

ENDING EUROPE'S ECONOMIC UNDERPERFORMANCE

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In recent decades, economic performance in Europe has been disappointing, with particularly pronounced weakness in the core European nations—Germany, Italy, and France. Estimates of potential growth in Europe have been revised down significantly. In the 1980s, average annualized economic growth in the EU15 was 2.5 percent, nearly 1 percentage point lower than in the United States, and in the 1990s—as European nations converged toward the Maastricht Treaty's criteria and entered into the European Union—the gap widened: Europe's 2.2 percent growth was 1.4 percentage points behind the United States. Since the European Monetary Union was established, eurozone growth has averaged 1.9 percent annualized (1.6 percent in core Europe), while growth in the United States has averaged 2.6 percent. Europe's persistent growth shortfall has been reflected in very high unemployment rates. It does not appear that the establishment of the EMU and the euro have had a significant effect on overall economic performance. In 1998, I stated that the EMU would not resolve Europe's economic problems, only reveal them, and that assessment still seems valid.

Misguided Fiscal and Regulatory Policies

The economic underperformance in Europe has been a direct result of misguided fiscal and regulatory policies. The European Central Bank is frequently blamed for Europe's slow growth but in fact it has consistently and successfully pursued its monetary policy mandate of maintaining low inflation. Excessive government spending, burdensome taxes and regulations in European nations misallocate resources, raise the costs of production, inhibit labor supply and distort

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labor mobility, and dull entrepreneurship and risk taking (Nicoletti and Scarpetta 2003). The startling gap between employers' costs of employment and workers' take-home pay in most European nations highlights the problem (Heitger 2000). Low potential growth, particularly in core European nations, points to constrained increases in future standards of living. Improving economic performance in the EU requires the smooth functioning of the EMU and the euro, but it hinges critically on whether the EU establishes an environment conducive to fiscal, regulatory, and labor market reforms that improve efficiencies and lift growth (OECD 2003). In the last decade, initiatives have selectively deregulated labor, goods, and capital markets, creating positive efficiencies. However, fiscal policy reform has lagged behind.

Fiscal policy reform in Europe is constrained and distorted by the Stability and Growth Pact, specifically its requirement that limits deficits to 3 percent of GDP. By limiting countercyclical fiscal policy and tax reform, the SGP does not enhance stability or encourage growth. Nor does it set the best standard for new EU entrants. It has led to budget gimmickry (earlier asset sales to reduce deficits) and heightened diplomatic discord. It has led key EU nations to explicitly violate the law. It has not materially reduced government spending and has constrained recent efforts to cut taxes. At the same time, it has failed to materially reduce the debt burdens of high-debt nations.

Such heavy reliance on cash flow budget deficits as a guideline for conducting fiscal policy—and coordinating fiscal policy across nations—is misguided. Established as part of the Maastricht Treaty in 1992, the deficit limitation clearly contributed to lower deficits among EU member nations. But the deficit/GDP ratio is an inadequate and potentially misleading representation of fiscal responsibility. It does not reflect the level of government spending or taxes, and it provides limited understanding of how the government allocates national resources. In Europe, it has not fostered a successful coordinated effort toward reduced spending or reduced taxes, and it has not contributed materially toward reduced indebtedness of high-debt nations. Continuing to rely on a deficit guideline for fiscal policy is allowing the tail to wag the dog. Arguing that support of the SGP is necessary to maintain credibility is misguided: adhering to a bad law creates a false sense of credibility.

Pension Reform

Pension reform is a necessary ingredient for fiscal reform. Similar to virtually every industrialized nation, the unfunded liabilities of the

public pensions in European nations loom large, but compared with the United States, Europe's distinctly unfavorable demographics bring a sense of urgency to pension reform. In core European nations, the ratio of retirees to workers is already high, and it is projected to skyrocket. Europe's aging population and early retirement age with full benefits drive up the number of dependents. The labor force, which is already growing slowly, will be suppressed further in the long run by adverse demographics: population growth is very anemic, reflecting the combination of low birth rates and imposed limitations on immigration (Eurostat 2002). In order to provide sufficient time for older workers to readjust plans for retirement, legislated changes in the legal age of retirement and pension reform in general must be implemented gradually over a long period of time. Pension reform cannot be delayed.

Reforming the Stability and Growth Pact

The SGP should be modified to focus on government spending and taxes as well as budget deficits. Remember, high government spending and high tax burdens each have been found to be negatively correlated with economic growth and employment, whereas the empirical linkage between budget deficits and growth is ambiguous, depending on a host of issues. As long as the SGP is going to involve quantitative budget guidelines, two new criteria should be added: limits on the ratios of government spending to GDP and taxes to GDP. These limits should be well below current levels, and phased in over an extended period, similar to the implementation of the budget, inflation, and interest rate criteria established by the Maastricht Treaty. Accompanying these two additions, by formula, the deficit/GDP limitation would be temporarily relaxed if tax cuts precede spending cuts. These modifications would be no more arbitrary than the existing 3 percent of GDP deficit limitation and would refocus the SGP on the largest fiscal issues facing Europe—excessive government spending and taxes—and provide a more comprehensive measure for achieving fiscal responsibility. In doing so, it would provide a more constructive, pro-growth fiscal framework, and reestablish the SGP's credibility. In practice, insofar as spending cuts, particularly pension reform, take longer to implement than tax cuts, this modification to the SGP would provide the legal flexibility to cut taxes immediately.

The ECB's Adherence to Price Stability

The ECB's pursuit of its low inflation mandate and its policy to allow the euro to float and avoid intervention is the most appropriate

monetary policy framework for enhancing economic performance in the EU. Since its inception, the euro has gone from \$1.17 to \$0.84 and now hovers near its inception level. It is very difficult and unproductive trying to predict the foreign exchange value of the euro, particularly short-term movements. The euro benefits from the ECB's sound, low inflation targeting and the credibility it has generated, and it would benefit from fiscal reforms that lift economic growth and raise expected rates of return on euro-denominated assets.

Conclusion

Whereas the flexibility of the U.S. economic and financial systems provides that a material change in exchange rates has little impact on aggregate economic growth, the rigidities in core European nations dictate that a significant change in the value of the euro may materially affect aggregate European economic growth. With Europe's domestic demand constrained, growth relies heavily on exports. The recent significant appreciation of the euro may dampen European growth by suppressing exports while not commensurately enhancing domestic demand and imports. This highlights the need for pro-growth reforms that reduce existing rigidities and permanently raise potential domestic growth.

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