

Rougher times ahead for the euro area

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The euro area will at the end of 2008 celebrate its 10th anniversary. Throughout the year, several advance birthday parties will provide opportunities for cheerful self-congratulations. Legitimately so. The doomsayers' predictions have proved wrong and the euro is a success. Since the start, no country has abandoned the European currency or even given serious thoughts to an exit, four new members have joined, and several candidates or would-be candidates are queuing at the door.

The European policymakers should however acknowledge that so far the euro area has benefited from an exceptionally auspicious world environment. With the exception of the short 2001 slowdown, world growth has constantly been buoyant since 1999 and the decade will be remembered as an astonishingly prosperous one. Against this background, however, the euro area growth performance has been acceptable, not great, growth-enhancing reforms advanced modestly only, and fiscal consolidation has made limited progress.

The worsening of the international situation in the wake of the meltdown of the US real estate market and the resulting financial market turmoil should be regarded as wake-up calls. In spite of severe financial shocks the euro area economy has not been caught in a recessionary spiral so far, but growth is slowing down and nobody really expects it to sail through headwinds without damage. Although it does not need to replicate the very aggressive US monetary and fiscal reaction of the recent weeks, it should start thinking about what could be done if the situation were to deteriorate further.

In a recent report for Bruegel¹ by a group of economists, we have looked at the ability of the euro area policy system to cope with adverse circumstances. Our conclusion is that it is questionable for it to rely on the same type of instruments in all conditions. While we would prefer more decentralisation in normal times, because the economic benefits of coordinating policies are not strong enough to outweigh the associated political costs, there is a case for being able to adopt a more centralised approach in exceptional circumstances. A lighter touch for high-frequency interference with national decision-making would avoid the drawbacks of procedure fatigue, while a stronger hand for low-frequency EU intervention would prevent the risks of coordination failure.

What does it mean in practice? Take for example national policies as regards labour and products markets. Nowadays the EU issues guidelines for national reforms and the member states prepare annual reform programmes. There is some value in exchanging information on successful policies, comparing agendas and measuring relative outcomes. But only insiders understand the complex flow of guidelines, commitments, and assessments generated by this process. This is not where the real policy impetus comes from.

But if failure to reform leads a country to experience serious trouble, because it has lost too much competitiveness vis-à-vis its euro area partners, or if the bursting of a real estate bubble results in a banking crisis, the policy choices of that country become an issue of common concern. It may, for example, be tempted to recourse to protectionist measures or

¹ *Coming of Age : Report on the euro area*, www.bruegel.org, January 2008.

to massive state aids. In such cases or, better, to avoid them from arising, a more assertive EU intervention would therefore be justified.

Take, also, budgetary policies. Here again, there is value in ensuring through regular reporting and assessment that national policies ensure the sustainability of public finances, but governance from Brussels has shortcomings. Whereas the Stability Pact has contributed to avoiding irresponsible behaviour, it is by tackling the domestic roots of fiscal indiscipline that real progress can be made. Furthermore, the rules and institution that are conducive to responsible behaviour must be tailor-made, depending on the national political and institutional context. There would therefore be merits in decentralising fiscal discipline, starting with countries that have demonstrated an ability to contain public debt within prudent limits.

There can be circumstances, however, when joint fiscal action is called for, either in the direction of restriction or of expansion. The recent experience with credit booms illustrates that there are cases when budgetary policy should be tightened over and above what is suggested by fiscal prudence. In the other direction, the US fiscal programme is a reminder that there are circumstances when cutting interest rates amounts to pushing a string. If confronted to such developments, the euro area would find difficult to move because many countries would prefer action to be taken by their neighbours. The question for the Europeans is therefore whether in case of need, they would tomorrow have the instruments to design and implement a coordinated budgetary programme: who should take the initiative for it and how it could be implemented.

Euro area policymakers should therefore remain modest and realise that the success they are rightly proud of has been achieved in fair-weather conditions. For the euro to be a lasting success, the policy system should also be fit to more stormy conditions. It is always better to start thinking about possible responses to a storm before it actually sets off.

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