Only teamwork can put the eurozone on a steady course
>By Jean Pisani-Ferry
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European policymakers returning to work after the summer recess are not being greeted with good news. In the post-referendum debate in June, the idea that emerged was that voters in France and the Netherlands had primarily expressed dissatisfaction with Europe's economic performance and that growth was needed to restore the European Union's legitimacy. Yet recently released statistics show that even before the recent hike in oil prices, growth in the EU as well as the eurozone barely exceeded 1 per cent.

Neither monetary nor fiscal policy can be expected to redress the situation. The eurozone's aggregate budget deficit is approaching 3 per cent and the European Central Bank is now wary of the potential second-round effects on inflation of the increase in oil prices. The consensus is therefore that, more than ever, growth can only be expected from structural reforms.

There is, however, wide agreement that the Lisbon strategy adopted five years ago has not delivered the expected boost to reforms. Indicators confirm that economic reform in Europe has neither accelerated nor become more co-ordinated since 2000. In fact, Romain Duval and JÃ□Â¸rgen Elmeskov of the Organisation of Economic Co-operation and Development find in a recent paper that reform has slowed in the 2000s, especially in the eurozone.

The revamped Lisbon strategy adopted this spring by the European Council to co-ordinate reforms is unlikely to deliver more. The set of objectives has been narrowed and the procedures streamlined but the strategy continues to lack incentives. If anything, the Commission's new reluctance to "name and shame" the laggards has removed one of the few incentives that there were. EU member states may decide to reform on their own but the EU framework hardly matters. After all, the Agenda 2010 of Gerhard Schröder, German chancellor, did not even refer to the EU strategy.

Does it matter? The answer differs for the EU as a whole and for the eurozone. Let us consider the case of countries within the EU. Assume, for example, that country A undertakes reforms that lower structural unemployment and increase productivity, while another, B, does nothing. Reform in country A affects country B through trade channels but without diminishing the gains to country A. A permanent lowering in unemployment or a rise in productivity are benefits in their own right, whatever the consequences for your neighbours. Country B could also be affected as voters observe the effect of reform across the border and make decisions accordingly. To risk being followed by neighbours, however, does not reduce the incentive to reform. The upshot is that the rationale for co-ordinating reform policies within the EU is weak. There is nothing wrong in fostering policy learning with the publication of comparative indicators and league tables, but there is not much to be expected from it.

What about the eurozone? Let us again suppose that A reforms and B does not. Lower structural unemployment and higher productivity translate into lower inflation - at least temporarily - in country A, thereby lowering the average eurozone inflation rate. As the ECB targets inflation, this in turn translates into lower interest rates. Country B's macroeconomic policy environment is thus modified by its neighbour's policy. But average inflation and interest rates remain higher than if both countries had reformed or if country A had had monetary policy autonomy. For B's government, there is a windfall. For A's government, some of the benefits of reform are lost.

The difference with the EU case comes from the fact that eurozone countries share an interest rate that is set by the ECB with respect to the average inflation rate. This creates an interdependence that extends beyond the usual realm of monetary and fiscal policies and affects structural policies too. This interdependence matters especially for measures that are costly in the short run, because a lower interest rate can help to offset their adverse effects and improve their overall balance. This is the case for many reforms. Labour market reforms may increase unemployment before they lower it if they create anxiety and lead firms to shed labour faster than they create new jobs. Product market reforms may also depress growth because incumbents react immediately to the loss of rents while entry only develops over time. This is why reform is easier when accompanied by monetary expansion (to offset the negative effects of reform on aggregate demand) and fiscal stimulus (which also helps to compensate the losers). This kind of strategy can be followed outside the eurozone, not within it - unless reforms are co-ordinated.

The conclusion is twofold. First, the case for co-ordinating reform policies is weak for the EU as a whole but stronger for the eurozone. Second, reform in the eurozone would benefit from being able to rely on macroeconomic support.

The EU started taking these requirements into account in last spring's reform of the stability and growth pact. It is now accepted that growth-enhancing reforms can be a motive for temporarily deviating from the "close to balance" target the member states are committed to, or for delaying the convergence towards it. Although this Ã□Âprovision does not give much additional margin of manoeuvre to the big-deficit countries, it is a step in the right direction.

More is required. First, the institutional framework needs to be adapted. The eurozone finance ministers who meet in the eurogroup do not set the reform agenda. The heads of government who are in charge of that agenda never meet in eurozone format. Neither do the labour or economy ministers. A eurozone meeting of the heads of government would remind them of their responsibility for the sustainability of the currency area that they have created, and would allow them to discuss their reform agendas and confront the effects of their interdependence.

The other change concerns the ECB. The central bank is long on exhortations but short on commitments. It should explicitly state that, without prejudice to price stability, it will back reforms that lower structural unemployment or put the eurozone on a higher growth path. ECB officials have already acknowledged the complementarities between monetary policy and structural reforms and have hinted at the additional room for manoeuvre that the latter would create for monetary policy. The ECB should go further and unequivocally recognise that, provided that governments act, monetary policy would be able to support their action. Such a promise would involve a risk. The question, however, is whether it is preferable to take the alternative risk of remaining in a deadlock that would ultimately undermine the very sustainability of the monetary union.

The writer is director of Bruegel, a Ã□ÂBrussels-based think-tank
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