

Europe needs a growth strategy

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There are several reasons why markets have reacted poorly to Europe's recent crisis management efforts. The response to the unfolding Greek drama was slow and hesitant. The design of the bail-out for Ireland was flawed. And the eurozone's woes are more and more seen as symptoms of underlying flaws in the currency union. Europe's response to date has been more innovative and effective than many of its critics realise. But it now must accept that what was once a crisis in the eurozone, is now a crisis of the euro itself.

The recognition of this difference is currently driving market reactions. The threshold of what constitutes a sustainable level of public debt is notoriously hard to assess. Debt intolerance can be especially high when countries borrow in foreign currency. Of course this should not be a problem for members of the eurozone – unless the markets start to believe that the euro might actually break up. If the euro really is threatened, existing debt begins to be seen as no different from foreign-currency denominated debt. And this, in turn, can lead a country previously considered solvent suddenly to seem insolvent. The more a break-up looks possible, the higher the risk of a self-fulfilling dynamic. For this reason the European Union cannot afford doubts about the viability of the euro to spread and strengthen.

What justifies these doubts? First, questions about the ability of the EU to make decisions. This is a matter of governance. Second, questions about the lack of a fiscal union. This is a matter of design. And third, political sustainability in times of harsh adjustment. This is a matter of remedial action.

On the first, it is easy to deride EU decision-making. It is governance by committee, which works acceptably in fair weather but is not enough when storms break and boldness is required. Improvements are needed. But the absence of a commander-in-chief is deliberate, so there is no point lamenting it. Instead, a fair benchmark would be a system about as effective as the US Congress.

Against this background, the creation of the European financial stability facility and the recent agreement on the European stability mechanism are genuine achievements. They suffer from shortcomings, not least the EFSF's insufficient size, but they also indicate Europe's ability to revisit and reform its old compromises. In the spring, a major difference of views emerged over one of the euro's fundamental principles, the no bail-out clause. Some in Germany said this implied no

assistance without debt restructuring. Some outside Germany said the opposite. The fact that the change was agreed in the face of disagreement shows the EU is not condemned to agonise over compromises negotiated decades ago. It can learn and reform. This is good news.

It is also easy to claim that the eurozone would work more smoothly with a federal budget. But it is pure fantasy to suggest that such a budget could be built purely for macroeconomic purposes. A common budget will emerge only if Europe decides to spend more at the federal level. In any case, transfers between countries are not necessarily desirable. They already exist between east and west Germany, for instance, but have failed to help poorer areas catch up with their more advanced neighbours. Greece and Portugal need to regain competitiveness and resume economic development, not to be put inside an economic oxygen tent.

Yet while the Germans are right to reject a transfer union, the fear of such a system is hampering discussions of sensible projects that could strengthen the euro. One example is the supervision of banks, for which improvements are slow and limited because of the fear of sharing the costs of rescue. Another is the issuance of new European bonds, as endorsed by Jean-Claude Juncker and Giulio Tremonti in the Financial Times. This is being resisted, although it can be pursued without countries ditching their national responsibility for public finances.

The third and final issue is the political sustainability of the euro. Many countries across Europe are making sacrifices in the name of the single currency. The early lessons from Greece are that harsh reforms do not necessarily weaken governments if the population regards them as necessary. But a backlash is likely when conditions set for assistance are inadequate or unfair – as was the case with the strings attached to the cost of the emergency loans offered to Ireland. This is why European leaders must urgently devise a strategy to help foster growth in crisis-affected countries, before the euro is blamed for their difficulties.

A revitalisation programme should involve a strengthening of integration within the single market, particularly in the market for services, to help Europe's economies converge. It must involve new measures to strengthen domestic demand in northern Europe and also to foster private investment in southern Europe. This should start with the unlocking of the EU structural funds earmarked for the less developed regions (which currently remain idle for the lack of co-financing) and their refocusing on growth-enhancing investments.

Europe must realise that a case-by-case approach is no longer sufficient. A bolder, more comprehensive response is urgently needed.

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