Columnists

Free Lunch: Easy steps to improve Europe's economies

Don't let Brexit distract the EU from the low-hanging economic policy fruit

Martin Sandbu's Free Lunch

SEPTEMBER 26, 2016 1:31 PM
by: **Martin Sandbu**

Brexit and how to carry it out may be the biggest question mark hanging over Europe. But the idea that the eurozone needs reform has not gone away and is receiving renewed attention.

A new report (http://www.institutdelors.eu/media/repair-and-prepare-growth-and-the-euro-after-brexit.pdf?ftcamp=crm/email//nbe/BrusselsBrief/product&pdf=ok) addressing this, from the Delors Institute and the Bertelsmann Foundation, is short in length but rich in content. While it pays homage to the vision of a fiscal union of sorts, it relegates that to a time when the politics is ready for it. In the short run it instead concentrates on two other packages of solutions: a "quick fix" first-aid kit for the euro to be prepared for a renewed balance-of-payment crisis and market panic, and a series of sensible policies to stimulate growth. The latter — a veritable toolbox of pro-growth policies — is by far the most original and convincing part of the proposal.

It's worth reading the whole list of policy ideas carefully, but in summary they involve much greater public and private investment; a smarter prioritisation of structural reforms — in particular, focusing on product market reforms when times are bad, since these help stimulate the economy, and postpone labour market liberalisation until times of stronger growth; use macroeconomic policy more flexibly to encourage and reward reform efforts; and a renewed effort to make the single market work better for cross-border economic transactions.

This dovetails with recent oblique or direct criticism of European economic policy elsewhere. The International Monetary Fund, in particular, has recently argued strongly (http://next.ft.com/content/40cd5912-0166-11e6-ac98-3c15a1aa2e62) for supplementing structural reforms with fiscal stimulus, in particular through investment, and for sequencing reforms according to whether they stimulate or hamper economic activity in the short run. The importance of allowing government budgets to support the economy while reforms are undertaken should be read alongside research by the Institute for New Economic Thinking, which shows (https://www.ineteconomics.org/ideas-papers/blog/how-economic-policy-drives-european-disintegration) how the European Commission interprets the budget rules in the Stability and Growth Pact in a way that defeats the purpose both of the pact and of the euro itself: it encourages macroeconomic policies that destabilise and accentuate the economic cycle, and lead to widening rather than narrowing economic differences between single currency members.

Striking, and useful, is that the report seems comfortable with an intergovernmental approach, something that would once have counted as heretical among the most ardent supporters of the European project. These authors understand that grand politics must also be pragmatic: the priority is to find solutions that make the economy work better for Europe's citizens. But this implies that their proposals are not particularly confined to the euro. They are ideas that can be adopted by the EU as a whole — indeed the report can be read as a welcome call for the commission to make much more use of the power it has to interpret the fiscal rules constructively and push for more stimulative policies at the national level. Conversely, many of the ideas could be adopted today by any national government that wants to improve its people's lot, alone or with one or more like-minded countries, without waiting for action at the EU level. This echoes a previous report (https://www.hertie-school.org/mediaandevents/press/press-releases/press-releases-detail/article/enderlein-and-pisani-ferry-submit-report-on-reforms-investment-and-growth-to-ministers-gabriel-und/News/detail/) which one of the lead authors, Henrik Enderlein, co-wrote with Jean Pisani-Ferry, on how France and Germany could bilaterally create "borderless economic sectors".

What about the first-aid kit, which (like the long-term vision) aims to "fix" the single currency, as opposed to economic growth in the economies that use it? The group's proposal is to reinforce the European Stability Mechanism — the euro's rescue mechanism for sovereigns — by setting aside €200bn in a rapid-response fund that would be easier to deploy. That has the merit of not requiring a change in the EU Treaties, just in the ESM Treaty itself.

But the solution is premised on a certain view of the problem, which is the fear that a new financial crisis could ravage the eurozone the way it did in 2010-12, and that government bailouts will again be required if investors withdraw capital from weak countries. But that view ignores the alternatives that can be, and have been, pursued to make sudden stops of capital less likely and easier to handle.

The large and politically toxic bailouts of 2010-12 were the consequence of a choice not to restructure sovereign and banking debt. As experience has shown (http://next.ft.com/content/9ef2a034-458b-11e5-af2f-4d6e0e5eda22), writing down debt is both possible and can drastically reduce the size of government-to-government aid needed. And reforms since the crisis have made it easier to restructure both sovereign and bank debt than it used to be (and more are being proposed, for example, by the German council of economic experts (http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_04_2016.pdf)).

And more can be done to reduce the risks of renewed capital flight in the first place. One is an idea that is currently being publicly discussed (https://www.esrb.europa.eu/news/schedule/2016/html/20160922_annual_conference.en.ht at the European Central Bank: to create new financial securities that combine different governments' bonds, but without creating any "joint liability" by which one country's taxpayers are on the hook for others' failure to honour their debts.

The proposed solution (summarised (http://voxeu.org/article/esbies-safety-tranches) in a VoxEU blog post, and described in greater detail in a working paper (https://www.esrb.europa.eu/pub/pdf/wp/esrbwp21.en.pdf?78c259326d82ec15a0918ffd5a094373)) goes by the name of ESBies, or European Safe Bonds. The basic idea is to package the bonds of many governments, then slice the package into safer and riskier parts (called European Junior Bonds or "EJBies"). The riskier EJBies would bear the brunt of any default by an underlying bond, thereby protecting the safer slice. These ESBies are not the "eurobonds" that advocates of fiscal union want, but financial engineering to create a larger pool of low-risk investments for banks and others, without making any government pay for the profligacy of others. It would in other words be entirely legal.

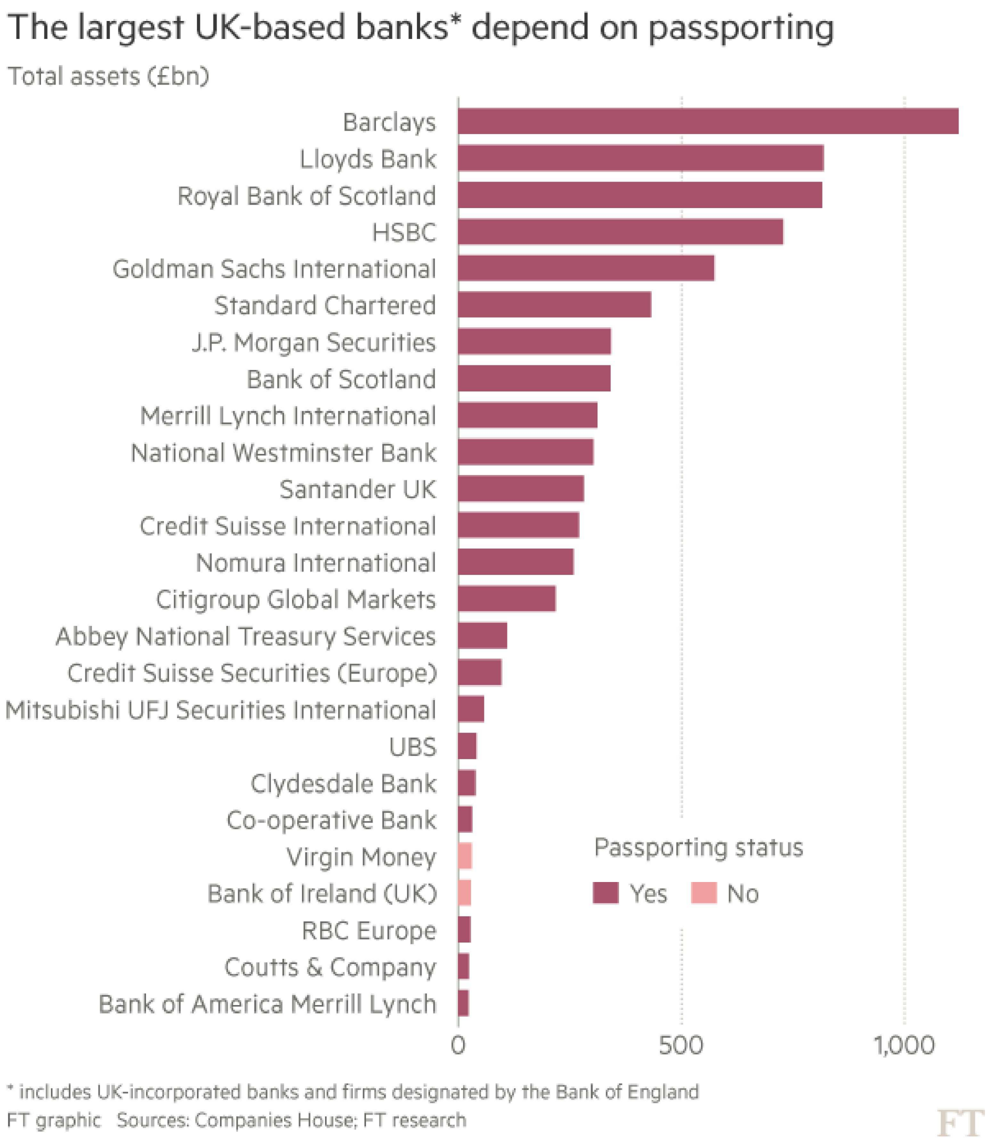
The benefits would be extensive. It would create a large pool of securities from which investors would find it both difficult and unnecessary to flee. Under certain conditions, the economists behind the proposal show they would be safer than German bonds today. Second, it would make it more straightforward for the European Central Bank to do asset purchases when required for monetary policy, as there would be no political or logistical difficulty in finding assets to buy. Third, by encouraging banks to hold ESBies, one could reduce their vulnerability to wobbly public finances. And finally, all of these things would make it easier to restructure the debts of a government that had overborrowed.

Other readables

- Ryan Avent addresses (https://www.theguardian.com/commentisfree/2016/sep/19/world-without-work-utopia-hell-human-labour-obsolete) what the robot revolution will to do work — and nails an important point: "Tellingly, workers and trade unions seem least interested in the policies, such as a basic income, that break the link between compensation and work. This makes the building of our eventual utopia tricky".

Numbers news

- Banks that use the UK as a gateway to the EU employ more than 590,000 people, have more than £7.5tn of assets and make annual profits of more than £50bn, according to Companies House data analysed (http://next.ft.com/content/d220e826-7b54-11e6-b837-eb4b4333ee43) by the FT.



To receive Martin Sandbu's Free Lunch (http://www.ft.com/martin-sandbu-free-lunch) by email every workday, sign up here (http://nbe.ft.com/nbe/profile.cfm).

Latest in Columnists

See all

Gideon Rachman

We are all Stalinists on Syria

Western politicians must try to frame policy that takes account of oscillations in public sentiment

NEW 42 MINUTES AGO

Andrew Hill

Companies court disaster with the wrong sales goals

Wolfgang Münchau

Scare stories will not stop populist insurrections

Targets are powerful incentives for staff so beware unrealistic objectives

Unpredictable electorates will no longer be cowed

Latest from Martin Sandbu's Free Lunch

See all

Martin Sandbu's Free Lunch

Free Lunch: Fed must commit to virtue of patience

The right arguments are winning. The right actions must follow

Martin Sandbu's Free Lunch

Free Lunch: How to help the left-behind

More domestic policy, not less globalisation

Martin Sandbu's Free Lunch

Free Lunch: Bank of Japan shows the toolbox remains full

Central banks must find the will to use their power