A Five-Step Plan for European Prosperity

WASHINGTON, DC – Though the Greek crisis has been placed on pause, the economic situation in Europe remains bleak. Eurozone growth is up slightly from its near-recession levels of a few months ago, but projections by the International Monetary Fund for 2015 and 2016 barely exceed 1%. Unemployment remains above 11% – and twice that among the young (and doubled again in countries like Greece and Spain).

Greece’s exit from the eurozone would likely be less disruptive now than it would have been a few years ago. The countries most at risk of contagion – Portugal, Spain, and Italy – are less vulnerable now in the eyes of the markets; the European Union has established a bailout fund; and the European Central Bank has launched a large bond-buying program.

The real challenge in Europe is continued stagnation and rising public-sector fiscal pressures in bloated welfare states with rapidly aging populations. Restoring growth, opportunity, prosperity, and financial stability will require bold solutions to five interrelated problems.

The first problem is fiscal. The math is simple. The tax rate necessary to fund social spending must equal the ratio of the number of people receiving benefits to the number of taxpayers (the dependency ratio), multiplied by the average benefit relative to the income
being taxed (the replacement rate). It was this math that led Mario Draghi, the president of the European Central Bank, to declare that, “The European social model has already gone.” Too many Europeans are collecting too many benefits, but so far governments have mostly ducked the issue, taking on massive debt in order to postpone the reckoning. Reform that targets social spending at true need is long overdue.

The second problem is economic: growth in Europe has fallen far short of that in the United States, decade after decade. Though economic theory predicts convergence in standards of living, Europe lags behind the US by 30% or more. High taxes and burdensome regulations stifle the labor market and potential new businesses. Overgenerous social-welfare payments create disincentives to work, hire, invest, and grow. Chronic sluggish growth is insufficient to create opportunities for the continent’s masses of unemployed and underemployed young people.

The third problem is the banking crisis. In Europe, banks supply roughly 70% of the credit to European economies, compared to 30% in the US. But many European banks are overleveraged zombies, kept alive by emergency public infusions of liquidity.

Fourth, there is the currency crisis. The euro’s many benefits – cross-border pricing transparency, lower transaction costs, and inflation credibility – required surrendering independent monetary policies and flexible exchange rates. But, given limited interregional transfers and labor mobility, this means that the continent has far less ability to absorb disparate shocks through the operation of so-called automatic stabilizers. In the US, by contrast, people in high-unemployment Michigan move to, say, Texas, where jobs are plentiful, even as the federal tax and transfer system automatically shifts money in the opposite direction, cushioning the local downturn.

Finally, Europe faces a severe governance deficit. Citizens are becoming increasingly disenchanted with European elites and supra-national institutions such as the European Commission, which impose rules and regulations that conflict with their countries’ economic interests and sovereignty. Voters are restless, as the Greek election result demonstrated. Nationalist sentiment is rising, and demagogic parties of the far right and left are gaining in every poll.

Addressing these problems will be difficult, but not impossible. The core challenge is fiscal; Europe cannot escape the need to scale back its sclerotic welfare states. By recognizing that, and implementing the following series of mutually reinforcing policies, the continent can move beyond its current torpor.
Gradual fiscal consolidation – reducing the projected future size of government spending, and hence future tax rates – will have to be at the center of the effort. This should be combined with the mutualization of some portion of the liabilities of highly indebted countries – defined as a debt-to-GDP ratio above, say, 60% or 70% – and modest write-downs in exchange for long-term zero-coupon bonds. The “Brady bonds” that the US used to help resolve the Latin American debt crisis in the 1990s could serve as a model.

Meanwhile, Europe’s zombie banks will have to be rapidly resolved by acquisition or temporary takeover, cleanup, and asset sale, as was done by the Resolution Trust Corporation during the US savings and loan crisis in the 1980s. Structural reforms that increase labor-market flexibility and reduce red tape and related obstacles to new business formation must also be implemented.

Finally, the eurozone should adopt a two-track euro with a fluctuating exchange rate – an idea championed by the American economist Allan Meltzer. Systematic rules would have to be developed to determine when members of the eurozone are demoted to “euro B” or promoted to “euro A.” Such a halfway house – call it “depreciation without departure” – would avoid some (but not all) of the problems of a country’s complete withdrawal from the eurozone. It would create its own set of incentives, which, on balance, would pressure individual countries to avoid demotion, just as top-tier football (soccer) teams seek to avoid relegation to the minor leagues.

Together, these policies would reduce sovereign debt, lower interest rates, ameliorate tax pressures, enable countries to increase competitiveness with fewer sacrifices to living standards, and provide Europe with a road map to prosperity. Until now, the EU’s leaders have followed the easiest, but least productive path, patching temporary, partial fixes on problems as they erupt. The possibility of a brighter economic future should be a prize large enough to evoke the same type of leadership through which Europe rose from the ashes of World War II.

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