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Going for growth, but how?

Europe is abuzz with talk of a growth compact, but nobody agrees what it means

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THE words of Mario Draghi were just an aside, but they caused a stir. "We have had a fiscal compact. Right now what is in my mind is to have a growth compact," the president of the European Central Bank told the European Parliament. He did not elaborate. But from a man closely linked to the German desire for fiscal rectitude, his words led many to hope that the euro zone might move on from its self-defeating obsession with austerity.

Mr Draghi, it seems, has started being less German and more French as Europe awaits the likely election of François Hollande as the new French president. Mr Hollande, a Socialist, wants to renegotiate the fiscal compact, a treaty toughening fiscal rules, to include growth. In Brussels there is talk of a new Marshall Plan. Herman Van Rompuy, president of the European Council, is expected to summon European Union leaders to a dinner to discuss growth. With parts of the euro zone crushed by recession and mass unemployment, many now look to Mr Hollande for relief. Even Angela Merkel, the German chancellor, has changed tone. She now insists that Europe's policy rests not only on budgetary discipline, but also on measures to promote jobs and growth.

Yet nobody should get carried away by a hope that the euro zone is embarking on a radical new course. Calling for growth is like advocating world peace: everybody agrees that it is a good thing, but nobody agrees how to do it. Mr Draghi's ideas, as far as they can be divined, are to promote structural reforms to make labour markets more flexible and encourage entrepreneurship. Mrs Merkel echoes this, saying promoting growth need not cost billions. Liberals add that a key to higher growth is to remove barriers to the EU's single market, particularly in services.

Yet Mr Hollande is against such ideas. His programme for France, which has one of the biggest public sectors in the world, is mainly about more spending and more taxes. In the EU he wants common European project bonds to finance infrastructure, a capital injection for the European Investment Bank (EIB) and a redirection of EU regional funds towards jobs. Much of this can be done so long as Mr Hollande does not try to reopen the actual text of the fiscal compact. Indeed, many of these ideas have already been proposed by the European Commission.

The frenzy about growth has gone too far, says one Eurocrat. In the end it will be a repacking of ideas rather than a revolution. Germany already favours boosting the EIB. The capital needed is modest, and it can be used as leverage for private-sector finance (the talk is of an extra €10 billion, or $13 billion, generating as much as €180 billion-worth of investment). Moreover, the EIB has a good record of managing projects. But on two other proposals—joint Eurobonds to mutualise European debt, and getting the ECB to lend directly to troubled sovereigns—Mr Hollande is likely to run into an immovable German obstacle.

Even so, Germany will find itself more isolated. It has pushed austerity too far and too fast. The myth of an expansionary fiscal contraction, the idea that deficit-cutting would boost growth, has been largely dispelled. The latest evidence is that in a downturn the multiplier effect of fiscal tightening can lead to deeper recession, making it even harder to cut the deficit. In the euro zone, moreover, countries cannot easily mitigate the impact through looser monetary policy or currency devaluation. Structural reforms may boost growth, but mostly in the medium term.

Yet if high deficits were the answer, Greece and Spain should be booming. Many countries in the euro zone had no choice but austerity to try to calm bond markets that were pushing them into bankruptcy. Others cut for fear of suffering the same fate. Debt in advanced economies has reached levels exceeded only during the second world war, and the evidence is that high debt can stifle long-term growth. Sooner or later, most European countries have to start working off their debt. So the choice is not really between austerity and growth, but over the timing and speed of deficit-cutting and the right mix of structural reforms.

The Goldilocks policy, as the IMF calls it, urges countries to embark on a gradual fiscal adjustment in the short term, if the markets allow it, coupled with a credible medium-term debt-reduction plan. European officials are now debating whether they can make fiscal targets more flexible without losing credibility, and without giving governments a licence to break the rules. Germany argues, with some justice, that the southern Europeans will reform only under extreme duress. It did not happen in good times, so now it must in bad times, declares one Eurocrat.

What sort of compact?

The biggest boost to growth would be to remove uncertainty about the survival of the euro. This requires risk- and burden-sharing across the whole zone. The adjustment will be faster if countries like Germany boost domestic demand through higher spending or lower taxes. The Germans will also have to accept higher inflation to allow others to regain competitiveness without being pushed into deflation. The euro could also be strengthened by a European system to recapitalise banks and guarantee deposits to break the vicious cycle of weak banks and weak sovereigns pulling each other down. Some form of joint Eurobond could stop countries being pushed into insolvency.

Many of these measures will not happen quickly. But, as Mr Draghi told the MEPs, European leaders need to create a sense that they will move in this direction given the right conditions, so as to show that "we are not stuck in a static position". Germany and other creditors need to be convinced that such integration is not an open-ended invitation to profligacy at their expense. Euro-zone countries may end up having to accept more, not less, reform and budget discipline. A growth compact, if it ever comes about, may not be quite what Mr Hollande had in mind.

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