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« Closing the year, closing the crisis? »

A Conversation with Tommaso Padoa-Schioppa

on the Eve of the December 2010 European Council

Tommaso Padoa-Schioppa
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1. 2010 has been the year in which the crisis has come to Europe. How can you describe the responses of the EU to the crisis, now that we approach the end of the year?

If we describe this crisis as a hurricane, which moves from one place to another making victims of different types, indeed 2010 has been the year in which the hurricane has targeted sovereign debt in Europe. Previously it had targeted the sub-prime market, toxic assets and large US financial institutions. In Europe, however, the real target of the market hysteria has been not so much the debt of individual countries (Greece, Ireland and possibly Portugal, Spain or Italy) but the euro itself.

What markets have been and are still testing is the capacity of the euro area to act as a single effective policy-maker in front of a crisis. They no longer seem to believe that "a currency without a State" is indefinitely sustainable.

2. Are they right in this belief?

Yes they are right. The single currency was conceived by its founders as a step in a process that bound to continue and, in fact, to be accelerated by the euro itself. This was consistent with the fact that the construction of a united Europe had been, from its very beginning, a step-by-step dynamic process, moving from one disequilibrium to another, and not a single act of constitutional change as it was the creation of the United States or the unification of Germany and Italy in the nineteenth century.

The Union has worked well for ten years, but for ten years there has been no further progress in the unification process. The Treaties of Amsterdam, Nice and the Constitutional Treaty were failed attempts to progress; the Single Market stalled, the Lisbon Strategy was disappointing, the EU budget was frozen. When the crisis arrived, the "lack of State" became a major impediment in managing it and a major source of concern by investors. However, 2010 is also the year in which the EU proved capable of a significant response so that many of the gaps of a "currency without State" were filled. In May there was the approval of the Greek package and the creation of a new instrument, the European Financial Stability Fund; in June important fiscal consolidation measures were agreed for all the member states; in October there was the decision to convert the European Financial Stability Fund into a permanent fund and to create a permanent crisis resolution mechanism.

3. In our October conversation you said the EU challenge was to move from emergency mechanisms towards structural measures. However, over the latest weeks we have seen Ireland making a formal request for aid from the EFSF and market pressure mounting again on Portugal and Spain. Can we say we have finished with the period of emergency?

Some of the emergency decisions taken from May to October are in the process of becoming permanent parts of the EU instruments. However, the crisis prevention and crisis management part of the reform is not yet complete. First, many of these measures are still a collection of member states' actions rather than EU actions (for example, financial support is provided by the member states and not by the Union itself). Second, the endowment of the EFSF may turn out to be insufficient and will perhaps need to be increased. Third, the crisis resolution mechanism and the thorny question of the sharing of the burden by private creditors is still unresolved; the latter is the issue that has triggered the Irish crisis.

4. Another point you raised in our previous conversation was the need to complement the current EU reforms on fiscal stability with EU initiatives to stimulate growth. Some people believe that talking on growth

is premature, that the priority now should be to calm down the markets and ensure the fiscal stability of the Euro zone. Is it the time to talk on growth?

Yes it is the time. Markets can quickly move from a concern on fiscal insolvencies to a concern on insufficient growth; in other words, from a concern about insufficient fiscal discipline to a concern about the negative consequences of fiscal discipline. Moreover, and more importantly, fiscal ratios – deficit or debt-to-GDP ratios – will not improve if the denominator of the ratio shrinks. Growth is indispensable to restore sustainable fiscal conditions.

5. By stressing the need to complement fiscal consolidation with growth-enhancing measures, you implicitly assume that budgetary austerity has negative effects on growth. However, many people argue that fiscal consolidation programs can boost growth if they are credible and well-designed.

There is the so-called "ricardian" effect whereby, in front of a fiscal austerity package, consumers spend more instead of less, because they no longer fear to have to pay more taxes in the future. The effect exists, but most statistical simulations and past experiences show that this can only mitigate, not reverse, the initial depressive effect of severe fiscal adjustments. This is particularly the case when adjustments are simultaneously pursued by many countries, including the largest ones such as Germany or the UK.

6. What type of EU growth-enhancing action do you envisage? Given the very limited margins available for budgetary stimulus, some people say that the best is to concentrate our efforts in making the single market more efficient.

Indeed, to make the EU the main actor in growth promotion a number of levers, not only the budget, should be activated in a coordinated way:

strengthening the single market, activating the EU2020 strategy, launching a program of EU investments financed by the issuance of Eurobonds as well as a larger and more effective EU budget.

With respect to the spending instruments, I agree that the order of magnitudes will be inevitably limited. Nevertheless, they can be significant, and the possible effect on the economic and social climate in the EU may be not as negligible as some critics fear. They would, for the first time, indicate that the Union is reactive not only to the threats to stability but also to the threats to growth.

As to the single market, there is no doubt that strengthening and completing it would unleash dynamic forces which are at present paralyzed by national segmentations and impediments, My fear, however, is that, in the short run, the completion of the single market won't have much positive effect on growth, because probably it will bring about the rationalization of industries and services and, thus, increase unemployment instead of reducing it. I am in favor of strengthening it because it will make the economy more efficient, but in the short run and in current circumstances, it has to be complemented with other types of growth-enhancing actions. No significant stimulus to growth from the EU itself can come without a bigger role for the EU budget and a large program of public investments at the EU level.

7. Let's consider the possibility of launching an EU budgetary stimulus plan. In order to have a significant impact on growth, such a plan should be or an order of at least 2-5 percent GDP. Can we imagine that, in a period of budgetary restraint, member countries will accept such an increase of the EU budget?

An increase in the EU budget today is perceived as a subtraction of resources from the national budgets. And indeed, in accounting terms,

this is the case because revenues accrue to the EU budget from national budgets. This state of affairs, however, is not inevitable. It is a unfortunate consequence of the lack of autonomy that member states have imposed upon the EU budget. It would be much more appropriate - and consistent with sound principles of fiscal federalism - if the EU budget was financed with genuine own resources, going from the taxpayer to the EU without transiting through national budgets.

The issue of own resources is central and, in my view, it can only be resolved in a satisfactory way if the EU takes two decisions. One is to introduce one or two specific EU taxes - for example on carbon emissions and financial transactions- and the other is to finance infrastructural projects with the issuance of EU bonds.

8. Coming back to the December European Council, what can we expect from it?

The agenda of the European Council is somewhat ambiguous, as it is often the case, on the subject of economic policy. But this does not prevent the adoption of decisions that could close this year of hard tests with concrete prospects to successfully withstand the passage of the hurricane in Europe and look at the future with greater confidence. For this to happen, the European Council should complete the ‘stability part’ of its program and open the ‘growth part’, by acknowledging that without growth no stability is really possible.

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