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1930s or 2020s? A European Growth Strategy

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“The Political Future of the Union” Paper

Abstract

The main onus of responsibility for the current global economic predicament is on the financial system, not on a lack of fiscal discipline. Nonetheless, the crisis is having an extremely severe impact on the real economy, which is felt most acutely in the southern Eurozone member states. Since the end of the deepest phase of the crisis in 2009, European governments have committed themselves to fiscal consolidation. The results of these policies have been perverse: the impact of fiscal tightening during a depression may result in depressed output and high unemployment, without lowering the debt-Gross Domestic Product ratio. In light of this, we make a case for restoring growth in Europe without further delay, and discuss the role of the EU budget as an instrument for setting and implementing a real EU growth strategy.

Keywords: *European Union / Economic crisis / Economic growth / EU budget*

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1930s or 2020s? A European Growth Strategy

by Francesco Prota and Gianfranco Viesti[*]

1. Introduction

The current global crisis was caused by a combination of asset price bubbles, mainly in the real estate sector, and a credit bubble that led to excessive leverage, coupled with regulatory weaknesses and distorted incentives in the US and European financial sector. Although the crisis erupted against the background of global economic imbalances, undoubtedly the main onus of responsibility is on the financial system, and not on a lack of fiscal discipline.[1]

Nonetheless, the crisis is having an extremely severe impact on the real economy. In the European Union, in particular, it has impacted on the real economy through tighter credit conditions, collapsing confidence, and a sharp contraction in demand and trade. This has led to a slump in investment activity and a sharp drop in output and capacity utilization, particularly in manufacturing and construction. As a consequence, this is leading to a massive, wasteful, labour shedding.

Four factors have contributed to making the economic crisis especially serious in Europe: (*i*) the asymmetric construction of Economic and Monetary Union (EMU), a common monetary policy, implemented by the European Central Bank, without a common economic and fiscal policy), and the fact that the euro is not embedded in a political union, which have questioned the very survival of the Eurozone; (*ii*) the existence of large commercial and payment imbalances within the Eurozone, in particular with Germany having large and lasting trade surpluses, financed by equally large capital flows to the “periphery” of the Eurozone; (*iii*) a pre-existing complex public finance situation in some European countries; *(iv)* specific problems of the EU banking sector, particularly in some countries, leading to a fragmentation of the European financial system.

Moreover, the crisis is having a strikingly differentiated impact on individual EU countries, particularly severe in the southern Eurozone member states, because of the

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[1] Joseph E. Stiglitz, “Interpreting the causes of the great recession of 2008”, in Bank for International Settlements (BIS), *Financial system and macroeconomic resilience: revisited*. Eighth BIS Annual Conference, 25-26 June 2009, Basel, BIS, 2010 (BIS Papers, 53), p. 4-19, http://www.bis.org/publ/bppdf/bispap53.pdf.

growing differential on interest rates on government bonds, the size of fiscal imbalances, their trading position and their banking system problems. As a consequence, the entire burden of adjustment has been placed on some countries. It is not only a matter of their governments' deficit or debt, as the case of Spain clearly shows. For example, British government bonds now offer significantly lower interest rates than those of France or Spain, even though the United Kingdom's fiscal position is considerably worse.

Since the end of the most acute phase of the crisis in 2009, European governments have committed themselves to fiscal consolidation. Austerity has become the political *mantra* in Europe. However, the results of these policies have been perverse: not only have they had substantially larger negative impacts on growth than expected, but also, and as a consequence, they have actually raised rather than lowered debt-Gross Domestic Product (GDP) ratios. According to recent International Monetary Fund (IMF) analysis, the euro area crisis has deepened.[2] In the current economic circumstances (where the economy is operating well below its potential and where interest rates are constrained by the zero lower bound), the negative impact of fiscal consolidation on growth may be so large that the debt-GDP ratios may be expected to increase further. This question has been thrown into sharp focus by the IMF's reassessment of the magnitude of the "fiscal multiplier" in major industrialized countries: since the start of the crisis, the multipliers used in generating growth forecasts have proved to be systematically too low. According to IMF estimates, multipliers have actually been in the 0.9 to 1.7 range.[3] This finding is consistent with research suggesting that in today's environment of substantial economic slack, monetary policy constrained by the zero lower bound, and synchronized fiscal adjustment across numerous economies, multipliers may be well above 1[4]. Moreover, the spillover effects due to simultaneous fiscal consolidation programmes are very large in the case of Europe because of the high level of economic integration across member countries. So, in the Eurozone, real GDP is projected to decline by about 0.75 percent during the second half of 2012, remain constant in the first half of 2013 and expand by about 1 percent in the second half. The most peripheral economies in the area are likely to suffer a sharp contraction in 2012, constrained by tight fiscal policies and financial conditions.[5]. In Greece, Ireland, Portugal and Spain the fiscal consolidation is indeed having a strong negative impact on GDP: respectively, -11.0%, -6.9%, -6.1%, and -4.7% over the period 2010-2014.[6]. This harks back to the period of the gold standard during the 19th century, when deflation and unemployment were seen as the only recipe to escape a trade deficit.

The remainder of this paper is organized as follows. Section 2 explains the reasons why restoring growth in Europe cannot be postponed any longer. Section 3 describes the "Compact for Growth and Jobs" agreed by the Heads of State or Government at the European Council in June 2012; while Section 4 describes the European Commission

[2] International Monetary Fund (IMF), *World Economic Outlook October 2012. Coping with High Debt and Sluggish Growth*, Washington, IMF, 2012, http://www.imf.org/external/pubs/ft/weo/2012/02.
[3] Ibidem, p. 41.
[4] J. Bradford DeLong, Lawrence H. Summers, "Fiscal Policy in a Depressed Economy", in *Brookings Papers on Economic Activity*, Vol. 44, No. 1 (Spring 2012), p. 233-297.
[5] International Monetary Fund (IMF), *World Economic Outlook October 2012*, cit., p. 9.
[6] Intesa Sanpaolo, *Scenario macroeconomico*, settembre 2012, p. 60, http://www.clal.it/downloads/showcase/scenariomacroeconomico_settembre2012_base.pdf.

proposal for the 2014-2020 Multiannual Financial Framework and discusses the role of the EU budget as an instrument for setting and implementing a real EU growth strategy.

2. Exiting the crisis

There is an alternative view according to which fiscal austerity alone risks being counter-productive, given its negative impact on expected long-term growth rates. The argument is not against restoring safer fiscal positions, especially after the large increase in debt in the last few years. The idea is that European policymakers should be focusing not only on today's deficit, but also on the long-term national debt-to-GDP rate, and, therefore, on designing effective policies to stimulate growth.

In the absence of such policies, we risk long-lasting stagnation or growth too feeble to return unemployment to normal levels anytime soon. Timing matters. The longer the recession lasts the more likely "hysteresis" effects prolonging the period of slow growth, because of the premature scrapping of fixed and human capital and the credit constraints on innovative firms.[7] In particular, many of those losing their jobs are becoming long-term unemployed and are losing their human capital. This implies that short-run demand-side policies may have long-run impacts on the productivity supply side of the economy.

Public as well as private investments should be increased. Even if this widens the deficit in the short run, it will reduce the national debt in the long run. The public expenditure composition matters: spending on education, technology, and infrastructure can actually lead to lower long-term deficits.[8] Indeed, faster growth and returns on public investment yield higher tax revenues. In addition, high growth rate makes future threats to solvency less probable and therefore it may result in lower risk premia.

There are at least other four reasons why restoring growth cannot be postponed any longer. The first has to do with preserving the European social model (already precarious, mainly because of ageing populations and structural financing problems). Even before the bubble burst, inequalities had grown rapidly within many countries. The situation has deteriorated since then, because of the large increase in unemployment. Growing inequality within European societies as well as recent political tensions within EU member states are undermining social cohesion.

[7] Philippe Aghion, Julian Boulanger, Elie Cohen, "Rethinking Industrial Policy", in *Bruegel Policy Brief*, No. 2011/04 (June 2011), http://www.bruegel.org/publications/publication-detail/publication/566-rethinking-industrial-policy. Extended periods of depressed output and high unemployment can have long-term implications for the productive capacity of the economy, the so-called hysteresis effect.
[8] Philippe Aghion, *Growth Policy and the State Implications for the Design of a European Growth Package*, London, LSE Growth Commission, 10 June 2012, http://www2.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/contributions/lseGC_aghion_state.pdf.

The second reason regards political tensions among European countries. It is fundamental to avoid the prevailing of a European zero-sum mentality,[9] contrary to the political belief and practice of the last 50 years, that may lead to pursue individual solutions to the crisis, even at the expense of other countries. Restoring growth and trade may enhance the political credibility of European institutions as well as the trust between member states; both are currently at stake.

The third reason regards the special challenges confronting southern Europe. North-south economic convergence has drastically stopped and has been reversed in Greece, Portugal and Spain, with little chance of short-term improvement. An integrated Europe as well as a common European currency cannot survive with increasing divergence and imbalances in the area, as made clear since the times of the Werner and Padoa Schioppa reports.[10] Benefits of an integrated Europe must accrue to all its citizens.

The last reason is the need to avoid the risk that unsustainable austerity may lead to the exit of a country from the Eurozone. The enormous political and financial costs of such an event for all member states[11] would call into question the resilience and indeed the very survival of the EU as a whole.

3. The Growth Compact

What about growth policies in Europe? At the European Council in June 2012, the Heads of State or Government agreed on a "Compact for Growth and Jobs", stressing the importance of restoring economic growth. The "Compact for Growth and Jobs" should complement and reinforce the ongoing efforts to restore financial stability and deepen the Economic and Monetary Union. The "Compact" includes, first, a political declaration of intent with a long list of measures designed to: (*i*) deepen the Single Market; (*ii*) achieve a well-functioning Digital Single Market by 2015 and complete the internal energy market by 2014; (*iii*) further reduce the overall regulatory burden at EU and national levels; (*iv*) ensure that research efforts are swiftly translated into innovations to meet market demands through strengthening the European Research Area; (*v*) achieve progress in the area of tax policy regarding Commission proposals on the revision of the Savings Tax Directive, a common consolidated corporate tax base, energy taxation and negotiating mandates for a savings tax agreement with third

[9] Loukas Tsoukalis, "Steering Europe out of the Crisis. Turning EU integration into a positive-sum game", in *Policy Network Paper*, October 2012, p. 3, http://www.policy-network.net/publications/4267/Steering-Europe-out-of-the-Crisis.

[10] Pierre Werner, *Report to the Council and the Commission on the realisation by stages of Economic and Monetary Union in the Community* (Werner Report), in *Bulletin of the European Communities*, Suppl. 11/1970, http://ec.europa.eu/economy_finance/emu_history/documentation/chapter5/19701008en72realisationbystage.pdf; Tommaso Padoa Schioppa et al., *Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community*, Oxford, Oxford University Press, 1987.

[11] UBS Investment Research, "Euro break-up - the consequences: reprise", in *Global Economic Perspectives*, 5 December 2011, http://www.mauldineconomics.com/images/uploads/overmyshoulder/Euro_break-up__the_consequences.pdf.

countries; (*viii*) boost employment, in particular for young people and long-term unemployed, and facilitating labour mobility; (*ix*) harness the growth potential of trade.

This list reflects a list of good supply-side reforms that have already been advocated by the Commission for several years. As convincingly argued in the Monti report,[12] however, further progress in implementing the Single Market is viable only if there is widespread political support, that is, if Europeans perceive its advantages. In other words, a completion of the single market cannot be obtained without pursuing, at the same time, social inclusion and territorial cohesion.

A package made up of three initiatives was approved to boost the financing of the European economy. First is the decision to increase the capital of the European Investment Bank (EIB) by €10 billion. These additional funds will strengthen the EIB's capital basis and thus - according to EU estimates - increase its overall lending capacity by €60 billion. This amount should unlock up to €180 billion of additional investment across the whole European Union. Second is the launch of a pilot phase of the "EU project bonds initiative", created to attract institutional investors to co-finance large European projects in transport, energy and broadband infrastructure. These projects will be entirely financed by the current 2007-2013 financial framework via a redeployment within the envelopes of existing programmes in 2012 and 2013. These are the only two new elements in the "Compact". Thirdly, the "Compact" reaffirms the readiness to reallocate existing Structural Funds worth €55 billion for specific projects for growth-enhancing measures in the remaining 2007-2013 financial period. As a result of the combination of these measures, a total sum of €120 billion should be mobilized (€60 billion lending capacity; €4.5 billion for Project Bonds; €55 billion via reallocated Structural Funds).

EIB financing may be very useful for Europe, also to mobilize private investments. However, it should be kept in mind that, as all credit operations, it may accrue only to infrastructures that are able to generate financial returns, with possible asymmetric effects among investment typologies as well as among countries and regions, given the different economic impact of infrastructures in environments with different market potential. As far as Structural Funds are concerned, most of 2007-2013 resources are already allocated, hence, a reallocation of funds to new measures may result only from a reprogramming. Moreover, co-financing of Structural Funds has already emerged as a key problem in several countries because of their fiscal difficulties.

In principle, the "Compact" points in the right direction. However, its size and the long-term nature of many of the foreseen interventions suggest that its impact will be rather limited. In addition, its implementation has been so far rather slow, as pointed out by a recent Commission assessment, with progress only in preparing the increase of EIB capital.[13] Its overall strength vis-à-vis the magnitude of the crisis is highly questionable.

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[12] Mario Monti, *A new strategy for the single market. At the service of Europe's economy and society*. Report to the President of the European Commission, 9 May 2010, http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

[13] European Commission, *Implementation of the Compact for Growth and Jobs*, Report to the European Council, 18-19 October 2012, p. 1, http://ec.europa.eu/europe2020/pdf/growth_report_en.pdf.

4. The EU budget

The possible instrument for setting and implementing a real EU growth strategy already exists: it is the EU budget. As well known, its size is remarkably smaller than what would be needed in an integrated area such as the EU, notably to contrast external, asymmetric shocks as the ones that hit Europe in the last years. However, it is European; and it is pro-growth.

The time for discussing its role is now. European institutions are preparing the Multiannual Financial Framework (MFF) for the next programming period (2014-2020). The Commission has proposed to have a budget that amounts to 1.05 percent of the European Union's Gross National Income (GNI) in commitments (translating into 1 percent in payments); a further 0.02 percent in potential expenditure outside the Multiannual Financial Framework, and 0.04 percent in expenditure outside the budget will bring the total figure to 1.11 percent. This includes financial amounts booked to respond to crises and emergencies (which cannot be foreseen), and expenditures which benefit from *ad hoc* contributions from member states.[14] The proposal means no significant increase in the available resources.

The Commission has stressed the pan-European nature of the EU budget, and the need to implement the Europe 2020 strategy and its objectives of smart, inclusive and sustainable growth. The Commission has not put into question the traditional policy priorities of European spending, such as the Common Agricultural Policy (CAP) and the Cohesion Policy, but has proposed changes in order to bring them more in line with the Europe 2020 strategy. As regards the Cohesion policy, the main novelties are the introduction of a new category of regions: "transition regions" to replace the current phasing-out and phasing-in system; and the "partnerships contract" which should become an effective means to "set the commitment of partners at national and regional level to utilise the allocated funds to implement the Europe 2020 strategy".[15] The Common Agricultural Policy is subject to reforms needed for an equal treatment of farmers across all the 27 member states (contrary to what happened in 2007-2013), that are hotly debated. Other two points deserve attention: (*i*) the creation of a Connecting Europe Facility which aims to boost the pan European value of infrastructure projects and to bring more interconnectivity across Europe; and (*ii*) the EU strategy called "Horizon 2020" worth 80 billion euro which aims to improve Europe's global competitiveness and to help create new jobs by gathering all projects in the

[14] European Commission, *A Budget for Europe 2020* (COM(2011) 500 final), Brussels, 29 June 2011, p. 4, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SPLIT_COM:2011:0500%2801%29:FIN:EN:PDF.

[15] Idem, p. 12. Every European region may benefit from EU Cohesion Policy according to the level of GDP. Three categories of regions will exist in order to ensure concentration of the Structural funds: "less developed regions", whose GDP per capita is less than 75 percent of the EU-27 average; "transition regions", which include all regions with a GDP per capita between 75 and 90 percent; "more developed regions", whose GDP per capita is above 90 percent. In order to increase the effectiveness of EU spending and in line with the territorial approach of the Lisbon Treaty, the Commission proposes to conclude a "partnership contract" with each member state. "Partnership contracts" will set out the commitments of partners at national and regional level and the Commission. They will be linked to the objectives of the Europe 2020 strategy and the National Reform Programmes. They will set out an integrated strategy for territorial development supported by all of the relevant EU Structural funds and include objectives based on agreed indicators, strategic investments and a number of conditions.

research and innovation area to eliminate fragmentation and make sure EU-funded projects better complement and help coordinate national efforts.

On the financing side, the Commission's proposals call for a reduction in direct contributions from member states, suggesting a new own resource system based on a financial transactions tax and a new Value Added Tax (VAT) resource. These new own resources would partially finance the EU budget and could fully replace the existing complex VAT-based own resource, while reducing the scale of the GNI-based resource. These two new resources would reduce the weight of national contributions in the financing of the budget from the current 85.3 percent to 40.3 percent (European Commission 2011b).

Those "modest proposals" are far from being approved. Several countries (including Germany) want the budget to be limited to 1 percent of EU GDP. The United Kingdom is proposing a freeze in real terms, in sharp contrast with the Commission's proposals, even if, under that proposal, "the UK could end up paying around £400 and £550 million per year more, at most […]. [The] same amount that England and Wales spend each year on flood and coastal defences, or the same size as Oxfordshire County Council's budget".[16] A large part of the debate is about the contribution of member states unwilling to finance the budget. Following the very negative historical track of the UK rebate, several countries are calling for discounts, even larger than those already set in the 2007-2013 budget.[17] Governments are calculating their own "financial balances" under different hypotheses about the budget structure (on both the revenues and the expenditures sides) as if the benefits of Europe - for example for Germany - could be calculated only comparing its financial contribution and the agricultural and structural funds accruing to its firms and Lander. A real cost-benefit analysis should also take into account the huge intra-UE trade surplus (due to the Single Market and the common currency) and the beneficial effects on government and firms financing due to the flight of capital - in an integrated financial environment - to those that are perceived as less risky bonds, such as the German ones.

A zero-sum approach is at work. The failure of the European Council of November 22 and 23, 2012 is due to that attitude.

On the contrary, the EU budget might turn out to be a real "growth compact". It includes the financing, albeit very limited, of new pan-European infrastructures, useful to integrate Europe and to re-launch economic activity in the construction industry. Europe 2020 describes the broad contours of a modern industrial policy, which combines horizontal features and support for competitiveness, by redirecting production and innovation towards green technologies, or by targeting skill-intensive sectors. In the current framework, Cohesion policies are particularly important. They aim at bringing growth and social inclusion exactly where they are more needed, in the weakest regions and countries of Europe; the only way to reduce political and social

[16] John Springford, "Much ado about little: Britain and the EU budget", in *CER Insight*, 7 November 2012, http://www.cer.org.uk/insights/much-ado-about-little-britain-and-eu-budget.
[17] Gianfranco Viesti, Francesco Prota, *Le nuove politiche regionali dell'Unione Europea*, Bologna, Il Mulino, 2007.

tensions as well as to strengthen their competitiveness, helping their export sectors and contrasting unemployment.

Growth in Southern Europe, if any, will not come at the expense of Northern countries, as in an 17th century mercantilistic framework. Pro-growth policies via cohesion policies substantially spill over across European countries; new investment and production, as it has always been in post-WWII European economic history, induce large imports from more advanced regions and countries, as is already happening since the accession of the Eastern European Countries.[18] Cohesion policy is a key instrument for the development of the EU (indeed, the only true European development policy); its links with the EU2020 strategy may further reinforce its effects. However, in the current scenario, those effects should not be taken for granted. Structural funds may end up barely substituting missing capital expenditures in national budgets, as is already happening; the difficulties in their co-financing and expenditure constraints due to public deficit targets may negatively influence their timing. A key component of a real Growth Compact should then be a “golden rule” to exclude those investments from the macroeconomic stability plans, regulated by clear EU rules and controls so as to avoid any abuse. Unfortunately, the macro-economic conditionality foreseen in the Commission’s proposal for a regulation of the Structural funds covered by the Common Strategic Framework, points exactly in the opposite direction. According to this clause, the Commission may adopt a decision suspending part or all of the payments for the programmes concerned if a country pursues “unsound macro-economic policies”. It remains unclear how cutting funding earmarked to investment for growth and jobs from financially troubled countries would help them get back on track.

The time for using the EU budget as a growth instrument is now. The point is not about avoiding reforms needed for fiscal sustainability across the EU. The point is to achieve this in a framework of a restored growth and prosperity scenario. Otherwise, the risk is the explosion of Europe, given the social and political unsustainability of blind austerity. The quest at hand is that of projecting Europe towards the 2020s rather than allowing it to slide back towards the 1930s. The choice is for European governments to make.

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[18] Instytut Badań Strukturalnych (IBS), *Evaluation of the benefits to the EU-15 countries resulting from the implementation of the Cohesion Policy in the Visegrad Group countries*, Warsaw, December 2011, http://ibs.org.pl/publikacja/_1.

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