How to break Europe’s economic taboos without shattering its union

By Reza Moghadam

Skip the stages of grief and accept a comprehensive solution now, writes Reza Moghadam

Here is a glass half-full story about Europe: asset prices have rebounded, growth has turned positive, reforms are taking root and the drag from fiscal austerity is tapering off. Here is a glass half-empty story: growth has been too feeble to translate into employment gains, and private sector credit is still contracting. The optimistic narrative was popular for much of the past year. But the glass is slowly draining.

The near-stagnation in Europe has many causes. A big drag comes from households and companies that are holding back consumption and investment so as to pay down debt. The resulting shortage of demand impedes growth – and so undercuts the progress made in reducing debt-to-income ratios. Ultra-low inflation, and deflation in some places, also means the debt burden keeps rising relative to income. On the supply side too, wages and other costs are stubbornly high even as prices fall, discouraging hiring. Restrictions in product markets prevent new ideas from sprouting into the next big thing. Europe is not creating enough jobs. This strains the social fabric and frays public patience with the euro.

Calls to do something are growing but the answers tend to focus on one policy or another rather than a comprehensive solution. An exception is the “three-pillar” strategy put forward by Benoît Cœuré, a member of the European Central Bank’s executive board, and Jörg Asmussen, his former colleague and now a German government minister. But even their welcome proposal, in essence, is to do everything that is already being done, only a bit more energetically. The European Central Bank is already meeting its responsibilities (but should be ready to do more); fiscal policy should use the existing flexibility in the Stability and Growth Pact (but Berlin could use some of its budgetary room for manoeuvre); and so on.

Such tweaks will not deliver broad-based growth. Nor can German fiscal expansion, by itself, save the periphery: fiscal rules constrain Berlin’s hand, and anyway the impact of German spending on the eurozone would be small.

Europe has to try something bolder – and soon – before stagnation becomes the new normal. This must involve fiscal policy, structural reform and ECB action all at once. Acting in just one area reduces pressure to act in the others, and can even be counter-productive: fiscal stimulus alone will raise fears over public debt, structural reforms alone invite social strife, and monetary easing alone may do more for the price of chalets and fine art than for employment.

First, fiscal policy. There is scope for a stimulus across the eurozone, not just in Germany. It should amount to between 1 and 2 per cent of the bloc’s gross domestic product – more where demand shortage is keeping output below potential, less elsewhere. The stimulus could come from higher public investment, for which the International Monetary Fund and others have made a strong case. But the scope is limited. Even the “shovel-ready projects” touted by the Obama administration at the height of the economic downturn raised US public investment by only 0.25 per cent of GDP. A permanent cut in payroll taxes would be more practical. It would directly address a big impediment to job creation and could be paid for with spending cuts, which would be agreed at the outset but take effect only in the future.

Yes, eurozone government debt would rise; but for the bloc as a whole, public debt is a lower percentage of GDP than in the US and UK. The trouble is that the debt is unevenly dispersed; with Italy alone accounting for almost half. This means the stimulus would have to be financed jointly, from the entire eurozone tax base. Unfortunately, just the hint of fiscal union is deeply disturbing to some, especially in Germany, even if the joint financing relates just to the stimulus, not to all deficits as in a proper fiscal union. But sooner or later this issue has to be settled in favour of more fiscal union if the single currency is to be viable.

Second, the reform agenda. This needs to be ambitious, in core and periphery alike. Wages and other labour costs are simply too high,
even by the standards of rich countries, let alone emerging markets competitors. Services market liberalisation, too, is lagging. Liberalising transportation, communications, retail and protected occupations could raise Europe’s growth potential. These are decades-old political taboos. Overcoming them will entail supportive fiscal and monetary policy.

Third, the ECB needs again to start dictating the agenda. This requires a decisive programme of quantitative easing – buying assets with newly created money. So far, the bank has merely dipped its toe in a shallow pond of select private sector debt. It should plunge into the much deeper pool of sovereign debt. The risks and mechanics need working out, but they are not nearly as problematic as critics say. A sustained dose of asset purchases – enough to hit the ECB’s 2 per cent inflation target or slightly exceed it – is the only way to lighten the debt burden and allow Europe’s economy to take flight.

Europe is stagnating because of the politics of status quo. The logic of economics usually prevails. Bailouts of countries, Greek debt restructuring, banking union – taboo after taboo has been cast aside. But the process is a slog from denial and anger to bargaining and eventual acceptance. Better to skip the stages of grief and accept a comprehensive solution now – before the centrifugal forces of anti-euro sentiment become overwhelming.

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