bruegelpolicybrief

ISSUE 2013/03
APRIL 2013

EUROPE'S GROWTH PROBLEM (AND WHA TO DO ABOUT IT)

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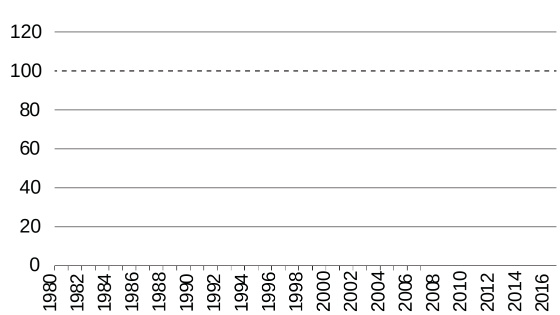
POLICY CHALLENGE

The European Union's weak long-term growth potential and unsatisfactory rec ery from the crisis represent a major policy challenge. Over and above the str tural reform agenda, which is vitally important, bold policy action is needed. T priority is to get bank credit going. Banking problems need to be assessed pr erly and bank resolution and recapitalisation should be pursued. Second, fost ing the reallocation of factors to the most productive firms and the sectors tha contribute to aggregate rebalancing is vital. Addressing intra-euro area compe tiveness divergence is essential to support growth in southern for the hard-hit economies in southe regain control of their public finance ness of Europe for investment. Und are bound to prove unsustainable.



Source: Bruegel based on IMF Word Economic Outlook October 2012. Note: GDP is measured at purchasing power parity. EU15: EU members before 2004. EU12: EU members that joined in 2004/2007.

2. See Zachmann, Georg (2012) ‘Smart choices

more inward looking countries, such as the UK and Spain.

- Pro-cyclicality of business research and development expenditures: the lingering crisis reduces the pace of innovation and companies' adoption of more innovative technologies, which weakens business investment, and thereby reduces the productivity increase.
- Impediments to reallocation across sectors and between firms: dysfunctional financial systems hamper productivity-enhancing restructuring, while obstacles arising from labour, capital market and bankruptcy regulations weigh more heavily in a time of profound change.
- Uncertain macroeconomic and financial outlook can also make companies cautious

10. Speedy restructuring in Sweden fostered economic adjustment

Without the relative price adjustment, the necessary reallocation of economic activities toward the tradable sector in the south will not take place. Without a symmetric enough adjustment, meaning inflation in the euro area is at two percent with higher-than two percent inflation in Germany and other surplus countries and close to zero inflation in the south, the south will need to deflate. That would endanger both private and public debt deleveraging, putting debt sustainability at risk and delaying the recovery even further.

CONCLUSIONS

Europe's long-term growth strategy has so far failed. Various initiatives have been unable to increase the growth potential of the EU15. EU12 members have on average performed better, but their futures will crucially depend on the EU15 because of the EU's financial and trade integration.

This failure is now compounded by a danger that the short- to medium-term challenges will interact perversely with the longer term ones and lastingly weigh on Europe's performance. Much of Europe suffers from a mutually reinforcing interaction between limited productivity gains, protracted deleveraging, weak banking sectors and distorted relative prices. This combination contributes to an overall weakening of economic growth and threatens to turn into self-perpetuating stagnation. This dark picture calls for bold policy action significantly beyond what is currently being undertaken.

Policy action should comprehensively address all four aspects of the problem. But the quest for growth is elusive. Growth policies are by nature difficult to encapsulate in a few recommendations. So the following suggestions are in no way exhaustive.

The sequencing of policy actions is important. Without credit, investment and growth, any structural reform is likely to fall victim to popular rejection. If fiscal retrenchment does not deliver results, support for it will vanish. Therefore, the strengthening of banking systems and the recognition of bad loans should be prioritised in order to create conditions for a resumption of private-led demand. Relative price and wage adjustment and structural reforms should also be pursued, but are unlikely to deliver immediately, in particular in the absence of growth.

The most urgent priority is therefore restoring a fully functional financial system, which is a precondition for the resumption of productivity and growth. Europe for too long has refused to recognise this. The forthcoming introduction of the Single Supervisory Mechanism (SSM) offers a unique opportunity to complete the strengthening of the European banking system. Before the ECB carries out the 'comprehensive assessment' of the banks brought under its supervision, national authorities should trigger a recapitalisation of undercapitalised banks and a resolution of insolvent ones. The ECB should make clear that it will not accept undercapitalised banks for the single supervisory system. Countries outside the SSM should also revitalise their domestic banks. The European Commission should encourage governments to bear the fiscal costs if necessary by announcing that deficit increases from public recapitalisations carried out until end-2013 will be treated as one-off costs within the framework of the Excessive Deficit Procedure.

Negotiations for the Bank Resolution and Recovery Directive should be urgently completed to achieve a level playing field. It is

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laying ary realloc14.8troductifacResolu-The [(of proe aggregate rebalancing is vital for productivity and growth. This involves bolder monetary action in combination with targeted fiscal support. As banks may choose not to lend to SMEs because loans are subject to significant haircuts when taken as collateral in central bank repo operations, there is a case for providing support to the enhancement of this collateral. In the euro area, the ECB cannot carry that fiscal risk. Instead, temporary collateral enhancement schemes should be explored, for example, in liaison with the European Investment Bank (EIB). Furthermore, EIB facilities should also be used to support credit, in particular for SMEs. Better access to finance for SMEs would greatly help the creation of new employment in the export sector.

Appropriate speed of fiscal adjustment is paramount. The speed of fiscal adjustment needs to be adapted to the context of stagnating economies throughout the EU. This is especially a concern where households and firms are still in the process of deleveraging. At the same time, it is important to ensure the (1nt t also be usegurl1eAailth.01 Tc .23352-7.8(teraterao b1eAum-o fmre)]s/GSd T* .4
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