

Stepping up Growth Policies

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No. 265, March 1st 2012

1. The macro-economic picture

The eurozone is in recession and will show negative growth in 2012; GDP will fall sharply in Greece and Portugal, and there is substantial risk that Spain and Italy will follow suit (the Commission's recent forecasts seem overly optimistic and complacent; the IMF is more downbeat). But fiscal policies are uniformly restrictive throughout the eurozone and much of the Union, and the hopes that fiscal consolidation could spur growth by improving household and business confidence are not materialising. In reality, domestic demand has been hit too hard by fiscal consolidation, and investment throughout the Union remains well below pre-crisis levels. Credit is tight due to the deteriorating quality of borrowers and the ongoing deleveraging in banking.

A specific difficulty in this regard is the persistently large current payment imbalances within the Union and the eurozone in particular, reflecting substantial competitive (wage and cost) imbalances. To a large extent, the deficits of France, Italy and Spain are just the counterpart of surpluses in Germany (6% of GDP in 2011) and other Continental and Nordic economies. The financing burden of these imbalances has mostly fallen on official channels, i.e. the ECB and official assistance programmes, as private financing from the surplus countries has dried up.

Coordination of macro-economic and structural policies designed to reduce payments imbalances

have of course been a main tenet of G-20 deliberations, but so far with little result. In practice, there seems to be little room to 'export' our imbalances to the rest of the world, at least not any time soon, owing to the large deficit reduction efforts and aggressive monetary expansion in the United States; slow adjustment of the surplus in China and other emerging countries; and the strength of the euro in foreign exchange markets. So, much of the adjustment will have to happen inside the eurozone.

In its Annual Growth Survey 2012, the Commission had advocated "pursuing differentiated growth-friendly fiscal consolidation" and had encouraged countries with strong budgetary positions to let their budgetary policy play "their counter-cyclical and stabilising role, as long as medium-term fiscal sustainability is not put at risk". In their recent Survey of the German economy, the OECD was outspoken and called for Germany to strengthen domestic demand by "improving competition-enhancing framework conditions for investment and innovation in Germany's domestic sector. This includes lowering the strict regulation in some services sectors".

But policies have not been adjusted as a result, and there is no trace of this Commission recommendation in the Council statement on growth of January 30th.

The Commission has also just published its first Alert Mechanism Report; the initial step in the

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new Procedure for the prevention and correction of macroeconomic imbalances. Much of the document is devoted to the analysis of internal imbalances of the member states, while the contribution that may come from growth and adjustment from a reduction of “large and sustained current account surpluses” is played down (less than half a page in a 20-page document, promising further attention to the problem in coming months).

The fact remains that if the burden of adjustment falls largely or solely on deficit countries, this will further depress demand and economic activity everywhere, including surplus countries that will see their net exports to the rest of the Union fall. There is also an urgent need to restore private capital flows from the centre to the periphery, but this largely depends on restoring confidence in the sustainability of sovereign debts and payment imbalances – which cannot happen, in the end, without a return to sustained growth.

2. The growth letter

The recent letter to Presidents Van Rompuy and Barroso signed by twelve heads of government is a most important and timely initiative. It builds on the restoration of confidence already underway in financial markets, thanks to the new policy directions in Italy and Spain and the recent agreement on the fiscal compact. Significantly, it lines up together the prime ministers of three Triple A countries, the UK and those of Italy, Spain and Poland, and many other countries in and out of the euro. Let’s hope that it will open the way to a shift in the agenda of the European Council to stronger common policies for growth.

The letter demands a significant broadening in economic philosophy: “The crisis we are facing, it says, is also a crisis of growth ... Action is needed to modernise our economies, build greater competitiveness and *correct macroeconomic imbalances*. We need to restore confidence, among citizens, businesses and financial markets, *in Europe’s ability to grow strongly and sustainably* and maintain its share of global prosperity”.

The Internal Market is central (not surprisingly, given the role played by the Italian prime minister in the initiative). Top of the list is the implementation of the Services Directive, the long-delayed implementation of energy liberalisation, an acceleration of the digital

internal market – that holds great promise in breaking national fiefdoms in commercial distribution and financial services – and a serious attack on red tape, as yet largely unrealised both at Community and national level.

On the labour markets, the emphasis is on improving labour market participation, an issue already under consideration by the Council, but also on improving labour mobility across borders by making progress on the preservation of pension rights and “reducing the number” of regulated professions.

While for skilled professionals the main impediment is in inadequate mechanisms for the recognition of qualifications, for less skilled workers, the key to an integrated labour market is the establishment of a common European platform of protection including a minimum wage system (set in proportion to national wages rather than as absolute numbers).

And, of course, there is an appeal to strengthen research and innovation policies: the main obstacle here has been the poorly managed and techno-nationalistic research policies of the member states, which still resist any serious coordination of priorities and the shift to a fully competitive system for the selection of projects.

The proposals are not new but there is a new sense of urgency: the key suggestion is “reinforce governance and raise the standards of implementation”, not only by setting firm deadlines but also by using all Community powers to encourage the member states to proceed. The Commission is explicitly asked to increase pressure on the member states, after many years of integration fatigue that were rather suggesting caution.

The twelve heads of government have stopped short of asking for a most important strengthening of decision-making, which is to make binding all commitments on the implementation of the internal market under the procedures of the common policy guidelines of Article 121 of the TFEU, including the sanctions for failing to implement Commission recommendations. In this manner the member states could no longer shirk their responsibilities and would be made more directly accountable before the European Council for their implementation record.

As familiar as they may sound, the twelve prime ministers' recommendations entail a stepped-up political commitment by the European Parliament and the Commission, and serious action to deliver by all the member states – a change of pace that is long overdue. They would open the way to a strong recovery of investment that has been lagging in no small measure due to the obstacles and barriers that still impede a well-functioning internal market.

3. Specific initiatives to raise investment spending at the EU level

To some extent, pushing the accelerator on the internal market and the other initiatives that have been mentioned may be effective in stimulating investment and domestic demand, and in due course could raise personal income and consumption. However, we must ask ourselves if this is enough to increase growth and avoid a vicious circle of budgetary retrenchment, leading to falling activity, larger deficits and yet more demands for retrenchment. Greece may already be in such a situation. More broadly, under current and projected growth rates, restoration of sustainable budgetary positions will continue to require painful sacrifices, economic and social, and place the political system under increasing stress over time.

Now that budgetary positions are improving throughout the eurozone and the Union, why shouldn't the European Council consider launching a new growth initiative, centered on mobilising vast resources at EU level for investment in worthy projects of common interest Europe-wide?

The initiative should involve at least three areas:

- (i) The acceleration in the disbursement of cohesion and structural funds; in this context it is also important to approve the reduction to 25% in the share of matching funds to be deployed at national level;
- (ii) A large increase in the capital of the EIB, which would thus be able to expand its lending substantially;
- (iii) The immediate launch of the Commission Project Bond initiative, with its strong potential to mobilise private capital for infrastructure investment for the internal markets; and more in general full exploration

of all the ways and means whereby the Union budget may be mobilised and levered to make more resources available for member state and private investment.

The European Council should also make good its commitment last summer to establish strong growth programmes assisted by additional resources in countries that are struggling to meet their debt obligations under very onerous adjustment programmes. A key goal here should be to make sure that there is light at the end of the tunnel, lest at some stage the unbearable social and political costs of adjustment lead to a breakdown of the domestic political system and disorderly default.



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