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MEDIOCRE GROWTH IN THE EURO AREA: IS GOVERNANCE PART OF THE ANSWER?

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Mediocre growth in the euro area: Is governance part of the answer?
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Over the last five years, average GDP growth has been 1.3% in the euro area, against 2.3% in the UK and 2.6% in the US. It is widely recognised that the growth performance of the euro area cannot be deemed satisfactory and that continuation of current trends could undermine public confidence in the single currency.

The most commonly held view ascribes mediocre growth to incomplete economic reforms in member states, especially France, Germany and Italy. According to this view, low growth does not result from problems in the economic governance of the euro area, but from policy failures in its largest member states. The response must therefore come from domestic reforms rather than from new common initiatives. According to this view, potential changes in the governance of the euro area – that is, in the principles, rules and institutions that constitute the framework of macroeconomic policy – are, at best, of second-order importance. Even sensible ones could be counterproductive, because they would divert attention from required focus on national reforms. At the extreme, temporary disaffection towards the EU might be a blessing in disguise if it leads to concentrate political energy on urgent domestic priorities.

The primacy of domestic reforms is undisputable. A reallocation of public spending towards education and research, as well as regulatory reforms of labour, product, and financial markets, are essential prerequisites to increasing productivity and thereby the growth potential of the euro area. However, from that observation it does not follow that the economic governance of the euro area does not matter. There are three reasons why it should not be overlooked:

1. There is a less clear-cut disconnection between long-term growth and short-term stabilisation than generally assumed. Recent research suggests that the quality of contra-cyclical macroeconomic policies has an impact on long-term growth, at least as long as financial markets do not provide full insurance against cyclical fluctuations to private agents. This is because in an economy subject to fluctuations and equipped with less-than-complete financial markets, companies confronted with the perspective of liquidity constraints during downturns may refrain from undertaking risky projects – thereby lowering growth potential. From this perspective, budgetary and monetary policies may have a bearing on long-term growth. This leads to question the non-activist character of monetary and fiscal policies (Figure 1) and especially the pro-cyclical behaviour of aggregate budgetary policy (Figure 2) that have characterised the early years of EMU.

2. Both budgetary and monetary policies affect incentives to reform. Structural reforms typically involve trading off (economic and political) short-term costs for long-term economic gains. Therefore, political considerations may lead governments to postpone them, unless a crisis, or the threat of it, forces them to take action, or unless they can

alleviate the short-term costs through macroeconomic support. However, monetary union has had the twin effects of removing the threat of exchange crises and of limiting the potential for macroeconomic support (because monetary policy cannot react to policies undertaken in a single country whilst the Stability and Growth Pact restrains the extent of budgetary support). In a way, an environment with neither sticks nor carrots has contributed to creating a 'reform trap'. This is especially worrying, as lack of reform in a member country reduces the overall potential for non-inflationary growth and thereby affects the policy of the European Central Bank.

3. Persistent inflation divergence within the euro area may lead to situations where real exchange rate misalignments represent a drag on overall growth. A situation where some countries within it suffer from overvaluation while others suffer from undervaluation, constrains the ability for the ECB to conduct a policy which is appropriate for the area as a whole and may lead to limiting actual growth to a below-potential path. Certainly not all discrepancies in price developments are reasons for worries. However, there is evidence that for some countries in the euro area such as Portugal and Italy, price developments since 1999 have not been in line with fundamentals. In this respect, the governance of the euro area matters because effective multilateral surveillance can help in detecting and correcting potentially detrimental divergence before imbalances develop.

How does the euro area economic governance regime measure up to those requirements? Its essential tenet is that each policy instrument is assigned a specific responsibility: price stability for monetary policy; public finance sustainability for budgetary policy; and long term growth for national reforms. This specialisation principle has considerable advantages, especially in a multi-player setting. However, it involves the risk of neglecting interdependence between policy areas or between countries. The above considerations therefore call for several improvements.

1. A major priority is to correct the pro-cyclical bias of national fiscal policies while ensuring the sustainability of public finances. A cyclically neutral or even contra-cyclical budgetary behaviour would contribute to smoothing out fluctuations and possibly to improving the long-term growth potential. The primary responsibility for this change rests with member states and their national parliaments, and to this end, possible improvements in the domestic governance of budgetary policy should be a matter for national discussion. Avenues for reform have been proposed, such as the reliance on independent economic forecasts for projections underlying the budget or the creation of national fiscal councils that would not have a decision role, but would provide independent assessments of both the aggregate budgetary situation and individual policy choices. They deserve thorough examination.

2. As regards fiscal policy, the role of the EU is limited to managing the incentives – both sticks and carrots. The first version of the Stability and Growth Pact (SGP) excessively relied on fixed rules and the threat of quasi-automatic sanctions. It has not passed the test of time. The reformed Pact is much more ambitious in its scope, and rightly so: it puts more emphasis on prevention (and therefore on the avoidance of pro-cyclical fiscal expansion in good times); gives more weight to debt sustainability issues (and therefore on the crucial intertemporal dimension of fiscal policy); and takes into account factors underlying a deficit (such as reforms that can contribute to improving public finances in the long term, but involve a cost in the short term). But it can only succeed if accompanied by a significant enhancement in governance. The reason is that with this reform, the EU has moved away from a policy philosophy that rests on the virtue of fixed rules and embraced a decision model that rests on economic

judgement. However, economic judgement can easily be a pretext for purely political compromises. For this not to happen, decision does not only need to be based on explicitly stated principles. It must also be supported by reliable and independent expertise – which gives a major role to the Commission; and achieve consistency over time and across countries – which emphasises the importance of the fixed presidency of the Eurogroup. All in all, neither the significance of the reform of the SGP nor the governance challenges involved in its implementation should be underestimated.

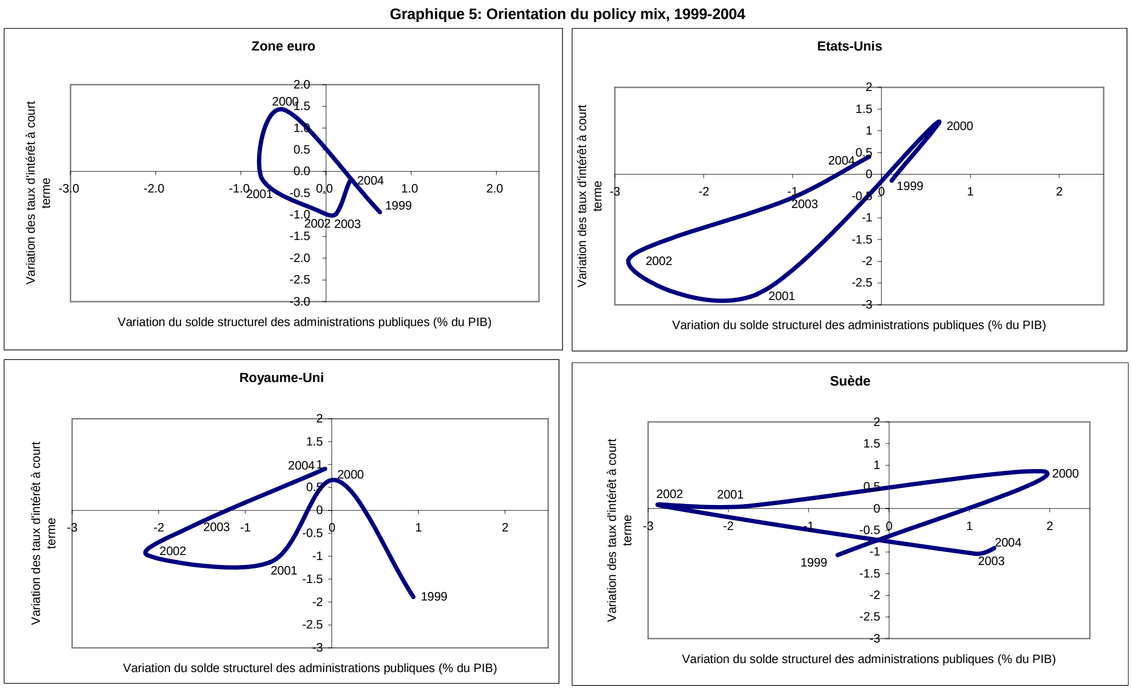
3. The issue of structural reform, and the incentives for it, should take centre stage in the discussions on economic policies in the euro area. Paradoxically, reform coordination takes place at the EU level through the Lisbon process, although the effects of national reforms frequently have a limited impact on the EU as a whole. Reform interdependence within the euro area is significantly stronger, but this does not translate into effective policy processes. What is required first and foremost is recognition of this interdependence through a greater common ownership of reform programmes in the euro area. This could call for extending the practice of holding meetings of the Finance ministers of the euro area, including, if well prepared, at the European council level. In addition to this institutional dimension, incentives to reform should be enhanced in the implementation of the Stability and Growth Pact, through the recognition that ambitious reform programmes that have the potential of improving growth and public finance sustainability may justify conditional budgetary support.

4. Beyond the mere implementation of the Pact, multilateral surveillance is bound to become increasingly important in the euro area. In the early years, emerging divergences could be regarded as a minor concern as they could be expected to be self-correcting. The lessons from experience are that this is frequently not the case. Unfortunately, surveillance cannot rely on strong legal instruments and basically relies on peer pressure. This does not mean that corresponding recommendations should be taken lightly. The European parliament and national parliament could have a role in giving this discussion the weight it deserves.

5. Beyond the preservation of price stability, monetary policy can contribute to enhancing growth in two ways. First, the main responsibility for stabilising euro-area wide fluctuations belongs to the European Central Bank. The ECB has consistently refrained from activism because it considers it a potential threat to stability. A more reactive stance could, however, help convince economic agents that negative shocks to the growth of the euro area will be effectively countered as long as this does not conflict with the goal of price stability. Second, the ECB should explicitly let it be known that provided there is a common political commitment to reform and without prejudice to price stability, it stands ready to back policies that lower structural unemployment and put the euro area on a higher growth path. It has already recognised the existence of complementarities between macroeconomic policies and structural reforms and hinted at the additional room to manoeuvre that the latter would create for the single monetary policy. The time has come to go further and to unequivocally recognise that provided the governments act, monetary policy would be able to support their action. Such a commitment would certainly involve taking a risk. The question, however, is whether it is preferable to take the alternative risk of remaining in a deadlock that would ultimately undermine the sustainability of monetary union.

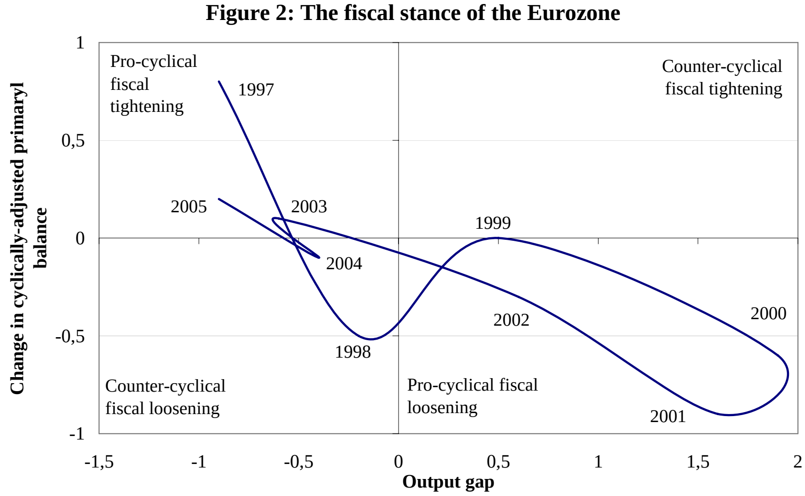
This note partially draws on joint research with Philippe Aghion and Elie Cohen (2006); with Benoît Coeuré (2006); and within the Sapir Group (2004).

Figure 1: A representation of the policy mix in four economies



Source : Aghion, Cohen et Pisani-Ferry (2006)

Figure 2: The fiscal stance of the Eurozone



Source : Coeuré and Pisani-Ferry (2006)