Social Europe Journal

11/03/2011

Andrew Watt

A Blueprint for Growth, Consolidation and Convergence in the Euro Area

In recent SEJ columns and blogs I have been critical of the Greek and Irish bail-outs, the European Commission's economic governance proposals, the policies of the European Central Bank, the EU2020 Strategy, the Franco-German competitiveness pact and the Commission's Annual Growth Survey.

The bottom line is that, singly and taken together, the policies and proposals of these actors are not fit for the purpose of ensuring balanced growth in the euro area and the European economy as a whole, of bringing down unemployment quickly and contributing as much as possible to the achievement of Europe's wider economic, social and sustainability goals. While they contain some useful proposals, as a whole they risk perpetuating the economic, fiscal and social crisis and possibly the break-up of the euro area.

Criticism is good, constructive proposals are better. Some earlier work contains proposals, but this piece is an attempt to bring them together into a plausible, feasible and effective alternative strategy: a blueprint for growth, consolidation and convergence in the euro area. I start with three meta requirements. I then sketch out a proposal for a set of policy initiatives and reforms that meet these requirements.

Three background requirements for an alternative strategy

First: learn the lessons of the crisis. I believe there are ten key lessons from the crisis for economic governance reform in Europe. It is worth listing them in staccato style here: 1. High unemployment results from macroeconomic and financial market mismanagement rather than labour market and welfare state institutions. 2. Annual government deficits are bad guides to country performance and a wider view incorporating private-sector balances is needed. 3. Large and persistent current account surpluses and deficits are dangerous and yet are systematically encouraged within a monetary union. 4. Strong counter-cyclical fiscal policy and automatic stabilisers are needed to address asymmetric shocks and support monetary policy in arresting a downturn. 5. There are positive and not just negative fiscal policy spillovers between countries. 6. Tax competition undermines government revenues and increases inequality. 7. Growing inequality is not just socially undesirable but economically dangerous. 8. Punitive sanctions cannot be imposed on countries in economic difficulty and instead solidarity (conditional transfers) is needed. 9. Monetary and fiscal policy need to be mutually supportive. 10. Myopic inflation targeting is not, certainly not always, a sufficient guide for monetary policy.

A reform strategy should seek to take account of these lessons, learnt at such high cost, but which only to a limited degree appear to be the basis for the reform proposals on the table.

Second: agree on the appropriate reform goals. The goals of economic governance reform are NOT to bring government budgets into balance whatever the cost, to shrink the public sector or welfare state, to protect bondholders, to weaken trade unions or reduce wages as a share of national income, nor to increase exports or 'competitiveness', whatever that may mean for a large monetary union. It may seem trivial to point this out, but it is necessary given the thrust of many of the policy initiatives that have been launched. At the very best some of these issues can be considered means to an end; in most cases

A Blueprint for Growth, Consolidation and Convergence in the Euro Area

they are simply the product of a particular political philosophy, one which by all rights, should itself be in crisis given the events of recent years, but which regrettably and unjustifiably appears to be enjoying a resurgence. Rather, the real policy aims must be to put Europe back on a track of:

- sustained and at the same time sustainable economic growth,
- rising living standards and employment,
- a rapid and substantial fall in unemployment before it becomes 'structural',
- economic convergence across the euro area and also socially within countries,
- steady fiscal consolidation towards sustainable long-term levels, and
- rising investment in all the areas vital for our long-term future (education, infrastructure, research and innovation, greening the economy, health and social services).

Three: get all relevant actors around the table. This is not the time for polarising initiatives and partisan attacks on segments of the population, least of all the most vulnerable, or on specific European countries. Instead the emphasis must be on fair burden-sharing, political compromises, a high-trust equilibrium between policy actors, evidence- and not ideology-driven policymaking and open dialogue between all relevant actors.

Learning the right lessons. Setting the appropriate medium and long-term goals. And mobilising all the relevant actors to seek consensual solutions. These are the three basic requirements for a successful strategy.

A blue-print for change in six key policy areas

Taking these requirements as the starting point, a reform blueprint for growth, consolidation and convergence in the euro area might look like this.

The **first** need is to arrest the deflation of demand and boost output growth in the periphery.

The peripheral euro area economies (Ireland, Greece, Spain, Portugal) cannot exit the crisis – simulatenously pay back foreign debt, stabilise their financial sectors, restore fiscal solvency and regain competitiveness – without external support. There is now, belatedly, a consensus that the euro area needs a permanent sovereign debt resolution mechanism. The no bail-out clause is dead. The debate is about the structure of such a support mechanism or mechanisms and the broad set of conditions to be attached to any such transfers; unlike, say, with IMF loans to individual countries, such 'conditionality' extends to the need for policy integration and longer-term policy constraints. Clearly the entire E(M)U cannot be asked to underwrite any and every government policy; the Irish government's fateful no-questions-asked assumption of dizzying amounts of bank debt is an obvious example.

Europe needs a permanent stabilisation mechanism that has sufficient funds at its disposal to offer rapid support to countries in need. Such aid should be provided with only a small spread over the lowest sovereign debt yields in the euro area. All but short-term aid should, though, be conditional on sensible medium-term consolidation policies in line with the needs of the country concerned and its partners. (These partners, especially the surplus countries, also need to adjust: see point three below). The mere existence of such a mechanism would dramatically reduce the likelihood of sovereign debt downgrades and speculation against individual member countries which, in a snowball effect, has driven a number of them to the brink of insolvency, with the huge risk of contagion. The stability mechanism should be able to issue bonds ('Eurobonds') up to an agreed limit to finance its operations. The ECB would no longer be directly involved in buying national sovereign debt, but could be called upon to purchase Eurobonds issued by the mechanism; this should only be necessary in extreme crisis situations, however.

A Blueprint for Growth, Consolidation and Convergence in the Euro Area

The **second** priority is to boost growth (and render it sustainable) across the euro area as a whole.

Europe needs an investment programme to get it out of the crisis and to enable it to face future challenges by raising productivity and potential output and tackling the needed transition to a low-carbon economy. Capital is historically incredibly cheap, particularly for solvent sovereigns. National governments and EU institutions must borrow and invest. That is the road to increased confidence and successful consolidation. Those member states that are fiscally constrained must have those constraints lifted by the European Financial Stability Fund and other sources. Fiscal consolidation through cutting public investment is simply bad economics.

There are a number of ways in which this investment boost can be organised. They are not mutually exclusive: surplus countries should not yet embark on fiscal consolidation but rather should boost public investment (this will also help reduce imbalances; see next point); lending by the European Investment Bank (which, by the way, already issues what amounts to eurobonds – they are not some strange new animal) should be ramped up; the very substantial allocated but undisbursed funds under the existing EU Cohesion and Structural funds should urgently be allocated to effective projects; the European Globalisation Adjustment Fund, which also suffers from unspent resources, should be similarly mobilised and expanded.

Lastly and crucially, monetary policy cannot be allowed to wreck the recovery: the ECB must commit to supporting the current fragile upturn with accommodating policies until there is a clear sign of it being self-sustaining in the form a noticeable fall in unemployment across the euro area as a whole. The ECB's practice (and ideally its formal mandate) should be made more balanced, as is the case with the US Federal Reserve, to emphasise its responsibility for maintaining employment at as high a level as is consistent with low inflation.

The **third** need is to address macroeconomic imbalances in a symmetrical way.

This means that the relevant actors in both surplus and deficit countries must be persuaded or constrained to alter their behaviour. The pace of demand growth (in each case relative to aggregate supply) needs to be faster in surplus countries and slower in deficit countries. And nominal prices and wages (relative to national productivity trends) need to rise faster in surplus and more slowly in deficit countries. The demand and the price/wage adjustments are linked and mutually supportive. The former is primarily the responsibility of national fiscal policy. In the medium-term it means that fiscal surveillance only makes sense within the content of the surveillance of macroeconomic imbalances. In the short-term it means surplus countries should postpone fiscal consolidation. To the extent that the investment initiative can be focused on the deficit countries it will help correct imbalances by raising productivity growth in these countries.

I have discussed the role of nominal wage and price setting in some detail here. It is a matter for national social partners and governments. At the same time European-level coordination mechanisms, such as the Macroeconomic Dialogue, but also trade unions' own autonomous efforts to coordinate nominal wage setting across Europe, need to be strengthened. The pricing power of firms is also important and needs to be addressed as well as wage setting. There are different ways to achieve these aims, and countries need to design appropriate policies: what counts is the outcomes. In a monetary union nominal price and unit labour cost trends must, over the medium run, be in line with the inflation target of the central bank. It is as simple as that. Wage policy, nominal wage-setting, is an important, but only one constituent, element within that. It is neither omnipotent in resolving imbalances nor impotent. Wage policy should be structured around a 'golden rule' for nominal wages based on national medium-run productivity growth, target (or medium-run) inflation and a symmetrical adjustment (bonus/malus) where necessary to correct undesirable competitive imbalances. As a huge literature clearly demonstrates, this, in turn, requires the development and strengthening of effective national and sectoral collective bargaining institutions, not their destruction or decentralisation. As well as inter-country rebalancing, this approach also ensures price stability for the eurzone as a whole, to which the ECB must respond by providing as favourable monetary conditions for growth and employment as possible.

In principle the proposed 'excessive imbalances procedure' is the right basic framework within which imbalances can be identified and corrected. However, substantial revisions are needed to the proposals currently under discussion to ensure the needed symmetrical and encompassing approach.

Fourth public finances must be brought back into a position of long-run sustainability

and future fiscal revenue sources safeguarded.

This requires a sensible Stability and Growth Pact in which fiscal (government deficit and debt) outturns are seen for what they are: namely only partly the result of government action, but to a greater extent the endogenous result of the actions of the domestic private sector. This means that fiscal policy monitoring must be integrated within the wider surveillance of macroeconomic imbalances. The key issue is long-run sustainability. Pro-cyclical austerity packages are not the way to achieve that. Faster growth is a necessary condition and one reason why the investment offensive is so vital.

Within this broader surveillance framework, a sensible rule is needed to exclude public investment from deficit calculations. At the same time, longer-term implicit liabilities (especially from pension systems) need to be taken into account. Member States should be encouraged to strengthen their automatic stabilisers, rather than weakening them as it at present the case: this could be achieved by way of a dedicated Open Method of Coordination. Each country should set its own longer run target debt-to-GDP ratio. Progress towards that target rate should be monitored in such a way as to avoid pro-cyclical policies in the shorter run. During the European policymaking semester, indicative recommendations for the appropriate fiscal stance (the cyclically adjusted deficit, as imperfect a measure as it is) should be made, taking all of these considerations into account. Countries may be encouraged to adopt a longer-term target growth path for nominal spending, but this should take care that it applies only to non-cyclical components.

It is vital that these consolidation measures are underpinned by serious efforts at national, but particularly at EU level to bolster state revenues. This implies first and foremost stamping out tax evasion and limiting tax competition on mobile production factors (notably corporation tax and the top rate of income tax). The latter can be effectively achieved by means of minimum tax rates (and harmonisation of tax bases). Agreement should be reached on financial transactions or other financial sector taxes and a carbon tax at European level. These would raise revenue and 'distort' production and consumption decisions in a socially desirable direction, and thus be efficiency-enhancing in a broad sense of that term: the former would help stabilise our economies and the latter promote the needed green transition.

A **fifth** requirement is to ensure greater fairness and equality.

This is key both for political and economic reasons. Politically, the difficult changes facing European countries in the coming years can only be achieved if there is perceived to be a fair burden sharing, across countries, between income groups, between capital and labour and among specific population groups (e.g. bondholders versus taxpayers, private and public-sector workers). Economically, it is clear that rising income inequality was one of the driving

A Blueprint for Growth, Consolidation and Convergence in the Euro Area

forces behind the unstable growth model on which the pre-crisis economy was based.

This requirement has its most immediately implications for the methods chosen for fiscal consolidation. However, also wage-setting institutions, and education and other policies (such as the privatisation of access to key services) have a role to play. A concrete European 'flagship initiative' would be a European minimum wage norm, in which Member States commit – using either statutory or collective bargaining institutions, as appropriate to the country – to raising the effective minimum hourly wage to at least 50% of the respective national average wage.

The **sixth** need is to ensure financial-sector stability.

This is one area in which some progress has already been, and is continuing to be, made. A good overview of what has been achieved and further reform needs is provided by this ETUC analysis, and I will not dwell further on this complex issue which does not readily lend itself to summary. Suffice it to say that such reform is a *sina qua non* for all the other policy reforms presented here leading to sustained and sustainable economic and employment growth in Europe. An unreformed financial sector risks destroying any other achievements in the next crisis. The most urgent task, however, is to clean up the problems that still exist in parts of Europe's banking sector. Rigorous stress-testing coupled with a willingness to inject further capital (where necessary as part of the support provided by the stability mechanism) into troubled but basically solvent banks and to wind-up those that have failed is vital.

Conclusion

Clearly this is only a thumb-nail sketch of the substantial policy reforms that would be needed in these six areas related to economic governance. My aim has been to set out the contours of an encompassing progressive reform agenda, one in which changes in different areas interact and together deliver the policy outcomes and contribute to the goals set out above. There *is* an alternative to the neo-liberal-inspired recipes coming from European policymakers and, particularly, conservative national governments who are using the crisis to take Europe down a liberal path. None of the measures I have proposed implies the need for sudden major institutional or constitutional changes. It is, I believe, a feasible medium term political project for all those who want to see a stronger, more economically viable and more social Europe.

Related posts:

1. Austerity Will Leave Britain No Choice but to Join the Euro
2. Austerity Policies and Fiscal Consolidation in Europe
3. Happy New Year for the Euro?