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EDITORIAL

After the French and Dutch refusal of the proposed European constitution, political Europe has come to a standstill for an indefinite period. Until it can bounce back, or rather to facilitate its recovery, we are going to have to count on "economic Europe".

This report begins with an observation that is widely acknowledged: Europe's strategy for growth has not lived up to expectations, and in particular to the ambitious targets set at Lisbon in 2000. Despite the European Union's enlargement economic integration is slowing.

Europe's disappointing economic growth may be partly attributed to deficiencies in its economic policy system.

This report offers several recommendations to correct this situation. One recommendation is to accelerate the liberalization of services and financial integration to ensure that the Single Market can effectively promote growth. The resources necessary to achieve the Lisbon goals must also be provided. Reviving the use of counter-cyclical macroeconomic policy measures in Europe will require more responsive monetary policy, better governance of the Stability and Growth Pact and redeployment of public spending. Furthermore, the euro area's intervention capacity must be strengthened.

Christian de Boissieu
Executive Chairman of the CAE

Economic Policy and Growth in Europe

Report by Philippe Aghion, Elie Cohen and Jean Pisani-Ferry

Although most people would agree that Europe has been lagging the United States, they may disagree completely as to why. This report proposes a new explanation, that focuses on the inadequacy of Europe's economic policy system. The authors propose many realistic recommendations within the current institutional framework.

This report was discussed in the presence of the Prime Minister, on September 14, 2005. This Letter, released by the Permanent Committee, summarizes the authors' main conclusions.

Various explanations for Europe's growth lag

The authors begin with the widely acknowledged observation that the United States enjoys faster economic growth than the euro area and that the US also continues to maintain a higher standard of living. They review the following explanations, which are generally proposed to explain the persistence of these gaps:

- Europe's weaker economic performance is due to the Europeans' preference for leisure as opposed to work. This analysis was first proposed by Olivier Blanchard, a professor at MIT;
- According to Jean-Paul Fitoussi of the OFCE, Europe suffers from weaker demand that may be attributed to a history of restrictive macroeconomic policies;
- The dominant analysis maintains that Europe's growth lag is the result of a combination of incomplete economic integration and insufficient structural reforms among the EU member states; particularly reforms in labour, goods and services markets;
- The last explanation is that the problem is not so much with Europe, but with Germany, France and Italy. These countries, unlike the smaller and faster-growing EU members, are unable to make the necessary reforms. This is put forward by Wyplosz and Tabellini in their report to the CAE.

The authors' analysis: Europe's economic policy system is inadequate

The authors do not systematically reject the above explanations but feel that no single one is satisfactory. Although they do not, for example, neglect the responsibility of the largest countries, they point out that the European Union's smaller members have benefited the most from integration, since their economies are inherently more open. For the authors, deficiencies in the EU's economic policy system are a main cause of inefficiency and slower growth. However, the effects of this system have not been sufficiently examined and tend to be neglected.

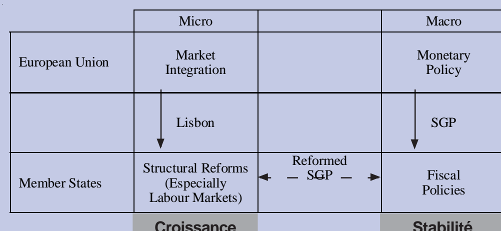
The authors begin their report by reviewing the following assump-tions that have underpinned the development of European economic policy over the years, and claim that some of these assumptions are questionable:

- The Union seeks to establish a Single Market where goods, services and capital can circulate freely, since such a market will

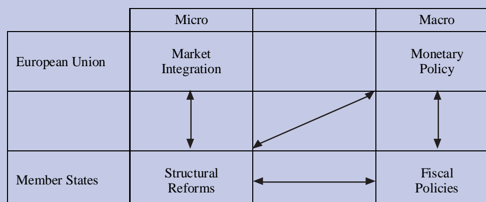
A graphical representation of policy interdependencies in Europe

Economic policies may be classified according to their level of application (micro or macro) and the corresponding level of authority (national or European). With this in mind, Europe's current economic policy system may be represented in diagram "a" below, which indicates the nature and strength of the links between the policies that result from the system's underlying model. It would be preferable to strengthen these links (as shown in diagram b) by leveraging the long-term complementarity between macroeconomic policies and growth. This would be done by coordinating fiscal policies within the euro area and by putting more emphasis on structural reforms in assessing each member state's fiscal situation.

a. Model underlying the current system



b. Proposed model



increase economic efficiency and growth;

- Except for the management of the Single Market, supply-side policies do not need to be centralized and must be handled by each country. This is the case in particular for the labour market, since labour is relatively immobile, and it is preferable to allow the individual member states to regulate this market;
- The Single Market requires a single currency;
- With monetary union, a large EU budget is not necessary. National fiscal policies must be monitored however;
- Real growth and nominal stability are not contradictory but complementary. Macroeconomic policy's only function is to maintain sound economic conditions;
- Cyclical fluctuations have no effect on medium-term growth, which thus depends solely on the smooth operation of markets. In other words, macroeconomic policies and structural policies may be conducted independently. This is the theory of "separability".

In 2000, the "Lisbon Strategy" –which seeks to make the European Union the world's most competitive economic region by 2010– became a part of this economic policy system. This strategy aims to achieve economic objectives (related to employment, R&D and growth) and social objectives (reducing poverty), while ensuring sustainable development. It encourages the member states to conduct the necessary reforms through the "open method of coordination" based on peer pressure and the monitoring of specific indicators. The capacity of the EU members to implement supply-side policies is not challenged, since the Lisbon Strategy provides guidelines and applies pressure but does not decide. This strategy – which policymakers agree has failed after five years – was revised in 2005 and its ambitious targets lowered.

A still-fragmented Single Market

The Single Market's utility is not disputed. It promotes economic efficiency and growth and must be further developed. However, European integration is not as advanced as generally thought.

For example, no sudden burst in the trade of goods and services has been observed since the Single Act entered effect in 1993, nor since the euro was introduced in 1999, as was seen after the NAFTA agreement was signed in 1989. The price convergence that EU monetary union was supposed to bring also did not occur, and convergence even came to a standstill in 1999. Within the United States trade still exceeds trade in Europe's most integrated markets by a factor of two to three, and price uniformity is much greater. Results are particularly disappointing in those industries where integration would be most effective. The liberalization of the telecommunications and energy industries began outside of Europe in an uncoordinated manner and has not resulted in the formation of a true European market in these sectors. The Financial Services Action Plan has failed to create a deep, liquid and integrated financial services market, such as in the United States. A European patent has still not been established, due to language problems. There is no unified body of European business law, as the EU countries continue to allow their national legal systems to play a dominant role, nor does Europe have unified bankruptcy legislation.

The authors believe that these problems may largely be attributed to the EU's institutional shortcomings. Europe has not been able to go beyond the first phase of the Single European Act (i.e. removing regulatory barriers to trade in goods) by focusing on those industries where the benefits of integration are most tangible, while Europe's leaders have limited political capital and there are still considerable differences in economic development and preferences between the EU member states.

The neglected power of counter-cyclical policies

The authors take an in-depth look at the effect of macroeconomic policy measures and how they may be used in conjunction with structural policies. After a quantitative study involving national statistics they come to two basic conclusions.

First of all, they maintain that counter-cyclical fiscal policies, which serve to reduce the amplitude of economic cycles, have a positive effect on long-term growth. In other words, fluctuations of output above and below the trend level are harmful to the economy, and policies that dampen these fluctuations also tend to raise the trend. One school of thought claims the opposite, arguing that recessions are good since they eliminate inefficient companies thus leaving only the best. However, the authors feel there is another seemingly more powerful effect that should be taken into consideration, i.e. that recessions are bad since they reduce external sources of funding for firms and therefore their capacity to innovate. This brings the authors to their second point: the less financially developed an economy is, the greater the negative impact a recession will have on the development of firms, and the more counter-cyclical policies will be effective.

The effectiveness of counter-cyclical policies also appears to be more important when goods and services markets have been liberalized. Although the study data do not support this idea as conclusively, it seems quite logical since in liberalized markets capital and labour can be reallocated more easily from short-term activities to long-term growth-generating activities.

When it comes to counter-cyclical policies, Europe is at a disadvantage in every way compared to the United States. Over the long-term, Europe's macroeconomic policies tend to be less counter-cyclical, even though the opposite would be justified by its less developed financial markets. And when Europe does use counter-cyclical

measures they are less effective since its markets are more rigid, i.e. less "liberalized".

The neglected power of accompanying measures to facilitate reform

The authors are convinced that the EU countries must undertake reforms to grow faster. The question therefore is not whether reforms are necessary but rather why there are still obstacles to reform.

European governments are confronted with two types of difficulties. The first is that the reforms are opposed by those who have something to lose and are often successful in reducing their scope and impact. The second has to do with the very nature of the reforms, whose initial impact on growth and employment will be negative and may require a few years to produce any benefits. This also explains why governments have little incentive to undertake reforms.

Expansionary macroeconomic policy measures that would either compensate those who will lose from reforms or reduce their near-term impact would make reforms more acceptable politically and easier for governments to implement. Only a few European countries, such as Sweden in the mid-1990s, have used such a strategy to undertake reforms, and with much success.

Europe's framework for macroeconomic policy however makes it very difficult to implement such a strategy. National fiscal policies are constrained by the Stability and Growth Pact and the 3% deficit rule, while European monetary policy focuses mainly on controlling inflation. As for structural policy measures, they are isolated from monetary and fiscal policy. The authors challenge two of the aforementioned assumptions: that macroeconomic measures alone should be used to preserve sound economic conditions; and the assumption of "separability". We will see that this framework has recently been improved, but that more progress is necessary.

Working within the current institutional framework

Economic integration has stagnated and no longer promotes growth. The euro's creation has not produced the knock-on benefits expected. The increase in trade has been relatively modest and financial and credit markets remain segmented. The single currency even seems to have had a "numbing" effect on the EU members, which no longer need to protect against a foreign-exchange crisis and have become complacent in their efforts to control spending and make structural reforms. Moreover, the euro area's macroeconomic framework has become obsolete. Furthermore, the Lisbon strategy has become bogged down in procedures and has degenerated into rhetoric. This is because it does not have the means to achieve its objectives, since EU members remain responsible for supply-side policies and the political economy of reform is still mostly national.

The authors make several recommendations to correct this situation. They do not however recommend changing the current institutional framework since they feel that attempting institutional changes would be costly and not very realistic, and that much progress may be made without modifying treaties. This does not mean that responsibilities should not be clarified.

Redefining the priorities of economic integration

The authors propose that integration efforts first of all be refocused in those areas most likely to promote growth and where potential benefits have been clearly identified, and notably when market size is a key factor and increasing returns may be obtained. Further development of the Single Market is indeed indispensable, for several reasons: it will promote the division of labour within the Union; enhance the euro area's effectiveness; facilitate the building of political Europe; and enable new EU members to catch up faster. Progress must therefore be made in the transportation, energy and telecommunications industries, by developing connection infrastructures and replacing national regulators with a pan-European regulatory authority. This is necessary to ensure the smooth flow of trade and achieve the benefits of competition. Financial integration must also be completed, since this enhances market liquidity, diversifies risks, increases the impact of monetary stimulus and reduces the amplitude of economic cycles, as the authors' study shows. Competition between national regulatory authorities is currently an obstacle to this integration. The indispensable opening up of services markets should be more strategic and focus on those sectors where a unified market will indisputably increase efficiency, such as business services. It must also be ensured that the host country's laws apply when employees work abroad. The Bolkenstein directive fails to meet both of these requirements. Sectoral directives seem to be more appropriate. Finally, the admission into the European Union of less-developed and lower-wage countries may result in painful restructuring in some industries that justifies direct EC budget aid to help those affected.

Keeping reforms decentralized, except for R&D

Most structural reforms should be left up to the EU members. Given the broad diversity between national labour markets and social protection schemes, policy measures must generally be decentralized to be effective. Although this is already the case, the EU's intervention creates an illusion of European political responsibility that has resulted in more disappointment than progress. However, centralized structural policies are justified where positive externalities have been identified. This is the case for R&D, which makes the creation of a European "area" for research and higher education indispensable. The recent establishment of the European Research Council, whose role is to allocate funding to research projects on the basis of their scientific quality, is a step in the right direction. However, the EU budget should also be used to promote the creation of 10 or so universities offering world-class postgraduate education. European funding would be allocated on the basis of merit and excellence. The EU budget in general should allocate far more resources to research and be more incentive oriented, which is far from the case today, with most of the budget still going to the CAP.

Improving the framework for macroeconomic policy

This would serve two purposes. First of all, it would enable more rapid monetary and fiscal response to symmetric and asymmetric shocks respectively. Secondly, more support could be provided to structural policies.

The European Central Bank has taken a step in the right direction by adopting a more flexible interpretation of its 2% inflation target, which now has a medium-term horizon. This enables the ECB to allow for economic policy measures intended to raise growth potential. Nevertheless, the margin above and below 2% should be broadened symmetrically, since monetary policy could thus more rapidly respond to changes in the economy. Furthermore, European Central Bank governance should be modified to reduce the impact of national interests on economic policy. The creation of a relatively small Monetary Policy committee would be preferable.

Advances in fiscal policy have also been observed. The reform of the Stability Growth Pact in March 2004 acknowledges the necessity of avoiding pro-cyclical policies at the top of an economic cycle, allows more flexibility during economic downturns and takes into account the effect of reforms. However, the 3% requirement is still essential. The sustainability objective is still not very clear. With respect to this, monitoring

public debt over the entire economic cycle and the implicit commitments of the member states (regarding pensions, for example), would seem more appropriate than just a deficit criterion.

Several things could be done to facilitate macroeconomic policy measures that would support reforms, particularly within the euro area, where interdependencies are greatest. Simultaneous implemetation of supply-side policies would enable the European Central Bank to take action, since it is well aware of the positive effects that such measures could have. Fiscal negotiations between national authorities and the European Commission could moreover also include a discussion of reforms, subject to a specific program and timetable.

The authors also propose the creation of a Euro Area Council, with decision-making power. This Council would replace the current system of fixed rules with a system of "constrained discretion" based on expert analysis and a common doctrine that aims to preserve fiscal discipline over the medium-term while also increasing the role of economic cycle management and accompanying measures for reforms. Furthermore, the European Council's euro-area members could meet once a year to stimulate political action.

Some comments

Béatrice Majnoni d'Intignano points out that Europe's economic sluggishness may be explained by the weakness of the euro area's three largest countries, since most of the smaller countries are growing faster than the United States. She also thinks that the European budget should be increased substantially to give the EU the resources it needs to implement supply-side policies, an idea that was not mentioned in the report.

Philippe Herzog agrees with the authors that the European econo-mic policy system is inadequate, but would like to make a few critical observations. To begin with, there must be a political agenda to stimulate economic activity, and which deals with the issue of responsibilities. The relationship between economic and social concerns must be dealt with at the European level. Although the Single Market remains an essential objective, additional measures in the areas of industrial policy and public services policy are necessary.

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