Growth, Convergence and Social Conditions: Where is Europe Headed?

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The critics who announced in 2011 and 2012 the coming disintegration of the eurozone have finally been proven wrong. But the continent is now facing three new and severe, if less acute, challenges.

First, growth: No recovery is on track; deflation is the coming threat; unemployment remains dramatically high, especially for the young; timid policies are progressively reducing growth potential. Is secular stagnation already imposing its mark?

Second, social conditions: The benefits of the single market for decades translated into a shared prosperity; the debt crisis led to the adoption of costly, albeit necessary, reforms that are exacting a high toll on the southern countries and are giving rise to a dual Europe. Can “social Europe” survive?

Third, convergence: The EU integration process has involved a succession of crises and steps forward that have required bold but converging views between the member states, France and Germany in particular; today, this “Franco-German engine” seems to have stalled. Can it be revived?

The eurozone, having successfully emerged from the acute phase of its debt crisis, is again entering unchartered waters. There is no region in the world economy where the three debates about growth, convergence and social conditions are more closely linked. This paper explores this new horizon and finds reason for hope.

Policy and the Eurozone Crisis: It’s Politics, Stupid

The management of the eurozone debt crisis can undoubtedly be qualified as chaotic. Mutual resentment, continuous hesitation and major policy errors have had dramatic consequences on financial markets. But the politics beyond the management of the debt crisis has been frequently misunderstood. The critical question that made a euro breakdown plausible for two exhausting years was as simple as this: Are the eurozone member countries willing to stick together whatever this implies?

This was a time when the Commission was weak and the Parliament nonexistent; inter-governmental cooperation was the rule of the game and Germany undoubtedly played the leading role. Two years of political debates between national governments, with decisive participation by the only federal institution, the European Central Bank (ECB), were necessary to offer to the public and to the markets a credible—and positive—answer to this question. The “Four Presidents Report,” launched by the European Council in December 2011 and adopted in June 2012, confirmed the unanimous adhesion to monetary union and designed policy changes to make it function properly in the future.1 ECB President Mario Draghi famously translated the political decision into financially intelligible words: “We will do whatever it takes to preserve the euro and believe me, it will be enough.”

The eurozone having clearly exited the financial danger zone is now moving—to British repulsion—towards ever greater integration (e.g., fiscal union, banking union); the result will not be perfect but it will work. Nevertheless, the costs of this crisis have been huge. In the wake of austerity measures and structural reforms, unemployment has skyrocketed in southern European countries and social conditions have deteriorated. Is Europe politically well-equipped to face these completely different challenges?
The most striking innovation in European politics has been the high-voltage political debate over the choice of the new president of the Commission; rightly so, but for the wrong reasons. The U.K. forcefully opposed the designation of Jean-Claude Juncker for weeks; the British prime minister relied on the traditional bargain of governments choosing the smallest common denominator (Mr. Barroso in the previous case) through a diplomatic process. Unfortunately for David Cameron, this time was different, because the Parliament’s powers have been extended to include the right to veto a candidate proposed by the European Council. Even if the decision by the European Council was unanimous, their candidate could not be imposed on a recalcitrant Parliament. Democratically elected by hundreds of millions of voters, the Parliament, the day after the election, proved clearly willing to exercise these new powers: parties of almost all political stripes—the right, the left, the greens, and even the Greek extreme-left (Syriza), proclaimed that they had one and only one candidate, Mr. Juncker who, as Spitzenkandidat, led his center-right coalition to victory. Misunderstanding this new political context, David Cameron entered into a rear-guard personal battle against Jean-Claude Juncker that he had no chance of winning. The electoral victory had turned into a democratic victory.

Contrary to the expression immediately coined by The Economist, there is nothing in this Parliament that could be called a “Eurosceptic Union.” To be blunt: “Brussels” may be discredited in Europe, but no more than Washington is in the U.S. electoral progress among Euroskeptics is a reality and it would be dangerous to underestimate voter frustrations. But frustrations against what? Against austerity in Greece? Yes. Against perceived excessive immigration in many countries? For sure. Against Hollande and what remains of Sarkozy’s UMP party in France? Absolutely. But certainly not against the euro. In fact, adherence to the euro remains extremely strong everywhere: A Pew research survey in spring 2013, confirmed in the elections a year later, showed around two-thirds of voters almost everywhere were willing to keep the euro (69 percent in Greece, 67 percent in Spain, 66 percent in Germany, 64 percent in France), with only one-third favoring a return to their old national currency. Make no mistake about the results: Euroskeptics will be vocal expressing frustrations, but they will prove much less influential than the headlines have suggested. It is true that the far-right Front National in France is a shock for the French political establishment, but the victory of the reformist Italian Prime Minister Matteo Renzi is a more positive outcome of that same election. The far-right Danish People’s Party topped the polls in Denmark, but in the Netherlands, the populist party, estimated to come in first, slid to fourth. All in all, Euroskeptics will have the loudest voice they have ever had within European institutions, but they have demonstrated that they do not have much in common. The reality is that, with their disparate voices, UKIP, the Front National, Syriza and the other Euroskeptics will prove much less influential in Brussels than, say, the Tea Party in Washington.

Pro-European parties represent a wide majority and Brussels is more than ever the center of European politics. These parties had strong reasons to agree on the choice of the Commission president, but they are unlikely to go any further towards forming a transnational “grand coalition” (like the German one). This strategy would reinforce the perception of an elite cartel running the EU to the detriment of many Europeans, and that would fit precisely the Euroskeptic narrative of a division between elites and the people. More importantly, pro-European parties must now design policies that will deliver jobs in the foreseeable future. There is no alternative, no way to turn political debates into a battle between pro- and anti-Europe. Politics in Brussels must be based on pragmatic responses to the challenges facing the union and its member states, primarily employment and growth.

Slow growth in recent years is not the start of a secular trend of stagnation; it has very understandable reasons. Investment and growth have been severely hampered by the consequences of the debt crisis in the eurozone. Despite decisive action by
the ECB, expectations everywhere bar Germany have suffered deeply from dramatic uncertainties regarding the future of the euro and the depressing effect of austerity measures. These two obstacles have largely but not fully been removed: There is no more uncertainty about the fact that the European market in five or 10 years will be the continental market companies are struggling for. Issues with economic policies are far more complex. Austerity produced the results that were expected, the lax fiscal policies too many governments had indulged in have been corrected, and structural policies that are a pre-condition of a successful monetary union have been significantly if not completely harmonized. This adjustment was costly but necessary, Germany was right to impose it and the indebted countries were right to adopt them. But more austerity now would mean deflation and depression. This would be a policy error in the same vein as the attempt by Winston Churchill to restore the parity of the pound in the 1920s. It’s time to start the policy debate afresh in Europe. The president of the Commission already outlined his proposal for a new strategy, and while Chancellor Merkel expressed reservations, this time it will be different for 2014 brings something new in the play: There is a Parliament where this debate will be democratically and publicly shaped.

Towards a Dual Europe or a New Social Contract?

Despite the lack of common social policies at the European level, the convergence of social conditions between most eurozone countries before the debt crisis was surprisingly strong, but based on weak foundations. First, financing was fragile; many governments had indulged in lax social spending permitted by extremely low interest rates. Second, this easy-going policy translated into significantly diverging trends for major policy parameters. The most evident example is the unjustifiable and unsustainable differences in pensions between countries belonging to the same monetary union. This could not last and the debt crisis was a moment of truth. Reforms were badly needed; and many reforms have been introduced in southern member states in the last three years. Excesses that made the social protection network unsustainable have essentially been corrected. Pension reforms in particular make the eurozone today much more homogeneous than it was. Differences between social conditions in different countries now mostly reflect differences in the macroeconomic outlook; a return to better converging social conditions relies on a proper solution to the success of a growth strategy. But this alone is not sufficient.

The worldwide financial crisis and its impact on Europe and the eurozone means that, for the first time since the late 1950s, the process of economic and social convergence is being challenged. Some countries, such as Germany and others in northern Europe, managed to weather the storm rather well despite a tough shock in 2009. Following the debt crisis, southern Europe suffered serious losses to GDP, rising unemployment and a surge in poverty that the region had not experienced since World War II. Should these divergences become permanent, they would undermine the political basis of the European project. As the Pew research mentioned earlier illustrates, the European project has been a clear casualty of the crisis. People are disappointed with the functioning and the performance of the EU and support for the European project is now lower in France than in Britain (22 percent versus 26 percent!) and even lower in Italy and Greece (11 percent). The contrast between the positive perception of the currency and the negative evaluation of the union is not sustainable. Employment and social conditions are at the center of this dichotomy.

For 60 years, social policies have been absent from the European integration project: Different countries have different social preferences that do not mix easily with each other’s. This is why most of the social protection network reflects nationally designed policies implemented by national institutions. The recent experience nonetheless demonstrates the need for a stronger European framework. Its goal should be the convergence of results, not the uniformization of policies. Stronger institutions
and procedures have to be built in order to regularly assess national policies as precisely as the fiscal compact does for national budgets. A “social semester” would allow an in-depth examination of past results, future trends and the need for reforms in every country. That would offer guidance about gradual changes to pension rules, health cost control, immigrant assistance and so forth. The European Parliament would work together with national chambers in order to place the indispensable convergence of policies under democratic control. Note that this framework would be applied to countries with different income levels, different age structures, different appetite for equality and so forth: Convergence means that these different situations would be made coherent, not identical. And this would cover, say, 80 percent or so of social expenditures. But “Social Europe” cannot be contained within national boundaries; there is a need to restore the sense of a community that is bound together by rigorous budgets and well-regulated finance.

Twenty percent or so of social expenditures could thus in the future be designed and implemented as eurozone-wide policies. Financing these expenditures would come from eurozone proper resources that would be decided within the budget procedure. They would be complements, not substitutes, to national policies. A realistic proposal for such a policy, already widely circulated, could be a eurozone-wide unemployment scheme; it makes sense from an economic point of view because exercising at the eurozone level contra-cyclical effects between regions diversely affected by changing conditions on the continent. These new eurozone policies should not duplicate traditional health or old-age policies; rather they should be oriented towards the preparation of a common future. Acting at a eurozone level can increase labor mobility within Europe, encourage innovative activities for all those who have the talent to engage in business or research, stimulate flexibility and adaptation through a vibrant social dialogue within European-wide companies and successfully integrate senior citizens (“the aging society”) as active participants in a vibrant social market economy. If finally willing to open more creative avenues and prepare the social state of the 21st century, one can think to introduce a version of a generalized minimal; it could start as a circumscribed instrument that could for example be specifically directed towards the young (18-25) that are suffering today from such adverse labor market conditions. After a modest departure, a eurozone-wide minimal income could prove a powerful tool that could after 2025 have developments comparable to what age or health protection, unthinkable one century ago, turned to be: a central piece of the social fabric.

Can Germany and France Make a New Start? Yes They Can

European integration has never been a story of old nations, having spent most of their history fighting each other, suddenly deciding to join together in a “perfect Union.” It has always been a tortuous political process whose most powerful engine has been Franco-German cooperation. France and Germany share major common interests but they are also competitors and frequently differ in terms of economic policy preferences. This is why, for more than 50 years, France and Germany compromising on an issue or making bold proposals to their fellow EU members made so many (unlikely) steps forwards possible. But the gap between the two countries in terms of economic competitiveness has increased during the last decade, and the divergence between the two governments on policy and structural reforms sometimes seems irreconcilable. So how serious is the present Franco-German disparity?

The contrast between France and Germany in the last 15 years is in this respect fascinating. Having flourished while Germany was engulfed in the reunification process, France ignored the opportunities and constraints of globalization. As globalization grew and voters asked for protection the country took an easy path and improved its social system. No government nor statesman rose up to offer a vision of how the country could keep its place in a changing world, to tell the truth to voters
and to make the economic and financial decisions that were more and more clearly required. On the other side of the Rhine, Chancellor Schröder recognized the changing globalized environment and in a couple of years transformed a struggling country into the economic powerhouse that Angela Merkel would subsequently inherit. At the outset, German elites decided to organize the competitive come-back of Germany (“Model-Deutschland”). The timing was perfect, exploiting in 2005-2007 the last period of global expansion before the financial crisis. By contrast, French voters and politicians agreed to kick the can down the road as long as possible. When Germany under Schröder decided to quickly restore fiscal discipline (from a 3 percent deficit in 2005 to balance in 2007), France continued on its complacent path so that a difference as high as 4 percent of GDP appeared between the deficits of the two countries in 2007 and 2008; and this difference has remained unchanged. The European Commission repeatedly pressed France to reduce its structural deficit to below 3 percent in 2013; the 2014 ratio will be above 4 percent.

That said, the French president’s commitment to more sound public finance now appears credible, and the need to pursue a fiscal policy that avoids pushing the economy into recession is accepted by financial markets and international financial institutions. The government recognizes competitiveness is an overarching challenge, and the president has progressively imposed on his recalcitrant majority what he himself called a “supply-side policy.” But the situation remains fragile: The resilience of the country to any adverse shock is diminishing, its financial external position remains weak, and government policy relies too heavily on tax increases rather than on spending cuts. Any sort of social upheaval could abruptly derail recovery efforts. The political institutions of the Fifth Republic are resilient; but the two major parties, the socialists and the center-right UMP, are deeply divided while the extreme right is making progress.

Germany thus remains ambivalent: On the one hand, there is a widespread belief that France is habitually tempted towards the wrong side of budget discipline; on the other hand, there is a deep conviction that France cannot be pushed into austerity like Spain or Italy without dramatic consequences for the rest of the eurozone. France is not the “ticking time-bomb” that The Economist painted in November 2012, but the correction of serious French imbalances remains a major hurdle in the Franco-German relationship.

The debt crisis has had two contradictory effects on the Franco-German relationship. For one, the difficulty to design and implement rescue packages and new institutions exemplified significant differences of interests. Germany has good reasons to be cautious as she remembers the French slogan in the 1920s, “Germany will pay.” This is, for example, why Germany has opposed the creation of euro-bonds in the absence of a properly functioning fiscal union. And yet, the crisis made clearer than ever the proximity of the socio-economic model of the two countries, traditionally called “économie mixte” and “Sozial-marktwirtschaft.” Franco-German differences regarding industrial policy may be real, but are little more than nuances when compared to other forms of capitalism, be it American, British or Chinese. This closeness explains and legitimates the constant willingness in the past to compromise when facing common challenges. Despite traditional divergences regarding monetary policy, the bold decision to create a monetary union was in that sense the pragmatic solution to a simple equation: A truly single market (not a free trade area) requires a single currency. What is required today is that the chancellor and the president demonstrate the capacity to push the work of their predecessors, Chancellor Kohl and President Mitterrand, further.
References


Endnotes

1. European Council (2012)
2. The Economist, “The Eurosceptic Union” (2014)
5. The Economist, “The time-bomb at the heart of Europe” (2012)