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For a credible growth strategy for the euro zone: the obligation to produce results

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Abstract :

Any growth strategy for the euro zone is doomed to failure if there is no improvement in the functioning of the Economic and Monetary Union (EMU). The incomplete nature of the euro's foundations became glaringly obvious during the most recent economic and financial crisis. However, thanks to the theory of optimal monetary zones developed by R Mundell in 1961 we know how to make the euro zone function satisfactorily. It comprises the development of alternative adjustment mechanisms to the exchange rate, such as the increased mobility of production factors. Then governments and the European authorities will be able to concentrate on freeing the traditional engines of growth, i.e. investment, innovation and training to improve the growth trend. But the real challenge lies in the definition of an integrated cooperative economic policy which prevents the market share gains of some being systematically made at the expense of those made by others as is the case at present. The rebalancing of the Member countries' current accounts, as it is being undertaken at present, cannot be considered a strategy for growth. [1]

REDUCING IMBALANCES WITHIN THE EURO ZONE ...

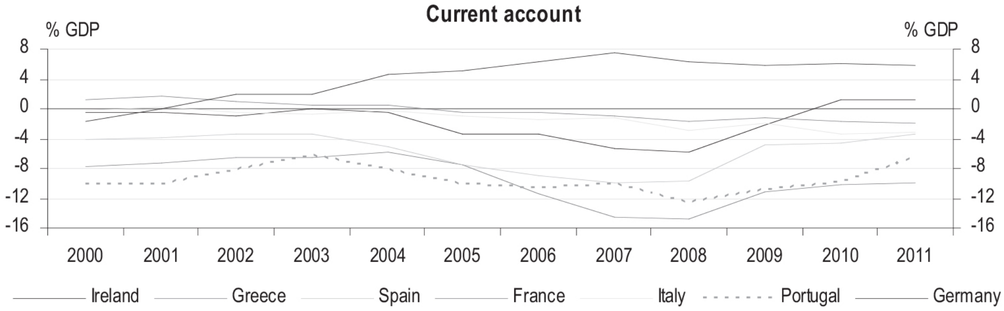
Inadequate economic integration and a lack of European funds to face up to asymetric shocks, i.e. the crises that are affecting the euro zone Member States differently, have led governments to privilege the reduction of current account imbalances. This is a means of limiting mutual commitment and therefore of delaying the moment when the issue of co-sovereignty in terms of economic policy will have to be addressed. Hence the balance of current accounts has replaced the quest to improve the functioning of the EMU. But although the reduction in the current account deficit can be requested by the creditors when it becomes unsustainable, this cannot comprise an economic policy goal nor can it be considered a growth strategy.

Current account balance reflects the difference between the value of exports and imports of goods and services traded abroad. It also includes net revenues, i.e. interests and dividends, as well as transfers abroad. A current account deficit means that imports are higher than exports or that national investment is higher than national savings. A deficit might therefore be normal in the countries that are catching up, which only have low domestic savings rates, or in countries which import to export tomorrow. Moreover the possibility of current account imbalance enables a reduction in the cyclicality of consumption and investment. In the event of a hurricane for example production stops but some consumption continues. Hence the deficit evens out the negative effects of the economic shock. Finally balance between national savings and investment can vary according to changes in the median age of the population.

As a result balancing euro zone Member States' current accounts at all costs can counter growth and can only be explained by the fact that the governments of Europe want to avoid an over coercive coordination of economic policy. Indeed, in the euro zone since rebalancing via the exchange rate is no longer possible the accumulation of commitments vis-à-vis European partners in the event of a current account deficit is only restricted by a country's ability to pay back its creditors. And so the problem is not as much the current account deficit but the country's real state of solvency. But it is not just determined by the development of public finances but also by that of private debt, which can

1. This text has been published in "The Schuman Report on Europe, the State of the Union 2013", Springer Verlag Editor. The report is available on our website: http://www.robert-schuman.eu/ouvrage.php?num=149

also lead to a crisis in the balance of payments. Hence a coherent reduction of imbalances that targets growth calls for the coercive coordination of European economic policy and not the rebalancing of current accounts.



Sources: Eurostat, HSBC

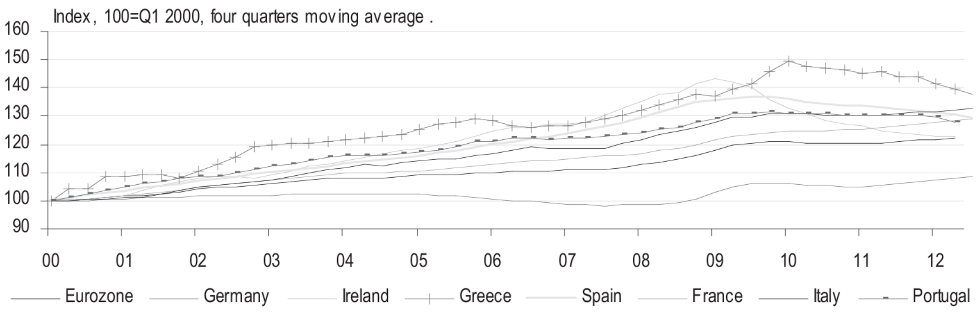
…. WILL NOT LEAD TO A CORRECTION OF THE FAULTS IN THE DESIGN OF ECONOMIC AND MONETARY UNION

Not only can the quest for the balance of the current account not comprise a goal of economic policy but the optimal monetary theory developed by R Mundell shows that the priority lies elsewhere. Indeed the establishment of a monetary zone demands the mobility of the production factors in order for it to function if it is not optimal. But this goal is not being pursued at the moment. It would require the "defragmentation" of the euro zone's financial market, greater responsiveness of prices and wages to economic variations, and finally a harmonisation and simplification of the European regulatory framework. Moreover a compensation fund would have to be established to help the countries which bear crises unilaterally, with wage mobility remaining of marginal concern.

A monetary zone like that of the euro is only possible if the mobility of production factors compensates the disappearance of national exchange rates. Indeed the economies are too different in order to react in the same way to crisis. For example if the unemployment rate in one country rose sharply, the exchange rate would not decline because it would be an isolated case. However, according to R Mundell's theory, an adjustment to decreasing prices and wages would lead to a reduction in production costs, which would support exports. At the same time workers would be able to go and work in the countries which still had a dynamic labour market. Another possible solution would comprise the introduction of transfer mechanisms between countries in the zone such as compensation funds for example. Of course if the euro zone economies were integrated changes like this would not be necessary. But the deepening of integration cannot be seriously considered as an alternative to the mobility of production factors and the implementation of a European compensation fund. Firstly, the geographic particularity of one country may impede economic integration, as for example the size of a Member State. Small countries tend, for example to be importers of net capital, which means that they favour non-resident investments. They would be more attractive to capital intensive activities than the larger countries. Secondly, it is illusory to believe that wage convergence would strengthen economic integration. Indeed the alignment of costs increases concentration and specialisation phenomena in areas with greater output as we saw during the German reunification. Thirdly and lastly, European regionalisation has generated the diversion of trade between euro zone countries. But its effects are contradictory since the single market has fostered specialisation and major savings at the same time. But specialisation increases the asymmetrical nature of the shocks i.e. for example the fact that oil price increases do not affect the German economy as they do that of Spain.

Recent progress made in terms of coordination in Europe are not enough to correct the shortcomings in the design of the single currency, i.e. the introduction of economic policies to compensate for the disappearance of trade flexibility between the countries in the euro zone, nor to avoid an intra-zone market share war.

Nominal unit labor cost in the Eurozone



Sources: Eurostat, HSBC

THE REDUCTION OF FINANCING REQUIREMENTS OF CERTAIN MEMBER STATES DOES NOT EXEMPT EUROPEANS FROM COORDINATING THEIR ECONOMIC POLICIES.

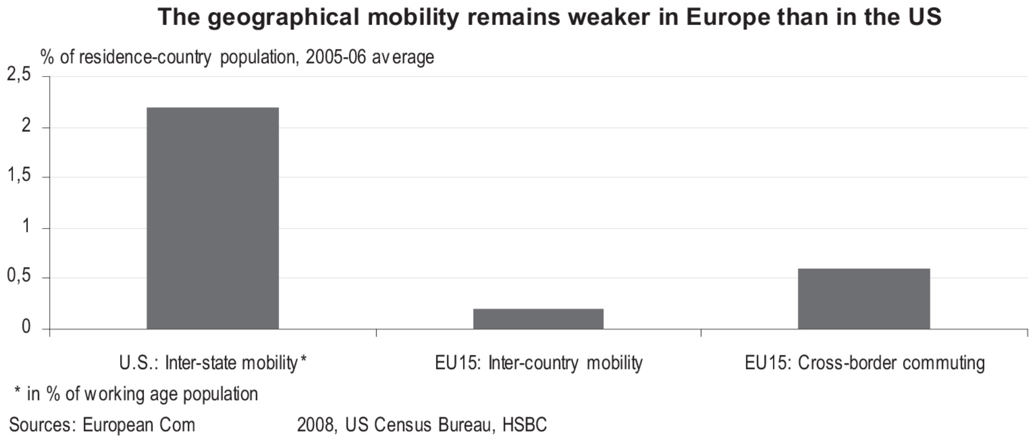
The governments of Europe should initiate three types of action to reduce macroeconomic costs caused by the setting of exchange rates and the improvement of the running of the EMU, prior to releasing the traditional engines of growth.

The first comprises a strengthening of the link between GDP development and inflation across the entire euro zone. Greater wage coordination within the euro zone and greater wage response to economic slowing would enable the European Central Bank to implement a more expansionist monetary policy and would limit unemployment increases, all things being equal. But in France for example the rigidity of consumer prices leads to strong resistance to wage stabilisation when GDP growth is slow or in times of recession. Indeed whatever the GDP development, regulated service prices, i.e. on electricity, gas, postal services, estate agents, administrative documents for marriages and funerals continue to rise sharply. And they represent a greater share in the French household budget than they do in Germany or Italy for example. Hence it is not enough to "reassess wage setting measures and if required, the degree of centralisation of the negotiation process" as put forward in the Euro Plus Pact.

An integrated economic policy framework is required that leads to a harmonisation in price formation processes and not just wage adjustment. This means that coordination will also have to focus on the development of regulated prices and service competition. Then a reform of the wage formation process will have to be started. It might take several shapes. The first would comprise centralised, collective negotiation on a European scale. The second might comprise intra-European sectoral negotiations. At the same time a European work contract might be drawn up including workers' rights. Finally tax issues would no longer require unanimity, which would ultimately help to take fiscal harmonisation forwards. The latter would do away with all types of market distortion between businesses in the various countries but also between their markets without challenging the redistributive principles in each country.

As a result mobility would be facilitated but it would remain limited due to linguistic and cultural obstacles and would never been as strong as in the USA.

The geographical mobility remains weaker in Europe than in the US



THE UNBLOCKING OF THE TRADITIONAL ENGINES OF GROWTH

Simultaneous to the improvement in the functioning of the EMU the traditional engines of growth will have to be unblocked. The 2020 Strategy is too similar to the Lisbon programme in order to comprise a credible growth strategy. On the one hand the quest for an improved functioning of the EMU must also be part of the quest for growth. On the other there are too many goals to be implemented rapidly. Finally there is no consensus on the means to achieve them. Of course all of the goals included in the 2020 Strategy are important but we have to take the risk of ranking them according to their capacity to correct the main weaknesses in Europe's principal economies and their expected impact on growth.
In view of these criteria four goals might be focused on: the improvement of employment rates, the rise in business investment in innovation, the increase in total factor productivity and the transition over to a carbon free economy.

– The improvement of employment rates would lead to the support of growth; it would also facilitate the relay of innovation and therefore help speed up potential growth. Indeed the employment rate is particularly low in the euro zone even though national disparities are significant. This results in a lack of adapted vocational training, particularly in the countries of the South and in France. General training is rarely given in the latter, whilst it comprises a prior condition for worker mobility and an increase in employment rates. To achieve these European businesses should offer vocational training that leads to certificates or diplomas according to a percentage of the workers which has to be defined.

– The increase in private investments in innovation would also lead to a strengthening in the euro zone's growth potential. Although business investments in innovation total 1.9% of the GDP in Germany in 2010, it only totalled 1.4% of the GDP in France, 0.7% in Italy, Spain and in Portugal. According to the OECD, business investment in innovation represented 2.5% of the GDP in Japan and 2% in the USA. Accelerated depreciation for this type of investment could be put forward to all businesses in the euro zone by the European Commission and financed by project bonds.

– Total factor productivity grew less between 2000 and 2010 in the euro zone countries than in the USA, Japan, South Korea and even in the UK. But according to our report for the Economic Analysis Council1, greater flexibility on the goods and labour markets as well as more high school graduates would help to support growth. The means to achieve this would be the same as those implemented to improve the functioning of the Economic and Monetary Union. As for high school graduates a specific figure has to be estimated.

– Finally as far as the transition over to a carbon free economy is concerned the implementation of a carbon tax would increase the necessary investments for the renewal of equipment. If oil prices continue to rise, investments would become profitable with the reduction in energy intensity.

THE EURO ZONE'S TREND GROWTH RATE MUST BE HIGHER

The crisis has led to institutional progress which will improve the functioning of the Economic and Monetary Union. Banking Union will facilitate the transmission of the monetary policy undertaken by the European Central Bank, thereby reducing the differences in private players' borrowing rates between the euro zone countries. Budgetary integration and macro-economic supervision will enable a reduction in the financing requirements of States experiencing a balance of payments crisis. But budgetary recovery and the quest for current account balance cannot comprise a growth strategy. A strategy like this must comprise two parts. The first being the correction of design faults in the single currency which limit its positive effects on growth. The second suggests an unblocking of the four most exhausted growth engines in the euro zone and would set out the steps to follow to achieve this. This is how the euro zone would define a future for itself.

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