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Shall EU Survive
EU on the verge of Balkanization:
Impact of Economic Theory and Economic Policy on Future of EU

Abstract

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The future of the EU seems fogy in the mid of November 2011.
The EU might eventually prove efficient and able to survive discovering its own and new way out of crisis. Flexible markets and neoclassical economic paradigm might become a new economic and political fashion within the EU.
The EU might be split into smaller parts if a new sort of interventionism-Keynesianism economic policy prevails. "New Economy „ may form mega-region as a new substructure within the territory of the EU. National states might melt down and be transformed into mega regions.
*Economic history teaches us that neoclassical economy leads rather to divergence than to convergence between unequally developed countries. Difference between the richest and the poorest members of the EU in terms of GDP was **1: 4, 9 in 1986.** In 2007 the difference was increased to **1: 20.***
Economic divergence means dead end for EU.
In the paper we try to analyze the future position of the EU depending upon accepted system of value within the EU and chosen economic paradigm to fight a crisis. We conclude that EU is more prone towards syndrome of balkanization than to efficient political union.

Key words: EU, development, economic paradigm, balkanization
JEL: F15, F59, O10

The Problem:Quo Vadis Europe

„You cannot make a single currency without economic convergence and economic integration. It's impossible. But on the contrary, one cannot plead for federalism and at the same time for the enlargement of Europe. It's impossible. There's a contradiction. We are 27. We will obviously have to open up to the Balkans. We will be 32, 33 or 34. I imagine that nobody thinks that federalism—total integration—is possible at 33, 34, 35 countries.
So what one we do? To begin with, frankly, the single currency is a wonderful idea, but it was strange to create it without asking oneself the question of its governance, and without asking oneself about economic convergence. Honestly, it's nice to have a vision, but there are details that are missing: we made a currency, but we kept fiscal systems and economic systems that not only were not converging, but were diverging. And not only did we make a single currency without convergence, but we tried to undo the rules of the pact. It cannot work.

There will not be a single currency without greater economic integration and convergence. That is certain. And that is where we are going. Must one have the same rules for the 27? No. Absolutely not [...] In the end, clearly, there will be two European gears: one gear towards more integration in the euro zone and a gear that is more co federal in the European Union"

Mr.Sarkozy, the President of France
(The Economist, 2011-11-12)

Introduction or Good Morning Fellow Politicians and the Economists of Invisible Hand

Treaty of Maastricht (1992) and the Stability and Growth Pact (1997) have saddled Europe with such an institutional framework which remind deeply on bastion of neoliberal economic orthodoxy. Still, Great experiment of creating monetary union (1999) without having political union promised success in time of fine-weather condition that prevailed until the onset of 2007 economic crisis.
Since time of A. Smith and D.Ricardo nation was the space within which Pareto optimum was supposed to be reached by free functioning of market forces. Keynes's „General Theory..."was focused on nation state much more deeply. Keynes's macroeconomic management deals with the issue how to improve market imperfections and market failure in order to increase well-being of a nation and nation state citizens. Globalization at work, particularly that one which is described by Krugman's "Economic geography" or Summers's "New Economy", is a nation-less process without a proper global economic management. As long as both politicians and some of the most influential economists were convinced (were true believers) either in free market or in "New economy" endless prosperity has been on horizon. Many distinguished economists were convinced that international Pareto optimum, relevant for EU enlargement, was quite realistic achievement just if one (country or region-EU) follows dictate of strong radical free market reform.(Frankel,1999) Therefore, creation of unique economic market within Europe ,the formation of European economic space without political union was quite feasible and promising future.
As long as functioning of Euro zone is concerned, Keynes's economy was taken as useless. Likewise, enlargement process was dictated by Maastricht criteria and promising Euro zone benefits were expected by newcomers.
However, crisis of 2007 on has raised question: how Europe may respond to serious economic crisis? Is Europe fine-weather union or may survive heavy economic storm?
Prime Minister Ferenc Gyurscany of Hungary has already warned „We should not allow that a new Iron Curtain should be set up and divide Europe"(New York Times, 4, 24, 2009). Urgent call from Hungary for a comprehensive bail out of all Eastern Europe has firstly been promptly rejected by madam Merkel.
National interests are inserted in the heart of Europe. Tomas Klaus; Paris director of the European Cancel on Foreign relations pointed out „This crisis affects the political union that backs the euro and of course E.U.as a whole and solidarity is at the heart of the debate"(International Herald tribune 4.24.2009)
Let us recall that the EU has: Maastricht treaty, Stability and Growth Pact, Euro for 17 members...However, the EU has no: joint fiscal policy, no joint tax policy, no joint industrial policy, no joint social policy. Europe has social democratic part of itself (Scandinavian countries) with well developed welfare policies, corporatist states such as Germany and France and Netherlands plus whole bunch of new members which try to emulate free market liberalism. Exactly those last mentioned are in deep economic turmoil. Adding to them Ireland (until recently a free market „created" tiger economy), Greece, Portugal, Spain and Italy we get half of the E.U. already entrapped by economic crisis. And all of these countries are devoid of any serious Keynesian macroeconomic management.
European Central Bank is obsessed with price stability, and national governments, members of euro-zone are devoid of monetary policy .Therefore, in absence of political union compromises might be worked out in case of good weather.

„That is precisely the framework that caused so many crisis and conflicts(economic, social, political)before World War II .No wander that economic performance has remained stagnant or even deteriorated since 1999 in France , Germany and Netherlands"(Panic,2006)
And we here from madam Merkel recently „there is not multi- culti any more", which is opposite from Madam Thatcher remark „There is not such a thing like society"made at beginning of eighties in past century.
Behind these words of two ladies might stay different sort of social paradigm, and different economic paradigm for solving the political and economic problems?
Let us in this paper try to discover how different economic paradigms suit to different visions of societies in general, and to the EU in particular. In the first part of the paper we deal with neoclassical economics paradigm and its effects on convergence. Then, in the second part we elaborate on interaction between economic policy and economic history since II World war. The last part of the paper tackles the issue of development of mega-region and it's probably effects on EU convergence process. We conclude that the future of EU is very uncertain regardless of sort of available economic policy chosen. New time asks for new economic solution which badly needs a new economic theory, and new theory might suggest transformation of EU into United Regions of Europe.

I Thoughts on fundamental economic theory and economic policy: neoclassical deception

Elementary textbook from Microeconomics teaches us that when marginal rate of substitution in consumption between good(X) and good (Y),that is : Mrs.=MRSy (we eventually may nominate as aggregate demand) is equal to marginal rate of transformation between good (X) and good (Y): Mart=Marty (aggregate supply) an economy reaches state of equilibrium .At that moment an economy enjoys the privilege of general equilibrium having all efficiencies and properties of general equilibrium (microeconomic and macroeconomics) reached: that is: efficiency in consumption, efficiency in production, efficiency in allocation of resources with maximized both: producers and consumers surplus.
Pareto optimum within a national economy suggests that the economy is at the level of full employment, there is neither balance of payments deficit nor surplus. Consequently, when equalization between aggregate supply and aggregate demand is reached there is no room for inflation.
According to Theory of Comparative Advantage, (which we consider as a component part of neoclassical economic model), and Say's law, two countries with common tastes and consumers preferences, and having the same technology may enjoy benefits of open foreign trade, that is they can enlarge „common "GDP by means of international division of labor, and by international specialization in production.
Specialization in production in both countries reaches optimum-equilibrium when marginal rate of transformation between goods (X) and (Y) equalizes with prices of good (X) and good(Y).
At that very moment both countries enjoy full economic equilibrium expressed by equation as follows:

$$\text{Marty}= Px/Py=MRSxy\ (A) =MRSxy\ (B)$$

Where (A) means country A and (B) means country B.
The logic of perfect competition , treating two countries as one country, or one country with two regions, and suggesting that both countries or regions are functioning as „connected dishes", may enlarge well-being of both(all) countries importing lower priced foreign goods, and therefore bringing social indifference curve to higher position in comparison with pre-trade levels. Under the condition of „International" Pareto Optimum free foreign trade contributes for both countries (global world) to the following effects:
-Optimal allocation of resources world-wide,
-optimal and enlarged consumers surplus without endangering producers surplus (win-win situation),
-Equalization of prices and wages in both countries and world-wide,

-Convergence of the growth rate of GDP in both (all) countries engaged in foreign trade.
All of these optimums are reached together with:
-full employment in both countries (world-vide),
-Price stability world-wide,
-equilibrium of balance of payments
Having in mind all of these achievements of free market economy and free foreign trade , neoclassical paradigm firmly suggests to all countries theoretically , and to transition countries even practically, not to disturb automatic mechanism of market forces. The paradigm pleads for abstaining from all of possible sorts of social (state) intervention into the market, and pleads for both entrepreneurial animal and rational spirit.
However, global economic crisis under way has raised the questions about the validity of the majority determinates of neoclassical economic doctrine. Invisible hand disappeared and visible hand of clever and frightened state is in the game again. Open issue become: does the world economic crisis mean the crash of neoclassical economic doctrine or we are only on the verge of a new-revitalized and restructured economic view of the world global economy?

In this paper we keep in mind that EU is not political union as well as it is not American melting pt. Besides, members of EU are not equally developed. Moreover, political geography of EU resembles more to that of former Yugoslavia having 27 instead of sixth countries (republics). Consequently, the imperative of convergence in economic development between members is even more important for EU than was the case for former Yugoslavia.

Distinguished Economists and Convergence Issue

Neoclassical and "the old "view of growth assumed that were capital is scarce, it has a high return. There was a natural possibility about this: when you give a machine to a worker who previously did not have one, it has a big productivity effect. Together with the assumption of constant return to scale, and the existence of unalterable factors such as labor supply, the assumption of diminishing returns has a sharp prediction. During the transition to a new steady state, growth in capital –scarce countries will be high because of the high returns to capital. Consequently, poor countries should catch up fairly rapidly to richer countries. Growth is high when capital per worker (k) is low, then declines as (k) rises. Growth stops when the rate of return to capital is just equal to the discount rate. (Easterly, 1998)
Similar view on: growth, development and catching up process are expressed by Madison (2001) «If the world consists only of two groups of countries (developed and developing countries) the pattern of world development could be interpreted as a clear demonstration of the possibilities for conditional convergence suggested by neo-classical growth theory. This supposes that countries with low incomes have «opportunities» of backwardness, and should be able to attain faster growth than more prosperous economies operating much nearer to the technical frontiers. However, Madison points out to the very crucial remark and fact never mentioned, but possibly hidden in neoclassical paradigm, to the existence of an exogenously given technology and capital. Madison reminds that « this potential can be only realized if such countries are successful in mobilizing and allocating resources efficiently, improving their human and physical capital to assimilate and adopt appropriate technology. Resurgent Asia seized these opportunities .The countries (other Asia, Latin America, Eastern Europe and former USSR, Africa) have not. Their relative position has deteriorated sharply since 1973**. »**
S.Fisher in "Economic Growth and Economic Policy,1987» shares Madison's conclusion pointing to the role of technical progress as one of the main determinates of economic growth of a country, and for a developing country in particular.«The modest long run rates of growth of the industrial economies and lessons learned from that growth are not necessarily relevant to the less developed countries (LDC). The prime reason is that those countries are far from the technological frontiers; technical progress could play a significant role in their future growth without any major technological breakthrough taking place. A quick look at the evidence is not supportive of the hypothesis. Except for Japan, most of the countries currently in the ranks of the industrial market economies have been among the high income countries for at least a century. »
World-wide experience with economic growth of different developing countries lagging more behind developed the more they apply neoclassical economic prescription, has led Vanek,J(2004)to conclude

on theory of comparative advantage, as an important component part of neoclassical economic paradigm, the following»

1. The point of departure of my paper is that the traditional theory of comparative advantage on which modern globalization is based is incorrect and not applicable to the present day conditions of world trading. Instead I propose a theory of destructive trade which explains much better what happens in world trading today, and whose conclusions are summarized on
2. Destructive trade leads to a world where a minority of the rich dominates a majority of the poor and what is worse, the situation tends to grow ever worse, the rich becoming relatively richer and the poor poorer. Technically, the situation is explosive. »

Discussion about convergence between LDC and developed countries touching upon the role of free trade and the role of capital flows hardly can escape Lucas paradox. Lucas paradox suggests that capital does not flow into the poor countries where capital is scarce, against the neoclassical view that the return to capital accumulation should be higher where capital is rare. Lukas concludes that the neoclassical paradigm should be abandoned, while Reinhart and Rogoff conclude that the risk premium due to bad behavior is the main culprit. (Cohen in Serra- Stiglitz, 2008).Cohen points out that the capital/output ration is, in general, the highest among poor countries: This can be coined as anty-Lucas paradox. "The intuition that we offer is that poor countries, lacking other inputs such is infrastructure, use physical capital as a substitute for the scarcity of those missing inputs."

At this moment seems useful to invite the deliberations into the critics of the paradigm of neoclassical economics, and theory of comparative advantage provided by: J.Stiglitz,(2005), Horvat(1995) Rodik(1999,2011), Rodik-MacMilan(2011),Panic(2003),Pitelis,2000),Adelman in Stiglitz-Meier,2001) . It is not by surprise that I.Adelman introduced a term KISS (keep it simply and stupid) in her "Fallacies in Development Theory and their Implications for Policy "(Meier, G.-Stiglitz, J (2001) Frontiers of Development Economics, World Bank). She writes" I shall argue that the discipline of economics has enshrined the "keep it simple, stupid" principle as an overarching tenet, imbedded in graduate school that can be violated only at the violator's peril. This principle demands simple explanation and universally valid propositions. It has led to three major fallacies, whit significant deleterious consequences for both-theory and policy: single-cause theories of under-development; a single figure of merit criterion for development: and the portrayal of development as a log-linear process"

Historical and challenging proof with plenty of examples of development experiences of many countries all over the history in favor of theses of Adelman's, Stiglitz's, Horvat's, Pitelis's, Eastery's Rodik,etc. might be found in seminal work of Madison A (2001) "The World Economy"

We might conclude this part of paper by asking the following question: if these economists are right how poorer members of EU may catch up with richer? And, if they can't, what is a future of EU like?

II Thoughts on the Relevance of Economic Policies

In the development of economic thought to date, there has been a fascinating interdependence between economic events, economic ideas and economic policies. One of the most obvious examples of the interaction since the Second World War is the change of focus from unemployment, a Keynesian idea and economic policy, to inflation that is Monetarism, as an idea and policy. An analogous change occurred in the acceptance of Phillip's curve and Ocun's law from the Second World War until 1970 and their replacement by the vertical Phelp's curve together with the notion of rational expectations.

With the formation of the IMF and GATT, stage was set for the greatest prosperity that the world economy has ever experienced to date.

In the years immediately after 1945 the supply curve of national economies showed a positive Keynesian slope. During the fifties and sixties "it came to be accepted wisdom that businessmen were always in a position to set prices at a margin over costs that would provide them with a rate of return at which they would be happy to invest more. The OEEC in a 1961 report stated:

'The share of labor, apart from cyclical shift, remained remarkably constant in almost all countries around 1950. With high employment, business has been able to maintain a profit margin'". (Marris, S (1984),

During the fifties it became generally accepted that the Phillip's curve, that is a Keynesian type of economic policy was completely compatible for national economies in their attempts to control deflation and also inflation.

It is certainly true that in comparison with XIX century economic liberalism internal economic equilibrium came to have priority over equilibrium of the balance of payments. Foreign trade and currency measures were targeted to achieve affirmative and useful effects from the foreign trade multiplier and accelerator in the interests of economic growth of the national economy. Keynesian economy policy at home was supplemented by choice of a growth strategy based on the dynamic approach to the theory of comparative advantages.
At the beginning, while the argument for protecting new industries was valid, a policy of import-substitution was the dominant strategy for the economic growth of small open economies as well as for large countries. In time the small open economy, which had become a price taker, became more and more geared to an export growth strategy, and had become not only the price taker but also the rule taker. Concentration on the production of an increasing number of tradable ever increasingly made the small and medium countries dependent countries. Unless, of course, the countries concerned had opted for the Prebish or Myrdal models of isolation from the world economy with all the negative consequences of such a decision for growth (as was the case of Latin America). In spite of this, the production of firms of the small open economy more or less completely became part of the offer curve of national economies. The process of transnationalization of the world economy had begun.

In 1958 the currencies of the EEC countries became convertible with the result that their markets and their economic policies became interdependent. Europe has very quickly become competitor to the USA. From 1960-1965 wages in Europe and Japan, the main US competitors, rose from between 2-6 per cent annually, while wages in the US fell during the same period 0.7 per cent. The new wage relationships caused a balance of payments surplus in America which reached 6.6 billion dollars in 1964. (Mandel, E. (1972)

However, acceptance of the concept of full employment based on the slogan ¨We're all Keynesians today¨ required in the USA, and not only there, an expansive monetary policy. In the meantime the expenses of financing the Vietnam War increased; with the result that inflation soon became enemy number one for the American economy. In 1971, the first time since 1888, America had a balance of trade deficit of 2 billion dollars.
The offer curve of the American economy had become a vertical. The world was at that point looking for a new economic policy. When the supply curve had become a vertical Keynesianism became counterproductive. Nevertheless, economists went on trying to cure stagflation by counterproductive Keynesian methods supported by a policy of fluctuating currency rates of exchange. By passing to fluctuating exchange rates in an attempt to save Keynesianism, the effect of the Phillip's curve deepened stagflation the world over. This showed that although the world might have become interdependent, isolationism was still very much alive. In other words priority was still given to the national interests. The supranational concepts, like the process of transnationalization in the world economy, were to gain impetus as soon as the time was ripe. The prosperity of the world economy was certain at some point or another to come to an end. According to C. Dumas "the long expansion of the 1950s and the 1960s consisted to a considerable degree of more of the same... This relates directly to the inadequacy of present capacity, not only in the implied need to invest in new industries' and write down the capacity in shrinking traditional industries but also in the need to transform by new investments the productive processes of industries with still salable products but outmoded method... Both the incentive to apply advanced labor-saving technology and the actual development of such techniques have to be linked to the large increase in wage cost over the past thirty years" (Dumas,C.(1985)

The world economy had to enter a phase of structural transformation. This was well presented by Schuker in his «American Reparations to Germany» in which he gave a reminder that the world economy had for 300 and more years experienced what he called- long waves. Long waves went together with the process of the concentration and centralization of capital - that is with the growth of firms and their efficaciousness. (Schuker, 1990)

The natural result of this was that after 1980 Keynes was replaced by Monetarism. Monetarism had a slogan: "Governments do not solve the problem they are the problem". The Welfare State had played out its role of guardian of economic progress and prosperity. The new economic policy operated under the slogan: "The best industrial strategy is: tough penalties for business failure, high rewards for success and low interest rates without inflation".

Monetarism brought bankruptcy to many firms in all the countries that resorted to it. Since then on Monetarism has become «main stream» economic policy. Even so, Monetarism is still a national economic policy; it still has a national identity. Operating, thus, with national economic development goals, Monetarism achieved structural transformation of the economy in all countries where it took hold, and in the process led to the centralization of capital and the creation of gigantic companies. In the world economy it created conditions for intercontinental economic integration of companies. According to Denis Lumb competition in traded goods rose significantly, since such goods are exposed to global competition. «Between 1979-1989 in America 1.4 million jobs were lost in industry, yet industrial production increased by about 30 per cent. Integration between the transnational corporations of the USA and Europe attained 200 billion dollars annually. In 1989 alone in Europe the business of European transnational companies was integrated by more than 50 billion dollars. Between 1984-1988 direct European and Japanese investment in the USA increased by 108 billion dollars and 37 billion dollars respectively» (.Marris, S. (1984)

Graham's contention concerning the production of « goods in common» is today vindicated. Seems that the production of «goods in common» demands formation of a world economic policy and a world government by replacing national economic policies by a world economic policy.
Any theory of international trade formed according to the principles of the theory of comparative advantages, regardless of whether the production curve is the result of differences in technology (Ricardo) or in proportional availability of factors of production (Hechser-Olin), may with increasing difficulty explain the Leontiev paradox. In an imperfect market Vernon's theory of foreign trade impulse is a far better explanation of the true role of firms on the market and in the international division of labor. Even though Vernon's theory of foreign trade impulse still places the firm and its products in the aggregate offer curve of a national economy. Multinational companies are concerned only by where to locate their production. Decisions concerned with financial sources are of secondary character, since the international financial markets are largely integrated and show a tendency towards complete integration. In this context recently, quite rightly, Krugman, Lancaster, Porter and others in their research to evolve an adequate theory of foreign trade stress characteristics not of countries but of products or industries. The comparative advantage characteristics that underlie trade patterns are viewed as dynamic and often endogenous rather than as static and exogenous. As a result, the welfare implications of trade considered in this framework and of intra-industry trade in particular, are fraught with ambiguity and fragility unknown to the classical and neoclassical paradigms.

III Mega –regions, convergence and economic policy

Krugman's, Lancaster's and others (Soderstein-Reed, 1994) work on economy of increasing returns under imperfect market condition has been confirmed by contemporary practice. Main economic actors on global scale are no nation state any more, particularly so if one thinks about small or underdeveloped nation state. The main actors are firms-transnational corporations.(TNC).TNC locate activities were skill, capabilities and market cluster; capital flows where the returns are greatest and highly skill people move were opportunities lies.

The data prove that high-knowledge activates are produced primarily in increasing return to scale environments that are dependent on urban agglomeration, while low-intensive activities are produced more in environment of constant return to scale(Mc Cann,2008)
New economy consequently contributes to economic divergence between countries. More developed country is the more mega-regions might be found either in the country or across the border with another reach country.
„Europe's largest mega-region is the enormous economic composite spanning Amsterdam-Rotterdam. Ruhr-Cologne, Brussels-Antwerp and Lile .Housing 59, 2 million people and producing nearly $1.5 trillion in economic output, this mega-region production exceeds Canada's and as well as China's or Italy's. "(Florida, R., Mellander, C.2008)
A mega-region asks for mega-regional economic policy, not a national economic policy. A poor mega-region asks for centrally- driven economic policy. The more poor regions in a country the more country has needs for centrally managed economic policy. Additionally a sort of economic policy needed by a poor region is different from a sort of economic policy required by reach region, let alone reach-mega region.

Conclusion

E.U. is economic union, but not completes one. E.U. is not a political union.
In time of fair-weather condition the E.U. may function well both on behalf of its citizens and national state members.
However, in bad-weather conditions (economic crisis) members of the E.U. might need to resort to Keynesian type of economic policy. Keynesian's sort of economic policy might not be effective without proper management of monetary and fiscal policy. Such effective Keynesian policy seems far from reality on the level of the EU. Applied nationally, such an economic policy might contribute to economic divergence between members and might dilute the efforts necessary for achievement of political union in the future. On top of that the reality of mega-region contributes to economic divergence between richer and poorer part of EU.
Taken altogether only one conclusion seems pertinent at this moment, and that is that EU is in the midst of economic policy fog. Great challenge for EU politicians is how to reconcile a) different interests between nations which need an efficient economic and developmental policy, and b) that of big companies having its own profit making motive and demanding state- less economic space? Is an EU as space of regions instead of a space of sovereign states feasible in near future? What is EU going to look like in near future if it is not feasible as state-less entity? Shall we witness another Balkan syndrome developing itself within EU?

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