CHALLENGE EUROPE

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The growth challenge for Europe and the EMU

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The European economy is slowly and painfully striving to reemerge from the last six years of crisis. It was a crisis of enormous intensity and contagiousness, given the unprecedented depth of global financial integration combined with the systemic flaws in the EMU architecture. And it is not over, as the high levels of unemployment and the growing divergence between Member States testify. The threat of fragmentation is imminent as ever: fragmentation between euro-ins and euro-outs; fragmentation between North and South; fragmentation within societies, with increasing income inequality and a growing number of, what used to be, the middle class population slipping through the social safety net and below poverty lines.

Policies of front-loaded fiscal consolidation have left welfare states in economically weaker countries severely underfunded. According to OECD data, the number of people living in households without any income from work has doubled in Greece, Ireland and Spain, and has risen by 20% or more in Estonia, Italy, Latvia, Portugal, and Slovenia. Fertility rates have dropped further since the crisis, deepening the demographic and fiscal challenges of ageing. There are long-term implications from these deteriorating trends, regarding people's long-term health, education and upward mobility from low-income families. It is also highly likely that many of the people unemployed for a long period of time will never again be able to gain proper access to the job market and build a normal career track. The enduring effects of the crisis risk creating vicious cycles of low growth, high debt levels, austerity, declining productivity, and stagnation.

These developments carry heavy implications for the future growth prospects of the European economies, for future prosperity, and for the sustainability of pension systems and welfare states. They must be urgently reversed.

What needs to be done (I): Euro zone adjustment on the short-term

The economic crisis in the euro zone must be addressed as a matter of priority, also given its wider implications for the entire European economy.

Over the last few years, under painful adjustment therapies, the euro zone took important measures towards confronting the large deficits and excessive imbalances which contributed to the sovereign debt crisis. Fiscal discipline and overall macroeconomic stability are essential preconditions for ensuring the viability of the euro and allowing the euro zone economies to move to a healthy growth trajectory.

However, the adjustment policy mix has been too procyclical, ending up amplifying the recession, fostering debt deflation and prolonging the crisis. The lack of any significant euro zone-level countercyclical measures, to offset the recessionary impact of adjustment, has been a significant factor for the prolonged stagnation of the European economy. The inability of the broken monetary transmission mechanism to transfer the low interest rates from the core to the economies of the periphery has further deprived healthy companies, especially SMEs, of precious capital.

Since the crisis began, the growth rates of the euro zone economy have been deplorably low. At well below 1%, the current rate of inflation in the euro zone falls short of the ECB's definition of price stability. Deflation or 'lowflation' makes the rebalancing effort in the euro zone extremely difficult. The economies of the euro zone South need lower inflation, in order to restore cost competitiveness *vis-à-vis* the core; but against an average 0.5% they can only rebalance in deflation. A nominal GDP growth rate around 1% or below means that the public and private debt burden in highly indebted euro zone economies will be growing further, to the point of eventually becoming unserviceable.

What is needed is a policy mix that would assist fiscal consolidation, economic adjustment and structural reforms in the economically weaker countries, starting from a higher average inflation rate (closer to 2%) in the euro zone. At the same time the Euro zone economy needs an urgent countercyclical stimulus, which should be provided via an EU- or EMU-wide investment stimulus. A large investment stimulus at the euro zone could be funded by the European Investment Bank (EIB), assisted perhaps by the EU budget. The EIB should increase its capital base and could issue bonds, which among others, could be purchased by the ECB. This and purchases of private sector assets could be part of an extensive asset purchasing programme by the ECB, which could facilitate financing conditions and help push inflation upwards. Investing in European public goods such as Trans-European Networks and infrastructures (energy, telecoms, digital networks reaching remote areas where the private sector is disinclined to invest) would enhance Europe's growth potential and deepen the single market.

A true recovery programme is necessary and urgent in euro zone Member States which are currently suffering intolerably high unemployment. Productivity-enhancing structural reforms in these countries must be combined with large investment in education and research, new technologies, networks, health, energy, environmental sustainability and the business environment, all of which would strengthen longer-term competitiveness.

With an average unemployment rate around 12%, unemployment remains the most important concern for Europe. It is painfully acute in the crisis-hit economies, peaking above 25% in Spain and Greece. Apart from an explosive socio-economic and political problem, long-term unemployment is a terrible waste of human capital, undercutting the productive capacity and future growth potential of the economy, eroding welfare state capacities. It is vital to maintain the employability of the unemployed, especially the long-term unemployed, by making sure that active support and training is extended and social safety nets are funded, to avert marginalisation.

Most of the existing studies reveal a large investment gap in the euro zone, including Germany as well as the crisis economies, as a result of public investment spending cuts, private sector deleveraging, and the credit crunch. It would be preferable to cover this investment gap through large scale EU investment funding as mentioned above. The

European Commission can also apply flexibility, if justified by the specific circumstances, in treating national investment expenditure with regard to budget deficit rules, whose credibility however should be safeguarded.

An investment boost will help restore the long-term growth potential of the receiving countries and the EU economy as a whole. It is a necessary complement but not a substitute for national reforms aimed to raise the underlying productivity of EU economies. euro zone countries with relatively low public debt levels, that have the fiscal space, should lead the investment stimulus required for the recovery of the euro zone economy.

Following the extensive adjustment (fiscal and external) in the periphery, the euro zone must move to a more symmetrical distribution of the burden of adjustment. A stronger demand stimulus in the export-surplus economies would help economic rebalancing across the euro zone.

The faster implementation and completion of a fully fledged banking union, and the repair of bank balance sheets and bank restructuring where necessary, are vital in restoring normal credit conditions in the bank-based European economy. The access to credit for healthy SMEs remains constrained, especially in the crisis-hit economies. In the longer run, the development of alternative sources of finance, such as venture capital, angel investors, and SME bonds would enhance financing conditions in Europe, especially with regard to new innovative enterprises.

What needs to be done (II): Fixing the EMU

Raising competitiveness, especially in economically weaker countries has extensively relied on wage deflation and lowering labour costs. Though the adjustment of unit labour costs since the outbreak of the crisis has been necessary, there should be stronger emphasis on other cost factors too, and on raising overall productivity levels. This mainly remains a national policy responsibility, but the EU should become more active in supporting investment and providing technical assistance to the less developed regions.

Economies which prior to the crisis had relied on credit-driven growth and an overexpansion of non-tradable sectors, at the expense of tradable sectors, will need to shift to a more export-led model. This will require far-reaching structural reforms and intelligently directing or 'nudging' resources towards higher value added export sectors. In some cases, typically non-traded economic activities such as real estate, education or health services, can be redirected towards external demand. Some of the otherwise less competitive economies can exploit a comparative advantage in high-tech start-ups, where impediments of bureaucracy, weaker infrastructure and other cost-factors are less crucial. The EU should work closely with national and regional authorities, private business, research centres and other stakeholders to encourage and sustain smart growth.

It is important to promote the speedy implementation of the banking union. Without it, the euro zone periphery could end up trapped in a permanent situation of high perceived country risk, higher capital costs, savings and investment flight, wage deflation, low growth and persistently high unemployment. This would undermine the economic and socio-political viability of the euro and European integration. The backstop established by the banking union needs to be strengthened. The third pillar of the banking union, a single deposit insurance system, needs to be added.

The recommendations outlined in the Presidents report "Towards a Genuine EMU" and the Commission's "Blueprint for a Deep and Genuine EMU" must be enacted upon. Most important among them is the need for the euro zone to acquire its own fiscal capacity. A euro zone budget, funded preferably by own resources (VAT, corporate taxation, financial transaction tax, etc.), should operate as a main instrument of macroeconomic stabilisation in the face of crises hitting Member States in an asymmetric manner. A euro zone budget, together with the EIB, should be able to direct investment to crisis regions, assisting their recovery. A European unemployment insurance scheme could assist national efforts to deal with excessively high levels of cyclical unemployment, while national reforms confront the sources of structural unemployment.

There should be progress towards an investment union, as proposed by the European Policy Centre (EPC), including a dedicated investment fund aimed at delivering investment for growth in Member States that are unable to make the necessary investments themselves. This would encompass and exceed existing initiatives such as frontloading EU budget funds, project bonds and the Connecting Europe Facility. A "European Investment Guarantee Scheme" would be a vital additional new instrument that would provide insurance against the higher country risks involved in private sector investment towards crisis-ridden economies. Such steps towards moderate mutualisation, combined with greater pooling of national budgetary and economic policies, would help build a more integrated, cohesive and sustainable euro zone. A Eurobond scheme could be employed to finance euro zone investment in infrastructure.

In general, the euro zone has not tapped on the advantages of a monetary union, and especially the status of the euro as the world's parallel reserve currency next to the dollar. This implies that euro zone bonds, Eurobonds, would be able to benefit from the advantages of a deep and liquid global financial market, ensuring low-interest finance for major EMU projects. Such projects include infrastructure, and they can also include the process of partly substituting the national issuance of debt through joint issuance in the form of Eurobills and a Debt Redemption Fund. Thus, through reducing servicing costs, high public debt levels would de-escalate more rapidly and financial markets would be better integrated and stabilised. The appropriate conditionality would effectively safeguard against moral hazard. Effectively dealing with the debt overhang is a crucial prerequisite for allowing the European economies to grow.

What needs to be done (III): EU growth strategy

The EU faces a great competitive challenge from the transformation of the global economy. The challenge is not only to reverse or decelerate the long-term trend of its shrinking share in the global GDP. The challenge is also to do so by preserving the European model of a social market economy, balancing growth and competitiveness with social cohesion, environmental sustainability, and a European quality of life. The unhappy prospect of a "1% European economy" needs to be resisted: 1% GDP growth, 1% inflation, 1% of the population controlling wealth.

Globalisation, technological progress, and the shift of power towards new global economic poles are leading developments in Europe and the world. European enterprises are responding to global market transformations by becoming integrated in global value chains. Tapping on new sources of growth and competitiveness requires open and interconnected product and services markets, higher investment in research and innovation, a favourable environment for entrepreneurship, and an appropriately skilled labour force.

The Europe 2020 strategy places emphasis on the appropriate areas and priorities that will allow the EU to enhance its medium- to longer-term growth potential. Following the euro zone crisis, the EU is now even further behind on the Europe 2020 targets than it was back in 2010. Prolonged unemployment and exit from the labour market in crisis countries has led to further divergence on the now overambitious 75% employment target (persons aged 20 to 64 in employment). The EU must seek to raise the employment rate especially in Member States at the lowest tier (Bulgaria, Greece, Hungary, Ireland, Italy, Portugal, Romania, Slovakia, and Spain). The employment rate should also be enhanced by better policies of skill-building and life-long learning, and social policies to support full participation of women in the labour market. In addition, Europe should counteract ageing and the shrinking of the labour force by adopting a dynamic immigration policy, integrating larger number of immigrants into the labour market and attracting talented young workers from around the world.

Other Europe 2020 headline objectives are also drifting further away. The percentage of people at risk of poverty has actually increased to 25% in the EU. The crisis has made it difficult to reduce the number of early school leavers, and raise the proportion of young people with tertiary education to 40%. Education, training and lifelong learning should remain a policy priority shielded by expenditure cuts, preferably favoured with higher investment than it currently receives. A quarter of the EU's adult population still lacks the skills to make effective use of ICT. Investment in R&D should be supported to reach closer to the ambitious 3% GDP target, and so should the shift to renewable energy, where the momentum has been lost.

These are targets that are vital for attaining the objectives of smart, sustainable and inclusive growth in Europe. They should be promoted with new rigor and commitment at EU and national level, employing EU budget and regulatory instruments to support national efforts. Among others, the European Union could use its available instruments in order to promote productivity-enhancing reforms on the ground, for example by attaching the disbursement of EU budget funds to administrative reform.

Completing the single market in services, energy, the digital sector, and research should feature at high priority. These are areas where single market integration can drive economic growth through spill over effects across sectors. In particular, completing the digital single market would enhance ICT, strengthen the productivity and competitiveness of European enterprises, improve the functioning of the labour market and the public services, assist Europe's transition to a low carbon economy, and promote education and skill-building in a knowledge-based society.

Linked to this is the objective of enhancing energy efficiency and autonomy. Europe is facing higher energy costs compared to major competitors such as the US. This warrants revisiting the energy policy mix, without compromising the main environmental and sustainability policy targets. The energy union must be promoted as a grand project (seeking among others greater energy security and lower energy prices) with important positive effects in a number of policy areas.

The functioning of the internal market for industrial products must be further improved and EU industrial policy should be strengthened, with a particular focus on SMEs which provide the majority of jobs in Europe. In particular, the more flexible reallocation of skills and resources across firms and sectors and towards emerging high-growth sectors and markets must be facilitated by financial systems and labour, capital market and bankruptcy regulations.

Finally, it is important for the EU and Member States to strengthen public finances by avoiding further tax increases on working people and productive enterprises, or deeper cuts on social and investment spending. In countries in need of fiscal consolidation, the tax burden should be shifted to tax bases linked to consumption, property, and pollution. Better EU-level and global coordination is necessary for broadening the tax base against tax fraud, tax evasion and tax havens.

In conclusion

Economic growth is vital not only for overcoming the enduring effects of the crisis but also for reintegrating millions into the labour market, for promoting prosperity, and defending Europe's position in the world. This would shore up public finances, reduce the debt overhang and deliver a functioning welfare state to the next generations of Europeans. Attaining this desired level of economic growth is also crucial for the European integration project to regain the trust of citizens, by delivering a European Union that actually works and delivers on their behalf.

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