European growth : what's to be done ?

By Jean Pisani-Ferry

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It is now clear. The European economy is at a standstill. Euro-area GDP dipped slightly in the second quarter and remained stagnant in the UK. From a 3% high at the start of 2007, growth dropped to 2% last autumn, then crashed almost everywhere in the spring and forecasts herald little change in the third quarter. Whether or not we will witness a recession in the technical sense (two consecutive quarters of negative growth) will not alter the fact that the downturn is here.

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This should be no cause for surprise. Europe has been hit by a string of violent shocks over the past two years. The appreciation of the euro, soaring commodity prices, the credit seize-up, a shrinking property market: each of these jolts would have been sufficient on its own to shake growth, so it can hardly come as a surprise that their combined effect has delivered it a knock-out blow. But it was as recently as April that the IMF was pilloried for sinking into pessimism when it produced growth forecasts identical to those which the ECB published a few days ago. As a result of failing to acknowledge the facts and clinging to outdated prognoses, European governments and institutions have undermined their own credibility.

But acknowledging is one thing, doing something about it is another.

Europe is confronted with an awkward situation. The cocktail of rising inflation and decreasing growth is preventing reliance on monetary policy to prop up output. The ECB can be expected to adjust its diagnosis in real time, be responsive, and correct its errors. But it cannot be put in the dock for spotting risk of persistent inflation, such as (especially in Italy) wage settlements going much beyond productivity gains or the slow drift of price expectations on financial markets. Here, the situation is clearly different from that of the US where the central bank can maintain very low interest rates as long as it sees unit labour costs decelerating.

So could recourse be made to fiscal policy, or else to European Investment Bank borrowing, as recently proposed by French economists? [1]

Fiscal support is obviously justified in Spain in order to respond to the collapse of the property market (residential construction dropped 60% in the space of one year) and the risk of spiraling into recession. What is a national problem should be tackled by a national response, and the budgetary surplus built up over several years clears the way for drastic action.

But this will not do for the euro area as a whole. Not so much as a result of the budget situation. With public debt flickering between 65-70% of GDP in recent years, aggregate public finances in the euro area are neither in a satisfactory nor in a disastrous state. But because stimulating domestic demand, even through EIB loans, would clearly be at odds with the monetary policy stance. In contrast to popular belief monetary policy does not bear directly upon inflation. An increase in the interest rate curbs domestic demand, slows employment growth and thereby acts upon prices and wages. Stimulating demand while the ECB is cutting it back would be inconsistent and indeed futile. In a clash between two demand-side policies the ECB would inevitably win because in order to counter government action it would not need to enter into any form of borrowing – it could just put interest rates up. Having two managers of aggregate demand competing for leadership in a single monetary area is a recipe for chaos.

But this is not a license for governments to fold their arms. There are several levers they can use.

First, they can ensure that credit scarcity does not endanger the most fragile businesses. This is the idea behind the current discussion about an EIB initiative to support borrowing by SMEs. The EIB already lends to banks which provide loans to SMEs and it can certainly do more and take more risks. But there should be no expectation, and especially no hint, that this move will have a perceptible macroeconomic effect.

More importantly, by acting on the supply side they can help alleviate the conflict of objectives faced by the ECB and allow it to support growth. The rise in the price of services has since January 2002 been three times higher (2.5% on average, against 0.8%) than for industry. More competition in services and distribution would not only lift the growth potential, it would also help contain price rises.

In countries where wage negotiations are centralized, governments can also promote nominal wage settlements in line with productivity and price stability. This is probably what Eurogroup president Jean-Claude Juncker had in mind when he recently declared that what was lacking was more a dialogue with the social partners than with the ECB.

Finally, governments can boost the growth potential of their economies so that they can set off again at a brisker pace. Even though attention is rightly focused on the current stalling of growth, this should not obscure the fact that, fluctuations aside, Europe's main problem remains its excessively low trend growth rate.

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[1] See Christian de Boissieu, Jean Jean-Hervé Lorenzi and Olivier Pastré, 'How to contain the financial crisis', *Le Monde,* 28 August 2008.

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