Le Monde

Europe is up against the wall

Published in Le Monde on 3 December 2008

By Jean Pisani-Ferry

The language is as striking as the figure. The price tag attached to the recovery plan called for by the European Commission is certainly impressive. At €200b the Commission is proposing to fund, by budgetary expenditure and tax reductions, the equivalent of ten days of EU household consumption. But after all the US is contemplating a much larger package. It is just as remarkable to hear Brussels recommending 'a massive injection of purchasing power into the economy' and arguing that this is the only means of neutralising the expected drop in demand. For an institution which has spent the last twenty years pleading non-stop for a reduction in deficits, this looks like a *volte-face*.

In fact this appeal for a large-scale Keynesian boost is welcome. Business surveys Europe-wide are blacker than they have ever been and are getting worse. Private demand is crumbling because businesses can no longer - or no longer dare to - invest, households are too scared to spend, and foreign markets are shrinking. In order to break this cycle of recession, governments must step up and play their role as buyers of last resort. Immediate action is all the more necessary because the prospect of contracting production is being priced by stock markets and this is in turn triggering fresh losses in the financial sector. The example of Citibank, which has just been rescued a second time only weeks after a first injection of government funds, should provide food for thought.

For the doyen of debt reduction to have undergone a damascene conversion to defender of deficits will not have been a decision taken lightly. Europe will continue to age during the recession, and the pension bill will continue to mount. Whatever is spent today will have to be paid back tomorrow, so the boost will entail a decade of rigour to come. But it would be a mistake to believe that the EU does not have the means to put together a robust programme of action. Europe's aggregate budget deficit was less than one percent of GDP in 2007, as against three percent for the US. The debt stock was around 60% of GDP in both cases. The EU overall is no more hemmed in fiscally than Barack Obama's US.

The special feature of Europe is that economic policy is not centralised : out of €100 spent by government in Europe, only €2 come from the EU budget. The Commission is free to propose but the member states dispose, because any stimulus must rely on joint action. But coordinating their efforts raises two major problems. First, the budgetary situation differs markedly from one country to another. In 2007 the Spanish had a budget surplus, Germany had after a determined effort managed to balance its budget, but France's budget continued to hover around the 3% deficit ceiling. Second, given that Europe's economies are tightly integrated, each country is tempted to free-ride on the fiscal boost of its neighbours. Or to put it another way: to announce major initiatives but actually do little.

So it would be illusory to expect a decentralised effort to do the trick – the sum of the national stimulus plans would be likely to fall short of what is needed. Moreover, purely national policies would be prone to granting subsidies to national producers and sectors rather than boosting demand and providing macroeconomic support. Heartened by the example of the banking sector, a string of other sectors will doubtless be standing in line for aid. The motor vehicle sector has already done this. But going down this road would lead to a subsidy race which would degenerate into squabbles and put Europe's single market at risk.

But it is equally unrealistic to bet on coordination if the end result boiled down to asking countries with healthy budgets to launch a stimulus on behalf of others. This would essentially mean tapping Germany, and Germany has already let it be known that, as in Lafontaine's fable, the ant refuses to lend to the 'grasshopper gay which sang the summer away'.

Europe is up against the wall. The Commission was right to show the way to go, but this is not enough on its own. Joint action must be organised. This implies that member states must resist the temptation merely to go through the motions, that Brussels must be tough in its assessment of national efforts, and that a serious debate must be held about burden-sharing. In order to cut the Gordian knot, it would be best for each country to contribute equally to the stimulus, with those whose initial fiscal position is poor having to specify upfront how they intend to put their house in order tomorrow. Only those in absolutely dire budgetary situations should be exempted.

We will know on 11 December, at the next EU summit, whether Europe is capable of such concerted action. Experience shows that this type of exercise is tricky in the extreme. The seriousness of the economic situation today warrants such action. If they succeed, they will have invented, in the heat of battle, the European economic government which France has been advocating so regularly without knowing precisely what it would entail. If they fail, or agree to erect a new Potemkin village, we will know that the EU is, alas, not built to weather storms.