POLICY CHALLENGES FOR EUROLAND OVER THE NEXT DECADE

STEFAN COLLIGNON *

After the success of the first ten years of the euro, what will the future bring? I will argue that the favorable economic environment of the last decade will profoundly change. This could be an opportunity for Europe, but if it lacks the institutional instruments and the political will to adjust its present policies, Europe's economic performance is likely to deteriorate. Integration policies would then come under pressure by populist Eurosceptics. What would be required are institutional advances towards a more democratic governance capable to raise the legitimacy of European policy decisions. Otherwise, the whole European edifice could unravel. I shall first discuss the economic environment, then the internal economic challenges and conclude on the need of more democracy in Europe.

THE ECONOMIC ENVIRONMENT

The first decade of the euro has been remarkably benign. The introduction of the new currency was a technical success and price stability has been preserved. Inflation was on average close to the 2% objective set by the European Central Bank (ECB) and interest rates have been at a historic low. The consolidation of public finances has continued, even if the pace has slowed compared to the previous decade. The average euro area budget deficit amounted to 1.8% of GDP and the debt/GDP ratio has been falling from 71% in 1999 to 66% in 2007. Nearly 18 million new jobs were created in the first nine years of the euro.

* Professor of European Economic Policy, Sant'Anna School of Advanced Studies, Pisa (Italy).

COLLIGNON GB 1 15/12/09, 10:08

Yet, these positive results mask underlying structural weaknesses. Growth was strongly driven by external factors: exports contributed 105% to the euro area's overall GDP growth; the equivalent ratio for the United States was only 19.3%. Private consumption explained only half of GDP growth in Europe (100% in the United States and 73% in Japan)[1]. European employment largely grew at the expense of productivity and the regional distribution of these jobs was very unequal. A decade of reforms has rendered labor markets more flexible at the low-wage end, but firms have taken advantage by hiring low-skilled workers instead of investing in new technologies (European Commission, 2007). With stagnating productivity, real wages cannot grow and this limits domestic demand. Although external demand has contributed to employment, these benefits have been very unequal accross Europe. Germany has cut wage costs to become internationally competitive, while Spain has enjoyed a property boom resulting from low interest rates. Germany, France, the Netherlands, Austria and Portugal have lost employment shares in the euro area, while in Spain, Ireland and Luxembourg, employment has grown significantly faster than average. These weaknesses will pose new challenges for the euro economy, when domestic demand will have to play a more prominent role as the engine of growth.

Monetary policy will also be severely tested. The achievement of monetary stability over the recent decade is particularly remarkable, as central banks in the industrialized world have taken highly accommodating policy stances. The low levels of interest rates indicate that liquidity supply has been generous. This development was most pronounced in the United States, where the Federal Reserve has kept short-term real interest rates in the negative range for three years (September 2002 until October 2005). In the euro area, real short-term rates were negative only in 2004, but the expansion of credit and money supply has been far in excess of the reference values stipulated by the ECB under its pillar I arrangement. For monetarist economists, who believe that money supply determines inflation, it must be a puzzle that prices have remained stable despite significant increases in liquidity.

One explanation focuses on labor market flexibility. But while it may be true that reforms have rendered them more "flexible" in the European Union, it is not clear why wages have not risen and pushed prices up when employment rose and unemployment fell. The reason may be the moderating effects of globalization. The opening of China and other Asian and formerly communist economies has roughly doubled the world's labor force. With the emergence of global markets, the supply of labor has become nearly unlimited or perfectly

COLLIGNON GB 2 15/12/09, 10:08

elastic and this has put pressure on wages, especially in developed industrial economies. The import of cheap consumer goods and the potential competition from Asia have kept inflation dynamics under control (Bean, 2006). While the rising costs for oil and other natural resources have occasionally pushed prices up, these shocks have not translated into systematic wage-price spirals, which are the ultimate cause for inflation. Thus, inflation has been anchored by stable unit labor costs and this has allowed easy money to become the stimulus for economic growth rather than the cause for inflation.

However, the last decade was not unambiguously benign because it has also led to the global imbalances, which have contributed to the severe financial and economic crisis in 2008. Monetary authorities had a large part in this. Their exclusive focus on consumer price stability prevented them from giving due attention to the accelerating asset price inflation. Low nominal interest rates have laid the foundations for the financial crisis, because they pushed commercial banks into seeking higher returns on capital by leveraging their lending. The credit boom has certainly financed real investment and growth, but also rising asset and property prices. American banks sought to diversify their risk by selling asset-backed securities, which European banks bought to increase their market share. Thus, European and American financial markets have become increasingly integrated. Most people seemed happy with this world, until monetary policy started to tighten. Asset price inflation came to a halt, expected returns then fell by the leveraged effects and the bubble imploded. Banks were stranded with bad assets and saw their net worth melting away. This has seriously damaged commercial banks' lending capacity and may reduce economic growth in the future. Unless banks are solidly recapitalized and the financial sector restructured, Europe's rate of investment will come down, thereby increasing equilibrium unemployment and lowering productivity growth. Hence, the economic crisis may not only have lowered European levels of income, but also the economic growth potential over the next decade[2].

THE GLOBAL CHALLENGES

Globalization has contributed to the "great moderation", which has marked the favorable environment of the last decade, even if policy mistakes have brought it to a sudden end. It is unlikely that the next decade will continue to be characterized by such favorable environment. The unlimited supply of labor will dry up. China will reach the Lewis (1954) turning point where labor supply will become less elastic. In 2005, its rural labor force amounted to 485 million workers, of which

200 million to 230 million migrated subsequently into non-agricultural industries or retired. According to various scenarios for productivity and working days, the Chinese rural economy requires between 178 million and 228 million workers, so that the labor surplus is between 25 million and 107 million workers. However, approximately, 50% of this labor force is over forty years old and not well adapted to migrating into non-agricultural sectors (Cai, 2006). Hence, it is reasonable to expect that China will shift from an extensive to a more intensive development model, with GDP growth gradually slowing down and labor costs starting to rise. This scenario has some resemblance with the structural changes that took place in Europe after the breakdown of the Bretton Woods system in 1971. If such a development would coincide with an appreciation of the Chinese currency, the renminbi, China would go through a severe domestic crisis and become more inward-oriented. The supply of cheap consumer goods will cease and inflationary pressures will re-emerge in the world.

All this will have important consequences for Europe.

Firstly, a slowdown of China's economy would directly translate into lower growth for Europe. Over the last decade, Europe's exports to China accounted for nearly one fifth of its GDP growth. Assuming the transformation of the Chinese economy described above, Europe's trade with China will change in speed and structure. European exports will be concentrated in sectors that could help raising the capital intensity of Chinese production and gradually, China will become an exporter of high technology products rather than of cheap consumer goods. Japan is the model for this development. China will then compete with Europe in a field where Europe sees its own traditional comparative advantage, but this could also provide opportunities for intra-industry trade and for new forms of transcontinental cooperation.

Secondly, if labor shortages in China start to drive wages up, monetary policies in Europe and in the United States will come under pressure. Central bank authorities will have to become more anti-inflationary and less growth-accommodating, reigning in liquidity and keeping real interest rates structurally higher. This will make growth strategies based on domestic demand more difficult, unless productivity improves. The economic climate in this scenario will be more like the 1990s than the 2000s.

Thirdly, in this new environment, it may remain difficult to rebalance global disequilibria. Over the last decade, the United States has been the consumer of last resort. The savings rate of domestic households had effectively fallen to zero, while a large part of the demand was met by imports from Asian and Chinese exporters. US consumers also

COLLIGNON GB 4 15/12/09, 10:08

benefited from the fixed and highly competitive exchange rates, but the consequence of this economic constellation was a current account deficit of historically unknown proportions. By contrast, the euro area has kept its external balance. Since the financial crisis broke in 2008, American savings have risen and this may reduce the current account deficit. But if reduced domestic demand in the United States translates into lower exports for Asia, economic growth and development in the region will slow down. This would be bad news for the euro area, because Asia has become an important market for European firms. Therefore, Europe must have an interest in continued economic growth in China and in the rest of the region.

A concerted action between Asia, America and Europe would be warranted to stimulate the world economy and avoid that trade protectionism and beggar-your-neighborhood policies turn the global economy into permanent stagnation. In this context, global exchange rate policies become a crucial variable. Asia's development has been depending in recent decades on stable and competitive exchange rates with respect to the dollar (Collignon, 2009 a). If these policies were maintained and the dollar would weaken significantly, a policy often recommended to restore American current accounts balance, Europe would bear the brunt of the international adjustment. This is not desirable. There is no guarantee that the resulting social tensions may not break up the European single market and its currency. Instead, policy coordination between Europe, Asia and the United States should aim at stabilizing the world economy. One way of doing, this is adopting exchange rate objectives as a joint policy benchmark. If the major financial currencies (euro, dollar and yen) would reduce the short and long-term volatility of their bilateral rates and simultaneously accept currency pegs by China and other East Asian economies at highly competitive levels, which will slowly adjust to long run equilibrium levels, the world economy could return to a more balanced growth path. Asia would remain the most dynamic pole while it catches up to the global production possibility frontier; Japan and the euro area would reduce their surpluses or run structural current account deficits, while America has time to rebalance its trade. In return, Asia's demand for investment goods from Europe would be sustained and this would stimulate growth on the old continent (Collignon, 2006).

However, such policy would require a coherent macroeconomic strategy, which could only be realized if the euro area had effective institutions for its economic governance. Muddling through will no longer work and restoring the *status quo ante* after the crisis is not sufficient to restore prosperity. If the euro area does not wish to be permanently impoverished, it must lift economic growth rates for a number of years above the previous potential growth rate of 2.4%. The question is whether it has the policy instruments to achieve such goal. The experience with the Lisbon strategy has not been promising (Collignon, 2008). What is needed is a stable, growth-supporting international environment and domestic policies that stimulate domestic activity.

The new forum for international policy coordination is the G20. There is certainly some benefit in bringing the main actors from all continents around the table and discuss policies. However, as we know from the theory of collective action, the complexity of negotiated decision-making grows exponentially with the number of decision-makers and large groups are less likely to produce an optimal allocation of public goods or policies. The G8 is no longer an appropriate framework for economic policy-making. There is simply no justification for having individual member states of the euro area as independent actors in such a forum when they share one of the major world currencies and have it managed by the independent ECB. It would therefore be preferable to set up a G3, or G4 with Japan, representing the euro area, America and Asia. But this poses the problem of coherence for the non-monetary macroeconomic policies in the euro area. Europe would need an institution capable of speaking with one voice, acting with authority and fully implementing decisions subsequently. Of course, this requires restructuring the institutions of Europe's economic governance.

EUROPEAN GOVERNANCE AND THE ISSUE OF DEMOCRACY

While the external environment is important, the essential impulses for Europe's economy must come from within. How can domestic policies support growth and job creation in Euroland? To achieve this objective, higher rates of investment are needed[3]. There is significant econometric evidence that the best explanation for investment in Europe is the accelerator model, i.e. investment is following aggregate demand (Centro Europa Ricerche, 2008). Spare a new asset bubble, the two main factors capable of boosting demand are wage increases and public spending. The issue is complicated by the aging of Europe's population. The European Union is expected to move from having four working-age people (aged 15-64) for every person aged over 65 to a ratio of only 2 to 1. The largest decrease is expected to occur during the period 2015-2035 when the baby boom cohorts will be entering retirement, while at the beginning of the next decade participation rates could still improve (European Commission, 2009a). However,

COLLIGNON GB 6 15/12/09, 10:08

Europe must be prepared for the consequences resulting from the structurally lower private consumption and higher age-related public expenditure like health care.

Higher wages would stimulate private consumption. But the margins for active wage and income policies are reduced by the structural slowdown of productivity in recent years. If nominal wages increase on average faster than total productivity in the euro area, unit labor costs rise and monetary policy will become restrictive to combat inflation. If real wages in aggregate increase more than productivity, profit margins will fall and unemployment will rise. This problem is compounded by the growing divergence of national unit labor costs (Centro Europa Ricerche, 2008; Collignon, 2009a). While aggregate unit labor cost for the whole euro area have grown less than 2% a year over the last decade, they have increased significantly more in the South and less in the North. The resulting competitive distortions in the single market (European Commission, 2007) may cause "rotating slumps" (Blanchard, 2006), because some member states adjust more rapidly than others. This will fuel regional discontent and anti-European sentiments and may solicit protectionist policies as one has witnessed already in the past. The outcome could be another decade of economic stagnation and popular discontent. Left-wing Eurosceptics will blame Europe for stagnating or falling living standards, right-wing populists will accuse European integration for shrinking profit margins in small and medium enterprises in the non-tradable sector[4]. Ultimately, the single market could break up, unless new policy instruments are found to stimulate Europe's economy. In a context where the legitimacy of European institutions is already steadily eroding, this could become a major policy obstacle. The only way out of this dilemma is a rapid increase in productivity, which requires high rates of investment.

Public spending could provide a short-term stimulus for domestic demand, but it does not automatically contribute to the long-term improvement of the growth rate[5]. The main channel, through which government spending affects growth, is public investment into R&D, education and public infrastructure. Over the last twenty years, the share of public investment has fallen in all member states of the euro area. The reason may be that governments find it easier to postpone and cancel investment than cutting current expenditure when they needed to consolidate their budgets in order to meet the constraints of the Stability and Growth Pact. This problem will become more acute if the potential growth rate of output is permanently lowered as a consequence of the economic and financial crisis: reduced long-term growth will translate into higher equilibrium levels of public debt and the resulting burden on national budgets to service the debt will limit the margins for fiscal policies. The European Commission projects that the euro area debt to GDP ratio will increase by 18 percentage points from its low in 2007 to reach 84% of GDP in 2010, with the deficit climbing to 6.5% of GDP. This is well above the Maastricht criteria for fiscal restraint and has caused alarm. The German government has passed constitutional limits for public debt and is urging its partners to consolidate their budgets, while Europe is still in the free fall of the recession. However, such positions do not distinguish short-term from long-term debt dynamics and thereby worsen the economic performance in the short and in the long run. If the average euro area deficit of 1.8% that has prevailed over the last decade is maintained, the debt/GDP ratio would converge to a steady state of only 51.4%, even if potential growth is reduced to 1.5%. Fiscal discipline is necessary for long-term debt sustainability, but this does not imply that structural budget positions need to be balanced at all times. There are therefore some margins for fiscal policy in the euro area as a whole.

However, it is important to avoid free riding by individual member states and this is the real purpose of the Stability and Growth Pact. But the Pact is not a suitable institution for designing and implementing coherent fiscal policies for the euro area. The budget of the European Union has been kept deliberately low (less than 1% of GDP) and there is no mechanism by which national fiscal policies are coordinated. An active growth strategy would require greater centralization of national expenditures with a focus on productivity-raising investment - although not necessarily a federal budget.

However, we touch here the nerve of public life. European policies affect all European citizens, wherever they live. Democracy means that every citizen should have an equal right to appoint a government as her or his agent and the freedom to choose between policies, which should be applied. Modern states are built on the principle "no taxation without representation". A coherent fiscal policy with its incidence on taxes and spending would need a government that represents all European citizens affected by these decisions. European citizens must be able to elect a government that will administer their public goods, their *res publica*[6]. Democracy provides legitimacy by giving citizens free and equal access to the process of deliberation on what is good and of deciding what they would like. Hence, the single most important reform that the European Union will face in the next decade is the issue of democracy.

COLLIGNON GB 8 15/12/09, 10:08

NOTES

1. Data from AMECO (macroeconomic datas of the European Commission) 2008; own calculations.

2. The European Commission (2009) has estimated that the effect of the economic crisis on the euro area's growth potential will be fall from 1.6% in 2007 to 0.7% in 2010. After the crisis, the potential output growth should grow again, but it may not return to its pre-crisis level.

3. Net job creation requires that GDP grows faster than productivity, which is equivalent to saying that total investment must grow faster than investment per worker.

4. See, for example: the economic roots of Swiss euroscepticism (Collignon and Serrano, 2007).

5. For evidence in the euro area, see: Centro Europa Ricerche, 2009.

6. For a full treatment of these issues, see: Collignon and Paul, 2008

BIBLIOGRAPHY

BEAN C. (2006), "Globalization and Inflation", Bank of England, *Quarterly Bulletin,* pp. 468-475.

BLANCHARD O. (2006), "A Macroeconomic Survey of Europe", mimeo, September.

CAI F. (2006), "Decreasing Supply of Rural Surplus Labor, Opportunities and Challenges", Chinese Economists 50 Forum.

CENTRO EUROPA RICERCHE (2008), *Report on Europe,* Rome, March.

COLLIGNON S. (2006), "Adjusting the US Current Account Deficit: what Role for the Dollar, Euro and Yen?", *Journal of Asia-Pacific Business,* vol. 7, no. 2.

COLLIGNON S. (2008), "Why Europe Is Not Becoming the World's Most Competitive Economy. The Lisbon Strategy, Macroeconomic Stability and the Dilemma of Governance without Governments", *International Journal of Public Policy,* vol. 3, no. 1/2.

COLLIGNON S. (2009a), "Monetary Mercantilism and Economic Growth in East Asia". Available at: http://www.stefancollignon.de/PDF/MonetaryMercantilisminAsia.pdf.

COLLIGNON S. (2009b), "Wage Developments in Euroland or the Failure of the Macroeconomic Dialogue". Available at: http://www.stefancollignon.de/PDF/WagedevelopmentsinEuroland34.pdf.

COLLIGNON S. and PAUL C. (2008), *Pour la République européenne,* Paris: Odile Jacob.

COLLIGNON S. and SERRANO O. (2007), "The Political Economy of Right-Wing Populism and Euroscepticism in Switzerland". Available at: http://www.stefancollignon.de/PDF/PoliticalEconomy Euroscepticism Switzerland.pdf.

EUROPEAN COMMISSION (2007), *Quarterly Report on the Euro Area,* DG ECFIN, Brussels, vol. 6, no. 4.

EUROPEAN COMMISSION (2009a), *Quarterly Report on the Euro Area,* DG ECFIN, Brussels, vol. 8, no. 2.

EUROPEAN COMMISSION (2009b), *2009 Ageing Report: Economic and Budgetary Projections for the EU-27 Member States (2008-2060)*, Brussels. Available at: http://ec.europa.eu/economy_finance/publications/publication14992_en.pdf.

LEWIS A. W. (1954), "Economic Development with Unlimited Supplies of Labor", Manchester School, *Economic and Social Studies,* vol. 22, pp. 139-191.