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The elephant in the room

A critical review of Draghi's
competitiveness strategy for Europe

The European Commission (2024) has described the Draghi Report, as the “way forward for EU’s competitiveness”. This paper critically discusses the main issues raised by the report, both empirically and theoretically.

This paper does not represent the view of the European Parliament
or any other institution of the European Union.

Abstract:

The Draghi report – officially entitled “The future of European competitiveness” – calls for more investment in the EU. The EU is indeed in great danger of falling behind due to a lack of public and private investment. But the Draghi report's analysis of a productivity gap with the US does not stand up to scrutiny. First, the gap is not in manufacturing but in information and communication technology (ICT), including financial services. However, productivity growth in ICT is difficult to measure. Indeed, in some areas the financial sector may have a negative impact on real economic activity and employment. Certainly, the rise of ICT and developments such as artificial intelligence (AI) are having an impact on the economy. But a significant contribution to growth and employment requires the application of ICT to manufacturing. Yet the US is hardly a model of successful industrial development. In the 2000s, the US lost one in three manufacturing jobs. Average annual productivity growth in US manufacturing was negative in the 2010s.

The European Commission suggests that the investment gap identified in the Draghi report could be closed through the Capital Markets Union. However, the main obstacle to business investment in the EU is lack of demand, not lack of finance. The EU should therefore work towards using the public sector to crowd in private investment. This could provide European citizens with world-class public infrastructure and attract technological innovation. The elephants in the room are the EU's restrictive fiscal framework and austerity in the largest EU economies, such as Germany and France, which are at odds with an investment push. A pragmatic solution could be a temporary suspension of the Stability and Growth Pact, as during the Covid 19-crisis, in the face of an economic crisis caused by geopolitical and other shocks. A more ambitious but still pragmatic solution could be a golden rule of investment with EU oversight on the definition of investment. The ECB should support public investment as a guarantor of sovereign debt.

Keywords: Draghi report, industrial policy, capital market union, Euro Treasury, European integration, European Union

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1. Introduction

The European Commission asked Mario Draghi to present a report on European competitiveness. The report, presented on 9 September 2024, contains strong language and stern warnings about the EU falling behind and risking its economic future. The main body of our paper is divided into three sections. The first section examines the theoretical underpinnings of the Draghi report. This is followed by an examination of the empirical claims. The final section provides a summary of the arguments and a discussion of the political feasibility of the proposed policies.

2. Competitiveness – a contested concept

Many economists are very critical of the concept of competitiveness - at least when it refers to whole economies. The trade economist Krugman (1994) called it a “dangerous obsession”, so we should examine the report closely. Standard economic theory sees international trade as a positive-sum game that creates win-win situations. More recent approaches, such as New Trade Theory, are more realistic and allow for scenarios where one country gains from trade and another loses (zero-sum-game). One recent example is the “Nobel laureate” in economics Angus Deaton (2024) who retracted from his past views on the benefits of free trade (and other key concepts of standard textbook economics) with a prominent article published prominently by the International Monetary Fund (IMF)¹. Others see exports also as a cost (Wray 2024, 239 ff.), as foreigners consume some of the output, leaving domestic workers worse off. The gains from trade would go largely to the exporters, who receive monetary income. Competitiveness seems therefore not a reliable indicator for the “wealth of nations”.

**“Price competitiveness is
a very spurious measure
of economic well-being!”**

Many economists would point out that it is not only supply-side factors that drive productivity and competitiveness. The demand side may be even more important and creates important feed backs to the supply side. Firms produce what the market demands. The higher the demand, the higher the output of the firm. The higher the output, the more the firm will invest in capital goods. Dividing fixed costs by increased output, average costs fall as productivity rises. As the famous classical economist Adam Smith already knew, it is the size of the market that drives labor specialization and hence productivity. If this is the case, then Draghi may have put the cart before the horse. Higher productivity is a result of the spending and incomes that determine GDP. If GDP is determined by expenditure, as macroeconomics defines it, then productivity cannot determine GDP but is a residual. This does not mean that higher productivity is not good for the economy. It means that to sustain a positive nexus between higher productivity and economic activity, requires sufficient demand.

¹ In fact the Nobel prize in economics is not a true Nobel Prize <https://www.nobelprize.org/nomination/economic-sciences/>. See Offner and Söderberg (2017).

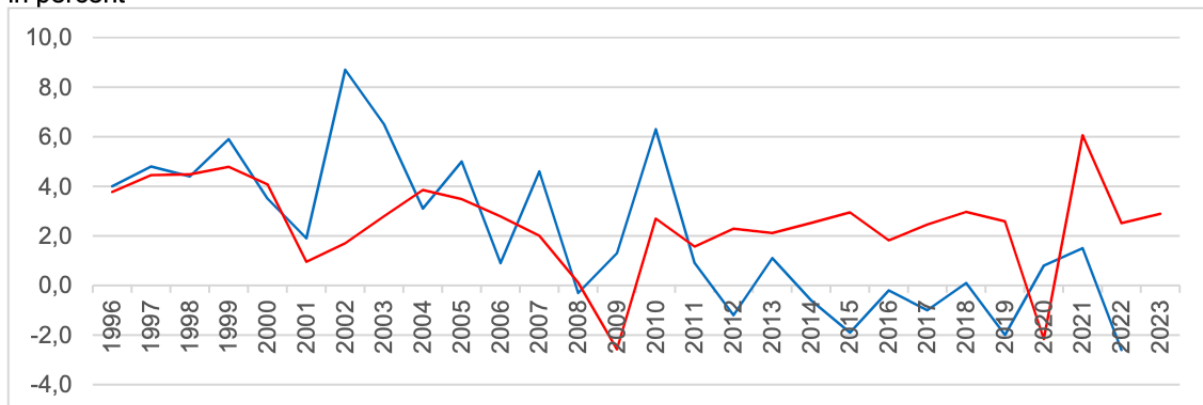
“The demand side has a significant impact on investment and productivity and hence on “competitiveness”

2.1 Empirical claims: productivity and real GDP growth

Moving from the theoretical to the empirical dimension, the report is far from clear in its analysis of productivity data. The productivity gap between the EU and the US is central to the report. According to Draghi (2024, 3), “technological change is accelerating rapidly”. The productivity gap is “largely explained by the tech sector”. Figure 1 shows that labor productivity growth in the US manufacturing sector has been declining for decades and turned negative in the 2010s. While the tech sector is certainly important, Europe's manufacturing sector is more important in terms of size (employment and output). Therefore, not only (labor) productivity seems to determine competitiveness. In the technology sector, network effects play an important role. The usefulness of an electronic platform increases with the number of users. The firms that can capture the market first may be impossible to dislodge, regardless of their productivity. Winner-takes-all competition calls for tougher regulation to break up monopolies that stifle innovation.

“Labor productivity growth in the US manufacturing sector has often been negative!”

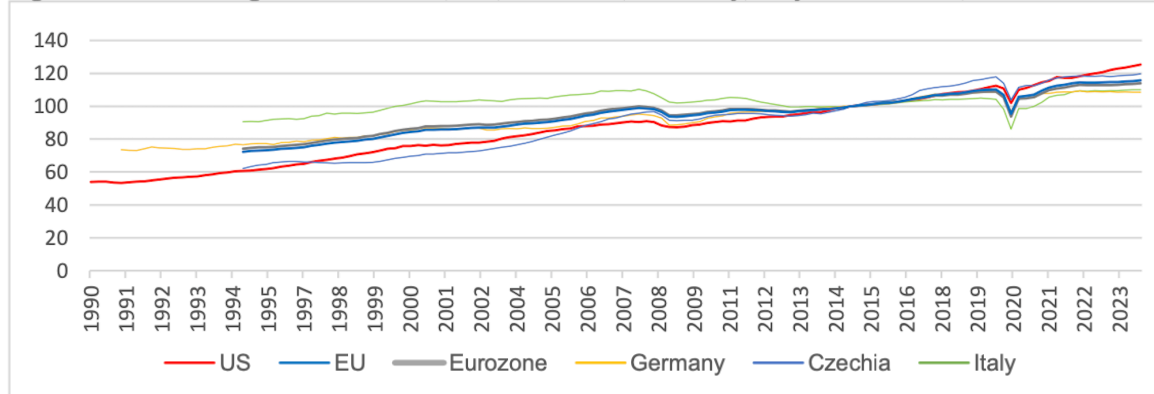
Figure 1: US Labor productivity growth in the manufacturing sector (blue) and real GDP growth (red), in percent



Source: BLS (MPU9900063), BEA (A191RX)

The report begins by lamenting that Europe has been experiencing “slowing growth since the start of this century” (Draghi 2024, 3). Various strategies have been tried, but the trend remains. A large GDP gap has opened up between the US and the EU, with real disposable income in the US growing twice as fast as in the EU since 2000. While these claims are true, they do not take into account that the European Union (“Europe”) is made up of different countries with different rates of economic growth and other characteristics. Figure 2 shows the real GDP growth rates for the US, the EU, the euro area, Germany, Italy and Czechia. The US leads the way, but Czechia is close behind. The EU and the eurozone are growing at a slower pace than the top two, while Germany and Italy have fallen behind as members of these two groups.

Figure 2: Real GDP growth in the US, EU, Eurozone, Germany, Italy and Czechia, Index 100=1995

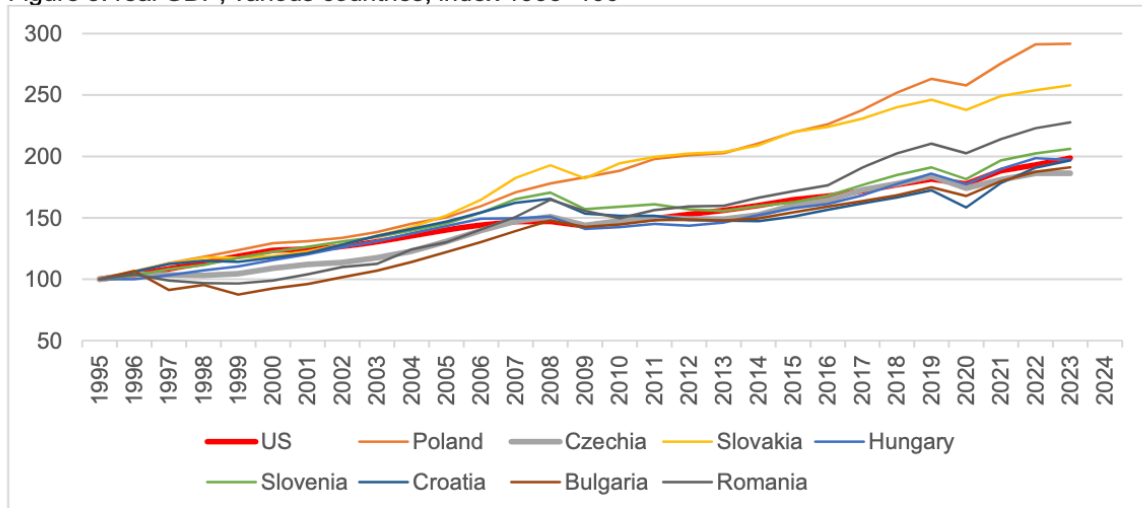


source: BEA (A191RX), Eurostat

Other countries, mainly in Western Europe, have also fallen behind. However, the Central and Eastern European countries (CEECs) have performed as well or better than the US, as Figure 3 shows. Slow economic growth since the beginning of the century may apply to the European Union as a whole, but certainly not to the CEECs. This means that the report should focus on the older Western European Member States rather than the whole of Europe.

“The growth gap with the US exists in Western Europe but less so in Eastern Europe”

Figure 3: real GDP, various countries, index 1995=100

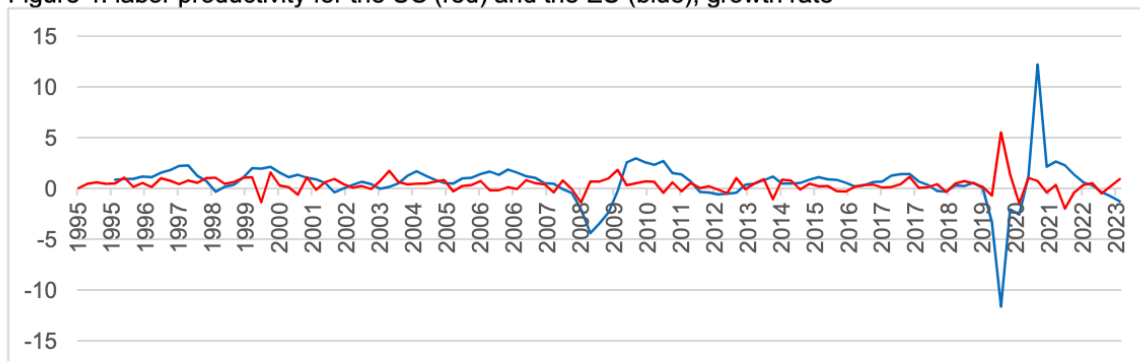


Source: BEA (A191RX), Eurostat

If the supply side or productivity data cannot sufficiently explain growth differences, then the demand side is the prime suspect for weak economic growth. As President of the ECB, Mario Draghi was responsible for monetary policy in the euro area from November 2011 to October 2019. As the ECB was also part of the troika, he was also partly responsible for demand policy, hampering structural reforms and austerity in some member states for a few years (Braun et al. 2024). Draghi (2024,10) states that growth in the EU has slowed “driven by weakening productivity growth”. Returning to Figure 1, this is an empirical claim that needs to be examined, as the US economy has grown in the 2010s while experiencing mostly negative productivity growth.

“The US economy grew despite negative productivity growth. Hence, productivity cannot explain the growth difference!”

Figure 4: labor productivity for the US (red) and the EU (blue), growth rate



Source: OECD (ULQELP01)

Figure 4 shows that US (red) and EU (blue) labor productivity growth, estimated in terms of unit labor costs, do not diverge significantly. There is no sign that the US economy is pulling away from the EU economy in terms of labor productivity. There is a lot of volatility in the data around the years of the pandemic. It can be expected that labor productivity in the US rose more than in the EU in 2020, because of the rise in unemployment in the US. As in most recessions, firms fire those workers who contribute least to the actual production of output first in an attempt to cut costs and survive the downturn. This shows up in the data as a rise in labor productivity, because the same output (or a little bit less) is produced with less working hours. In the EU, furlough schemes were commonplace and industrial workers often kept their jobs.

“Labour productivity in the US and the EU do not diverge much”

The latest data [MPU9900063] available from the Bureau of Labor Statistics shows, however, that labor productivity in the US manufacturing sector was negative in 2022 at around three percent. It seems prudent to wait for data revisions before concluding that a productivity gap would have opened up between the US and the EU. It is reasonable to expect that the recent strong GDP growth under the Biden administration and the widening growth gap when compared to Germany and Western Europe will in the near future also show up in productivity data. However, such effects may be more plausibly associated with fiscal stimulus (Inflation Reduction Act) rather than a persistent long-term trend.

“For Draghi the ICT sector is the key driver of US productivity. But “productivity accounting” of the ICT sector is very problematic. To have a lasting impact ICT must connect with manufacturing.”

Draghi (2024, 23) singles out the ICT sector: professional services, finance and insurance. These sectors are special in terms of productivity (and GDP). They were mostly not included in the calculation of GDP until the 1970s (Assa 2016, 2018). However, the politics of financialization has led the US to push for new accounting standards and measures of economic output. Now that they are included, they are mostly imputed. The BEA (2008) writes:

“Another important imputation measures financial services provided by banks and other financial institutions either without charge or for a small fee that does not reflect the entire value of the service. Examples are checking-account maintenance and services provided to borrowers.”

Additionally, it is far from clear whether a rise in financial services at the individual level leads to a rise in value added at the societal level. In the case of rising inequality, assets are shifted towards the rich. Why the financial services that enable this shift should increase GDP is a very good question. In addition, replacing public services provided for free (public education) or at subsidized prices (public transport, public housing) with private goods and services which then increase GDP might not increase well-being in the society at all. The same goes for higher house prices and rents, which increase GDP but might not change the quality and quantity of housing.

Financialization can increase economic fragility and have significant long-term negative effects on real economic activity (Tran 2023, Tori and Onaran 2017). For example, the financial sector engages in rent seeking and thus extracts income from economic production (Coutts and Gudgin 2015). Moreover, a shift towards short-term shareholder value can crowd out long-term corporate spending on R&D. Finally, without central banks acting as lenders of last resort, as in the early stages of the euro crisis, panic in financial markets is often addressed by cutting government spending, thus hurting investment and growth.

“Financialization can hurt growth and the there are major problems with measuring productivity in finance.”

Moreover, there are major problems in determining the productivity of the banking and financial system. Assa (2015, 9) notes that “the reported productivity of the financial sector is more of a statistical artifact than a real phenomenon.” Related to this finding is the empirical observation that the coefficient of correlation between the share of value added and the share of employment is negative for both financial intermediation and real estate services. A higher share of value added is correlated with a fall in the share of employment in these sectors. One way to explain this empirical observation would be to “find” a strong increase in labor productivity, but this is completely unrealistic and inconsistent with the anecdotal evidence.

2.2 Empirical claims: productivity and manufacturing

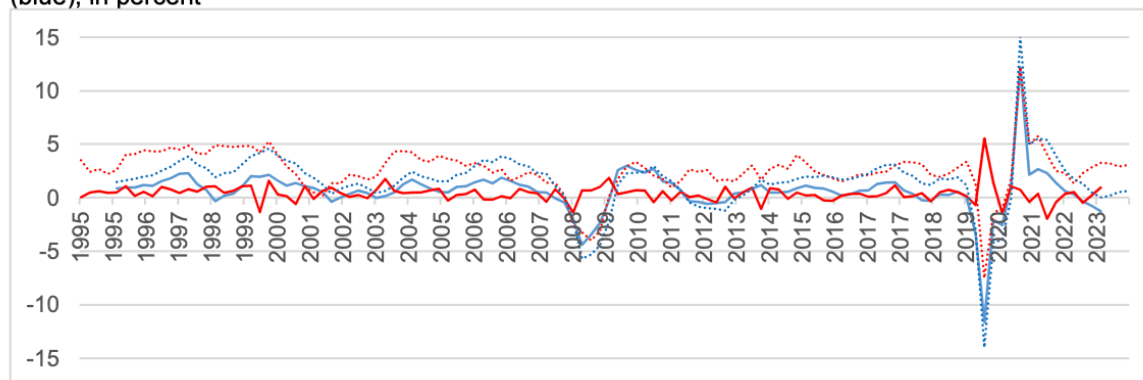
Looking at the labor productivity data for finance and insurance in the US, one is left none the wiser. Labor productivity there averaged minus 1.1 percent from 2010 to 2019. It was -4.1 percent in 2020, then jumped to 11.2 percent in 2021, before falling back to -7.2 percent in 2022. It then rebounds to 5.8 percent in 2023. While the four-year average is 1.4 percent, the data hardly inspires confidence.

Figure 5 compares the rate of change of labor productivity and real GDP in the US (red) and the EU (blue). There is little difference between the two. The biggest difference concerns the

return to growth after the Global Financial Crisis (GFC) of 2008/09. While the US literally threw money at the economy with an \$800 billion fiscal stimulus to get the economy going again, the EU imposed austerity on countries with “excessive deficits”. This led to a recession in the EU caused by a lack of government spending and economic reforms aimed at reducing wages in both the public and private sectors.

“The main difference between the US and the EU: The US threw money at the economy during the financial crisis while the EU prolonged the crisis via austerity.”

Figure 5: change in labor productivity (solid) and real GDP (dashed) for the US (red) and the EU (blue), in percent

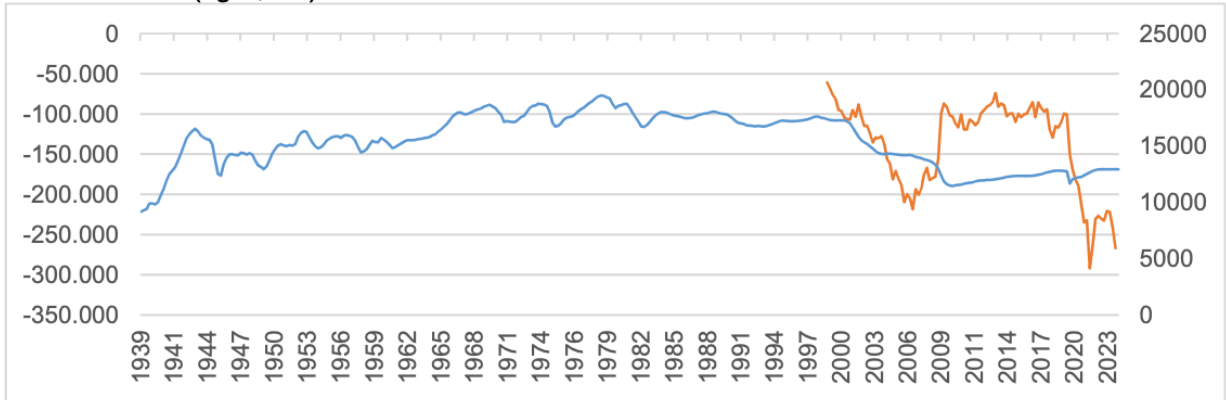


Source: OECD, BEA and Eurostat (real GDP)

According to the Draghi report, higher productivity leads to higher competitiveness, which then leads to more employment at higher wages. However, at the beginning of this century, the US experienced the sharpest deindustrialization in its history. In January 2000, the US manufacturing sector employed 17.3 million people (see Figure 6). By December 2009, that number had fallen to 11.5 million. Nearly 6 million manufacturing jobs were lost in a decade—nearly one in three. This job loss was accompanied by a current account deficit as imports of goods and services replaced domestic production. The timing is no accident.

**“What if Draghi got the story wrong?
What if higher demand leads to more
investment and growth in productivity
and not the other way round?”**

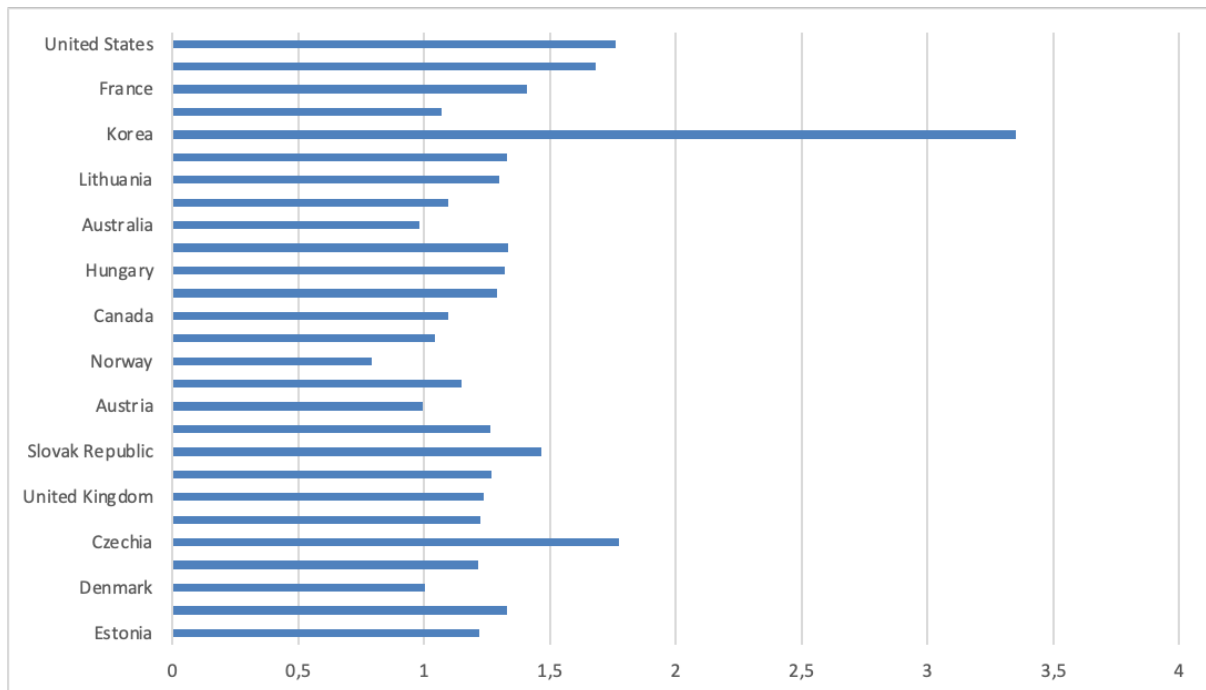
Figure 6: Employees in US Manufacturing, in thousands (left, blue) and balance on the US current account in USD (right, red)



Source: BLS, BEA

In 2004, the US media debated whether Wal-Mart, which was replacing US manufactured goods with cheaper Chinese imports, was good for America (PBS 2004). US manufacturing has only partially recovered in the 2010s. This development gave rise to the “Make America Great Again” (MAGA) movement supporting Donald Trump. Therefore, the US cannot and should not be seen as a role model for the EU. It has consistently shown weak productivity growth and its manufacturing base shrank by a full third in the first decade of this century.

Figure 7: Labor productivity of information industries relative to other non-agriculture business sector activities



source: OECD, <https://goingdigital.oecd.org/en/indicator/01>

Draghi (2024, 23) notes that excluding the ICT sector, EU productivity growth has exceeded that of the US. His Box 2 promises a “closer look at the role of the ICT sector”, but no data points or sources are given. OECD data show that the US does have higher productivity in this sector, but the gap is not that large (Figure 7). Also, Korea seems to be the technological leader, not the US. In summary, the US-EU productivity gap seems to be an optical illusion, and trying to pin it down does not sharpen the picture.

“It is highly doubtful that the European Union can use the vague concepts of productivity and competitiveness to design policies that advance economic activity for the benefit of EU citizens.”

The problem seems to be that Draghi sees productivity and competitiveness as a means to an end, i.e. GDP growth. However, investment drives productivity and economic success and not the other way round. There is a lot of anecdotal evidence suggesting the EU falls behind on key innovations such as Artificial Intelligence (AI). AI requires a lot of initial ICT investment and hence tends to favor Big Tech firms such as Apple or Facebook with big data sets. Big Tech firms can penetrate different markets and create new ones, benefit from oligopolistic market power, prevent market entry of competitors and spread the high innovation costs over a larger customer base. However, even AI is not an end to itself but delivers its commercial benefits to a large part from applications in manufacturing such as data technology in cars. Hence, AI without a solid manufacturing base is unlikely to support the broader economy.

In the next section, we will examine the link between productivity/competitiveness and GDP growth and broaden the debate to include other objectives of economic policy, namely the provision of private and public goods to enhance the social welfare of European citizens.

3. Theoretical foundations

“Europe’s need for growth is rising.” Draghi (2024, 3) is sure that (economic) growth is what drives our economy and allows us to overcome scarcity. If we do not become more productive, writes Draghi, “we will be forced to choose”. A leader in new technologies, a beacon of climate responsibility, an independent actor – all of them would be unattainable without growth. The same goes for our social model. This view of the economy is quite peculiar because it assumes that production takes place first and then goods and services are distributed. A modern monetary economy works the other way around.² Demand for goods and services translates into production, which is produced for monetary profit by private sector firms (Levy et al. 2008). These are generally not constrained by the scarcity of factors of production, but by the demand for their products.³

² This is not a coincidence. Neoclassical economics, the school of economics that Draghi belongs to, has its roots in the 19th century. The role of the state was very small then and the economy was mostly agricultural. Only what was produced could be distributed, and a certain amount of demand from the state would not have increased production, but just redistributed resources from the private to the public sector.

³ Eiteman and Guthrie (1952) showed early on that companies faced decreasing average costs when expanding output, meaning that the supply curve should slope downwards and not upwards. Today’s problem with sustainability, climate change and other issues are largely caused by the fact that companies can almost always increase production. If they run out of one input, they usually innovate around that input.

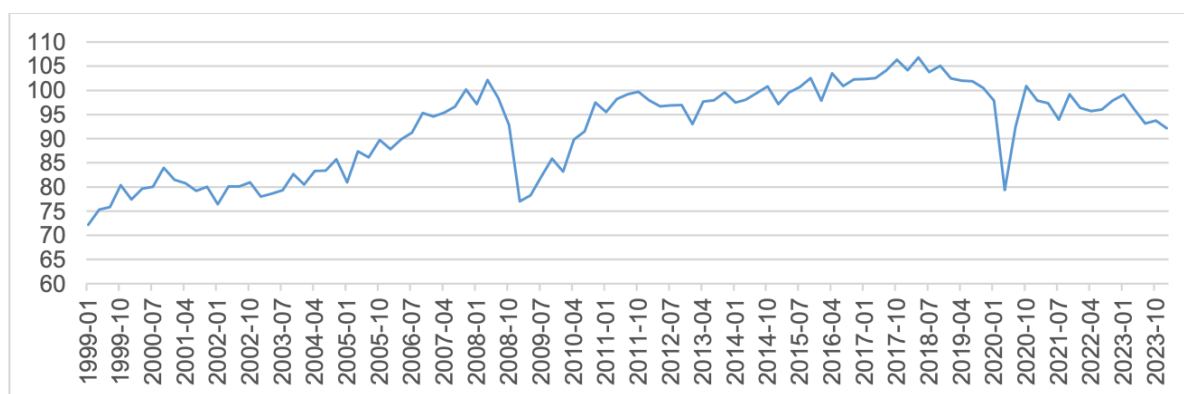
“Modern economies feature companies whose production is to a very large extent limited by the demand for its products, not by resource or finance constraints.”

Verdoorn (1980), building on neoclassical growth theory (see footnote 3), finds that output determines productivity. This finding is known as Verdoorn's Law. An increase in total spending in the economy leads to an increase in output, as long as firms are not constrained by a lack of resources. An increase in output leads to increasing returns to scale on the shop floor and possibly other positive effects in the form of spillovers and linkages to other firms. In other words, the larger the output of a factory, the more profitable it is to use machinery. Since machinery is a fixed cost, average costs will fall as output rises. If firms compete, lower costs will eventually translate into lower prices, even if imperfectly.

Economic growth and development over the decades means that both supply and demand play a role. Logically, it is the expansion of demand that causes supply to increase. Serious economic crises result when demand falls, as output shrinks and unemployment rises. Economic crises do not usually result from a fall in supply caused by problem within the production side. Since the time of Malthus (1766-1834), the Malthusian “devil” of lack of food and energy has been chained (Garcia 2017). Only in times of war did supply (resource) constraints become binding, and a shortage of labor, energy, or primary products translated into lower output of consumption goods. Modern macroeconomic models have long since accepted this and forgotten about the Malthusian devil.

The supply chain problems and the disruption of European access to Russian energy are real problems. The economic sanctions against Russia do not weaken considerably its capacity to wage a war while hurting European economies such as Germany (Galbraith 2023). However, the current geo-economic conflicts can not explain Draghi's “productivity gap” alone. Their negative impact is multiplied by the lack of public and private investment. The decline of European industry already started before the Covid-19 crisis and the war in Ukraine. German manufacturing peaked in 2017, then went on a downward trajectory (see Figure 8). The pandemic hit manufacturing hard, and it did not fully recover. Instead, economic activity was stagnating from 2020-2023 and now seems on a downward path again. It was normal for economic activity in German manufacturing to increase over a business cycle in the 2000s and in the 2010s.

Figure 8: Economic activity in German manufacturing, Index 2015=100



Source: OECD [PRMNT001DEQ661N]

4. The macroeconomics of the European Union

The data clearly shows that there is a “demand gap” that has opened up between the US and the EU countries, which explains the divergence in GDP per capita. This “demand gap” has created a “productivity gap”. It would most likely close when the “demand gap” closes.⁴ A future path for the European Union should address both the supply and the demand side. Since the two are intertwined, a competitiveness strategy should include a discussion of macroeconomic governance. The approach taken by Draghi misses half of the economic story. Here is the full picture with both supply and demand side (>>> = cause):

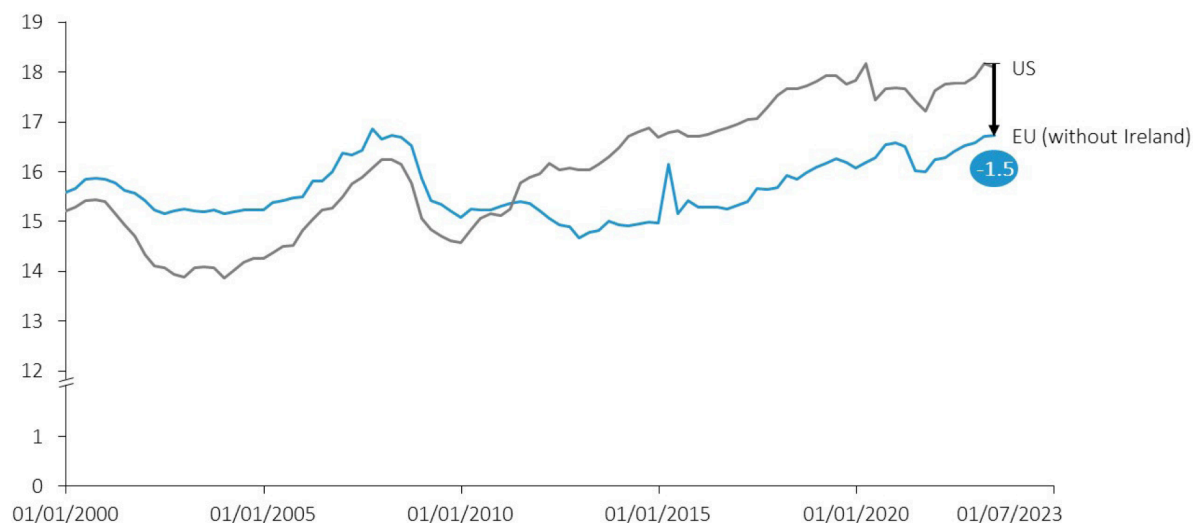
(1) changes in SUPPLY >>> changes in DEMAND

(2) changes in DEMAND >>> changes in SUPPLY

Draghi (2024) covers (1) but clearly omits (2). He argues that we need changes on the supply side in order to increase output, which would allow the European economy to absorb more demand for goods and services. He neglects that higher spending can cause a rise in supply, and with that, a rise in productivity as the scale of output expands (following private and/or public investment).

⁴ This is very similar to DSGE models, which assume that the inflation gap would close once the output gap closes. Central banks target inflation to close the output gap. They do not target output to close the inflation gap.

Figure 9: Real gross fixed capital formation excluding residential investment, percent of GDP



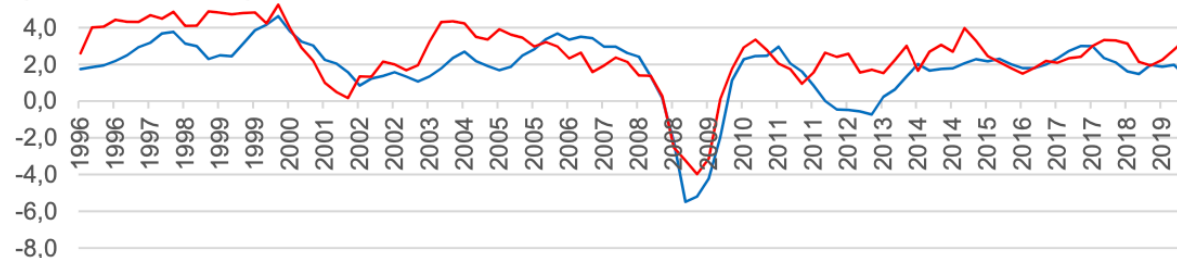
Source: Draghi (2024, 24), taken from EIB (2024)

This is probably why he does not further examine his figure 5, which is reproduced below as figure 9 above. Productive investment in the EU was higher than in the US in the 2000s. In the 2010s, it was lower, with the main divergence occurring in the period from 2010 to 2014. During this period, the EU imposed austerity policies that forced national governments to cut government spending. Greece is still below its 2007 historical GDP level. It seems that a reduction in public could led to a reduction in private investment, as companies saw a decline in demand for their goods and services. Cutting government spending cuts non-government income in the economy, euro for euro, as a matter of logic.

“The European Union needs to rethink its macroeconomic policy. Cutting government spending seems to be the main cause of weak growth performance.”

Moreover, an increase in the growth rate of investment does not automatically translate into an increase in the growth rate of real GDP. Private investment is not the largest component of GDP, and while fluctuations in private investment can and do affect the business cycle, the link is not as straightforward as presented in the Draghi report.

Figure 10: Real GDP growth rates in the EU and the US, in percent

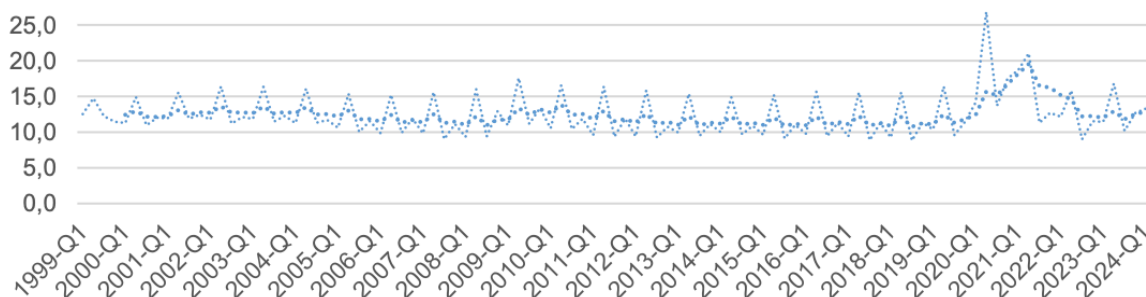


source: BEA and Eurostat

For example, Figure 10 shows that real GDP growth was higher in the US than in the EU both in the 2000s (1.9 versus 1.6 percent) and in the 2010s (2.4 versus 1.6 percent). In terms of economic growth, the divergence is rooted in the second decade of this century. During the period of austerity in the EU (2010-2014), the average growth rate of real GDP was only 1.1 percent. For the rest of the decade, it was 2.1 percent – just 0.3 percentage points behind the US rate. These empirical observations point to a macroeconomic demand-side explanation of low GDP growth. We now turn to the macroeconomic view.

A potential explanation of divergences could be found in monetary policy. The latter is said to affect the economy by influencing changes in consumption and investment (and expectations thereof). According to prevailing central bank doctrine, an increase in the interest rate acts as an incentive to save more. The associated reduction in consumer spending should lead to lower demand for goods and services, thereby easing price pressures in consumer goods markets. However, available data for the EU (data for the euro area are not available) show that after July 2022, when the ECB first started to raise interest rates, the gross household saving rate in the EU was essentially unchanged (Figure 11). This seems to indicate that this transmission channel from higher interest rates to more saving is not working properly.⁵

Figure 11: Gross household saving rate in the EU, by quarter and moving average, in percent



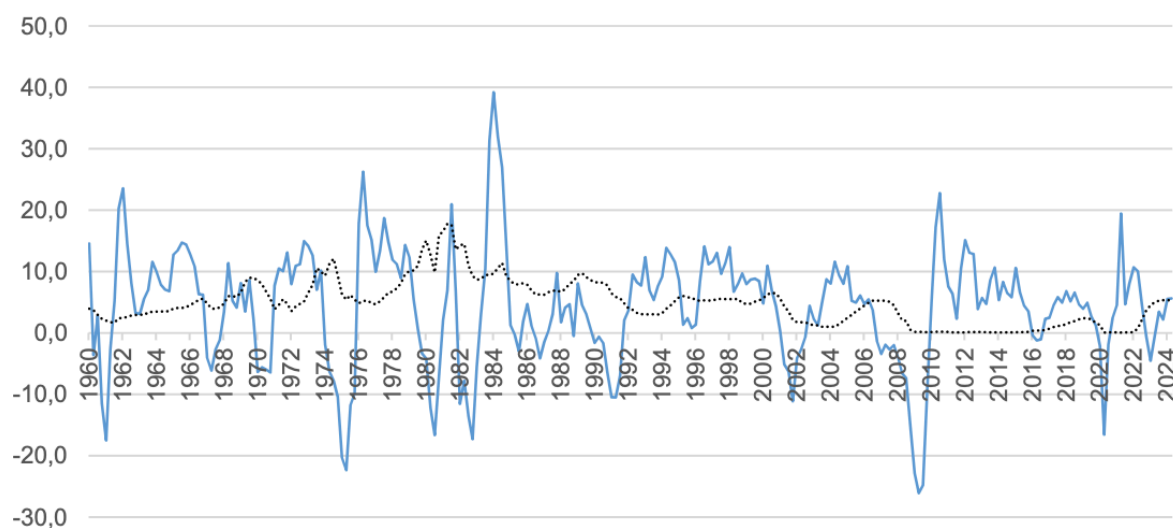
source: Eurostat (nasq_10_ki)

⁵ Note that this result is not surprising, as saving is unspent income. When government spending does not increase by much, then an increase in saving is only possible if exports are rising or private investment is rising or both. Neither of that happened in 2022-24.

Today's central bank doctrine assumes that higher interest rates would act as a brake on private investment. Higher capital costs would make some investment projects financially infeasible, all else being equal. The resulting reduction in private investment, including real estate, would create less demand for goods and services from the capital market and less demand for labor. The subsequent rise in unemployment would in turn reduce spending on consumer goods. This logic of higher interest rates leading to lower inflation has recently come under considerable criticism (Coy 2022). Also, the topic of seller's inflation needs to be addressed, as firms exploit their market power to increase prices without a corresponding increase in costs (Weber and Wasner 2023).

“There is no empirical evidence that supports the idea that low interest rates can increase private investment. Monetary policy cannot increase productivity.”

Figure 12: Real Gross Private Domestic Investment as a share in GDP (blue) and the Effective Federal funds rate (black), in percent



source: BEA (A006RX), Federal Reserve Bank

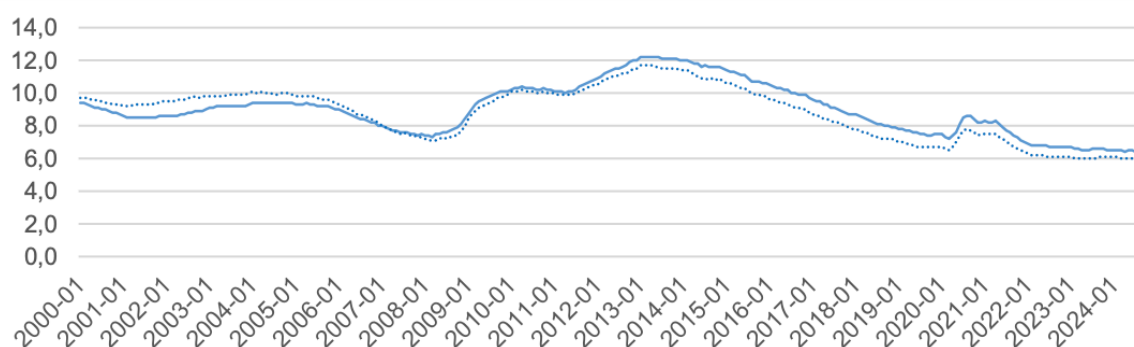
Private investment appears to be relatively inelastic to interest rates. In a situation of high demand for goods and services, firms will invest even when interest rates are high. After all, they can pass on the higher cost of capital by raising their prices. As long as they can sell at a profit, firms are forced to invest and sell, otherwise the competition will take their market share. Similarly, at a time of low aggregate demand, low interest rates will not help. Without rising demand, there is little reason to invest in modernizing and/or expanding production capacity. If a firm cannot sell its output at a profit, it is very doubtful that a lower interest rate will cause the cost of capital, and hence its price, to fall enough to raise demand to a level consistent with more private investment. In the US, higher interest rates have led to an increase in interest payments by the federal government to holders of

government bonds (more below).

Higher interest rates in the US did not lead to a soft landing, but to a sustained boom, including rising private investment. Figure 12 shows that real gross private domestic investment turned negative when the Fed started to raise interest rates in the spring of 2022. However, by Q3/2023, private investment had started to grow again, and by 2024 it had returned to its late-2010s level. The real GDP growth rate in Q3/2023 was just under 5%. Whatever effect higher interest rates were supposed to have on the US economy, they clearly did not work. In the EU, real GDP growth has been essentially flat since Q3/2023. Whether this is due to fiscal policy removing the extra support from the pandemic or to higher interest rates or both is an open question.

Both of the transmission channels emphasized by central banks work through an increase in unemployment. The reduced demand for goods and services in consumption (lower spending due to higher saving) and capital goods (lower investment due to higher capital costs) would translate into higher unemployment. Current central bank doctrine (called New Keynesian Macroeconomics) says that this must be accepted in order to achieve price stability. However, there has been no increase in unemployment in the EU until very recently (while producer inflation slowed down much earlier) Figure 13 shows that the expansionary fiscal policy in the aftermath of the pandemic reduced unemployment in the EU and the euro area to record lows despite the major economic shock and disruptions. Since the end of the general escape clause of the Stability and Growth Pact of the Maastricht Treaty in December 2022, the “excessive” budget deficit limits are back.

Figure 13: Unemployment rates, EU (dotted line) and EA, seasonally adjusted, in percent



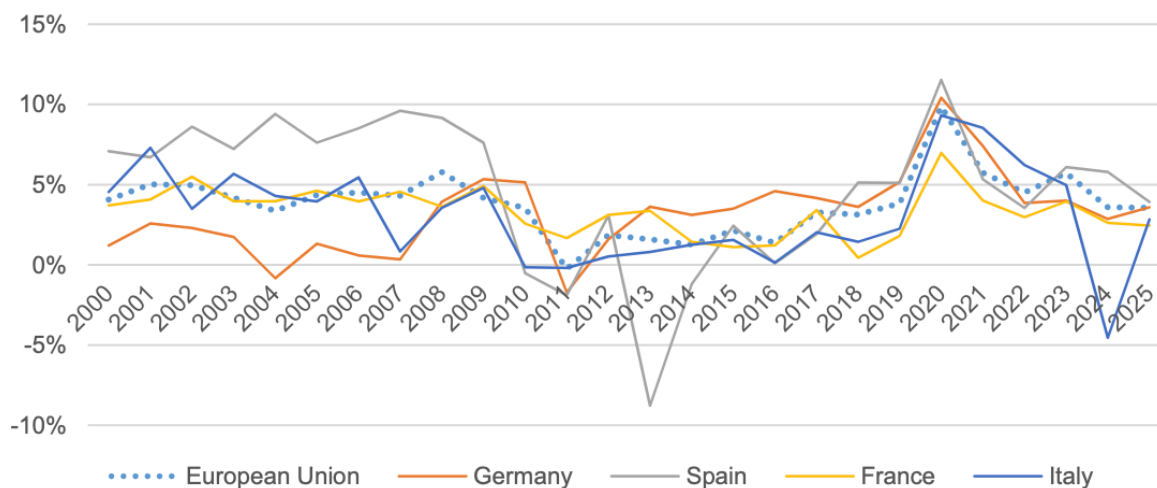
Source: Eurostat (une_rt_m)

Figure 14 shows that from 2023 to 2024, government spending growth is flat in three of the four largest economies, with Italy being the exception. There, expenditure growth goes from -4 percent to +4 percent. Overall, we can see that EU member states are on a path of cutting government spending. They probably did so in the expectation that they would also reduce their respective budget deficits or inflation. Nevertheless, that has not happened.

“Rising government spending correlated with falling unemployment in the years of the pandemic, then a reduction in the rise of government spending correlated with economic stagnation and constant unemployment.”

There are currently 8 countries in the EU Commission's excessive deficit procedure and inflation has come down everywhere, including in countries with expansionary fiscal policy. It is hard to see how the deficit countries will be able to run smaller budget deficits when the European economy as a whole is as weak as it has been since the return to the Stability and Growth Pact. Perhaps a sinking oil price, which is outside their control, is their best bet.

Figure 14: Growth rate of government expenditures except interest payments for EU and selected member states, in percent



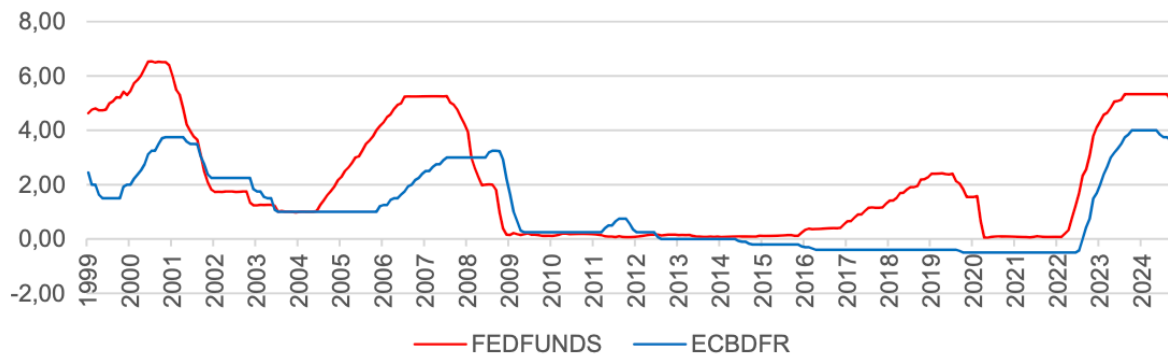
Source: AMECO

A US-EU macroeconomic gap?

The above macroeconomic analysis raises the question of whether there is a “macroeconomic gap”. The main macroeconomic tools available to a (supra)national government are monetary and fiscal policies. These steer the economy by adjusting demand up and down, with the idea that an increase in demand will cause output to expand and a decrease will cause output to contract. In the U.S., the Federal Reserve Bank sets interest rates. In the EU, this is done by the European Central Bank (ECB) and the respective central banks of the non-euro member states. Fiscal policy is in the hands of the national government, both in the U.S. and in the EU member states.

Looking back, Figure 15 shows that monetary policies in the United States and the euro area have not diverged much. The main differences are twofold. First, the ECB under Trichet decided to raise interest rates in 2011 in response to rebounding energy and commodity prices. Second, the Fed raised rates in the late 2010s in response to rising inflation in the US. From 1998 to the present, nominal interest rates in the US have almost always been higher than in the euro area, but not by much. It therefore seems unlikely that monetary policy has made a major contribution to higher GDP growth in the US.

Figure 15: Effective Federal funds rate (red) and deposit rate of the ECB (blue), in percent

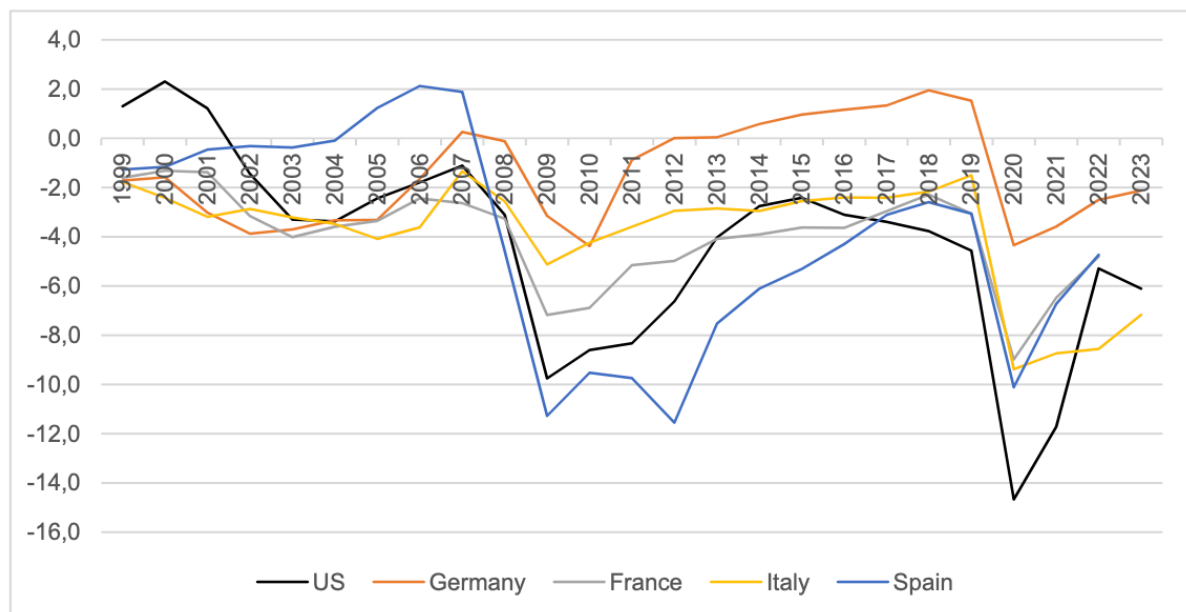


Source: Board of Governors of the Federal Reserve System, ECB

However, major differences between the EU and the US can be found in the fiscal domain. In terms of fiscal policy, Figure 16 shows that the US has consistently run higher budget deficits than EU countries.

“Whereas in the EU “excessive deficits” are punished, in the US they are part of the solution. The results speak for themselves.”

Figure 16: Federal surplus or deficit, various countries, in percent of GDP



Source: U.S. Office of Management and Budget, IMF World Economic Outlook

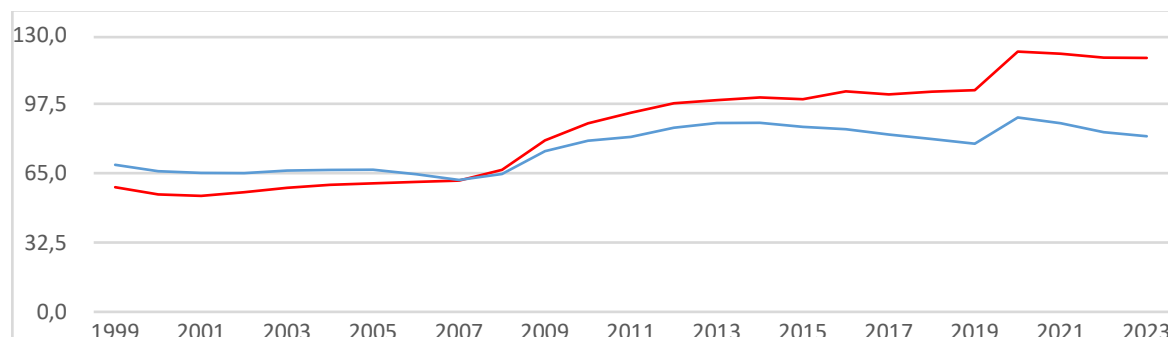
Governments more or less control government spending through the budget process at the federal, state and local levels (Kelton 2020). During downturns, social spending increases, which is outside the control of the (federal) government. In addition, tax revenues fall in a downturn, increasing the deficit without any prior change in the government's fiscal stance. Any fiscal deficit recorded by the government sector implies a surplus in the non-government sector. In other words, when the government spends more than it takes in in taxes, the rest of the economy accumulates net financial wealth. Therefore, an increase in government spending has two effects that push in the same direction.

An increase in income will induce consumer spending and at the same time lead to the accumulation of net financial wealth. It matters how the government spends the money as an increase in productive capacity might result as well.⁶ However, bond holdings are highly concentrated on wealthier households. While they might spend more on (luxury) consumer goods or assets such as shares and real estate, the relative propensity to consume additional income is usually lower than with the middle and lower income households. Hence, government expenditure has usually greater and more sustainable effects on GDP if combined with progressive taxation or some other measures of redistribution.

“Both the quantity and the quality of government spending matters for the European economy.”

Draghi (2024, 61) sees “lower returns that they [households] receive from financial markets on their asset holdings” as the cause of lower household wealth in the EU compared to the US. An alternative view would emphasize the higher government deficits in the US, which lead to an increase in net financial assets held by the private sector. In other words, rising US government spending and public debt have been good in macroeconomic terms, albeit it may have contributed to inequality via the asset channel in the absence of adequate taxation of financial wealth. Currently, the federal government's interest payments on its national debt alone amount to more than \$1 trillion (!) per year. This alone is more than the 800 billion euros recommended by the Draghi report.

Figure 17: Public debt to GDP in the EU (blue) and the US (red), in percent



Source: AMECO and U.S. Office of Management and Budget [GFDEGDQ188S]

⁶ We think that this should not be overemphasized. Social transfers do not lead to an increase in productive capacity, but that does not mean that public investment should be preferred to public consumption.

In a highly financialized economy high interest rates set by the Fed may lead to increased household spending on interest payments. The distributional effects are considerable. Anecdotal evidence suggests that the majority of houses sold in Manhattan are bought with cash (Kaysen and Koeze 2024). Which of the theoretical effects of higher interest rates dominates – depressing investment, employment and wages or accelerating spending by wealthier household – is ultimately an empirical question.

Figure 17 shows how budget deficit flows have added up to government debt in the US and the EU. At the start of the GFC in 2008/09, both variables were just over 60 per cent of GDP. Since then, the US federal government has accumulated almost 40 percent of GDP more net financial assets than European governments. Currently, EU GDP is €17 trillion. 40 percent of that would be €6.8 trillion. Over the 15 years from 2008 to 2023, this would have meant an increase in annual spending of €453 billion, very likely more. An extra euro spent by a European government or the European Commission will generate additional cents in consumer spending as the private sector spends some of its income. This increases GDP and reduces the deficit. This means that the EU would have to spend much more than €453 billion a year to end up with a budget deficit equal to that of the US. This is certainly a huge difference in terms of economic policy.

“The Stability and Growth Pact is the one big problem that needs to get out of the way for the Eurozone’s economy to prosper.”

The Stability and Growth Pact (SGP) is to blame. It limits member states' budget deficits to three percent of GDP. In good times, this may not be a problem. However, in bad times, the limit is too tight. After the GFC and the 2009 fiscal stimulus, Europe turned to austerity because it was enforcing the rules of the SGP in times of economic depression. Cutting government spending and public sector wages deepened the depression, especially in countries like Italy and Greece. The evaluation by the IMF's Internal Evaluation Office (2016) concluded with hindsight:

“The IMF-supported programs in Greece and Portugal incorporated overly optimistic growth projections. More realistic projections would have made clear the likely impact of fiscal consolidation on growth and debt dynamics, and allowed the authorities to prepare accordingly or persuaded European partners to consider additional—and more concessional—financing ...”

The EU's policy response to the Covid-19 pandemic was a huge step forward (Ehnts and Paetz 2021). While the management of the pandemic itself is rightfully an area of contested debate, the fiscal response was pragmatic. Already in March 2024, the ECB acted by creating the Pandemic Emergency Purchase Program (PEPP). At the same time, the

European Commission activated the SGP's general escape clause. Together, these policies meant that national governments could spend without worrying about running out of euros. The ECB ensured the demand for government bonds so that national governments could always replenish their accounts with the respective national central bank (Ehnts 2016, ch. 6). This was not a new policy, but rather a continuation of the ECB's role as lender of last resort. Mario Draghi himself introduced this policy with his famous “whatever it takes” speech in 2012.

“The policy response to the pandemic opened the door towards a new paradigm in which government spending addresses society’s ills instead of adjusting to a level consistent with non-excessive fiscal deficits.”

The removal of deficit limits meant that national governments could spend to address deficits in social systems, health care, the business sector as a whole, and employment (through leave programs). Since resources are limited, governments did not overspend. This could have created inflationary pressures and diverted valuable resources from the private sector, but this does not appear to have happened. The rebound in energy prices caused the inflation spike that rocked the global economy in 2022-2023. Since then, inflation rates have returned to normal, near normal, or even below normal although real wages lack behind in some major economies such as Germany (ILO 2022). Anecdotal evidence suggests that higher interest rates have not been critical in bringing inflation rates down. Japan is the prime example, having kept interest rates near zero throughout the pandemic to date. In the next section, we return to the theoretical dimension of understanding how the supply and demand sides of an economy interact.

4. The future of the European Union - a centralized budget?

The reform of the fiscal framework looked like the perfect opportunity to adapt the rules to the new normal. A debt-to-GDP ratio of 60 percent is unrealistic for most of the larger euro area countries.⁷ Public debt creates net financial assets for the non-government sector, euro for euro. How much net financial wealth is needed at full employment and price stability is not clear a priori. It is likely that the answer is not the same for all Member States.⁸

Moreover, the 3 percent budget deficit target for this decade is not realistic. Additional public sector spending of several hundred billion euros could push up public deficits in the short term, while creating jobs, sustainable infrastructure and higher tax revenues in the future. Turning off the SGP was good economic policy; turning it back on in 2023 will cause

⁷ See European Commission (2024b).

⁸ A European job guarantee would solve this issue (Cruz et al. 2019).

macroeconomic problems for many member states.⁹ A cut in government spending in 2025 would certainly be a blow to any economic momentum that is still present in the European economy.

“The way forward is increasing government spending to move resources where they are needed to invest in the future.”

Draghi (2024, 61 f.) argues that the increase in investment should be financed partly by the private sector and partly by the EU and national governments. This sounds like an economically sound idea. However, the EU budget accounts for only about one per cent of EU GDP and is therefore too small to have a significant impact. Most public investment in the EU takes place at national level. Even private investment will not automatically boost the economy, as it needs to be preceded by increased demand through higher government spending and thus better economic expectations. In our view, the main obstacle to business investment in the EU is the lack of demand, not a lack of finance. The ECB (2024, p. 12) comes to the same conclusion, arguing that “[w]hile supply-side constraints have eased, weak demand has become the main headwind for European manufacturers”.

A larger EU budget seems neither realistic nor desirable at present, despite the economic arguments in favor of a centralized budget in a heterogeneous monetary union. The institutional design of the EU and its treaties show a strong bias towards negative market integration, firmly anchored in rules that artificially constrain economic and fiscal policies. During the euro crisis, EU funds were often tied to demand-reducing Troika reforms such as privatization and wage and pension cuts. The heterogeneity of EU economies and the overly complex and centralized bureaucracy of fiscal surveillance create strong political resistance among member states to transfers or an EU treasury.

“Centralization risks moving fiscal policy further away from the electorate in the member states.”

Thus, while there is certainly an economic case to be made for a centralized budget, at the political level centralization risks moving fiscal policy further away from the electorate in the member states. As the multilateral European political process is very complex and less anchored in national democracies, centralizing the budget risks weakening democratic control over fiscal policy. However, an economic policy that stabilizes aggregate demand and the economic well-being of the majority of citizens requires that fiscal policy makers are not isolated from democratic processes.

⁹ In July, the Council adopted decisions establishing the existence of excessive deficits for Belgium, France, Italy, Hungary, Malta, Poland and Slovakia. The procedure for Romania remains open.

5. Conclusion

The analysis in the Draghi report does not hold much water. The empirical data does not confirm the existence of a fundamental productivity gap between the US and the EU. Additional empirical data does not support the argument that the economic woes of the EU can be explained primarily by a productivity and competitiveness gap – instead, the US has lost a third of its industrial jobs and is now struggling to regain them. However, the demand side offers valuable lessons for the EU and its economic problems. Higher government spending can help to increase the demand for goods and services, and thus output, with a consequent increase in productivity (if there are increasing returns to scale).

“An increase in public sector activity cannot be replaced by capital market union.”

An increase in public sector activity cannot be replaced by capital market union. Anonymous investors with little knowledge of fragmented European markets are prone to herd behavior, information asymmetries and hence pro-cyclical boom-bust cycles (Rothschild and Stiglitz 1976). The structure of European markets is more fragmented than in the US with a unified language, legal and political system. The average firm sizes of European enterprises are smaller. Banks do hence play a more important role in corporate funding as funding via the capital market is often too costly for SMEs (De Masi 2015a, 2015b, Hache 2015).

The next logical step would be to review (again) the fiscal framework and the role of the ECB. As part of the Eurosystem, which is the monopoly supplier of euros, the ECB sets the interest rate. Higher interest rates mean that companies have to have higher profits, because they pay interest out of profits. Otherwise, they would have to borrow more to roll over existing debt, increasing financial fragility. There is a case to be made for a return to the low interest rates of the 2010s. The national central banks that are members of the Eurosystem act as banks for their respective governments, making payments and crediting bond proceeds and tax payments to government accounts. Rising interest rates channel unearned income to government bond holders, increasing inequality. Fiscal policy seems to be a much better way to deal with today's problems than handing out free money to bondholders.

”The next logical step would be to review (again) the fiscal framework and the role of the ECB.”

We saw during the pandemic that it is possible to increase fiscal spending to “whatever it takes” - and that is what we think is the elephant in the room. Financial markets can finance sectors that add value and are still profitable. An increase in government spending would crowd in private investment as companies ramp up production to fulfill government contracts. This is what is happening in the US. However, many investments will not be immediately profitable given the uncertainty of the future. As Draghi pointed out, a combination of more national government spending and more European spending will provide the investment we need. This debate is crucial. There is no easy solution, as any change has political implications.

Three options could be implemented in the short term. The first option is to reactivate the general escape clause of the Stability and Growth Pact. This would allow Member States to address the problems identified above: a lack of public investment . This has worked very well in the context of the macroeconomic recovery following the pandemic. Justifications for activating the general escape clause could be the extraordinary economic shocks due to the ongoing war in Ukraine, the insecurity in the Middle East and adapting to climate change. These circumstances make the current fiscal rules unworkable.

A second option would be to establish a golden rule that would exclude certain public investments from the calculation of the relevant public deficits and debts in the context of the Stability and Growth Pact. The EU would define and monitor the investments covered by the golden rule to ensure that the money is well spent. This is already being discussed in the context of the military sector. It is, however, contradictory to exempt military expenditures such as armament from the Stability and Growth Pact while curtailing civil investment . A peaceful use of the state’s fiscal capacity could be imagined along the lines of a “mission economy” (Mazzucato 2021), targeting the deficits of European communities and societies.

Options for the European Union:

- reactivate the general escape clause of the Stability and Growth Pact again
- establish a golden rule that would exclude certain public investments from the calculations
- issuance of ECB bonds, replacing government bonds and shifting the debate from public debt towards “missions”

A third option that could help with the politics of higher government spending at the member state or EU level is the issuance of ECB bonds (Wyplosz 2023). The ECB would swap member states' government bonds for ECB bonds, which carry no risk of default: “As the sole issuer of euro-denominated central bank money, the Eurosystem will always be able to generate additional liquidity if needed” (Christine Lagarde, quoted in Reuters 2020). This would put an end to the “liability union” (the German “Haftungsunion”) debate by ensuring that no member state would ever have to pay a single euro in the event of default of another member state.

Any alternative should focus on the EU addressing deficits in the provision of public goods and services. A pan-European high-speed rail network would certainly be a good idea. This would mean changing the EU's macroeconomic mindset from one of austerity to a mission-oriented approach, focusing on available (sustainable) resources.

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