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A Renewed Political Deal for Sustainable Growth within the Eurozone and the EU

An open letter to the President of the European Council

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Dear Mr Van Rompuy,

At its forthcoming December meeting, the European Council will deliberate on new rules of economic governance. We fear, however, that the proposals under consideration are not a sufficient cure for the economic plight of the Union since they will not resolve the competitive and payment imbalances that are undermining the credibility of the budgetary consolidation programmes and the euro itself. There is an urgent need to lift the growth rate of the Union, and budgetary consolidation, as important as it is, will not suffice.

In this Policy Brief, we have tried to outline the elements of a comprehensive economic policy initiative at the EU level capable of matching fiscal discipline with higher growth, as well as restoring a climate of cooperation between the Member States. We hope that you will consider bringing our proposals to the attention of the European Council.

Under current policies, the European Union will only be able to pull itself out of low growth and high unemployment very slowly – too slowly to exclude dangerous economic and political assaults on the Union's continuing cohesion and viability. What is needed is a substantial increase in the EU output growth rate, which has been persistently low for too long a time. With low growth, sovereign debt sustainability in a number of member states will remain uncertain, possibly leading to renewed strains in financial markets and rising spreads that will aggravate the costs of budgetary consolidation. The divergences in productivity and competitiveness and the current external imbalances they engendered can be unwound at an acceptable cost only if growth accelerates in the core and the periphery. On present trends, the adjustment burden might be unbearable for peripheral countries and generate strains that may eventually undermine the euro.

EuropEos This Policy Brief is a collaborative effort between CEPS and EuropEos, a multidisciplinary group of jurists, economists, political scientists and journalists set up in 2002 with the aim of creating an ongoing forum for the discussion of European policy and institutional issues. Giulano Amato is former Prime Minister and Minister of the Interior of Italy and served as Vice President of the Convention on the Future of Europe. Richard Baldwin is Professor of International Economics at the Graduate Institute in Geneva, Policy Director of Centre for Economic Policy Research and Editor-in-Chief of Vox.eu. Daniel Gros is Director of CEPS. Stefano Micossi is Director General of Assonime in Rome, Professor of Economics at the College of Europe in Bruges, Member of the CEPS Board of Directors and Chairman of the CIR Group. Pier Carlo Padoan, is Deputy Secretary-General and chief economist of the OECD.

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The Union is right in seeking sustainable correction of fiscal imbalances, which seriously threaten not only the viability of the euro but also long-term growth prospects. Concrete proposals for important improvements in the economic governance of the eurozone and the Union to help restore sound fiscal policies and consolidate excessive budgetary imbalances have already been tabled by the European Commission. However, insufficient attention has been devoted to policies capable of raising actual and potential growth rates and correcting competitive imbalances.

The European Union needs a comprehensive political deal not only to stabilise financial markets and tackle its widening internal competitive imbalances, but also to raise growth on a sustainable basis. We present below the main pillars of this comprehensive deal whose central component must be a decisive commitment to re-launch economic integration and push back protectionism and populist policies undermining the Union.

1. Fiscal consolidation

The European Council and Ecofin have already outlined the main elements of fiscal discipline and adjustment policies to restore sustainable sovereign debt positions, notably including sustained reductions of the debt-to-GDP ratios underpinned by operational and verifiable quantitative commitments.

A critical aspect that requires stronger tools in this context is the quality of consolidation programmes, to be centred much more than in the past on permanently lower growth of current public expenditures, based on efficiency and growth-enhancing reform of entitlements (pensions) and unemployment support schemes (active labour market policies). These steps would be supplemented by measures aimed at increasing efficiency in public spending so as to enhance the growth-friendly components of fiscal consolidation. An appropriate strengthening of relevant provisions in the SGP legislative texts before Council and Parliament seems in order.

Furthermore, the public debate has placed too much emphasis on the 'corrective' arm of the reformed Stability and Growth Pact (SGP), i.e. sanctions for non-compliance in the excessive deficit procedure. In any event, that option will always come too late and will be hardly affordable by countries running off-track.

Instead, greater weight should be placed on strengthening the 'preventive' arm of the Pact, which is really where policy coordination within Ecofin and the European Council failed. To this end, the European Commission's powers to publish league tables of performance, launch early warnings and make public its analyses and recommendations on divergent countries should not be subject to Council approval; and reverse voting in the Council on Commission recommendations on how to deal with divergent countries should apply across the board. Full publicity should always be given to Council deliberations.

Policy coordination will benefit from the 'European Semester'**,** a six-month cycle of economic policy coordination to be launched as from next year, and associated enhanced surveillance over national policy programmes, but this will require effective implementation to be seriously assessed on a regular basis, not just paid lip service. The new powers granted to Eurostat should establish stronger safeguards against 'cooking up' the public sector and national accounts. Both innovations are welcome. They should be matched by national rules preventing all interference by governments in national statistical agencies – a still quite common practice in many eurozone members.

The most important elements to underpin the reformed SGP are the envisaged changes in national fiscal institutions and procedures, which should be made legally binding at EU level. Prominent among them is the establishment in all member states of an independent fiscal authority, accountable to Parliaments and entrusted with the task of publicly assessing the state of accounts and the quality of national consolidation programmes. Their scrutiny should explicitly cover compliance of national budgetary policies with common goals agreed within the European Council and Ecofin, and be made public. Their assessment and recommendations should play a prominent role in budgetary deliberations by national Parliaments, with a requirement that all decisions not complying with EU recommendations be explicitly justified and notified to competent EU institutions.

2. Crisis management

A stronger framework for budgetary and macroeconomic stability to prevent the build-up of unsustainable private debt will reduce the likelihood of future crises, but even the strongest framework will occasionally fail and the present crisis is likely to drag on for quite some time. The EU thus needs a framework for dealing with a crisis in a member state that may threaten the stability of the euro.

The key to making crisis manageable is a strong financial system that is able to withstand systemic shocks. A variety of measures should be used to strengthen market discipline. For one thing, intermediaries and institutional investors should be required by supervisors to pay adequate attention to the Commission's warnings on the sustainability of sovereign obligations of eurozone members. Rules limiting excessive credit expansion and risk-taking by financial intermediaries will also affect their willingness to finance risky sovereign debtors. Critical

in this respect is a credible promise, in the event that one member state becomes insolvent, not to intervene to relieve its creditors. Careless lending to some member states by core euro-area banks, despite their worsening fundamentals, indicates that they expected to be bailed out at no cost in case of insolvency. The key issue then becomes how to lend sufficient credibility to the no-bail-out clause vis-à-vis the member states and financial markets.

Such a promise must be founded on two pillars.

The first pillar is new banking rules making it possible for any bank, including large cross-border banks, to fail and thus not reimburse fully their creditors and equity holders – with the sole exception of insured (retail) depositors.[1] Such a system would introduce strong incentives for bank managers and equity holders to limit risk-taking and create much more stringent market discipline also extending to sovereign borrowers. A good start would be to make it adamantly clear that banks will have to bear the losses still hidden in their balance sheets and government deficits will not be swollen even more to bail out their creditors.

The second pillar is a European Monetary Fund (EMF) – the permanent continuation of the present European Financial Stability Facility (EFSF), which has now been endorsed by the European Council – endowed with sufficient capital and access to market financing to protect the euro and the Union's financial system from the fall-out of a sovereign debt crisis. Its mandate should not include covering losses of public and private insolvencies.

Its principal task should be to cushion systemic financial shocks and keep them from turning into fully-fledged runs on depository financial institutions, thus preserving confidence. It could lend to the member states, with reimbursement of the loan taking priority over all outstanding debt and strong conditionality – but never bail out their creditor banks, as was clearly the goal with the Greek interventions last May. And it could similarly help manage the resolution of large cross-border banks, e.g. as suggested by the Commission by providing capital to bridge banks emerging from the liquidation, while leaving equity holders and creditors to bear full residual losses.

3. Structural reforms for sustained growth

Two main features stand out in Europe's economic performance: low productivity growth and low growth of domestic demand, mainly reflecting the evolution of labour incomes. Productivity growth has slowed down in a number of EU countries, although at different speeds and reflecting different efforts at structural policies and innovation. In cases where these have succeeded in enhancing productivity in the manufacturing sector, they have allowed some core countries to benefit from a buoyant demand by emerging economies for investment goods, letting them climb back more quickly from the recession in the current (slow) recovery phase. However, both the core and periphery suffer from low growth in productivity in services. Even in Germany, during the past decade, domestic demand has barely increased and real wages have stagnated. While the low growth of German GDP was mainly a result of the stagnation of the working age population in Germany, the country would have benefitted from a more dynamic service sector and its contribution to the rest of the eurozone would then have been much more positive.

Policies for public sector consolidation will strengthen financial stability and improve incentives for private investment. However, positive effects on confidence will kick in only in the medium term and to the extent that announced policies are credible. In the short term consolidation will have a negative impact on demand, compounded by the simultaneous budgetary restrictions in all the eurozone member states – albeit some analyses indicate that such effects may be limited.

Europe cannot return to sustained growth without durably raising the rate of growth of domestic incomes and domestic demand. While demographic factors weigh importantly on long-term growth potential, one should not underestimate the strong impact on productivity from innovation and innovation-related investment notably in intangible assets. OECD data show that in the decade 1996-2006, more than two-thirds of productivity growth came from these sources in advanced economies. Stronger productivity growth can lead to increased household demand through higher wages. However this must be achieved without weakening competitiveness and taking into account the need to rebalance current external payments within Europe and the eurozone.

To this effect a much stronger role must be played by structural reforms. There is a need for labour market reforms aimed at increasing flexibility that would allow real wages to respond more efficiently to competitive pressures. Increasing employment rates among women and youth can add significantly to the labour force and strengthen potential output. Most of all, service sector liberalisation can boost investment including in countries where current account surpluses reflect a low level of investment with respect to savings, thus addressing the structural determinants of external payment imbalances.

[1] For a full description of a feasible bank crisis resolution mechanism, see *Overcoming too big to fail: A regulatory framework to limit moral hazard and free riding in the financial sector*, by J. Carmassi, E. Luchetti and S. Micossi, CEPS, Brussels, March 2010.

We have been at this point before. At the start of the last decade, Europe's economy had to digest the aftermath of another financial boom and bust – the dot-com bubble – and the psychological shock of the 9/11 attacks. The recovery was slow and relied mainly on massive credit expansion pushing demand in the periphery beyond sustainable limits; the Stability Pact was made less stringent when it suited the core. Too little was done to support the supply side: the Lisbon agenda was largely ignored and the Services Directive was carefully tailored to tame its liberalising potential.

Timidity in structural reform of services has played a crucial role in depressing growth and employment since services represent well over two-thirds of our economies and are plagued by massive inefficiencies due to barriers to entry and corporatist protections. A wealth of studies has confirmed over and over again that this is where the productivity and income gaps relative to the United States mainly arise. By opening the services sector to competition we would create enormous opportunities for domestic investment and productivity increases, which would translate into higher domestic incomes, as well as indirectly strengthen our industry with lower-cost and higher-quality services.

In retail distribution, transport, construction, financial and professional services, the Union trails far behind: therefore, this is where we should concentrate our efforts of reform. In all these areas, while many a country is lagging behind, we have within the Union best practices that have produced world leaders and enormous productivity increases.[2] Thus, we could copy the Swedish retail revolution, German and Dutch road transport efficiency and the UK's successes in reducing fragmentation and improving project quality in the construction industry. And banks should no longer be allowed to delay recapitalisation and loss recognition, which is a major factor holding down the supply of credit and the recovery of the housing sector.

Critical in this context is the liberalisation and full integration of energy markets, still fragmented into closed national gardens and controlled by national monopolists reaping hefty rents by imposing very high costs on industry and consumers.

Last but not least, service sector liberalisation is instrumental to enhancing the impact of innovation and innovation diffusion, hence amplifying productivity growth. In order to maximise innovation benefits, Council and Parliament should finally break the deadlock on the European patent.

In his Report "A new strategy for the Single Market", Professor Mario Monti offers the complete list of regulatory changes that would cut the chains holding down Europe's growth and denying all improvement in living standards of our working population. Fast-track procedures for their transposition into Union law would bring rapid benefits and entirely change the dire economic climate throughout the Union.[3]

We urgently need a revolution in services regulation. There are gigantic rewards waiting to be reaped, if only we can summon up the imagination to envisage them and the political will to pursue them with determination and continuity.

4. Investing in infrastructures for the internal market

"It is impossible to imagine a Single Market without the physical infrastructure connecting its parts: roads and transport connections, electricity grids, electronic communications and water networks. Infrastructure is vital for ensuring the mobility that underpins a functioning integrated market and for promoting growth and sustainable development. They are key to ensuring territorial cohesion. Despite the recognition of the importance of the infrastructure dimension of the single market … a range of obstacles still prevent us from thinking European in this area".[4]

There is little question that a substantial increase in investments for the single market infrastructures would bring great benefits by boosting demand in the short term and by raising the Union's potential output in the long term. The obstacles to overcome are two-fold: the planning and selection process and the financing means.

As to the planning and selection process, notably within the TENs (trans-European networks) framework, the member states have displayed great dexterity in gaining support for national priorities, but much less in agreeing on the required concentration of efforts in cross-border projects effective for removing cross-border bottlenecks in energy, transport and communications and creating the integrated open playing field that is needed for the internal market to function. The scanty available means have been deployed to a ludicrous number of projects.

A new start is needed, able to identify a new list of priorities and projects, strictly and rigorously aimed at removing obstacles and laying the groundwork to a functioning single market. To this end, effective

[2] See the recent study by McKinsey Global Institute, *Beyond Austerity: A path to economic growth and renewal in Europe*, October 2010.

[3] "A new strategy for the Single Market – at the service of Europe's economy and society", Report to the President of the European Commission José Manuel Barroso by Mario Monti, May 2010.

[4] Ibid.

criteria of economic value added and long-term profitability should be strictly enforced. The initiative can only be taken by the Commission; but Parliament can play a useful stimulus and monitoring role – if only it can overcome pressures to lend its support to petty projects of no value sponsored by local constituencies and interest groups. All projects should be validated by the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), which should also be entrusted with their implementation – thus barring all national interference and ensuring maximum value for money.

The very low level of real interest rates strengthens the case for public infrastructure investment in general. Given that low interest rates are likely to persist for some time, many projects that were not economically viable could now be financed at market terms.

As to financing, there is a need to mobilise major resources, to a scale unseen so far. As suggested by the Monti report, this requires exploring new combinations between private and private funding, based on innovative techniques for awarding contracts that are able to offer long-term private investors appropriate rewards. Structural funds may be mobilised in this context to reduce risks to private investors and paying a fair share for public benefits that cannot be monetised. Significant resources could be freed by the development in Europe of a liquid bond market for very long maturities: a development that would be facilitated by substantial issuance of Union bonds by these development banks, the EMF and other Community institutions.

In this context, the issuance of Union bonds should not be seen as a way to redistribute resources between the member states, but only as a way to ensure ample finance at the lowest possible cost for critical infrastructures.

At a time when the public finances of some peripheral member countries are under intense stress, it might seem paradoxical to support an end to unlimited bail-outs and propose at the same time new Union financial instruments which have to be backed by everybody. However, the Union bonds we have in mind would not create hidden excess liabilities for the fiscally stronger member states because contributions to the EU budget (a supra-national body) are senior to the claims of holders of national public debt. Moreover, these Union bonds could also be backed by real guarantees, namely the returns from the projects to be financed, thus transforming them *de facto* into some sort of covered bonds with a double guarantee.

But most of all there is a need for a political decision to strengthen dramatically the Union's specialised financial institutions – the EIB and the EBRD – which over time could usefully merge into one large-size infrastructure and development bank, adequately capitalised to be a credible and attractive counterpart to sovereign and institutional investors worldwide.

Gearing up public sector infrastructure spending in a sensible way will take time: it is not meant to provide a quick fix to the current lack of demand, but rather to strengthen growth prospects over the medium term. However, a strong commitment in this direction would play a major role even in the short term in improving investors' expectations and mobilising private investment in complementary projects and project co-financing.

5. Playing ball in international policy coordination

The initial response to the financial crisis by the major countries and economic regions was effective in avoiding a financial meltdown and freefall of output. Afterwards, however, cooperation has faltered, leaving room for uncoordinated policies to emerge that raise fears of renewed instability and do not seem able to restore sustained growth and reabsorb high unemployment.

In Seoul the G20 has reached limited agreement to 'monitor imbalances', which is a step forward but no panacea. As fiscal and monetary policy spaces are narrowing in the advanced economies, increasingly abundant liquidity creation coupled with less than adequate exchange rate flexibility risk aggravating distortions and disequilibria without providing durable solutions to lagging demand and persistent unemployment, especially in the United States.

Together with a number of emerging economies with flexible exchange rates, Europe is bearing the negative consequences of these policies as the euro rises too high and weakens further an already anaemic economic system. A new deal on economic policies at the international level should start by recognising the obvious, i.e. that not every economy can export itself out of the recession and that sustained growth necessarily requires a more balanced growth across countries and regions. The G20 approach is based on the idea of a reasonable division of labour among large countries using all available policy tools, including macroeconomic, exchange and structural policies. IMF and OECD simulations have shown that this would lead to a superior outcome in terms of higher growth, effective fiscal consolidation and smaller global imbalances including within the euro area.

On this score, we should acknowledge that China is doing a lot to help world growth, with very rapid growth of its domestic demand. Appreciation of the yuan is necessary but it needs to be carefully sequenced and accompanied by structural measures to deal with very large savings in both the household and corporate sectors.

In this context the European Union must recognise its responsibility to increase domestic demand and contribute to help support a balanced world growth.

Europe in general and the eurozone in particular have little voice, or rather too many voices in global fora. The recent agreement on reducing the number of European representatives on the Board of the IMF goes in the wrong direction as it disperses euro-area country representation over a number of different constituencies comprising also other countries with quite different economic structures and interests. The real option is a single euro-area seat. However, lacking a Union proposal, this was not even discussed and has become more difficult to achieve as a result of these changes.

6. In conclusion

The economic and financial situation of the European Union risks once again entering acute instability, and the economic recipes under discussion in the European Council are not adequate to restore sustained growth nor, as a consequence, to ensure sovereign debt sustainability and financial stability. Nor can we expect to be lifted out of the present dire straits by net demand from other countries and regions of the world.

Debt sustainability can only be founded on sustained growth of our economies. Exclusive emphasis on restoring sound public finances will not suffice. A broader political deal on economic policies and economic governance is needed to lift growth and restore confidence in the future of the eurozone and the Union. This requires agreeing on well-identified policy priorities both at EU and member state level, taking full account of the different positions of the members in terms of growth, external imbalances and competitiveness.

Such a deal must include, together with better-designed measures for fiscal discipline, a decisive drive to accelerate the completion of the single market and strong investment in cross-border infrastructures. Structural reforms can and should be designed and implemented to reflect national priorities, but also to recognise the contribution that national policies can bring to raising growth durably and helping reabsorb competitive and payment imbalances that threaten the long-term viability of the euro.

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