CENTRE FOR STUDIES ON FEDERALISM

policy paper

Olimpia Fontana

Beyond the Recovery: Europe's New Challenge Is Growth

March 2014 - n. 4

*The **Policy Paper** series of the Centre for Studies on Federalism includes analyses and policy-oriented research in the field of national and supranational federalism. The papers aim to stimulate scholarly and political debate on topical issues by presenting original data, ideas and proposals.*

OLIMPIA FONTANA is a research fellow at the CSF.

Beyond the Recovery: Europe's New Challenge Is Growth

Olimpia Fontana

Introduction

In recent months, the Eurozone has shown positive signs of change: the path towards banking union has been undertaken, financial markets have once again begun to invest in peripheral countries' government bonds, and the current account deficits of the weak peripheral countries are in the process of being reduced.

Despite these achievements, Europe's position on the international stage remains a matter of concern: according to the International Monetary Fund (IMF), Europe is estimated to grow at a rate of 1% in 2014, compared to a growth rate of 2.6% in the U.S., while the number of unemployed on the old continent has risen to 20 million, with youth unemployment peaking at 50% in Spain and Greece[1]. Unemployment has gone from being a result of the crisis to the cause: people without jobs consume less, while businesses invest and hire less.

To paraphrase the words of Pier Carlo Padoan, the former Vice-President and Chief Economist of the OECD, the problem emerging in Europe is that it is unclear to what extent there are mechanisms by which, once the effect of the various support measures has worn off, recovery will be sustainable[2]. Essentially, even in the best-case scenario, one in which we stay abreast of economic recovery, the risk is that it would not evolve into a true path of growth.

Even the IMF has now rejected the theory of expansionary austerity, and the austerity measures taken by the European

Union do not explain the recent improvements in the economy[3]. A more plausible explanation of recovery seems to lie in the monetary policy adopted by the European Central Bank (ECB) thanks to the purchase of government bonds on the secondary market. This has resulted in market recovery and stability, but in the long run monetary policy will not be enough: initiatives need to be taken aimed at growth and prioritising employment.

European Macroeconomic Policy

The structure of the macroeconomic policy of the Economic and Monetary Union (EMU) is unique and unprecedented among monetary unions: the Union's monetary policy is centralised, while fiscal policy largely remains a national prerogative. While European monetary policy addresses price stability, fiscal policy consists of a set of rules that are designed to ensure macroeconomic stability, which is not related to employment stability, but, again, to price. Therefore, the priority upon which the entire apparatus of European macroeconomic policy must converge is controlling inflation and pursuing sound public finances. Such an approach creates two types of problems.

Firstly, the rules superimposed by the Stability and Growth Pact (SGP) and its developments[4] interfere with national fiscal policies to the extent that these should ensure the stabilisation of the economic cycle against any events that might disrupt its performance. In economic theory, when automatic stabilisers are not sufficient to correct economic downturn, the public sector may intervene with discretionary measures to stimulate recovery. However, in European practice, this initiative clashes with the rules that place constraints on deficit creation. In a non-optimal monetary union such as the Eurozone, fiscal restrictions should be imposed to prevent the excessive debt of one country from being transmitted to another.

Secondly, the fact that the EMU is not backed by a substantial federal budget generates an atypical monetary union, which must constantly seek ways to create a compromise between European and national decision-making powers with respect to national budgets[5].

Consequences of the Coordination Method

The European Union's approach to ensuring its member countries' fiscal sustainability is based on a mix of coordination of national policies - to be carried out by "merely" complying with established parameters - and the supervision of the same policies - through special infringement procedures. This method was first applied with the SGP, signed in 1997, which on the one hand confirmed compliance with the limits of 3% deficit-to-GDP ratio and of 60% debt-to-GDP ratio, and on the other the early warning mechanism provided for states that do not comply with, or are on the way to not complying with, these limits.

At the height of the crisis, greater fiscal discipline[6] for European economic governance was adopted also because the SGP had proven to be inadequate to achieve stabilisation objectives. The measures taken followed two lines of action: crisis prevention, i.e., measures for pre-existing debt reduction and the consolidation of public finances, and crisis management, i.e., measures to contain the worst effects of the crisis through the establishment of new intergovernmental bodies (the EFSF and the ESM) for the financial salvation of the euro. At this stage, macroeconomic coordination took place within the framework of the first dimension, through a series of complex packages designed to strengthen the SGP (the Six Pack and the Two Pack) and the requirement for countries to incorporate the balanced-budget rule preferably at the constitutional level (the Fiscal Compact).

Despite ambitions to create convergence of economic fundamentals among the member countries, the introduction of the euro combined with the coordination method has produced a number of economic and political vulnerabilities. The stability of the average inflation rate, namely the ECB's categorical imperative, has been achieved in the Eurozone, but the lack of attention to other macroeconomic variables has led Europe down a path of unsustainable economic growth, because it has been based on strong financial and external imbalances among the member countries. Household debt in the peripheral countries increased by an average of 53% from 2002 to 2007, while in Germany it actually decreased by 10% and in France rose by only 16%. In the same period, the weak countries showed strong current account deficits in the balance of payments (an average of almost 7% of GDP), compared to a surplus in Germany (5.1% of GDP) while France broke even[7]. This is the result of a strong outflow of capital from the centre to the periphery stimulated by the single currency thanks to the elimination of the exchange rate risk. This movement may have represented a gain for the monetary union, but it was actually used to finance investments in sectors such as real estate with a low potential for productivity growth. In addition, large current account deficits then became a great risk for debt sustainability when countries were confronted with an unexpected liquidity shortage in the economic system due to a sudden capital reversal resulting from the financial crisis.

From a political standpoint, the coordination approach combined with the practice of imposing conditionalities on aid to the states in difficulty has reduced Europe's political unity, creating, on the one hand, a hierarchical structure with Germany at the centre and, on the other, the "ideological divorce" between peripheral countries and core countries, polarising European public opinion of EU institutions[8].

The EMU's Current Challenges

The current difficulties in the Eurozone may be aptly illustrated as a trilemma[9]. According to this model, three irreconcilable triads may be identified, depending on whether the constraint is internal, external or financial.

1. Internal trilemma

In this triad, both national fiscal policy choices and the stability of the welfare systems needed to address the high unemployment rate come into play. According to the internal constraint, the required fiscal discipline cannot be achieved while maintaining the European model of social protection without undertaking at the same time structural reforms to create new jobs, generate development through increased competitiveness and provide the tax revenue needed to finance these models.

2. External trilemma

The theme of increased competitiveness, already present as a solution to the first trilemma, fits into another impossible trinity, which involves public debt sustainability and trade balance re-balancing. This poses problems in terms of debt sustainability for those countries that have to address external deficit corrections through increased competitiveness. In fact, given the impossibility of resorting to devaluation, countries with trade imbalances can only resort to internal devaluation, i.e., in weaker economies wages (hence prices) must increase less than in stronger economies. However, embarking on a path of deflation is very risky for economies in debt.

3. Financial trilemma

A final challenge for the EMU is to break the so-called "deadly embrace" between the sovereign and the banks, a key point when considering that the aggregate debt of Eurozone countries increased from 60% in 2008 to 80% in 2010, mainly due to bank bailout at the expense of the State[10]. The objective of a stable and integrated financial system at the European level can only be achieved under a banking union based on mutual assistance, in which state governments and their banking systems are no longer obliged to bail each other out to remedy the destabilising effects caused by the movement of capital.

What Are the Solutions?

1. Internal Trilemma

Countries plagued by high debt and high unemployment can only loosen the fiscal knot through increasing competitiveness. However, these results cannot be achieved merely through price competitiveness, namely through the so-called supply-side policies aimed at making the labour market more flexible, because albeit desirable in the long run, they do not provide a remedy to the problem of short-term growth[11]. When aggregate demand is already down, reducing nominal wages, simplifying termination procedures or removing controls on goods markets has little effect on labour demand, since businesses have to deal with the overproduction resulting from the lack of demand. In addition, the precarious situation both in the real economy, where the propensity to consume remains low, and in the banking system, where credit is still struggling to recover, prevents private investment from being made.

In such a context, the alternatives to supply-side policies may be different. Employment may be boosted through technological innovation developed by the private sector, generally understood as all those sectors (from industry to entertainment, from environment to finance) in which innovation arising from individual talent provides high added value to the production process, which can hardly be produced by low-cost labour, and generates a kind of job multiplier effect[12]. However, this process produces new sources of social discrimination, based on education levels and the geographic location of the technological hubs.

Public investment can also help revive the economy. If in fact an injection of public spending, the so-called "fiscal multiplier", has a greater impact on a country's economy during periods of crisis than in normal times and that cuts in productive investment during a recession generate more negative effects than cuts in current spending, then the fiscal policy of a country during a crisis should preserve public spending in productive investment. While the United States, Japan and Canada have followed this path, countries in the Eurozone periphery reduced their share of GDP investment from 4% in 2009 to 1.5% in 2013 to meet fiscal consolidation needs, with the most affected areas being transport, education, health and social protection[13].

The possibility of removing a part of or all public investment expenditure from the balanced budget constraint should be supported in addition to the so-called investment clause, which provides for deviations from the constraint only for specific projects and only under certain conditions of negative growth or objectives already achieved[14]. Rather, a "qualified golden rule" would allow states to have greater leeway in public finances, carrying out in return a quality assessment of the projects possibly

exempted from the constraints in order to select public investment that is essential to the structure of the economy (infrastructure and education, in particular), as well as those leading to sustained economic growth in the long term. To facilitate this task, it would be appropriate, even in the interest of greater transparency, to separate public accounting entries that refer to current expenditure and capital expenditure.

Therefore, public spending policies should be re-directed towards more focused objectives. The labour market is one of the areas in which the State could intervene by acting as the direct employer of anyone who is willing, eager or able to work according to the employer-of-last-resort scheme. This is an idea originally developed by Hyman Minsky[15], according to which there is no economic policy that is more important than job creation, thus assigning the State this function. As pointed out by the European Commission's 2013 Annual Growth Survey, investments in education, innovation and energy should be a priority in spending choices and particular attention should be paid to youth guarantee schemes[16]. However, work is a right of every person and should be granted to all, regardless of their age and of the economic situation.

The fundamental question related to the feasibility of public intervention is finding funding sources. This is true both for individual Eurozone states, whose governments issue debt in a currency over which they exert no control, and at the European Union level, where a budget of 1% of the member countries' total income is not sufficient to cover real needs, while advanced federations, such as the United States and Germany, have budgets equal to 20/25% of GDP.

A possible solution would be the creation of an additional budget to be allocated to Eurozone countries to launch a development and growth plan for Europe[17] funded through the financial transaction tax (FTT). The FTT initiative launched in 2011 under the enhanced cooperation of eleven euro area member countries has recently once again taken centre stage in the debate at the behest of the governments of Germany and France, which aim to reach an agreement before the European Parliament elections in May. However, the proposal has to address the reservations expressed by financial operators, especially the English ones, who believe that the tax would have very damaging effects on UK markets.

2. External trilemma

The recovery of the European Union has to address a rather low inflation rate at the aggregate level, which is far from the "below, but close to, 2%" objective. In 2013, the inflation level was 0.8%, an average which hides different realities: deflation, such as in Greece and Portugal, and inflation that has practically been reduced to zero, such as in Spain.

However, deflation can be dangerous for an economy because it aggravates the real debt burden of borrowers, in addition to producing downward tendencies in inflationary expectations, which result in the postponement of consumption. Therefore, for peripheral countries, the external trilemma means being unable to cope with imbalances in the balance of payments using internal devaluation, because an increase in competitiveness generated by internal devaluation would be offset by the increase in public debt in real terms due to deflationary dynamics.

Rebalancing the asymmetry among countries with respect to the external constraint would require coordination among all the parties. The peripheral countries faced with an inflation rate close to zero can only reduce nominal wages to bring down real wages, with a depression as the associated consequence. If core countries such as Germany, Austria and Finland, where the average inflation rate is around 1%, agreed to increase their level of inflation, this would also produce an increase in the level of inflation in the peripheral countries, allowing them not to have to reduce the growth rate of nominal wages, without compromising the competitiveness of their products. For example, if in the Eurozone periphery inflation were 1.5% (compared to the current 0.2%), core countries could let it running at 2%, in perfect compliance with the rules.

In the EMU, according to the implicit rule associated with cost-push inflation, wage growth should not exceed the productivity rate growth plus the target inflation rate. In other words, given the target 2% inflation rate, wages and productivity should grow at the same pace. In the long run, this rule should bring the unit labour cost and the national inflation rate in line with the target inflation rate[18]. However, since the birth of the EMU, the unit labour cost has remained almost constant in Germany, while in the peripheral countries nominal wage growth has been higher than productivity and this gap has widened over time. This has put pressure on prices, which have increased compared to those of German products. Although nominal exchange rates were no longer valid, Germany's real exchange rate has significantly depreciated, allowing German exports to become more competitive in international trade.

Moreover, the introduction of the euro increased the heterogeneity among countries due to the de-industrialisation process in the peripheral countries as a result of the process of production specialisation[19]. For these countries, the comparative advantage lays in the production of non-tradable goods and services. And this heterogeneity has not lessened with the crisis and internal devaluation: in Germany industrial capacity has continued to grow, while in the countries in difficulty it has decreased.

A quick recovery is unlikely without a fundamental improvement in the imbalances in competitiveness among Eurozone countries. Furthermore, a policy to stimulate demand may also lead current account deficits to grow due to an increase in aggregate demand. A symmetrical adjustment would be appropriate in the short term. The peripheral countries could adjust their monetary wages without decreasing growth but rather only slowing it down, provided that there is some inflation; while the core countries should make upward adjustments, making their wages increase faster to stimulate their demand for imports and encourage a reduction in peripheral countries' deficit. If Northern countries internally accepted a higher inflation rate, this would help bring the debt of the peripheral countries back into more sustainable dynamics[20].

However, in the long run, the competitiveness of peripheral countries should be increased, not through price adjustments but through increased productivity made possible through technological advancement, economies of scale and a reduction in unused production capacity.

3. Financial trilemma

The process towards creating a banking union has been launched, but the European Resolution Fund will take another ten years before a common Guarantee Fund enters into force, financed by bank levies and supervised by the ECB. In addition, the new direction of U.S. monetary policy raises the issue of a new wave of financial flows released from emerging markets, which might again destabilise European markets, now that the yields on peripheral countries' government bonds have returned to pre-crisis levels.

The FTT, as well as directly financing tangible investment or investment in human capital and producing public collective goods, could also be one of the instruments to combat financial speculation. Since it is applied only to transactions among actors regularly active in the financial markets, it would affect the speculative trading of day traders, while long-term investors would suffer only on the purchase and sale of shares that they hold.

Conclusions

The inadequacy of the fiscal coordination method, the worsening of macroeconomic imbalances between core countries and peripheral countries, the priority given to price stability without considering the national dynamics of prices and wages, has made the Eurozone a precarious monetary union which is unable to automatically generate the adjustment process needed to revive growth.

To support economic recovery that will soon become a growth process, it must first be acknowledged that the economic crisis in Europe has not been caused by the unhealthy management of public finances by a certain group of countries, but by heterogeneity relating to different production structures that the financial crisis has helped expose.

Since the crisis has developed along a path of asymmetries, a new start should be made on political bases aimed at harmonising growth among member countries. The EMU should adopt a fiscal policy model that provides for a division of tasks on two levels: a stabilising function at the central level and a redistribution function at the national level. However, to perform the stabilising function at the central level, Europe should have the actual power to coordinate at the European level and be able to overcome the coordination approach based on compliance with the national fiscal rules that European governance has pursued during the crisis.

Coordination should be understood as a concerted economic policy at the European level, where in addition to the ECB's function of price controls, there would also be a supranational European Treasury in charge of fiscal policy choices as well as the management of the EU budget to promote sustainable development. By virtue of these prerogatives, the need then emerges for the Treasury not to remain an independent entity, as is the ECB, but to operate under the consent and the close supervision of the European Parliament.

Note

1 IMF (2014), "Jobs and Growth: Supporting the European Recovery", http://www.imf.org/external/np/seminars/eng/2014/EURbook/index.htm

2 Conference on "Towards the Recovery? Risks and Opportunities of the International Economic Cycle", organised by the Centre for Studies on Federalism (CSF) and the Institute of International Affairs (IAI) in Rome on December 20th, 2013.

3 De Grauwe, P. e Ji, Y. (2013), "The legacy of Austerity in the Eurozone", *CEPS Commentaries*, http://www.ceps.eu/book/legacy-austerity-eurozone

4 See "Six Pack? Two Pack? Fiscal Compact? A short guide to the new EU fiscal governance" http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

5 Emerson, M. e Giovannini, A. (2013), "European Fiscal and Monetary policy: A Chicken and Egg Dilemma", *IAI Imaging Europe n.2*, http://www.iai.it/pdf/ImaginingEurope/ImaginingEurope_02.pdf

6 Council of the European Union (2010), "Strengthening economic governance in the EU. Report of the task force to the European Council", http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/117236.pdf

7 Lane, P. (2012), "The European Sovereign Debt Crisis", *Journal of Economic Perspectives*, 26(3): 49-68.

8 Alonso, S. (2013), "The growing economic and ideological breach between Northern and Southern EU countries is pushing Europe towards a perfect storm", *LSE EUROPP Blog*, http://blogs.lse.ac.uk/europpblog/2013/07/22/the-growing-economic-and-ideological-breach-between-northern-and-southern-eu-countries-is-pushing-europe-towards-a-perfect-storm/

9 Buti, M. (2014), "A Consistent Trinity for the Eurozone", *Voxeu*, http://www.voxeu.org/article/consistent-trinity-eurozone

10 Gallino, L. (2013), *Il colpo di stato di banche e governi*, Einaudi.

11 Rodrik D. (2013), "La risposta ai guai della UE è la domanda", *Il Sole 24 Ore*, 06/16/2013, http://www.ilsole24ore.com/art/commenti-e-idee/2013-06-16/risposta-guai-domanda-162559.shtml?uuid=AbovJW5H

12 Moretti, E. (2013), *La nuova geografia del lavoro*, Mondadori.

13 Barbiero, F. e Darvas, Z. (2014), "In sickness and in health: protecting and supporting public Investment in Europe", *Bruegel Policy Contribution n. 2*, http://www.bruegel.org/publications/publication-detail/publication/812-in-sickness-and-in-health-protecting-and-supporting-public-investment-in-europe/

14 European Commission (2012), "A blueprint for a deep and genuine economic and monetary union. Launching a European Debate", COM(2012) 777.

15 Minsky, H. (2013), *Ending Poverty: jobs, not welfare*, Levy Economics Institute of Bard College.

16 European Commission, "2013 Annual Growth Survey", http://ec.europa.eu/europe2020/pdf/ags2013_en.pdf. The youth guarantee system ensures that every young person under the age of 25 receives a good quality offer of employment, continued education, an apprenticeship or a traineeship within four months after becoming unemployed or leaving the formal education system.

17 Majocchi, A. (2012), "Linee Guida di un Piano di Sviluppo Sostenibile per l'Economia Europea", *CSF*, http://www.csfederalismo.it/index.php/attivita/appelli-e-interventi/2402-linee-guida-di-un-piano-di-sviluppo-sostenibile-per-leconomia-europea

18 Flassbeck, H. e Lapavitsas, C. (2013), "The systemic crisis of the Euro – True Causes and Effective Therapies", *Rosa Luxemburg Foundation*, http://www.rosalux.de/fileadmin/rls_uploads/pdfs/Studien/Studien_The_systemic_crisis_web.pdf

19 Artus, P. (2013), "The paradox of the euro-zone crisis: It has not led to a correction of heterogeneity through an adjustment of costs; it has intensified heterogeneity through a relocation of production capacity", *Natixis Flash Economics*, http://cib.natixis.com/flushdoc.aspx?id=70753

20 Merler, S. and Pisani-Ferry, J. (2012), "The simple macroeconomics of North and South in EMU", *Bruegel Working Paper n. 12*, http://www.bruegel.org/publications/publication-detail/publication/740-the-simple-macroeconomics-of-north-and-south-in-emu/

CENTRE FOR STUDIES ON FEDERALISM

The **Centre for Studies on Federalism (CSF)** was established in November 2000 under the auspices of the Compagnia di San Paolo and the Universities of Turin, Pavia and Milan. It is presently a foundation.

The activities of the CSF are focused on interdisciplinary research, documentation and information on internal and supranational federalism, the developments of regional and continental integration (notably, of the European Union), the issues related to the world order and the democratization process of the international system.

The CSF promotes an annual **Lecture**, named after Altiero Spinelli, on topical European issues. The CSF publishes **Research** and **Policy Paper**, as well as its own "**Studies Series**", **The Federalist Debate** (also online), the **Bibliographical Bulletin on Federalism**, the online-journal **Perspectives on Federalism**, the **International Democracy Watch**.

CENTRE FOR STUDIES ON FEDERALISM
Via Real Collegio, 30
10024 Moncalieri (Turin) - ITALY
Phone +39 011 670 5024
Fax +39 011 670 5081
info@csfederalismo.it
www.csfederalismo.it