A DIVERGING EUROPE ON THE EDGE

(…)

"There must be some way out of here," said the joker to the thief,
"There's too much confusion, I can't get no relief.
Businessmen, they drink my wine, plowmen dig my earth,
None of them along the line know what any of it is worth."

"No reason to get excited," the thief, he kindly spoke,
"There are many here among us who feel that life is but a joke.
But you and I, we've been through that, and this is not our fate,
So let us not talk falsely now, the hour is getting late."

(…)

All along the watchtower, 1968, Bob Dylan

Six years after the world economy entered its deepest crisis since World War II, most economies are showing some solid signs of recovery. Most, but there is a prominent exception: the European economy—and within it especially the euro area—is still stuck in the crisis. Powerful forces of divergence are being fed by the failure to exit the crisis quickly. The risk of a long-lasting stagnation is real.

The euro area crisis has been a tough test of the construction of the euro. A lot has been done to respond to the revealed failure of the European institutional framework, that some rightly denounced years before. Europe is advancing in crisis, as often said, even if this way to progress is far from efficient and presents juridical challenges. Having said that, we need to acknowledge and to react to the fact that presently Europe is not doing what is needed to exit the crisis once and for all. Losing that opportunity is certainly not acceptable to citizens who already question a construction that many feel impinges negatively, and no longer positively, on their lives.

It is no surprise against this background that we have seen the rise of Eurosceptic parties on both the Right and the Left calling for the break-up of the euro area and, in some cases, withdrawal from the EU or for the European integration project to be thrown into reverse gear. We reject these siren calls. A return to national currencies and the supposed certainties of national politics is not the way forward. The costs of a disorderly break-up of the euro area are incalculable, and it is hard to imagine how an orderly break-up might be brought about. Should a Eurosceptic majority be elected in one of the Member States the crisis will be upon us once again. Instead the aim must be to build on what has been achieved in the past five years and to chart a path towards a euro area that is viable, stable, vigorous and sustainable.

Times of divergence

Recovery has been announced many times since 2011 (see Table 1 and chapter 1 of this report). All these hopes have vanished as economic indicators repeatedly showed that Europe, and especially the euro area, was unable to lastingly free itself from stagnation at a much reduced level of output and employment (Table 2). At the end of 2014, economic activity as measured by GDP is still below its pre-crisis level and far from its potential. The output gap is wide open and the per capita GDP comparison –which allows for the more favourable demographics in the US—is striking (Figure 1).

Table 1. EC and iAGS forecasts and outcomes

In %

	EC Autumn forecast in year n-1	iAGS Autumn forecast in year n-1	GDP growth
2012	0.5		-0.7
2013	0.1	-0,3	-0.4
2014	1.1	1.0	0.8
2015	1.1	1.3	
2016	1.7	1.6	

Sources: Eurostat, European Commission, iAGS.

The Great Recession in 2008-2009 was as deep in the euro area as in the United States. But recovery has continued overseas whereas it broke down in 2011 in the euro area, precisely when member states engaged a strategy of tough and synchronized fiscal consolidation and when existing European institutions were unable to circumvent the sovereign debt crisis.

Table 2. GDP growth rate forecasts

In %

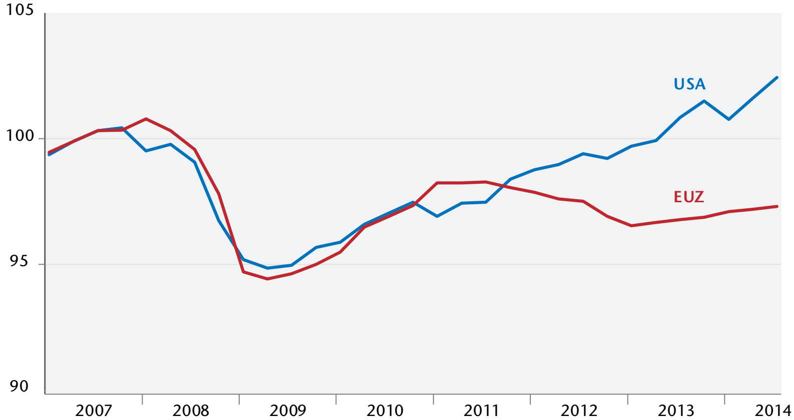
	2013	2014	2015	2016
DEU	0.2	1.5	1.4	1.7
FRA	0.4	0.4	1.1	1.7
ITA	-1.8	-0.2	0.5	0.7
ESP	-1.2	1.3	2.1	2.3
NLD	-0.7	0.6	1.4	1.9
BEL	0.2	1.0	1.2	1.6
PRT	-1.4	0.8	1.4	2.0
IRL	0.2	4.0	2.8	2.6
GRC	-3.3	0.4	1.9	1.9
FIN	-1.3	-0.1	1.3	1.2
AUT	0.3	0.7	1.3	1.6
EA	-0.4	0.8	1.3	1.6
UK	1.7	3.0	2.1	1.8
UE-28	0.1	1.3	1.5	1.7

Sources: Eurostat, iAGS calculations.

The unemployment rate has been slightly decreasing recently but remains at historical high levels. Since October 2009, it has been plateauing at a level above 10% of the active population. A profound divide exists between countries experiencing unemployment rates around 25% (Spain and Greece) and some nearly at full employment (Germany and Austria).

Figure 1. Per capita GDP in the United States and in the euro area

2007 = 100, PPP-1995



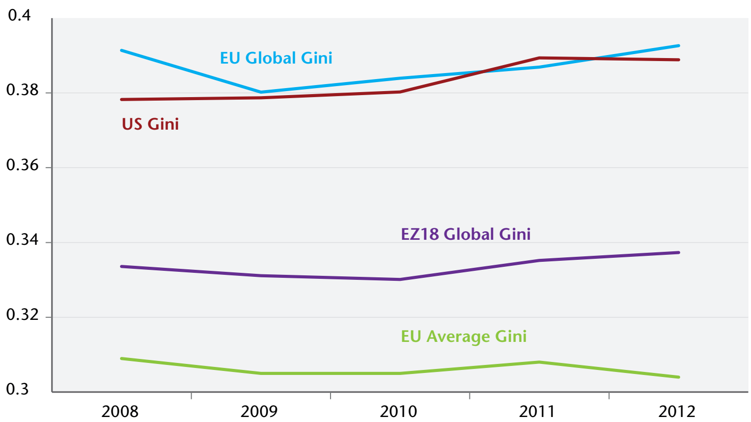
Sources: Eurostat, iAGS calculations.

Nearly 12 million people in the EU28 have been unemployed for one year or more. Young people find it harder to get their first job, their first experience, which is so important for the rest of their working-life. More and more people have been thrown out of unemployment benefit schemes and forced to take any job on offer. Welfare states are being cut back, in some countries slashed, under austerity programmes and because they are wrongly seen as being at the roots of the crisis. More and more Europeans are suffering from material deprivation—absolute poverty—notably in Greece, Hungary, Cyprus or Italy. Falling GDP per head, the rise of unemployment and the cut in social public expenditures are highly correlated to the extent of poverty increases in the different EU countries (chapter 2 of this report).

Inequalities are widening. A global EU inequality indicator (a gini coefficient) that—in contrast to an average measurement by country—measures overall inequality among EU28 or euro area citizens (Figure 2) is striking: the level of inequality in the EU28 is comparable to that in the United States. It has significantly increased since 2009, and euro area also displays such a trend of rising inequality. Divergence between countries is the main source: regional convergence, once a goal, has stalled in the crisis and gone into reverse (see figure 1 and 2 of chapter 2 of this report).

The current trends of the European economy are not those of an inclusive society. The severity and particularly the duration of the crisis are compromising the achievement of the Europe 2020 strategy goals. High unemployment is already pushing real wages downward in many countries. Labour market reforms have amplified and will probably continue on the race to the bottom already engaged by countries using relative competitiveness as a mean to compensate for the negative impact of fiscal consolidation. But this asymmetrical strategy is bringing inadequate results in terms of adjustment, threatens to exacerbate the loss of social cohesion and is fuelling disinflation while risking deflation (chapter 5).

Figure 2. Evolution of inequality in EU, euro area and United States



Source: EU-SILC, OECD, iAGS calculations.

Is Europe condemned to underachieve?

In the heat of the Euro sovereign debt crisis, a lot has been done. Since July 2012, the ECB (European Central Bank) publicly stated a willingness to act as a lender of last resort, securing sovereign debt markets. The banking union is laying the ground to end the *liaisons dangereuses* between banks holding national public debt and states covering extreme balance sheet risks in the financial sector. Under the reinforced SGP (Stability and Growth Pact) and its sequel, the fiscal compact, fiscal discipline has been more under the scrutiny of peers than under the scrutiny of the market, hence removing speculative attacks.

What was done has certainly contributed to put an end to the double-dip induced by the euro sovereign debt crisis. Paradoxically though, it has in part also contributed to this double-dip and risks longer-run stagnation. The counterpart of the emergency assistance from the European Institutions was the frontloading of fiscal policy in Member States. The frontloading was done in a time of high fiscal multipliers and therefore placed a large toll on economic activity. This has been analysed as a failure or as a lost opportunity in previous reports (iAGS 2013 and iAGS 2014). There is now a broad consensus ranging from the OECD to the IMF about the value of fiscal multipliers, and drawing on this consensus, alternative scenarios of backloaded fiscal consolidation[1] with the same powerful intervention of ECB and other European institutions (ESM in particular) showed that it was possible for the euro area to avoid most of the double dip of the years 2011-2012. The significance is grave: it means that the double dip was self-inflicted.

Failing to exit promptly from the euro crisis and enduring the double dip have come with consequences: the euro area is now close to deflation and the debt-deflation dynamic is threatening to prolong stagnation. Moreover, the reinforced rules of the SGP call for a reduction of the public debt ratio back to 60% within 20 years from now. Low inflation (not to mention deflation) is going to imply higher structural primary surpluses than those aimed at today. A more restrictive fiscal stance, in a time when fiscal multipliers are still high in many countries, will close the fiscal trap.

The ECB is clearly aware of this situation and, even if the board is divided on the policy implications, stands firm on the “whatever it takes” doctrine. Aggressive monetary policy will be maintained, quantitative easing will be conducted, even probably extended to sovereign bonds in 2015. The tightening of US and UK monetary policies, meanwhile, will depreciate the euro against the dollar or sterling. But many fear that monetary policy alone will not be effective enough to prevent stagnation. Quantitative easing by the ECB is to be welcomed. But it must be recognised that it works through indirect channels. In a deflationary environment with private and public actors struggling to deleverage, it may not be enough to avoid a continent-wide paradox of thrift, i.e. in the end an increase of debt to GDP ratios.

There is more. Sustained unconventional monetary policy in a stagnating economy may bring distributional downsides and negative side effects under the form of risk mispricing, asset price bubbles, carry trade and exchange rate volatility. This adds to the imperative need to escape the stagnation.

The Annual Growth Survey,[2] published by the Commission in November 2014, proposes a three-pillar response to the crisis. The first pillar is the 300bn € Juncker plan. Presented as a way to revive investment in Europe, back to “normal and sustainable” levels, the Juncker Plan adds virtually no fresh money. Recycling funds from the EU budget and the EIB (European Investment Banks), a new vehicle, the EFSI (European Fund for Strategic Investment) will carry on projects with an expected leverage of 1:15, thus expanding 21bn € to 315bn €. It is not at all clear that, in the current environment, the incentives offered will be anywhere near sufficient to induce additional private investment of this order of magnitude. It is highly likely that any investment forthcoming under the Juncker plan will be in large measure a reflection of reduced investment elsewhere (substitution) or will be investment that will have occurred in any case (deadweight). The scheme is a step in the right direction but it would be foolhardy to rely on such an inherently uncertain pillar to jolt Europe out of crisis.

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1. Backloaded fiscal consolidation alternative scenarios have been simulated by iAGS 2014 and iAGS 2015. These alternatives are calculated such as to bring the same debt to GDP ratios as in the frontloaded fiscal consolidation 20 years from now. The better outcome in term of GDP and unemployment is due to fiscal multipliers being lower when output gap is closed than when output gap is largely negative.
2. http://ec.europa.eu/europe2020/pdf/2015/ags2015_en.pdf

The second pillar refers to structural reforms and investment-friendly regulations. Promoting legitimate evolutions of the competitive framework might be genuinely beneficial in the long run. But the real question remains: is that going to help to change the course of events in the next few years? On that matter, empirical evidence leaves no doubt and suggests that most structural reforms may have negative effect on activity or prices in the short term. Any payoffs come much later and are themselves contingent on adequate expansion of demand.

The third pillar is the streamlining of the fiscal governance architecture. Indeed, the current fiscal governance is complex and biased toward frontloading. It is profoundly inadequate to deal with a sustained period of low inflation not to speak about a deflation. Streamlining the fiscal governance could end in the deepening of the fiscal trap. The Commission rightly points out that some countries have fiscal space and could compensate countries in consolidation. Unfortunately, —not for the counties themselves, but for policymaking at the European level—those countries with fiscal space—the only one with the potential to have substantial spillovers to other countries is Germany—are countries with low unemployment, not likely to boost an economy seen as being already close to a steady-state path. Hence, the spillovers one can expect from a positive fiscal stance in a country like Germany are highly unlikely to be strong enough to alleviate the burden of consolidating countries.

To repair the damages of past frontloading, more than less frontloading—utilising the flexibility opened for countries in the preventive arm of the SGP—is needed. Overall, the three pillars strategy of the Commission, as proposed in the AGS, is likely to miss the target. Underachieving policies while claiming to enforce a stricter discipline will end in a loss of confidence in European institutions and the integration process more generally. The advances from the common market to the single currency and the painful and slow establishment of a more democratic Europe in 28 countries are promises we cannot break.

Beyond the fiscal compact

More is needed. Suspending the SGP is unfortunately not an option, in the short term. The SGP and its reinforcement with the TSCG (Treaty on stability, coordination and growth) is one of the pillars of the nascent solidarity that ended the euro sovereign debt crisis. Weakening or renegotiating it could reopen a period of large uncertainty in which the euro may not survive. Asking more from countries where political and social discontent is everyday fuelled by the crisis can reveal the European fiscal governance weakness. Peers have no democratic legitimacy to define national policies except where there are clear consequences on the common house. Peers face no responsibility nor accountability, and, consequently, have no coercive power on national policies. In the end, current European governance rely on the willingness of member states to apply recommendations. The bias toward frontloading thus ensues: discipline only works out of fear, not out of responsibility and accountability. It fuels distrust in Europe and peers, perceived as advisors defending their own interest.

It is not going to be possible to exit from the crisis and have a sustained upturn while sticking to the letter and spirit of all the rules (see Box 1). At the very least we are going to have to creatively use all the legal ambiguities and all the backdoors we can to overcome the limits the fiscal compact imposes. The Juncker Plan has opened a breach, excluding Member States participation in the EFSI from the deficit and debt rules. A proposition similar in spirit is to be found in the recent Franco-German joint report by Enderlein and Pisani-Ferry.[3] Fresh money, borrowed using present-day very low rates, channelled through a supranational vehicle and targeted on specific uses can ease the acceptance of peer pressure on national fiscal policy, as long as it excluded from calculation of the national debt or deficit. It is a way to give room of manoeuvre while monitoring specific policies through the control of the funds reinvested. It is a way to backload fiscal consolidation while at the same time safeguarding fiscal discipline and moderating its negative impacts.

As we show in chapter 5 of this report, although some progress has been made in bringing about an adjustment in competitiveness, the remaining nominal adjustment requirement is still large. Solving it with a (further) decrease of nominal wages in deficit countries will precipitate deflation. The fiscal cost of the real public debt appreciation will exert further deflationary pressure resulting in a vicious circle. Reflation of surplus countries is an important objective to rebalance European competitiveness issues. Increasing wages is not something you can decide by law or by government action. We advocated in iAGS 2014 a differentiated evolution of minimum wages norms based on current account (or preferably on structural current account) positions. The implementation of a minimum wage in Germany is one step forward and this policy proposal still stands. More generally, a strengthening of capacities at both national and European level to ensure balanced wage and price developments and prevent beggar-thy-neighbour strategies is needed in the medium run.

We should assess the scope for further-reaching measures which should be prepared for use and that would lead to *direct* impacts on investment and the economy, rather than relying on measures that work through indirect channels. A fiscal carbon shock and a targeting of investment in transition toward a low carbon economy could add 200bn € a year in investment and produce the needed boost. The key element is political acceptance of the implementation of a price of carbon using either a cap-and-trade mechanism (ETS) or a carbon tax. A transition fund, fed by member states and exempted from the SGP accounting, could finance over-compensation to Member States of the resources withdrawn via the tax, and support action with significant contribution to the economy and particularly in the area of climate-change-prevention (this is developed and simulated in chapter 4 of this report). Public investment on this scale would be enough to counter the stagnation, especially if, as the IMF now estimates, the multiplier for public investment in the current environment could be as high as 3.

Ultimately consideration needs to be given to financing public investment through purchases of newly created EIB bonds by the ECB on secondary markets and the distribution of resources to Member States for the purposes of public investment (this proposal is discussed in chapter 3 of this report). The bonds are held by the ECB for an agreed period, and this forms part of its QE program, with

3. http://blog.en.strategie.gouv.fr/wp-content/uploads/2014/11/Rapport-Henderlein-Pisani-EN-final-1.pdf

the difference that real spending in the economy is assured without initially raising the government debt burden. Different modalities for distributing the resources and paying down the loans are discussed, along with a mechanism to ensure compatibility with the ECB's mandate to ensure price stability.

Once again Europe finds itself in a critical situation. A change of policy course is required. The existing policy space needs to be exploited to the full. And more unconventional policies need to be readied in the case of a failure to emerge from what otherwise threatens—secular stagnation.

Box 1. Four trilemmas

The crisis opened in 2008 implies that the Euro area is confronted with at least 4 trilemmas. Retrieving a stable macroeconomic equilibrium requires a different strategy for the European economy. iAGS 2015 develops on this.

Trilemma 1: achieving inflation at target (of 2% per year in the mid term), endorsing structural reforms (flexibilising goods and service or labour markets) and achieving fiscal discipline (60% debt-to-GDP ratio in the mid term) is not possible at the same time. Fiscal discipline and structural reforms pave the way for deflation. Fiscal discipline and inflation at target produce high social costs to structural reforms (fiscal discipline urges a mix of higher taxes and lower spending in high-employment countries, those where structural reforms are urged; inflation at target without nominal wage increase reduces purchasing power) and make their endorsement unlikely. Inflation at target and structural reforms are inconsistent with fiscal discipline: a rise in inflation reduces the real debt burden and governments face incentives to use the proceeds to increase, not decrease, public deficits, and the (short-run) costs of structural reforms need to be mutualized.

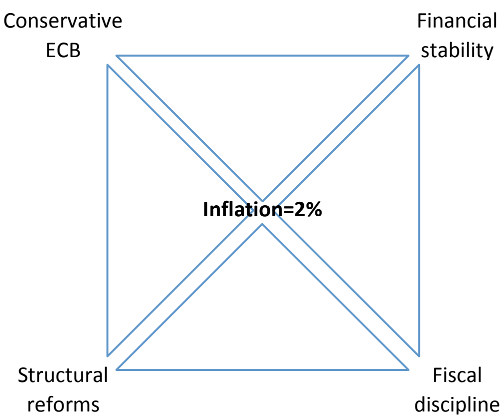
Trilemma 2: achieving inflation at target (of 2% per year in the mid term), financial stability and having a conservative central banker (with a relative high aversion against inflation) is not possible. If the ECB is leaning against the wind to achieve financial stability, hence implementing a restrictive monetary policy to dampen financial bubbles, the ECB will underperform its inflation target. Experience has finally shown recently that inflation close to target with a conservative ECB has been inconsistent with financial stability. Consequently, achieving the inflation target and financial stability requires an accommodative monetary policy.

Trilemma 3: achieving inflation at target (of 2% per year in the mid term), endorsing structural reforms and having a conservative central banker is not possible. A conservative ECB achieving its inflation target sets high real interest rates which increase the opportunity cost of implementing reforms in the real sector, hence benefiting the financial sector where real yields are rising. A conservative central banker and endorsement of structural reforms lead to below-target inflation. Inflation at target and structural reforms therefore require an accommodative monetary policy.

Trilemma 4: achieving inflation at target (of 2% per year in the mid term), under fiscal discipline, and achieving financial stability is not possible. Inflation at target and fiscal discipline prevent the endorsement of structural reforms (see trilemma 1) and limit the attractiveness of the real sector at the benefit of the financial sector: investors buy more private financial assets, hence paving the way for a disconnection between the real and the financial sectors which fuels new bubbles. Recent experience has also shown that despite fiscal discipline and inflation close to target, the euro area has been hurt by financial instability. Inflation at target and financial stability require a balanced portfolio of risk-free and risky assets: they are not consistent with fiscal discipline of all euro area countries alike. Achieving financial stability and fiscal discipline requires to limit leverage, not only from governments but also from private firms (high leverage is one important component of the global financial crisis); it would thus lead to below-target inflation because of low overall activity level.

These 4 trilemmas are strikingly interconnected (see the four triangles in figure 3 below). It thus appears that to solve these trilemmas, only two changes are required; replacing the conservative central banker with a social central banker, and fiscal discipline with fiscal accommodation. Of course, a general overhaul of monetary and fiscal policies in the euro area would be the first-best option. Nevertheless, it is unlikely that these changes would be accepted all over the euro area. The second-best option is to have a central banker who endorses unconventional monetary policies (the current one does) and implements them. In this latter case, we propose a plan by which some monetary financing of domestic public spending with positive spillovers to all member states which could start the process. As for fiscal accommodation, the latter plan, including a reform of the carbon tax, would give an impetus to euro area economic growth in the short run but also an improvement in the path towards a sustainable economy in the longer run.

Figure 3. Four trilemmas in a graph



Source: iAGS calculations.