Forget the sword and the straightjacket, balance is what's needed for growth

by

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These are troubling times for Europe. Across the whole region growth varies between anaemic and negative. The "recovery", expected since three years for the next six months, still lacks hard evidence. For Germany, France and Italy, in technical recession in the first half of 2003, doldrums is no longer a fair description of the state of their economies. Recently, the rising Euro de-couples the European development from the US upswing, further darkens the outlook and tightens the overall monetary conditions despite absolute low interest rates. Fiscal policy in the big countries is cutting expenditure but public budget deficits are on the rise and violate the 3 % threshold of the Stability and Growth Pact. The Commission, the guardian of the European treaties, is under pressure to unsheathe the sword of fiscal sanctions to punish the big evildoers.

Into the bargain, the smaller European countries are complaining about their big neighbours. If Germany, France and Italy would only play fairly in terms of government austerity, as they have done, then the ECB could be more expansionary and the Euro could be more convincingly sold to sceptics in the UK or Sweden.

Certainly, looking at the record of the countries inside the Euro area a clear split between small and big countries catches the eye: Small is beautiful and big is ugly. Conventional wisdom has it that smaller countries have better managed their budgets, or have better positioned themselves in the global markets because they embraced globalisation much earlier and much more efficient than the inflexible giants? On closer examination, however, the virtues of the small and vices of the big are not so clear cut.

Among the group of the top performers are countries which have found comfortable niches since they joined the European Union. Spain, Ireland and Luxembourg have, in one way or the other, used their membership to fight for extraordinary high net subsidies from the Union, passing these on to companies as an incentive to relocate their business into the realm of such a niche-player.

Others, like the Netherlands, Belgium, Finland have gained big advantages from a devaluation strategy vis à vis their big neighbours and the rest of the world. The Netherlands tried their hand in the 80s competing Germany by means of much lower wage increases than warranted by productivity gains. Belgium tested German in the same way, even with official intervention by the government in the wage setting process. Austria benefited enormously from the German unification boom without contributing one Euro to bear its burdens. Finland entered the EMU with a massively undervalued currency, and, in this way, very effectively beggared their neighbours portable phone industry. Ireland combined rent seeking in Brussels

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with undervaluation and tax competition and managed to reap the highest profit of all. Outside the Monetary Union, Sweden massively and successfully devalued in the 1990s, accumulated a huge surplus on its current account and lectured insiders, before and after its referendum, on their failure to achieve a growth and public budget deficit performance comparable to their own.

The problem is easy to understand. Small countries can do things that big ones cannot do. The pain of an Alsatian bitten by a Yorkshire Terrier may be bearable. The other way round is a different matter. If Germany or France would try to devalue by means of a massive wage dumping, the small ones would quickly surrender. If Italy, France and Germany all reduced their taxes to the Irish level to attract foreign companies from the rest, it would be a corporate Blitzkrieg. If the big players fought for EU subsidies with the same fervour as Spain in the last 20 years there would be no big spender like Germany around to foot the bill.

But this is more than just a big versus small economic war. There is logical reason, an adding-up problem, that would lead the whole Union into troubled water if the "big's" applied the same policy approach as the "small's". Obviously, not everybody in the Monetary Union can run a current account surplus if the rest of the world is no longer willing to comply. Just as obviously, not everybody can reduce their budget deficit without driving Europe into a second dip after the longest period of stagnation for many decades. And, if everybody would try to compete by reducing labour costs the result for the Union would be deflation and not, as in the case of a small country, expanding external demand.

The small countries, by lamenting the inability of their bigger neighbours to turn the European economy around by following their footsteps, end up by shooting themselves in the foot. What is needed is a coherent approach to macroeconomic policy for the Union as a whole: A monetary policy pro-actively going for growth and stability at the same time, counter-cyclical fiscal policy without the straightjacket of the Stability Pact and recognition of the fact that only Europe can pull the world economy out of the slump without further increasing the global imbalances.