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Addressing the core-periphery imbalances in Europe: resource misallocation and expansionary fiscal policies

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November 2017

ABSTRACT: This work illustrates the nature of the core/periphery imbalances and anemic long-run growth in the Euro area and discusses the problems associated with addressing them through expansionary fiscal policies in the core regions and greater domestic expenditures in unreformed peripheral areas. As competitiveness imbalances across regions have widened, both fiscal measures may backfire and a more nuanced policy mix is in fact needed to reverse the unequal spatial distribution of high value-added activities and resource misallocation. Addressing the factors behind such imbalances is key for the survival of the Euro area because their size and persistence clash with the tendency towards an equalization of workers' aspirations: this aspirations/resources mismatch is in fact fuelling discontent and populist animosity against the EU institutions and the core countries.

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Introduction

It is almost a platitude that countries in the Euro area (EA, hereafter) are extremely heterogeneous from an economic viewpoint. Countries with large external surpluses, high GDP per capita levels, good GDP growth rates and low unemployment rates coexist with others faring worse along several of such economic dimensions. In fact, countries differ in a nuanced manner, so that similar external positions with the rest of the EU and of the world are recorded by countries that exhibit fairly diversified economic features, and vice versa. This notwithstanding, the current debate on the macroeconomic conditions of the Euro area associates the external surpluses in the EA core with the low growth and high unemployment rates in the EA periphery. Accordingly, some scholars and pundits have advocated exploiting the very low interest rate environment in order to increase fiscal expenditures and "redistribute" aggregate demand from the EA core to EA periphery.

While there might be good reasons to let fiscal policy play a greater role in certain countries, given the expansionary monetary conditions, this work addresses a number of controversial issues connected with such policy recommendations. More precisely, it raises doubts as to whether a generalized fiscal expansion would necessarily be conducive to a higher long-term growth path and warns that it might even have counterproductive effects. Rather, the analysis calls for greater urgency in addressing the deep-lying determinants of the enduring competitiveness imbalances across EA regions and in tackling the emerging clash between socio-economic fundamentals diverging across regions and people's aspirations for similarly high living standards, whose disappointment fuels discontent and populist animosity against the EU institutions and the EA core.

Although this study is mainly inspired by the current political debate on the state of the EA and on the specific role of expansionary fiscal policy measures, it refers to various recent areas of research. First, the analysis of the limited success in achieving economic convergence in the EA combines elements of both macroeconomic and regional economics. Second, in order to establish the connection between economic convergence and economic integration, the analysis draws on the

recent literature on international value chains and, in particular, on studies assessing the relationship between place-based factors and the regions' ability to retain stages of the chain able to create more value added. To delve further into the structural problems of the laggard regions in the EA periphery, moreover, we also borrow from the very recent literature on resource misallocation across and within sectors. Finally, we explore comparative political studies and the literature on the political economy of the Euro to discuss the political implications of the aspirations/resources mismatch and the political feasibility of alternative ways to tackle the competitiveness imbalances. Hence, besides proposing an original intuition concerning the onset of an aspirations/resources mismatch in various regions of the EA periphery, this work contributes to the debate by bridging various disciplines and strands of the literature and drawing consistent policy implications.

The paper proceeds as follows. Section 1 will illustrate the macroeconomic heterogeneity in the Euro area, distinguishing cyclical and structural aspects of the observed macroeconomic imbalances. In Section 2, the reasons for and against an extraordinary fiscal stimulus in the EA will be presented and discussed. Moving from the national to the regional dimension, Section 3 will illustrate a number of stylized facts showing the limited economic convergence achieved in the EA and in the EU, introducing the concept of competitiveness imbalances. Section 4 will address the structural problems affecting the laggard regions in the EA and preventing them from reaping the potential benefits of globalization and European economic integration. On this basis, Section 5 will present the provocative idea that the EA is suffering from a growing aspiration/resource mismatch whereby, in certain laggard regions, the deep economic fundamentals and people's widespread aspirations in terms of living standards are not aligned. This mismatch, it will be argued, has fuelled both Euroscepticism and populism and has the potential to jeopardize the stability of the Euro area. Section 6 will discuss alternative ways to address regional competitiveness imbalances and the aspiration/resource mismatch. A final section with further remarks will conclude the study.

1. Macroeconomic heterogeneity in the Euro area: structural and cyclical aspects.

"Diversity in unity" is the famous European motto. Certainly, at least as far as diversity is concerned, this slogan appears appropriate. Economic heterogeneity in the EA is a well-known phenomenon, ranging from employment to growth rates, from public and private debt to wage and price dynamics. In the recent years of recovery from the sovereign debt crisis, however, close attention has been paid to differences among current account balances and economic performances. Accordingly, many commentators have advocated a "redistribution" of aggregate demand from the EA core to EA periphery, so as to reduce the external surpluses of the former and foster GDP growth in the latter. This section will provide some stylized facts to show that EA countries differ in a more nuanced way, so that similar external positions with the rest of the EU and of the world are recorded by countries that exhibit fairly diversified economic features, and vice versa.

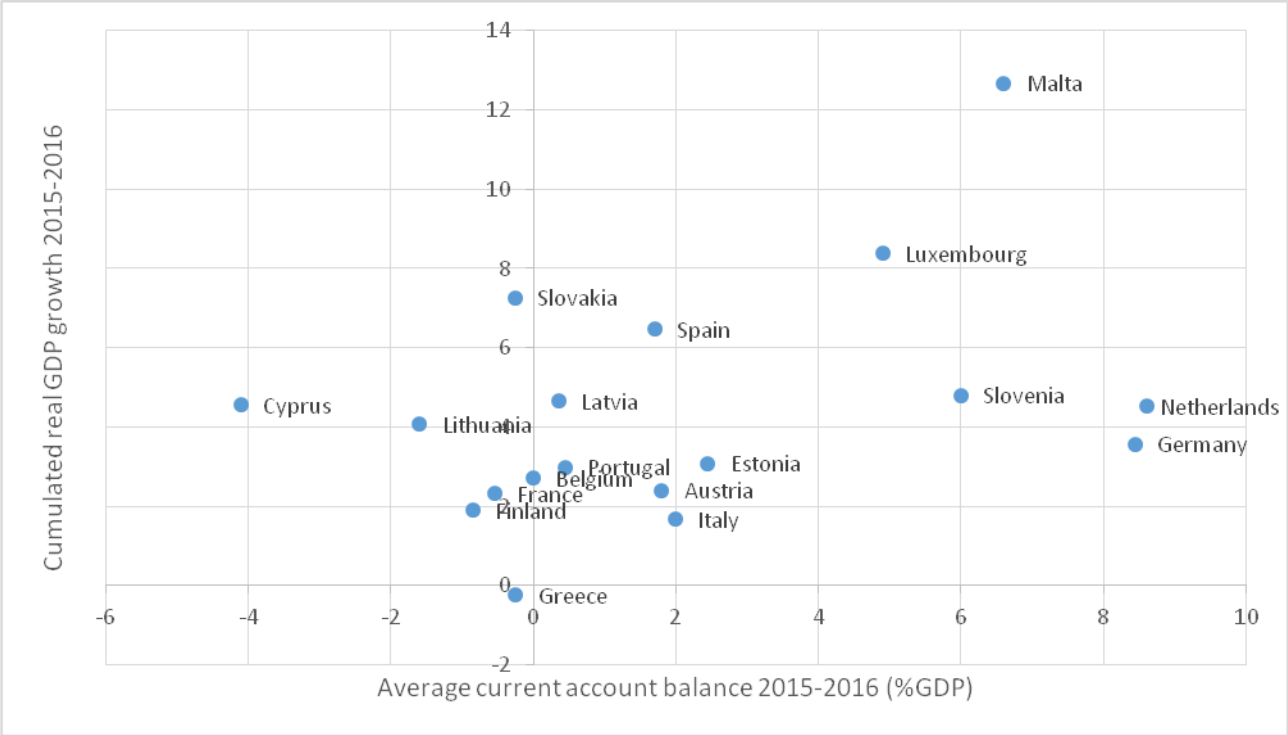

Figure 1. Average current account balances (as % GDP) and cumulated real GDP growth (2015-2016). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

Current account balances and cumulated real GDP growth rates in the years 2015-2016 are reported in Figure 1. A positive relationship does not clearly emerge. Spain has grown fast to remedy the severe contraction during the crisis and recorded a current account surplus of about 2%,

whereas Italy has grown by less than 1% per year with a similar external surplus. Cyprus has grown as fast as Germany despite a marked difference in terms of external positions.

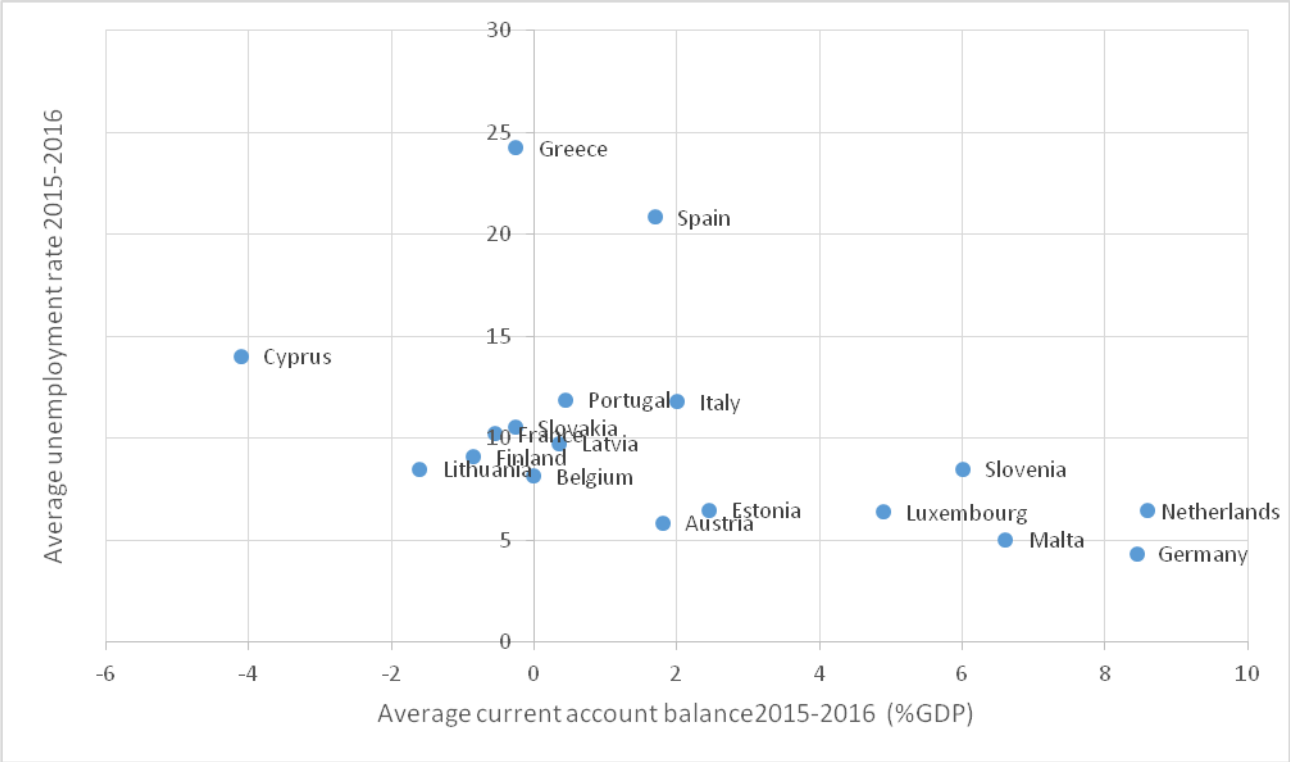

Figure 2. Average current account balances (as % GDP) and unemployment rates (2015-2016). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

A similarly differentiated picture emerges when current account balances are considered with respect to unemployment rates (Figure 2). While there seems to be a negative relationship between these variables, it is to be noted that Belgium, France and Greece share similar figures for the current account balances with different unemployment rates, and a similar situation holds for Austria, Spain and Italy as well.

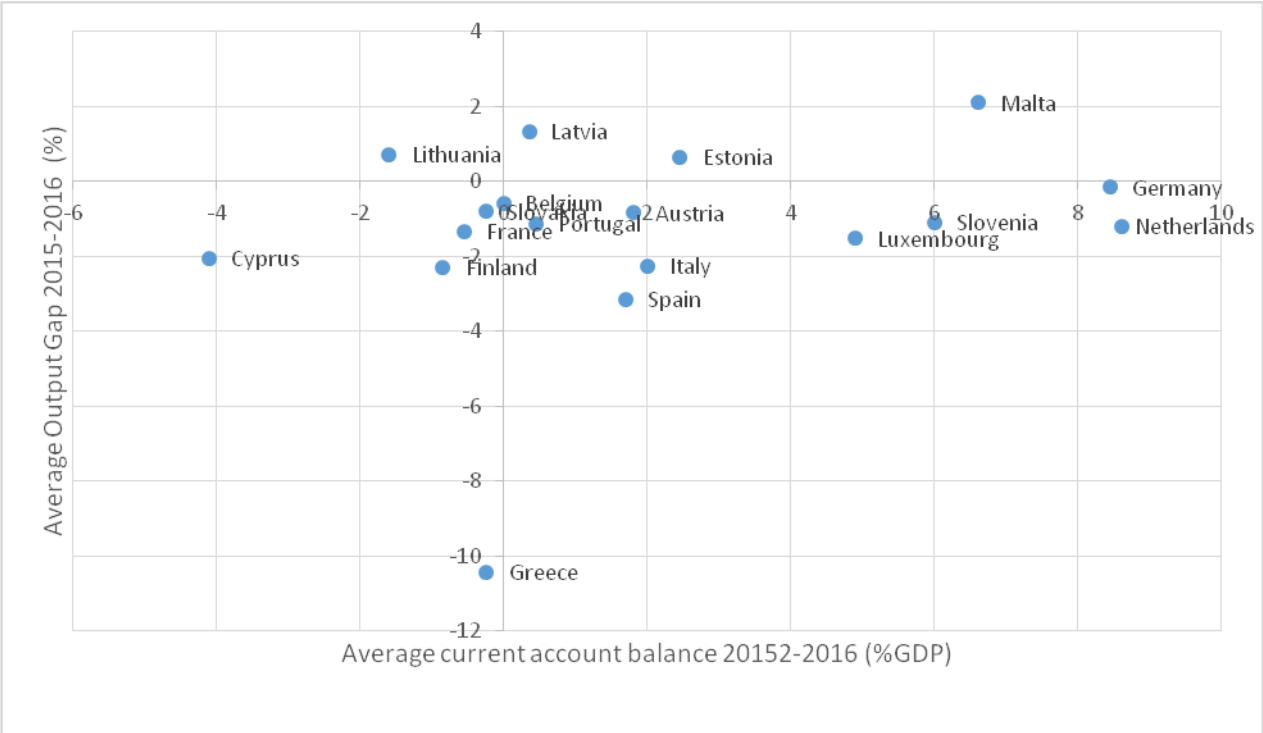

Figure 3. Average current account balances (as % GDP) and output gap (2015-2016). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

Figure 3 plots the average values of the output gap in 2015 and 2016 against the average current account position. Besides confirming the wide heterogeneity in the EA, the scatter plot suggests that there is not a clear unconditional relationship between output gaps and current account balances. Cyprus, Finland and Italy, for instance, have similar average output gaps, yet their current account balances are extremely diversified.

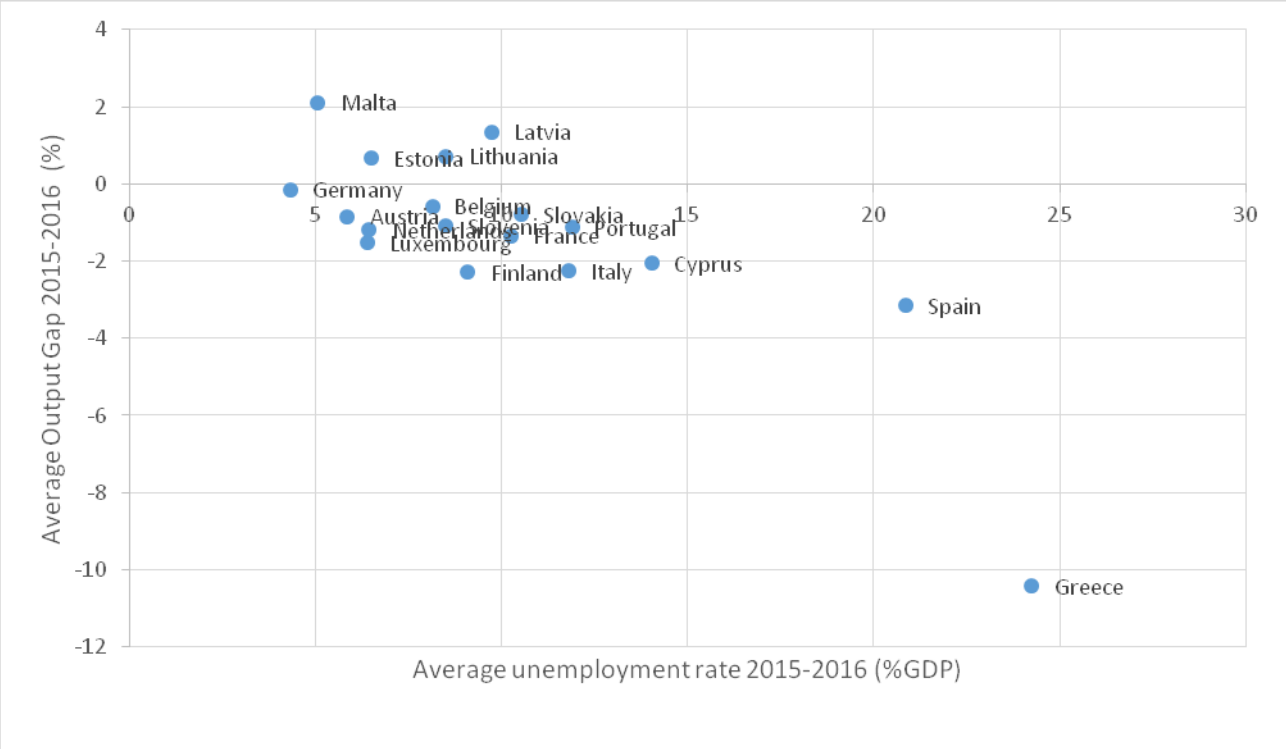

Figure 4. Average unemployment rates and output gap (2015-2016). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

Setting the current account positions aside and focusing on the other variables, one can observe the existence of an unconditional negative relationship between these latter and the average values of the output gap (Figure 4), as the economic theory would suggest.[1]

In regard to the distance between the real potential GDP in 2016 and that in the pre-crisis period (2007), Figure 5 sets the current unemployment rates in relation to the progress (or lack thereof) achieved by member states' GDP potential in recovering after the crisis. A negative relationship between these variables is evident, thereby suggesting that the heterogeneity in unemployment rates has a structural component that cannot be ascribed to the cycle, as often done.

[1] However, if Spain, Malta and Greece are excluded, this association becomes somewhat weaker. This may be due to measurement problems in the output gap, which is in fact unobservable. Potential GDP can also be overestimated and the gap underestimated, as forcefully argued by the Italian authorities with respect to the European Commission's estimates.

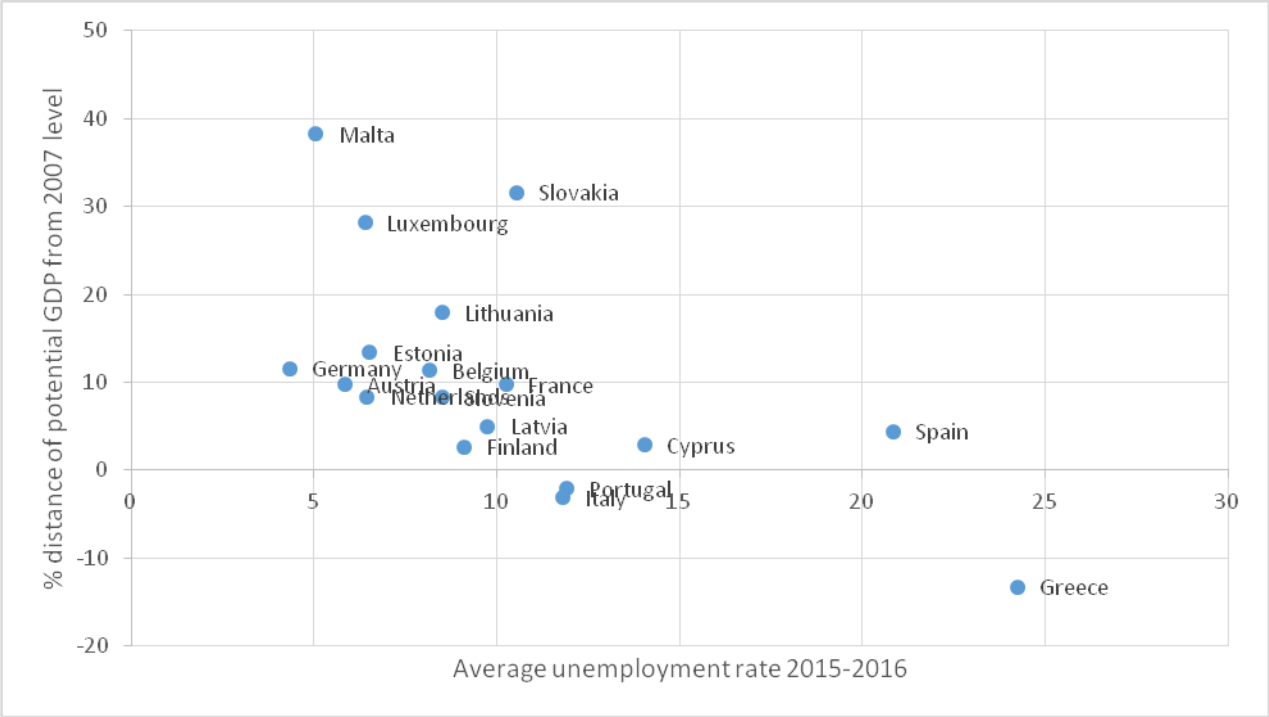

Figure 5. Average unemployment rates (2015-2016) and distance of potential GDP from 2007 level (in %). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

To substantiate this intuition, we consider also the relationship between the average output gap and the percentage distance between potential GDP in 2016 and 2007. Interestingly, a positive relationship between these variables emerges in Figure 6. It could be argued that part of what is measured as "cyclical" can in fact be associated with more "structural" factors; countries that have not entirely recovered from the crisis are those that are still facing more negative cyclical conditions. While this finding could suggest problems in the methodology used to estimate the output gap, it also warns against hastily associating cross-country differences in unemployment rates with their different positions in the business cycle. Moreover, it indicates that the convergence process at work in the pre-crisis period has probably come to a halt. As Benoît Cœuré, member of the Executive Board of the ECB, effectively put it: "We are faced, then, with two facts: first, cyclical dispersion is close to or at historic lows; and, second, structural dispersion remains high and may even be growing." (Cœuré 2017).

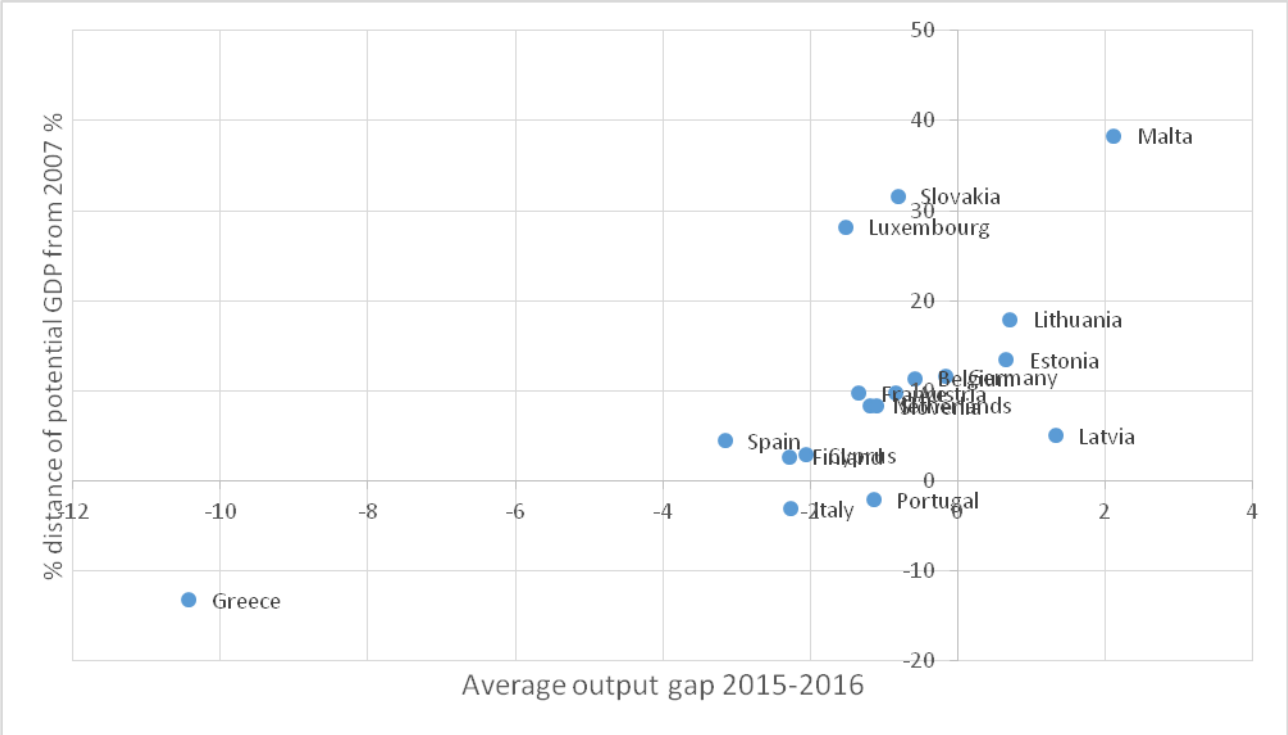

Figure 6. Average output gap (2015-2016) and distance of potential GDP from 2007 level (in %). Euro area countries. Own elaboration on data from Eurostat 23 July 2017.

The figures presented in this section certainly do not provide statistically significant insights into the exact determinants of the differences in performance across the Euro area. Yet they reveal that i) similar current account figures are associated with diversified economic performances, and ii) unemployment rates are correlated with the distance between potential GDP in 2016 and in 2007 as much as with cyclical conditions. This evidence is at odds with the conjecture that achieving lower external surpluses in the EA core countries through temporarily more generous fiscal policies would raise GDP growth and lower unemployment rates in the EA periphery in the medium term. As will be argued below, this recipe is unlikely to work and may even contribute to preserving a worrying misalignment between expectations and fundamentals.

2. Helping the periphery: is boosting aggregate demand in the core the solution?

As said, the divergent conditions across the Euro area have induced various scholars to argue that aggregate demand should be increased in those countries exhibiting greater economic slack and, more precisely, that demand should be "redistributed" across EA member states by means of differentiated efforts in boosting consumption and investment of the public and private sectors.

The widespread support gained by such policy recommendations has various explanations. First, they are deemed to be a patent antidote to those austerity measures that—according to those advocating more expansionary macroeconomic policies—have failed to deliver growth in the past ten years.[2] Second, these recipes are in accordance with well-established Keynesian principles, and in particular with the relative effectiveness of fiscal and monetary measures in the presence of a liquidity trap.

In what follows we shall discuss these explanations in greater detail. We certainly agree on a number of points: that brutal adjustments in the programme countries—although inevitable—had severe recessionary effects in the short term; that fiscal stimulus might be most useful in a liquidity trap; and that a redistribution of fiscal efforts in the EA would have brought about some (marginal) but immediate relief in the periphery with limited costs in the core. Yet, as the following sections will show, expansionary policies to enhance aggregate demand do not solve the underlying structural economic problems in the EA periphery and, paradoxically, may even worsen the misallocation of resources and contribute to the mismatch between local economic fundamentals and people's shared aspirations.

[2] Even senior economists at the IMF have, in recent years, openly discussed some patent failures of the neoliberal approach/agenda, among which are the alleged expansionary effects of fiscal consolidations, which never materialized (Ostry et al. 2016). More in general, Blanchard and Leigh (2013) raised doubts concerning the effectiveness of fiscal consolidation plans in serious recessions and stimulated further work on the relationship between fiscal consolidation and growth.

As anticipated, the first reason why the recommendation of expanding aggregate demand in the core has gained support is the painful recession that occurred in the periphery when the EU strategy based on internal devaluation and fiscal consolidation (i.e., austerity) was implemented. The internal devaluation strategy, pursued by the Institutions (i.e. ECB, EU Commission and IMF) in a particularly aggressive manner in Greece, was based on the simultaneous increase in VAT, cuts in (or caps on) public sector salaries, and similar conservative measures to slash labor costs. Ultimately, the strategy was designed to improve cost competitiveness and substitute foreign for domestic demand in high twin-deficit countries. Fiscal consolidation was intended to go hand in hand with internal devaluation: lower public sector salaries and reduced public demand for tradables and nontradables would have contributed to reducing the external and internal deficits and to restraining wage dynamics also in the private sector. Especially in the case of Greece, whose export sector was particularly weak, the problems generated by such two-pronged approach had to do with the fact that a large fall in domestic demand cannot be easily counterbalanced by an offsetting increase in foreign demand obtained only through an increase in cost competitiveness.[3] Indeed, the bursting of the gigantic bubble fueled by the unsustainable accumulation of foreign debt that inflated domestic demand in the programme countries led to a weakening of banks, a disruption of existing production networks, and a widespread increase in insolvency.[4]

Besides the supposed failure of austerity measures in the past, coordinated expansionary fiscal policies, together with a sufficiently accommodative monetary policy, have been invoked by a number of eminent economists to revive economic growth and rebalancing (see DeLong and

[3] As much as this strategy was not effective in the EA, it did seem to work in some Baltic states and in other countries outside the EU. The different outcomes depend on the size and degree of openness of the countries, as well as on the exchange rate regimes in place. Even in the successful cases, however, the adjustment channels at work appear to be complicated and controversial, as shown by Blanchard et al (2013), and previously discussed by Dani Rodrik in "What I learned in Latvia" on his weblog http://rodrik.typepad.com (2012) and Paul Krugman "Latvian competitiveness", http://krugman.blogs.nytimes.com (2012).

[4] Paulus et al. (2017) show that consolidation measures not only negatively affected aggregate household income and consumption but, due to salaries and benefit cuts, also generated undesirable distributional effects due to the penalization of financially constrained, poor households. On the contrary, Attinasi et al. (2017) find limited negative externalities on the vulnerable countries of widespread fiscal consolidation because of the beneficial effects materializing in the financial realm and of the endogenous expansionary reaction of the ECB monetary policy (in line with the channels identified by Corsetti et al. 2013).

Summers 2012; Summers 2016, Krugman, 2016; Roubini, 2016; Spence, 2016; Stiglitz, 2016) because of the alleged existence of a liquidity trap in the EA. Facing a liquidity trap—the argument runs—a money-financed stimulus to aggregate demand tends to be very effective in contrasting deflationary impulses and boosting growth.[5] In particular, these scholars advocate large investment projects, given that overall investment has fallen in the EA since the beginning of the crisis.[6]

Basic Keynesian economics does indeed suggest that fiscal stimulus is appropriate when productive assets and resources are underutilized because of a lack of demand, and the post-crisis environment in the EA allegedly qualifies as such a condition. The extent to which this is correct, however, represents the crux of the matter. As the Figures reported in the previous sections suggest, differences in unemployment rates seem more closely related to the persistent difficulties in redressing the course of potential GDP than with temporary deviations of output from its potential level. This in turn suggests that competitiveness problems and structural difficulties in mobilizing idle resources represent the entrenched problems hampering growth in the EA periphery and acting as a drag on its economic recovery. Fiscal expansions may provide some immediate relief to these countries but they can hardly tackle long lasting and structural problems.

Clearly, until competitiveness problems are properly addressed, domestic fiscal expansions in the laggard areas can impact more on their external balances than on their domestic outputs.[7] This raises issues concerning the sustainability of such additional fiscal efforts in high-public debt countries as borrowing costs, due to risk premia, exceed the low short-term nominal interest rates in the EA.

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[5] See, among others, Wood (2012), Reichlin et al. (2013), and Borio et al. (2016).

[6] This view, however, is contested by other scholars. First, it is not clear whether or not the pre-crisis investment level in the EU was abnormally high (Gros, 2014). Second, the declining growth rates of the working age population and total factor productivity may not be compatible with a higher rate of investment, given the high capital-output ratio in the Eurozone. Finally, it appears that waste and inefficiency reduce the extent to which public investments are translated into actual improvements of public assets in various countries (see IMF, 2014).

[7] No consensus has yet been reached in the debate on the size of domestic fiscal multipliers, which can vary depending on the type of the fiscal shock, on the contingent state of the economy (with larger multipliers in recessions) and on its structural features (Blanchard and Leigh 2013, Ilzetki et al 2013).

If greater domestic fiscal stimulus in countries plagued by high public debts and competitiveness problems is not a viable option, greater aggregate demand in surplus core countries could, the argument goes, help to push GDP growth in the periphery through cross-national fiscal spillovers. Various economists have argued that a significant German-led fiscal stimulus could have provided the EA peripheral countries with some relief. Blanchard et al. (2017), for instance, stress that the liquidity trap in the EA periphery might enhance the effectiveness of an external fiscal stimulus: given a liquidity trap lasting three years, an expansion of EA core government spending equal to 1% of EA GDP could boost the GDP (though also consumption and welfare only to a lesser extent) in the periphery by over 1%. In fact, the estimated effects of core countries' stimuli are subject to a number of caveats and to large uncertainty: the intensity of fiscal spillovers (from the cross-country transmission of fiscal shocks) depends on countries' characteristics and on the specific channels at work (e.g. trade, price, interest rate, and exchange rate channels), and the literature is still far from being conclusive about the size of cross-national fiscal spillovers.[8] Even disregarding such uncertainty and assuming these most favorable estimates as accurate, the argument propounded by Blanchard and co-authors focuses on the short term and is motivated by concerns with the current unemployment and welfare conditions in the periphery. Yet the long-run sustainability of the EA requires consideration of other aspects and consequences associated with a large short-term fiscal stimulus in the core countries.

[8] Using model simulations, IMF (2013) finds that a two-year increase in spending in Germany (for about 1% of German GDP) boosts real GDP in the rest of the EA by 0.2 percent; and according to In't Veld (2013), an increase in government investment by 1% of GDP in Germany and other EA core countries could raise? real GDP in the remaining EA countries by 0.2-0.3%. ECB (2014), however, finds values for the same stimulus varying between 0.03% in France to 0.06% for the small EA member states. The two-step methodology adopted by Ivanova and Weber (2011), where only the impact of fiscally-induced changes in domestic output on net exports of trading partners is considered, suggests that a reduced consolidation effort by Germany alone would have had a limited positive impact on the European periphery. Studies adopting the GVAR methodology, such as Hebous and Zimmermann (2013), are not conclusive either, because they provide evidence of a highly differentiated impact of foreign fiscal shocks across the EU countries. Different are the results from the adoption of the local projections methodology (used for instance by Auerbach and Gorodnichenko 2013 and Goujard 2017), which tends to produce greater estimates of the spillover effects: Goujard (2017), for instance, argues that a fiscal contraction in Germany by 1% of GDP leads to a reduction of output growth by 0.23% points for a typical OECD country and to an even greater contraction in EA countries, whereas Poghosyan (2017) finds that 1% of GDP fiscal consolidation in Germany has large contractionary impacts in both the short and the medium term, respectively 0.16% and 0.24% of euro area GDP (of which only 0.07% and 0.08% are associated with spillovers).

In particular, it is important to recognize that an expansionary policy action would not be able to move the weakest economies towards sustainable high-growth paths. Larger expenditures in EA core countries could work against such a goal if they contributed to enlarging some existing gaps: this would be the case if domestic investment in the core further boosted the productivity and competitiveness of the core regions or if the relief received in the periphery from greater external demand reduced the incentives to address the structural problems. Past experience shows that effective reforms able to improve the fundamentals tend to be either softened or postponed when expansionary policies provide temporary relief (see OECD 2010 and Agnello et al. 2015 among others). Moreover, the transient nature of growth accelerations may curb investment in new productive assets, thereby dampening the impact of the stimulus on GDP growth. Hence, without a proper mobilization of resources across sectors, places and alternative uses, any positive effects of a money-financed stimulus to aggregate demand in the core are unlikely to be either full-fledged or long-lasting.

Greece and Southern Italy exemplify some of the reasons why it is unlikely that sustainable long-term growth can be revived by temporary fiscal stimuli. Greece and Southern Italy share a number of negative structural characteristics affecting their potential GDP and growth: 1) a restricted employment base and a relatively large fraction of workers in public employment and in irregular jobs; 2) an endemic competitiveness problem, particularly in the services sector, and heavy dependence on domestic demand and public expenditure; 3) many (very) small firms, active in low valued-added service activities and investing little in R&D and ITC; 4) poor social capital endowment and low-quality institutions (Alcidi et al. 2016).[9,10] Both areas have been granted access to external funds in recent decades: Greece mainly by borrowing from abroad and as net recipient of European funds, the Italian "Mezzogiorno" as part of a transfer union within Italy, so that it

[9] Moreover, both were hit by two common shocks that turned out to have highly asymmetric effects within the Eurozone: i) the accession of China and Eastern Europe in the global market, and ii) the introduction of the euro, with the rapid convergence of nominal interest rates.

[10] Focusing on the trial length of civil disputes to proxy for the quality of contract enforcement in Italy, Accetturo et al (2015) find that firms located in courts with higher trial length have a lower probability of supplying customized intermediate inputs to foreign firms.

received substantial fiscal transfers (close on average to 20% of its GDP) from the rest of the country.[11] The availability of financial resources did not contribute to empowering these regions and to making them less dependent on internal demand.

Of course, fixing the structural weaknesses undermining these and other regions' performances takes time, while in the short term consolidation efforts may worsen the situation to the extent that informal economy, school dropouts, and inactive population increase with the contraction of social expenditures. But expansionary fiscal measures in the EA core countries cannot fix any of the fundamental problems either. Expansionary policies cannot fundamentally reduce the gap that separates leaders and laggards and, for the reasons explained above, may even expand that gap.[12]

3. Convergence and growth at the regional level: some stylized facts

The last part of the previous section focused on the Southern Italian regions, rather than on the entire country. This was not accidental and reflects the importance of moving the analysis from the national to the subnational level so as to capture the evolution of price and non-price competitiveness, which is one of the main determinants of GDP growth and living standards in the long run.[13]

[11] Since the 1970s, nominal wages have been negotiated at the national level and extended to the whole of Italy, in spite of the remarkable differences in productivity, prices and unemployment rates between the regions in the Center-North and the South. As a result, salaries and wages in the formal economy of South Italy's labor market have responded little to local labor-market conditions. The Mezzogiorno was already part of a malfunctioning currency union long before its accession to the Eurozone, and it instantiates the kind of situation that the core countries would like to avoid reproducing within the Eurozone.

[12] Capello and Cagliaru (2016) develop quantitative foresights for the future development of the North-South divide in Italy under two alternative scenarios in terms of policies to address the crisis: a place-based competitiveness scenario and a social cohesion one. They conclude that the former approach can lead to the highest aggregate growth rates and to the lowest increase in regional disparities.

[13] By proxying non-price competitiveness with cumulative investments, Algieri (2014) shows that the long-term export performance of EA peripheral countries is affected by worldwide real income and price competitiveness, but also significantly by non-price competitiveness. In particular, in Italy the erosion of non-price competitiveness has been the most important determinant of its declining export performance since the mid-1990s (Algieri 2015).

Indeed, notwithstanding some income convergence observed in the entire European Union during the period leading up to the crisis, the EU and the EA still exhibit enduring regional disparities.[14]

	Theil index		Standard deviation of logs		Coefficient of variation	
	EA19	EU28	EA19	EU28	EA19	EU28
2003	4.4	8.9	31.0	47.5	29.9	43.0
2007	4.0	7.7	28.6	41.7	28.6	41.0
2011	4.4	7.3	30.2	38.4	30.4	41.1
2015	4.7	7.1	30.7	36.8	31.2	41.4

Table 1. Dispersion of regional GDP per capita in PPS within EA and EU. All inequality indexes are weighted by population. Own elaboration. Data at NUTS2 level from Eurostat, 23 July 2017.

If anything, the crisis has set the clock back in the Euro area, where, by most measures, regional inequality has returned to the levels recorded at the beginning of the 2000s (Table 1). The current situation is certainly related to the differentiated impact of the crisis and of the corrective measures taken to tackle it. Yet Crescenzi et al. (2016) show that increasing regional disparities in the euroarea during the crisis cannot be explained only by the generalized contraction of certain economies.

But the level of GDP per capita (in purchasing power parity) is not the only yardstick with which to gauge the extent of regional differences. As a matter of fact, it is rather the manifestation and the result of more profound differences, in particular in terms of efficacy as well as the capacity to attract and foster the development of "competitive firms". These latter are those that "*hire more workers, offer better job security, pay higher wages, invest more (also in human resources), generate more revenues and profits, and therefore allow regions to raise more tax revenues for any given tax rate*" (Békés and Ottaviano, 2016: pp. 36-37). This is consistent with the fact that in all

[14] Cuadrado-Roura et al (2016) put forward a more nuanced account whereby growing regions in Poland, Slovakia and Bulgaria have compensated lagging regions in Romania, Hungary and Latvia, thereby limiting but not halting the catching up process. That said, they concur that in the EU-15, considerable regional divergence has taken place after the crisis, widening regional disparities.

countries more advanced areas co-exist with peripheral regions.[15] As pointed out by the European Commission in a recent report on 47 regions in 8 Member States that lag behind in terms of either GDP per capita levels or growth rates, "lagging regions have lower productivity, educational attainment and employment rates compared to the other regions in their country. Evidence shows also that they score poorly on labour market and business dynamism Indicators. [..] Underdeveloped regional innovation systems, skills gap and poor institutional quality undermine the growth potential of lagging regions (EC 2017, p. iv)".[16] Finally, regional differences are often associated with the presence, or lack thereof, of large cities, which tend to be more productive because of first and second nature advantages (such as agglomeration economies).

Notwithstanding the limitations of any comprehensive index measuring intangible concepts such as institutional quality, the index of regional competitiveness (RCI) elaborated by the European Commission (Annoni et al. 2016) helps to gauge such regional heterogeneity in terms of the capacity to attract and foster the development of competitive and innovative firms.[17] In contrast with the well-known 'Blue Banana' pattern (stretching from Manchester to Milan and capturing the European manufacturing heartland before the 2000s), the map of the standardized RCI exhibits a polycentric pattern with strong capital and metropolitan regions in many parts of Europe and capital regions surrounded by similar competitive regions.

[15] Similarly, Crescenzi et al. (2016) provide evidence of a negative association between the regional resistance to the crisis in the EU and the extent to which the regional environment is innovation-prone.

[16] Low-growth NUTS-2 regions are among the less developed and transition regions that did not converge to the EU average between 2000-2013 in countries with a GDP per capita in PPS below the EU average in 2013. Such regions are in Greece (11), Italy (8), Spain (5), and Portugal (4). Low-income regions include those with a GDP per capita in PPS below 50% of the EU average in 2013, i.e. those in Bulgaria (5), Hungary (4), Poland (5), and Romania (5) are included for low income.

[17] Besides measurement problems, we acknowledge that it is indeed controversial to maintain that regions, like firms, compete in a zero-sum game. While this interpretation of regional competitiveness has been harshly criticised in the literature (Krugman 1996, Kitson et al 2004), regions do strive to attract high value-added activities. Based on this very idea is the RCI proposed by Dijkstra et al. (2011) and we interpret the index in these terms.

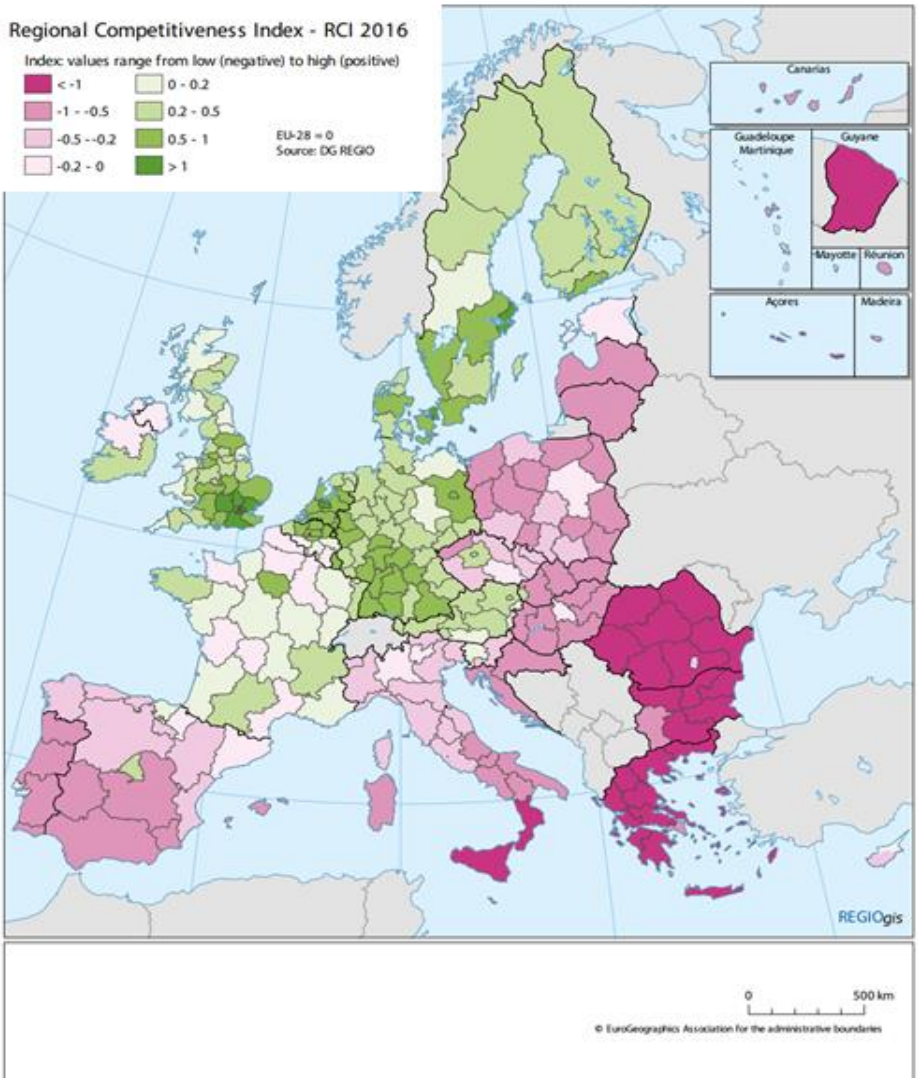

Figure 7. Standardized RCI scores (2016). Figure 1 in Annoni et al. (2016).

The regions' relative positions in terms of RCI are closely related to their relative incomes, but the two concepts are not identical (Figure 8). The differences yield various insights: for instance, to the extent that a better institutional and business environment is conducive to higher growth, a relatively stronger position in terms of RCI may signal potential gains to reap in the future (Fritsch and Wyrwich 2017; Kibler et al. 2014; Westlund et al. 2014). Conversely, the relatively worse performance of all Italian regions recorded in terms of RCI than in per capita income levels can be seen as the by-product of common institutional rigidities and nationwide inefficiencies negatively affecting the business climate and innovation capacity. These examples strengthen the case for considering such measures of the fundamental determinants of growth and competitiveness to envisage the possible evolution of economic convergence in the long term.

Interestingly, greater similarity in terms of RCI can be found among regions across different Member States than within the same country. Lombardia, for instance, is among a varied group of peer regions such as Köln, Bucuresti Ilfov, Oberpfalz, Zuid-Holland, Oberösterreich, Unterfranken, Provincia Autonoma di Trento, Braunschweig, Düsseldorf, Comunidad de Madrid, Valle d'Aosta/Vallée d'Aoste, Noord-Brabant, Tübingen, Mittelfranken and Schwaben. By contrast, Campania is placed in the group consisting of Extremadura, Severozápad, Lódzkie, Latvija, Sicilia, Kriti, Norte, Puglia, Pomorskie, Sterea Ellada, Kontinentalna Hrvatska, Calabria, Stredné Slovensko, Peloponnisos and Malopolskie.

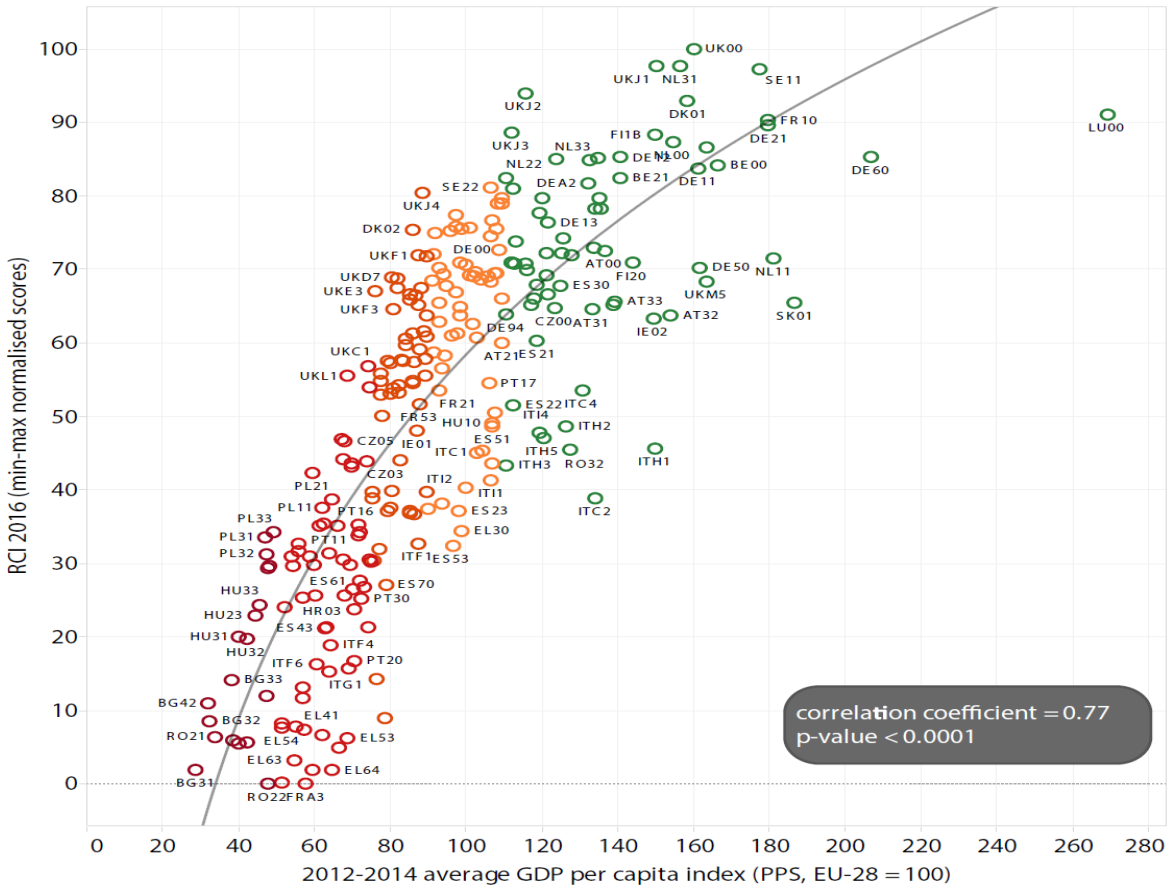

Figure 8. Standardized RCI scores (2016) and GDP per capita index (in PPS, EU-28 = 100, averages 2012-2014). (Figure 3 in Annoni et al. 2016)

Figure 9 maps the standardized scores obtained for the various dimensions of the RCI by these two Italian regions and the EU average. The values for Lombardia are in line with the EU average;

by contrast, Campania lags behind in infrastructures, technology, innovation and institutions. Interestingly, regional differences tend to be long lasting. More precisely, there seems to be evidence of inertia in the 47 lagging regions considered by the European Commission (EC 2017): on comparing competitiveness indices in 2016 with those in 2010, one can observe improvements only in a very few regions, namely Severoiztochen (BG), Ciudad Autónoma de Melilla (ES), Warminsko-Mazurskie (PL) and Algarve (PT). Most of the other regions did not record significant improvements (and almost all the Italian and Greek regions fared worse than in 2010).

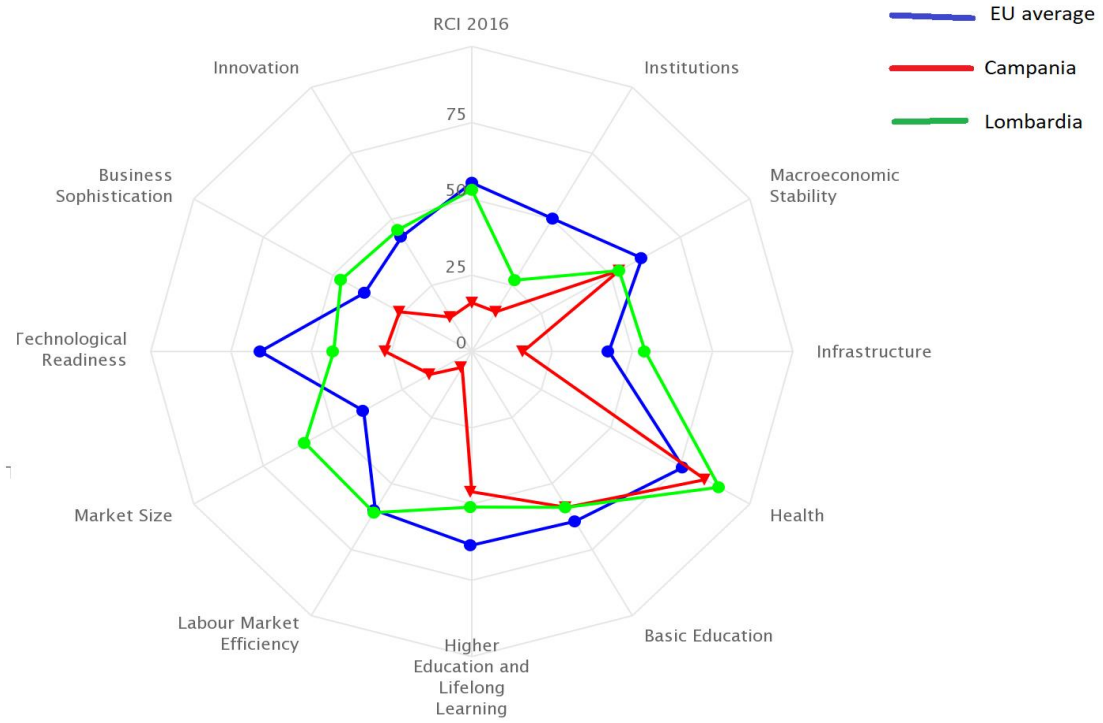

Figure 9. Standardized sub-indices of RCI 2016 scores for Lombardia, Campania and EU average.

This is in accordance with the literature on economic development showing that path dependence affects the relative living standards of different regions, even ones located in the same country (see, for instance, Bleakley and Lin, 2012 and Nunn and Puga, 2012).[18] Path dependence in income convergence is in line with the idea that cultural traits, a relatively persistent phenomenon, tend to

[18] The former find that, despite having lost their original advantages, historical portage sites in the US continue to enjoy a relative importance in terms of industrial activity. The latter, by focusing on the protection that rugged terrain provided to African areas during the slave trade, show that geography can have important effects on income through its interaction with historical events.

affect economic development in the long run (Guiso et al. 2006, 2016; Nunn 2009; Alesina and Giuliano 2015). By focusing on differences among the EU15 regions, Tabellini (2010) shows that historically more backward regions exhibit specific cultural traits such as less generalized trust and respect for others.

These stylized facts strengthen the case for policy interventions promoting radical change rather than fiscal measures providing short-term relief. The risk of relief-oriented measures is that they may entrench the underlying weaknesses. This is a sensitive issue in the Euro area because, as stated by the Italian Minister of Economy and Finance, Pier Carlo Padoan, "a monetary union is dynamically unstable if structural differences persist." (Padoan 2015, p. 274)

4. Regional competitiveness: international value chains and resource misallocation

The self-enforcing relationship among cultural traits, institutional quality and business environment strengthens the case for considering the structural factors affecting regions' competitiveness, interpreted again as the ability to attract and make flourish innovative and competitive firms.[19] This Section will discuss two mechanisms that make cultural traits, institutional quality and business environment such important determinants of regional growth prospects.

The first mechanism to consider the position of the regional economic activities in the international value chains which, only for the sake of brevity, we shall call 'global value chains' (GVC) whenever they exhibit a marked cross-national dimension. The quality-cost effectiveness of the region where firms are located has a remarkable effect on their competitiveness and on their ability to control a larger share of value added along the production chain. Baldwin and Evenett (2015) explain that certain areas can preserve (even attract) valuable activities occupying good

[19] Exploiting regional variation in Italy, Lasagni et al (2015) show that better local institutions help firms to become more productive.

positions in the value chain thanks to favorable local factors: natural advantages (such as geography), external economies of scale and agglomeration rents (associated with firm co-location[20]), high institutional quality, and monopoly power (deriving from patents, copyrights, trademarks, tacit knowledge, and the like) in the downstream links of the chain create above normal rewards to employed factors. It follows that a) the average position of local activities in the international value chains matters for local welfare, and b) that position depends on the presence, or lack thereof, of local features creating a source of local comparative advantage. As pointed out by Brakman and van Marrewijk (2013), forward and backward linkages have become responsible for agglomeration at the task (rather than sector) level, and the comparative advantages of a few large cities in certain stages of the production process may figure among the fundamental determinants of the comparative advantages of entire countries. Dollar et al. (2016) show that differences in the quality of local institutions (down to the city level) explain the diverse abilities of areas to deepen international value chain participation in the production of complex and customized (hence high value added) products, in particular for more contract-intensive stages of production.

It should not be surprising that in the world, and also in the EA, strategic and high value-added tasks related to the intangible-intensive sectors have been concentrated in relatively few places, while lower value-added tasks have been offshored during the process of international fragmentation of manufacturing production that occurred in the two decades preceding the global crisis (Baldwin 2006; Timmer et al. 2013,2014; Esposito 2017). The internationalization of production and the offshoring of low-added value tasks (a process called "nearshoring" in the case of Germany with respect to the Central and Eastern European countries, see Marin 2006,2011) have reduced neither the demand (in the periphery) nor the real retribution (in the core) of low-skilled workers in manufacturing.[21] It follows that European integration and globalization have accelerated

[20] The concentration of competitive firms in an area generates static and dynamic agglomeration externalities, forming a self-enforcing circle. See Fracasso and Vittucci Marzetti (2017) and the references therein.

[21] Giordano and Zollino (2016) also show that the varying extent to which offshored intermediate inputs have been incorporated in the domestic production functions across countries has determined the divergent developments in unit labour costs and producer price indices across EU member states, thereby complicating the assessment of price

and magnified the specialization trends, whose underlying forces can be self-sustained thanks to positive economies of scale. As recognized by UNCTAD, this process is a mixed blessing for those countries and regions placed in lower-value-added stages of GVCs: "Concerns exist that the value added contribution of GVCs is often limited where imported contents of exports are high and where GVC participation is limited to a small or lower value part of the overall GVC or end-product. [..] A large part of GVC value added in developing economies is generated by affiliates of TNCs. This raises concerns that value can be leaked, e.g. through transfer price manipulation. Also, part of the earnings of affiliates will be repatriated" (UNCTAD 2013, p. 148)

The second mechanism of interest in explaining the EA periphery's difficulties in maintaining high living standards and promoting growth regards resource misallocation. While before the crisis low-skilled workers were absorbed across Europe either in the construction sector or in labor-intensive non-tradable services (such as personal and health care, retail, hotel and restaurants, security, public administration), the economic downturn has left many jobless. This had certainly to do with the low interest rates achieved in the pre-crisis period: as shown by Benigno and Fornaro (2014) and Benigno et al. (2015), large capital inflows tend to be accompanied by a misallocation of resources across sectors and firms as consumption booms drive resources into nontradable sectors, thereby reducing productivity growth. Also Gopinath et al. (2017) show that the decline in real interest rates brought about by admission into the EMU led to an increase in the dispersion of the return to capital and to lower total factor productivity in Spain, Italy and Portugal (whereas stable conditions held in Germany, France and Finland). Gopinath and co-authors argue that, especially where financial markets were less developed and size-dependent financial frictions existed, capital tended to be directed towards less productive firms with greater net worth. Reis (2013) provides a thorough description of the resource misallocation observed in Portugal over the decade preceding the crisis. Diaz and Franjo (2016) model the impact of inefficiently high investment rates in

competitiveness indicators. Timmer et al. (2013) provide evidence that between 1995 and 2008 the ability of countries to retain final manufacture goods-related GCV jobs was correlated with real wage moderation.

residential structures in Spain on overall growth and total factor productivity. Fratesi and Rodriguez-Pose (2016) show that 'sheltered' or 'protected' economies, whose growth depended mainly on non-market oriented sectors prior to the crisis, exhibited also the least favorable employment dynamics during the crisis.

The misallocation to which we refer, however, extends beyond the unsustainability of the construction sector bubble. This construction sector-related explanation does not fit the Italian case, where no housing bubble could be observed in the 2000s, and it would imply that no further allocative distortions should have occurred after such bubbles burst. Structural misallocation, in fact, concerns also the ongoing expansion of those service sectors where productivity has grown little and the deterioration of resource allocation across firms within sectors. While the importance of within-sector resource misallocation in explaining the dispersion of productivity and income across regions (both in levels and rates of growth) has gained momentum in the past decade (see Hsieh and Klenow 2009, Bartelsman et al. 2013, Restuccia and Rogerson 2013), most observers have failed to recognize that most service sectors are characterized by low productivity growth and, although they create employment opportunities, they hardly contribute to raising living standards. [22]

There is indeed increasing evidence of considerable resource misallocation across sectors and firms in countries of the European periphery, as well as remarkable differences in the contribution to productivity growth of the service sectors catering to domestic demand.

As regards the latter, Van Ark et al. (2013) show that productivity growth in the service sectors is considerably lower in the Mediterranean countries (including France in the group) and that the recovery after the crisis did not change much. Since most employment and resources are allocated to those sectors, overall productivity is hampered by the relative size of such low-productivity-growth activities. This is confirmed by ECB (2015), which finds that much of the employment growth since 2013 has been concentrated in sectors with relatively low productivity levels. A global slowdown in technology diffusion, moreover, has been particularly pronounced in the service

[22] Bourles et al. (2013) show that market power in upstream industries reduces incentives to improve efficiency and curbs productivity in downstream industries.

sectors in the EA relative to other advanced economies, possibly due to the fact that the gap between frontier and non-frontier firms in the EA widened during the period 2003-2013 (ECB 2017b).

As regards within-sector resource misallocation, the ECB-led research on granular data at industry and firm level has focused on the interaction between institutions and firms' features and performances, and in particular on total factor productivity growth (ECB 2017a). A number of studies, among them Giordano et al (2016), show that the dispersion within sectors of the marginal product of capital was large and grew over time, particularly in the service sectors. This suggests that capital was allocated inefficiently not only across sectors, as explained above, but also within sectors. This may reflect a business environment and an institutional framework (including the legal systems and the public administration) that prevent more productive firms from thriving (see for instance Andrews and Cingano 2014). Although these concepts are difficult to measure empirically, there is evidence that resource misallocation tends to be higher where corruption and cronyism plague the public and private sectors (García Santana et al. 2016 provide some evidence for Spain): this confirms the important relationship among business environment, firms' performances and a region's competitiveness (as previously defined).[23] As discussed above, because both national and local factors contribute to determining the business climate and institutional quality, regional differences are important for gauging the dispersion of economic performances within and across EA countries.

The above-cited studies show also that capital misallocation worsened with the recovery. This strengthens our interpretation that structural, rather than cyclical, factors undermine economic convergence. As observed by Cœuré (2017) on the basis of the results discussed in ECB (2017a), "in Italy and Spain capital misallocation is higher today than at any point in time before the crisis. In other words, the process of reallocation of resources from unproductive firms to productive firms

[23] Notably, Garcia Santana et al (2016) find that heterogeneity in financial dependence, capital structure intensity, skill intensity, tradability, and innovative content are unrelated to changes in allocative efficiency. Similarly, regional differences in wage growth or house price growth appear uncorrelated with the increase in distortions.

during recessions – let's call it the Schumpeterian creative destruction – was not sufficient to boost aggregate productivity during the recovery."[24]

5. A resource-aspiration mismatch and its political implications

The Southern members of the EA periphery exhibit massive labor (and capital) underutilization, together with an inefficient allocation of persons in employment. Unable to furnish an environment suitable for the flourishing of high value-added activities and too costly to attract and retain activities at the low end of the value chain, these areas can be considered among the 'losers' of globalization and European integration. This phenomenon occurs in all Euro area countries, even the most advanced ones, as shown for instance by Malgouyres (2017), who analyses the differentiated impact of exposure to globalization on the French regions. [25] But this phenomenon is particularly apparent in those areas of the peripheral countries that have been hit hardest by global competition because of their economic structure, specialization, institutional quality, social capital and business climate.

As maintained, increasing private and public (foreign) indebtedness and large public transfers within countries have made it possible to conceal such structural problems for a prolonged period of time. In the time span between the introduction of the euro and the onset of the sovereign debt crisis, the abnormal growth of certain non-tradable sectors (such as construction, public services, retail sales) masked the underlying problems in several countries. It was these sectors that shrank

[24] Cœuré (2017) acknowledges that other factors may temporarily contribute to capital misallocation and poor productivity growth: "The crisis, for example, might have restricted access to external finance for financially constrained firms, which sometimes are those with high productivity growth potential. [..] Furthermore, banks typically require loan collateral in the form of tangible assets, such as real estate, machines, etc. This may encourage firms reliant on bank funding to invest more in tangible assets than they would otherwise do. At the same time, research shows that having a greater share of intangible assets is related to a greater ability to create and absorb new technology. But, financial frictions are likely to have been only a temporary factor."

[25] Malgouyres (2017) finds that import competition from China negatively affected local employment. First, there is evidence of a strong effect of direct competition in the manufacturing sector. In particular, jobs destruction is concentrated in the low and medium-skilled occupations. Wages appear to be uniformly negatively affected in the manufacturing sector, whereas wages in the non-tradable sector are affected only in the middle of the distribution (contributing to greater wage inequality and polarization).

the most and dragged employment down because the onset of the sovereign debt crisis and its consequences on private finance led to a rapid and brutal downward readjustment.[26] In several areas, therefore, the level of private wealth and public entitlements enjoyed in the recent past appeared hardly reconcilable with the low quality of institutions, social capital and business climate required to retain high value added activities and activities exposed to global competition.

As said, the direct consequence of the large and persistent structural differences across the EA regions is that the standards of living and the aspirations to which people were accustomed in the peripheral regions seem not to pass the test of sustainability. This tension between resources and aspirations has already surfaced and its materialization includes worse job prospects and lower household wealth in various laggard regions.

The South of Italy, for instance, displays many symptoms of the so-called ”public resources curse”, according to which the permanent separation of a society’s possibility to consume and to enjoy welfare benefits from its capacity to generate income in the long term makes that society addicted to public transfers, thus creating distorted incentives for both ordinary citizens and the local elites.[27] If standards of living were forced to match current productivity, it would entail a major setback in people’s well-being. Yet these considerations hold also for other regions of the EA. People’s aspiration levels in the less productive areas are not significantly lower than those prevailing in the most productive ones. As a result of the growing fraction of total population that attains medium or even high levels of education, there is an increasingly large number of educated people that encounter difficulties in finding “adequate jobs”. High unemployment and inactivity rates, as well as non-negligible emigration rates, among young people are visible manifestations of these problems, often aggravated by a policy-induced segmentation of the labor markets.

[26] It is worth noting that these phenomena have spurred a literature investigating the effect of financial developments on the cyclical and structural component of the business cycle (see Borio et al. 2017).

[27] These considerations go hand in hand with the negative effects exerted on the public finances by regional decentralization in Italy (and in France). Some have argued that the low stock of civic capital in the Mezzogiorno, and therefore the clientelistic and often corrupt habits of the local élites, led in many cases to the wastage of public funds.

As a matter of fact, in the face of lower labor demand due to the crisis, inactivity rates (especially among the youngest people) have massively increased in many peripheral areas and slowed down the market-based adjustment mechanisms at work in other economies; the large emigration and wage compression observed in the Baltic countries contrast with the increase of NEETs and inactivity rates in the peripheral ones.[28] In various countries, furthermore, significant resources have been transferred to social measures targeting (directly or indirectly) the elderly, thereby discouraging labor mobility (because parents and grandparents provide an implicit safety net for the younger members of the household) and shifting additional resources away from productivity-enhancing uses. More in general, numerous groups have protested vociferously against any attempts to reduce entitlements even in the face of unsustainable public finances and large generational and geographical imbalances.[29]

European Social Surveys data provide some evidence about the frustration of aspirations in the various regions. Although no question in the dataset makes it possible to assess whether the levels of aspirations have converged across the European regions, it is interesting to look at how the citizens in different areas answered in 2012 the question: "To what extent do you agree or disagree with the statement 'little chance to show how capable I am'?". Figure 10 reports the percentage of respondents declaring that they agreed with the statement 'little chance to show how capable I am'" for the regions in the core (Germany, Finland, Netherlands), periphery (Italy, Spain, Portugal, Cyprus) and Visegrad countries. The density plot shows some heterogeneity within each bloc, but differences across blocs are even more striking. Notably, in the peripheral countries people tend to feel less positive about their future than in Visegrad countries, despite the latter exhibiting lower average income per capita. Indeed, inspection of the entirety of countries in the Eurozone for which the EES data are available shows that regional GDP per capita in PPS (from Eurostat) in 2012

[28] A special Eurobarometer survey conducted by the European Parliament in 2016 shows that the share of young people feeling that in their country young people have been marginalised by the economic crisis (IT 78, ES 79, EL 93, PR 86, IE 68, CY 81) is much larger than those thinking that they are compelled to leave the country in order to improve their circumstances (IT 26, ES 25, EL 43, PR 41, IE 15, CY 51).

[29] We would like to thank Roberto Tamborini for encouraging us to explore our hypothesis in greater detail.

explains less than 10% of the variation in the shares of population agreeing with the sentence under scrutiny (less than 5% using the values of GDP per capita in 2007).[30]

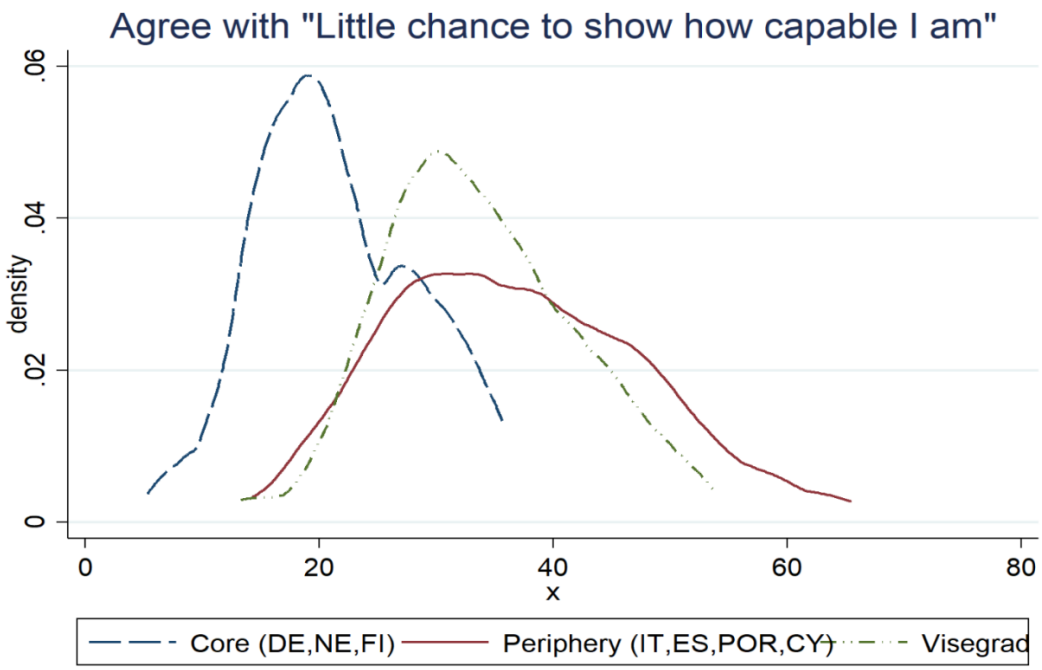

Figure 10. Share of population that agrees with the statement "Little chance to show how capable I am" in NUTS2/3 regions. Own elaboration. Data: European Social Survey (6-2012, ed.2.3).

Further evidence about this phenomenon can be derived from a multivariate analysis of the regional share of population agreeing with the statement 'little chance to show how capable I am' and a number of potential explanatory variables. In particular, among the latter, we consider the regional GDP per capita (in PPS) from Eurostat and the share of people in each region who live with an household income in the lowest three deciles of the distribution (elaborated from the series hinctnta in ESS 6-2012), exhibit little self-confidence (i.e. disagree with the statement 'there are lots

[30] Using the data from the European Social Survey (6-2012, ed.2.3), it can be shown that the share of those with a household income lower than the national median value is, in almost every region, larger than the share of people placing themselves in the lower half of the social scale. A similar finding holds for the share of the population receiving an income in the first decile of the distribution and the share of population perceiving itself at the bottom of the social scale. This pattern is particularly marked in the regions of the periphery where the correlation between these variables is extremely low. These results are consistent with the idea that most people perceive themselves as occupying a position in society that is not in line with their relative income, and this misperception may be associated with a widespread inclination to hold unrealistically ambitious aspirations.

of things I feel I am good at'), feel it difficult to live on present income (variable hincfel in ESS 6-2012), are not 'always optimistic about future' (variable optfr in ESS 6-2012).

The results reported in Table 2 reveal that differences in regional GDP per capita are not relevant *per se* but as a proxy for the regional shares of people encountering income difficulties and feeling scant optimism about the future and their own abilities. Controlling for GDP per capita, regions in peripheral countries exhibit higher shares of population frustrated by not having chances to demonstrate their value; this idiosyncratic result, however, disappears once income-related and general optimism-related variables are included. The results are almost identical using GDP per capita in 2007 rather than in 2012. Controlling for the self-assessment of underlying abilities, individuals are concerned with not being able to express themselves fully, and this is particularly true in the peripheral countries, irrespectively of average income.

	Share of people agreeing on "little chance to show how capable I am"					
	1	2	3	4	5	6
GDPpc 2012	-0.532*** (0.140)	-0.500*** (0.140)	-0.212 (0.148)	-0.187 (0.146)	-0.238* (0.137)	-0.225 (0.137)
Periphery		4.510* (2.444)				-2.841 (3.083)
Share with low income			0.310*** (0.073)	0.213** (0.083)	0.151* (0.079)	0.174** (0.083)
Share with little self-confidence			1.039*** (0.295)	1.006*** (0.291)	0.790*** (0.275)	0.671** (0.304)
Share with income difficulties				0.239** (0.104)	0.137 (0.099)	0.166 (0.105)
Share with little optimism					0.548*** (0.119)	0.585*** (0.125)
Observations Adjusted R-squared	143 0.086	143 0.102	143 0.208	143 0.231	143 0.33	143 0.329

Table 2. Standard errors in parentheses. * p<0.10, ** p<0.05, *** p<0.01. Notes: Periphery is a dummy equal to 1 for Italy, Spain, Portugal, Cyprus, and 0 otherwise. Variables are calculated at regional level. NUTS2 - NUTS3. Data: European Social Survey (6-2012, ed.2.3).

The recognition that entitlements and aspirations have somewhat precarious foundations represents a source of distress and fuels growing animosity towards external "enemies" guilty of not being sufficiently supportive to the laggard regions. This situation, in our view, contributes to explaining part of the success achieved by populist parties (and, more in general, euroskeptic

movements, as shown by Nicoli 2017) blaming the central governments, the European authorities and the core countries for what is, in fact, the by-product of a long-standing mismatch between efficiency and productivity, on the one hand, and standards of living and aspirations, on the other.[31]

This conjecture leads to a tentative and provocative hypothesis: the competitiveness imbalances across regions in the EA have determined an unequal spatial distribution of high value-added activities and "good jobs", in contrast with the tendency towards the equalization of workers' education levels and aspirations. If not adequately addressed, this creates fertile ground for the rise of populist claims and probes the sustainability of the Euro project.

Notably, the mismatch between the private wealth and the social entitlements experienced in the past and expected for the future, on the one hand, and the actual performance in terms of competitiveness and growth fundamentals, on the other hand, is directly related to various political debates about the EMU. As explained, it is associated with the perception of the differentiated impact of the Euro on the regions, whereby certain countries are perceived as having gained an allegedly unfair advantage and others, deprived of control over the exchange rate, have struggled to keep up with global competition.[32] But the mismatch has also to do with the perceptions about the distributive consequences of participating in the European integration process and in the EMU for sectors, firms and individuals; in the post-crisis period, in particular, the specific trade-offs imposed by participation in a monetary union generated some of the typical political conflicts over the distribution of the adjustment burden within countries that were observed in previous debt and balance-of-payments crises around the world (see Copevelich et al. 2017, Frieden and Walter 2017).[33] Moreover, the emerging distributional conflicts between payer and recipient countries in

[31] Economic-related issues are only some of the various determinants of the success of populist parties in Europe. Caiani and Graziano (2017) show that the emergence of populist parties is better explained by political determinants, such as institutional mistrust. Inglehart and Norris (2016) find evidence in favor of the cultural backlash thesis, according to which in European countries there has been a reaction by predominant sectors of the population against "progressive" values, with the emergence of anti-immigrant attitudes, support for authoritarian values, and the like.

[32] It has been observed by some that Germany benefited from an external value of the euro that did not fully reflect the differential in economic fundamentals between Germany and the non-euro countries, due to the fact that the external value of the euro depends also on the fundamentals in all the other Eurozone countries.

[33] For a discussion of the political economy of national debates, we refer to Bonatti and Fracasso (2013) and Bonatti and Fracasso (2017) for Germany (or to Matthijs and McNamara 2015 for an alternative take), Featherstone (2015) and

the EA has plagued the debate on the correct sequencing between greater solidarity (i.e., cost and risk sharing) and more responsibility (i.e., reforms and fiscal consolidation), negatively affecting the speed and the effectiveness of the reforms of the architecture of EMU (Copelovitch et al. 2017). As effectively put by Cœuré, "convergence is also a political prerequisite to engage in a discussion on any new public risk-sharing mechanisms – just like John Rawls pointed out with his concept of the "veil of ignorance" (Cœuré 2017).

To be stressed is that we refer to widespread perceptions about the unintended consequences of the Euro, not to actual causal mechanisms. Italy and Germany have experienced long lasting large regional disparities and tried to cope with them through fiscal transfers with mixed success since well before the introduction of the Euro (Streeck and Elsässer 2016). Notwithstanding generous resources transferred to equalize living standards, regional inequalities persisted. The structural weaknesses discussed above have always been a drag on regional economic convergence both before and after the introduction of the Euro. Similarly, a large comparative political economy literature on the Euro area focusing on the varieties of capitalism has shown the existence of a persistent cleavage between the export-oriented, skill-intensive, coordinated market economies (with coordinated wage-bargaining, patient capital and corporatist-etatist socio-economic models), on the one hand, and demand-driven countries with large public sector and antagonistic unions, on the other hand (for a comprehensive overview see Iversen et al. 2016). This cleavage was made evident, but not created, by the crisis and the (debatable) approach adopted to address it.

This notwithstanding, the current debate has dangerously evolved so that most people in the periphery think harder about how to reverse the recent external shocks (globalization and euro) and to design mechanisms for cross-national fiscal transfers than about how to address the structural features underlying the weaknesses of their local economies.

Afonso et al. (2015) for Greece and Portugal, and Fernández-Albertos and Kuo (2016) for Spain. It is worth noting that the evolution of poverty and inequality across different age-, job- and nationality-based groups has been as extremely diversified across and within EU countries, resulting from the interaction of different underlying structural problems, a differentiated impact of the crisis, and of austerity measures varying in accordance with domestic political economy forces (Walter 2016).

6. Addressing the EA competitive imbalances in a consistent way

Given the economic and political analysis conducted so far, it could be argued that higher public investment is a very suitable form of fiscal expenditure with which to address such a complex situation: it is conducive to "good jobs" for both skilled and unskilled workers; it enhances productivity and technology and long-term growth prospects; and it improves the capacity of a region to attract competitive firms. This course of action, however, demands time and fiscal space: large investment requires adequate planning, implementation and financing, and the EA periphery has never stood out in this respect. Hence, while reasonable, the strategy of pushing investment in the periphery requires addressing the very problems that have kept these regions back: solving the bottlenecks in administrative capacity, addressing local political discontent and interest groups, solving financing problems, and mobilizing the remaining forces operating in the private sectors. Although meaningful, "more-investment in the periphery" is a recipe that, *de facto*, assumes the problems away.

Domestic public spending may also have a role in theory. State interventions are essential to provide basic public goods—like law enforcement, property rights protection, good infrastructure and quality education—that are often in short supply in the laggard areas. Favorable tax treatments, moreover, may help to counterbalance, at least partially, the unfavorable socio-economic environment in which firms have to operate. Nevertheless, these interventions cannot substitute for the need to ensure a cost structure that may offset the comparative disadvantages of these low-competitive areas and induce competitive firms to locate in their territory. If the structural features that constrain long-run growth in these areas are not properly tackled, expansionary fiscal policy boosting their local demand cannot but amplify their external imbalances.

If fiscal stimulus in the EA periphery is unlikely to work as expected, higher domestic investment in the core regions, it is argued, could do the job. As explained in Section 2, higher investment in

Germany could have positive and significant spillovers in the rest of the EA. While the short-term effects of an extraordinary investment plan in the core countries would certainly provide some relief to the periphery and help to soothe political tensions, they would paradoxically strengthen the long-term growth prospects of the core countries and contribute to increasing the gap in the fundamentals across the EA. Moreover, domestic constraints in the core countries must be considered as well: over recent years, the German economy has for example been close to full employment and any large stimulus would have caused large inflows of immigrant workers, produced non-negligible increases in production costs of the tradable sector and run counter to the prudent fiscal patterns necessary in rapidly ageing societies.

The additional risk associated with a European plan to increase investment in the core with a view to increasing aggregate demand in the periphery is that the fiscal stimulus may sooner or later be transformed into a system of fiscal transfers and cross-regional redistribution within the Eurozone. A system of fiscal transfers would certainly make it possible to "cover", though not solve, structural regional imbalances, as happens in other federal countries such as the USA (see Poghosyan et al 2014 and Furceri and Zdzienicka 2015).[34] As suggested by Obstfeld (2013), financial shocks in a monetary union, in particular, require common tools to react to them and, by working on financial vulnerabilities and cross-national integration, prevent them from jeopardizing individual countries and segmenting the EA banking and financial sectors. To the extent that transfers are not too large, too politicized and too evident, a fiscal transfers mechanism may be necessary to preserve macroeconomic stability within a highly heterogeneous monetary union: given the heterogeneity of the members in a monetary union and considering the nature of the possible idiosyncratic and common shocks hitting them, the amount of solidarity necessary follows (Schelkle 2017).[35] While reasonable *per se*, this approach is at odds with the logic underpinning the original framework of economic governance in the EA, whereby policy coordination falls short of

[34] On the role of federal transfers within a monetary union we refer, among others, to Evers (2012, 2015). On the multifaceted issues associated with the creation of a EU stabilization fund, we refer to Farvaque and Huart (2017).

[35] Put another way, whether structural disparities and imbalances are excessive or not depends also on the system's capacity to withstand them, which is in turn determined by institutional and cultural factors.

any systematic redistribution of resources (Copelovitch et al. 2016).[36] As observed by Cottarelli (2016) on the basis of the research carried out at the IMF (see Cottarelli and Guerguil 2014), the key differences between the fiscal institutions in the EU and in other fiscal federations arise exactly from the lack of a Union budget, which EU members deliberately chose not to enlarge with the extension of EU competences and the deepening of economic integration to preserve national sovereignty and responsibilities.[37] It has been argued that the risk sharing and fiscal transfer mechanisms in the EA are not in line with the amount of monetary solidarity necessary to keep very heterogeneous regions within the monetary union, and that the EA founders created an intrinsically flawed set-up for the EA (Schelkle 2017). While theoretically plausible, this argument does not take account of the fact that any institutional design of the EMU has to be viable under the existing political constraints in the core countries and that these constraints are associated with the persistent failure to address the cultural, institutional and economic weaknesses that undermine economic convergence in the periphery. To paraphrase (Cœuré 2017), there is no veil of ignorance as to what peripheral regions will most likely keep lagging behind, and this is undermining any regime change in terms of EA-wide risk-sharing mechanisms. As Sapir (2016) noted "In political terms, this suggests that the acceptance by (some) EZ countries of steps towards a fiscal union will only be possible if (other) countries undertake major structural reforms."

7. Closing remarks

Recognition of the key role played by structural differences in affecting income and growth differentials and competitive imbalances across EA regions could improve the debate on policy coordination and redistribution because it would facilitate the accumulation of mutual trust among EA countries. As correctly observed by Pier Carlo Padoan, a virtuous circle is possible: "preventing

[36] On the two pillars (rules and coordination) that historically characterize economic governance in the EMU, we refer to Pisani-Ferry (2006).
[37] The creation of the ESM can, to a certain extent, be seen as an ad-hoc exceptional alternative to the creation of a stable Union budget to alleviate serious financial problems at the country- and Union-level.

moral hazard [via abiding by rules] strengthens mutual trust and supports mutualisation. Risk sharing and mutualisation offer a powerful incentive to abide by the rules and prevent opportunistic behaviour" (Padoan 2015 p. 276). Recognizing and addressing structural imbalances is therefore essential to make further steps towards further political union and greater risk sharing. Also Cœuré (2017) is optimistic in saying that "reforms that aim to improve the quality of institutions can help unlock the productive potential of our economies and can provide the basis for a renewed process of real economic convergence – a process that would not only strengthen social cohesion but also the belief in the benefits of our currency union."

This might be true, but we would like to draw a less optimistic conclusion from our analysis. To the extent that certain competitiveness imbalances find their determinants in cultural and institutional problems, no simple and rapid solution addressing the abovementioned problems is easy to find. Temporary fiscal stimulus may soothe political discontent, yet it does not produce permanent improvements and risks antagonizing payers and recipients across and within countries. Structural reforms are necessary to engineer radical change, but they have upfront costs and short-term negative consequences and may feed the distributional conflicts at the national and local levels, crossing the threshold of social tolerance. Permanent cross-national transfers may provide local relief but also exacerbate the tensions among the Member States without solving the underlying problems. As pointed out by Copelovitch et al. (2016) "conflict among EU member states has threatened the progress of European integration, while polarization and unrest have unsettled domestic politics in a host of European countries."

The role of Germany in this context is also worth discussing briefly (more in Bonatti and Fracasso 2013, 2017). While it might be reasonable to argue that Germany has not acted as a benevolent hegemon in the EA (see Paterson 2011, Bulmer and Paterson 2013, Bulmer 2014), the German stance clearly amounts neither to a 'beggar-thy-neighbor' policy nor to a sort of 'social dumping' damaging EA partners: it has instead reflected the country's reasonable efforts to improve its position in the international division of labor by retaining and attracting high added-value

activities, along the lines of what was discussed above. Accordingly, while the large external surpluses that Germany records year after year may signal too limited domestic investment (associated with outflows of capital) and a very prudent fiscal policy, they are not *per se* indicative of non-cooperative behavior with the other countries in the EMU. This accusation would otherwise entail that any gain in competitiveness, achieved through improvements in the institutional and economic systems, should be forgone in the core countries out of an undefined duty of solidarity towards other peripheral Member States. Such a position would galvanize the populist and euroskeptic movements in the core as much as the recession triggered by the European debt crisis did with those in the periphery. The political debate, in our view, should rather focus on how to address competitiveness imbalances across the regions in the EA in the face of a tendency towards an equalization of people's aspirations, whose failure is fuelling discontent and animosity against the EU institutions and rules, as well as the core countries. The risk is thus still that the one identified by Tsoukalis some years ago: "Europe runs the risk of becoming a victim of complexity in times when mass politics turns into populism and simple messages" (Tsoukalis 2011, p. 21).

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