CAGE
Competitive Advantage in the Global Economy

CHATHAM HOUSE

The CAGE-Chatham House Series, No. 1, June 2012

Saving the Eurozone: Is a 'Real' Marshall Plan the Answer?

Nicholas Crafts

Summary points

- Renewed support for the view that austerity measures are not sufficient and that more robust policies to stimulate growth are required to help the eurozone, and especially southern Europe, survive its current crisis has triggered a debate about the merits of a 'Marshall Plan for Europe'.
- Faster productivity growth in the euro periphery could help improve competitiveness, fiscal arithmetic and living standards; the main role of a real Marshall Plan would be to promote supply-side reforms that raise productivity growth. This would repeat the main achievement of the original Marshall Plan of 1948.
- A real Marshall Plan would have to work as a 'structural adjustment programme', in much the same way as its famous predecessor, namely by achieving reforms through strong conditionality in return for serious money. To be credible the funds would have to be committed, but only released when reforms had been implemented satisfactorily – similar to the deal that worked in the context of EU enlargement in 2004.
- The experience of the Gold Standard's collapse in the 1930s suggests that seeking to keep the eurozone intact by imposing a 'golden straitjacket' on the policy choices of independent nation-states is not a viable option. This points to fiscal federalism with genuine democracy at the EU level as the long-run solution; a new Marshall Plan may not be a substitute for reforms of this kind, but it can certainly serve as a valuable complement.

Introduction

The election of new French president François Hollande has sparked renewed support for the view that austerity measures are not sufficient and that more robust policies to stimulate growth are required to help the eurozone, and especially southern Europe, survive its current crisis. In early May 2012, headlines such as 'EU mulls Marshall Plan for Europe' were splashed across the media, underpinned by stories suggesting that a €200bn 'pact for growth' – comprising investments in infrastructure, renewable energies and advanced technologies – would be proposed at the EU summit in late June.

Sixty years ago, the original Marshall Plan confronted a difficult situation with clear similarities to today's problems. At the end of the 1940s Western Europe had a large balance-of-payments deficit (the 'dollar shortage'). It also faced a potential battle with political extremists who were hostile to the market economy, it was struggling to ignite the growth process that eventually delivered the 'golden age', and it was reluctant to embark on the integration of European markets. Economic historians have little doubt that the Marshall Plan made an important contribution to solving these myriad problems, and in the eyes of the general public it has attained an iconic status, underscored by repeated calls for a new Marshall Plan for Eastern Europe (in the 1990s), for Africa (in the 2000s), and for the Middle East (in 2011).

Could a new Marshall Plan, therefore, come to the rescue of the eurozone by making an exit by countries such as Greece less likely and reducing the risk of a more general exodus? This would surely be attractive to European countries generally since a Greek exit would in all probability have a very damaging impact on their own economies, while a break-up of the eurozone itself would undoubtedly entail a serious negative shock and be likely to trigger a very deep recession. To answer such a question convincingly, it is important not only to understand the problems to which a new Marshall Plan might be the solution but also to recognize both what the original Marshall Plan really was and how it worked in practice. Today, this is not appreciated by most economists, let alone the politicians who argue for a Marshall Plan in a cavalier fashion. If it were well understood, then there would be a greatly improved chance of designing not only a new plan, but a real Marshall Plan that might work.

What are the problems facing the euro periphery countries of southern Europe?

It is well known that the countries in the euro periphery need to undertake fiscal consolidation if they are to restore long-run fiscal sustainability and reduce public debt-to-GDP ratios to prudent levels. Hagemann (2012) has estimated that in 2010 Greece and Portugal needed to achieve a sustained improvement in their primary budget balance of about 10% of GDP in order to achieve a debt–to-GDP ratio of 60% (the limit laid down in the Maastricht Treaty) by 2025, while for Italy and Spain the required improvements were 7% and 9% respectively. Not surprisingly, the economic adjustment programmes for Greece and Portugal agreed as a condition for the emergency loans granted by the EU and IMF entail big fiscal consolidations, with the budget deficit targeted to fall by 13.7% of GDP in Greece between 2009 and 2014 and by 6.8% of GDP in Portugal between 2010 and 2013.

It is also apparent that since the beginning of the Economic and Monetary Union (EMU), southern periphery countries have experienced a substantial loss of international competitiveness as their relative production costs have increased. On average, wage rises have outstripped labour productivity growth by a greater margin than is the case for their trading partners, with no offsetting effects available through a devaluation of the exchange rate. The European Commission (2010) estimated that the overvaluation of the real exchange rate was 13.7% for Greece, 18.5% for Portugal and 12.2% for Spain, while in the previous 15 years, unit labour costs in manufacturing relative to Germany had risen by 45%, 35% and 50% respectively.

It might be expected that fiscal retrenchment could contribute to solving both the public finance and the competitiveness problems of these countries, but the process is likely to be both very painful and seriously protracted. Indeed, a 'lost decade' beckons. High unemployment – to which fiscal contraction will contribute – is central to an adjustment process of this kind as it is needed to create

downward pressure on wages in labour markets that are not very flexible.[1] There is also an unfortunate feedback loop from price and wage deflation as the route to improved competitiveness in that falling prices push up the primary budget surplus required to stabilize or reduce the public debt-to-GDP ratio.[2] It would not be surprising if the option of 'devalue and default' – a chaotic exit from the eurozone – gathered political support in these circumstances.

Table 1: Pre-crisis productivity performance

	2007 Real GDP/hour worked ($1990GK)	Real GDP/HW growth, 1995–2007 (% p.a.)	TFP growth, 1995–2007 (% p.a.)
Greece	17.29	3.36	0.61
Italy	25.63	0.46	-0.20
Portugal	15.62	1.16	-0.63
Spain	23.50	0.48	-0.58
EU15 median*	30.44	1.67	0.64
Czech Republic	14.51	3.87	0.79
Estonia	22.69	7.18	4.71
Hungary	10.66	3.08	0.21
Latvia	14.20	5.84	2.86
Lithuania	15.30	6.30	4.31
Poland	11.83	3.20	2.01
Slovakia	17.32	5.18	2.96
Slovenia	22.40	4.32	1.70

Source: The Conference Board.
*EU15 refers to the pre-2004 accession EU countries and $1990GK indicates the levels are measured at purchasing power parity (PPP) in terms of 1990 US dollars.

A much more attractive way to address the competitiveness and fiscal problems of the euro periphery of southern Europe would be to increase the rate of labour productivity growth. Provided wage increases are restrained, this could be a substitute for either internal or external devaluation, and it would improve fiscal sustainability by narrowing or even completely closing the gap between the real interest rate and the growth rate. Prima facie, there is a lot of scope to improve the euro periphery's productivity performance, as Table 1 illustrates. Pre-crisis total factor productivity (TFP) growth was very weak and there were large labour productivity gaps between southern Europe and the EU15 median. In that context, labour productivity growth was at best mediocre and at worst very disappointing. This is underlined by the far superior labour productivity growth generally achieved by the 2004 accession countries, which saw Greece and Portugal overtaken in the early 2000s by Estonia, Slovakia and Slovenia. If the euro periphery's productivity problem could be effectively addressed, living happily within the eurozone would look much more feasible in the long run.

What would speed up productivity growth in southern Europe?

In recent years, a large body of empirical evidence has been produced which has resulted in a wide consensus on the reasons for disappointing productivity growth in southern Europe. As the Organisation for Economic Co-operation and Development (OECD) puts it, there has been insufficient 'structural reform'. This has retarded the diffusion and effective assimilation of new technologies, impeded the entry of new producers and the exit of inefficient firms, and impaired incentives to innovate and invest. Several quantitative indicators in Table 2 highlight these weaknesses.

The 'Doing Business' indicator takes account of several aspects of the business environment, including the costs of starting a new business, the ease of obtaining construction permits, the difficulty of enforcing contracts, protection for investors etc. Greece and Italy are both in the third quartile of the rankings; econometric estimates suggest that this exacts a productivity growth penalty of about 1.5 percentage points per year compared with being in the first quartile alongside northern Europe (Djankov et al., 2006). Similarly, the OECD product market regulation (PMR) indicator, which seeks to capture how far regulation inhibits competition in

1 Fiscal contraction can be expansionary, but history says this is not the normal result and, in particular, this is unlikely when the exchange rate is fixed (Guajardo et al., 2011).

2 The basic algebra is that $\Delta d = b + (i - \pi - \Delta Y/Y)d$ where d is the debt-to-GDP ratio, b is the primary budget deficit, i.e., the budget deficit without including interest payments on the debt, i is the nominal interest rate, π is the rate of inflation and $\Delta Y/Y$ is the rate of growth of real GDP. So for $\Delta d = 0$, the required primary budget surplus $-b = d(i - \pi - \Delta Y/Y)$. Price deflation means that π is negative and this clearly makes the fiscal task much harder given that i cannot be negative.

Table 2: Structural reform scoreboard

	Doing business rank (1–183)	Product market regulation (0–6)	Employment protection legislation (0–6)	PISA score	Years of schooling
Greece	100	2.30	2.97	468	12.3
Italy	87	1.32	2.58	486	11.5
Portugal	30	1.35	2.84	490	9.8
Spain	44	0.96	3.11	486	12.2
EU15 median	29	1.27	2.58	495	13.0
Czech Republic	64	1.56	2.32	496	12.7
Estonia	24	1.24	2.39	520	n/a
Hungary	51	1.23	2.11	497	12.3
Latvia	21	n/a	n/a	n/a	n/a
Lithuania	27	n/a	n/a	n/a	n/a
Poland	62	2.20	2.41	502	12.6
Slovakia	48	1.54	2.13	494	12.9
Slovenia	37	1.38	2.76	507	n/a

Sources: Doing business rank: overall score (World Bank); Product market regulation: overall PMR (OECD); Employment protection legislation (OECD); PISA (Programme for International Student Assessment) score: average of maths and science (OECD); Years of schooling: 25–34 age cohort (OECD).

product markets, shows high scores compared with more liberalized countries within the EU. Conway and Nicoletti (2007) report that if PMR fell to the level of the least restrictive country, labour productivity growth would be about 1.8 and 1.3 percentage points per year higher in Greece and Portugal respectively. The estimates in Bassanini et al. (2009) are that if employment protection in Greece fell to the lowest level in the EU, productivity growth would increase by about 0.3 percentage points per year.

Another key area of weakness in the euro periphery of southern Europe is education. This has productivity implications both through the direct impact of labour quality and through indirect effects on the diffusion of new technologies, especially ICT. Hanushek and Woessmann (2011) suggest that the quality of education, as reflected in international test scores, has a strong effect on productivity growth in the long run. If Greece's PISA score were to rise from 468 to the top EU score of 548, they estimate that this would raise growth by nearly 1 percentage point per year. A shortfall of human capital is highlighted by Conway and Nicoletti (2007) as the major reason why countries in southern Europe were relatively slow to invest in ICT as these technologies took off.

Table 2 also offers some comparisons with the 2004 accession countries. It is noteworthy these tend to show southern Europe in a rather unfavourable light on several fronts. Indeed, post-communist reform of the business environment has taken the accession countries well past Greece and Italy. PISA scores in all 4 countries (Greece, Portugal, Spain and Italy) lag well behind Estonia's, while the level for average years of schooling in Portugal is much lower than those prevailing in the East. Moreover, the weakness of competition in Greece stands out and is much greater than in most of the accession countries.

Beyond the data reported in Table 2, OECD economists have pointed to a wider range of policies that could be reformed with a favourable impact on real GDP per capita. These include a number of labour market policies and various aspects of the tax system. If all of these were implemented to bring countries in southern Europe in line with the OECD average, the study predicts that the long-run income level would rise by over 40% in Greece, 36% in Portugal, 17% in Italy and 16% in Spain (Barnes et al., 2011). However, it is important to note that while much of the impact of regulatory and fiscal changes

feeds through within 10 years, the full effect of educational reforms inevitably takes much longer to be realized.

What does a look in the 1930s mirror reveal?

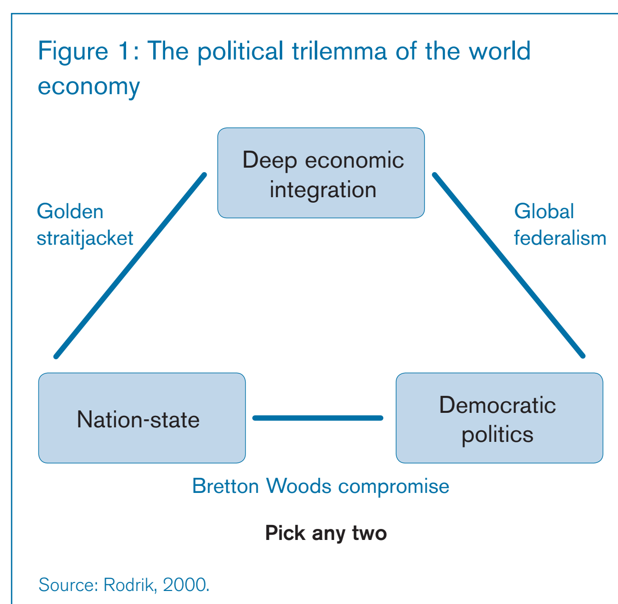
During the Great Depression the Gold Standard collapsed. The demise of this fixed exchange rate system was complete when France, the Netherlands and Switzerland abandoned the Gold Standard in 1936, but it was already doomed from September 1931 onwards when Britain left it, followed by the United States in March 1933 during the early days of President Franklin D. Roosevelt's New Deal. The 1930s were also notable for a large number of sovereign debt defaults, especially in Latin America, but Austria and Germany suffered the same fate too.

The key point in this regard is that devaluation and default were good for growth. Indeed, there is a very clear correlation between the countries that exited early from the Gold Standard and those that recovered rapidly from the slump (Bernanke, 1995). Abandoning the Gold Standard allowed countries to reduce both nominal and real interest rates, to relax fiscal policy and to escape the need to reduce money wages and prices through a prolonged recession in order to regain international competitiveness. It is also clear that growth was promoted by sovereign default, which improved the fiscal arithmetic by eradicating debt overhangs and bolstered the balance of payments through the elimination of debt-service flows (Eichengreen and Portes, 1990).

The decision to leave the Gold Standard was analysed by Wolf (2008), who used an econometric model to examine the odds of countries remaining in this fixed exchange rate system. The model accurately predicts departures and shows that a country was more likely to exit from the Gold Standard if its main trading partner had done so, if it had returned to gold at a high parity, if it was a democracy or if the central bank was independent. Conversely, it was less likely to leave if it had large gold reserves, less price deflation and strong banks. In other words, the loss of international competitiveness and greater pain from deflationary pressures hastened a country's exit.

The implosion of the Gold Standard can also be understood in terms of the political trilemma, formulated by Rodrik (2000) and reproduced in Figure 1. This posits that it is generally only possible to have at most two of the following: deep economic integration, democratic politics and the nation-state. In the 1920s, with the return to the Gold Standard, countries had signed up to the 'golden straitjacket', which had been acceptable in the context of very limited democracy in the 19th century. But in the 1930s, democratic politics at the level of the nation-state overruled this policy choice, and when reconstruction of the international economy was subsequently undertaken under the auspices of the 1944 Bretton Woods agreement, economic integration was severely restricted by controls on international capital flows (the 'Bretton Woods compromise' in Figure 1). The point is that retaining the benefits of deep economic integration required action to organize it through democratic politics at a supranational level. It should also be noted that undertaking long periods of deflation, perhaps in the attempt to comply with the golden straitjacket, helped spawn the rise of extremist political parties.[3]

Figure 1: The political trilemma of the world economy



Source: Rodrik, 2000.

3 Econometric analysis shows that undergoing a long and deep contraction in GDP was associated with votes for extremist political parties (de Bromhead et al., 2012). The example of deflation under Chancellor Heinrich Brüning in Germany, followed by the rise of the Nazis, is often cited in this context. The link between prolonged recession and extremism is clearly more complex than this, and de Bromhead et al. point also to the importance of the structure of the electoral system and the depth of democratic traditions in determining political outcomes.

Several aspects of the 1930s experience have implications for the OECD structural reform agenda. First, it is well known that the Great Depression saw big increases in protectionism. Eichengreen and Irwin (2010) demonstrate that countries that devalued were, on average, less protectionist in nature. They argue that protectionism in the 1930s should be seen as a second-best policy, which was used when conventional macroeconomic management tools in the form of fiscal and monetary policy were unavailable. The countries in this position today are eurozone economies with sovereign debt and competitiveness problems. Second, the 1930s saw a general retreat from competition, together with increases in regulation and, in Europe, nationalization. Voters were less willing to place trust in markets and demanded greater state intervention. Third, the 1930s experience encouraged workers to demand greater social protection and promoted tighter regulation of the labour market. Across European countries this pointed the way towards the development of much more ambitious social policies and a big increase in social transfers.

The broad direction of these policy responses to the 1930s economic crisis runs very much against the grain of the supply-side reforms that are required to speed up European growth. They do not bode well for the agenda of completing the single market and making labour markets more flexible and employment-friendly, as put forward by Sapir (2006).

The 1930s experience suggests that a strategy of devaluation and sovereign default is an attractive escape route from the eurozone for the periphery countries of southern Europe. It also suggests that once one country exits, others may quickly follow. The pressures on the survival of the eurozone are thus likely to intensify. However, the benefit/cost ratio of leaving the Gold Standard then was very different from that of leaving the eurozone today; a decision to reintroduce a national currency now might engender 'the mother of all financial crises' (Eichengreen and Temin, 2010) through instantaneous capital flight and a collapse of the banking system.

If that is the case, then logic points to a solution to the political trilemma problem that is different from either the 1930s retreat from economic integration or the 1950s 'Bretton Woods compromise'. The implication is that deep economic integration and democratic politics are chosen by going down the route of 'global federalism' in a 'United States of Europe' rather than that of deep economic integration combined with the nation-state through the 'golden straitjacket.' Ultimately, this would require major political and economic reforms which would lead to a fiscal union while at the same time addressing the European Union's democratic deficit. In this context, might a new Marshall Plan have a key role to play?

What did the 1940s Marshall Plan achieve?[4]

The Marshall Plan was a major aid programme which transferred $12.5bn (an average of about 1.1% of American GDP) from the United States to Western Europe between 1948 and 1951. The idea of the Marshall Plan, later formally designated as the European Recovery Program (ERP), was first put forward by US Secretary of State George C. Marshall in a commencement speech at Harvard University on 5 June 1947.[5] The United States had already given substantial amounts of aid: between July 1945 and the end of 1947 flows amounted to $13bn and the GARIOA programme was under way.[6] Without the Cold War, the further support of Congress for such a massive aid programme would have been inconceivable, but it is important to recognize that the provision of aid through in-kind transfers had solid support from exporters and agricultural interests, and that the trade unions were placated by provisions stipulating, for example, that the supply of goods to Europe would be carried on American ships loaded by American dockers (Gardner, 2001).[7] The rhetoric that the Marshall Plan was vital for saving Europe prevailed.

4 More detail can be found in Crafts (2011).

5 Marshall was awarded the Nobel Peace Prize in 1953 for his role as the architect of and advocate for the Marshall Plan.

6 GARIOA is an acronym for Government and Relief in Occupied Areas, which financed imports of food, petroleum and fertilizers. Germany received aid under this programme from July 1946 to March 1950, and during the period of overlap with the Marshall Plan it received more from GARIOA.

7 Congressional support would presumably not have been forthcoming if the Soviet Union had accepted the American offer that it could participate together with its East European satellites. For a game-theoretic analysis which claims that this was an offer whose refusal was rationally anticipated, see Gardner (2001).

Table 3: The distribution of Marshall Aid, 1948–51 (US$ million and % GDP annually)

	$ million	% GDP
United Kingdom	2826.0	1.8
France	2444.8	2.2
Italy	1315.7	2.3
West Germany	1297.3	1.5
The Netherlands	877.2	4.0
Austria	560.8	5.7
Belgium and Luxembourg	546.6	2.2
European Payments Union	350.0	N/A
Denmark	257.4	2.2
Norway	236.7	2.5
Sweden	118.5	0.4

Sources: Bossuat (2008) and Eichengreen and Uzan (1992).
Note: Other countries not listed here received funds.

The key mechanisms by which the Marshall Plan was implemented were as follows. First, European economies were allocated aid according to their dollar balance-of-payments deficits (see Table 3). These inflows amounted to about 2% of GDP per year for the European beneficiaries. American goods were shipped to meet the requests of individual countries. Second, each recipient country deposited the equivalent amount to pay for these imports in a so-called Counterpart Fund. The balances in this fund could be reclaimed for approved uses, and approval was determined by the Marshall Plan authorities in the guise of the European Co-operation Agency (ECA), which had a resident mission in each country. Third, a productivity assistance programme aiming to reduce the productivity gap between Europe and the United States was established. This financed study tours by Europeans and provided follow-up technical service. Fourth, each recipient country signed a bilateral treaty with the United States committing it, *inter alia*, to follow policies of financial stability and trade liberalization, including most-favoured-nation treatment for West Germany. Fifth, the Organization for European Economic Co-operation (OEEC), which was established in April 1948, provided 'conditional aid' of about $1.5bn to back an intra-West European multilateral payments agreement; in 1950 Marshall Aid recipients became members of the European Payments Union (EPU).[8]

It is generally agreed that the direct effects of the Marshall Plan on European growth were small, and the bottom line is that by alleviating bottlenecks and raising savings the growth rate of recipients was on average only raised by perhaps 0.3% per year (Eichengreen and Uzan, 1992). But this is to miss the much greater significance of the Marshall Plan as a 'structural adjustment programme', that is to say policy-based lending with conditionality – according to DeLong and Eichengreen (1993) the most successful ever. Indeed, looking at the Marshall Plan as a structural adjustment programme also reveals that it had a common core with the Washington Consensus as originally formulated by Williamson (1990).[9] This comprises support for policies that are conducive to macroeconomic stabilization, are outwardly orientated, and strengthen the operations of the market economy. It worked in post-war Western Europe by tipping the balance in favour of these reforms.

Conditionality was embedded in the Marshall Plan in several ways. First, the bilateral treaty that each country had to sign was an agreement that embodied sound macroeconomic policies and a commitment to trade liberalization. Second, the requirement for American permission to use Counterpart Funds gave the ERP authorities both some control over the use of resources and ostensibly important bargaining power with regard

8 The EPU was a mechanism that addressed the absence of multilateral trade settlements in a world of inconvertible currencies and dollar shortage. In such circumstances, the volume of trade between each pair of countries was constrained to the lower of the amount of imports and exports, because a surplus with one country could not be used to offset a deficit with another. The EPU provided a multilateral clearing system supplemented by a credit line for countries temporarily in overall deficit. This was facilitated by the United States through conditional Marshall Aid acting as the main 'structural creditor' to address the difficulty that would otherwise have arisen from the prospect that some countries were likely to be persistent debtors; see Eichengreen (1993).

9 This is based on interpreting the Washington Consensus through the prism of its economic dimensions rather than its alleged ideological connotations of neo-liberalism or market fundamentalism.

to domestic policy decisions. Third, Marshall Aid gave the Americans leverage to encourage recipients to join the European Payments Union (EPU), which also entailed reducing barriers to trade and adopting most-favoured-nation treatment of imports from other members.

Although the EPU was a second-best way of reviving European trade and multilateral settlements, compared with full current-account convertibility, it accelerated the process by solving a coordination problem. It lasted until 1958, by which time intra-European trade was 2.3 times that of 1950, and a gravity-model analysis confirms that the EPU had a large positive effect on trade levels (Eichengreen, 1993). This can be seen as a stepping stone to further trade liberalization through increases in the political clout of exporting companies relative to import-competing firms. By the mid-1970s, the long-term effect of economic integration raised European income levels substantially, by nearly 20% according to estimates by Badinger (2005).

In sum, the ERP was quite far removed from what most people who advocate new 'Marshall Plans' have in mind. The amounts of aid were modest relative to the GDP of the recipients and conditionality-based policy reform was central to its success. The reforms promoted by the ERP, however, were highly conducive to faster economic growth in an attempt to bridge the gulf with the United States by reducing the large productivity gaps that existed at the end of the 1940s.

What would a real Marshall Plan entail today?

The objective of a real Marshall Plan for crisis countries in the euro periphery of southern Europe would be to underpin European economic integration and the survival of the eurozone by raising productivity growth. This would entail increased but not massive transfers of funds. The central component, as in the 1940s, would be to formulate a successful structural adjustment programme with strict conditionality focused on improving productive potential rather than simply spending more of the EU budget. Counterpart Funds would be required and staying in the eurozone would be mandatory. Such a scheme would be similar in spirit to the ERP. Conditionality would be enforced by the donors.

The structural reforms that would be targeted by a real Marshall Plan are those already identified and regularly featured in OECD commentaries. These include commitments to product market reforms, which would mean serious moves towards full implementation of the Single Market and, in the case of Greece, rapid improvement in its PMR and Doing Business scores, fiscal reforms to broaden the tax base, a switch towards rapid consumption and property taxes, and labour-market reforms to increase flexibility, to reduce the NAIRU (non-accelerating inflation rate of unemployment) and to increase labour force participation. Such changes would not only improve productivity but also go some way towards restoring lost competitiveness. They are essentially changes in economic policy rather than investments in projects and in most cases would incur political rather than monetary costs. In the longer term, improvements in educational quality should also be a focal point.

There are considerable unused Structural and Cohesion Funds from the 2007–13 allocations for both Greece and Portugal, amounting to around 7% and 9.3% of GDP respectively at the start of 2012. In principle, if these were quickly transferred, perhaps financed by borrowing against the commitments of the contributors to the EU budget, the flow of funds in the near future would be similar to the levels of the ERP. They could contribute to a European Fund for Economic Revival and partly offset fiscal consolidation while also helping with structural reform (Marzinotto, 2011).

A real Marshall Plan could not, however, be based on the present design of the EU's Structural Funds and would require this programme to be thoroughly reformed. As Table 4 shows, the spending priorities of the current programme are not well aligned with the supply-side reforms that are required to improve productivity performance in southern Europe. There is far too little emphasis on promoting structural reforms. Nor is there any conditionality that uses structural funds as a lever for these purposes.

Table 4: Top 6 Structural Funds allocations, 2007–13 (% total)

Greece		Portugal	
Transport	25.6	Human capital	23.7
Environment	17.5	Research and development	21.8
Research and development	9.3	Social infrastructure	12.8
Employment	8.0	Environment	11.2
Information society	8.0	Transport	8.9
Human capital	8.0	Regeneration	4.2

Source: European Commission.

Research on the impact of structural funds shows that, although there are positive short-run effects on regional growth, on average this spending has not been optimized. A key point is whether the recipient region has adequate absorptive capacity, which seems particularly to concern its level of human capital and its quality of government (Becker et al., 2012). Without an appropriate threshold being reached in this regard, structural funds have had no medium-term growth effect and, indeed, have been unsuccessful in raising investment in Greece and Portugal. The implication is that a real Marshall Plan would have to be delivered under the auspices of much stronger surveillance and with a credible threat to withhold funds for non-compliance, as was pointed out in a recent IMF Staff Report (Allard and Everaert, 2010).

Expectations of what could be achieved need to be realistic and the limitations of this approach must be recognized. An increase of 1 percentage point per year in productivity growth over the next decade would be a good outcome. It is certainly not a substitute for moves towards fiscal union or reforms to banking aimed at achieving financial stability which are needed to repair the flaws of the original eurozone design, but such a plan might increase the chances of the area's survival and this could be in the interests of countries in both northern and southern Europe.

Would it work?

What does a real Marshall Plan have in its favour? Clearly, if it worked as well as its predecessor, then the outlook for the euro periphery crisis countries of southern Europe would be significantly better. Growth prospects would improve and life within the eurozone would become less difficult. There would be considerable scope for catch-up growth based on a reduction of productivity gaps with northern Europe if structural reforms were taken seriously. And from the perspective of northern Europe, it would in principle be worth paying something to reduce exposure to a chaotic break-up of the eurozone.

However, the general record of structural adjustment programmes suggests these are big 'ifs'. The experience of the IMF and World Bank in the 1980s and 1990s was that the results were generally disappointing in terms of both compliance and outcomes. More specifically, the success or failure of World Bank programmes seemed to have depended mainly on domestic political economy considerations, the implication being that 'the key to successful adjustment lending is to find good candidates to support' (Dollar and Svensson, 2000).

Do Greece and Portugal shape up as good candidates? At best, this seems doubtful. Austerity is deeply unpopular in both countries and there is already ample evidence to draw on following the implementation of the reforms agreed with the EU and IMF in return for the loans granted in the last two years. In this context, the recent European Commission Reviews of these programmes make for disappointing reading, especially with respect to Greece. Indeed, the record shows a lack of both progress and enthusiasm for structural reforms in Greece (European Commission, 2012a) and a falling behind in the case of Portugal (European Commission, 2012b).

The EU does have recent experience of great success in using conditionality to achieve political and economic reform in the light of the accession process that led to enlargement in 2004. The key reason for this success was the incentive of a big prize, notably in the form of the perceived benefits of EU membership relative to the political costs of compliance, together with a credible threat to withhold membership if the conditions imposed were not met (Schimmelfennig et al., 2005). Could something similar be constructed in the guise of a real Marshall Plan?

Yes, but the programme would have to offer serious money to the crisis countries and most of it would have to be made available only after structural reforms had been fully

implemented. Although the politics of this is challenging, the arithmetic is not. Because the economies of northern Europe are so much larger than those of the crisis countries, even a quarter of the flows involved in the ERP (0.25% GDP per year) would be a major boost to southern Europe and could finance inflows of over 5% of GDP for both Greece and Portugal.

The threat to abort the programme in future if reforms were not undertaken as prescribed would be given additional credibility by ensuring that the time bought in the initial phase was used to minimize the collateral damage from a Greek and/or Portuguese exit from the eurozone. But it would also depend on designing an institutional mechanism to guarantee the punishment of an existing member, and it is here that the EU's track record with the Stability and Growth Pact does not inspire much confidence. In effect, pursuing a newly designed real Marshall Plan would require a triumph of hope over experience. This would make it a hard sell to German politicians in 2012 in the absence of the Cold War pressures that persuaded the US Congress to give the original Marshall Plan the green light in 1948.

Conclusion

Faster productivity growth in the euro periphery could help improve competitiveness, fiscal arithmetic and living standards; the main role of a real Marshall Plan would be to promote supply-side reforms that raise productivity growth. This would repeat the main achievement of the original Marshall Plan in the 1950s.

The rationale for a real Marshall Plan would be both to reduce the chances of a chaotic break-up of the eurozone and to allow more time to prepare for this eventuality – while at the same time working to improve the medium-term economic performance of the euro periphery.

Throwing money at southern Europe through more of the same structural funds is not the answer because they are badly targeted and have not been successful in raising long-term growth prospects; a real Marshall Plan would have to be designed differently.

A real Marshall Plan would have to work as a 'structural adjustment programme', in much the same way as its famous predecessor, namely by achieving reforms through strong conditionality in return for serious money. To be credible the funds would have to be committed, but only released when reforms had been implemented satisfactorily – similar to the deal that worked in the context of EU enlargement in 2004. Unfortunately, the eurozone's track record inspires little confidence that conditionality can be imposed effectively on existing members, and the history of structural adjustment programmes imposed by agencies such as the World Bank suggests that a key condition for success – a domestic acceptance of reforms – will continue to be a tough sell in the euro periphery of southern Europe.

While there is considerable scope to improve productivity performance in southern Europe and to agree on the policy changes that would be required to deliver this, a well-planned structural adjustment programme could provide a much-needed incentive. Indeed, delivering productivity-enhancing reforms that do not require massive financial outlays – but that have been too costly in terms of domestic politics – could rapidly improve the growth prospects of these periphery countries.

The experience of the Gold Standard's collapse in the 1930s suggests that seeking to keep the eurozone intact by imposing a 'golden straitjacket' on the policy choices of independent nation-states is not a viable option. This points to fiscal federalism with genuine democracy at the EU level as the long-run solution; a new Marshall Plan may not be a substitute for reforms of this kind, but it can certainly serve as a valuable complement.

References

Allard, C. and Everaert, L. (2010), 'Lifting Euro Area Growth: Priorities for Structural Reforms and Governance', IMF Staff Position Note 10/19.

Badinger, H. (2005), 'Growth Effects of Economic Integration: Evidence from the EU Member States', *Review of World Economics*, 141: 50–78.

Barnes, S., Bouis, R., Briard, P., Dougherty, S. and Eris, M. (2011), 'The GDP Impact of Reform: a Simple Simulation Framework', OECD Economics Department Working Paper No. 834.

Bassanini, A., Nunziata, L. and Venn, D. (2009), 'Job Protection Legislation and Productivity Growth in OECD Countries', *Economic Policy*, 58: 349–402.

Becker, S. O., Egger, P. and von Ehrlich, M. (2012), 'Absorptive Capacity and the Growth Effects of Regional Transfers: a Regression Discontinuity Design with Heterogeneous Treatment Effects', University of Warwick CAGE Working Paper No. 89.

Bernanke, B. (1995), 'The Macroeconomics of the Great Depression: A Comparative Approach', *Journal of Money, Credit and Banking*, 27: 1–28.

Bossuat, G. (2008), 'The Marshall Plan: History and Legacy', in E. Sorel and P. C. Padoan (eds), *The Marshall Plan: Lessons Learnt for the 21st Century* (Paris: OECD), pp. 13–28.

Conway, P. and Nicoletti, G. (2007), 'Product Market Regulation and Productivity Convergence: OECD Evidence and Implications for Canada', *International Productivity Monitor,* 15: 3–24.

Crafts, N. (2011), 'The Marshall Plan: A Reality Check', University of Warwick CAGE Working Paper No. 49.

de Bromhead, A., Eichengreen, B. and O'Rourke, K. H. (2012), 'Right-Wing Political Extremism in the Great Depression', NBER Working Paper No. 17871.

DeLong, J. B. and Eichengreen, B. (1993), 'The Marshall Plan: History's Most Successful Adjustment Program', in R. Dornbusch, W. Nolling and R. Layard (eds), *Postwar Economic Reconstruction and Lessons for the East Today* (Cambridge, MA: MIT Press), pp. 189–230.

Djankov, S., McLiesh, C. and Ramalho, R. M. (2006), 'Regulation and Growth', *Economics Letters*, 92: 395–401.

Dollar, D. and Svensson, J. (2000), 'What Explains the Success or Failure of Structural Adjustment Programmes?', *Economic Journal*, 110: 894–917.

Eichengreen, B. (1993), *Reconstructing Europe's Trade and Payments* (Manchester: Manchester University Press).

Eichengreen, B. and Irwin, D. (2010), 'The Slide to Protectionism in the Great Depression: Who Succumbed and Why?', *Journal of Economic History*, 70: 871–97.

Eichengreen, B. and Portes, R. (1990), 'The Interwar Debt Crisis and Its Aftermath', *World Bank Research Observer*, 5: 69–94.

Eichengreen, B. and Temin, P. (2010), 'Fetters of Gold and Paper', *Oxford Review of Economic Policy*, 26: 370–84.

Eichengreen, B. and Uzan, M. (1992), 'The Marshall Plan: Economic Effects and Implications for Eastern Europe and the former USSR', *Economic Policy*, 14: 13–75.

European Commission (2010), *Surveillance of Intra-Euro Area Competitiveness and Imbalances.*

European Commission (2012a), *The Second Adjustment Programme for Greece.*

European Commission (2012b), *The Economic Adjustment Programme for Portugal.*

Gardner, R. (2001), 'The Marshall Plan Fifty Years Later: Three What-Ifs and a When', in M. Schain (ed.), *The Marshall Plan: Fifty Years After* (Basingstoke: Palgrave), pp. 119–29.

Guajardo, J., Leigh, D. and Pescatori, A. (2011), 'Expansionary Austerity: New International Evidence', IMF Working Paper No. 11/158.

Hagemann, R. P. (2012), 'Fiscal Consolidation Part 6: What Are the Best Policy Instruments for Fiscal Consolidation?', OECD Economics Department Working Paper No. 937.

Hanushek, E. A. and Woessmann, L. (2011), 'How Much do Educational Outcomes Matter in OECD Countries?', *Economic Policy,* 67: 427–91.

Marzinotto, B. (2011), 'A European Fund for Economic Revival in Crisis Countries', Bruegel Policy Contribution, 2011/01.

Rodrik, D. (2000), 'How Far Will International Economic Integration Go?', *Journal of Economic Perspectives,* 14(1): 177–86.

Sapir, A. (2006), 'Globalization and the Reform of European Social Models', *Journal of Common Market Studies*, 44: 369–90.

Schimmelfennig, F., Engert, S. and Knobel, H. (2005), 'The Impact of EU Political Conditionality', in F. Schimmelfennig and U. Sedelmeier (eds), *The Europeanization of Central and Eastern Europe* (Ithaca, NY: Cornell University Press), pp. 29–50.

Williamson, J. (1990), 'What Washington Means by Policy Reform', in J. Williamson (ed.), *Latin American Adjustment: How Much Has Happened?* (Washington, DC.: Institute for International Economics), pp. 5–20.

Wolf, N. (2008), 'Scylla and Charybdis: Explaining Europe's Exit from Gold, January 1928 to December 1936', *Explorations in Economic History*, 45, 383–401.

The CAGE–Chatham House Series

This is the first in a series of policy papers published by Chatham House in partnership with the Centre for Competitive Advantage in the Global Economy (CAGE) at the University of Warwick. Forming an important part of Chatham House's International Economics agenda and CAGE's five-year programme of innovative research, this series aims to advance key policy debates on issues of global significance.

Forthcoming:
Adjusting to Global Economic Shocks, S. Mukand

Financial support for this project from the Economic and Social Research Council (ESRC) is gratefully acknowledged.

About CAGE

Established in January 2010, CAGE is a research centre in the Department of Economics at the University of Warwick. Funded by the Economic and Social Research Council (ESRC), CAGE is carrying out a five-year programme of innovative research.

The Centre's research programme is focused on how countries succeed in achieving key economic objectives, such as improving living standards, raising productivity and maintaining international competitiveness, which are central to the economic well-being of their citizens.

CAGE's research analyses the reasons for economic outcomes both in developed economies such as the UK and emerging economies such as China and India. The Centre aims to develop a better understanding of how to promote institutions and policies that are conducive to successful economic performance and endeavours to draw lessons for policy-makers from economic history as well as the contemporary world.

Chatham House has been the home of the Royal Institute of International Affairs for ninety years. Our mission is to be a world-leading source of independent analysis, informed debate and influential ideas on how to build a prosperous and secure world for all.

Nicholas Crafts FBA is Professor of Economic History and Director of the ESRC Research Centre, Competitive Advantage in the Global Economy at Warwick University. His previous academic career has included posts at the London School of Economics, Stanford University, UC Berkeley, and the University of Oxford. He has been a consultant to BIS, EBRD, European Commission, HM Treasury, IMF and World Bank. His book *The Great Depression of the 1930s: Lessons for Today* (edited with Peter Fearon) will be published by Oxford University Press in 2012.

Chatham House
10 St James's Square
London SW1Y 4LE
www.chathamhouse.org

Registered charity no: 208223

Chatham House (the Royal Institute of International Affairs) is an independent body which promotes the rigorous study of international questions and does not express opinions of its own. The opinions expressed in this publication are the responsibility of the author.

© The Royal Institute of International Affairs, 2012

This material is offered free of charge for personal and non-commercial use, provided the source is acknowledged. For commercial or any other use, prior written permission must be obtained from the Royal Institute of International Affairs. In no case may this material be altered, sold or rented.

Cover image: 'Chancellor Merkel Meets With Social Partners At Meseberg' © istockphoto.com
Designed and typeset by Soapbox, www.soapbox.co.uk