumer goods in their internal and export markets, and ii) the negative effects on their exports deriving from the eastward restructuring of German value chains.

**The economic consequences of the crisis**

The austerity policies implemented during the crisis intensified various divides. First, the core-SP divide meant that two different industrial models now co-existed: a strong industrial platform in the core, which was export-oriented and had a solid position in the global market; and a less

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\(^5\) G. Celi et al., op. cit.
The diversified industrial sector in the periphery. Second, there were increasing divergences within the core: France was falling behind Germany and exhibiting some features of the SP. Finally, regional divides became worse such as the North-South divide in Italy and the East-West divide in Germany. The reorganisation of the German manufacturing platform, with its eastward relocation, was at the basis of the spectacular reorientation of its surplus in the crisis. Figures 2 and 3 illustrate the structure of the trade network in 2008 and 2016 for selected countries and areas. The 2008 network (Figure 2) displays the following key features: i) China has a surplus while the US and the rest of the network have a deficit, ii) within Europe, Germany rises to the role of trade leader, iii) the SP runs a deficit with the rest of the network except the US, iv) the Eastern Periphery (EP, hereafter) becomes an important German regional partner. The network displays the interaction of the hierarchical reorganisation in the EU with global trends such as the rise of China and the increase in the US trade deficit.

The 2008 crisis and the following years have reshaped the trade network. In 2016, we see the formation of a Germany-China-EP triangle (Figure 3). Germany now has a trade surplus with China and a trade deficit with the EP, which has increased its deficit with China. This trend exemplifies the ability of Germany to redirect its exports away from the SP and towards China and the strong expansion of the industrial base in the EP. In general, intra-European trade flows

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6 The SP (Southern Periphery) includes Greece, Italy, Portugal and Spain. The EP (Eastern Periphery) comprises the Czech Republic, Hungary, Poland and Slovakia. Euro-9 includes the following EZ countries: Austria, Belgium, Cyprus, Finland, Ireland, Luxembourg, Malta, the Netherlands and Slovenia. ROW stands for the rest of the world and includes the sum of exports to/from all remaining countries.

7 The disproportionately large size of trade flows of the Euro-9 area is mostly due to the role played by the Netherlands as entrepôt for continental Europe.
shrink due to the combined effects of the crisis and austerity policies, while trade flows outside the EU continue to grow at a significant pace (see, for instance, the huge growth of Chinese exports towards the Rest of the World (ROW) and the US). Actually, in the years following the 2008 crisis, the high-growth of non-European markets acted as a sort of ‘importer of last resort’ for the EU countries, with the SP switching from deficit to surplus with ROW. The EU’s balanced trade with the EP conceals the dramatic rise in bilateral trade that occurred between 1999 and 2008 in parallel with the formation of a dense network of production links. The value of EP’s exports to Germany, which exceeds the SP’s exports to Germany, signals the relative weakening of Germany-SP’s ties.

The political consequences of the crisis: two vicious cycles

The 2008 crisis exerted its most severe effects on the SP. By 2013, the SP’s unemployment rate skyrocketed to 20.5%, almost four and two times the levels registered, respectively, in Germany (5.2%) and the EMU (12%). Industrial production plummeted and has not yet returned to its pre-crisis level (Figure 4). Deteriorating economic conditions, increasing inequality and poverty nurtured a pervasive feeling of insecurity and anger that eroded trust in both the national and European parliaments, increased political instability and strengthened political movements with strong anti-EU sentiments and programs. However, these electoral effects are not confined to the countries most battered by the crisis, which suggests that while economics matters, it is not the only or even the primary factor.

In the SP, structural fragilities and economic anxiety have been exacerbated by the hierarchical reorganisation of the European economy and the austerity policies that created a vicious cycle perpetuating distrust and resentment. The core countries also experienced increased segmentation, income polarisation, regional divides and growing anxiety. Of course, the wane in political support for the European Union was supported by other forces such as changes in technology, the threat of globalisation, erosion of labour market protections and disillusions about the future. The old promise of a ‘European social model’ delivering global public goods and providing security is now in tatters.

The complexity of factors supporting populism is illustrated by the Italian vote in the last general elections. The electoral results support Rodrik’s argument that although anxiety and discontent may provide a base for populism, they do not necessarily determine its political orientation. “The relative salience of available cleavages and the narratives provided by populist leaders are what provides direction and content to the grievances”. There is a clear relation between an indicator of economic malaise – such as the unemployment rate – and the electoral outcomes of the Italian Five Star Movement. The Five Star Movement is one of the two political movements currently in power in Italy on a conflictual platform towards the EU that is supposed to have a more ‘leftist’ political orientation. The Italian regions with higher unemployment have a significantly higher number of Five Star voters (Figure 5). The other populist party, the Northern League, has a much longer political tradition and a ‘rightist’ orientation. It maintains its stronghold in the richer North, although it is rapidly expanding its support throughout the country on a program of anti-immigration policies and open confrontation with the EU. The Democratic Party (which was in power when most of the austerity policies were put in place) maintains a pro-EU position, presents a less dispersed scatter, which ranges from low in Sicily (where unemployment is high) to peaks in Tuscany and Emilia Romagna (where unemployment is lower).

While inequalities and poverty in the SP go hand-in-hand with structural fragilities and rising unemployment, sky-
rocketing exports and continuous accumulation of external surpluses cover the discontent alimented by social and regional inequalities in the core. In Germany, the popularity of radical parties that question the legitimacy of EU institutions is rising and political instability grows election after election. Between 2013 and 2017, the Alternative for Germany (AfD), founded in 2013 with a strong anti-European stance, experienced a profound transformation with anti-immigration positions defining its political platform. In the 2017 general elections, the AfD grew exponentially (from 4.7% in 2013 to 12.6%) to become the third largest parliamentary group in the Bundestag. The political and scientific debate on the causes of the AfD’s success warns against mono-dimensional explanations. As argued by Guiso et al., “one single measure is unlikely to capture well voters’ economic insecurity”, as exemplified by Germany, which saw a rising populist vote despite low and declining unemployment (below four percent as of September 2017). The aggregate data, however, misses the role of regional differences. The AfD has been most successful in Eastern Germany: in Saxony, the party obtained 27% of the vote. Berning stresses that the AfD’s constituency is largely made up of “working-class males with medium to little formal education”. Thus, the existence of a relation – analogous to the one reported for the Italian case – between unemployment, inequality and prevalence of low-wage jobs on the one hand, and the AfDs growing popularity on the other cannot be dismissed. The divergences within the core (labour market segmentation, geographical divides and inequalities in income distribution) that lay behind the German-EMU’s growth model seem to unravel another vicious circle: export-driven growth (partly favoured by wage moderation and polarisation) feeds increasing inequalities that fuel political instability and anti-EU right-wing parties. Forced to chase the populist parties on their grounds, traditional parties struggle to pursue an antagonistic program. These political developments cause German positions in the European political arena to harden, making it less likely

\[\text{Vote shares} \quad \text{Five Star Movement}\]

\[\text{Vote shares} \quad \text{Democratic Party}\]

\[\text{Vote shares} \quad \text{Northern League}\]

\[\text{Percent over total regional votes}\]

\[\text{Unemployment rate}\]

\[\text{Note: Electoral data refer to the last Italian general elections (Camera dei Deputati, 4 March 2018).}\]

\[\text{Source: Authors’ elaboration on Italian Ministry for Internal affairs and ISTAT data.}\]
to address EMU structural flaws through cooperation. A full analysis of causes and consequences of these complex political developments is beyond the scope of this article. However, the developments in Italy and Germany (bearing in mind that similar dynamics are observable in many other EU countries) signal that socio-economic divergences, both between and within countries, may lead to political instability and radicalism. If revitalising convergence (between and within European economies) requires redefining key features of both the EMU’s growth model and its institutions, it will result in a lack of political space for cooperation which in turn raises the risks of disintegration.18

German refl ation: a way out?

Austerity policies have proved to be ineffectual in reducing the fiscal imbalances in a context of simultaneous fiscal consolidation (Table 1). Competition policies aimed at reducing costs spark a race to the bottom with no beneficial effects on competitiveness. Social and fiscal dumping produces negative spillover effects across countries and regions, resulting in a dead-weight cost for societies. Reinforcing deflation, these policies prod the exit of marginal firms, reduce the productive capacity and destroy the connective tissue jeopardising, rather than favouring, long-term growth. To resume growth, therefore, the European Union needs policies based on sustained domestic demand.

After a brief, deep crisis, Germany resumed growth. Its heavy reliance on exports has been recently buttressed by an increase in domestic demand, driven by the introduction of minimum wages and private (and public) spending (Figure 6). The current refl ation – an average growth rate of 1.38% from 2008 to 2017 – is still contained, especially considering Germany’s fiscal and external position, and compares poorly with the US (Figure 1).

Table 1
Southern periphery – the dynamics of debt over GDP between 2008 and 2017

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<tbody>
<tr>
<td>Greece</td>
<td>109.4</td>
<td>126.7</td>
<td>146.2</td>
<td>172.1</td>
<td>159.6</td>
<td>177.4</td>
<td>178.9</td>
<td>175.9</td>
<td>178.5</td>
<td>176.1</td>
</tr>
<tr>
<td>Italy</td>
<td>102.4</td>
<td>112.5</td>
<td>115.4</td>
<td>116.5</td>
<td>123.4</td>
<td>129.0</td>
<td>131.8</td>
<td>131.6</td>
<td>131.4</td>
<td>131.2</td>
</tr>
<tr>
<td>Portugal</td>
<td>71.7</td>
<td>83.6</td>
<td>96.2</td>
<td>111.4</td>
<td>126.2</td>
<td>129.0</td>
<td>130.6</td>
<td>128.8</td>
<td>129.2</td>
<td>124.8</td>
</tr>
<tr>
<td>Spain</td>
<td>39.5</td>
<td>52.8</td>
<td>60.1</td>
<td>69.5</td>
<td>85.7</td>
<td>95.5</td>
<td>100.4</td>
<td>99.3</td>
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<td>98.1</td>
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Source: Authors’ elaboration on Eurostat data.

cit countries to prop up growth. The reorganisation of production at the European level and the redirection of trade flows that we analysed before suggest a cautionary note. Although some regions in the SP did succeed in retaining their links in the value chains of the core industries, the surge in the productive links with the EP and the consumption links with Asia indicate a weakening of the ‘trickle down’ effects of a German locomotive for the SP.19 Moreover, as argued in Simonazzi et al., the spur in demand induced by a German refl ation would reflect the composition, the characteristics of demand and the requirements of the German industry rather than the developmental necessities of the SP.20

What is required, then, is a coordinated expansion, like a Marshall Plan for Europe, capable of reducing the divide. There are two considerations that must be taken into account. First, a coordinated effort would also suit the interests of core countries. As previously argued, there is a common and urgent need to respond to the new social challenges, invest in social and physical infrastructures (not only environment, energy, innovation and knowledge, but also health and welfare, education and R&D) and spur new waves of innovation. These will have higher multiplier effects and a high domestic content, sustain the level and the quality of employment and offer synergies with innovation policies. Second, demand is important, but the past experience has demonstrated that we should refrain from generically supporting purchasing power (avoiding construction or consumption bubbles). Supply plays an important role, which means that the composition of demand is crucial. Industrial policy can help to guide demand to meet the economic and social needs of the SP and the fragilities of its industrial structure. Thus, industrial policy should pursue three interrelated objectives: rebuild the economic and productive fabric of the areas devastated by the crisis, expand the range of efficient or viable firms which include

20 A. Simonazzi et al., op. cit.
Export markets or ‘the most innovative sectors’ as well as the promotion of an investment program targeting the domestic market and physical and social infrastructures, upgrade the production structure and respond to the challenge of new technologies.

This will call for a multilevel industrial policy targeted at the specific needs of core and peripheral countries/regions. At the European level, the various strategies – the Juncker Plan, structural and cohesion funds, Industry 4.0 – should be reoriented to respond to the goal of rebalancing the core-periphery divide in Europe (which is presently inadequate in terms of financing and focus). At the national level, domestic investment should focus on orienting firms in accordance with future development targets and accompanying and controlling the development of complex systems. At the local level, policies should target the specific needs of regions at various levels of development.

In conclusion, we need the combination of a macroeconomic policy to assist the recovery of demand with an industrial policy focused on bringing those areas that have been left behind up to speed. Coordination of the various levels of intervention and a macroeconomic environment favouring growth are both essential: the market has proved to be unable to ensure convergence, while a deflationary environment hinders innovation and restructuring. Is an alternative policy likely? The political sentiment across EU Member States makes a cooperative solution extremely difficult. Yet, the global environment (with its looming threats of protectionist measures) makes reliance on an export-led growth more and more difficult, especially as it is now pursued by the whole euro area (exports account for three percent of the Eurozone GDP). Should these developments make an inward orientation of growth inevitable, the EU domestic market could become more important for core countries. However, the shift from exports to domestic demand would require a restructuring of the German industry. The size of its export industry (with its value chain) is too large for its domestic market, perhaps too large even for the EU market, especially if austerity policies restrain its growth. Converting the production structure away from exports to serve new social needs may be a difficult task.

To conclude, making the European project sustainable requires returning to the original political project of Europe, inspired by the political resolve to promote convergence. A more balanced European economic integration calls for a common undertaking to stop domestic devaluations and pursue production upgrading, diversification and structural change. Peripheral countries need an entrepreneurial state capable of broadening their productive capacity and increasing their capabilities (to reduce the gaps between and within countries). Industrial policy must fit the needs of countries/regions at different levels of development. At present, the European industrial policy still relies on the idea that competition alone can guarantee convergence. Combined with a deflationary environment, this approach cannot escape new forms of social dumping, or plain destruction of the domestic productive capacity of weaker economies. Rebalancing can only work if the focus turns to domestic demand. However, a change of strategy is unlikely in the present economic and political program. It is stubbornly focused on fiscal rectitude and economic rules, devoid of strategic vision and totally blind to mounting structural and political instabilities. There is an alarming inability to reconcile differing political interests to solve the institutional faults.

German interests have been shifting away from Southern Europe towards Eastern Europe, the emerging markets, and the rest of the world, specifically the US. The rise of populism worldwide has put pressure on governments to take nationalistic positions. The recent developments seem to question Eichengreen’s optimistic conclusion that “[a]s a result of the lessons policymakers drew [...], they resisted the beggar thy neighbor tariffs and controls that caused the collapse of international transactions in the 1930s”.21 The fragmentation of the international order may suggest a more positive attitude towards the preservation of the Union.