

Growth in Europe. Notes for a policy agenda

Pier Carlo Padoan*

Abstract

This paper discusses topics related to the growth mechanism in Europe, and specifically in the eurozone. It looks at the interaction of macroeconomic and structural aspects identifying issues where more analysis is needed in order to draw policy implications. It also looks at how developments in the governance of global system are affecting growth. Finally it looks at how political economy obstacles to a stronger growth environment and a structural agenda can be overcome by improving incentives to collective action.

Keywords: Growth, Europe, Eurozone

JEL Classification: E6, F320, F330

Introduction

The debate on the future of the Eurozone (EZ) has so far showed a clear pattern of priorities. Very high priority has been devoted to Banking Union and the need to complete it especially by establishing its third pillar, the deposit guarantee scheme. Increasing attention has been devoted to Capital Markets Union, and more recently to the reform of the EU budget. Some attention, but less with respect to other topics, has been devoted to issues related to progress towards “Fiscal Union”. Limited (but growing) attention has been devoted to issues related to adjustment, convergence, and stabilization mechanisms. These latter topics relate to what one could refer as “real side” macroeconomic aspects or, more generally to the features of the growth mechanism of the EZ. Time has come to give more prominence to these components of the EZ policy debate.

Growth performance in Europe has been weakening over the past decades suggesting explanations related to long term factors, in addition to cyclical components, as well as the large negative shock represented by the great financial crisis (GFC). We need to better understand the causes of such a performance in order to develop a pro growth policy agenda for Europe.

Growth can hardly be explained by single factors, rather it is the result of the interaction of macroeconomic, microeconomic, and structural dynamics and related policies (monetary, fiscal,

* Prof. Pier Carlo Padoan, School of European Political Economy, LUISS Rome E-Mail pcp19gennaio@gmail.com

financial, and structural). Defining a growth agenda requires that such interactions are carefully analyzed. It is useful to summarize some of the features of the growth mechanism specifically related to the EZ and connect them to the desirable features of the functioning of a monetary union, taking into account convergence, stabilization and adjustment mechanism.

What would such features be? In terms of convergence, it would be desirable that structural differences between countries and regions narrow down or are eliminated. In terms of stabilization it would be desirable that macroeconomic fluctuations be minimized and, finally, that adjustment of imbalances be obtained at minimum costs. More generally one would expect that the EZ be characterized by strong and sustainable growth and that both cyclical and structural factors contribute to satisfying such requirements.

In what follows I will look at the different aspects of the EZ experience with respect to stabilization, convergence and adjustment and draw some lessons for a policy research agenda that could enrich our knowledge of the functioning of the EZ from the point of view of the “real side”. I will also consider the impact of the state of global governance on growth and, finally consider the political economy aspects of building consensus for a pro growth structural reform agenda.

Some lessons from the functioning of the EZ. Adjustment and growth

Growth is sustained if imbalances are adjusted, i.e. there is no persistence and accumulation of imbalances. If imbalances persist and grow larger they eventually break out into a crisis and weaken growth. We omit dealing with global imbalances at this stage although they certainly have a bearing on EZ growth. We will return to the global dimension later.

What do we know about adjustment mechanisms within the EZ? We can distinguish three phases in the operation of the EZ since its inception. 1) The period from the beginning of the euro until the break out of the “sovereign crisis” (starting with the Greek crisis). 2) The crisis and the institutional response. 3) The post crisis period.

The initial stage has been characterized by significant interest rate convergence, suggesting that, thanks to the single currency, country risk was gradually erased. At the same time current account imbalances have widened reflecting, to a large extent, growing savings investment gaps.

This mechanism was generating destabilizing dynamics. In surplus countries imbalances it fueled capital outflows. In deficit countries capital inflows were invested largely in non tradable sectors (notably real estate), fueling structural divergence and real exchange rate appreciation (Buti and Turrini 2015). All in all in the initial stage monetary union has been characterized by real divergence. With two aspects: a growing gap between creditor and debtor countries and a related gap between core and periphery. As events showed such a mechanism was unsustainable and a crisis broke out.