THE GLOBE AND MAIL
CANADA'S NATIONAL NEWSPAPER • FOUNDED 1844

The Canadian model: How euro zone can find more economic stability

The European Union states that use the euro currency should adopt Canada's fiscal transfer system so that it could provide stimulus to economies experiencing a downturn in the economic cycle and boost market confidence

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724 Words
Wednesday, June 25, 2014
Globe and Mail Update
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Europe has been going through a few rough years recently, with a double-dip recession and an unemployment rate that seems to be sticking at a record high of about 12 per cent. Of course, the recession lingering since 2008 has many causes and dimensions, but now that the dust has (mostly) settled, it is becoming evident that the European economic and monetary union has a fundamental design flaw that most likely made the pain much worse than anywhere else in the developed world: A monetary union should be accompanied by a fiscal union.

This idea is finding an echo with Laszlo Andor, the European Commissioner for Employment, Social Affairs and Inclusion, who earlier this month gave a lecture about the need to put in place a "well-designed mechanism of fiscal transfers between member states using the euro." Sound familiar? Is the Canadian model finally becoming the blueprint for a successful Europe?

To our knowledge, this is the first time a European commissioner goes as far as describing a complete transfer scheme where euro zone states would not only use the same currency and share limited fiscal policies, but would actually go as far as instigating a European unemployment insurance program.

Europe does have some limited fiscal consolidation in place through the European Fiscal Compact (the latest version, in fact, went into effect in January, 2013). In short, members have to respect agreed limits on deficits and national debt. There are also some bailout provisions in the European Financial Stability Facility and the European Financial Stability Mechanism, as well as the Euro Plus Pact, which states that member states must peer review each other's budgets before they are presented to national parliaments.

These initiatives have their merits, true, but are of limited utility in situations where the use of a single currency is preventing some member states (Spain, Greece and Portugal come to mind) from inflating their way out of debt by purposely lowering their currency and benefiting from higher exports. In hard times, a country's currency often becomes its most important tool. When control over the currency is delegated to an outside authority, compensatory stabilization measures have to be established.

This is precisely the strength of Canada as a federal state, in which partly self-governing states operate under a central government. Under this type of system, some sovereign power is given by the states to the central government in exchange for some sort of transfer system that benefits the stability of the whole. This system has worked wonders for Canada since its inception (dare we say, for some more than others) and the country sailed smoothly through the Great Recession without much worry about its fiscal stability. Case in point: Who would have believed 20 years ago that Ontario, with the strong presence of the auto sector, would be receiving equalization payments after a global recession changed the North American manufacturing landscape?

Still, the Canadian model is not without its flaws. Revenues from natural resources have created some difficulties, since provinces own the natural resources in their territory and use the related revenues to pay for the services provided to their residents. As is well known, natural resource endowments differ from province to province, meaning that some provinces become net payers and others net recipients. In Europe, the same phenomenon could happen, the likely scenario being that countries that undertook painful reforms would become net payers for those that opted to keep kicking the can down the alley.

Should the European Commission seriously consider this option, it would definitely meet with strong resistance from richer countries such as Germany, which would be net contributors to a European fiscal transfer mechanism and would initially feel like they are picking up the tab for excesses enjoyed in the south. But we firmly agree that a basic European fiscal transfer system modelled on Canada's would provide a stimulus to economies experiencing a downturn in the economic cycle and boost market confidence. As we have been saying for the past few years, what Europe needs are deep structural reforms, not additional austerity.

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