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Growth in Europe. Notes for a Policy Agenda

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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.

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I. 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.

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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, 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 pro growth structural reform agenda.

II. 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.

The crisis enacted a broad policy response based on major institutional changes. The crisis also highlighted the lack of appropriate instruments for crisis management as well as the need for a brand new institutional architecture to complement monetary union with a banking union and a capital markets union. This process is still in the making and, as mentioned, occupies the center stage in policy action and policy discussion. The crisis sparked a broad policy debate over the mechanisms required for a well-functioning EZ. The debate has concentrated on the bank/sovereign nexus as a major source of fragility that needed to be addressed. Banking union was launched. The ESM was launched. Capital markets union, on the contrary has lagged behind, also as a consequence of the Brexit saga.

As the EZ slowly (and painfully) exited the crisis a new pattern of adjustment, convergence and stabilization emerged. Interest rate convergence was replaced by divergence as markets began to price country risk. Current account adjustment remained asymmetric with pressure concentrated on deficit countries. This aspect highlighted that, in a monetary union, adjustment of current accounts requires changes in competitiveness (real exchange rates) which in turn requires lower inflation in deficit countries, and higher inflation in surplus countries. Clearly a pattern not confirmed by facts. At the same time, in high debt countries the need to adjust current account deficits may conflict with the need of higher nominal growth to maintain debt on a declining path. The more so if the country displays a positive difference between the interest rate and the (nominal) growth rate. A condition which, other things equal, can be sustainable only if the country runs an offsetting primary surplus.

A first conclusion is that, at least initially, the internal adjustment mechanism in the EZ was in very limited way supportive of growth. However, as the initial stage of the euro has shown, current account imbalances also reflect structural factors and therefore adjustment also requires structural change.

III. Competitiveness, Growth and Debt Reduction

Could growth be supported by improving the imbalances adjustment mechanism? Is there a trade off between debt reduction, growth and current account adjustment? More specifically, if debt reduction requires more inflation how can external adjustment be obtained in high debt countries? Irrespective of inflation, debt should be put on downward path to reduce risk and support convergence. In other words growth must contribute to fiscal sustainability. However high growth, both real and nominal, may lead to a worsening external imbalance if pushed by internal demand only, which can be unsustainable for the country (less so for monetary union as a whole), so the issue of external adjustment needs to be addressed. A second conclusion therefore is that, for sustainable growth a current account adjustment mechanism is needed, and this includes real exchange rates adjustment. More specifically wages should reflect productivity. Such an adjustment mechanism may be unavailable, however, reflecting rigidities.

This leads us to a broader issue. It is a fact that, in the EZ and elsewhere, labor market dynamics has become increasingly blurred, for instance as wages hardly reflect labor demand pressure. How could wage adjustment be improved? Could more wage coordination better address imbalances? Do we need more wage centralization or decentralization, possibly better reflecting productivity? A third conclusion is that these questions should be evaluated taking into account that, lacking wage adjustment, imbalances will be more persistent and fiscal response more deflationary with further implications for growth.

IV. Cyclical and Structural Factors

Current account adjustment depends on other factors in addition to real exchange rate changes. To improve effectiveness and avoid hard growth-competitiveness trade offs, fiscal policies should be better designed. (including output gap measurement issues). Country specific recommendations should provide overall consistency among actions and targets within the MIP (macroeconomic imbalances procedure) that should be based on more symmetry. The question remains of where does pressure to increase symmetry come from. As market pressure on surplus countries is hardly effective more pressure should come from policy surveillance.

Symmetry involves other dimensions as well. Persistent saving/investment imbalances, to the extent that they reflect structural factors, require structural reforms to boost investment in surplus countries and wage flexibility in deficit countries. Both actions would support growth. A fourth conclusion is that more symmetry is good for growth. This, in turn, requires looking more in depth at how structural reform (SR) impact on the economy and help symmetry. Several points can be made.

First, for a given set of structural measures the cyclical stance impacts on SR effectiveness (*Boone*/*Buti* 2019). Evidence shows that such an impact is stronger in an upswing. At least for two reasons. As the cycle gains strength the propensity to invest is stronger and investment is the vehicle through which reforms impact the economy (Think of e.g, new capital spending taking place as a consequence of a more favorable business environment, or a more innovation intensive capital reflecting better innovation incentives or more effective human capital formation). A fifth conclusion is that there is a complementarity between the structural, the microeconomic and the macro dimensions in the adjustment process.

Second, the Structural Reform cycle may be very long. By this I refer to the sequence of steps that are needed to fully implement a reform measure. The cycle evolves from the moment in which new legislation is introduced and approved by Parliament, to be followed by the adoption of administrative measures, their actual implementation, and possible revision. And the "final stage" which involves the impact on behavior (of firms and households) reflecting the change in incentives which the reform (should) produce. Finally one should not forget the perception (by firms and households) that the reforms have improved individual welfare. Possibly (but not necessarily) such a perception may lead to an increase in approval and political support to the Government that is recognized as responsible for the improvement.

Evidence shows that the duration of the reform cycle may differ significantly across the reform portfolio and across countries. For instance, education reforms are usually credited with the largest impact on long term growth but they also carry the longest implementation cycles. Other reforms such as product market liberalization require shorter cycles and may produce an impact on behavior also through expectations if the announcement of their introduction is credible enough.

But, also due to the duration of the reform cycle, introducing reforms may not be rewarding for incumbents as eventual benefits of reforms may be recognized too late (with respect to a possible vote in favour of the reforming Government). This is a particular severe problem given that the costs of reforms are usually concentrated on limited segments of the population while benefits are delayed and distributed over larger population groups. This opens the opportunity to introduce instruments to provide compensation measures for those segments of the population that are negatively impacted by the reform process.

Conclusion six, while structural reforms are essential to support growth the incentive to introduce them may be too weak to spark reform action. This is reverberated on persistent imbalances and lower growth.

V. Longer Term Factors

As we move towards the longer term issues structural aspects gain even more prominence. Disentangling these aspects may be to some extent arbitrary but nonetheless necessary to identify issues and policy responses.

A first long term element is related to geography aspects i.e. the impact of factors that lead to agglomeration phenomena and, through agglomeration, they impact on growth and imbalances. A number of issues must be considered. First it is not obvious if geography produces structural convergence or divergence and under which conditions the former prevails on the latter. Second, geography impacts on regions, cities, local communities and companies (as companies can relocate, regions and cities can lag or lead, communities can decline or prosper). Third, evidence shows that aggregate growth is lower in economies where the distance between frontier and laggard regions, companies is higher, i.e. growth is higher when convergence is stronger.

Conclusion seven, geography matters for growth in a number of, not always self evident, ways. Policy implications follow. Europe needs both a policy at the national and a policy at the European level to close the gap between frontier and laggard regions and companies. In particular there is a need to improve the diffusion of new technologies from frontier to periphery so that productivity can be enhanced. This implies a major effort in productivity augmenting structural reforms.

A second longer term/structural element relates to secular stagnation. Symptoms of secular stagnation in Europe include the persistent decline in productivity growth, the associated decline in profitability, and the, implicit, decline in the natural rate of interest. Evidence also shows a structural shift in the long term growth rate with respect to the growth trend which would have prevailed in the absence of the financial crisis. This latter aspect is particularly evident in periphery countries, suggesting a link with geography dynamics discussed above.

The relevance of the theme is related to the underlying causes of secular stagnation. Much of the debate on secular stagnation has concentrated on a dilemma: is secular stagnation a demand or a supply phenomenon? Conclusion eight is that both demand (investment) and supply (productivity factors) play a role. Demand factors relate to lack of investment, supply factors relate to lack of structural reforms and hence productivity enhancement. Structural reforms in turn require investment to be implemented. Investment is needed to "introduce" structural reforms, and hence drive structural change in the economy. Investments need profitability to be activated and profitability depends on structural reforms. So both sides of the coin must interact to react to stagnation pressures.

One implication of the above is that, also because of risks of secular stagnation, supporting long term growth in the EU requires stronger investment, both public and private. Hence reconsideration must be carried out of EU wide investment instruments. Including those related to the Junker plan. In addition, an investment strategy has to be integrated with mechanism to improve incentives for structural reforms.

A third component of the long term dimension are the issues related to the role that industrial policy, competition policy, and innovation policies play in a world of very rapid and widespread technological change. Digital technologies, artificial intelligence, internet of things are the dominant factors of the economic landscape for many years in the future. Conclusion nine is that to appreciate the challenges and the implications of such a scenario it is necessary to consider technological change as a massive pressure for investment in intangible capital.

VI. Intangible Capital

As discussed by *Haskel* and *Westlake* (2018) intangible capital has four dimensions: it implies sunk costs, so a large investment is needed upfront, it is scalable so it encourages market expansion, it implies synergies with other capital classes (human, physical, financial, etc.), it generates spillovers so it is exposed to free riding.

Policy implications follow. Competition policy (in a world of intangible capital or otherwise) must deal with trade offs between favoring scale expansion and avoiding excessive concentration. Industrial policy must provide a healthy business climate to encourage synergies. Financial markets must adapt to a world where intangible capital presents problems with collateral evaluation, and equity financing may not be available. A crucial issue is obviously the identification of the relevant market which is in most cases global and evolving in size and characteristics.

The intangible capital approach is particularly useful if we take into account two of the main structural challenges for sustainable growth in Europe: the shift towards more service intensive economies, also driven by increasing digitalization; the mounting pressure for a shift towards a green economy, which also is service intensive and facilitated by digital technologies. From both viewpoints the role of intangible capital is of the essence both in understanding the basic mechanisms which lead to investment and in defining a long term growth strategy. In both cases policies must be designed also taking into account the impact on social inclusion.

VII. National and European Policy Levels

We have argued at length that understanding growth mechanisms requires looking at both macroeconomic and structural aspects and their interaction. This implies looking at the respective role of EZ and national policy levels. The issue is how different policy instruments (or domains) interact. The key point can be summarized as follows. It has become increasingly clear that monetary policy alone cannot bear the burden of supporting the EZ economy by itself. It must be complemented with fiscal and structural policies. Monetary policy impact on inflation, risk perception, and structural reforms efforts may have reached a limit. Conclusion ten: progress in the structural reform agenda (*Masuch* et al, 2018, OECD 2018) improves the effectiveness of monetary policy. This is a further element that strengthens the growth dimension of the EZ.

On the other hand, there is still no agreement on the stance and design of EZ level fiscal policies and strategies and, while there is agreements that structural reforms should be boosted there is limited political appetite to follow up as structural reforms require time to deliver benefits and may have significant distributional costs in the short term.

A proactive fiscal policy in the EZ has several dimensions and the debate on how to reform or strengthen the fiscal framework is underway. As mentioned at the national level prominence should be given to debt reduction. Hence, as long as the interest rate is larger than the nominal growth rate a primary surplus is needed. At the same time a reconsideration of the stability and growth pact should be initiated so as to strengthen incentives for public and private investment, simplifying the rules and give more prominence to a debt rule.

In addition, more coordination of national policies would be welcome. More symmetry in adjustment is needed. Countries with fiscal space should use it. Those without fiscal space should try to expand it and concentrate on structural policies. The EZ as a whole would benefit from such distribution of policy measures.

Conclusion eleven: beyond changes in national fiscal rules a EZ fiscal capacity is needed. Steps towards a EU budget are moderately encouraging. The EU budget is the natural instrument to deal with convergence and structural adjustment. Its impact is enhanced when operating in coordination with the structural agenda. Budget resources should provide buffers favoring structural adjustment costs of transition. Convergence and adjustment are considered in the debate although on a limited scale. On the other hand a stabilization instrument is needed. For instance an unemployment insurance mechanism. Such a mechanism could improve labor market adjustment, prevent hysteresis and avoid that cyclical unemployment turns structural without the risk of a transfer union (*Giammusso, Padoan* 2019). A fiscal policy capacity should be developed to support both stabilization and adjustment of imbalances, but also allocation of resources and therefore an impact on long term growth.

Conclusion twelve, dealing with structural issues implies considering the role of the Single Market in facilitating structural change. The Single Market is largely incomplete in areas more relevant for an intangible capital driven strategy, such as immaterial networks, energy, digital, tax, education, transport. All elements that represent the pillars of what could be considered an "innovation union".

VIII. Global Economic Governance and Growth

Governance of the global economy has an impact on growth. Conflictual global relations depress growth other things equal. Over the last few years global governance has been under increasing pressure. Pressure has impacted on several policy domains, notably trade and security. In addition, policy uncertainty has increased, The Economic Policy Uncertainty (EPU) index has gone up (more uncertainty) in tandem with events such as the Eurozone crisis in 2009, it has gone down with the initial solution of the Eurozone crisis during 2011–15, increased with the Brexit vote in 2015, increased with the migration crisis during 2015–17 and increased with the US-China trade war.

Policy uncertainty reflects, among other factors, changing conditions in global governance. Over the past few years, increasing fragmentation and conflicts have replaced a more coordinated approach to global governance that had prevailed in the recent past. Taking into account evidence of the relationship between policy uncertainty and risk (*Johannidis* and *Kook* 2018) as well as between policy uncertainty and growth, other things equal, higher uncertainty about global governance translates in an increase in the interest rate and lower growth. A more conflictual approach to governance implies, other things equal, that adjustment of imbalances is more costly and disorderly with negative consequences on growth and risk perception. The current state of global relations suggest that conflicts and weak governance are on the rise and this trend will persist. Other things equal the degree of risk should increase, leading to (possible) higher interest rates.

Conclusion thirteen. There is a need to improve global governance, lower systemic risk, and raise long term growth. Revert the trends to higher confrontation and declining growth (including secular stagnation). How can this be achieved? Policy should at the same time decrease global risk and raise global growth: two targets that mutually reinforce each other (in both directions).

What are the challenges for global economic governance? Global governance has changed dramatically after the outbreak of the global financial crisis, shifting the focus from the G7 to the G20 recognizing the raising role of large emerging economies. The G20 agenda has extended over a very broad range of issues, including "strong, sustainable, balanced and inclusive growth". However it is hard to say that global governance has succeeded in achieving risk reduction. Rather, the opposite holds as we look at the state of international relations today.

Over the recent past attempts to strengthen global cooperation and multilateralism seem to be replaced by increasing bilateralism and 'sovereignism' (i.e. the view that nation states should prevail over multilateral agreements). The policy of the global hegemon, the US, has been increasingly inward oriented, looking at national interests and contributing less to global public goods such as stability and open markets. In other words, there is a lack of hegemonic stability as the largest power prefers bilateral relations (both positive and negative) over multilateral cooperation. And other key countries have similar attitudes. Therefore governance needs to deal with increasing fragmentation.

Because of the absence of a global hegemon, the provision of public goods by global governance would require fundamental changes, which are unlikely in the short to medium term. Conditions for systemic risk to be minimized are not at hand. Without hegemony international cooperation is much more difficult, requiring key players' willingness to reciprocate, adjust preferences and adopt a long term perspective. Europe could play a much more effective role from this point of view, contributing to better global governance in a multipolar world

IX. Political Economy of Adjustment and Growth

Defining a policy agenda for growth raises the issue of consensus particularly in the structural domeain. As far as monetary policy is concerned there are limits to what can be achieved by "normal" policies and less traditional policies may clash against the resistance of some countries. The asymmetry of national monetary policy preferences between low and high inflation countries is well known. Such asymmetry may be a serious obstacle to intra monetary union adjustment as low inflation, surplus countries, would need higher inflation and real exchange rates and vice versa for high inflation countries. In addition, as mentioned above, limits to monetary policies require that fiscal and structural policies be activated. But political economy obstacles arise here, too.

Because of alignment of countries over the fiscal stance progress towards fiscal union may be very limited. *Lehner* and *Wasserfallen* (2019) find that northern EZ countries oppose any forms of fiscal relaxation while the opposite holds for southern countries. As far as the structural agenda is concerned timing and perception of SR impact may be incompatible with timing of politics. Investment and technology policies may gather more consensus also given the level of external threats and geopolitical risks. In addition growth enhancing measures will have to be accompanied and complemented by inclusion preserving measures.

So under which conditions can there be consensus for an inclusive growth policy agenda? The challenges to be addressed are of a structural nature and require a structural response, a reform strategy addressing both obstacles to aggregate growth and lack of efficient convergence mechanisms. Structural reforms require significant political capital and such a political capital, in Europe, seems to be in short supply. Reform fatigue and discontent with the prevailing economic system have been on the rise in Europe (*OECD* 2018, *Rodrik* 2018). As mentioned political support and the related political capital are attracted by "new" options (such as populism and "sovereign nationalism"). Dismantling reforms rather than strengthening the reform agenda, favoring state-led rather than market-based policy recipes, and focusing on national rather than European solutions seems to be the winning political bet. There are two main reasons why this is the case. One is, as mentioned above, that the "structural reform cycle" is long and difficult to complete over the "political election cycle", thus generating reform fatigue. Another one is that increasing reform fatigue is associated with decreasing support for Europe and the European project because of rising populism and nationalism. So, while Europe needs more reforms, Europeans reject the idea.

Structural reforms can be implemented at the national and the EU levels. One example is the interaction between market liberalization at the national level and at the EU level (Single Market). In some cases EU policies can be more attractive insofar as they are perceived as dealing with inequality (examples include competition policy as a way of confronting monopoly power of internet giants, tax policy as an instrument for redistribution). In other cases, EU level policies are seen as mechanisms that weaken national sovereignty, and hence they are resisted. A possible misalignment between economic and political reform priorities may emerge as economically crucial reforms may be much harder to introduce if they are perceived to weaken national sovereignty.

Some reforms, both national and EU level, have a direct impact on convergence. National policies include labor and product market reforms, and also human capital accumulation (i. e. education policies). Such national level policies can be targeted to securing convergence. Convergence can be supported by EU level instruments (e. g. structural funds), so that the two levels of policy can support each other. One would expect, therefore, that political capital for national reforms can be made available by EU level action. This has been the case for some time. More recently however, with the rise of populism EU level policies are seen as limiting the national political agenda and are perceived as "foreign interference", thus making it more difficult to implement national reform policies.

As reform fatigue increases, the incentives governments face for a reform strategy are likely to get weaker and a vicious cycle may materialize. Widespread discontent in many European countries following the financial crisis is related to slow or weak growth and employment, and the cause of such poor performance is identified with a "wrong" European policy response based on structural reform and fiscal austerity. So insofar as lifting growth and employment requires a structural effort, there is little or no political capital available to implement it. This dilemma is compounded by the pressure for political capital needed to complete the "macroeconomic pillar" of European integration; Monetary Union and Banking Union. In addition the rise in populism and "sovereign nationalism" in several EU member states is flying on the wings of euro skepticism. This makes it questionable that a EU policy for productivity growth, based on intangible capital driven growth, which requires action at two levels, both EU and national, would win sufficient support. However *Conclusion fourteen.* A strategy to win support for reforms can be designed and implemented by leveraging the multidimensional characteristics of European integration.

X. Two Level and Parallel Games

Consensus for reforms has to be mobilized at two levels. At the national level consensus must be raised by governments facing national electorates. At the EU level consensus must be raised vis a vis other governments. These two processes are interconnected as famously described by Robert Putnam (1988) in his "two level games" framework (see also Guerrieri and Padoan, 1989). The interconnection runs both ways. Governments may be interested in negotiating binding agreements at the international level so as to force consensus domestically on relevant policies. At the same time they may be interested in leveraging a strong domestic political mandate so as to extract more concessions when they bargain internationally. The "populist/sovereign approach" to EU policies would favor the second component, while the "EU approach" would favor the first component. In fact both elements play a role, possibly with different relative weights in different countries and at different times. This is an element of flexibility which may turn out to be very useful to find a solution to the bargain.

When and if a solution emerges there will be a "win set" of policies which satisfy both levels of bargaining and a cooperative rather than a nationalist framework will emerge. A second element is useful to describe the consensus building process in Europe: the fact that governments have several items in their reforms agenda developing in parallel and, therefore, several bargaining tables open at the international level. Such a situation, unsurprisingly, has been identified as a "parallel games" framework (Alt and Eichengreen, 1989). Typically bargains are struck simultaneously on more than one table, so as to exploit mutual concessions, i. e. establishing "issue linkages" across tables. The European policy agenda is characterized by both "two level" and "parallel" games. Parallel games are present insofar as the reform agenda includes "growth" elements (as we have described) and "money" elements related to eurozone reform. By exploiting both two level and parallel games elements Europe is more likely to work through a successful reform drive and overcome reform fatigue. The intuition is that progress in one area (growth) is conditional upon making progress in the other area (money) and vice versa. At the same time, progress in one area may foster progress in the other: "growth" reforms and "money" reforms support each other.

This conceptual framework may be redrafted to take into account the, now familiar distinction between risk sharing and risk reduction. Cooperation at the macroeconomic (money) level requires building appropriate institutions, including, in the case of the EU, those associated with the establishment of a banking union. This requires agreement on risk sharing and risk reduction. Both elements are needed to make progress. It can be argued that risk reduction implies striking a bargain at the national level while risk reduction implies reaching an agreement at the EU level. The two dimensions reinforce each other as progress in risk reduction across countries reinforces mutual trust and raises incentives for collective action needed to enhance risk sharing. Conversely, more risk sharing and the consequent strengthening of EU level institutions and instruments reinforces incentives for risk reduction at the national level. How does this impact on agreement and reform in other (growth) areas? The issue is complex but an example may help describe the point.

We have argued above that slowdown in growth and productivity is a Europe wide phenomenon partly related to the financial crisis, and that productivity decline is also associated with increasing fragmentation. One way to invert productivity decline and spur growth is to arrest fragmentation and support integration. Integration can be supported if, among other things, appropriate macroeconomic instruments are available at the European level for this purpose. The recent proposal to establish a convergence instrument in the EU budget goes in this direction. The idea of an EU wide unemployment insurance mechanism also does. Conversely, if growth is strengthened, macroeconomic and financial stability are also strengthened and so is risk sharing as benefits from European integration are perceived as more compelling. In terms of consensus building if growth is strong and inclusive one can expect support for reforms to be stronger. Presumably support would be extended beyond the (inclusive) growth agenda as the monetary (union) agenda would be seen as instrumental in achieving (inclusive) growth. The opposite is also true. An effective national reform agenda would significantly strengthen the EU wide macroeconomic (money) process.

Consider the impact of reforms on current account imbalances. As we have discussed above a number of countries have been systematically running current account surpluses, thus subtracting aggregate demand vis a vis the rest of the EU. These countries have also resisted the pressure to expand domestic demand through fiscal policy. To overcome political resistance and provide more effective solutions to the challenge of persistent imbalances, the issue can be approached recalling that current account surpluses reflect excess savings (over investment). So a policy that would raise investment would, both, support growth in surplus countries and smooth imbalances within the EU. As discussed structural reforms, especially those improving the business environment, and liberalizing product and labor markets, would raise investment and contribute to narrowing payment imbalances. As a consequence the macroeconomic environment would be strengthened benefiting from higher growth and smaller imbalances.

Conclusion fifteen: Both cross reforms fertilization and cross country interaction would help growth because, a) the structural reform agenda would spill over, positively, on the macro (money) agenda, and, conversely, the reform (growth) agenda would be strengthened by the macroeconomic (money) agenda; b) all countries, not only low growth or lagging countries, would benefit from a reform agenda; c) international cooperation would benefit from establishing both two level and parallel games; d) risk sharing would increase. A non-cooperative ("nationalistic") scenario, on the other hand, would impact both the growth and the money agenda. Failure to agree on risk sharing options would imply that fewer resources are made available to support convergence, thus a failure in the money agenda would reverberate on the growth agenda. And support would fail to materialize for both agendas. A weaker growth agenda would imply a weaker money agenda. In short, the whole range of European policies would lack support. Ultimately this vicious circle could significantly weaken the very foundations of monetary union.

Another example of interconnectedness between levels is tax policy. Consider the case for a digital tax. Taxing digital companies is appropriate both for efficiency and for fairness reasons. Taxing internet giants, however, is extremely difficult given their very high mobility and the large role intangible capital plays in their activity. In addition, the very low tax revenues that are extracted from such companies are also seen as unfair from a social distribution point of view, given the very high income and wealth levels these companies enjoy. Such features make it desirable to introduce a digital tax, however, its practical implementation is quite difficult for at least two reasons. First, it is not clear what to tax (revenues, equalization levy, bit tax, flat fee, etc). Second, the tax should be implemented on a global basis or, at least, on a European basis to minimize tax competition and free riding. Hence cooperation is needed. As mentioned one can expect political support at the domestic level given the fairness component of such a tax, but more confrontation at the international level given the resistance to adjusting national tax systems to an international or European standard. Stronger collective action would address the issue, and support for such a tax at the national level would encourage governments to find an agreement at the international level. In such a case, political capital at the country level could leverage political capital at the EU level needed to introduce reforms. Conclusion sixteen: The EU needs a comprehensive reform agenda to deal with significant risks of further productivity decline and increasing fragility and fragmentation. The more so as the global economic environment appears to be getting weaker and more exposed to negative shocks. However, Europe lacks the political capital needed to implement the ongoing reform agenda (the "money agenda") and introducing the, necessary, "growth" agenda. The situation is made more difficult by the fact that the growing populist/sovereign nationalist is gaining increasing political support.

XI. Summing Up

We have summarized elements of a possible growth agenda for the EZ. Such elements, in turn can be grouped in different sets. A first set relates to the interaction between short term and long term factors, as well as between macroeconomic and structural aspects. In an evolving monetary union it is imperative to improve adjustment mechanism so as to avoid the persistence of imbalances that would eventually lead to a crisis thus hurting growth. One case in kind is the persistence of large saving investment gaps that perpetuate asymmetric pressures to adjust and depress aggregate growth. Another set of issues relates to imbalances associated to geography factors reflecting agglomeration dynamics which exacerbate inequalities and depress growth and competitiveness. Such imbalances need to be addressed both at the EZ and national level with appropriate instruments including a revamped ad redesigned EU/EZ budget. This would also allow to set up a EU wide fiscal capacity that should also provide a stabilization function. A third set of issues relates to broad policy interaction. Both monetary and fiscal policy effectiveness would benefit from a strategy of structural reforms to boost productivity and market efficiency. However the incentives to implement structural reforms may be insufficient. So it is important to strengthen incentives to reforms exploiting "two level games" and "parallel games" frameworks whereby political capital for reforms can be enhanced by linking domestic and European bargains as well as linkages between a "growth" agenda (the real side of EU economic integration) and a "money" agenda (completing monetary union). A last, but not least, set of policy issues stems from the fact that growth in Europe would be enhanced by a stronger governance of the global system which would reduce policy uncertainty and multilateralism as opposed to more conflictual bilateral relations.

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