What assumptions will govern future EU economic policy?

Introductory remarks to hearing in the Finnish Parliament
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Thank you for inviting me to speak today.

The backdrop for this hearing is the existence of very widespread discontent with the European economy. This is, understandably, expressed as dissatisfaction with the EU and EU institutions, and in particular eurozone institutions. My view is that while understandable, it is an erroneous inference. There are big problems with the economy and economic policy in Europe, but it is a mistake to blame those problems on the institutions and rules of the EU and the eurozone.

Europe entered the crisis eight years ago with a combination of two big economic problems: a collapse in aggregate demand and an overhang of debt (the debt had sometimes been built up by governments, but more often by the private sector). Insufficient spending in the economy is a demand-side challenge; a debt overhang affects both demand and supply.

I do not think that the structural long-term growth problems, while real, are an acute problem. This is not to say that structural reforms are not necessary; they are. The long-term growth rates of most European countries could and should be higher. But it is important to focus first and foremost on responses to the more short- to medium-term challenges of aggregate demand and debt. It is to those challenges that the political discontent with Europe is most directly linked, and in particular high unemployment and stagnant incomes. For the time being these are burdened more by short-term economic obstacles than by an unsatisfactory long-term rate of growth. Put differently, being *below potential* is the politically most acute problem, not the slow growth rate of the potential itself.

Besides, those who are most sceptical about Europe today are those who have been most affected by structural change in the economies of Europe (and globally) over the last three decades or so. So we should be cautions about further structural reforms when these are likely to hit most negatively the very same people who have already been on the losing end of structural change. While appreciating the importance of structural change, we must make sure we get the timing right, and make a priority of the more immediate problems.

Europe as a whole, and the eurozone in particular, responded very disappointingly to both the collapse in demand the overhang of debt. To understand the why the response was so disappointing, and for me to make the argument that this is not a built-in feature of the EU or the eurozone institutions, it is useful to distinguish how the EU and the eurozone economies are governed at three different levels.

The first level, the top level, concerns the *overarching goals* of the EU. These are set out in the first couple of articles of the Treaties. Article 3 of the Treaty on European Union outlines and list a number of *economic* goals for Europe, to which the member states and the community as a whole have committed themselves. Most of those goals are not often talked about, but they include: Full employment; social justice; combating social exclusion; balanced growth; and of course sound public finances.

These are Europe's stated goals, which, if we look at the record, have not been accomplished. The failure in particular to achieve full employment, and the fact that eurozone economic policies have led to social exclusion in many countries, are at the root of much of the political discontent with Europe. In other words, if there is now unhappiness about Europe, it is not because of what the EU is set up to do, but because of the EU's failure to respect its own goals.

The second level of governance consists of the *policy rules* laid down in the treaties as a way to achieve the top-level goals. The Stability and Growth Pact (SGP) is one set of rules, single market rules another, competition rules a third. These are legal constraints and requirements on policy intended to promote the overall goal. They are often expressed as general principles: no excessive deficits, sound public finances, price stability, competitive market economies and so on.

Finally there is the most *specific level of governance*, which states the exact way those principles are applied. Some of this is also laid down in law, such as the 3% deficit rule, the 60% debt rule, and the structural balance and numerical adjustment rules in the Fiscal Compact. But there are also pure policy choices, which are simply decisions taken by Europe's leaders. They include an emphasis on competitiveness, in particular in terms of "unit labour costs" (ULCs); a focus on structural reforms; and certain policies on debt restructuring, or rather an aversion to debt restructuring. Those are choices about how to apply the rules or interpret them, or how to achieve the overall goals.

My contention is that Europe's economic problems have their roots at this third level, the level of largely discretionary political choices about how to apply the treaty purposes and the laws. The *rules and design* of the EU or the eurozone do not prevent better economic policies, it is rather that national governments and EU- and eurozone-level policymakers have made the wrong choices within the ample room for manoeuvre they enjoy according to those rules.

Why and how have wrong policy choices been made? Part of the reason has to do with the need for compromise in a union of nation-states and the role of relative political power in how compromises are struck. But part has to do with incorrect ideas about how the economy works. I'm tempted to remind you of the old Keynes quote:

> "the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas." (John Maynard Keynes, *The General Theory of Employment, Interest and Money*, Chapter 24)

Something like that has been happening in Europe. I will briefly go through four different policy areas where bad economic policy choices have been made, not because EU or eurozone rules required them, but simply because policymakers thought they were good choices.

First, the question of the euro itself and adjustment within it. There is a widespread view that when you cannot devalue to adjust your economy, you have to pursue "internal devaluation", which is taken to mean becoming more competitive by cutting ULCs. I think this view is misguided. First of all that it may not achieve the result you want. One reason to adopt the euro was to get beyond an economic strategy of competitive devaluation, so it seems perverse to try to mimic precisely the strategy you were trying leave behind.

Second, the focus on unit *labour* costs is one-sided, as it misses out the other part of inputs to production, namely capital. Nobody says we need to become more competitive by cutting “unit capital costs”, which can be defined in analogy to ULCs as essentially the profit margin of companies. It’s worth asking why nobody says this. One reason is that unit capital costs are not frequently measured, whereas ULCs are. But the outcome is to adopt policies that aim at cutting wages or holding back wage growth.[1]

Third, even if competitive (internal) devaluation works, it is supposed to do so by creating export demand. It intentionally achieves this by making workers poorer – which means it is more likely adjust the economy by reducing imports than expanding exports – but if it succeeds we should acknowledge that it does so by taking demand away from other European economies. That may be possible for a small open economy such as Finland’s. But it does not fulfil the goal set out in the Treaties whereby member states commit themselves to working *collaboratively* towards *balanced* economic growth. It is a beggar-thy-neighbour policy even if it works for the country in question.

The second area where bad policy choices have been made in the belief that they were correct is the SGP. In a situation where aggregate demand falls short of productive potential, and an economy therefore fails to achieve full employment, the current interpretation of the SGP is counterproductive. It fails to restore growth, because it imposes contractionary fiscal policy, but more importantly it does not secure sustainable public finances. Across the eurozone and especially in the periphery, contractionary fiscal policy has made debt burdens (debt as a ratio of economic output or GDP) heavier rather than

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[1] A technical aside: At an economy-wide level, ULCs are simply the national price level times the labour share of income. So reducing ULCs very easily turns into redistributing income from capital to labour. It is an inherently redistributive and not very progressive strategy. On this and unit capital costs, see Jesus Felipe and Utsav Kumar, “Unit Labor Costs in the Eurozone: The Competitiveness Debate Again”, Levy Economics Institute Working Paper No. 651, February 2011, http://www.levyinstitute.org/publications/unit-labor-costs-in-the-eurozone.

lighter because it has held back the GDP out of which a given debt has to be serviced.

For example, the absolute euro value of Greek public debt has hardly grown since the 2012, but the debt-to-GDP ratio has increased fast because GDP continued to shrink. The way the SGP, and the fiscal rules in general, have been interpreted is counterproductive against their own purpose and the broader purpose of the EU. Moreover, the fiscal rules are applied on a country-by-country basis. But it follows from the overall purposes of the Treaties that the aggregate fiscal stance of the eurozone as a whole is a matter of common concern. Respecting the Treaties requires taking that seriously, but current practice fails to do so.

The third area is structural reform. There is nothing in the Treaty that *directly* requires structural reform. There are provision for economic policy being treated as a matter of common concern and this has been strengthened with recent institutional changes in the field of economic monitoring (the 2-pack, the 6-pack and so on). Here, too, policy has been driven by misconceptions, in this case about what structural reform means, or should mean in light of the Treaty goals.

I comment to you the International Monetary Fund's recent research on structural reform. It has tried to measure what effects various kinds of reforms may have on growth. The findings are unambiguous. For labour market reforms, in particular those making labour markets more flexible, it is impossible to find any positive short-term growth effect (indeed sometimes they are negatve). There are some long-term effects, but they are rare and small. In contrast, product market reforms lead to much larger growth effects in the long-run, and tend to boost growth even in the short run.

These results are not surprising in a setting of inadequate aggregate demand. Product market reforms work by increasing competition and production, which leads to falling prices. This is the good kind of deflation, as it increases real wages, purchasing power, and demand. Labour market reform, in contrast, works by squeezing real wages, which detracts from demand and may be counterproductive when a demand shortfall is the most acute problem.

This is why the IMF has become increasingly vocal in insisting on the right timing: start by those reforms that help growth in the short run, and postpone those that detract from growth until the economic cycle is at a better point. This is advice the eurozone would be very wise to heed.

The fourth area is the attitude of policymakers towards the restructuring of excessive debts. Europe went into the crisis with larg public and private debt overhangs. It was said then that there could not be a sovereign default in the eurozone, so one resorted to a range of bailouts, first of the Greek government and then of others. There was also a deep aversion towards letting private banks restructure their debts, which led many sovereigns into unsustainable debts of their own, in particular Ireland and to some extent Spain.

When you have insufficient demand and debt overhangs, the right strategy is to boost demand and cut the overhang. Europe chose the opposite, trying to protect existing debts – insisting that they had to be repaid in full – and to do this it tried to squeeze ongoing borrowing, which also squeezed demand. But there is nothing in either the EU Treaties nor the eurozone setup that required this policy choice. There was an alternative, which was to write down debts and let borrowing take longer to come down in order to support demand. That policy — writing down debt stocks and consolidate new borrowing more slowly — would have had better economic effects, and would have vastly reduced the need for politically toxic bailouts.

There has been movement in this area. We have had a sovereign restructuring (in Greece in 2012) and a private bank restructuring (in Cyprus in 2013), and bank debt write-downs are now official policy as per the Bank Recovery and Resolution Directive. Politically, however, it is very much in doubt whether this newfound understanding of the need for write-downs will be applied robustly, as illustrated by the discussion around Italian banks and Deutsche Bank at the moment. There is still a very protective attitude on behalf of eurozone governments in particular (and European governments in general) towards “their banks”. In this context progress towards a Banking Union is essential in order to loosen the unhealthy embrace between national governments and national banking systems.

To sum up, I have argued that there is nothing in the structure, the institutional setup, or the laws in the EU and the eurozone that prevents better policy. Instead, better policy depends on a change in the attitudes of policymakers. In the first three areas I discussed, the choices that have been made have intentionally or unintentionally had the effect of punishing workers — or that is how it is understandably seen by Europe's workers, in particular the lower-paid. As a result of these policy choices, the EU and eurozone has been made the arena of intensified conflict between labour and capital. In terms of the fourth area of how to deal with a debt overhang, there has been a choice not to restructure debt. Delaying the ultimately inescapable realisation that a debt that can't be paid back, won't be, has often led policy to side with creditors over debtors. That has exacerbated another secular conflict, this one between creditors and debtors (which of course overlaps with the conflict between capital and labour).

To finish: I was asked what assumptions will govern European economic policy in the future. Rather than hazard a prediction, I will just state what assumptions should govern it. What should govern European economic policy in the future is a change in policymakers' outlook on the importance of these conflicts, between labour and capital and between creditors and debtors, and an attempt to mitigate them rather than intensify them. Finland, with its strong tradition of successfully tempering these conflicts, has an important role to play in bringing about that change in policy thinking.