Still time to save the euro

A new agenda for growth and jobs with a focus on the euro area's four largest countries

Edited by Hansjörg Herr,
Jan Priewe and Andrew Watt

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A NEW AGENDA FOR GROWTH AND JOBS WITH A FOCUS ON THE EURO AREA'S FOUR LARGEST COUNTRIES

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HANSJÖRG HERR, JAN PRIEWE AND ANDREW WATT

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HANSJÖRG HERR, JAN PRIEWE, ANDREW WATT: INTRODUCTION – REFORMS OF THE EURO AREA AND DEVELOPMENT OF ITS FOUR LARGEST ECONOMIES

In June 2018, the editors of this book organised a workshop on "Twin Reforms in the Euro Area – Structural Reforms in Member States and the Design of the Monetary Union".[1] We intended to identify "structural reforms" necessary in selected Member States (MS) of the European Monetary Union (EMU) – mainly the four large EMU economies – in a more concrete manner than how the term is used in the predominant terminology where the focus is mostly on cutting budget deficits and liberalising labour, goods and services markets. Such structural reforms should be put in the context of reforming EMU's design which is widely agreed to be incomplete, despite the reforms that have taken place since 2011 in the aftermath of the global financial crisis. The search for the two layers of structural reforms, in MS and at EMU level, includes taking stock of reforms that have already started and identifying reform areas that are either under debate or not even addressed as key issues in policy-making. Our debates include institutional and constitutional reforms of the European Union (EU) and EMU itself. The results of our analyses are presented in this book. All authors aim to write intelligibly for non-professional readers as well, thus refraining from technical analyses but pointing to them in the references.

The Big Four in EMU

The focus of the country studies is on the four largest EMU economies, Germany, France, Italy and Spain which together comprise 75 percent of the GDP of the euro area (with GDP shares of roughly 28, 21, 15 and 11 percent in 2017). Their performance is therefore key for overall EMU performance and strongly impacts upon the 15 smaller MS in EMU (and the rest of the EU) due to the deep interdependencies between their economies. A quick comparative glance at the Big Four of EMU, compared with a few other OECD countries, shows surprising results (Figure 1). We show growth of GDP *per capita* which differs dramatically from total GDP performance, given that Spain had population growth of 15 percent 1999-2017, France 11 percent, Italy 6 percent, Germany 1.5 percent[2] while the US experienced nearly 17 percent. Per capita GDP is more telling about the economic well-being than overall GDP (although it too has well-known limitations as a comprehensive standard of well-being).

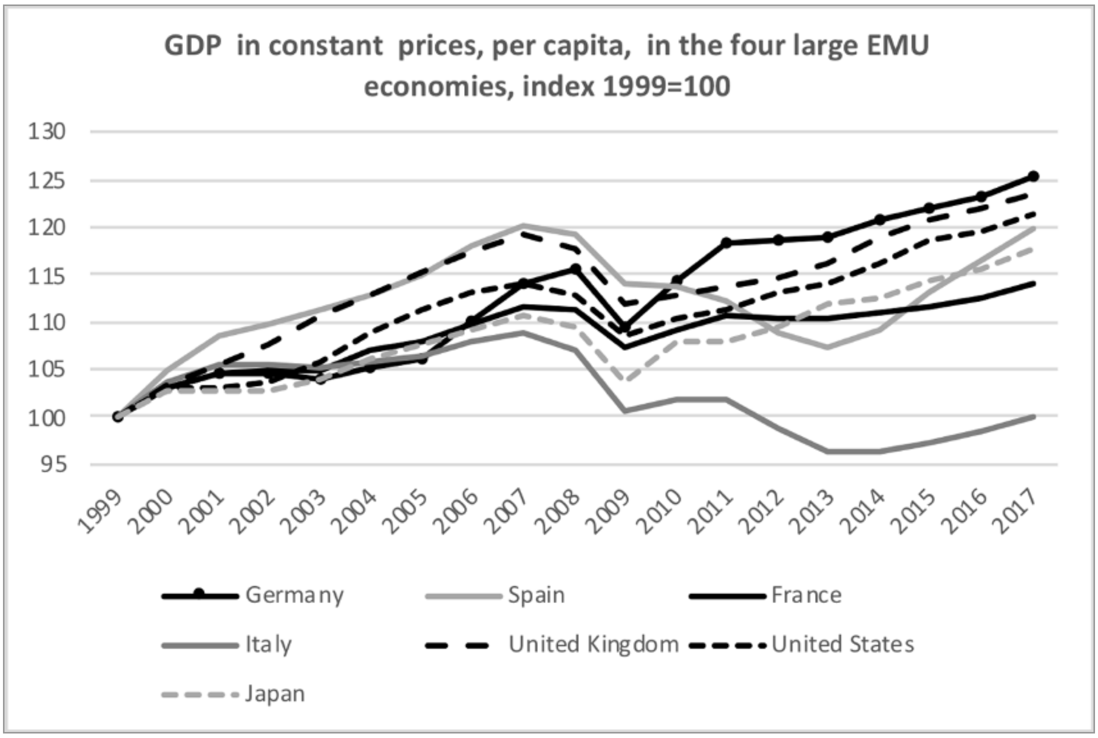

Figure 1: GDP per capita in euro (constant prices), 1999-2017 (Source: AMECO)

Since the launch of the euro in 1999, Germany has grown by 1.3 percent per capita, faster than Spain with 1.0 or France with only 0.7 percent (just below the EMU average of 0.8 percent), while Italy brings up the rear with zero growth. Of course, these low values reflect the depth of the global financial crisis and the length of the subsequent double-dip recession in EMU. Yet, the US performed, with 1.1 percent, slightly worse than Germany and below the UK's 1.2 percent, but slightly better than Japan on 0.9 percent. Impressive is Germany's strong recovery since 2009 and Spain's after 2014, while France and even Spain (despite that recent spurt) have not yet reached their pre-crisis level of per capita output in 2017 (using annual data). Italy is in 2017 still eight percent below its pre-crisis peak, and at the same level as 1999. All four big EMU countries have severe regional problems, most pronounced in Italy, with enormous social and political repercussions.

In Table 1 we show a few key structural indicators for the four countries which mainly illustrate marked divergences but also some common features. In 2017, Spain and Italy stood at around 59 and 75 percent, respectively, of German GDP per capita, in constant prices; France ranked in 2017 nine percent below Germany, but was in 1999 at par. While Italy ranked in 1999 only 6.3 percent below Germany's per capita income, Germany stood in 2017 almost 35 percent above Italy. Much of the gap came after 2008.

The most striking difference is the very varied current account balances, showing a spread of almost 11 percentage points between the German surplus and the French deficit in 2017. Furthermore, unemployment rates have ranged widely from a rate of 3.8 percent in Germany to one of 17.2 percent in Spain. This disparity is also reflected in high negative output gaps (actual output below potential output) in Spain and Italy during the period 2010-2017, indicating a lack of aggregate demand. Differences in real wage developments in the recovery period 2010-2017 are strong, with real wage cuts in Spain and Italy contrasting with expansion in France and Germany. The contrast in the core basis of exports, manufactured goods (value added) per head, is stark, with Germany's level twice as high as in Italy, while France ranges below the latter, and tourism-oriented Spain is even lower. Exports as a share of GDP increased there by 20 percentage points 1999-2017, in the other countries only by 5-11 points. Research & Development (R&D) expenditures in Germany reached in 2017 almost the EU target of three percent of GDP, similar to the US, but Italy and Spain spent less than half as much. This indicates Germany's cutting edge in non-price competitiveness on world markets and the deep technology divide in EMU (and EU).

In 2017, the Gini-coefficient – a rough measure of inequality in disposable household income – ranked a bit lower in Germany and France relative to Italy and Spain. Over the longer period, it increased in all four countries: scarcely so in France but very substantially in Germany. One factor explaining the higher income inequality is the marked rise in labour market deregulation, as indicated by the "Fraser Economic Freedom Index". This index shows higher values for low regulation (lowest regulation at value 10); distinct deregulation occurred in all countries apart from in France. For comparison, "labour market freedom" has long stood in the US above 9 in the index. Germany has liberalised its labour market more than the other three. Deregulation of labour markets has been a key tenet of supply side structural reforms, pushed by the European Commission and mainstream economics to improve price competitiveness in current account deficit countries, especially via "internal devaluation" or cutting unit labour costs as a replacement for the no longer available option of currency devaluation.

	Euro area	Germany	France	Italy	Spain
GDP per capita in constant 2010 prices, relative to Germany, 1999/2017	85.8 (91.0)	100 (100)	91.2 (99.6)	74.5 (99.7)	69.0 (72.6)
Average output gap, 2010-17, % of GDP	-1.9	-0.4	-1.2	-2.8	-5.3
Unemployment, in %, 2017	9.1	3.8	9.4	11.2	17.2
Current account balance, % of GDP, 2017	3.5	8.0	-0.8	2.8	1.9
Real compensation per employed person, change 2010-17 in %	3.3	9.4	8.5	-4.0	-4.3
R&D expenditure, % of GDP in 2016	n.a.	2.92	2.27	1.34	1.22
Manufacturing value added in euro, 2017, constant prices, per head of population	4590	7215	3455	3694	2870
Exports, % of GDP, 1999/2017	31.4/47.2	27.0/47.0	26.1/30.9	23.3/34.3	26.4/34.3
Gini coefficient 1999/2017, disposable income (equalised)	n.a./30.5	25/29.1	29/29.3	30/32.7	33/34.1
Labour-market regulation index, 2000/2016*	n.a.	2.98/7.44	5.33/5.62	4.58/6.77	5.14/6.17

Table 1: Select key structural indicators for the large EMU countries (Source: AMECO, Eurostat); *Fraser Economic Freedom Index, line 507. The Labour-market regulation index is a composite index which includes six dimensions. The index rises with lower hiring and firing costs, lower or no minimum wages, less centralised wage bargaining, fewer working time regulations etc.

Table 2 lists some indicators for public debt and fiscal policy which are pivotal in modern European economies with a high share of public spending within their GDP. The long-term real interest rate in 2017, under the European Central Bank (ECB) policy of quantitative easing (QE) geared to lower borrowing costs, shows sobering divergence: Italy has a massive comparative disadvantage with +1.6 compared to Germany with -1.2 percent. Since the real interest rate less the real GDP growth rate is a determining factor for the public debt ratio, the constellation in Italy pushed its public debt up to almost 132 percent of GDP in 2017, after dropping until 2007 to slightly below 100 percent. In Germany the ratio of public debt to GDP dropped in 2017 to barely 64 percent due to higher growth and negative real interest rates (a dream combination in respect of public debt development) (Table 2). A closer look shows that Italy benefited strongly from QE, since the real interest rate fell from 4.1 percent in 2012 to 1.6 percent in 2017, while Germany's real interest rate fell from zero to -1.2 percent in this period. QE had quite different effects on the EMU economies, and these in turn had different effects on public debt.

	Euro area	Germany	France	Italy	Spain
Real long-term interest rate, 2017 (GDP deflator)	-0.1	-1.2	0.2	1.6	0.3
Public debt, % of GDP 2017	88.8	64.1	97	131.8	98.3
Budget deficit, % of GDP 2017	-0.9	1.3	-2.6	-2.3	-3.1
Primary budget balance, % of GDP 2017	1.1	2.3	-0.8	1.5	-0.5
Interest payment for public debt, % of GDP 2017	2.0	1.1	1.8	3.8	2.6
Structural deficit, % of GDP 2017	-0.7	1.4	-2.2	-2.1	-3
Real primary expenditure, change 2010-2017 in %	2.4	8.3	9.0	-1.7	-7.3
Net public fixed capital formation, % of GDP 2017*	-	-0.16	2.4	-2.05	1.06

Table 2: Select key indicators for public finances in the large EMU countries. (Source: AMECO) *Note: gross fixed capital formation less depreciation. A negative value means absolute reduction of the public capital stock. Here cumulated value net public fixed capital formation 2010-2017, as percent of GDP 2017

How far fiscal policy is restrictive can be measured by the primary budget balance – the higher the budget surplus less interest payments, the more restrictive fiscal policy is. In 2017, Italy was much more restrictive than Spain and France, but less so than Germany. With fairly high growth and a negative real interest rate, the German government preferred cutting public debt rather than fuelling aggregate demand, with the side-effect of further increasing the current account surplus. The German twin surplus in government budget and current account is one of the key structural macroeconomic problems in EMU, ignored by the German government despite muted criticism from the EU Commission. The divergence in interest payments on public debt between Germany and Italy (1.1 and 3.8 percent of GDP in 2017) functions as a self-reinforcing vicious circle: Germany benefits from the low interest burden within the budget and uses this as public saving for debt reduction, while Italy is burdened by a huge interest payment bill, albeit owed mainly to domestic creditors. In spite of the deficit in the overall budget the primary budget balance is in surplus, which impedes aggregate demand, growth and growth in tax revenues. So, real primary spending dropped in Italy, and even more so in Spain, while it increased in Germany. Net public investment fell dramatically in Italy in 2017, meaning that the stock of infrastructure capital has shrunk since 2012. What escapes all understanding is that Germany – with shrinking public debt and negative interest rates – can let its infrastructure capital shrink. High infrastructure investment, for example in ecological transformation, would be good for Germany and Europe as a whole and would help to reduce the German current account surplus. The malfunctioning of the euro system, preventing a level playing field despite a common monetary policy, but also the inadequacy of member state policies, become crystal clear behind these numbers.

Here ends our short introduction to the problems of poor growth performance and the features of divergence between the four large EMU countries. National and EMU reforms for increasing GDP growth and employment and at the same time reducing divergences are key for EMU's viability. Further divergence and a low-growth EMU would be a suicidal mix for the euro – especially when or if a cyclical downturn emerges. We now delve deeper into the analyses of the book's 14 chapters and the policies proposed therein.

Chapter overviews

The overture to the reform debate in this book is written by László Andor, a former European Commissioner. The next four chapters highlight peculiar features of the four biggest EMU countries. The following eight chapters provide overviews on specific euro area policies and reforms. After an analysis of options for change in the EU's constitutional law, a comprehensive set of policies for a reform agenda in the years to come is presented by the editors in a concluding chapter.

All authors express their personal views, independent of their institutional affiliation. Their opinions may differ but they all agree that further deep reforms in the design of EMU are necessary to make the Union viable, sustainable, convergent and, last but not least, more democratic. We plead for a better euro system, not for exits which would be economically and politically very costly; even in the long-run, reverting to national currencies would set the clock back and mark a return to old and well-known currency problems.

László Andor sets the stage for the debates on reforms in the euro area at central level. He reviews the European Commission's scenarios for the future of the European Union, published on the occasion of the 60th anniversary of the Treaty of Rome. The Commission added six reflection papers in 2017. All of this is not really conclusive and does not lead towards a push for fundamental euro area reforms and, moreover, the various reflections failed to win over the Council. Andor complains about "slow-motion reforms", still rooted in the old logic of the Maastricht Treaty and the ordoliberal school of thought, downplaying the need for more fundamental reforms. By contrast, the more federalist view on euro reforms, inherently including the idea of a limited transfer union, a view traditionally more represented by French economists and politicians, has lost influence. Andor sees a third line of thought calling for a greater re-nationalisation of policies, especially regarding room for fiscal discretion. A "triangular debate" has emerged. Overall, Andor concludes that the euro area is ill-equipped for further crises despite many reform attempts in the right direction. Hence, the as-yet-unhealthy euro could be more divisive than a source of integration.

Jérôme Creel reviews the successes and failures achieved so far by French President Emmanuel Macron on both European issues and domestic challenges. A year and a half after his election, and despite the implementation of many tax and social reforms, optimism regarding the outlook for the French economy and Macron's proposals on European governance has faded. Before the European Council of mid-2018, there were expectations that the principles and proposals of Macron's speech at the Sorbonne (September 2017) would start to be implemented. This did not happen and, since then, the slowdown in domestic economic growth has curbed the credibility of the President's agenda. Budget constraints have tightened and the French commitment to fulfil the fiscal rules has become harder to reach. A new wave of spending cuts is reducing economic growth, employment and increasing inequality. Neither monetary policy nor fresh structural reforms will be able to offset this pressure on demand. This revives the question of how far the euro area fiscal framework is appropriate. Macron's reform agenda is unlikely to bear fruit in the absence of reforms that permit a more expansionary fiscal stance, i.e. go beyond merely homeopathic measures such as the small stabilisation fund of around €30 billion or 0.2 percent of euro area GDP which has been agreed upon. Whether France's export competitiveness needs to improve, especially in terms of non-price competitiveness, remains open in this contribution.

Sergio Cesarratto and Gennaro Zezza review the evolution of the Italian economy in the post-war period. They see a shift from an early period when fiscal policy was targeting full employment to a later one when controlling inflation became the main policy target. By reviewing the literature on the Italian productivity slowdown, they stress the – often neglected – role of low aggregate demand and labour market deregulation on poor productivity dynamics. Finally, they suggest that euro area institutions should adopt new rules to keep interest rates low enough to render public debt sustainable, thus enabling fiscal policy to stimulate growth. The high interest rate spread and the lack of an active lender of last resort are seen as key problems.

Jorge Uxó, Nacho Álvarez and Eladio Febrero analyse whether the Spanish economic upswing since 2014 has been driven by "structural reforms", mainly fiscal austerity and "internal devaluation" in the form of wage restraint, or by other determinants. They reject the proposition that the economic turnaround was a positive outcome of "structural reforms" advocated by the European institutions and the former Spanish government. They find no empirical proof for this view. Rather, Spain followed an export-led upswing by returning to the trend of increasing exports that existed already before the financial crisis – and achieved a turnaround from an almost ten percent current account deficit in 2007 to a two percent surplus ten years later. Due to low labour productivity growth as well as reduced fiscal restraint, employment rose markedly and this fed into aggregate demand. The authors calculate the real effective exchange rate with export prices (rather than unit labour costs) and find only a small, almost negligible real devaluation. Moreover, the price elasticity of Spanish exports is low so that export demand beyond price elasticity was much more important. The double dip recession in Spain in 2008-2009 and in 2011-2013 was mainly caused by wage and fiscal austerity. These "structural reforms" were counter-productive. This means that "internal devaluation" via wage restraint as a replacement for currency devaluation is not only ineffective but has huge negative consequences.

Jan Priewe scrutinises the evolution of Germany's current account surplus from an almost two percent deficit in 1999 to an eight percent surplus in 2017. The main driver for the surplus is Germany's superior non-price competitiveness, supplemented by increased price competitiveness due to wage restraint until 2008 and the devaluation of the euro against the US dollar thereafter, along with building up international value chains with low-cost countries. The wedge between strong world demand dynamics and low domestic demand growth – leading to low import growth apart from imports for exports – added to the trade surplus. The result has been a long-standing trend of higher growth of exports than imports. Germany has become the country with the highest surplus in absolute terms on the planet and is the main driver of the euro area surplus. If this trend continues for the next ten years, the German trade balance would reach 15 percent of GDP in 2026 which would be a time bomb for EMU cohesion. Hence a change towards higher growth of imports relative to exports is necessary. Even the same level of growth in exports and imports would further increase the surplus.

The author briefly sketches proposals for rebalancing. German governments have stubbornly denied in the past any problem with the surplus, while the Commission's criticisms in recent years have been without consequence. Rebalancing is the key structural reform Germany needs - and Europe needs Germany's reform urgently.

Hansjörg Herr, Martina Metzger and Zeynep Nettekoven analyse the reforms of banking regulation in the EU after the financial crisis, which were almost completely based on the Basel III international framework. After the sub-prime crisis regulators added a new macro-prudential regulation pillar to what was previously mainly micro-economic regulation and supervision. Important macroprudential institutions were established and the banking system became better and more uniformly regulated. However, shortcomings remain. Pro-cyclical risk models still play an important role in banking supervision. Further shortcomings are the lack of control of international capital flows, e.g. by an international transaction tax; insufficient attention is given to currency mismatches and to unsustainable current account imbalances; furthermore, regulation of the shadow financial system is unsatisfactory. This includes the control of linkages between banks and shadow financial institutions. Therefore, the new banking regulation system leaves intact important vulnerabilities, despite remarkable progress in some areas.

Jörg Bibow holds that the euro system has failed to deliver on its promises and, despite many reforms, remains incomplete. He envisages a minimalistic fiscal union as a necessary condition for sustaining the euro. The fiscal union ("Treasury Plan") proposed is – by design – neither a "transfer union" nor does it presuppose a deeper "political union" than currently exists. The new fiscal policy rules which he proposes are much like the old ones – with one key difference: a common pool funding public investment spending in the EMU member states by issuing common debt securities, i.e. bonds to the tune of three percent of each country's GDP and earmarked solely for public investment. Issuance is mutualised regarding new sovereign debt, but old liabilities remain national.

Structural budgets in MS would have to be (almost) balanced, as in the Fiscal Compact. In the (very) long run, almost all debt would be mutualised and the 60 percent debt target would be achieved at the European Treasury level while national debts converge to 10 percent of GDP. Public investment would be debt-financed in line with the traditional public finance view. According to the author, the euro system will lack a safe footing as long as the ECB is missing a federal Treasury partner – establishing the "central Treasury & central bank axis" that is the prime instrument of demand management in all sovereign states.

Sebastian Dullien analyses reform proposals for the euro area put forward by Emmanuel Macron in his Sorbonne speech (September 26, 2017). He contrasts these proposals with the underlying causes of the euro crisis and the euro area vulnerabilities that have not been addressed by EMU reforms implemented between 2010 and 2018. He concludes that Macron's proposals address important remaining vulnerabilities of EMU but leave open many details, so it is unclear whether his ideas would really be useful in making the euro area more stable and crisis-proof. Among the problems not or only marginally addressed are boom-bust cycles, diverging competitiveness and inadequate democratic legitimacy of the euro area authorities.

Annamaria Simonazzi, Giuseppe Celi and Dario Guarascio analyse the role and potential of industrial policy in the euro area. In their view, the euro area faces two great challenges: a structural core-periphery divide, which resulted in the deepest economic crisis since the end of World War II, and several big societal challenges. In order to restore sustainable growth, EU policies must address both: tackle the fragility of the periphery's industrial base, reducing the gap in industrial capabilities, and create a new agenda for innovation and growth. The paper argues that this requires a policy combining support for domestic demand with industrial policies targeted at the developmental needs of economies at different levels of evolution. Multi-level governance is needed, coordinating action at the European, national and regional levels. The authors call for a developmental conception of industrial policy in peripheral member states, integration of sector-specific policies with regional and innovation policies, geared to establishing productive regional networks with backward and forward linkages along the value chain. They outline their idea against the backdrop of Italy's unabated North-South divide and the erosion of an erstwhile well-developed industrial network in the Italian region of Emilia Romagna.

Marianne Paasi gives an overview of EU innovation policy. R&D investment as share of GDP (R&D intensity) is persistently lower in the EU compared to the USA, its main competitor (2.0 percent in the EU and 2.7 percent in the US in 2016). In recent years, China has overtaken the EU in terms of R&D intensity. This relatively poor performance in Europe is supplemented by the intra-EU gap between member states. The EU target of three percent R&D expenditure, close to the US average, is reached by "innovation leaders" in the EU, like Germany, Austria and the Nordics, while the group called "moderate innovators under fiscal pressure" (mainly Mediterranean countries) reach a much lower level. Both gaps – the US/EU gap and the intra-EU gap – have widened since 2008. The data could be interpreted as indicating that the EU/US gap stems mainly from the intra-EU technological divide. The Commission's innovation policy has as its main focus reducing the global technology gap against the US and China. In the EU budget 2014-2020, ca €70 billion were allocated to innovation policy, relatively little compared to some €400 billion for the Common Agricultural Policy. Paasi argues that shortcomings of Mediterranean MS can hardly be offset via EU-level intervention, for the time being at least.

Christian Calliess is convinced that the current institutional setting of the European Treaties was not and is not yet capable of dealing efficiently and legitimately with the fundamental issues of the euro crisis: the banking crisis, the sovereign debt crisis and the competitiveness crisis led at the same time to a crisis of European democracy. It has proven to be insufficient to prevent or to resolve a financial and economic crisis in a sustainable manner. The Five Presidents' Report on Completing Europe's Economic and Monetary Union (2015) highlighted the need "to move from a system of rules and guidelines for national economic policy making to a system of further sovereignty sharing within common institutions" by 2025. Calliess discusses reform options that range from intergovernmental concepts with the Council and the Eurogroup at their heart to more supranational concepts based within the Commission, ranging from a European Economic Government to a European Economic and Finance Minister. Regarding the principle of democracy, he elaborates on different options for the role of the European Parliament and national parliaments.

A *group of 14 French and German economists* (*Agnès Bénassy-Quéré et al.*) propose six reforms seen as a comprehensive package. First, breaking the vicious circle between banks and sovereigns through the coordinated introduction of "sovereign concentration charges" for banks which hold an excessive share of domestic sovereign debt and, furthermore, through a common deposit insurance. Second, replacing the current system of fiscal rules focused on the "structural deficit" by a simple expenditure rule guided by the long-term debt target of 60 percent. Third, creating the economic, legal and institutional underpinnings for orderly sovereign debt restructuring in countries whose solvency cannot be restored through conditional crisis lending. Fourth, creating a euro area fund, financed by national contributions, that helps MS to absorb large economic disruptions. Fifth, an initiative to create a synthetic euro area safe asset that would offer investors an alternative to national sovereign bonds. Sixth, reforming the euro area institutional architecture by – inter alia – separating the fiscal "watchdog" function from the "judge" function of the President of the Eurogroup and assigning it to the Commission.

Peter Bofinger criticises the key proposals of the 14 economists. He argues that the specific insolvency risk of potential euro exit (the "redenomination risk") is the main risk that should be covered by a joint risk-sharing mechanism not yet available in the euro system. The proposals of the 14 economists for public and private risk-sharing are insufficient in this regard. With a strengthening of market discipline, this risk could even be increased. So far, there is little evidence that financial markets could play a stabilising role in the euro area. The proposal for an expenditure rule has its merits as it focuses on a target which governments can control effectively. But it requires a sensible debt-to-GDP target, for which the completely arbitrary 60 percent value of the Maastricht Treaty should not be slavishly adopted. For a productive compromise between France and Germany, the German side has to take the first step by allowing at least some debt financing of public investments within the fiscal framework of the euro area.

Hansjörg Herr, Jan Priewe and Andrew Watt in a concluding chapter propose a six-point reform agenda for EMU. First, the ECB should expand its *Lender of Last Resort function* to overcome the key shortcoming that, after the asset purchasing programme of the ECB is wound down, there is no reliable and quick-acting mechanism for reducing rising interest rate spreads amongst MS. Believing that "disciplined" national fiscal policy can do the job is an illusion. Second, the *Banking Union* including the European Deposit Insurance Scheme (EDIS) needs to be completed soon. Third, the present fiscal policy rules are too complex, biased towards contractionary policy and prioritising sovereign debt reduction to the arbitrary goal of 60 percent. Either more centralised fiscal policy space is needed, or more decentralised space, or a new mix. Fourth, rebalancing the current account imbalances of EMU and within EMU is urgently necessary and has to include the group of surplus countries headed by Germany. Economic governance reforms that incorporate social partners and focus fiscal policy on symmetrical rebalancing are proposed. Fifth, should the European Stability Mechanism (ESM) be changed into a European Monetary Fund, the goals, tasks and the institutional setting of the new institution should be thoroughly reconsidered to enable the ESM to act as a true euro rescue fund. Sixth, the institutional structure needs to be changed, although this is difficult within the treaties, to improve both the legitimacy and efficiency of decision-making.

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2

LÁSZLÓ ANDOR: EMU DEEPENING IN QUESTION

Risks posed by slow motion monetary reform to European unity

The European Union spent much of 2017 contemplating its future, publishing a "white paper" on the 60th anniversary of the Treaty of Rome. This document outlined five possible future scenarios, supplemented by five additional "reflection papers", including on globalisation, the social dimension, economic and monetary union (EMU), and the finances of the EU. The idea was to shore up the EU's foundations and unify the member states behind a common vision, following the United Kingdom's decision to leave the bloc.

Unfortunately, these debates have failed to bring the community to a consensus on most critical issues, not least on the question of EMU. Despite multiple calls for "repairing the roof when the sun shines", the EU seems to be approaching the next economic downturn without a sufficiently reformed and reinforced monetary union. This chapter argues that the divisive nature of a minimalist EMU has not been understood. EMU reform has been taking place in slow motion. While the European Commission has responded to the call for a

Eurozone fiscal capacity with modest and controversial proposals, powerful forces continue to downplay the importance of systemic reform. Since, however, the political capital to muddle through another crisis with austerity policies is now lacking, the risk of disintegration remains high despite the relative tranquillity of markets in the 2014-18 period.

EMU: from unifying to divisive

The European Union was designed with the goal in mind of overcoming the various forces of nationalism that had divided the continent for centuries. As a program for peace, it includes certain economic tools, one of which, over the last three decades, has been the common currency. The question, however, is how far the single currency can fulfil its unifying mission.

Based upon the experience of the recent crisis and subsequent reform period, we can examine the question of unity at four levels: the German - French axis, North - South polarisation, the UK and the Continent, and East - West asymmetry.

Monetary integration in Europe, like economic integration in general, has always relied primarily upon Franco - German cooperation. In the 1970s, Valéry Giscard d'Estaing and Helmut Schmidt worked together to develop the European Monetary System (EMS), first as finance ministers, and then as President and Chancellor respectively. Another outstanding pair, Francois Mitterrand and Helmut Kohl, facilitated the 1992 Maastricht Treaty.

These leaders managed to overcome the intellectual divide described recently by Markus Brunnermeier, Jean-Pierre Landau and Harold James (2016): Germany considers EMU to be primarily a rules-based stability union, while France considers growth and stability to be of equal importance, allowing for the use of common (and discretionary) policy instruments in the event of crisis.

This basic divide reappears all the time, in different guises. Today, the whole world is watching whether a partnership comparable to earlier ones could at last emerge. Emmanuel Macron is the fourth French counterpart of Angela Merkel and he has only a brief window of opportunity to convince the German leadership about the importance of substantial change.

Franco - German understanding in the area of economic policy and more specifically eurozone reform has been cultivated by cooperation between two groups of economists: the so-called Eiffel Group[1] and the Glienicker Group[2]. Their very modest proposals appear to be too radical for the German government, however.

In 2018, convergence between German and French views on EMU took place not by Berlin becoming more ambitious but by Paris starting to scale down expectations. However, France and Germany should not only speak to each other, but also others in the EU, in particular the countries of Southern Europe.

During the period of the so-called eurozone crisis (2011-2013), major divergences developed between the North and the South, or more precisely between the core and the periphery. Financial fragmentation and capital flight caused longer and deeper recessions on the periphery, which pushed unemployment to record high levels and increased poverty levels too. Political structures were shaken.

Since 2011, the break-up of the eurozone with the departure of one or several member states was an oft-discussed scenario, even if most did not regard it as desirable. Various anti-EU forces — the National Front (now renamed National Rally) in France, Northern League in Italy for instance – in certain periods raised EMU break-up as a possible solution, but in 2015 it was a very mainstream politician, the German finance minister, Herr Schäuble, who offered Greece a "five year holiday" from the euro; the temporary nature of such a holiday was not taken seriously and it was seen as an invitation to exit... permanently.

Beyond the polarisation between North and South, one should also look at the role of the euro in the rise of British isolationism as well. The UK Independence Party (UKIP), a main driver of the referendum, was formed at the time of the Maastricht Treaty and retained the Sterling sign in its emblem until recently. The Eurozone crisis gave a lot of ammunition to UK eurosceptics who wanted to prove that "the EU is not working." At the time of the 2014-6 debates on EU membership, it was not so much the existence of the euro which fuelled UK euroscepticism but its functioning and performance. As pro-Brexit campaigners often said: Britain was chained to a corpse.

The eurozone crisis also boosted migrant flows from the South to the UK, making it harder to reduce the level of immigration as promised by the Conservative government of David Cameron, and many Britons became disaffected when they saw how the community (or, more precisely, the Eurozone finance ministers) treated its most unfortunate member, Greece, in the Summer of 2015. Some people asked if this really was a community to which Britain should belong.

British people voting for Leave did so for a variety of reasons in June 2016. However, a shared currency in a 30-year debate repeatedly played a role in putting a wedge between Great Britain and the Continent, eventually contributing to the vote to leave.

Following a post-Brexit reflection, in September 2017, Commission President Jean-Claude Juncker outlined his vision to reunite both eurozone and EU. As part of this, to ease the further enlargement eastwards of the eurozone, he proposed a budget line that would smooth entry for those who might wish to join in the coming period. This proposal revives the original idea that there should be no separation between the currency union and the single market.

However, some non-eurozone countries show absolutely no intention of accelerating the process of accession. When we look for the reasons for keeping a distance from the single currency in Poland, Hungary and Czechia within the Visegrad group, but also Sweden in the North, it is by and large an insistence upon policy-making autonomy/sovereignty.

The dilemma of joining the eurozone is thus essentially about the choice between sitting at the "top table" but accepting more rule-taking and taking fewer discretionary decisions. In the current political environment, marked by strong Polish, Czech, and Hungarian nationalism, the power elites clearly favour more discretion and autonomy. But this also involves their taking on the risk of becoming part of a political periphery within an envisaged two-tier EU.

Slow-motion EMU reform

We have seen that the functioning of the single currency in practice has been more divisive than unifying from the perspective of the EU as a whole. But divisions have not been enough to spur systemic reform. The only period when high-level agreement on reconstruction looked at all possible was when the single currency came close to disintegration.

Between 2010 and 2014, the EU went through a cataclysmic financial and economic crisis, which nearly destroyed the euro. The tide turned in 2012, when the European Central Bank (ECB) was authorised to intervene with an expanded toolkit to stem financial panic and reform of the EMU began with the announcement of the proposed Banking Union. In the same year, the Commission was also asked by the European Council to work on EMU's social dimension.

Because of these changes, the eurozone has experienced a recovery in the last four years, when GDP growth has been positive and unemployment falling. In this more benign environment, however, reconstruction was seen as less urgent, as the more influential member states felt no need to move ahead with EMU reform. The new institutions that have been created in response to the crisis are not insignificant, but they need to be developed further, in terms both of political legitimacy and systemic effectiveness.

For example, the European Stability Mechanism (ESM) was proposed already in 2010 and made permanent in 2012, rendered more substantial in volume. However, the ESM also awaits further reform steps, especially on how it should be integrated within communitarian structures.

Two pillars of the Banking Union were established by the Barroso II Commission by 2014, but no progress has since been made, so deposit insurance has not been added to the regulatory and resolution functions. Thus, the Banking Union remains incomplete and fiscal risk-sharing has effectively been ignored. Instead, a capital market union (CMU) has been promoted on the argument that, if risk-sharing is required inside EMU, it needs to take place in the private sector and not through the channels of public finance.

Given the threat of disintegration in 2012, a number of EU documents confirmed the need for closer cooperation in the wake of the euro crisis. Together with the Four Presidents' Report[3], the Commission's Blueprint for a Deep and Genuine Monetary Union and the European Parliament's Thyssen Report[4] on the Four Presidents' Report can be mentioned. These documents pointed towards fiscal union, banking union, and political union as well. However, the necessary consensus and high-level political commitment did not emerge; it proved easy to slow down the process of reform and divert it in all sorts of directions.

The Four Presidents' Report was followed up in 2015 by a Five Presidents' Report (adding Martin Schulz, President of the European Parliament) which further elaborated on the problem of divergence and enhanced vital aspects of political legitimacy. At the same time, it stepped back from the vision of fiscal and political unions and spoke merely about fiscal capacity and stabilisation functions in very vague terms. The high-quality reflection paper on the future of the EMU published by the Juncker Commission was followed in December 2017 by a Communication with modest proposals[5] largely ignored by the European Council.

There have been many signs that the old order has been dying but not "yielding place to the new." In 2016 August, when Spain and

Portugal were supposed to be fined under the Growth and Stability Pact for violating deficit rules and not taking effective counter-action, the Commission eventually proposed a zero fine and the ECOFIN (Council of economic and finance ministers) acted accordingly. It was well understood by ministers that a mechanistic application of the rules and imposition of punitive fines would have dealt a further blow to the credibility of EU economic governance after a period when several austerity-orientated governments had lost elections and the majority of the British people voted against continued EU membership.

Since the 2011-2 eurozone crisis, several EU documents have pointed to the need for a 'fiscal capacity' to stabilise the single currency and thus make it truly sustainable. Indeed, certain functions (cross-border risk-sharing and counter-cyclical stabilisation) can be performed only via fiscal instruments in a monetary union. Following calls for a fiscal capacity, including from the European Parliament and the newly elected French President Emmanuel Macron, the Commission President in his 2017 State of the Union speech announced that a dedicated eurozone budget line would be embedded in the next seven-year Multi-annual Financial Framework (MFF) proposal.

Although previously new requests and suggestions were linked to the eurozone as it now stands, this solution is consistent with the Treaty definition of the euro as the currency of the whole European Union. On the same basis, calls for a separate eurozone parliament have also been rejected, since it is the full European Parliament which is competent on all related matters. At the same time, the Commission voiced its intention to reunite the EU and the eurozone – a proposal that, post-Brexit may face fewer hurdles, given that out of all eight non-eurozone countries only Denmark[6] is under no obligation to introduce the single currency as soon as the criteria are met. Thus, the point is not so much that the proposed eurozone budget should be embedded within the MFF but what concrete tools are put forward and how they would work.

Eurozone fiscal capacity proposal within the EU budget

In its proposal for a new MFF (2021 - 2027), the Commission included two new tools associated with the Eurozone. These are: a Reform Support Program (RSP) with €25 billion for seven years, and a European Investment Stabilisation Function (EISF) with €30 billion for the same period. The RSP, apart from offering a Reform Delivery Tool and technical assistance, also introduces a Convergence Facility to provide dedicated support for member states seeking to adopt the euro. But the precise goals and functions of these new instruments will determine whether they can at least be called "steps in the right direction".

To start with the RSP, it is designed to support structural reforms within the member states in line with recommendations outlined in the European Semester. The benefit and function of such an instrument is not obvious for several reasons. First of all, a monetary union justifies fiscal tools that are more cyclical than structural. Events that trigger fiscal support require urgent treatment; they cannot wait for the next round of the Country Specific Recommendations (CSRs). On the other hand, the previous round of CSRs may not be relevant for the new situation, should a financial crisis occur in the Autumn (which is normally the case). Second, a practical difficulty is how to "price" structural reforms? How could one design a menu with reforms and related financial envelopes that would, in an even-handed way, apply from Finland to Portugal, and from Ireland to Bulgaria. Even more important, the content of the support programs also has to be scrutinised. If such programs just serve the purpose of internal devaluation, this may prove more controversial and counter-productive than helpful.

Altogether, the RSP seems to revive an old (and failed) idea, which was on the table of the European Council in the 2012-13 period: the Competitiveness and Convergence Instrument (CCI). It was shredded for much the same concerns as outlined above. The RSP appears to be at best an attempt at political fudge, promoted by those who fear that economically sounder instruments will be impossible to agree politically. A harsher assessment would be that the RSP is a hobbyhorse of people who forgot nothing but learned nothing from experiencing the crisis. A combination of a robust cohesion policy and new instruments for counter-cyclical stabilisation would be a superior solution.

The second newly proposed tool, the EISF, is supposed to maintain the continuity of investment projects in times of crisis. However, it would not serve as a source of direct transfers but of loans, designed to offset any hike in interest rates in a turbulent period. This tool would indeed serve a useful purpose, but at this stage there are still question marks around it. In a major crisis, it is not unnatural to reprogram investment projects, and this process might well be lengthy. This may also cause delay in the arrival of support from the EU institutions. Besides, the crisis also means that some economic actors may have changed significantly or even disappeared from the stage in the meantime, which causes further complications. Crucially, any support from this facility would be destined for a specific project, which probably means that the effect would be local, or at least territorially concentrated. The EISF might then provide uneven support in times of asymmetric shocks, leaving large parts of a country and its population uncovered. One way to mitigate this risk would be to modulate the EISF so as to include general budget support that may also be used to co-finance country-wide social investments, e.g. teachers' salaries.

After the Commission unveiled these fiscal tools to be integrated into the new MFF, the small scale of these instruments and their inappropriate design led *Financial Times* columnist Wolfgang Münchau to call the approach homeopathic. On the other hand, discussion of these token instruments allows for a new round of debate about effective stabilisation in the eurozone. There are multiple options to resolve this problem. One may opt for a new stabilisation facility comparable in size to the existing EU budget, or a significant relaxation of the fiscal rules. Further innovative action inside the ECB is also possible, but has the big drawback of being non-transparent. One of these directions, however, has to be chosen before it is too late. Budgetary solutions have the advantage of being rules-based, targeted and transparent and of involving political accountability, as long as they are appropriately designed.

The small size of the proposed budget makes it necessary to explore whether the revenue side can also help in the stabilisation function by bringing in new incentives with a rebalancing effect. For example, it would be logical to impose a small levy on current account surpluses. The EU has named excessive current account surpluses as destabilising factors since 2010, under the Macroeconomic Imbalances Procedure (MIP), but no sanctions were attached, and moral suasion alone has proven ineffective. The new MFF provides an opportunity to put into real effect the rule that requires surplus countries (Germany and the Netherlands most of all) to increase domestic investment and wages and thus boost aggregate demand, helping themselves but also the whole community at the same time.

The Commission rolled out its MFF proposal with the intention of getting member states, as well as the European Parliament, to reach an agreement within one year, i.e. before MEPs start to campaign for re-election. The euro area fiscal capacity is clearly one of the several sticking points that limit the feasibility of such a speedy adoption, and it is one due to both context and content. Advocates of a systemic EMU reform may be open to a constructive compromise as long as it is assured that there would be follow-up, in the not too distant future, outside the MFF context. At the same time, it is also noted that the small space required for the embryonic euro area budget at this stage has been created at the expense of cohesion policy, which is the fiscal stabiliser of the single market. Politically, this means playing out the Eastern and the Southern peripheries against each other. The sums in question would not be sufficient to solve the euro area's problems, but they would be sufficient to create tensions around the single market.

Triangular Debate on EMU

In recent years, EMU reform has not only lost speed but also direction. In and after 2012, the debate was binary: between advocates of the original Maastricht design on the one hand and a federalist-inspired reform on the other. Austerity was linked to the first position and acceptance of a transfer union to the second. The first position has been advocated by economists like Hans-Werner Sinn and Jürgen Stark, the second by academic critics like Joseph Stiglitz (2017) and Paul Krugman as well as Paul De Grauwe and Peter Bofinger.

The first approach was clearly dominant in the early period of Eurozone crisis response (2010-1) but started to lose ground after the turnaround by the ECB and the proposed Banking Union. Representatives of the second tendency not only criticised austerity but also outlined many concrete steps that would need to be taken to make EMU resilient and sustainable in the long-run. The usual "shopping list" – elements of which can be found in various contributions to this volume – includes the completion of the Banking Union (with deposit insurance), the widening of the ECB's mandate (similar to that of the US Fed), the creation of safe assets, and the integration of the ESM into community law. Some form of unemployment insurance[7] would also be justified and necessary.

In contemporary discussions, some would like to see faster progress, while others would prefer to take a few steps backward and withdraw tools established at the time of the crisis (e.g. abolishing the ESM or streamlining the European Semester). The debate, therefore, is not only about speed, but also direction. Having witnessed the stalemate between fiscal federalists and ordoliberals, some have advocated for a third position which rejects both fiscal union and excessive austerity. It puts forward the "re-nationalisation" of fiscal rules and the restoration of the "no bail-out" principle, together with the establishment of a sovereign default mechanism.

Under this "third option", surplus countries would stop pushing for austerity and deficit countries would stop pushing for transfers. Neither risk-sharing nor risk-reduction is the solution but risk-re-nationalisation. Completing the Banking Union is desirable but efforts to move towards fiscal union are pointless for both economic and political reasons. Nor is there a need to monitor divergence in the eurozone or strengthen the social dimension of the EMU.

Author	Diagnose	Therapy
Sinn, Stark	Loss of fiscal discipline and economic competitiveness	Adjustment within countries, structural reforms (muddling through)
Stiglitz, Krugman, De Grauwe	Flaws of original (Maastricht) EMU model	EMU reform: banking union, fiscal union, wider ECB mandate, wage coordination
Sandbu, Legrain, Wren-Lewis	Policy mistakes in crisis response (austerity)	timely debt-relief, flexible fiscal rules, risk renationalisation

Table: Three schools of thought on the Eurozone crisis and EMU reform

Leading economic theorists and commentators like Charles Wyplosz (2016), Philippe Legrain (2014), Martin Sandbu (2016), Simon Wren-Lewis (2014) can be seen as backing the third option. Barry Eichengreen, originally close to the systematic reform tendency, has also moved closer to this position. Their fundamental message is that for Europe's economic (and social) misfortunes not the euro but incompetent political leaders should be blamed.

In his book Sandbu argues that the allegedly incomplete nature of the EMU has never been a problem. Political leaders who before and during crisis missed opportunities (e.g. debt relief to Greece) or took necessary decisions with just too much delay (e.g. quantitative easing) are at fault. Better decisions would have averted the 2011-12 euro-zone crisis (e.g. counter-cyclical as opposed to pro-cyclical monetary policy in 2010-11).

While there is no doubt about the need for good decisions, the question is whether the Union can rely on these in future without institutional guarantees (and even automaticity in certain aspects). Without those, individuals (current and future decision makers) would need to go through a rapid learning process and become very highly skilful to avoid pitfalls at the next emergency. This also requires the capacity to reconcile national and European interests at a time of financial market turbulence, since many of the "bad" decisions were not necessarily bad from a national point of view but became ineffective or counterproductive in an all-European perspective.

Conclusions

Establishing a currency union has been a symbol and driver of an ever closer union. However, in its original design, the single currency has also contributed to current cleavages and asymmetries. North-South divergence was particularly serious at the time of the 2011-3 eurozone crisis, which helped to drive the UK out of the EU and made some non-eurozone countries more cautious about accession.

Without substantial eurozone reform it is hard to see how the unifying role of the single currency could be strengthened and the gap between EU and eurozone closed. To avert an eventual break-up, convergence has to be restored. And to regenerate convergence, the system needs to be corrected and, for lasting convergence, fundamental reform is needed.

While some may fool themselves by saying that "Europe is back on track", in the absence of reinforced instruments we might just be sleepwalking into the next crisis. The incapacity of political leaders in surplus countries to explain these risks to their public (together with the necessity of fiscal risk-sharing) has been a major barrier to progress in recent years.

If and when eurozone reform can be relaunched, the most urgent task will be the completion of the Banking Union by adding deposit insurance (EDIS) to the existing pillars, and the introduction of fiscal stabilisers in support of risk-sharing and convergence. Such measures do not require a federal leap or treaty change. Political leaders must convince the public of the necessity of repairing EMU and preparing it for the next downturn by adding effective shock-absorption tools.

Following the Four Presidents' report in 2012 and the Five Presidents' Report in 2015, a Six Presidents' Report could have been produced in 2018 to maintain the rhythm of reform cycles. One may wonder how many EU Presidents it takes to draft a report which truly convinces national leaders but also the general public about the need for a robust EMU reform process.

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3

JÉRÔME CREEL: MACRON'S REFORMS IN FRANCE AND EUROPE: A CRITICAL REVIEW

Emmanuel Macron was elected French President in 2017 on a pro-European and reform-oriented programme: not only would France be back as a strong player on the international scene but radical changes in taxes and regulations were planned to improve French attractiveness and competitiveness. This bold programme in an era of growing discontent with politicians and with the European Union faced, however, at least two pitfalls: external and internal credibility.

External credibility required a profound shift in the reputation of France in Europe. The capacity of Macron's predecessor, François Hollande, to change the course of European affairs, despite the promises he made during his presidential campaign, was weak if not entirely null. The credibility of France on the European scene declined markedly under his presidency. Regaining it is thus a challenge. To meet it, Macron has chosen to use the European fiscal rules as an instrument: abiding by the rules should show that France can stand by its commitments. External (European) credibility should follow.

Internal credibility required convincing the French people that reforms are necessary and that the chosen ones will be effective in improving the economy. Once again, the recent past comes as a heavy burden: many supply-side reforms were implemented under Hollande's presidency, like the Competitiveness and Employment Tax Credit (CETC, or CICE in French). To be credible, Macron must therefore convince people that *further* reforms are necessary. This is also a challenge, as the recent protest by the "Yellow Jackets" has shown.

Economic growth can prove a very sensitive issue in both challenges facing Macron. If recovery is strong, meeting both is relatively easy. Indeed, in that event, committing to the discipline of the euro area on budget issues would be facilitated and *previous* structural reforms appear effective. On the contrary, if recovery recedes, difficulties in meeting both challenges arise. The effectiveness of *past* reforms vanishes and public support for *new* reforms vanishes as well. Meanwhile, French fiscal commitments prove harder to fulfil.

The French President has decided to accelerate the pace of domestic reforms while abiding by the European fiscal rules since the beginning of his term in office. Yet, thanks to the French economic recovery up to spring 2018, it seemed that budget constraints would soften and that the French people would back the reforms. The situation was almost perfect. It would have been so had the European Council of June 2018 been conducive to a European impetus in line with Macron's proposals. Its outcome was disappointing though with no improvement foreseen in the governance of the euro area. The recent shift in French economic outlook has finally weakened the internal credibility of Macron's agenda: the most recent data show that GDP growth is slowing down and point to the fact that past and on-going reforms might not have been very effective so far. An (imperfect) indicator of Macron's internal credibility is his approval rate. According to recent surveys, only a quarter of French people approve of him, a sharply declining rate that puts him below the level of Hollande one year and half after his election. Moreover, under slower growth, budget constraints are tightening once again and are no help to France in regaining its external credibility.

In the following, I review the successes and failures achieved by Macron so far, on European issues and domestically, before I conclude on the burden that the EU continues to have on the French economy.

Macron's European agenda: half-empty or half-full?

Macron's speech at the Sorbonne on 26 September 2017 will certainly stand the test of time as a profound rethink in French politics about the European Union. As Macron himself put it: "The time when France proposes is back"[1]. In a divided French political landscape, between so-called anti-system parties (Far right *Front National*, Leftists from Mélenchon's *France Insoumise*) and long-established/ageing parties (*Républicains* on the centre-right and *Parti Socialiste* on the centre-left), Macron already adopted during his campaign a centrist *and* pro-European position that had permitted no one before him to win a major election during the Fifth Republic. In fact, many forward steps towards EU integration had been initiated by French Presidents (Valéry Giscard d'Estaing and François Mitterrand, jointly of course with other foreign counterparts). Unlike Macron though, they did not explicitly and vocally summon the EU as a *positive* argument during their political campaigns.

Many proposals in the Sorbonne speech were part of Macron's programme during the presidential campaign[2]: EU sovereignty and ability to protect its borders; the necessity to rebuild trust in the institutions and to reinforce the EU, notably with the creation of a budget dedicated to macroeconomic stabilisation. In the speech, this concrete proposal is viewed as a prerequisite for the pursuit of "growth and stability" in the euro area: "We need to make the eurozone the heart of Europe's global economic power. In addition to national reforms, Europe needs the instruments to make it an area of growth and stability, including a budget allowing it to fund common investments and ensure stabilisation in the event of economic shocks." Achieving this budget requires new funding that may have to come from other important areas: innovation and the environment. Macron proposes the creation of a European tax on digital companies, as a regulatory device, and a European carbon tax at the EU's borders. Macron finally advocates social and tax convergence across EU Member States in a manner which he views as following common European rules: "We need to encourage convergence across the whole EU, setting criteria that gradually bring our social and tax models closer together. Respect for these criteria needs to be a precondition for access to European solidarity funds. Where tax is concerned, we need to define a 'corridor' for corporation tax rates; in social affairs, we need to guarantee a minimum wage for all, adapted to the economic realities of each country, and regulate social contribution competition."

In a later speech in Aachen (10 May 2018)[3], Macron reiterated his plea in favour of common rules, putting solidarity up against hegemony ("Our Europe (...) can no longer function on the basis of successive hegemonies. It can build itself only on constant solidarity"). He also warned Europeans against resistance to change and hoped for a change of priorities in Germany:

> In France, [people say] the treaties mustn't be changed any more, we also mustn't reduce public spending any more, and we have a classic preference (...) for public spending rather than complying with standards, and so let's agree to shake up these obsessions and not be afraid to say: yes, to move forward in Europe we must at some point be prepared to shake up the treaties, change them and take this democratic risk. Yes, I'm prepared to say that we must carry out in-depth reforms and make radical changes to reduce public expenditure, which is the only condition for moving forward in this Europe and complying more with standards, building these common rules; but in the same way in Germany, there can't be a permanent obsession about budget and trade

> surpluses, because these are always at the expense of certain others.

So far, there can be no dispute in saying that such obsessions have not vanished and that concrete deeds have not matched the words of Macron. There have been at least two disruptive elements blocking the path of Macron's European agenda towards its enactment. The first has to do with timing. The Sorbonne speech was given a few weeks before the German general election. It should then have served as a a key input in the discussions between the French and Germans shortly after the appointment of the new federal government in Berlin. The protracted political process of negotiations to form a government in Germany and a political balance at the Bundestag less oriented towards the EU thwarted that initial plan. The second element relates to the unambitious "roadmap for deepening Europe's EMU" that the European Commission released in December 2017 although German political negotiations were still continuing. Even so, the "roadmap" does propose the adoption of a "stabilisation function at European level" that "would provide the possibility to activate resources rapidly to deal with shocks that cannot be managed at the national level alone." While this proposal seems close to the French one, it has received a lukewarm welcome from other Member States, including Germany. In May 2018, the Commission announced "back-to-back loans under the EU budget of up to €30 billion" for the European Investment Stabilisation Function (EISF) for the next Multi-Annual Financial Framework (MFF or EU Budget) (2021-2027). The EISF would complement existing domestic and European instruments to dampen "large asymmetric macroeconomic shocks in the euro area and countries participating in the European Exchange Rate Mechanism". If the allocated amount were set annually, it would provide extra financial support of around 0.2% of euro area gross national income[4]. While some might argue that budget size does not always matter, its allocation does. In this respect, the use of public investment support as a *rapid* stabilisation tool sounds puzzling: to reduce time lags in decision-making regarding the identification of public investment projects and the activation of funds, European authorities will have to draw up and update a list of non-implemented/yet-to-be-implemented projects. This would raise the question of why these identified projects are to be implemented *only* after a shock and not before. On December 4 2018, a minimal agreement on a "comprehensive package to further strengthen EMU" was reached. It equips the European Stability Mechanism (ESM) with "more effective (precautionary) tools (for countries) which could be affected by an adverse shock" that remain conditional on "sound economic fundamentals". Moreover, the "operationalisation of the common backstop for the Single Resolution Fund (SRF) (...) will be introduced earlier" although risk evaluation before full operationalisation will not occur before 2020, leaving the SRF without a backstop until then. Finally, "technical discussions continue" about "possible instruments for competitiveness, convergence and stabilisation in EMU".

More cumbersome for France's external credibility has been "the return of the budget constraint" (see below). The French government's commitment to abide by the public deficit limit of 3% of GDP was part of a bargain with other EU governments and institutions in 2017. The argument was that, by fulfilling the fiscal rules, France would be in a better position to recommend some modifications to EU governance. The latest data release of GDP growth, followed by the announcement of a stimulus package to (try to) curb the "Yellow Jackets'" protest have weakened the French position. Maybe worse for Macron, the growing French difficulty in reducing public deficits and debts may be used by the Italian government to legitimise its own deviation vis-à-vis former commitments and to target a higher deficit than the one negotiated with the European Commission. The fact that a eurosceptical government may use France as an example to renege on fiscal commitments sounds a shade paradoxical for a pro-European President.

French economic outlook after reforms

The recovery of the French economy accelerated in 2017 when the GDP growth rate reached 2 percent, or twice the rate achieved in 2016. Spring 2018 forecasts by the OFCE (French Economic Observatory) (Heyer and Timbeau, 2018) were 2.0 and 2.1 percent respectively for the years 2018 and 2019. The public deficit was below 3 percent of GDP in 2017 and expected to be close to 2.5 in 2018 and 2019. This improvement in the French economic situation in 2017 had two origins: first, the impact of previous policy measures, mainly due to the CETC decided under Hollande's presidency, and, second, the increase in world demand.

Despite this improvement, the output gap remained negative, at 1.9 percentage points, and closing it was not expected before 2019. Overall, the GDP performance of France as regards the euro area could be viewed as disappointing. Indeed, according to Heyer and Timbeau (2018), the GDP growth of France between 2014 and 2017 was 2.7 percentage points below that of the euro area as a whole. They also show that the biggest source of the difference was exports: their contribution to GDP was 5.6 percentage points lower in France than in the euro area.

Against the backdrop of these good though imperfect economic conditions in 2017, the reform agenda of President Macron has been directed towards three goals: limiting public spending, reducing structural unemployment and boosting competitiveness.

On the first objective, the message has not been very clear though: the announcement of a drop in spending via cuts in public sector employment and a freeze on public sector wages is certainly consistent with a stricter application of European fiscal rules, whereas the €50 billion investment plan (over 5 years) in training, environment, health, agriculture, government modernisation and transportation is not, at least until the budget deficit reaches the announced 2022 target at 0.5 percentage point of GDP. The fact remains that to date most of the fiscal measures, whether up or down, have not been implemented, apart from the wage freeze.

On the second objective, the labour-market flexibility agenda passed by decree (*Ordonnances*) in September 2017 complemented the reforms adopted (in Parliament but without a vote) under President Hollande. Non-reliance on votes at the Parliament shows that modifications of labour law in France remain a very sensitive issue. The aim of the latest reform is to enhance the scope for labour negotiations at company level, to ease the scope for referenda and to limit obstacles to agreements in small- and medium-sized enterprises (SMEs). The conditions for achieving collective agreements depend on the size of firms: there are two thresholds for collective bargaining at 11 (or 20) and 50 employees. In small firms without trade union-elected representatives or without an economic and social committee, employers can initiate referenda on all issues related to labour conditions, *e.g.* gender equality, difficult working conditions, and older workers' employment. Agreement can be obtained by a simple majority of voters. According to the new employment law, compensation for unfair dismissal is capped, clearly an advantage for firms from which the government expects a higher elasticity of labour demand *vis-à-vis* economic fluctuations. Still on the side of firms, a permanent 6 percent cut in employer payroll contributions will replace the CECT in 2019. On the employees' side, payroll contributions began to fall during 2018, financed by an increase in a more broadly-based tax that started at the beginning of 2018. This gap in timing is partly responsible for a temporary drop in households' purchasing power in 2018. The rise in ecological taxes, in taxes on tobacco and on retail oil sales has also had a negative impact on purchasing power.

Drops in employer and employee payroll contributions are also part of the third objective, aiming at improving external competitiveness. Another important policy in this respect consists in the gradual reduction in the corporation tax rate from 33.33 to 25 percent in 2022. The three remaining important tax reforms that broadly aim at boosting either competitiveness via improved attractiveness for investors or purchasing power are the replacement of the wealth tax with a tax on real estate (with a narrower tax basis), the adoption of a single tax on interest income, dividends and capital gains set at 30 percent and the reduction, then elimination, of the local property (or council) tax (*taxe d'habitation*). In 2018 and 2019 respectively, the tax-cuts will amount to €7.2 and €3.5 billion (Madec et al., 2018).

The tax reform agenda of the French government has undoubtedly impinged on inequality. Some measures, like the flat tax at 30 percent on financial incomes and the reduced reach of the new tax on real estate which replaced the wealth tax, are biased in favour of households earning the highest incomes. Other measures like the ecological and tobacco taxes bear a higher cost to households with the lowest incomes. Estimates carried out with the tax-benefit microsimulation model for France developed by INSEE and DREES show that tax and social policies reduce the standard of living of those in the bottom 5 percent of income share by 0.6 percent in 2018, while those within the top 5 percent would gain 1.6 percent (Madec et al., 2018). It must be stressed that the deterioration in purchasing power at the bottom of the income distribution relates in large part to the timing of social and tax reforms. First, increases in some benefits have been planned during the last quarter of 2018. Second, the transformation of employee payroll contributions into a broader tax (generalised social contribution, or CSG in French) has not been annualised: the CSG has increased in the first quarter of 2018 whereas the decline in the employee payroll contribution will reach its full effect only during the last quarter of 2018. Third, the local property tax will decline only gradually over 2018. In contrast, tax reforms on financial incomes and real estate were implemented earlier in the year. In 2019, the top 5 percent should still receive a gain of 2.2 percent in their purchasing power while the bottom 80 percent would also have a gain whose maximum, at 1.7 percent, would be for those within the 30th percentile of the income share[5].

The consequences of tax and social reforms on inequality and purchasing power have had detrimental effects on the internal credibility of structural reforms, as the "Yellow Jackets"' protest has proven. In an economy that is still beset by a demand deficit, it has also had negative effects on GDP growth.

Recently-released forecasts for France from different institutes (see table 1) show that growth has been decelerating since 2017. After 2.3 percent in 2017, the GDP growth rate is expected to fall within a range of 1.6 to 1.8 percent in 2018 and 2019. After an improvement in public finances between 2016 and 2017, the budget deficit may deteriorate between 2018 and 2019 according to the French government (see table 2). It must be stressed that the deficit figure for 2019 includes a one-off measure resulting from the transformation of CETC into a permanent reduction in employees' social contribution: the tax yield in 2019 will be based on the payroll of 2018 whereas the reduction in social contribution will be effective immediately. This one-off measure amounts to approximately 0.9 percentage points of GDP. That said, with a public deficit forecast at 2.8 percent of GDP and a forecast of the cyclically-adjusted improvement in the deficit of only 0.2 percent of GDP, the risk of infringement of EU fiscal rules by France may be high in 2019. Indeed, the cyclically-adjusted deficit does not decline at a pace consistent with the preventive arm of the Stability and Growth Pact: it should be 0.5 percentage points of GDP per year under the medium-term objective.

	France		Euro area	
	2018	2019	2018	2019
European Commission (July 2018)	1.7	1.7	2.1	2.0
IMF (July 2018)	1.8	1.7	2.2	1.9
OECD (September 2018)	1.6	1.8	2.0	1.9
Banque de France / ECB (September 2018)	1.6	1.6	2.0	1.8
OFCE (September 2018)	1.7	1.8	-	-
Government (Law of Finance 2019, Sept. 2018)	1.7	1.7	2.1	2.1

Table 1: Growth forecasts (%), France and the Euro area, 2018 and 2019 (Source: *Haut Conseil des Finances Publiques,* September 2018)

	2017	2018	2019
Public balance	-2.7	-2.6	-2.8
Cyclically-adjusted balance	-2.3	-2.2	-2.0

Table 2: Public finances (percentage points of GDP), France, 2017 to 2019
(Source: Law of finance 2019, September 2018)

The French situation is thus paradoxical: the facts show an official will to abide by EU rules but the public deficit does not decline fast enough to reduce the debt to GDP ratio. Stated differently, the adoption of tax and fiscal policies has been fully consistent ex ante with both the EU's fiscal framework and with its competitive agenda but, at the same time, the economic results have not been in line with expectations. Does that mean that sticking to the EU rules is a dead-end?

Does the EU weigh on France?

It is very striking that the mood regarding the French economy and Macron's proposals on European governance has changed radically during 2018. The scars of the global financial crisis on the French economy had almost entirely disappeared and, before the European Council of end of June 2018, one could hope or expect that the principles and proposals of Macron's speech at the Sorbonne would start being implemented. This did not happen and since then the slowdown in economic growth has curbed the internal and external credibility of Macron's agenda.

The modernisation of the French economy that Macron is willing to achieve is still on-going, but results are not up to his expectations. To be fair, it is not unusual that a reform package takes a few years to produce its full effect. The reform agenda may eventually prove economically effective in the near future. However, the modernisation of the French economy has already fuelled inequality and there are risks that spending cuts are looming in the short term. Such dangers may materialise if the French government sticks to its commitment of a decreasing public deficit, despite higher-than-expected amounts for automatic stabilisers. Indeed, with lower growth than initially expected, social spending will grow above the initially planned level while tax receipts will slow down, all other things being equal. Spending cuts may push inequality up and economic activity down, as the output gap remains negative. If this happened, it would be clear that the EU and the governance of the euro area weigh heavily on France.

Still, other economic policies in the euro area are not geared towards expansion. Monetary policy and the trend in the euro exchange rate will be unable to alleviate the impact of spending cuts in France. The quantitative easing of the European Central Bank is now close to its end and long-term interest rate forecasts for 2019 are on the rise. Finally, the large trade surpluses of the euro area *vis-à-vis* the rest of the world maintain pressure on the euro which tends to appreciate and hence weighs on prices and real activity (Blot et al., 2017). This may put a particular drag on the French economy. Unlike most other euro area countries, France has still a current account deficit. Moreover, the geography of global value chains for the French industry is not the same as that for Germany, typically in the automobile industry. France's suppliers come from the western part of Europe whereas Germany's are located in the eastern part, hence in part outside the euro area (Frigant, 2014). Consequently, benefits from the appreciation of the euro for German importers of intermediate goods and services may be larger than in France. It must be added though that the improvement in mark-ups in the French exporting sector has been steady recently: value added gained almost 6 percentage points between 2013 and 2016 and the level of mark-ups has now risen above its former peak in 2000 (Heyer and Timbeau, 2018). Additionally, investment in the manufacturing sector has been fairly strong. Both trends dampen the risks that euro appreciation and rising long-term interest rates might place on the French economy.

The occurrence of a new wave of spending cuts in the short run in France could not be offset by new structural reforms either. As reported above, the number of tax and labour market reforms has been high since 2013. Margins of manoeuvre for an extension of reforms are rather thin.

This revives the question of the appropriateness of the euro area fiscal framework. First, the debt objective in the Stability and Growth Pact of 60 percent of GDP corresponds to the average debt ratio of European countries in 1990, almost 30 years ago. Second, it is now widely acknowledged that EU fiscal rules are not flexible enough to foster macroeconomic stabilisation, most importantly during downturns, and debt sustainability. The current fiscal framework has given more weight to the second than to the first objective and has therefore been responsible for the self-defeating austerity of 2011 and 2012 (Holland and Portes, 2012; iAGS, 2012).

Whether one should or should not maintain the hierarchy between macroeconomic stabilisation and debt sustainability should be open to debate. Anyway, even if the latter continues to take priority over the former, there is still some space for reforms. A first reform might consist of modifying the debt target so that it would be consistent with the economic and financial conditions of the euro area Member States *since* the creation of the euro rather than *before* the euro was created. In so doing, the change in the debt target would not violate the logic that prevailed when the 60 percent target emerged. Adapting this logic to the first 20 years of the euro gives a debt target set at 80 percent of GDP and that would provide fiscal margins for manoeuvre to European governments (Creel, 2018). France would escape having to resort to spending cuts while abiding by the new debt rule.

Asserting that some logic prevailed in the choice of the debt target in 1990 at 60 percent of GDP might be interpreted as a misuse of the term 'logic'. Averaging debt-to-GDP ratios across different countries at a given period and concluding that the resulting debt-to-GDP ratio will anchor future fiscal policies is not an economically or financially sensible way of dealing with sustainability. Debt sustainability is related to many factors that ought to be taken into account before recommending fiscal adjustments. Aldama and Creel (2017) show that public debt is sustainable provided there are sufficiently long periods during which fiscal policy aims mainly at curbing debt. Comparing the relative sensitivities of fiscal policy towards debt when the government aims at curbing debt and when it does not and comparing the relative lengths of both episodes, they show that French public debt has been sustainable since the mid-1960s despite episodes of accelerating debt-to-GDP ratios. The priority given to public debt in the European fiscal framework appears misleading in the case of the French government at least. A complete overhaul of the fiscal framework should be put on the European agenda: an obligation of result (like macroeconomic stabilisation and public *and* private debt sustainability) could substitute for an obligation of (fiscal) means that has failed.

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4

SERGIO CESARATTO AND GENNARO ZEZZA: WHAT WENT WRONG WITH ITALY AND WHAT THE COUNTRY SHOULD FIGHT FOR IN EUROPE

The Italian economy has returned to modest, positive growth but it is the only large economy in the Eurozone which has not recovered yet from the Great Recession (GR) of 2008 (Figure 1). In the final quarter of 2017, its real GDP per capita was 8 percent below its peak of 2008, while Spain – which suffered a similar downturn – has recovered faster. Figure 1 includes the current IMF projections up to 2023 which predict that the situation is not likely to change in the coming years.

As the chart in Figure 1 shows, the slowdown of the Italian economy, relative to its major partners, seems to have started earlier than 2008. After many years when real GDP per capita was growing in line with that of France, and closing towards that of Germany, in the second half of the 1990s Italy's performance worsened, and the combination of the effects of the GR and of the policies implemented afterwards implied a widening gap with both Germany and France.

This slowdown has been addressed by many mainstream commentators, who endorse the hypothesis that aggregate demand matters only in the short run but a prolonged slowdown in the growth rate must depend upon supply-side factors. In addition, the (fallacious) (Reinhart & Rogoff, 2010) argument on the relevance of the level of public debt for growth has contributed to putting the reduction in public debt at the top of the Italian economic agenda, to be achieved through austerity measures which – as for Greece – have instead contributed to slowing down growth even further, causing an increase in the ratio of debt to GDP, not a fall.

We will argue that, on the contrary, changes in aggregate demand have consequences for the growth rate and austerity measures are inappropriate to help the economy recover, while failing to reduce or stabilise public debt relative to GDP.

In the next section we will briefly discuss the determinants of Italian growth, showing that the post-war period can be broken down into different sub-periods. In section 3 we will review the arguments on the sources of imbalances in the Eurozone, and their policy implications. In section 4 we will review the current proposals for reform, both as regards Italy and the Eurozone. Section 5 concludes by discussing our own proposals.

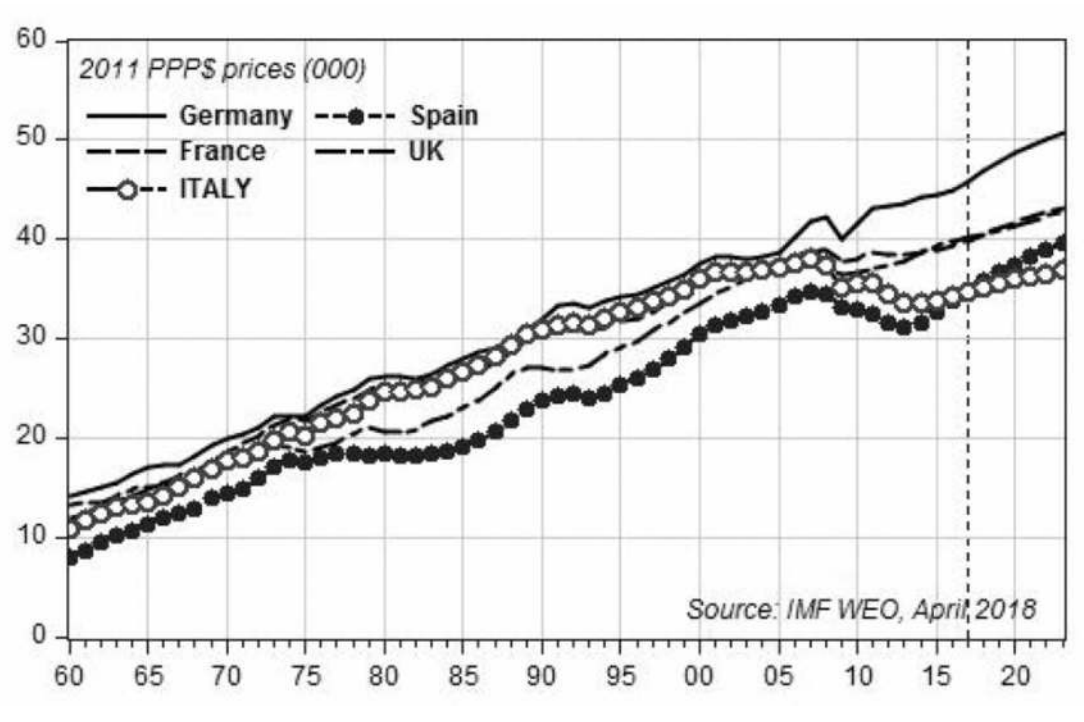

Figure 1: Selected countries. Real GDP per capita

From prosperity to austerity

As we documented in Figure 1, real GDP per capita in Italy has been growing in line with that of other major European countries, up to the 1990s. This does not mean that the Italian growth model remained the same over this period of time. On the contrary, as we discuss elsewhere in more detail (Cesaratto & Zezza, 2018), the post-war reconstruction period of rapid growth was based first on domestic demand (Ciocca, Filosa, & Rey, 1975), and later on exports (Graziani, 2000). In the early 1960s the country experienced an unfortunately short-lived reform season that failed, however, to introduce the social reforms necessary to mitigate likely social conflicts, and the "structural reforms" aimed at modernisation such as reducing the relevance of family-ownership of most businesses, facilitating the production of domestic innovation and fully exploiting a substantial technological potential in advanced technologies (like electronics, chemistry and nuclear energy) – rather than relying on copying foreign technologies (Amatori, 2017; Graziani, 2000). At the same time, full employment in the industrialised North-West (Italy was, and still is, marked by strong regional divides) started a period of labour market turbulence which prompted the Bank of Italy to intervene through the deflationary measure of credit restriction that depressed investment and thereby put an end, in 1964, to the years of the "economic miracle". The subsequent growth rate was lower but, again, in line with that of other countries. In the second half of the 1960s the Italian economy became even more export oriented (De Vivo & Pivetti, 1980; Salvati, 1975), with price competitiveness being achieved by an increased exploitation of the workforce, rather than by increasing capacity or by innovation. These processes led to even stronger social conflicts, peaking in 1969, and the oil shocks of the 1970s exasperated the battle over income distribution. Later, the labour movement obtained full indexation of nominal wages but exchange rate flexibility averted a decline in price competitiveness. Fiscal policy still targeted full employment (De Cecco, 1997) and subsidised the business sector, with an accommodative monetary policy which kept real interest rates low enough to help keep public debt sustainable (Basevi & Onofri, 1997; Rossi, 1998).

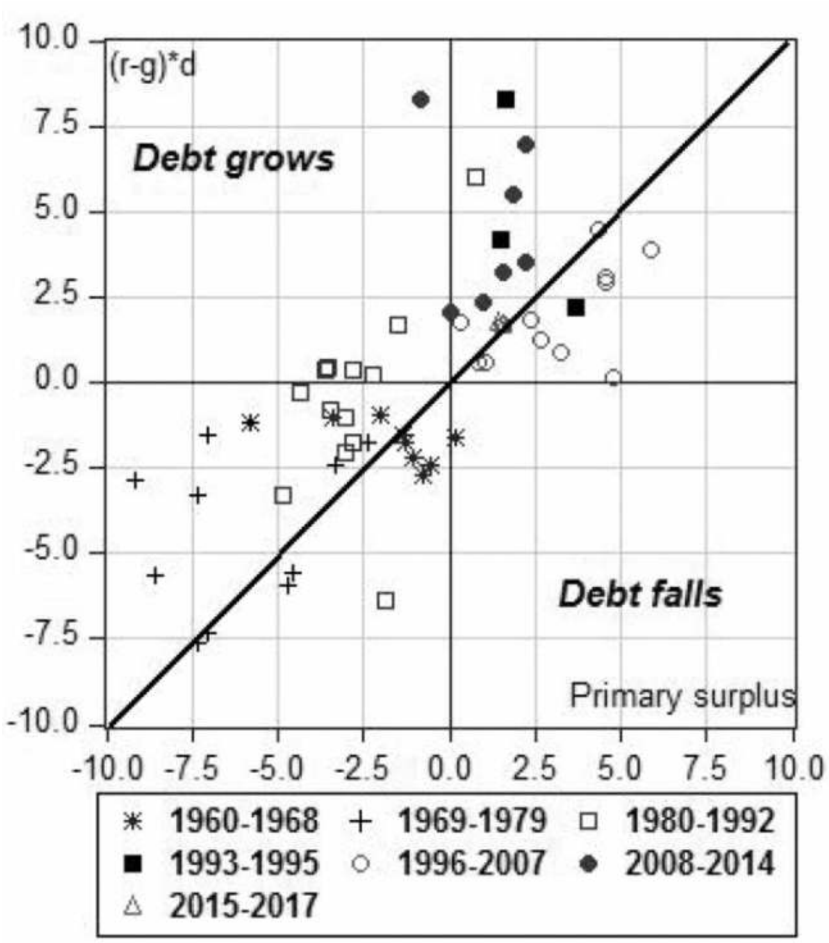

Figure 2: Italy Debt sustainability (Source: Arcelli, 1997)

To evaluate the sustainability of the Italian public debt in different periods, we use standard accounting for the evolution of debt relative to GDP. Standard textbook accounting shows that, when (where *r* is the nominal interest rate, *g* the growth rate of GDP at current prices, *d* the starting debt to GDP ratio, and *s* the primary surplus relative to GDP), the debt to GDP ratio increases. In Figure 2 this accounting relation is used to divide the diagram in two: in the upper left portion, public debt is increasing because the interest rate is higher than the growth rate, and/or the primary surplus is too small, or negative. In the lower right part of the diagram, debt is falling relative to GDP. Using data from (Arcelli, 1997) for earlier years, and from Bank of

Italy and Istat, we have plotted the evolution of Italian public debt over the years, showing that in the earliest periods a large GDP growth rate coexisted with reasonable primary deficits, implying a fall in the debt to GDP ratio. The 1970s are characterised by large primary deficits, but with interest rates low enough, relative to the growth rate, to allow for a fall – or merely a moderate increase – in public debt.

In 1979 the government decided to join the European Monetary System (EMS), without being fully aware of the consequences (Arcelli & Micossi, 1997; De Cecco, 1997; Rossi, 1998), even though the then governor of the Bank of Italy was sceptical, as he was fully aware of the perils of a fixed exchange regime without substantial assistance to weaker countries (Baffi, 1979). In 1980, the trade unions were defeated, putting an end to a long period of social conflict. This defeat allowed the monetary authorities to switch to a new, restrictive monetary regime (Simonazzi & Vianello, 1998), with the political support of the Treasury. In 1981 the Bank of Italy stopped its intervention on the primary market of government treasuries, so that the cost of borrowing for the government was no longer under control. In the early 1980s, monetary policy started to target monetary stability, aiming at reducing inflation and stabilising the exchange rate. Fiscal policy, however, did not change its target of sustaining employment: the outcome was a rapid increase in interest rates, and in the public debt to GDP ratio, as documented in our chart in Figure 2 (Arcelli & Micossi, 1997; Longobardi & Pedone, 1994; Rossi, 1998). In addition, the attempt to stabilise the exchange rate and reduce inflation was particularly difficult, since inflation expectations adapted slowly, and nominal wages were still fully indexed. The result was a deterioration in the current account balance, which added pressure to the choice of using fiscal policy to sustain employment levels. Our econometric exercise – not reported for reasons of space – shows that the data support the hypothesis of the current account balance helping to predict the government's net borrowing position, rather than the other way round.

While the temporary Italian exit from the EMS in 1992 gave the economy some breathing space and time to adjust the current account imbalance, the decision to import foreign discipline was completed by joining the European Monetary Union. Some commentators (Daveri, 2017; Piluso, 2017) interpret the choice of adopting a common currency issued by an independent Central Bank – the Maastricht Treaty – as a way of imposing, once and for all, rigid discipline on the Italian labour market and on fiscal policy, with the political bonus of putting the blame for real wage compression and austerity onto foreign institutions, rather than the domestic government.

The convergence towards the Maastricht criteria first, and the adoption of the euro later, were indeed successful in lowering the inflation rate, albeit not as much as in Germany, so that a small inflation differential persisted, implying a slow but growing deterioration in price competitiveness. Lower interest rates helped the convergence towards the Maastricht fiscal criteria, but the price of the restrictive fiscal stance and the loss of external competitiveness was a substantial stagnation of aggregate demand and productivity growth.

In the 2000s, up to the GR, Italy grew less than its major partners (Figure 1). Aside from the above-mentioned reasons, other countries (the U.S., Spain, Greece, etc.) experienced faster growth in this period because of a boom in the real estate market, going hand in hand with the explosion of mortgages, and private sector indebtedness. Italian households already had a fairly large share of wealth tied up in housing, and the Italian financial sector was at the time less open to international markets. The effects were that Italy did not experience a dramatic increase in financial fragility in the pre-GR period, and was comparatively less exposed to the financial crash of 2007, but it did not enjoy the rapid finance-led growth of other countries. Stagnating domestic demand, along with the shrinking of the manufacturing sector, were the main contributors – in our view – to the relative decline in Italian productivity. Another determinant of low productivity growth, which assumed greater importance later on, was the deterioration in labour market conditions, with a number of reforms enabling firms to increase the share of temporary and/or part-time jobs. Workers on temporary contracts are unlikely to contribute to productivity growth arising from learning-by-doing and have few incentives to increase their efforts.

If the Italian financial sector suffered less than other countries from the 2007 shock, the combination of the belated response of the ECB to the crisis, climbing interest rates after the Greek crisis in 2010, and the adoption of a restrictive fiscal stance by the Monti government in 2011 brought a strong and prolonged recession, with a considerable fall in private sector investment, a credit crunch which created liquidity problems for small business initially and insolvency problems later (leading the banking sector into troubled waters), as well as a dramatic increase in poverty. The combination of rising interest rates and low growth produced an increase in the public debt to GDP ratio (Figure 2) which called for further austerity, plunging the economy into a deflationary spiral.

The feeble recovery which started around 2014 is mainly due to exports: part of the business sector diversified its foreign markets, and companies were able to increase sales abroad, mainly to non-euro countries (Bugamelli et al., 2017). Since most of these firms are located in the North, the recovery is widening regional disparities even further.

Summing up, the decline in Italian productivity, which started in the 1990s, is mainly analysed from the supply side (Bugamelli et al., 2018). However, supply-side determinants internal to firms (small size, family ownership, etc.) were already extant in earlier decades and did not preclude the country's ability to grow. On the other hand, the external determinants of productivity (rule of law, efficiency of the public sector, etc.) would have required public investment, rather than austerity-driven cuts. Finally, more attention should be paid, as discussed above, to the determinants of productivity on the demand side as well as to the vicious circle formed by labour market "flexibility", human capital and productivity.

Eurozone imbalances

The idea that the design of Eurozone institutions inevitably implies imbalances, and the inability of individual eurozone governments to address asymmetric shocks without starting a recessionary spiral was diagnosed early on – see (Godley, 1992) among others – but still the 2007 shock found Eurozone institutions unprepared. The imbalances are mainly visible in the polarisation between northern countries – notably Germany – running a large current account surplus and "southern" countries with a corresponding deficit. In a closed system, of course, it would be impossible for some countries to run a trade surplus without some other countries running a deficit, with the implication that the former group is financing the net balance of the latter.

Some commentaries focus on price competitiveness, given by differentials in labour costs, as the main source of trade imbalances (Flassbeck & Lapavitsas, 2016): notably achieved by stronger wage moderation in Germany (Baccaro & Tober, 2017; Nocella, 2015). Further evidence on the relevance of price competitiveness can be found in (Paternesi Meloni, 2018), while (Algieri, 2015) finds that for Italy non-price factors played a more relevant role. Others (Horn, Lindner, & Stephan, 2017; Storm, 2016) point to the quality of German exports and the reshuffling of the European production network in a direction unfavourable to southern countries. (Cesaratto & Stirati, 2010) point to the role of faster growth in domestic demand in southern countries. Another crucial role was the progressive integration of the German economy with that of Eastern European countries (Celi, Ginzburg, & Guarascio, 2018). On the structural determinants of the German surplus see also (Priewe, 2018).

Current account imbalances are obviously mirrored in imbalances on the capital account or, to express it differently, current account deficits must be financed. Before the Greek crisis, the private financial sector of surplus countries was willing to meet the demand for funds from deficit countries. After the crisis, current account imbalances were reflected in Target2 balances, giving rise to a debate on whether the crisis is similar to a standard balance of payments crisis, a debate we do not address here for reasons of space (Cesaratto, 2013, 2018a; Febrero, Uxó, & Bermejo, 2018; Lavoie, 2015).

In any case, after the Greek crisis, it became clear to financial markets that the ECB would not act as a lender of last resort for governments in trouble, and the spread between the cost of borrowing for the Italian and German governments increased markedly (Figure 2); the Italian debate in turn started to gravitate even more towards how to reduce the size of public debt, instead of focusing on how to increase aggregate demand and reduce unemployment and poverty.

Summing up, economists disagree on the roots of Eurozone imbalances, and therefore on the appropriate policies to address them. Mainstream economists who stress the role of price competitiveness call for "internal devaluation", to be obtained through labour market reforms. These have been implemented in Italy, so much so that the vast majority of new jobs come with temporary contracts, and according to Eurostat (table lfsa_epgar[1]) the country has the largest share in Europe (after Greece and Cyprus) of part-time workers who would like a full-time job. As we have argued, labour market flexibility may have an ephemeral impact on price competitiveness, but also a negative one on domestic demand and productivity, which more than offset the gains, as both Greek and Italian experiences have shown.

Heterodox economists who stress the role of price competitiveness would rather underline the necessity for Germany to abandon its mercantilist, low-wage policies. This is in line with those who stress the role of aggregate demand on imbalances and call for German reflation: expansionary fiscal policy coupled with an increase in nominal wages. While this would be beneficial, the literature shows that the impact might be insufficient to rebalance the Eurozone (Angelini, Ca' Zorzi, & Forster van Aerssen, 2016; Garbellini, Marelli, & Wirkierman, 2014; Gaulier & Vicard, 2018; Horn et al., 2017; Landmann, 2017; Portella-Carbó & Dejuán, 2018).

Reforming the Eurozone

That the euro is dysfunctional is the current consensus. How to fix it is not. There are two fundamental positions – leaving aside the most radical one that suggests that one or all members should abandon the monetary union.

The mildly Keynesian French position maintains that there is a problem of completing the EMU institutions by complementing the common monetary pillar with a common fiscal one. An old inspiration behind this position is the MacDougall report (Commission of the European Communities, 1977). This stance was abandoned in the eighties under the influence of New Classical Macroeconomics and the shift towards neoliberalism.

The second, monetarist German stance finds the origin of the euro's troubles in the negligent application of the existing rules, particularly of the fiscal rules.

The first position was revived by Macron's speech at La Sorbonne in September 2017 when he proposed a wider macroeconomic coordination and a more robust European budget, given that "no state can tackle an economic crisis alone when it no longer controls its monetary policy". This budget should be financed by "European taxes in the digital or environmental fields" and by "partly allocating at least one tax to this budget, such as corporation tax once it has been harmonised" (Macron, 2017).

The German response was given in (Schäuble, 2017), where a European budget was rejected, and the suggestion was to transform the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) responsible for monitoring the member states' compliance with the fiscal rules and, eventually, for making sure that governments implement the necessary restructuring processes. In addition, emphasis was laid upon respect for the debt rule, which would compel Italy to meet the fiscal compact's prescription of a reduction in the public debt/GDP ratio to 60 percent in 20 years: an impossible target, given the expected growth rate in GDP, and knowing that any attempt to reduce the debt to GDP ratio by increasing the primary budget surplus will result in a fall in GDP larger than the fall in debt, as was the case during the Monti government.

An attempt at finding a common ground was made by a group of French and German economists (Bénassy-Quéré et al., 2018): their paper aims at strengthening fiscal discipline in exchange for some "risk-sharing" among partners. To be quite clear: countries with high debt would have to accept more discipline and receive less risk-sharing than others. The document is made up of three parts: the first is devoted to the completion of the banking union; the second to budgetary rules; and the third to the institutional framework. In essence, the latter endorses the German proposal of a reinforced monitoring and crisis-management role for the ESM. France seems to have abandoned the idea of turning the Eurogroup (the Council of Eurozone finance ministers) into the arena where countercyclical budget policies are coordinated and has now surrendered completely to the German reduction of economic policy management to a strict observance of rigid rules.

The Germans have consented to a common European deposit insurance scheme (EDIS), but only with guarantees concerning the financial sustainability of banks. They have therefore subordinated EDIS to the disposal by national banks of domestic Treasury bonds, in order to avoid the 'doom loop' between banks and sovereign, and of the non-performing loans (NPLs) in their possession beneath a certain threshold (sanctioned by penalties). This would penalise countries like Italy that would hastily have to sell the large amount of government bonds they own, with destabilising effects on the Italian treasuries market. The reduction in NPLs – due to the austerian policy stance so far – obviously requires a reversal of this policy. German economists also forget the huge role played by the big German banks – almost speculative institutions – in the run-up to the American financial crisis and the huge financial help they received from the German government. The involvement of the private sector in public debt restructuring is also a proposal likely to destabilise markets by increasing the financial risk as soon as it is implemented (Bastasin, 2017; Cesaratto, 2018b).

Contrary proposals have recently been advanced by Paolo Savona, the current Minister of European Affairs (Savona, 2018), suggesting, inter alia, selective action by the ECB as a lender of last resort to eliminate the spread differentials on peripheral debt, in order to restore uniform credit conditions for member states, banks and firms in the Eurozone:

> A much more delicate issue to be addressed in terms of monetary policy concerns the development of the lender of last resort function [...]The constraints related to quantity and proportionality between Member Countries (the "capital key" that introduces a monetary base even whereby it is not necessary e.g., buying Dutch and German government bonds), as well as quality of financial assets, result from the required compatibility with the Statute underlying the ECB action. Hence, rationalisation of the related institutional powers would be required to face future speculative attacks in a more timely and efficient manner. (Savona, 2018, p.27)

Conclusions

What should be the reform priorities for Italy? Much discussion is taking place there about supply side-reforms (Bugamelli et al., 2018; Cottarelli, 2018). The list of inefficiencies is long, ranging from those of the judicial system to the worsening quality of education; from the (perhaps exaggerated) spread of corruption to (obviously more worrying) organised crime; from poorly managed SMEs to commercial law. At the root of these inefficiencies lie poor social institutions, especially in the *Mezzogiorno*, characterised by a limited sense of civic participation and commitment (with, of course, laudable exceptions), at all social levels and hierarchical positions. The perception is that merit goes unrewarded and family or political connections matter much more. The absence of advanced, cooperative institutions to regulate social conflict over income distribution has already been pointed out as the main origin of the Italian troubles. The quality of the political class has become poorer. After the surrender to the EMU of any independent policy space, the room for alternative, serious policy proposals has been drastically reduced, so that older political parties resemble one another and new leaders will be rapidly burned once their promises prove unfeasible in the Eurozone context. Trust in the democratic process cannot but be badly affected.

The above-mentioned studies (and others) attribute the stagnation of productivity in Italy to the supply-side inefficiencies set out above. They forget, however, to explain why productivity growth started to fall precisely in the mid-Nineties when, as we have seen, Italy resolutely pursued early membership of the EMU. We may concede that the most enlightened of the Italian bourgeoisie was scared that an Italy outside the EMU would have been a lost country (and the entry of unreliable leaders like Berlusconi in politics seemed to prove these fears). The majority of the population was led to consider early membership as a matter of pride. The challenge by a part of the Italian bourgeoisie to modernise institutions by importing them from abroad through exchange rate discipline has largely been lost, making things worse in real terms. A matter of genuine pride would have been to stay outside, taking the challenge of an endogenous institutional change seriously.

What should Italy expect from Eurozone institutions?

The news coming from Berlin is not encouraging. The new German finance minister Olaf Scholz has made it clear that his country's stance within the Eurogroup will not change. Nothing will be done to alter the path of the German current account surplus, which is a main cause of Eurozone imbalances. If a coalition of northern Eurozone countries backs the proposal for implementing more stringent fiscal rules, the outcome will be either a financial crisis and/or the collapse of the euro area, given the growing support for populist movements supporting – at least in theory! – an *Italexit*.

One of the authors still believes that, in principle, Eurozone institutions can be reformed following the suggestions given by Keynes at Bretton Woods (Amato, Fantacci, Papadimitriou, & Zezza, 2016). The ECB mandate should be changed so to introduce mechanisms for creditor countries to contribute to the elimination of imbalances: one possibility is charging an interest rate on positive Target2 balances, to introduce an incentive for countries running a trade surplus to take corrective actions, while at the same time creating a fund to finance investment targeted at the convergence of income per capita and productive capacity. At the same time, the introduction of domestic fiscal currencies, which would circulate parallel to the Euro, could provide fiscal space for increasing aggregate demand where needed, while at the same time increasing the sustainability of the existing debt commitments in Euro-denominated liabilities. By "domestic fiscal currencies" we mean very liquid financial instruments issued by the Treasury which would not be a new legal currency, but would be accepted for tax payments by the government (Amato et al., 2016). We do recognise, however, that this is for now an academic exercise lacking sufficient political support at the European level.

What Italy needs, if a eurozone break-out is to be avoided, are rules of the game which allow for increasing domestic demand without destabilising public debt. As we recalled earlier, this can be achieved by keeping the interest rate below the growth rate of the economy: any of the different proposals which require the ECB to act to eliminate any spread between the yields on treasuries of different Eurozone countries would serve this purpose. If this can be achieved, Italy could expand aggregate demand, within the limits given by (non-binding) external constraints, i.e. making sure that the expansion in aggregate demand does not increase imports to produce a current account deficit.

References

The list of references is available at
http://gennaro.zezza.it/files/CesarattoZezza2018.html

5

JORGE UXÓ, NACHO ÁLVAREZ AND ELADIO FEBRERO: THE RHETORIC OF STRUCTURAL REFORMS: WHY SPAIN IS NOT A GOOD EXAMPLE OF "SUCCESSFUL" EUROPEAN ECONOMIC POLICIES.

The true causes of the recent recovery in Spain and the debate on Eurozone reform

At the end of 1998, twenty years ago, the exchange rates between the euro and the currencies of the first member states of the Economic and Monetary Union (EMU) were irrevocably fixed, and the ECB began to define its single monetary policy: the eurozone had been created. Unfortunately, most European citizens will not celebrate this 20th anniversary in a climate of euphoria about the outcomes but of deception. From our point of view, this is due to three main reasons.

First, economic results have been disappointing, especially after the onset of the global financial crash. Although the eurozone is emerging from the crisis and has regained GDP growth, the two recessions suffered in 2009 and 2011-2013 have had severe consequences on some European countries. Particularly for the peripheral countries, the last ten years have been a "lost decade". Second, these negative results have much to do with the mistaken economic policies – fiscal austerity and wage devaluation - advocated by the European authorities and implemented by national governments post-crisis. Moreover, these policies are deeply rooted in the current configuration of the monetary union itself. Although the European Commission (EC) says that the aim of the European economic governance is "to monitor, prevent, and correct problematic economic trends"[1], it is much more than that because it also fosters a specific economic policy orientation, based on a concrete ideology, which is embedded in the different rules and procedures that guide and constrain national decisions. Third, the main decisions have been taken – or directly imposed – without a genuinely democratic debate on the options available and often take place outside or against the national parliaments that embody popular sovereignty.

In official discourse the economic prospects are always bright (the eurozone GDP growth rate is 2 percent) and the economic policies "are in fact working very well across the Union, despite the criticism" (Juncker 2017, p.1). However, whether openly acknowledged or not, the abundance of proposals for reforming the governance of the euro implicitly reveals a deep dissatisfaction with the results achieved since the creation of the monetary union.

The aim of this chapter is to use the Spanish experience within the eurozone governance framework to reach some conclusions that could be useful in the ongoing debate about required reforms.

Our point of departure is that the improvement of the eurozone governance framework necessarily requires a critical assessment of the consequences of the application of economic policies during the last years. Therefore, a redefinition of the mechanisms that decide upon governance structure, without any attempt to change its political foundations/principles, is clearly not enough. The major weakness of the main proposals under discussion (for example, those formulated by the EC[2] or by French President Emmanuel Macron in 2017)[3] is precisely that they neglect the essentials: in the end, they do not question the fundamental ideas behind current economic policies.

One of the more problematic aspects of this policy orientation is the central, almost exclusive, role devoted to "market-oriented structural reforms", and in particular to labour market flexibility. These are considered to be the main instrument to lift long-term potential output and "to make economies more resilient to economic shocks by facilitating price and wage flexibility and the swift reallocation of resources within and across sectors" (Draghi 2015, p.2). Moreover, deliberate wage devaluation, frequently associated with a significant erosion of working conditions, is advocated as a means to obtain competitive advantages, improve the external balance and promote export-led growth. However, competing for export success by keeping labour costs low leads to a "race to the bottom" in wages that depresses domestic demand and ends up being counterproductive for creating jobs.

Despite this, the high growth rates registered in Spain since 2015 have led European authorities and national institutions to portray the Spanish case as an example of the 'success' of austerity policies and structural reforms – and these should be reinforced by the eurozone reforms. "The structural reforms set in train during the recession contributed to laying the foundations of the recovery", says Banco de España (2018, p. 50). We do not share this belief and offer here an alternative explanation of the transition from recession to growth.

From recession to recovery: an alternative hypothesis

Spain experienced a period of outstanding prosperity from 1997 to 2007, when GDP and employment growth rates were well above the eurozone average. However, the opposite holds true between 2009 and 2013: it suffered a double-dip recession and was one of the European countries most strongly hit by the crisis (figure 1).

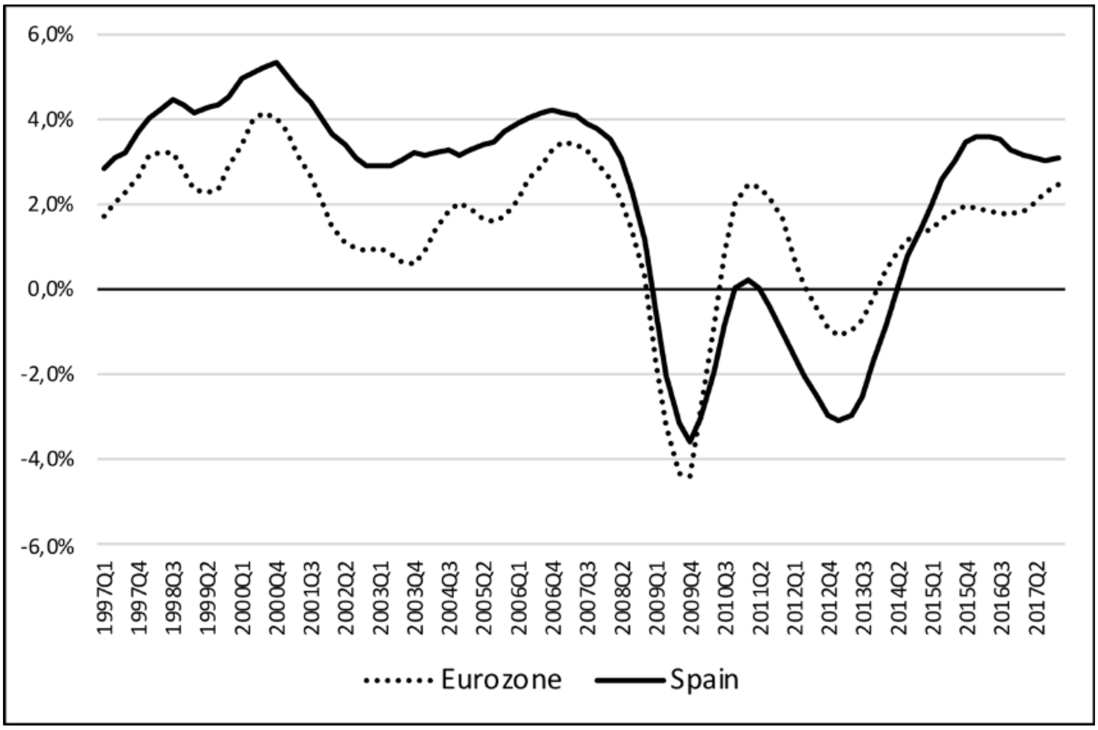

Figure 1: Real GDP, annual growth rate (Source: Eurostat)

This is the result, first, of the imbalances accumulated by the Spanish economy during the first decade of EMU (private indebtedness, housing bubble, financial fragility and current account deficit). The international financial crisis put a stop to this unsustainable growth model, provoking a generalised collapse of private demand in Spain in 2009. As the country had substantial fiscal room for manoeuvre (budget balance and public debt were +2 percent and 36 percent of GDP in 2007), the government implemented one of the most expansive and anti-cyclical packages in the world (2.3 percent of GDP in 2009), following the recommendations of many international organisations and the European authorities (European Council, 2008).

After the onset of the sovereign debt crisis in May 2010, however, mainstream approaches viewed current account and financial imbalances accumulated by eurozone peripheral countries pre-crisis as occasioned by a loss of competitiveness via-à-vis core countries, owing to an excessive rise in unit labour costs and fiscal prodigality. In order to correct those macroeconomic imbalances, European authorities insisted on strict fiscal austerity packages as well as an internal devaluation policy, and the European governance framework was reformed to enhance the surveillance and "discipline" of national economic policies (Uxó and Paúl 2011, Dodig and Herr 2014). This combination of fiscal austerity and wage restraint provoked a new collapse in domestic demand in Spain and triggered a second recession in 2011-2013, with severe effects on employment.

Notwithstanding, the Spanish economy recovered GDP growth at the end of 2013. From then onwards, it has been growing well above the Eurozone average. The European authorities present this as evidence of the success of their "structural reforms strategy", which supposedly brought about a 'healthy' export-led economic recovery. In particular, supply-side structural reforms would have enabled three paths to recovery. First, an improvement in price competitiveness and exports, thanks to lower relative unit labour costs. Second, a higher rate of job creation as a result of labour market flexibilisation. Finally, an increase in corporate profitability and, therefore, investment.

Contrary to this standpoint, we do not believe that the adjustment programme applied in Spain accounts for the current recovery. The "expansionary fiscal consolidation" hypothesis (Alesina 2010) has been proven wrong, and fiscal austerity has been systematically associated with lower growth during the crisis (Muñoz de Bustillo 2014). On the other hand, internal devaluation fostered a reduction in the wage share and there is abundant empirical evidence that shows that the Spanish economy is wage-led (Onaran and Obst 2016, Álvarez et al. 2018). Although wage compression might foster private investment (if it is sensitive enough to profitability) and exports (if corporations translate lower wages into cuts in export prices), it reduces consumption as well, since the propensity to consume out of wages is higher than that out of profits. Moreover, economies that are heavily indebted and shave large current account imbalances, like Spain, face the risk of suffering a debt-deflation problem when trying to rebalance their external sector through wage devaluation: falling wages increase the burden of debt servicing, reducing private consumption. Private consumption registered negative growth rates in real terms during this period, especially in 2012 and 2013, when wage restraint was at its most intense. At the end of 2013, household final consumption was 7 percent lower than in 2009 in real terms. Undoubtedly, this drop is the result of falling household disposable income, which largely consists of wages (Uxó et al., 2016). Therefore, in the Spanish case, the two main mechanisms (fiscal consolidation/depressed pay) derived from the wage constraint strategy that mainstream analysts consider to be at the root of recovery seem too weak to offset its recessionary impact upon consumer demand.

Therefore, we consider that structural reforms are not the key drivers behind economic recovery in Spain and we present in this section a brief alternative explanation of the transition from recession to recovery, based on three principal mechanisms.

First, as the canonical business cycle theory states (Sherman 1991), some autonomous components of aggregate demand have acted as automatic stabilisers of the economic cycle, countervailing the accelerated and multiplier effects and the restrictive consequences of fiscal austerity and wage devaluation. After a certain period, these stabilising effects stop the fall in the use of productive capacity, thus enabling investment to recover. In the case of Spain, the counterbalancing role of exports, which have been growing since 2010, is especially relevant, buttressed by the decrease in households' savings ratio which assures some downward stickiness in final consumption (their spending remains relatively constant).

Specifically, exports have maintained a significant growth rate from 2010 onwards, very similar to the solid performance registered during the expansive pre-crisis period. In a context of otherwise generalised contraction in final demand, exports have avoided a deeper recession, and this robust performance is one of the factors that finally contributed to stabilising economic activity, enabling the return to GDP growth. Nevertheless, it is important to note that this good export performance is not unique to the post-crisis period. On the contrary, Spanish exports have managed to maintain a more or less steady growth rate since 2000: the average annual growth of exports of goods and services in the periods 2000-2008 and 2011-2017 was very similar, around 4 percent in real terms. These growth rates are not very different from those registered by the entire eurozone during the same years. Therefore, although exports are a key factor behind the transition from recession to growth, all this evidence casts substantial doubt upon the idea that it is cost-competitiveness gains derived from the applied internal devaluation policy that triggered an exports boom – one that in turn brought about the post-2014 recovery.

Regarding households' final consumption, we find two opposing trends. On the one hand, as economic theory predicts, the decrease in households' gross disposable income during the recessive period translated into a significant drop in their final consumption expenditure as well, with a notable pro-cyclical impact. On the other hand, the downward stickiness of some quasi-fixed spending led to important reductions in the savings ratio from 2010 onwards, reaching very low levels and helping to stabilise aggregate demand. When the first recession took place in 2009, the adjustment in consumption expenditure started by affecting durable goods and then spread to non-essential non-durables. Afterwards, the margin for additional reductions in expenditure on these two types of goods was clearly lower, while staple goods and quasi-fixed expenditure were growing (in nominal terms)[4]. Overall, the contribution of households' consumption to GDP growth was negative during the double-dip recession, as part of the multiplier effect. Nevertheless, we must also emphasise the stabilising role played by the downward rigidity of this kind of autonomous consumption demand and the consequent reduction in the savings ratio (from 13.9 percent in 2009 to 9.6 percent in 2013, according to Spanish National Accounts).

The strength of exports and the downward rigidity of these components of private consumption finally drove up investment in equipment (because capacity utilisation stopped falling). The turning point from negative to positive GDP growth occurred in the third quarter of 2013, while productive investment began to grow three quarters before the trough. Once investment in equipment changed course and started growing, other components of domestic demand followed in late 2013.

Second, we cannot explain the reasons for the recovery without taking into account the softening of fiscal austerity policy[5] and different external tailwinds (the Quantitative Easing policy developed by the ECB since 2014, the fall in oil prices, and booming tourism) that have had a significant impact on Spanish GDP growth since 2014.

Obviously, these factors are completely unrelated to the structural reforms strategy, but they are the direct cause of an important part of the high growth rates recorded recently in Spain. Banco de España (2017, Box 1.2) shows that the net effect of the fall in oil prices, the more expansionary monetary and fiscal policies stance and (on the counter-vailing side) the lower than expected growth on world markets, accounts for two thirds of the "growth surprise" recorded in 2014-2016 (IMF 2017 presents similar estimates). The impact of these tailwinds has been higher on the Spanish economy than on the eurozone as a whole, given the dependence of Spain on energy imports and on bank financing (ECB 2016).

Finally, the third mechanism which explains high GDP growth in Spain is the effect that swift job creation, due to the specialisation of the Spanish economy in employment-intensive activities[6], has had on households' consumption.

In spite of wage stagnation, disposable income of households began to rise in 2014, thanks to this rapid job-creation, leading to a disproportional increase in consumption expenditure, and a new cut in the savings ratio (from 9.6 percent in 2013 to 5.7 percent of disposable income in 2017, according to Spanish National Accounts).

Although there are other factors explaining this reboot in private consumption (for example, the strong adjustment suffered by durable goods during the recession, see Martínez and Urtasun 2017, and Dossche et al. 2018) rapid employment creation – even although it has been concentrated in low paid jobs - seems to be the decisive factor behind this performance of households' consumption, for two reasons. First, the change from job losses to job creation has more than likely boosted households' confidence, reducing the perceived need for precautionary savings. Second, marginal propensity to consume among individuals who find work is higher than among the unemployed, and higher than those currently employed. Therefore, increases in income coming from job creation tend overwhelmingly to be translated into spending.

Supporters of the "structural reforms hypothesis" usually argue that changes in the labour market framework have enabled this rapid jobs-creation. However, the relation between GDP growth and employment growth has not changed substantially post-crisis. In fact, the employment/GDP elasticity – calculated from GDP and employment growth rates provided by National Accounts – was 0.97 in the expansion cycle of 1995-2007 and 0.77 in 2014-2017.

Does improved competitiveness explain exports and GDP growth?

The key point of the "structural reforms hypothesis" is that competitiveness gains derived from labour market reform are the main cause of resumed economic growth because of their positive effects on exports that, in turn, push up investment. We can take Banco de España (2016, p. 39) as a good illustration of this mainstream view:

> "The recovery observed in the Spanish economy since mid-2013 is the result of a combination of various factors. (...) One of the most significant factors is the increase in recent years in the competitiveness of the

> Spanish economy, understood in a broad sense, encompassing both lower costs (labour and financing costs) and lower prices, compared with the euro area as a whole. (...) The adjustment in prices and costs, which has triggered the depreciation in the real exchange rate of the Spanish economy, gave rise in the early years of the crisis to a highly dynamic export performance and a significant correction in the external imbalance. In turn, the strength of export sales drove up demand for production resources, enabling the recovery in activity to spread to domestic expenditure components.

Certainly, the good performance of export demand is one of the prominent facts that helps to explain the evolution of GDP in Spain during these years. We do not deny this. Nevertheless, we find at least three problems in accepting the role that the mainstream standpoint attributes here to competitiveness gains and structural reforms.

The first is that, as figure 2 clearly shows, the growth rate of exports is not much higher after the implementation of the internal devaluation strategy than in the previous expansive period (when relative unit labour costs were increasing). On the other hand, the weight of exports over GDP increased sharply during the double-dip recession (from 25 percent in 2008 to 32 percent in 2013), and it has continued rising during the recovery period (up to 34 percent in 2017). But this change is mainly due to the fact that domestic demand collapsed after the Great Recession and continued to fall from 2009 until mid-2014. The increase in the ratio of exports over GDP is not mainly the consequence of a faster growth of the numerator, but the result of stagnation in GDP, whose level in 2017 was approximately the same as in 2007, joined to a much more stable trend in exports (figure 3).

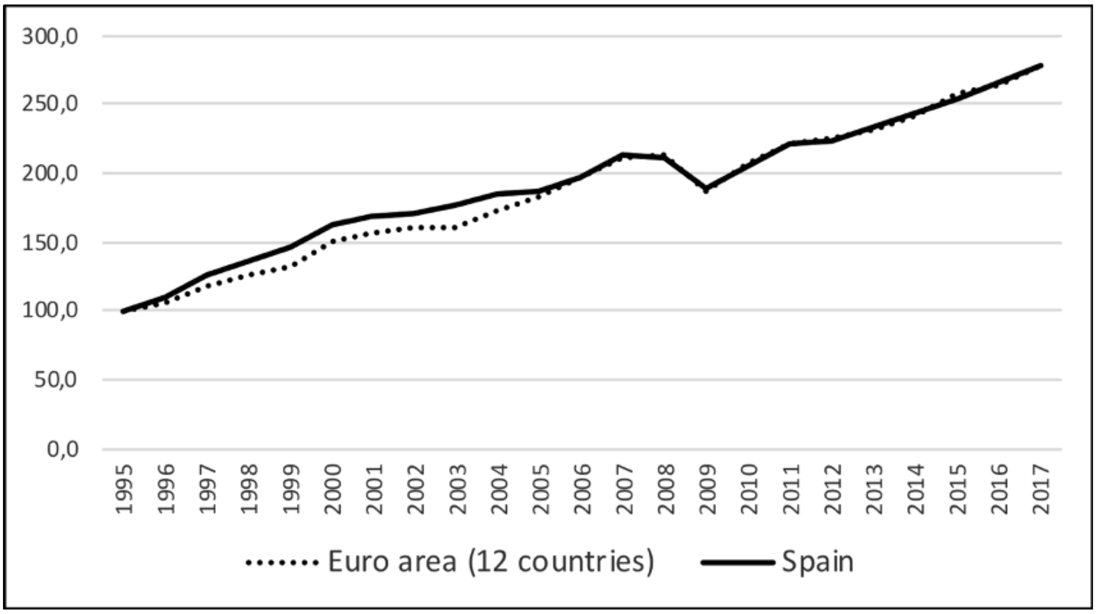

Figure 2: Exports, chain-linked volumes, 1995=100 (Source: Eurostat)

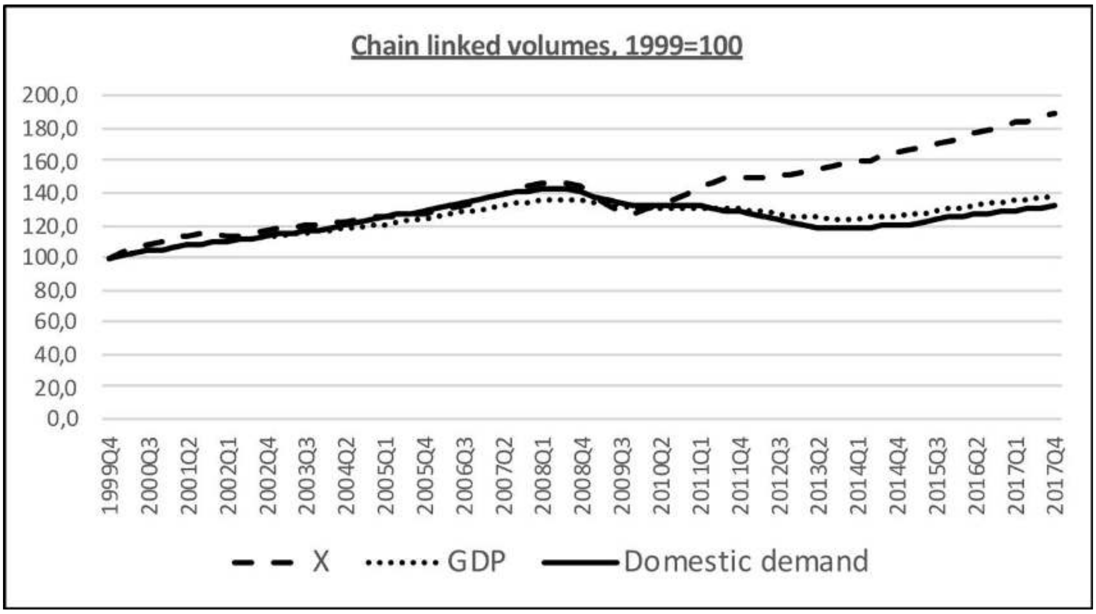

Figure 3: Exports, GDP and domestic demand, chain-linked volumes (1999=100) (Source: Eurostat)

The second problem in the conventional explanation of exports growth after 2010 is that changes in costs are not typically passed through in full to prices. Looking at recent experience, the real effective exchange rate of Spain vis-à-vis its 37 main partners decreased by 14.4 percent between 2008 and 2017 when calculated using unit labour costs, but only by 0.6 percent if export prices are used. Therefore, the real improvement in price competitiveness is much lower than the change in labour costs might indicate.

Figure 4 represents the relationship between the real effective exchange rate calculated using unit labour costs (REER-ULC), the same indicator calculated with export prices (REER-XP), and the volume of exports of goods and services. During the first ten years of EMU, Spanish unit labour costs grew faster than those of its main competitors and they were largely passed on into export prices. Thus, both cost and price competitiveness deteriorated, but exports grew at a remarkable clip. After the Great Recession, however, we can see a sharp recovery in cost-competitiveness, one that is not translated into a fall in export prices (the evolution of the real effective exchange calculated using export prices is rather flat), while exports go on growing at a very similar rate to before. Hence, any potential relationship between unit labour costs and exports seems to be pretty weak.

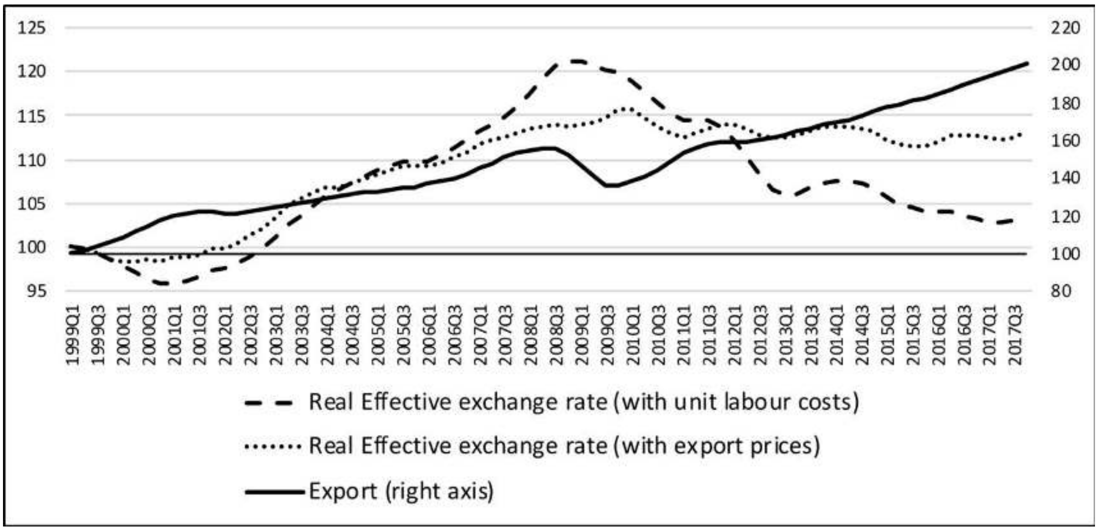

Figure 4: real effective exchange vs 37 partners (1999Q1=100) (Source: Eurostat, authors own calculations)

Finally, there are other factors, such as domestic and external demand growth differences, or a higher export orientation of Spanish firms due to the shortfall in domestic demand, that seem to have a higher impact on exports and imports than price competitiveness.

Banco de España (2017) recognises that the decrease in Spain's unit labour costs relative to the rest of the euro area, together with the decrease in long-term interest rates, account for less than 10 percent of the cumulative adjustment in the current account between 2008 and 2015. Previously, Banco de España (2016, p.45) had said that "as it is usual in estimates of this kind, external demand is the main determinant of exports", since "the literature generally finds that the ability of cost or price-competitiveness indicators to explain export performance is quite modest". Most recently, the Commission (2018, p.49) has confirmed that "export growth is mostly explained by growth in Spain's export markets", and also that "Spanish exports have become less reliant on price competitiveness". Regarding imports, Banco de España (2017, p.94) confirms that "given the traditionally low price elasticity of imports, the process of internal devaluation played a more limited role in the aggregate behaviour of goods and services imports over the last few years".

By the same token, Xifré (2017, p.64) analyses the impact of changes in cost-competitiveness on export performance in Spain and other euro area economies (Germany, France, Italy and Netherlands). He concludes that the link between relative unit labour costs and the behaviour of Spanish exports appears to be tenuous, while other non-price factors, such as a dynamic/advanced exports structure and company characteristics, are driving export developments. In short, "non-price factors have largely dominated price-cost factors in the crisis and post-crisis periods".

Villanueva et al. (2018) estimate export and import equations for the Spanish economy, including both demand and competitiveness indicators as explanatory variables. Using the results of this estimation and the evolution of the independent variables, they calculate the influence of demand and price variables on the annual average growth of exports and imports in recent years in Spain. As expected, their results confirm that the influence of demand as a driver of exports and imports is much more striking than the impact of changes in price-competitiveness on exports or the mechanism of import substitution.

Internal devaluation and the adjustment of the external sector

One of the most remarkable changes since the onset of the crisis is the adjustment of the Spanish external sector. The current account deficit of -9.6 percent of GDP in 2007 has turned into a surplus of 2.1 percent in 2017. Moreover, this external surplus has been compatible for the first time in recent economic history with high growth rates. Once more, both facts are usually presented as the proof that the economic reforms implemented in Spain (and, specifically, the internal devaluation strategy) have fostered a structural change in the growth model, rendering it supposedly more sustainable and "healthy" post-crisis.

Nevertheless, we have seen in the previous section that unit labour cost reductions have only partially translated into lower export prices. Therefore, it is necessary to evaluate to what extent and through which mechanisms the internal devaluation has truly been responsible for this readjustment of the external sector.

To this end, Villanueva et al. (2018) use the estimation of a Bhaduri-Marglin model for the Spanish economy to distinguish between a demand-channel and a price-channel through which internal devaluation could affect both exports and imports. Specifically, the ways in which this wage cut might affect the current account are threefold, with the first two the effect on exports and imports via prices, and the third the effect due to changes in final demand:

- Price-competitiveness of exports: It takes effect if the unit labour cost reduction derived from the internal devaluation strategy is at least partially passed on into a decrease in the price of exports, where their price elasticity is significant.
- Import substitution: If the fall in unit labour costs is passed on into domestic prices, this could foster a process of

substitution of imports by domestic production, depending again on the price elasticity of imports.

- Demand effect on imports: Besides relative prices, imports depend on the evolution of different components of final demand. Consequently, if the fall in unit labour costs provokes a reduction in the wage share and the economy is wage-led – as is the case in Spain – final demand will decrease, with the demand for imports correspondingly lower.

An initial conclusion from this empirical analysis is that changes in demand (the differentiated behaviour of GDP in Spain and in the rest of the OECD) have been much more important for the evolution of net exports of goods and services than changes in cost and price competitiveness. Spanish exports have been growing at a similar yearly rate in the last 20 years despite a very different pattern of unit labour costs before and after the crisis. The continuity of this good performance of exports and the substantial fall in GDP during the double-dip recession – and, consequently, in imports – is the biggest factor behind the external adjustment of the Spanish economy.

As Spanish domestic demand is wage-led, the effects of lower unit labour costs and the reduction in the wage share (figure 5) have been less dynamic aggregate demand and stagnant imports. Although this effect has not been very large, it has contributed to the other causes that have provoked the collapse of Spanish domestic demand in recent years (in 2017 domestic demand was still 8 percent lower than in 2008).

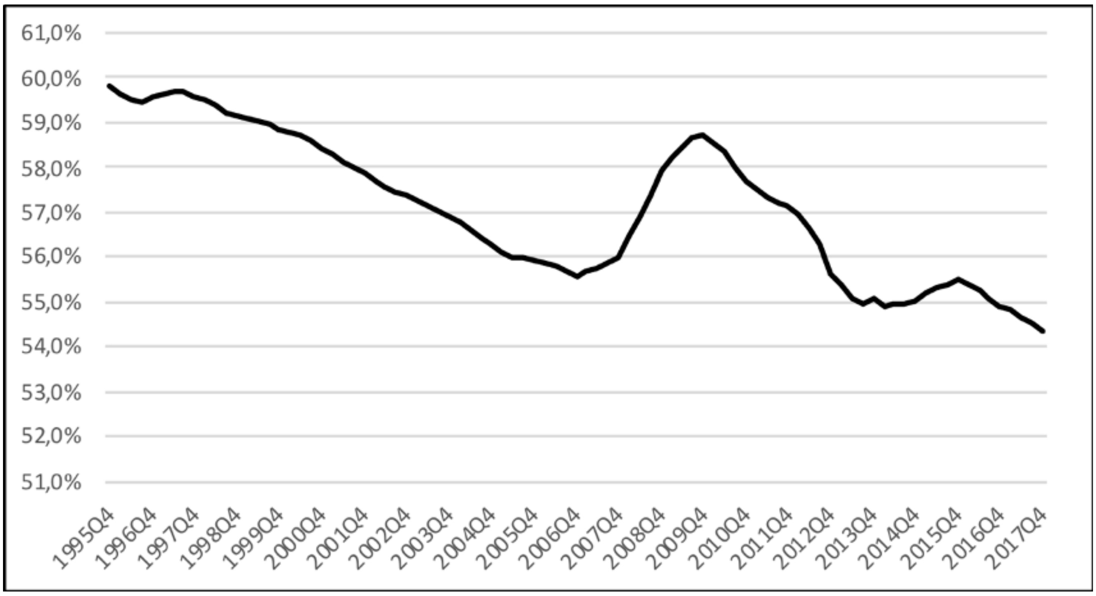

Figure 5: Adjusted wage share, Spain, market prices (Source: Eurostat, authors own calculation)

What's more, wage devaluation has also lowered domestic prices, thus rendering domestic products more price competitive than imports, resulting in some import substitution. Yet this effect is tiny, reflecting that imports demand is quite price-inelastic in Spain.

Therefore, the internal devaluation strategy has had a limited effect on Spanish current account readjustment and this effect has taken place, on the other hand, through a different transmission mechanism (demand compression or "competitive austerity", according to the terminology proposed by Paternessi 2017) than put forward by proponents of the internal devaluation strategy ("price-competitiveness gains").

Conclusions

High GDP growth recorded in Spain since 2014 is frequently presented as proof of the "success" of the structural reforms strategy advocated by European authorities. According to this standpoint, the competitiveness gains supposedly derived from labour market flexibilisation are the main driver of current Spanish growth. We do not find empirical support for this view. Fiscal austerity and wage restraint triggered the second recession of 2011-2013, while the factors behind the recovery are entirely different. Therefore, internal devaluation was an unnecessary and extremely costly policy and the reform of the eurozone unconditionally requires radical changes in the orientation of economic policies.

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6

JAN PRIEWE: GERMANY'S CURRENT ACCOUNT SURPLUS – A GRAVE MACROECONOMIC DISEQUILIBRIUM

In the year 2017, Germany ran a current account (CA) surplus of €263 billion, the largest surplus ever in its history and the highest among all countries on the globe. Relative to GDP, the surplus was 8.1 percent, the highest among all large advanced economies. It rose from a deficit of 1.7 percent 1999, at the inception of the euro, by around ten percentage points to its present level. The second and third largest surplus countries are Japan and China, but their surplus is much less both in absolute and relative terms. In 2017, a handful of small countries run mammoth surpluses relative to their GDP, such as Singapore (18.8 percent), Ireland (12.8 percent) and Netherlands as well as Switzerland (both around 10 percent)[1].

Had Germany a *CA deficit* of 8 percent, all economists would agree on a severe macroeconomic disequilibrium – which logically implies that a large country with a large surplus, relative to GDP, qualifies as in a macroeconomic disequilibrium as well. An imbalance on this scale is unsustainable and bears huge risks for an export-heavy country like Germany. Yet, the situation is odd: after the low of the great financial crisis 2009, Germany enjoyed fairly good growth, unemployment has reached the best values since 1990, inflation is close to the ECB target of 2.0 percent, public debt fell close to 60 percent of GDP. However, the exorbitant surplus casts a cloud over the stability of this seemingly good performance. It reflects a grave mismatch of internal equilibrium (price stability, high employment, low public debt) and external disequilibrium that, taken together, amount to a fundamental macro disequilibrium.

The official statement of the German Federal Government, in answer to a query of an opposition party in the parliament, is as follows:

> "The current account surplus is not an excessive imbalance. Besides, in a monetary union the surplus must not be viewed in national isolation. From a worldwide perspective, the overall current account balance of the euro area with the rest of the world is crucial. The surplus of the euro area (3.6 percent of GDP 2016) is not considered by the Federal Government as part of global imbalances[2].

The German Council of Economic Experts (GCEE 2014) denies potential problems with the surplus if structural budget deficits in CA deficit countries are avoided and if a proper banking union is implemented in the European Monetary Union (EMU) capable of preventing sudden reversals of capital flows out of deficit countries (GCEE 2014). In contrast, both the European Commission (EC 2017) in its report for the "Macroeconomic Imbalance Procedure" as well as the International Monetary Fund (IMF 2017a) see grave problems for the cohesion of the EU/ EMU and the world economy at large, respectively. The IMF (2017) diagnoses an undervaluation of Germany's real effective exchange rate in the range of 10 to 20 percent while the excessive part of the surplus is estimated at around 4.5 percentage points.

US President Donald Trump complains about the German, the EU and the Chinese surpluses. Facts and figures are as follows, using the database of the US Bureau of Economic Analysis (BEA 2018):

Germany runs a bilateral current account surplus with the US of $66.4 billion (2017) which is almost identical with the bilateral trade balance. This amount is not more than 11.7 percent of the US trade deficit this year. The same database records a bilateral US-China current account deficit of $356 billion, 67 percent of the total US deficit. This is at odds with international statistics (used by the IMF and the World Bank) which record a Chinese current account surplus of only $165 billion (which is not more than 1.4 percent of China's GDP)[3]. The BEA database reports a mild bilateral current account surplus of the US with the EU and only a tiny deficit with the EMU for 2017.

In this essay, we evaluate the German surplus. First, the performance and emergence of the current account is reviewed over the period 1999-2017. Then, we look at the causes and prospects, discuss benefits and risks of the surplus for Germany, the other EMU members and the rest of the world. Finally, we explore policy proposals for rebalancing. Our key proposition is that the surplus is way too high and has a built-in mechanism to rise. With severe negative consequences both for Germany and for the functioning of the EMU, it poses a big risk for the common currency. Thus, the imbalances in the euro area reflect a fundamental flaw in EMU design that is unfortunately not addressed by the recent reform initiatives of the EC or by the French President or the German government.

The evolution of the German current account since 1999

In the framework of the balance of payments, the current account balance comprises the trade balance (exports and imports of goods and services), i.e. the key component, the primary income balance (cross-border in- and outflows of profits, interest and wages) and the transfer balance. Since a current account surplus is matched, by definition, by a current account deficit elsewhere, net capital must flow – directly or indirectly via other countries – from surplus to deficit countries. A CA surplus results normally in wealth income such as profits or interest revenues. Hence, a continuous CA surplus increases net incomes from abroad, accompanied by a rising net international investment position (NIIP) which represents the stock of assets held abroad less the stock of liabilities owed overseas. Figure 1 shows the rise of the German trade surplus and the complementary rise in the primary income balance, whereas the transfer balance remained small and constant relative to GDP. Germany entered the euro era with a slightly overvalued DM/Euro rate and a small CA deficit but the subsequent CA rebalancing excessively overshot itself towards a strong, seemingly ever-rising surplus until 2008. When exports fell in the financial crisis of 2009, triggering a sharp drop in GDP and also imports, the current account fell only somewhat, but recovered quickly and shot then upwards.

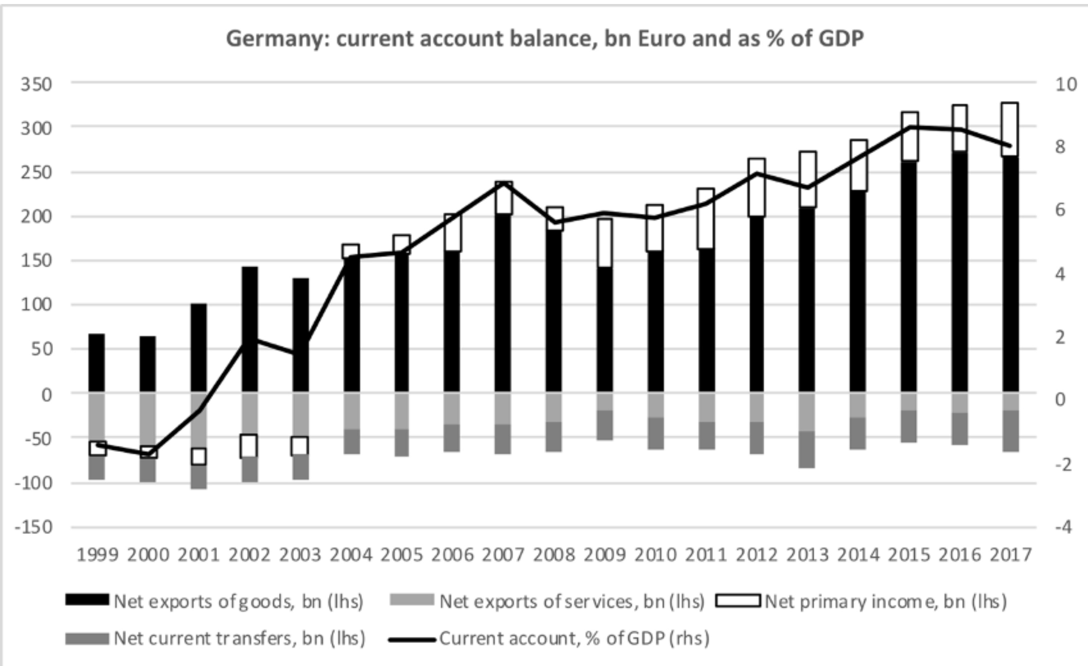

Figure 1: Germany: current account balance, bn Euro and as % of GDP (Source: AMECO 2018)

Until 2009, the surpluses of Germany, Netherlands and a few others were matched by intra-EMU deficits, mainly of Spain, Greece and to some extent Portugal and Italy (Figure 2). After 2008, the CA deficit countries fell into a prolonged crisis which compressed imports while exports did gradually recover, following the pre-crisis trends. This improvement changed the traditional EMU external balance from zero into surplus of which Germany contributed 68 percent (2017). Only France kept a small deficit. So, deficits of EMU members almost evaporated, but massive differences between the hard-core surplus bloc with a collective surplus of 8.6 percent (Germany, Netherlands, Ireland and Luxembourg) and an average surplus of 0.2 percent of the other 15 members of EMU remained in place (2017). As soon as real incomes per head rise again in the former deficit countries, their imports are likely to pick up and CA deficits might reappear. Yet, for the time being, the former imbalances turned into diverse surpluses, thus contributing to a sizeable collective external surplus of 3.6 percent for the EMU. The EU surplus exceeds – in absolute numbers – the US current account deficit. Of Germany's external trade surplus 38 percent comprised a surplus with non-EU countries (predominantly against the US), with 33 percent bilateral surpluses with other EMU and 29 percent with EU members outside EMU (Destatis for 2016[4]). So, sizeable internal EMU imbalances have been maintained.

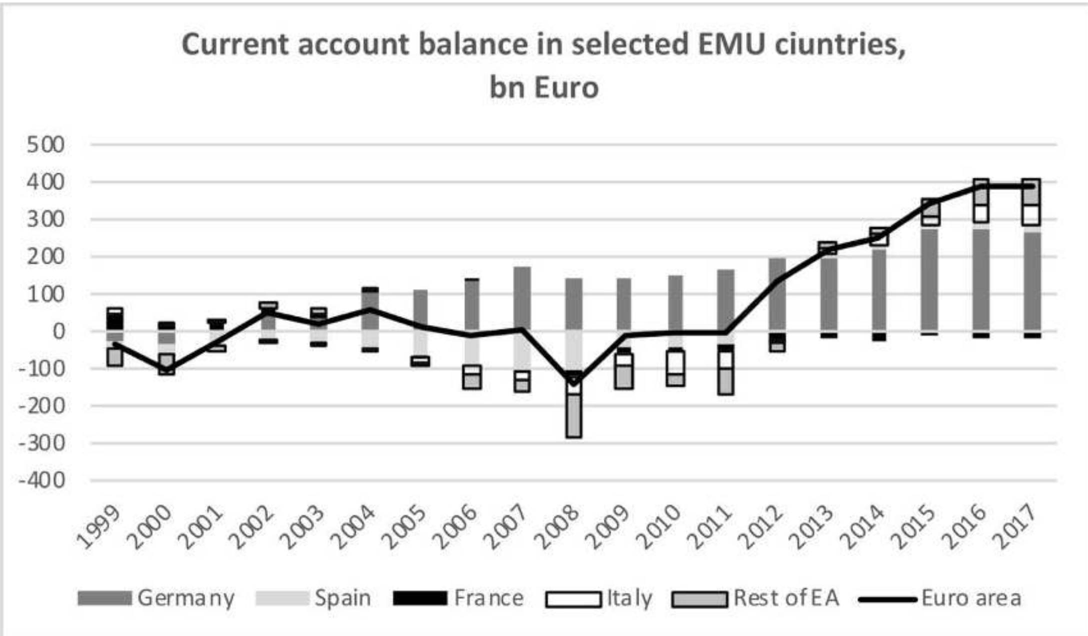

Figure 2: Current account balance in selected EMU countries, bn Euro (Source: AMECO 2018)

As mentioned, the flip-side of the current account surplus is the capital account surplus aka net capital outflows, which accumulates to rising net assets held abroad. Germany's NIIP stands in 2018 (1st quarter) at 60.7 percent of its GDP (Eurostat 2018), starting from zero in 1999. The main net debtor countries are Spain, Greece and Portugal in the EMU, while Italy's private and sovereign debt is mainly held by domestic creditors. Because of the rise in Germany's NIIP one would expect rising German net primary incomes which would reinforce the CA surplus. This has not been the case, and some blame Germany for having invested its surplus poorly. However, about half of Germany's net asset position is held against the ECB, reflecting Target 2 imbalances. Claims against the ECB are remunerated by the bank's policy rate which was long held at zero. Due to the malfunctioning of the interbank money market in EMU, the former deficit countries had (and partly still have) to refinance their liquidity demand (including liquidity for CA deficits) directly via their national central banks and thus the ECB. Without this flexible credit creation, not least to compensate for capital flight to the safe havens in EMU and outside, Germany's trade surplus – as far as EMU members go – would be much smaller, or, more likely, the euro system would have broken down through lack of liquidity in deficit countries.

Causes of Germany's surplus

The current account of a country, say Germany, depends chiefly on four variables if we focus on the determinants of the trade balance; this implies assuming for simplicity's sake that the primary income and the transfer balance net out. The first is the propensity of the rest of the world (RoW) to take imports from Germany at the prevailing exchange rate (i.e. the ratio of imports from Germany to GDP, for the RoW); the second is the domestic propensity to import from the RoW, and the third is the real effective exchange rate (REER), viz. the inflation adjusted nominal exchange rate, weighted against all trade partners. The fourth variable is the price elasticity of exports and of imports.

The first two variables reflect the output structure of Germany relative to other countries, but also the demand for German exports and the domestic demand for imports. If we look at the *change* of the current account, the two first variables mutate into the income elasticities[5] of the RoW and of Germany, respectively, regarding imports. The third variable becomes the change in the REER. The price elasticity of exports and imports is assumed to be constant over the medium run, following econometric studies (Horn et al. 2017). In a dynamic perspective, a fifth determinant has to be added: the ratio of the growth rate of export markets, approximated by the GDP growth in the RoW, and growth of domestic GDP, a co-determinant of import growth. As the external balance is measured in nominal prices (in local currency), we look at the *nominal* values of exports, imports and GDP. The first, second and fifth variables can be summarised as factors of *non-price competitiveness*, the third and fourth as *price competitiveness*. More competitiveness of exports means in this context increased market shares of exports within global exports.

Germany's comparative trade advantage rests on specialised production of mainly medium-technology investment goods and related intermediate goods, hence on high-quality manufacturing with a high degree of diversification. The price elasticity of exports (and imports) is low, around -0.5 for exports and even smaller (absolute value) for imports, reflecting highly imperfect competition on export markets (cp. Horn et al. 2017). This implies that a very strong real exchange rate change would be necessary to alter the trade balance[6]. Higher growth of export markets than of import markets feeds the surplus. Low domestic growth was exacerbated by below average inflation within EMU. This feature was reinforced by wage restraint until 2010, caused by high unemployment and the government's labour market policy pushing flexibilisation and deregulation. Continuous fiscal restraint – with the exception of 2009-10 – complemented wage restraint. Mercantilist policies promoted exports in manifold ways. The saying of former Chancellor Gerhard Schröder that he was also the "Cars' Chancellor" is telling. Germany followed a supply-side policy (under the buzz words "*Standortpolitik*" and "international competitiveness") of smart corporatist fostering of manufacturing and related services, in contrast to the UK, the US, France and others, which promoted or tolerated offshoring and deindustrialisation and gave more attention to service sectors (e.g. the financial sector or non-tradables).

The most important factor in promoting Germany's export performance was building-up international value chains with Eastern Europe and other emerging economies. The national statistical office (Destatis 2018) estimates the import content of exports at 39.5 percent (2014) which led to a jump in the exports-to-GDP ratio from 27 to 47 percent (1999 to 2017). By way of contrast, the import content of goods used for domestic final demand is only 21 percent[7]. This structural development led to an enlarged supply of manufactures, to the tune of 46 percent of GDP; half of this value is produced domestically. For manufactures used domestically only 12.8 percent of GDP is needed. Fostering this manufacturing powerhouse gradually crowded out parts of manufacturing in France, Italy, Spain and the smaller EMU economies which catered less than Germany for the growth of their industries by following a domestic-demand-led growth strategy. As a result, direct competition between the manufacturing sectors in Germany, France, Italy and Spain, the larger EMU countries, has shrunk. The outcompeted ones, often producing in below-premium segments of manufacturing that face markets with lower income elasticity, are more exposed to competition from Eastern Europe and emerging market economies, thus squeezed between Germany and other emerging markets, particularly China.

The role of the loss of exchange rate adjustment in EMU has been debated hotly, often with a focus on unit labour costs. Looking at the REER, hence at many trade partners inside and also outside EMU, shows in the German case a real appreciation until the outbreak of the financial crisis 2008 (when the euro surged to $1.60) and a real depreciation afterwards; however, this appreciation aspect is much more pronounced in EMU partner countries so that Germany gained and maintained its competitive advantage against the rest of EMU (see Figure 3). Since the REER values are mostly measured with consumer prices which can differ markedly from export prices, the REER performance likely underestimates Germany's benefits from relative exchange rate undervaluation. Germany reversed almost fully its appreciation (in REER terms) after 2008 by real effective depreciation whereas a number of Mediterranean EMU countries appreciated until 2008 even more strongly than Germany and depreciated afterwards less than it. So, for instance, the gap between the lines for Germany and Spain in Figure 3 remained almost as wide in 2017 as it was in 2008, reflecting a considerable relative undervaluation of Germany against these partners.

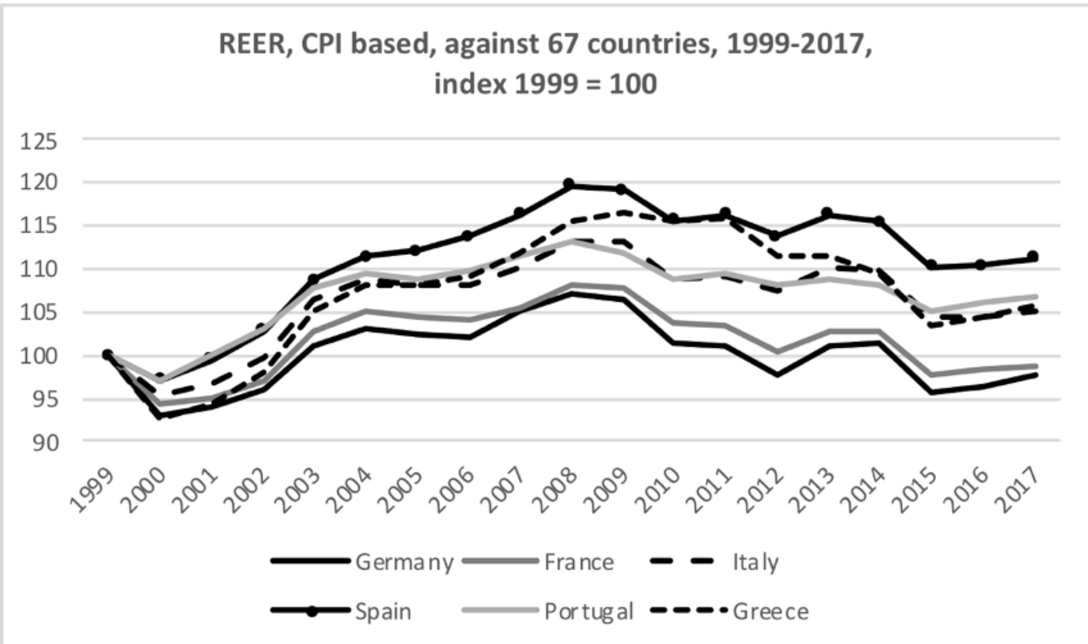

Figure 3: REER, CPI based, against 67 countries, 1999-2017, index 1999 = 100
(Source: AMECO 2018)

An alternative view on the current account balance (CAB), used in many analyses of CA imbalances, is based on the national accounting identity CAB = S – I, which applies when output and national income are given. These analyses are unconnected to the trade analysis, presented above. S represents here the flow of private and public sector saving (revenue less expenditure of private households, producing firms, financial institutions and government, including expenses for depreciation), and I is domestic private gross fixed investment. Since S and I depend, among other variables, on national income, partly determined by exports, the process of income generation is excluded from the analysis. The focus is a narrow approach on too low domestic demand (because of high saving rates) which triggers S > I, or, seen dynamically, higher growth of S compared to growth of fixed investment. The gap is filled by the export surplus.

An empirical analysis of the components of the rise in excess saving in Germany reveals that the main driver is first and foremost increasing undistributed profits of firms. Budget surpluses of the government (including social insurance) and, to a lesser extent, reduced private investment, including housing, added to the surplus. Household saving remained constant, as a share of GDP, apart from some fluctuations. This indicates that increased precautionary saving for old age due to the ageing of German society has played no role so far, contrasting with oft- held assertions (for more details see Priewe 2018).

The amazing increase in undistributed corporate profits is open to different interpretations. A major chunk of this saving is used for purchases of short-term securities rather than foreign direct investment. This corporate "savings glut" can be seen as reflecting a disconnect between profits and investment, and hence as evidence for corporate financialisation. From this angle, rising profits add to a more unequal functional income distribution, i.e. a depressed wage share in national income.

The bottom line of our analysis is that the determinants of exports and imports have led to a wedge between the growth of these, especially Germany's specialisation in goods with high non-price competitiveness. Supplementary price competitiveness was achieved by relative under-valuation against most EMU partner countries and by using international value chains. Subdued domestic demand via wage and fiscal restraint has kept the lid on imports required for final domestic demand while imports for exports mushroomed. Without the common currency, the exorbitant size of Germany's surplus would have been impossible; with a common currency, the opportunity of national appreciation is lost but there is one of financing CA deficits in the common currency by creating credit at commercial banks in deficit countries, refinanced via the ECB[8].

Projection of the surplus 2016-2026

The period 1999-2016 shows a clear trend: growth of exports of goods and services (x) was continuously higher than growth of imports (m), with the latter higher than growth of GDP (y) in current prices: x > m > y 5.7% > 4.8% > 2.5%. This is the formula for a built-in tendency towards an ever-rising surplus.

The average wedge between growth of exports and imports was 0.9 percentage points. With the base value for the year 2016 for imports being 17 percent lower than that for exports, the trend of the recent past leads to an ever-rising trade surplus relative to GDP. Therefore, the German surplus tends to rise. It is not only unsustainable because of the risky size of the surplus, it is its *dynamic* which is even more dangerous. Since net primary income from abroad depends mainly on the trade balance, the current account is going to rise faster than the trade balance if the present trend continues (with stable transfers as share of GDP). As shown in Table 1, the present trend would lead to a trade surplus of 15.0 percent in 2026. Variations in the nominal growth rate (3 and 4 percent p.a.) have little impact on the rising trade balance. Even if imports rose at the same rate as exports trend-wise, the trade balance would reach 9 or almost 10 percent of GDP. Only if imports rise faster than exports can a reduction of the current account surplus be achieved, excluding the unrealistic option of exorbitant GDP growth acceleration in Germany.

Germany: Seven projections for the trade balance 2016-2026					
All numbers pertain to current prices	Exports	Imports	Trade balance	GDP	Trade balance
2016	1441.7 bn	1202.6 bn	239.1 bn	3132.7 bn	7.6% of GDP
1999-2016, growth trends, % p.a.	5.74%	4.78%		2.48%	
Projections	Assumption of growth p.a., %				Expected results % of GDP
2026, trend, 1st	5.74	4.78	601.0 bn	2.48 (3.0)	15.0 (14,25)
2026, 2nd	5.74	4.78	601.0 bn	4.0	12.9
2026, 3rd	5.74	5.74	417.8 bn	3.0	9.9
2026, 4th	5.0	5.0	389.5 bn	4.0	8.4
2026, 5th	5.0	6.0	194.7 bn	3.0	4.6
2026, 6th	5.0	6.0	194.7 bn	4.0	4,2
2026 7th	4.5	6.0	85.2 bn	3.0	2.0
2016 7th	4.5	6.0	85.2 bn	4.0	1.8

Table 1: Germany: Seven projections for the trade balance 2016-2026

Our projection is simple but sufficient to identify the key problems. There is no doubt that a further increase in the German current account would lead to severe international conflicts between the euro area and the rest of the world, or it would lead to untenable intra-EMU imbalances which would tear the currency union apart[9]. From this angle, the surplus is a time bomb. A turnaround with accelerating imports but unchanged growth of exports would require either a strong growth in the import content of exports or a massive rise in domestic final demand with much higher growth and/or income redistribution towards households with a high propensity to consume so that excessive saving would be diminished. Hence, a realistic scenario would require in Germany lower growth of exports than of imports. Yet, 48% percent of all imports are imports for exports (estimate for 2014, based on Destatis 2017). Any reduction in these would have to be offset by more imports for final demand in order to shrink the surplus. Or, the import content of exports and even more so of domestic final demand needs to rise.

Consequences and associated risks of the surplus

A current account surplus reflects excess output relative to domestic demand.

In general, a high or even rising CA surplus poses the following standard sequence of risks though these may take on different forms in specific countries.

1. Since domestic aggregate supply exceeds domestic aggregate demand (overproduction of tradables), the country is free riding on other countries' aggregate demand; in the CA deficit countries, the aggregate supply of goods is less than their domestic demand. Hence, the deficit countries produce less, employment drops, compared to CA balance. Thus, a reduction of the combined demand and output of deficit and surplus countries is generated; unemployment rises subsequently in the deficit country, all things being equal. Joan Robinson coined this "beggar thy neighbour" and "export of unemployment" by the surplus country. We ignore for the sake of simplicity the complex effects of net capital exports in deficit countries; while they are considered positive through the lens of the loanable funds theory (more saving, reduced interest rates and more investment), in reality they can be positive, neutral or negative (e.g. appreciation of the currency, asset price rises etc.).
2. The reduced combined aggregate demand of both country groups tends to exert pressures on prices, wages and other costs. Inflation rates fall, or deflationary risks arise, propelled by the surplus country making efforts to increase price competitiveness, and by the deficit countries facing

fiercer price (or non-price) competition, thus being forced to respond with lower prices if their non-price competitiveness cannot be improved quickly. Deflationary price competition would emerge in such a scenario.

3. Deficit countries incur external debt to finance the CA deficit; they might be inclined to offset the loss of employment by higher budget deficits ("twin deficits" of CA and budget).
4. Deficit countries may counter their deficit by devaluing their (real) exchange rate, which in turn could be responded to by deliberate currency depreciation on the part of the surplus country – downward currency competition could emerge. Within a currency union it would be competitive *internal* devaluation by lowering unit labour and other costs. Devaluation lowers prices and costs for exporters, and in deficit countries it might lead to increased external debt, often with debt due in foreign currency.
5. Lower inflation or even deflation prompts the central bank to lower interest rates until the zero lower bound is reached.
6. Surplus countries might stop financing the deficit countries since risks are deemed too high. "Sudden stops" with the reversal of capital flows can occur. This tends to trigger banking crises, devaluation and interest rate hikes due to increased country risk (spread). The latter is/are likely to occur early on when expectations regarding country risks turn more pessimistic.
7. Deficit countries are forced to reduce their twin deficits by devaluation – nominal or internal – and fiscal austerity.

This vicious circle can also happen within a monetary union that forms a kind of separate universe within the world economy where – due to trade and financial integration – the sequence of risks can unfold. Owing to the use of the common currency and access of each member state to money and credit creation at the central bank, current account deficits are easier to finance and refinance and thereby external surpluses are rendered possible over extended periods. The principal benefits of a monetary union seem to morph into great pain if and when the loss of exchange rate adjustment becomes critical. An occasional devaluation or appreciation can be extremely valuable as an adjustment mechanism but internal devaluation with wages and other costs is slow, linked to deflation and crisis. The need for labour market flexibilisation undermines social welfare and “efficiency wages” needed for productive labour. Internal appreciation is less conflict-laden, but the need for adjustment seems to be on the deficit side where the problems are more pressing.

That running persistent surpluses tends to have deflationary effects and induces competitive devaluations, as practiced in the 1920s and early 1930s in the world economy, is the IMF’s main critique when it comes to the surplus of Germany and half a dozen other high surplus countries around the globe (IMF 2017). This is valid for imbalances in the world economy, but even more for those within EMU where nominal exchange rate realignments are no longer possible. If surpluses tend to have contractionary effects, inflation is low and close to deflation; subsequently, interest rates are close to the zero lower bound which reduces the effectiveness of monetary policy.

In the special case of Germany, there are a few peculiarities:

- Indeed, Germany did not reach the inflation target of the ECB (HCPI) on average in the period 1999-2017 (1.5 percent p.a.), in fact, it reached a value slightly above 2 percent only in two years (if the years 2007/2008 affected by the prior three percentage points increase of VAT in 2006 are left out); furthermore, Germany had the lowest export price performance in the euro area. Yet, its superior non-price competitiveness was probably more important due to the low price elasticity of exports. Many German companies produce premium goods that are not or significantly less produced by other EMU countries. This implies that less competitive countries depend more on price competitiveness parameters than Germany.

- An export-oriented stock of fixed and human capital is built up which cannot easily be used for domestic demand should the current account surplus prove unsustainable (e.g. shifting automobile exports to domestic use is scarcely possible). Changing the production structure towards more domestic demand, largely non-tradable goods and services, takes time and is difficult due to path dependency regarding production according to long-standing comparative advantages.
- Germany's surplus is spread over many deficit countries across the globe, whilst being concentrated in some EMU countries, UK and US. This way, the corresponding deficits are more diversified.
- Germany's economy is divided in the well-developed export sector with by and large well-paid employees, and a large proportion in employment with markedly lower pay and precarious labour, including parts of the civil service. This is a drag on income dynamics and impedes imports.
- Germany's surplus performance evolved in two phases: before 2008 and after 2009. The bulk of the rise since 1999, namely 8.5 percent points, came until 2007, and the second bout occurred 2010-2015 with almost 3 percent points (reduction 2007-2010 and a mini fall 2015-17) (cp. Figure1). Three main causes were at play in the second phase: accelerated exports due to a recovery in world demand outside the EU, real depreciation of the euro against the US dollar, and a rise in the German budget surplus. In the second phase, unit labour costs grew by roughly 2 percent p.a., more than before but too little to reach the 'golden rule' norm (productivity increase plus inflation target). Unit labour costs seem stickier in an upward than downward movement. Boosting imports requires much more domestic demand dynamics. In brief,

rising surpluses can occur in low growth but also in high growth periods.

- Raising the surplus via all means of wage and fiscal restraint, semi-mercantilist policies and new international value chains seems much easier than reducing it. Even if export markets grew less or were impeded by protectionist measures, imports for exports would grow less or fall. There seem to be ratchet effects that make the surplus resilient.

Overall, the German economy as a whole has not benefitted very much from the increase in the surplus since 1999. The main beneficiaries of this were exports and – until 2008 – financial services. Also, regarding net capital exports, the mirror image of the surplus, Germany benefitted little since the net international creditor position improved strongly only on paper, as mentioned above. Germany's GDP growth 1999-2017 was only 1.35% percent p.a., below this until 2008 and a bit above after 2009. Final domestic demand – consumption and investment – grew by a meagre 0.9 percent p.a. In other words, only 62 percent of the additional output produced between 1999 and 2017 was used for domestic final demand, with 38 per cent destined for net exports (AMECO 2018). Consumption (private and collective consumption of government) rose only 1.1 percent p.a..

Still, the bigger part of the problems caused by the German (and others') surplus stems from the repercussions on other EMU members. The post-crisis recovery brought to the surface the deep divide within EMU. The surplus countries contributed to slow GDP growth within EMU from its very inception.

For monetary policy in EMU, the CA differences amongst member states pose great problems as the euro/dollar exchange rate does not fit all. For the surplus countries it is a marked undervaluation, for the others an overvaluation or may just be appropriate if the difference in current account balances (as percent of GDP) is around 8 percentage points. This way monetary policy is close to paralysis, centralised

EMU-wide fiscal policy – apart from the rules set for member states by the Stability and Growth Pact and the Fiscal Compact which do not provide for co-ordinated expansionary policies – is non-existent and national fiscal policies have limited room for manoeuvre, except in the handful of surplus countries.

Overall, a sustainable coexistence of strong and persistent surplus countries with countries saddled with chronic deficits countries and others with a more or less balanced current account (like France) is impossible. Either internal imbalances arise which tend to be untenable, or the EMU as a whole becomes a heavy surplus engine contributing to global imbalances. The problem escalates if the surpluses tend to grow.

Policy conclusions

The conventional way to tackle excessive current account surpluses in countries with their own currency is a mix of nominal appreciation – which turns out to be a real appreciation – and fiscal expansion. This course is superior to a mix of internal depreciation and fiscal contraction in deficit countries. It would be better to prevent any excessive surplus early on. To some extent, chronic surpluses may be justifiable, for instance for small countries such as financial hubs (unless tax or regulatory privileges are exploited) or oil producers with a very special comparative advantage. Furthermore, if the surplus were accompanied by long-term stable capital exports, such as net foreign direct investment, we could be less critical. Intertemporal allocation of resources internationally could perhaps justify long-standing surpluses if they are sustainable for debtor countries. All too often such strategies have failed, leading to excessive external indebtedness in foreign currency. The US is an exception in this regard largely as it issues the main global reserve currency. However, grave imbalances within a monetary union without any option for nominal devaluation are different.

The refinancing options in the EMU for deficit countries, having debt in common currency due to EMU, allows more flexible financing of deficits via national central banks. However, these are meant to be only temporary and not an alternative to normal financing of deficits via capital flows channelled through the banking system or via transnational firms. For this reason, rules regarding tolerable deficits and surpluses are necessary, however neglected when the euro system was crafted. This opens the door for moral hazard on the part of surplus countries pursuing selfish and reckless export-led strategies which exploit the absence of market mechanisms propelling appreciation of their currency.

At national level, the four key surplus countries within EMU, led by Germany, should strengthen domestic demand via fiscal policy. Running a fiscal surplus or "black zeros" in the budget balance increases their current account balance which is the sum of private and public sectoral balances. Supporting wage rises above average productivity increases, hence with increasing unit labour costs, would support domestic demand and prompt real "internal appreciation". Wage increases in the lower parts of the value chains, especially in Eastern Europe, could increase the value of imports; continuous wage increases on this front could be very effective. With huge buffers of undistributed corporate savings, it is unlikely that investment would drop – the opposite is more likely, unless the economy slides for other reasons into recession. Even so, these measures will be insufficient as the import content of domestic final demand is so small, and many of these imports come from non-EMU countries. The underlying problem is that the supply-side structure of Germany's fixed capital stock is geared to exporting. Strengthening domestic demand is necessary, but insufficient.

Mercantilist policies should be reconsidered, such as protecting energy-intensive enterprises from fuel price increases, protecting lignite coal extraction and related power generation, allowing lax controls on diesel cars, promoting arms exports and the like. Financial support for regional clusters of small- and medium-sized enterprises (SMEs), cooperating with larger ones, is tacit export promotion.

Fiscal measures such as increasing VAT by three percentage points (2006) – which favoured exports – could be reversed. Administrative measures like a special temporary export tax and import subsidies could mimic a real appreciation. But this would require profound changes in EU legislation. A precondition and first step for reforms is simply raising awareness of the problems. The statement of the German Federal Government cited above reflects amazing ignorance and neglect of responsibility.

Waiting for protectionist measures by deficit countries is as risky as waiting for a big wave of demographic change in the 2020s when the baby-boomer generation retires. They might save less relative to their income, but the CA-reducing effect could be neutralised by lower output growth associated with a declining population. Furthermore, if housing investment falters due to ageing, the effect of demography on the current account is also neutralised. Besides this, ageing occurs also in other EMU countries. Overall, the assertion of an effect of demographic change on the current account lacks sound evidence.

At EMU level, reform of the "Macroeconomic Imbalance Procedure" is urgent. The asymmetry of the -4/+6 percent warning signals for deficit and surplus countries is arbitrary and came via German lobbying in Brussels, as insiders frankly admit. A symmetrical rule with -4/+4 percent plus sanctions that truly bite would be advisable. Within the "European Semester" and among the "Country-Specific Recommendations" with "Medium-Term Budgetary Objectives" of the Commission, current account surpluses play hardly any role. Regarding sanctions, excessive surplus countries could be barred from access to structural funds – having to replace them with domestic funding – or obliged to pay a tax on the surplus that would be channelled into a fund to support industrial policy in countries with a weak export base. A key measure would be supporting countries with structural deficits in establishing industrial policy to improve non-price competitiveness and lean against the wind of further deindustrialisation.

All in all, such measures are also in the national interest of Germany and the other surplus countries. These are the structural reforms that Germany needs to undertake in order to return to macroeconomic equilibrium. They require deep change, but the alternative is unfettered growth in the surplus with disastrous consequences.

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HANSJÖRG HERR, MARTINA METZGER, ZEYNEP NETTEKOVEN: FINANCIAL MARKET REGULATION AND MACROPRUDENTIAL SUPERVISION IN EMU – INSUFFICIENT STEPS IN THE RIGHT DIRECTION

The deregulation of financial markets together with merely micro-prudential regulations and supervision increased the frequency and intensity of financial crises from the 1980s on. After the subprime crisis starting in 2007 regulatory authorities in advanced countries added a macroprudential pillar to regulations and supervision. Important macroprudential institutions were established and the resilience of advanced countries' banking systems to crisis seems to have increased. The main shortcomings of the regulations are: first, the still prevalent pro-cyclicality of both risk weights and risk models within (international and European) banking regulation; second, the inadequate regulation of the shadow banking system, including the interdependence between banks and shadow banking institutions; and, third, the complete lack of control over international capital flows, including spill-overs, currency mismatches and unsustainable current account imbalances.

Introduction

After the sub-prime crisis and the Great Recession in the years 2008-10 it became clear that pre-crisis financial market supervision in advanced countries displayed severe deficiencies. Already in the G 20 meeting of 2008 it was decided that a fundamental re-regulation of financial markets was necessary. At the 2009 meeting this was made more concrete and, at that same time, the G 20 further decided to transform the Financial Stability Forum (FSF) into the Financial Stability Board (FSB) as the major central co-ordination body for international re-regulation of financial markets (G20 2008 and 2009). According to the G20 a missing pillar of macroprudential regulation and supervision should be added to the existing regulation. The new macroprudential approach led to the creation of new macroprudential institutions and instruments. In this paper we will discuss both.

In the next section we briefly present the most important developments in the financial system which led to the subprime crisis. This enables one to judge the reforms which have been implemented. Then, the new institutions are described along with the new regulatory instruments. Finally, we evaluate what has been changed.

Main changes in the financial system before the subprime crisis

In the age of financial globalisation, starting in the 1970s and gaining speed in the following decades, financial systems became more deregulated, more complex and more unstable.

Mark-to-market accounting in the valuation of assets on balance sheets introduced in the 1990s has been one of the exacerbating factors behind the sub-prime and global financial crisis. In boom phases rising asset prices increase the asset side of balance sheets, stimulate the confidence that profits are lasting and will remain high; during financial crisis asset prices fall, destroy equity and may lead to insolvency.

Risk models which were based on previous economic developments such as earlier volatility of assets or default rates became widespread and were used in the management of financial institutions or in the design of complicated financial products. Within the Basel II framework the equity holding of banks was also made dependent on these models – all of which suffer from pro-cyclical effects and are extremely weak in predicting financial crises. Risk models signal very low risks when, for example, credits in the real estate sector increase in a boom phase and property prices reach heights that, in the subsequent bust phase, prove unsustainable (Herr 2011). For normal individuals it seems to be a 'craziness' to look at the past to find out what will happen in the future. But exactly this 'craziness' became a widespread practice in financial markets where flawed regulation under Basel II meant that banks became under-capitalised

Securitisation of credits exploded where securitisation describes the outsourcing of loans, e.g. for housing, credit cards, cars, or student loans on the balance sheets of banks into new and so-called off-balance sheets institutions called *structured finance vehicles*. Outsourcing had two destabilising consequences. First, credit institutes did not hold any equity for the loans they outsourced; thus, when the bubble burst, they did not have sufficient equity at hand. Second, credit checks and monitoring by banks badly deteriorated as the loans were no longer intended to stay on their balance sheets until maturity. The business model of banks became giving loans, selling them on to other investors and earning fees. This change in banking strategy from originate-to-hold to originate-to-distribute stripped credit institutions of their traditional business and turned them into investment bankers.

A further destabilising impact of securitisation came with the construction of complex financial products which lacked transparency and gave rise to moral hazard. Buyers of securitised assets had limited information about the credibility of the end-borrowers and could not monitor them directly. High bonus payment arrangements for managers in financial institutions also contributed to moral hazard as there was an incentive to give, for example, sub-prime loans and sell them as part of securitised assets without revealing the real risk involved. Rating agencies did not arrest this business model but also used risk-based evaluation models and completely failed to understand the mounting risks in the financial system before the sub-prime crisis.

Sectors with special regulations became fully integrated into financial markets, for example real estate markets or future markets for natural resources. Of special importance were real estate markets. After World War II, property markets in all developed countries were in different ways regulated to deliver cheap and sufficient housing (see for instance Börsch-Supan 1994). During the period of deregulation these markets were also integrated into general financial markets with the well-known effects upon financial stability, rents, house prices and social justice.

The shadow banking system stands for activities of institutions outside the scope of traditional banking regulation[1]. Shadow banking institutions, e.g. investment funds and other financial intermediaries, are less regulated than banks or even not at all. Shadow banking institutions are part of the overall financial system, but the usual banking system back-ups such as deposit insurance or lender-of-last-resort facilities do not normally apply to them. In other words, the shadow banking system carries substantial risks to financial stability, which became evident during the sub-prime crisis in 2007 and its aftermath.

Against the background of financial globalisation, international capital flows increased to extremely high levels in comparison to trade flows. Three risks above all stem from this development. First, international capital flows are also pro-cyclical and might strengthen boom-bust cycles in countries. Second, they create currency mismatches for most of the debtor countries. Third, the international interconnectedness of financial markets also in the shadow banking system can lead to contagion so that a financial crisis in one country results in a global and systemic financial crisis.

A number of financial crises in emerging markets in the 1990s, but also the sub-prime crisis starting in 2007 with its global repercussions, showed that financial systems in many countries had become fragile and had to be re-regulated. A revision of international banking regulation was triggered by the South-East Asian crisis in 1997; Basel II was adopted in 2004 and phased in from 2005 onwards. In 2010, Basel III was decided upon and revised in 2017. Financial market regulation and supervision in advanced countries had for decades a microeconomic focus following mainstream economic thinking. This changed with the traumatic experiences after the outbreak of the subprime crisis. *Macroprudential policy* became an important part of financial market regulation and supervision. Its main purpose is to detect systemic risks in the economy which lead in a crisis to contagion in the financial sector and problems in parts of or indeed the entire financial system.

New macroprudential institutions

A number of important international institutions are engaged in issues of macroprudential oversight of international and national financial systems: two committees at the Bank for International Settlement (BIS), namely The Basel Committee on Banking Supervision (BCBS) and the Committee on the Global Financial System (CGFS), the International Monetary Fund (IMF)'s Financial Sector Assessment Programs and the FSB. Our focus here will be on macroprudential institutions in the EU established after the financial crisis.

The European Systemic Risk Board (ESRB)[2], chaired by the European Central Bank (ECB), was founded in December 2010 as the macroprudential authority at EU level. Other members of the board are the European Commission, the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and Economic and Financial Committee (EFC), national macroprudential authorities of the EU Member States as well as observers from Norway and Iceland. Besides, each EU Member State has established its own macroprudential authority and designated an authority which is in charge of determining discretionary national macroprudential measures. In some Member States, one institution takes over both roles. For example, in the UK the Financial Policy Committee established within the Bank of England has both the role of a macroprudential authority and an authority deciding about discretionary measures. In Germany, the German Financial Stability Committee, established in 2013 by the Federal Ministry of Finance, is the macroprudential authority and the Federal Financial Supervisory Authority (BaFin) is the designated authority to decide macroprudential measures (ESRB 2017a).

The ESRB and the Member States' macroprudential authorities have a two-way interaction, whereby the ESRB's macroprudential power is limited to giving recommendations and warnings to Member States about systemic risks by observing all types of financial institutions (ESRB 2014). The national macroprudential authorities are obliged to inform the ESRB about systemic risks and macroprudential policy actions in their own territories. The power to decide about macroprudential instruments remains in the hands of Member States. These have a constrained discretion. For example, setting countercyclical capital buffers, although left to the discretion of the Member States, has a rule-based component depending for example on the development of the individual country's credit-to-GDP ratio. The Member States can also increase the prudential requirements above those set by the EU Capital Requirements Directive if they justify the need for systemic risk mitigation, albeit this needs to be negotiated with the ESRB, EBA, European Commission and the European Council. The ECB also has a powerful role in influencing national macroprudential policies within the euro area as it has the right to object to or request tightening of national macroprudential measures as regards banks.

Macroprudential institutions are part of the EU financial market supervision architecture. In order to improve cross-border co-operation a network of several institutions and committees was established which is called the European System of Financial Supervision

(ESFS) and is a "(...) multi-layered system of micro- and macroprudential authorities" (EU 2018, p.1). Besides the ESRB and national supervisors, three supervisory authorities belong to the ESFS, covering the three major segments of the financial market - banking, insurance and securities. The institutions are the EBA as part of the European Banking Union (EBU), the EIOPA and the ESMA. All three had predecessors in the form of European committees on banking, insurance and securities; their mandate had been expanded into regulatory agencies during the global financial crisis, with the three institutions officially established in January 2011. The EBA writes a so-called European Single Rulebook with binding technical standards and guidelines in the framework of EU supervision laws. It does not take over any direct supervisory tasks. The ESMA also supervises credit rating agencies and trade repositories[3] besides its core business of security markets. All three institutions have the obligation to protect consumers.

The European Banking Union has three elements (EU 2018). The first element is the Single Supervisory Mechanism which is composed of the ECB and national supervisory authorities. The ECB directly supervises bigger banks in the EU; smaller banks remain supervised by national authorities. The ECB monitors the implementation of the Single Rulebook and can enforce it on banks. The second element is the Single Resolution Mechanism which deals with failing banks' resolution process. The final element which is yet to be established is the European Deposit Insurance Scheme which aims in its final stage at providing full deposit insurance to all euro area banks' customers up to 100 000 euro in case national systems are insufficient. Until now, deposit insurance has had a national character.

The introduction of macroprudential institutions and policies both at a regional level in the eurozone and at national level in each individual country signals a change in the philosophy of supervision. Before the sub-prime crisis and its repercussions, supervision in advanced countries had a microprudential focus on the assumption that solvency of individual financial institutions would ensure systemic stability. The new macroprudential institutions and supervision, including the two established EBU pillars, must be considered to constitute an important step towards a more stable financial system. The still absent European Deposit Insurance Scheme (EDIS) is a flaw in the European financial market architecture. In the event of a confidence crisis afflicting a single bank or even a complete banking system, deposits might be transferred to another member country on a large scale, thus requiring a European response.

Macroprudential institutions can only be as good as the rules they have to follow and the instruments they have to enforce the rules. In the next section we briefly discuss these topics.

New macroprudential rules and instruments implemented after the financial crisis

To mitigate the various risks several new rules and instruments were introduced at the EU level. Almost all of them followed the recommendations of the BCBS developed after 2007 in the framework of Basel III (BCBS 2011). In this section the new EU regulations are presented.

In comparison to the situation before the sub-prime crisis more and a higher quality of capital has to be held by banks. To understand capital holding requirements, different definitions of capital have to be made clear. Tier 1 capital has a higher quality than Tier 2 capital. Tier 1 capital is divided into two parts: *Common Equity* and additional Tier 1 capital. Common Equity is a bank's core capital and includes common shares, retained earnings and other types of accumulated income. Additional Tier 1 capital consists of assets which can be quickly converted into equity when needed and also participate in loss absorption. Tier 2 capital is less reliable than Tier 1 capital. It is more difficult to calculate it accurately and it is composed of assets that are harder to liquidate.

Banks have to keep a certain percentage of their assets as equity capital. An important point is that equity holding still can be weighted according to banks' internal risk models based on historical data. In spite of all the weaknesses of these risk models the approach introduced with Basel II was not abandoned.

The rules for capital holdings now in place can be seen in Table 1. General minimum requirements[4] for capital holdings remained as before at 8 percent of risk-weighted assets. But the minimum requirements of Tier 1 capital increased from 4 percent in the old rules to 6 percent of risk-weighted assets. In addition, of the 8 percent equity holding banks now have to hold at least 4.5 percent of risk-weighted assets as Common Equity.

For all banks in all Member States	
a) Minimum total capital	8.0%
b) Tier 1 capital as part of minimum total capital of 8%	6.0%
c) Common Equity as part of minimum total capital of 8%	4.5%
d) Capital Conservation Buffer, must be kept in Common Equity	2.5%
e) Minimum holding of Common Equity (c + d)	7.0%
f) Minimum capital holding (a +d)	10.5%
Depending on discretionary decisions of Member States	
Countercyclical Capital Buffer, must be kept in Common Equity	0 - 2.5%
Systemic Risk Buffer, must be kept in Common Equity	1% or higher
Capital holding for global systemically important institutions	
Surcharge on global systemically important financial institutions, must be kept in Common Equity	1 – 3.5%
Surcharge on other systemically important financial institutions, must be kept in Common Equity	0 – 2%

Table 1: Requested capital requirements in the EU in per cent of risk-weighted assets (from January 2019) (Source: BCBS 2011)

Several new types of capital holdings were introduced. An additional *Capital Conservation Buffer* of 2.5 percent of risk-weighted assets was introduced and has to be kept as part of Common Equity. With this buffer, the minimum capital requirements of a bank add up to 10.5 percent and the minimum for Common Equity to 7 percent of risk-weighted assets. The objective of this buffer is to create some flexibility. In situations of stress this buffer can be used up and later filled up again when the crisis is over. When a bank does not meet this buffer, automatic mechanisms are implemented to enforce it. For example, the amount of dividend and bonus payments is then limited until the full buffer is met again.

The objective of the new *Countercyclical Capital Buffer* between 0 and 2.5 percent of risk-weighted assets held in Common Equity is to smooth the impact of the financial cycle on equity and limit leverage. Each EU Member State sets the buffer according to national conditions. In the upward phase of a credit cycle, the capital buffer is meant to be increased. During a downward trend with financial stresses, banks would have more capacity for loss-absorption. In the down-turn it has more or less the same function as the Capital Conservation Buffer but can be used according to the needs of individual Member States. A major reference for setting this buffer in each Member State is the credit-to-GDP ratio along with other country-specific indicators.

Furthermore, a *surcharge on global systemically important financial institutions* (G-SII) between one and 3.5 percent of risk-weighted assets held in Common Equity was also introduced; insolvency of these institutions has high negative externalities and entails substantial economic and social costs. Thus, they have to hold an extra portion of equity. The BCBS developed a methodology for identifying such institutions based on a number of indicators. Covered are institutions with an exposure measured at more than 200 billion Euros (BCBS 2013). In almost all cases, the ECB directly supervises these big banks as well.

A *surcharge on other systemically important financial institutions* (O-SII) in Common Equity between zero and 2 percent can be enforced, too. O-SII might be, for example, institutions of special national importance which are not covered by G-SII. The ESRB proposed an increase in the capital holding of these institutions to 3 percent and even higher when required (ESRB 2017b). Thus, the ESRB is prepared to tighten control of the banks as well as some large shadow banking institutions when necessary. However, this is yet to happen in reality[5].

Going beyond Basel III recommendations, a *Systemic Risk Buffer* for financial institutions was introduced in the EU which can be brought into play by individual Member States. This buffer aims to address systemic risks of a long-term and non-cyclical nature and to strengthen the resilience of the banking sector to potential shocks. The buffer level can vary across institutions or sets of institutions. The minimum rate for the buffer is one percent. There is no maximum limit but, depending on its level and the impact on other Member States, authorisation from the European Commission is required. Around one-third of the EU Member States currently uses this buffer.

In addition to higher equity holding, the EU introduced a *non-risk-based Leverage Ratio* defined as Tier 1 Capital in percent of a bank's total exposure measure[6]. In other words, banks are required to keep a proportionate amount of capital in percent of their total assets, including certain off-balance sheet exposures independent of the risks involved in these exposures. With the leverage ratio, the role of risk-based models is reduced as a minimum capital holding is enforced independent of any risk evaluations. This is a positive step away from the flawed philosophy of Basel II.

To prevent the risk of illiquidity at banks, two liquidity-based rules were introduced. The *Liquidity Coverage Ratio* is defined as the ratio of the value of a stock of high-quality liquid assets to total net cash outflows over the next 30 calendar days. Banks have to fulfil this ratio by at least 100 percent. Its purpose is to prevent short-term liquidity stress in the financial system by ensuring that banks keep sufficient high-quality liquid assets against their due payments. With sufficient liquidity, fire-sales of assets with their deteriorating impacts on capital can be prevented. High-quality liquid assets include cash, deposits at the central bank but also certain government and private bonds. The *Net Stable Funding Ratio* stands for the ratio of available to required stable funding, including banks' off-balance sheet activities[7]. This ratio is required to be met in full as well. It aims to ensure banks' funding sustainability.

Borrower-based macroprudential measures in the EU refer to the rules of borrowing for end-borrowers (households and non-financial firms) from financial institutions. Typical borrower-based measures are loan-to-value ratios, debt-service-to-income ratios, loan-to-income ratios and interest-coverage ratio[8]. The caps on these ratios are expected to limit the leverage of exposure vis-à-vis households and firms and reduce default rates. In this field of supervision Member States have different regulations and different instruments.

In this paper we do not discuss the variables used to detect macroprudential risks – for example, the risk of higher credit expansion or asset price increases compared to the long-term trend. The length of time that macroprudential institutions and instruments have been in place is too short.

Philosophy of financial market regulation not fundamentally questioned

Basel I which was adopted in 1988 introduced for the first time an internationally compulsory standard for equity capital holding for international operating banks. The standard itself was relatively simple as the risk weights for equity capital holding are allocated according to just three distinctive features: membership of the OECD, maturity of claims and, finally, the three debtor categories (sovereign, banking sector, companies). Each of the categories led to a certain minimum capital holding of banks. For example, OECD country government debt held by banks did not lead to equity capital holding, corporate debt to the highest capital holding and residential mortgages to capital holding in between. A bank, therefore, could not alter its capital requirements based on its individual risk assessment. This only came with Basel II which was adopted in 2004 and phased in thereafter. At that time, financial market institutions lobbied for the introduction of risk-weighted capital requirements in order to cut equity holdings (Helwig 2008).

Basel II would "(...) reinforce the familiar national and international boom-bust-cycles underlying international capital flows. This pro-cyclical tendency holds true not only for high-rated emerging market economies but also for industrialised countries" (Metzger 2006: 148). Considering the experience with the sub-prime financial crisis and a number of crises before, we subscribe to the idea that uniform capital requirements according to Basel I's approach are superior to risk-weighted requirements as under Basel II.

With the new macroprudential regulations a whole set of new rules was established. At their centre are a stricter definition of bank capital and the introduction of new buffers. This makes the banking system safer and especially reduces the costs of financial crises. But high equity holding does not automatically prevent unsustainable boom-bust cycles and asset price bubbles.

More important, however, is that macroprudential regulation of banks in the EU has several weaknesses which keep the financial system potentially unstable. First, as mentioned above, the regulations still incorporate banks' internal risk models to determine capital requirements. There are elements in the EU regulation which try to offset the pro-cyclical effects of risk-based models and capital holdings based on these models. The Countercyclical Capital Buffer and the Systemic Risk Buffer can be mentioned here. The Leverage Ratio limits the role of risk models. But the question is why the banks' internal risk-based capital requirements were introduced in the first instance.

Second, counter-cyclical elements in financial market regulation are insufficient. Who is convinced that a booming economy with strong credit expansion can be stopped by a Countercyclical Capital Buffer of only 2.5 percent when all the risk models signal low default rates and an endless boom? The Systemic Risk Buffer is potentially powerful enough to control credit expansion by banks but is not at the core of financial market regulation and has no anti-cyclical function. Stronger instruments would have been required to mitigate negative impacts of credit expansion on systemic stability of banking systems.

Third, the instruments to tackle bubbles or destabilising developments in specific sectors are neither adequate nor sophisticated enough. A real estate boom, for example, requires specific instruments to target the property market. There is no attempt to go back to a more socially regulated real estate market with housing as public goods comprehensively controlled by governments. This is the case in spite of the fact that the existing market-driven real estate sector leads to huge instabilities that undermine social justice. In addition, borrower-based macroprudential measures which include powerful instruments to regulate financial markets only play a role regionally and are not at the core of macroprudential regulations.

There are more destabilising elements of the financial system which go unchecked. Mark-to-market accounting is not fundamentally changed. Equally, the structure of financial products is not made sufficiently transparent. For example, it would be possible to allow standardised financial products and innovations only after they have been approved by regulators. Two shortcomings are discussed below in more detail: non-bank financial institutions and international capital flows.

Non-bank financial institutions and the international financial system remain largely unregulated

The general orientation of the financial system reforms after the subprime crisis was decided at the G20 meeting in November 2008 in Washington D.C. The burden of the financial crisis and the collapse of Lehman Brothers that September, the fourth biggest US investment bank at the time, meant the instabilities of the financial system could not be ignored. The strategy was: "We will make regulatory regimes more effective over the economic cycle, while ensuring that regulation is efficient, does not stifle innovation, and encourages expanding trade in financial products and services" (G20 2008: 3). The G20 meeting a year later in London strengthened this philosophy of reform: "Financial markets will remain global and interconnected, while financial innovation will continue to play an important role to foster economic efficiency" (G20 2009: V). Preventing any erosion of global financial markets and further strengthening them was a major concern of the G20 and international institutions as a whole.

From these quotes, the general idea of financial market reform becomes clear. Regulators focused on the reform of banking. The philosophy was that a stronger control of the banking sector and a certain control of banks' interaction with the *shadow banking system* – but with *no control of international capital flows* – suffice to ensure the overall financial system's stability. Comparable standards for all segments of the financial market were not part of the reform schedule. Some observers even point to the lack of comprehensive regulation which allows the shadow banking system to remain a place of financial innovation that stimulates growth. However, experience shows that there is a trade-off between financial innovation and financial stability and that even highly regulated financial systems (as for example in the 1950s and 1960s) could deliver high GDP growth and levels of innovation in the non-financial sector.

In sum, the following major flaws in the supervisory architecture in the EU exist. First, international capital flows are not regulated. The urgent global issue of current account imbalances, unstable international capital flows, exchange rate regimes and mounting currency mismatches were not even discussed by supervisory authorities. Particularly dangerous is that the shadow banking system, often acting in off-shore centres, is a global system which is subject to a very low level of regulation. This has to be seen against the background that even the database to analyse what is going on is weak while shadow institutions, especially other financial institutions (OFI), are intensely interconnected. This, according to the FSB: "While this dataset has improved ... this dataset still has gaps. Nonetheless, some preliminary observations can be made, including that banks and OFIs potentially display material interconnectedness with the rest of the world." (FSB 2018, p. 43) It would be desirable for EU financial market regulation to control currency risks at EU financial institutions, limit short-term capital flows and help developing countries protect themselves from boom-bust cycles. A financial transaction tax (FTT) could reduce short-termist financial flows. Offshore centres in the EU could be regulated and business with such centres outside the EU controlled. Last but not least, the EU could push for a debate how the global currency and exchange rate system could be made more stable.

Second, the shadow banking system is insufficiently controlled. Under new EU regulations, global systemically important financial institutions must retain more equity capital, but this is not enough to control the shadow banking system. Also, in the same shadow banking system a bit more transparency was created, for example for rating agencies; or, to give another example, managers of hedge funds have to provide proof of reaching a certain degree of qualification. However, overall reforms here were more of a cosmetic nature than a radical change.

Third, reform of the supervision of banks should have enforced supervisory authorities to cut the links between the banking and shadow banking systems. This was the substance of the United States

(US) Glass-Steagall Act of the early 1930s and the recommendation of the Volcker-rule after the sub-prime crisis (Volcker 2010) and it is included in diluted form in the US Dodd–Frank Wall Street Reform and Consumer Protection Act, albeit with deregulation under the Trump presidency. In the EU, links between banks and non-bank financial institutions go untouched. Banks can own non-bank financial institutions and they can give credit to them. Some off-balance sheet activities of banks come under regulation, but the banks themselves can undertake speculative activities. Without separating the banking sector from shadow banking, a bust or crisis within the shadow banking sector might easily spread to the banks. And, finally, there is the real danger that banks will shift their activities into the shadow banking system to circumvent banking regulation.

Conclusions

The introduction of macroprudential supervision in advanced countries following the sub-prime crisis was (and is) a step in the right direction. The establishment of macroprudential institutions created a mechanism which allowed the monitoring of financial markets from a macroeconomic perspective to identify and tackle potential instabilities. Overall, the new macroprudential instruments both at European and national levels are an improvement. They constitute a broadening of the supervisory approach to embrace macroprudential supervision and monitoring. However, the regulations and instruments created are not sufficient to make the financial system stable. We have not yet reached the targets set. Hopefully, the next financial crisis will not emerge until the supervisory architecture is completed and comprehensive instruments to tackle all segments of the financial system are in place. At the present stage of regulation, a sub-prime-like financial crisis cannot be excluded.

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content of this paper the authors are solely responsible and it reflects their own opinions alone.

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8

JÖRG BIBOW: NEW RULES FOR FISCAL POLICY IN THE EURO AREA

Introduction

The euro has failed to deliver on its promises. In our view, the euro is indeed unviable without fiscal union. The only question is: what kind of fiscal union should Europe's currency union aim for at this point?

This contribution presents a minimalist fiscal union as a necessary condition for sustaining the euro. The fiscal union proposed here is – by design – neither a "transfer union" nor does it presuppose a deeper "political union" than currently exists. Moreover, the "new rules for fiscal policy" are much like the old ones – with one key difference: a common pool that funds public investment spending across the Union by issuing common debt securities. This complements the Maastricht regime of Economic and Monetary Union (EMU) by supplying the vital missing element: a Euro Treasury (ET). The euro will lack a sure footing for as long as the ECB lacks a federal treasury partner – establishing the vital treasury-central bank axis that stands at the centre of power in sovereign states (Goodhart, 1998).

Section 2 offers a diagnosis of the euro's failure. Section 3 zooms in on the euro fiscal regime, which we argue is flawed and unworkable. The Euro Treasury Plan (ETP) is the subject of section 4, while section 5 compares the ETP with alternative reform proposals. Section 6 concludes.

Diagnosis of the euro's failure

Successive crises since 2007 have exposed existential flaws in the euro regime. Intra-area divergences and a parallel buildup of grave imbalances had remained unchecked prior to the crisis. As those imbalances eventually imploded, member states (MS) were found exposed to systemic banking problems and abruptly deteriorating public finances. Lacking a (federal) treasury partner, the European Central Bank (ECB) battled to stem area-wide contagion while becoming subjected to legal challenges. Labouring under the Stability and Growth Pact (SGP) and Fiscal Compact (FC), governments across the euro area have cut public investment spending to an extraordinarily low level. The austerity frenzy has proved socially devastating and counterproductive from a cyclical and long-term perspective.

The euro regime features the following three key regime flaws responsible for its malperformance. First, the failure to integrate policies at the same time as markets, a flaw that was most critically felt in the banking domain. The euro unleashed a fresh push towards integrating Europe's financial markets. Banks ventured across borders with gusto. A policy vacuum opened up when common policies were not put in place and national policymakers were no longer capable of minding the store either. Europe's "Banking Union" initiative of 2012 is meant to heal this regime deficiency but remains dangerously incomplete.

The second blunder was to let intra-area competitiveness positions run out of kilter. Inspired by inter-war era "beggar-thy-neighbour" policies, exchange rates were declared "a matter of common concern". But when the euro eliminated exchange rates no safeguard was put in place to enforce the regime requirement of keeping competitiveness positions aligned with the ECB's common inflation norm.

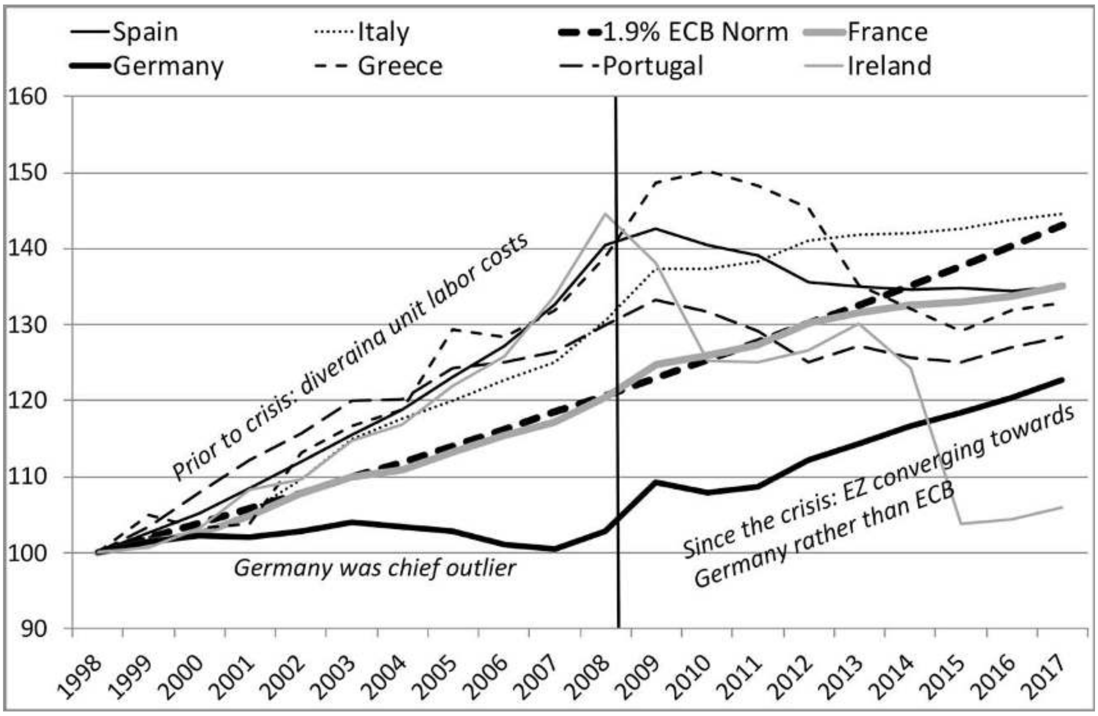

Figure 1: Intra-area competitiveness positions (unit-labour costs) unhinged
(Source: Eurostat AMECO)

Figure 1 shows Germany's mindless mission to "restore" its competitiveness. Germany's unit labor cost trend was the chief outlier prior to the crisis. By rejecting reflation and symmetric adjustment, Germany has forced its partners to restore their competitiveness through "internal devaluation". A *symmetric and effective* "Macroeconomic Imbalances Procedure" (MIP) is critical.

The third flaw concerns macroeconomic stabilisation in general and crisis management in particular. Already, the 2001 global slowdown had shown that the euro area lacked sufficient stabilisation capacity to deal with normal downturns. The global crisis of 2007-9 and subsequent euro crisis proved truly devastating. The euro fiscal regime is counterproductive: destabilising in the short run, deflationary in the long run. The ECB too found itself facing rather peculiar policy constraints. It acted as "lender of last resort" (LOLR) to banking systems. But, in its support for sovereigns, ideology and the Maastricht rules provided bigger obstacles. Only at the last minute did the ECB find cover for supporting sovereign debt within its monetary policy mandate. Monetary policy alone is not quite powerful enough to compensate for a notoriously inadequate overall fiscal stance.

Importantly, the euro's key challenges have arisen from symmetric rather than asymmetric shocks: first the 2001 global slowdown, then the calamity of the global financial crisis and Great Recession. If Member States suffered the consequences unequally, this was not due to any true asymmetric shock but, rather, is owed to the fact that prior to the crisis the euro regime had failed to contain intra-area divergences and imbalances that had left some countries more vulnerable than others.

The euro currency union is unique in featuring a common currency and common central bank, but only national fiscal authorities. This decoupling of fiscal and monetary powers is the ultimate euro flaw. Fixing it requires marrying the ECB with a common treasury.

Euro fiscal regime is flawed and unworkable

It is a common error to attribute poor public finances to a lack of discipline or effort. Yet, if austerity destabilises the economy, worsening public finances are a natural consequence: a symptom of misguided macroeconomic policies. The euro area can claim anything but a lack of effort in inflicting mindless austerity upon itself. It has not suffered from too little austerity but too much.

Already, the Maastricht "convergence criteria" prescribed unconditional austerity operated jointly across a large economic area. Matters got far worse with Germany's constitutionally-anchored "debt brake" and "black zero" fiscal priorities. The FC is meant to transform this new German dogma into a pan-euro area affair: the dream of balancing the budget forever and, alongside, paying down the public debt.

That is a nightmare endeavour. Balancing the budget implies that public debt – expressed as a share of GDP – will converge to zero in the long run. There is no basis in economic theory for this pursuit. Public finance principles of intergenerational justice suggest debt- rather than tax-financing of public investment. Denying the financial system public debt as a vital safe asset is at loggerheads with financial stability policies. And, in terms of first principles of sound macroeconomic reasoning, the peculiar prioritisation of keeping the financial balance of the public sector in balance is pure folly and a recipe for disaster – as Wynne Godley (1992) did not tire of emphasising.

A closed economy may be understood in terms of three sectoral financial balances: households, corporations, and the public sector. Their sectoral financial balances must always add up to zero. Macroeconomic textbooks typically portray the household sector as a net saver, as running a financial surplus and acquiring claims against the other sectors. In practice, a sizeable part of an economy's capital stock has public good character, which makes the disallowance of debt-financing public investment an oddity. If the public sector is precluded from running budget deficits, it is up to the corporate sector alone to persistently run financial deficits, supposedly funding its persistently strong investment drive.

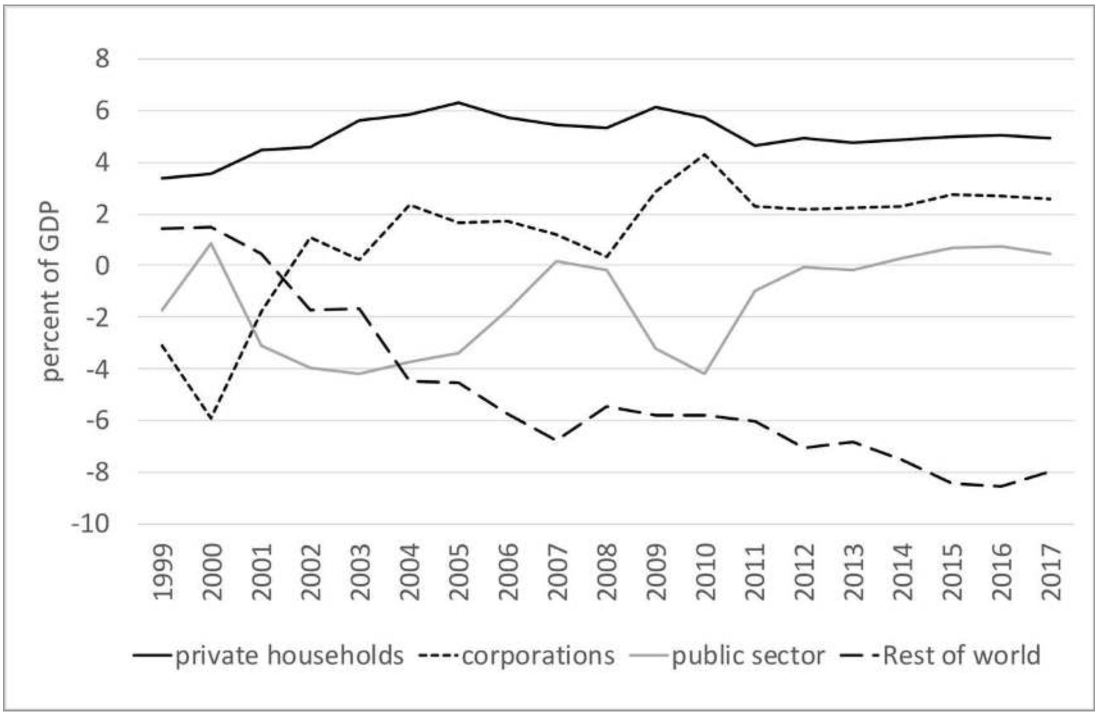

Figure 2: Germany's sectoral financial balances reflect "the German model"
(Source: Eurostat AMECO)

Opening up the economy adds a fourth – external – sector and introduces another possibility: an open economy that runs current account surpluses acquires claims against the rest of the world. This is not an option for the world as a whole, as the – closed – global economy can grow on "domestic" demand only. If certain countries or groups of countries persistently grow via external rather than domestic demand, running up current account surpluses and relentlessly amassing claims against the "external sector" accordingly, this can only work for as long as other countries continue to run external deficits and pile up debts. Excessive debts create fragility and tend to end in tears.

The evolution of Germany's sectoral financial balances is revealing. Under Dr. (Wolfgang) Schäuble's reign in the German finance ministry the "black zero" policy attained a special mystique: it became seen as the tablet of all economic wisdom and the secret behind Germany's apparent recent prosperity. True, when viewed in the context of the euro calamity that has dealt great hardship to much of the rest of Europe, Germany appears to be relatively prosperous. That apparent prosperity does not rest on any sound foundation though (Priewe 2018).

Figure 2 shows the damage wrought by permanent austerity over the past 25 years or so: Much like the public sector, corporations have lastingly curtailed their investment in Germany. In other words, contrary to appearances, Germany has not been investing heavily in its own economic fortunes and prosperity. Instead, it has piled up massive financial claims against the rest of the world. Prior to the crisis, in addition to U.S. mortgage risk exposures, Germany's foreign financial exposures were heavily concentrated in the euro area. This was very much in line with the fact that the euro area's current account position was balanced while featuring soaring intra-area imbalances (Bibow 2012).

In more recent years, Germany's euro partners have started running current account surpluses as well. This is mainly due to the compression of incomes and domestic demand, which, in turn, is down to the policy mix of fiscal austerity cum wage repression that is driving the process of "internal devaluation" designed to restore the euro crisis countries' lost competitiveness vis-à-vis Germany (Bibow/Flassbeck 2018). The euro area has also benefited from the global recovery and a weak euro exchange rate, especially since the ECB turned more active in mid-2014.

The sectoral financial balances constellation for the euro area resembles Germany's ever more closely. Figure 3 shows that both the household and corporate sectors have increased their propensity to save rather than spend. This would normally be reflected in a greater sectoral financial deficit for the public sector, as was indeed the case initially. But in recent years the euro area has been "Germanised": its public finance position is improving on the back of rising current account surpluses. Like Germany, the euro area overall is relying on the willingness of the rest of the world to undertake the extra borrowing and spending that is necessary to enable it to freeload on external growth.

Persistent reliance on export-led growth hardly constitutes a sustainable strategy for a large economy like the euro area. Currently running at 3.6 percent of GDP, the euro area's current account surplus still falls well short of Germany's imbalance of 8-9 per cent. Reaching that magnitude would imply scaling up the area's external surplus to €1 trillion and beyond. It does not take a Donald Trump supporter to view this beggar-thy-neighbour strategy – the euroised German model – as problematic from a global perspective. It is in stark conflict with G20 agreements on containing global imbalances (IMF 2018).

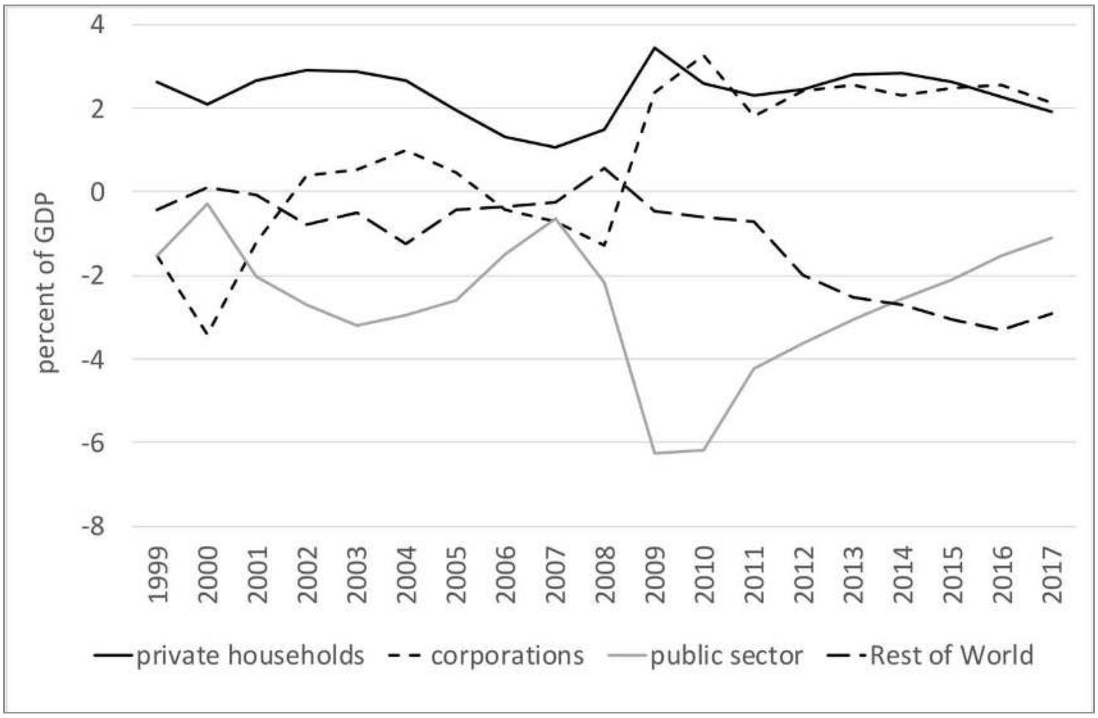

Figure 3: Euro area sectoral financial balances turning German (Source: Eurostat AMECO)

The fiscal rules of Europe's EMU have produced perverse outcomes: automatic fiscal stabilisers turned into destabilisers, public debt ratios surged, and public infrastructure across the euro area crumbled (Germany included!). These are not symptoms of any lack of ambition or effort. These are the consequences of folly, of excessive efforts to make the unworkable work.

The correct interpretation of the evidence for Germany and the euro area is that the euro's fiscal regime, SGP and FC, is indeed *unworkable*. The euro's fiscal regime is deflationary and bound to suffocate domestic demand *lastingly*. Today, the euro area is in the process of repeating the mistake Germany made prior to the crisis: enticing its trade partners to take on (excessive) debts until crisis and default loom. Europe's EMU is waiting for another accident to happen.

The euro area must give up on this ill-founded austerity obsession and return to a fiscal normal. As part of such a return, featuring steady debt-financed public investment, a common fiscal authority should be added to the euro regime. The next section addresses the question of what kind of fiscal union might best suit Europe's flawed EMU.

Fiscal federalism and the Euro Treasury Plan

Politically, the euro area consists of sovereign nations and is characterised by complex and diverse government structures. When deciding on the matter of fiscal centralisation versus decentralisation, the EU's subsidiarity principle provides guidance: only those functions should be transferred to the federal level that cannot be taken care of equally well at lower levels of government. With the Maastricht Treaty the decision was taken that the currency sphere was such a matter for superior federal solutions: the common currency, as the engine of joint prosperity, was supposed to foster political unity as well.

It is now widely accepted that Europe's EMU is "incomplete" and needs to be complemented by some form of fiscal union (Van Rompuy et al. 2012, Juncker et al. 2015). The difficulty lies in identifying exactly what form and degree of fiscal federalism and risk sharing might be most suitable at this juncture. In general, governments take on spending, regulatory, and taxation responsibilities. According to Musgrave (1959) public finances serve three broad functions: allocation, redistribution, and stabilisation. How best to allocate specific government functions and responsibilities in the euro area?

From early on European integration has featured some tentative centralisation of allocative and redistributive functions. Shared public control of the coal and steel industries provides an example of the former; the structural and cohesion funds exemplify the latter. The stabilisation issue featured in requiring MS to treat exchange rates as a "matter of common concern". The approach taken was purely passive: MS should avoid destabilising the Union. The SGP and FC are similar in approach. The belief is that by "keeping their own fiscal house in order", MS avoid destabilising EMU. Any active role for either centralised or coordinated (national) stabilisation policies was missing until the introduction of the euro put the ECB in charge of countering common (or: "symmetric") shocks affecting the euro area economy, with price stability taking primacy over the secondary stabilisation obligation.

In view of the euro's broken promises, a case may surely be made for more redistribution between winners and losers. But strong resistance exists against extending any federal redistribution between MS beyond existing levels. A case may also be made for a federal allocative role regarding the joint provision and sharing of common public goods. But, again, moving forward in this direction might be complicated if benefits were not perceived as being shared equitably among MS. Similar concerns might arise regarding federal fiscal stabilisation policy if arrangements were perceived as constituting a transfer union.

So how can we implant a more effective stabilisation mechanism into the euro regime body? How much stabilisation should occur at the centre? How much can remain at the national level? How can the right mix be best achieved? And how about accountability in the absence of proper political union?

The approach to fiscal union taken here is minimalistic and squarely focused on stabilisation. The Euro Treasury Plan (ETP; see Bibow 2013) foresees the smallest possible fiscal union that would make the euro viable. It only creates a small common budget of, say, 3% of GDP, targeting public investment (broadly defined). It largely leaves it to the MS to decide on their respective public investment priorities, and, apart from adding the small common budget, it largely leaves the existing fiscal regime untouched.

The central idea of the ETP is very simple: to create a Euro Treasury (ET) as a vehicle to pool future euro area public investment spending and have it funded by proper Euro Treasury Bonds (ETBs). MS are apportioned their share of investment grants and they also contribute their respective shares towards the interest service on the common debt, *both mechanisms based on GDP shares*. This latter feature of the ETP rules out a "transfer union" by design. The ET is separate from and runs parallel to the EU budget, which remains the sole instrument of any intra-regional redistribution.

MS governments would agree on the initial volume of common area-wide public investment spending funded by the ET and its growth rate thereafter. With initial parameters set, the ET then follows a fixed rule or the "golden rule of public finance", namely that (only) public investment should be debt-financed (Truger 2016). The result is steady "deficit spending" on public infrastructure funded at the centre.

Take the Maastricht parameters as an example: an initial volume of (gross) public investment of 3 percent of GDP, annually increased at a 5 percent rate thereafter. Assuming annual nominal GDP growth of 5 percent, the stock of ETBs would converge to a steady-state level of 60 percent of GDP. The adjustment would be largely completed within one generation.

The ET will not directly undertake investment spending itself but give investment grants to MS. On the revenue side, special tax provisions are designed to generate revenue earmarked for servicing the debt. In line with the EU's subsidiarity principle, the ET's power to tax is strictly limited to obtaining revenues to service the interest on the debt and to keeping the debt ratio stable at its target level.

Apart from adding the ET to the euro regime, the old fiscal rules remain largely in place. MS will still be required to abide by all the rules of the current euro regime, *but applied to current public expenditures only* – as national public capital expenditures now form a separate capital budget funded through common ETBs. This makes a vital difference.

The current regime asks MS to run (near-) balanced public budgets forever, which would see public debt ratios decline towards (near) zero in the long run. As argued above, this is an impossible endeavour: the euro regime is *unworkable*. In addition to its inherent deflationary bias, the euro regime would also starve the financial system of safe assets, creating avoidable financial and economic fragilities. Debt – and in fact growing public debt – is a very natural concomitant phenomenon of economic growth.

The flawed euro regime led to a surge in public debt – national public debts though, debts made unsafe by the peculiar divorce of fiscal and monetary authorities that characterises the euro regime. It lacks a central fiscal institution with the power to spend, tax, and issue (safe) debt. This void is the key source of its vulnerability and ill-performance.

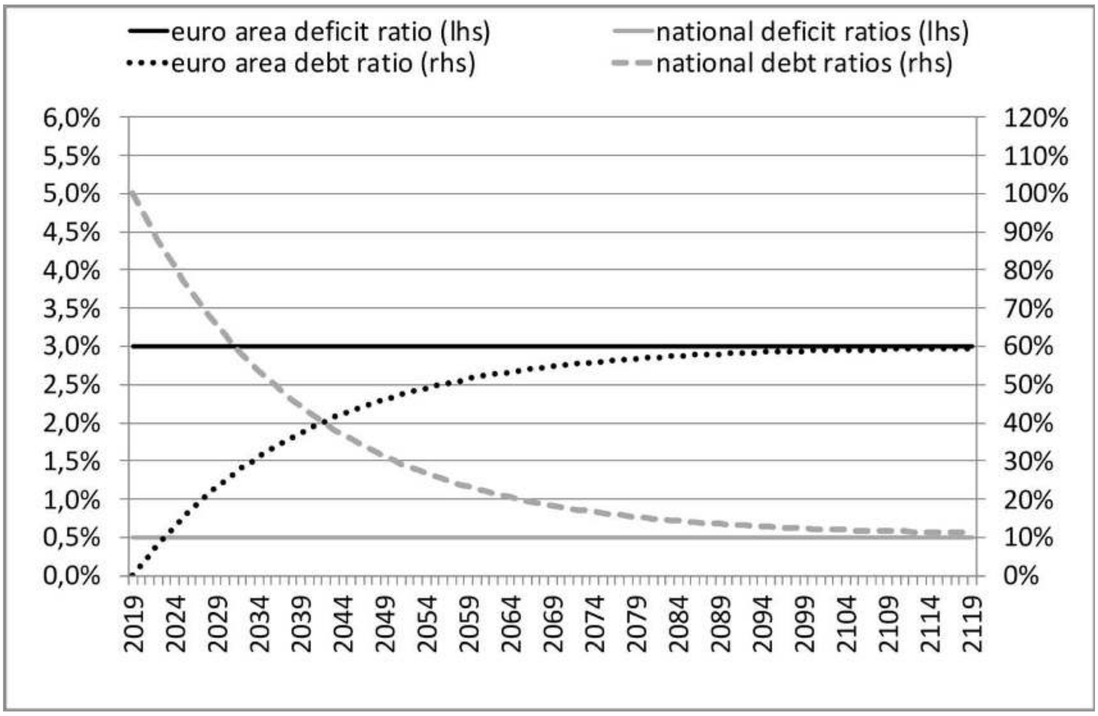

Figure 4: Convergence to steady state of central and national debt ratios (Maastricht parameters) Source: own calculations

The ET will fill this void and fundamentally change the course of national public debts. Steady deficit-spending on public investment funded at the centre will finally allow and *enable* national treasuries to (nearly) balance their structural current budgets. Within one generation there will be little national public debt left to worry about. The bulk of public debt will by then be federal debt (Figure 4) – which would resemble the situation in the US, a functioning currency union.

The ETP accommodates some key German reservations: the proposal does not constitute a transfer union, requires that the MS abide by the current rules, and foresees that the ET operates on a fixed rule rather than discretion. Incidentally, the "golden rule of public finance" was anchored in Germany's constitution until it was replaced by the "debt brake" in 2009. In the absence of a fully-fledged parliamentary democracy an auto-pilot regime for the ET seems advisable.

How would the ET help to stabilise the euro area and finally deliver on the euro's (broken) promises? Lets' recall here that the euro's key challenges so far have arisen from symmetric rather than asymmetric shocks. Pre-crisis intra-area divergences and imbalances have been responsible for asymmetric developments subsequently.

First, by steadying public investment at an adequate level, the ET would provide a basic ingredient for turning the euro into an engine for joint prosperity rather than shared impoverishment.

Second, while public investment spending funded by the ET will not be counter-cyclical but merely steady, indirectly, the ET would empower national automatic fiscal stabilisers. These were shut off and turned into destabilisers when most needed. By requiring *and enabling* the decline of national public debt ratios to very low levels in abidance with the rule of balancing structural current budgets at the national level, MS will restore their fiscal room for manoeuvre. National automatic stabilisers would thereby regain the necessary breathing room to actually do their job.

Third, the ET could easily do more in a severe downturn and (automatically) extend additional all-purpose grants to MS (based on GDP shares). This would provide extra breathing space for quasi-automatic stabilisation put into effect in a decentralised way. Once recovery is established the tax for servicing ETBs could be temporarily raised to assure re-convergence to the target debt ratio.

Fourth, as a flexible and reliable emergency funding source, the ET is the natural fiscal backstop for the banking union project. The solvency backstops currently foreseen in the banking union are insufficient and remain largely national. The European Stability Mechanism (ESM) is too small and unwieldy. Coupling the ECB's quick (liquidity) pockets with the ET's deep (fiscal/solvency) pockets would alone provide the euro area with a strong bulwark against any threat of financial meltdown.

Fifth, the ET would provide the common safe asset that the single market yearns for, serving to establish a common term structure of (risk-free) interest rates. Currently private creditors across the eurozone are facing diverging borrowing costs and credit spreads based on their nationality as private credit risks continue to be priced off their respective national benchmark (Constancio 2018). This situation conflicts with the whole purpose of both the common market and the common currency. The ETP would overcome this fundamental inconsistency. Banks would hold ETS as their primary safe asset. By ending the doom loop and providing a truly safe asset, the "no-bailout clause" is made workable too.

Sixth, the ET could facilitate mutual insurance schemes featuring temporary fiscal transfers that are designed to stabilise – rather than level – incomes across the euro area. Mutual insurance is called for to counter "asymmetric shocks", shocks that affect currency union members differently.

Last, but not least, a direct area-wide stimulus arises from simply normalising public investment spending, which remains at severely depressed levels (around 2 percent of GDP).

Euro Treasury Plan compared to other proposals: advantages and limitations

Post-crisis reforms of the euro regime have been either ill-thought-out or remain incomplete. Any reform that simply aims at "tightening the fiscal screws", the FC being the prime example here, fits the first category. Mindlessly trying to make an unworkable regime work is like beating a dead horse. No good will ever come of it. The banking union project fits the second category. Motivation and objectives are good ones, albeit pursued belatedly after much damage was done. The initiative got stuck and remains incomplete. It cannot be properly completed without also moving towards more risk sharing and fiscal union.

In many ways, French President Macron's reform proposals featuring a sizeable euro area investment budget point in the right direction.

But there are critical differences too. His proposal targets the joint funding of common euro area public goods. Resistance might arise from perceived inequities in the sharing of the benefits. The investment budget may be an easier sell if MS were granted the freedom to decide on their respective national investment priorities – as the ETP foresees. Macron envisions funding the common budget through common taxes. The ET issues ETBs instead and raises taxes from MS to cover the interest service.

Macron's proposal also seems to foresee control over fiscal policies by a "euro area finance minister". If Europe's EMU were a fully-fledged political union, this would be the obvious way to go. Some may even see the current Euro Group as a precursor to a finance ministry. The hegemonic relations and lack of shared democratic control that characterise the situation are worrisome. Exacerbating the EU's existing "democratic deficit" seems hardly advisable. An auto-pilot-run ET is preferable for now.

Many proposals for mutual insurance schemes exist. In line with traditional OCA (Optimum Currency Area) theory, their focus is on asymmetric shocks: MS in more favourable cyclical positions contribute to a common budget (or rainy day fund) that lends temporary support to MS that find themselves in less favourable cyclical positions. The rise in indebtedness among the latter group is thereby contained. According to Pisani-Ferry, Italianer and Lescure (1993), who provided an early scheme of cross-border budgetary risk sharing, the mutual insurance budget can be fairly small in size (even less than 0.5 percent of GDP), but still provide significant stabilising effects. Credit lines for struggling MS are an alternative. Fiscal risk-sharing and solidarity should be part of any currency union. Among common unemployment schemes the reinsurance model seems superior in view of significant national differences in labor market and unemployment insurance institutions.

The US has a complex unemployment insurance model, consisting of state-based systems, rainy day funds, and a federal fiscal backstop. At times of deep nation-wide recessions (common shocks) there is effective support running from the federal level to the states rather than any inter-state transfers. Taking its cue from US institutional arrangements and actual euro area experiences, the ETP provides a federal fiscal stability anchor but leaves dealing with asymmetric shocks at the national level. The ET could provide additional support during deep recessions and serve as a conduit for facilitating inter-MS mutual insurance as well. But that is not the ETP's priority as a starting point.

While we sympathise with mutual insurance proposals, we consider them a sub-optimal starting point for establishing a euro area fiscal union. Remember that common shocks and intra-area divergences rather than proper asymmetric shocks have represented the euro area's key challenges. Mutual insurance schemes do not address the euro regime's most fundamental flaws: its deflationary bias, the divorce between fiscal and monetary policies, and the lack of a common safe asset.

Starting fiscal union with a common unemployment scheme also seems challenging politically. Currently, such a regime would start with transfers from Germany to weaker partners and hence face German resistance. The argument that prior to the crisis such arrangements would have produced temporary transfers to Germany hardly qualify as a selling point. If a MS sets out to "restore" its competitiveness and ends up suffocating its economy while causing intra-area divergences and imbalances that threaten the viability of the currency union, it should hardly be rewarded by way of transfers from its beggared partners. Any effective mutual insurance scheme would have to rule out such perverse transfers.

This point also underlines that the ET is not a sufficient condition for turning the euro into a viable currency. The ET too is bound to fail if divergences in competitiveness positions are not prevented in future. Divergences in competitiveness end up bankrupting debtor MS and ultimately result in permanent transfers. We dubbed this point of economic logic as Germany's "euro trilemma", which says: "Germany cannot have it all — perpetual export surpluses, a no transfer/no bailout monetary union, and a 'clean,' independent central bank" (Bibow 2012).

Apart from its huge external imbalance, reflecting the degree to which Europe's EMU has exported its internal problems to the rest of the world, the ECB's balance sheet and its zero-interest rate policy are the last thing standing between Germany and a euro transfer union. Effectively, the ECB's balance sheet has served as a mechanism for mutualising credit risks that were previously concentrated on German banks' balance sheets. The Bundesbank's TARGET2 claims against the ECB involve risk sharing among MS. It is truly ironic that the ECB has faced so much criticism for its policies from the German side. In dealing with the mess ultimately caused by Germany's beggar-thy-neighbour wage devaluation (Bibow 2006, 2012, Flassbeck 2007, Bibow and Flassbeck 2018), the ECB has been Germany's best friend.

The euro area must find a way to keep trends in unit-labor costs and competitiveness aligned with the ECB's common price stability norm. This requires a *symmetric and effective* MIP (macroeconomic imbalance procedure) deserving that name.

It also seems advisable to help crisis countries with their legacy issues. But this would involve transfers, which the ETP excludes by design. The ET foresees no mutualisation of any old national debts.

The ETP therefore differs fundamentally from other "euro bond" proposals which feature either mutualising and/or transforming national public debts. These alternative proposals completely ignore the deflationary bias in the euro regime and fail to properly fix the regime's underlying flaws.

It appears that true euro bonds – the ETBs featuring in the ETP – would require Treaty change. So be it. Ultimately there is no way around it: the euro cannot be made viable without marrying the monetary union with fiscal union. We are not even convinced that selling some fake "safe bonds" to the public is any easier than a transparent Treaty change.

Extending the ECB's mandate to be LOLR to sovereigns (without any conditionality attached, as in OMT (outright monetary transaction) programs) would require Treaty change too. Using the ECB's balance sheet involves mutualisation of risks and hence an implicit fiscal union with possible "transfers". U.S. states do not have a LOLR by their side either. They are fiscally vulnerable and therefore generally maintain low debt ratios (10-20% of GDP). The ETP would replicate this situation in the euro currency union.

Conclusion

The current euro regime is flawed: the decoupling of treasury and central bank functions leaves all parties vulnerable, with permanent austerity creating a deflationary bias. The ETP addresses the flaws head on, complementing the euro monetary union with a fiscal union, pairing up the ECB with a federal fiscal capacity to overcome the fatal divorce between fiscal and monetary policies.

The ETP is not an optimal ultimate solution for Europe, but a starting point and foundation to build on. Starting with a small common budget, the ET would provide steady deficit spending from the centre combined with steady issuance of a common safe asset – establishing a minimalistic but functional fiscal union that is not a transfer union. The ET can operate on auto-pilot. By requiring *and enabling* MS to balance their current structural budgets, national public debt ratios would decline to low and safe levels, restoring the fiscal space for automatic stabilisers to operate freely at the national level.

The ETP neither addresses the debt legacies burdening euro crisis countries nor does it by itself prevent persistent divergences in intra-union competitiveness positions. Germany finally needs to acknowledge its "euro trilemma": huge and persistent external surpluses are not an option unless a transfer union is also accepted (Bibow 2012). Blocking constructive reforms – denial and pretence – has been Germany's strategy until now. The "incomplete" euro remains an accident waiting to happen.

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9

SEBASTIAN DULLIEN: MACRON'S PROPOSALS FOR EURO AREA REFORM AND EURO-AREA VULNERABILITIES: A SYSTEMATIC ANALYSIS

Across Europe, the election of Emmanuel Macron as French President in 2017 was received with relief and hope. Relief, because Macron had just beaten Marine Le Pen, an outspoken EU- and euro-critic candidate from the right-wing *Front National*. Hope, because the landslide victory of Macron's movement *La République en Marche* both in the presidential and parliamentary elections was perceived as an opportunity to finally complete the unfinished euro area's architecture and make the currency union more crisis-proof. Behind this hope was the perception that, despite almost a decade of reforms, important vulnerabilities of the euro area had not been addressed. While important questions such as the need for a fiscal capacity or a common deposit insurance for the currency union had been raised and put into official EU documents by 2012, the reform process had come to almost a complete standstill after common oversight of the region's banks by the European Central Bank began in the fall of 2014 owing to the lack of political capital and political commitment in both Germany and France.

A year later, in the summer of 2018, these hopes for change had only partly materialised. While no detailed large-scale technical proposal for changes in the EU institutions has been published by the French government during Macron's first year in office, the new President presented his vision for a stronger and more stable European Union in a number of public speeches, including one key speech at the Sorbonne university on September 26, 2017.

As Macron's ideas on the euro zone were not presented in a structured, technocratic paper, but rather in a long, well-crafted speech designed to induce enthusiasm among the audience, they are hard to disentangle from his vision for the EU as a whole. Against this background, this contribution tries to summarise what Emmanuel Macron has been proposing with regards to euro area governance and will analyse how far these proposals would help to address remaining EMU vulnerabilities. Section 2 will first list Macron's most important reform proposals with respect to the monetary union. Section 3 will list the vulnerabilities which led to the euro area crisis, and section 4 will present the reforms implemented since the onset of this crisis in 2010. Section 5 will contrast Macron's reform proposals with the remaining vulnerabilities and section 6 concludes.

Macron's proposals for euro area reform

As mentioned above, Emmanuel Macron's proposals for euro area reform came in a speech in which he presented a political vision for the future of Europe at the Sorbonne on September 26, 2017 (intentionally scheduled for two days after the German federal election of that year). In his vision (Macron 2017), the euro area is part of a broader project to create a Europe which protects its citizens ("*L'Europe qui protège*"). In Macron's narrative, a stronger EU is needed to protect the European way of life and the euro is at the heart of this stronger Europe.

As the challenges from which a "Europe that protects" is supposed to shield its citizens are very broad, Macron proposes a number of measures which are not directly (and, in many cases, not even indirectly) related to the euro area architecture, such as defence and common refugee and asylum policies.

Among the measures directly related to the euro area, a euro area budget with a volume of several percent of GDP sticks out. This budget would have the following characteristics:

- It is supposed to be financed through new own taxes plus a part of existing corporation tax revenues. Macron here mentions a levy on digital companies and ecological taxes.
- It is supposed to be overseen by a European finance minister under direct European (not national) parliamentary control.

This proposal for a common budget is directly linked to one for a harmonisation of corporate taxation, even if the latter is proposed for the EU as a whole (necessary to close loopholes and limit tax evasion).

He makes several proposals for initiatives on which more funds could be spent at the EU level, yet he fails to explain which of these measures could (and should) be financed from the euro area budget as opposed to from the EU budget. His basic argument is that "common goods" should be jointly financed by Europeans. While this argument rings a bit like "European public goods", it is not clear whether Macron really had the economists' definition of public goods (as being non-rival in consumption and non-excludable) in mind when he spoke about "common goods".

Among Macron's spending proposals, the following stand out

- Common refugee policies & border protection
- Common defence initiatives
- A common policy for Africa and the Mediterranean
- Common investment in technology and infrastructure, including a "European industrial support program" for clean vehicles and a common infrastructure as well as a

"European agency for disruptive innovation", modelled after the U.S. Defence Advanced Research Projects Agency (DARPA).

In addition, Macron calls for new common regulations for the EU, by proposing "social convergence criteria" and "safeguards against social dumping".

Given that several German commentators had earlier warned that Macron might force Germany to bear some of the costs of failed French economic and fiscal policies, it is interesting to note what has *not* been proposed (and even ruled out) by Macron: he made no mention of Eurobonds or any other form of common borrowing. Indeed, he even ruled out any mutualisation of old debt.

He also ignored any type of European Unemployment Insurance or European Unemployment Reinsurance system, despite the fact that the French treasury had previously worked on that topic extensively (Trésor Economics 2014). The only reference he made in that direction was a statement that "in the end, transfers will happen". Yet, this does not necessarily mean that Macron is opposed to such a system of EMU-level automatic stabilisers, especially since the idea of a "European Unemployment Stabilisation Fund" popped up in the declaration of the French and German governments of Meseberg from June 19, 2018).

A similar argument probably holds for banking union. Macron made no reference to completing banking union. However, it is safe to assume that he generally favours completing the banking union at least at a technical level, given that his government has been working towards these goals, including a common deposit insurance, known as EDIS (European deposit insurance scheme).

Euro area vulnerabilities and the euro crisis

In order to see how far Emmanuel Macron's proposals could make the euro area more stable and crisis-proof, it is helpful to first systematically review the underlying causes of the euro crisis which has haunted the continent since 2010. While initially the crisis was mostly seen as one stemming from fiscal profligacy, the consensus today is that it had a number of interacting origins and causes (Fratzscher 2013; Sachverständigenrat 2010; Shambaug 2012). Broadly, one can identify seven crisis elements (Dullien 2014; 2017)[1]:

1. Shaky public finances: While the crisis has not been primarily a public debt crisis everywhere, unsustainable public finances were an important element in the genesis of the crisis at least in some cases. In Greece, fiscal deficits had been persistently above the stipulated 3 percent of GDP, and debt-to-GDP ratios well above 100 percent. In Italy, debt-to-GDP ratios have also been high, primarily as a consequence of high deficits in the period before the introduction of the euro (even if deficits since then have been rather moderate).
2. Boom-and-bust-cycles in the periphery: With falling borrowing costs after the introduction of the euro, many countries in the euro periphery experienced an economic boom. As inflation in Spain, Ireland or Portugal was higher than in the core countries, but the nominal interest rate was roughly the same, real interest rates in these countries were much lower than in Germany or the Netherlands. This boosted investment especially in housing which in turn boosted economic growth, employment, wages and inflation. The boom ended when real estate price increases came to an end and the countries in the euro periphery found themselves saddled with vastly diminished price competitiveness.

3. Problems in the banking sector: As a consequence of these boom-and-bust cycles, but also because of the engagement of some banks in the securitised U.S. subprime mortgage sector, banks in a number of euro countries had to write down assets and saw their capital buffers dramatically shrinking, prompting governments to bail out banks. The banking sector became a drag on economic growth (because banks became more careful in their lending decisions) and a burden for public finances.
4. Toxic link between banks and sovereign debt: In most euro area countries, banks hold a significant share of their assets in domestic bonds. This created a vicious circle of escalating bank balance sheet problems and sovereign debt issues. When investors became wary of problems in a country's banking sector, they started to anticipate that large-scale bail-outs would become necessary. As a consequence, they began doubting the sustainability of public debt and sold government bonds, pushing down prices and forcing the banks to write down their holdings, exacerbating their balance-sheet problems.
5. Self-fulfilling market panics: Doubts about governments' ability to service their debt exacerbated the sovereign debt problems. Falling confidence in some governments led to a sale of their bonds, pushing down prices and increasing yields. These rising yields made it difficult for the countries in question to access markets and service their debt. As discussed in the literature on self-fulfilling crises (Cole/Kehoe 1996), some euro area countries were thus pushed to the brink of insolvency just by the deterioration in investor confidence.
6. Structural divergence of price competitiveness: In the first decade after the euro was introduced, euro area countries experienced a dramatic divergence in price competitiveness, caused partly by structural differences in wage setting institutions, partly by the above-mentioned booms in some

countries with corresponding stagnation in others facing high real interest rates. In countries such as Germany, Austria or the Netherlands, unit labour costs grew much more slowly than in the euro area as a whole, while countries such as Ireland, Greece and Spain experienced much higher unit labour cost increases. When the euro crisis struck, the latter group found themselves in a position of very weak price competitiveness. They experienced subsequently an extended period of poor economic growth.

7. Loss of the population's trust in (European) institutions, linked to a loss of legitimacy: The long period of high and rising unemployment, low economic growth and falling or stagnating disposable household incomes has led to a crumbling of the population's trust in national and European institutions. As a result, support for populist parties has grown in many euro area countries. This support has started to interact with the economic dimension of the crisis: As populists question their country's euro membership or at least their country's adherence to European fiscal rules, investors start selling government bonds as soon as a country experiences a populist surge, pushing up yields and hence creating new problems of debt sustainability for the countries concerned.

Current state of euro area reforms

To put Macron's reform proposals into perspective, one should first look at the status quo. Here, it is important to realise that a number of the causes and origins of the euro crisis discussed above have already been addressed by changes to the euro area's governance framework, even if the measures taken have not always solved the underlying problems. The main reforms implemented since 2010 (up to early 2018) have been the following[2]:

1. Reform of fiscal rules: European policy makers significantly

tightened fiscal rules in the two legislative packages dubbed "six pack" and "two pack". Critically, the new rules force euro member states to take part in a synchronised budget cycle under which draft budgets have to be submitted already in the prior autumn for vetting by the European Commission. In addition, medium term budget targets are defined as well as the speed with which euro area countries have to correct excessive budget deficits. Moreover, countries with debt-to-GDP ratios above 60 percent are now obliged to bring down the debt level by one twentieth of the difference between their actual debt level and the 60-percent threshold each year. Excessive deficit procedures can now be initiated even when the deficit itself is below the 3-percent-threshold, but if the debt-to-GDP ratio is not reduced swiftly enough. The voting rules in an excessive deficit procedure have also been fundamentally changed: for an excessive deficit procedure to go ahead, a qualified majority is no longer necessary. Instead, countries need a qualified majority to *stop* the process. With the fiscal compact, an additional treaty outside the EU treaties, euro area members agreed to codify some of the EU's basic rules on deficit and debt reduction in national law, preferably their constitutions. If member states fail to fulfil these commitments, they can be sued by other member states and fines can be imposed. Hence, the problem of excessive budget deficits has already been addressed. Whether it has also been resolved, in contrast, is a matter of dispute. Especially conservative German economists often criticise the fact that the current rules are not enforced strictly enough. They point out that, even in 2017, countries such as Spain or Italy had not followed up on their commitments and were still running deficits larger than what the rules prescribed. Other economists pointed out that the euro area countries had reduced structural deficits more strongly than other industrialised economies; the real problem was excessive consolidation given that the economic situation kept debt-to-GDP-ratios at high levels in the end.

2. Introduction of mechanisms to deal with excessive macroeconomic imbalances: A formal procedure has been implemented to address these and, in many aspects, this works similarly to the one dealing with excessive deficits. Potential imbalances are monitored, countries can be issued with warnings, and if they persistently fail to correct macroeconomic imbalances, even fines can be imposed. Yet, the mechanisms to evaluate macroeconomic imbalances are much more complicated than those to evaluate an excessive deficit: Instead of focusing on single indicators, macroeconomic imbalances are evaluated using a scoreboard with more than a dozen indicators (including current account imbalances, growth in private indebtedness and excessive increase of unit labour costs) with a discretionary process to make the final judgement. The mechanism to deal with excessive macroeconomic imbalances clearly aims at preventing boom-and-bust-cycles as well as divergent competitiveness between the countries. However, analysis of the procedure generally concludes that the impact on actual policies is marginal at best (Darvas/Leandro 2015), and that especially Germany has continued to run a very large current account surplus without reacting to the recommendations from the mechanism (Gros/Busse 2013).
3. Creation of large-scale lending facilities for governments in financial trouble: The no-bail-out clause found in the Maastricht treaty, which prohibited other countries and the EU from assuming liabilities for individual member states, has been softened. With the escalating crisis, European policy makers first created the temporary European Financial Stability Mechanism (EFSM) and the European Financial Stability Facility (EFSF), which were then replaced by the permanent European Stability Mechanism

(ESM). With pay-ins and guarantees from the euro area member states, the ESM is able to lend out up to €500 billion to euro member states which have lost or are about to lose access to financial markets. As ESM programs usually come with conditionality, its lending facilities now work similarly to those of the International Monetary Fund (IMF). The creation of such a liquidity facility clearly addresses the problem of self-fulfilling market panics since investors are signalled that countries under stress can get financing at moderate interest rates, making it unlikely that rising interest rates can push them into insolvency. So far, also, it seems to have worked quite well. The announcement of OMT (outright monetary transactions) by ECB president Mario Draghi is often credited with the fall of spreads and the end of the most severe period of the euro crisis. It remains to be seen, however, whether the current combination of OMT and ESM is robust enough to prevent all self-fulfilling market panics.

4. Reform of the ECB's monetary policy framework: Independently from the heads of state and government and the European Commission, but nevertheless very important for the broader question of a resilient euro area architecture, the ECB has changed its operating framework and has hence moved closer to becoming a true lender-of-last-resort for euro area governments. Under OMT, it has announced that it would be willing to buy government bonds in the secondary market with maturities of up to three years from countries which are at risk of losing access to financial markets, provided these have agreed on a conditional loan package with the ESM. As the ECB is not constrained in its money creation, this new tool effectively allows the central bank to indirectly lend as much liquidity as might be needed to a government under pressure, thus greatly increasing the financing volume effectively available for countries under ESM programmes. Economically, OMT

leverages the lending power of the ESM and hence addresses once more the problem of self-fulfilling market panics.

5. Reform of the financial oversight structure: Within the framework of the newly created banking union, financial regulation and oversight has been moved to the ECB. It is now responsible directly for the oversight of larger banks in the euro area and indirectly (through national authorities) for the oversight of all banks in the currency union. In addition, capital requirements for banks operating in the EU have been strongly increased. Even prior to the inception of the banking union in 2012, the EU had started to centralise financial market oversight as a reaction to the 2008/9 crisis via the creation of oversight authorities for banks, markets and insurances. The reform in the supervisory structure aims at addressing banking problems: The hope is that in future banks will be better supervised and hence the likelihood of a renewed banking crisis like that starting in 2007 will be much lower.
6. Introduction of a common framework for bank resolution: Also within the banking union, a common framework for dealing with banks in trouble has been created: The decision on how to resolve or rescue a bank is taken centrally and supposedly under uniform rules. Banks are required not only to hold a certain amount of equity capital, but also of subordinated debt instruments which can be bailed in. Such a bail-in of private creditors is a pre-requisite for injections of public funds into an ailing bank. In order to shelter national governments from the fall-out of national banking crises, a Single Resolution Fund (SRF) has been created which is supposed to finance bail-outs, with the costs being over the coming years.

The common framework for bank resolution is aimed at cutting the toxic link between bank balance sheets and government finances because a banking crisis cannot directly lead to large bail-out packages.

Even though a number of issues in the banking sector have been addressed, several unresolved problems remain. For example, the SRF is usually seen as being too small in the event of the failure of several banks.

Moreover, because there is so far no common deposit insurance, and national deposit insurances are financed by a nation's banks' contributions, a crisis of several banks in one country carries the risk of being amplified into systemic problems at the national level by the deposit insurance: If several banks fail, the remaining (possibly sound) national institutions would have to pick up the burden as they would have to cover any deficit in national deposit insurance.

Finally, holdings of individual governments' bonds are usually concentrated on the country's bank balance sheets so any deterioration in its debt sustainability is likely to have detrimental effects on that country's banking system.

Thus, of the causes of the crisis discussed above, only the problems of excessive deficits and of self-fulfilling market panics have been comprehensively addressed. In contrast, problems in the banking system, the doom-loop between banks and sovereigns as well as the boom-and-bust-cycles and diverging competitiveness have only been partly addressed. The question of a loss of legitimacy because of dismal economic performance has not been addressed at all: None of the measures so far implemented directly aims at increasing economic growth or bringing down unemployment; none of them increases democratic accountability of economic policy-making at the European level.

Macron's reform agenda and euro-area vulnerabilities

The question now is how far Macron's reform proposals address the causes of the crisis, especially the unresolved ones. The following section analyses this issue. Table 1 summarises the causes that have already been solved or at least addressed by reforms implemented so far and those that are addressed by Macron's reform proposals. Column 1 lists the causes discussed above. Columns 2 to 7 deal with the extent to which these reasons have been addressed by past reforms. Column 8 summarises the status quo at the beginning of 2018 regarding causes that have been addressed and those which have not. Column 9 examines how far Macron's proposals address the seven causes of the crisis identified above.

Reforms / Crisis causes	Six Pack	Two Pack	Fiscal compact	ESM & OMT	Banking Union	Evaluation of reform status early 2018: Crisis causes addressed?	Macron's proposals
Excessive deficits	+	+	+			Addressed	
Problems in the banking sector					?	Partly addressed	
Doom-loop between banks and sovereigns					?	Partly addressed	
Self-fulfilling fiscal crisis				+		Addressed	
Boom-bust-cycles	?				EMU reforms implemented since 2010	Marginally addressed	?
Diverging competitiveness	?					Marginally addressed	?
Loss of legitimacy because of dismal growth performance						Not addressed	+
+: issue has been addressed; ?: issue has been marginally or partly addressed.							

Table: EMU reforms implemented since 2010 Note: ++: issue has been addressed and measures have shown a significant degree of effectiveness; (+): issues have been addressed, but effectiveness is questionable; ?: issue is addressed, but measures cannot be evaluated yet.

One can immediately see that Macron mainly aims at unresolved problems: The investment and innovation agenda he brought forward clearly aims at remedying the problem of diverging competitiveness. In his speech, the French President repeatedly put his proposals for innovation policies within the context of failing competitiveness in parts of Europe.

Also, arguably, Macron's proposal for a common budget at least to a certain extent aims at limiting the boom-and-bust cycles in the currency union, or at least dampening their consequences. His intention is clearly described in the following passage of his speech (Macron 2017):

> We need convergence and stability through national reforms, but also by coordinating our economic policies and a common budget. If we want to reduce our differences and develop our common goods – everything I have just mentioned, security, protection in the context of migration, digital transition, ecological transition, a genuine development and partnership policy – these common goods, foremost among which is our currency, must be financed. *And we therefore need more investment, we need the means to provide stability in the face of economic shocks, as no state can tackle an economic crisis alone when it no longer controls its monetary policy.* [Author's emphasis.] So for all these reasons, yes we need a stronger budget within Europe, at the heart of the eurozone.

Here, Macron does address two problems which have hitherto been left largely unaddressed by prior reforms.

In addition, Macron clearly takes on the issue of a loss of legitimacy owing to a dismal economic performance in the euro area. He repeatedly mentions the need for the creation of jobs, and the whole narrative of "*L'Europe qui protège*" is one of creating output legitimacy by delivering tangible benefits for Europe's population. Also, the call for parliamentary control of the proposed euro area finance minister can be seen as an attempt to repair legitimacy. Finally, Macron tries to create policy space at the European level where national governments have lost their own room for manoeuvre due to globalisation and European integration.

Nevertheless, Macron's proposals also have blanks. As described above, he does not propose any measures which would directly change national governments' fiscal behaviour[3]. Also, he does not mention banking union, including a common deposit insurance scheme. Hence, both the problem of excessive deficits as well as outstanding issues in the banking system are left unaddressed along with the issue of self-fulfilling market panics. However, given that arguably both the problems of excessive deficits as well as that of self-fulfilling market panics have been addressed by reforms already implemented by early 2018, only banking sticks out as a blind spot.

Conclusion

In conclusion, one can say that Emmanuel Macron's proposals seem like sensible additions to the euro area reforms implemented since 2010. If one shares the analysis of the seven causes of crisis presented above, one has to state that more than half of these causes have not been properly addressed by past reforms. Macron's proposals now address at least some of these.

However, even if they were implemented in full, some important issues would remain unresolved. First, weaknesses in the banking sector and the problem of sovereign bonds of certain governments being consolidated on their country's banks' balance sheets persist. Second, it is far from clear whether Macron's ideas are sufficient to genuinely limit boom-and-bust cycles and the divergence of competitiveness, or whether additional measures are necessary.

Finally, Macron's proposals come with some risks: First, so far they are not well-formulated as regards details. Whether they can really deliver on what they promise, however, depends very much on details. Second, if poorly or badly implemented, the proposals carry the risk of making the euro area more unstable: If they were to be enacted in a way that fails to improve economic performance and might be perceived as a waste of public funds, the package would make the legitimacy problems of the euro area even worse. This would further strengthen anti-euro political forces at the national level and hence increase the risk of euro-exit referenda and a subsequent break-up of the euro area.

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10

ANNAMARIA SIMONAZZI, GIUSEPPE CELI, DARIO GUARASCIO: DEVELOPMENTAL INDUSTRIAL POLICIES FOR CONVERGENCE WITHIN THE EUROPEAN MONETARY UNION

Introduction

The Eurozone faces two great challenges: a structural core-periphery divide, which resulted in the deepest economic crisis since the war, and several significant societal problems. To restore sustainable growth, EU policies must address both: tackle the fragility of the periphery's industrial base, reducing the divergences in industrial capabilities, and create a new agenda for innovation and growth. The following sections argue that this calls for a policy combining support for demand with industrial policies tailored to the specific needs of economies at different levels of development. This requires a multi-level governance model acting at the European, national and regional levels.

The interaction of a 'developmental' industrial policy with macro-economic and distributive policies is crucial. Austerity policies, constraining the spending capacity of governments, force reductions in social investment, while structural reforms, interpreted as favouring more 'flexible' labour markets, undermine long-term growth. Higher employment is an indispensable prerequisite for the long-term sustainability of an inclusive system, while an increase in the skills supply needs to be matched by a greater creation of quality jobs. Positive complementarities between equity and efficiency suggest that investing in people and targeting inequality may better respond to the urgent need to create employment while also favouring innovation and long-term sustainability. Capacitating public services can yield better long-term results than the neoliberal deregulation of labour markets, which works by lowering labour costs and compelling the unemployed to take on poorly paid jobs. This framework calls into question the whole adjustment agenda of the European Central Bank (ECB) and the European Commission (EC), which has been inspired by the idea that the market takes care of convergence and growth.

In our conception, "developmental industrial policies" comprise a comprehensive set of policies aimed at developing a region within a country or, indeed, an entire country. The focus is not on promoting a specific modern sector, or specific new technologies and products at the global frontier, but on a network of enterprises in the region connected by forward and backward – mostly regional – linkages. It is a systemic approach with a strong role for the state as a coordinating agent to help regions/countries catch up with more advanced ones and break up vicious circles of persistent backwardness. These ideas are applied here to Mediterranean countries in the European Monetary Union (EMU), mainly Italy, Spain, Portugal and Greece which share - despite marked differences - common characteristics of structural weaknesses that detach them from the EU North.

Cumulative causation and path dependence: the structural causes of the current crisis

The process of European integration, culminating in the creation of EMU, has led to increasing divergences among the economies of the member countries. Divergence started well before EMU (Figure 1), driven by the way in which integration has been achieved (Celi et al.

2018). In fact, the institutions of the EU and EMU were based on the premise that all its members were on a level playing field, except for 'less modern' ('anti-competition') institutions, individual values and attitudes. The implicit assumption was that market forces, associated with institutions close to those assumed to be prevailing in 'core' countries, would create in the periphery the 'right' environment for a sustained flow of investment and a smooth process of convergence. Thus, over the 35 years of European integration since the early eighties, the Southern peripheral countries were exposed to macroeconomic and industrial policy measures that, though apparently neutral, generated increasing regional disparities, both between EMU core and periphery and within countries themselves.

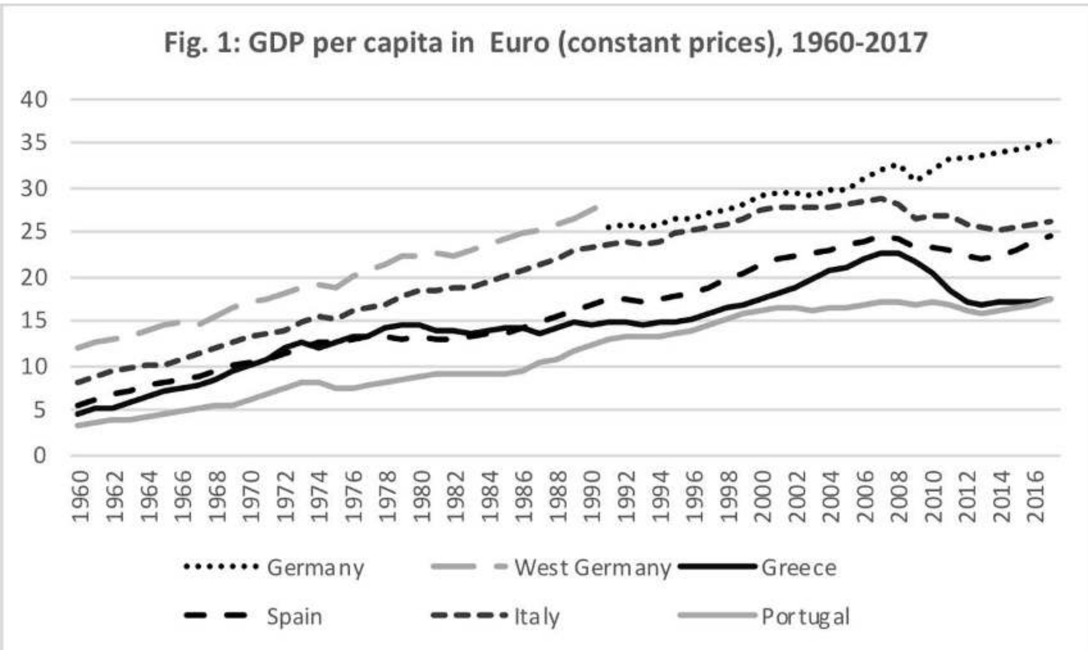

Figure 1: GDP per capita in Euro (constant prices), 1960-2017 (Source: AMECO: GDP per capita in Euro (constant prices), 1960-2017)

Laissez-faire suited the technological leaders: the creation of the single market provided an expanded market, protected from non-EU competition, which eased the restructuring of German industry, while exchange rate agreements (the 'Snake' and the 'EMS'[1]) contained the German Mark's (DM) appreciation, making possible the pursuance of systematic trade surpluses (Körner/Trautwein

2017). Conversely, premature deindustrialisation — restructuring without reindustrialisation — exposed the peripheral countries to stunted growth and persistent fragility with respect to external changes even before the formation of the Monetary Union (Ginzburg/Simonazzi 2016). The opening up of their economies increased exposure to external shocks. Early liberalisation - with industrial policies redefined as policies to guarantee competition - prevented public investment guidance. The slow growth in the euro area did not sustain their capacity to achieve a sufficient level of diversification and specialisation in their productive structures; indeed, it contributed to worsening it: this is the case with Southern Italy and the many less developed areas in the periphery and core alike. Import penetration and loss of domestic market shares by the periphery represented the other side of core countries' export-led growth and surpluses (Table 1).

	Germany		Italy		Spain		Portugal		Greece	
	GDP	CAB	GDP	CAB	GDP	CAB	GDP	CAB	GDP	CAB
1960-67	3.8	0.5	5.6	1.4	7.7	-0.9	6.0	-3.6	8.3	-1.8
1968-73	5.0	1.2	5.1	1.3	6.7	0.4	7.0	-1.4	9.0	-1.5
1974-79	2.6	0.5	3.7	-0.2	2.3	-0.6	3.2	-7.4	3.4	0.9
1980-91	2.5	2.1	2.4	-1.1	2.8	-1.5	3.7	-7.9	0.9	-0.9
1992-98	1.4	-0.9	1.4	1.2	2.2	-1.5	2.7	-6.0	2.1	-2.1
1999-2007	1.6	2.5	1.5	-0.6	3.9	-5.6	1.8	-9.5	4.0	-10.4
2008-14	0.7	6.4	-1.3	-1.3	-0.7	-2.7	-0.9	-6.0	-4.1	-8.8

Table 1: Rate of growth of real GDP and current account balance (CAB) as a percentage of GDP (average values) (Source: AMECO). Note: 1960-1991 West Germany

Many economists (see for instance Myrdal 1957) had warned that opening the market to competition between countries at different levels of development, without adequate countervailing measures, would increase divergence. In the 1970s and 1980s, the European dependency school[2] - joined, later on, by mainstream economists – had issued similar warnings. Why, then, did peripheral countries' leaders choose this suicidal path? In Celi et al. (2018), we argue that two role models - German disinflation and US financialisation - shaped the process of European integration, leading to monetary integration and global finance. Thus, partly as a consequence of their policies, the growth of peripheral countries fell behind and the problems associated with deregulation and integration opened a gap in aggregate demand that was eventually filled by welfare and construction expenditure.

The economic crisis of the eurozone from 2008 until 2014 has increased the divergence between the core and the southern periphery. Two different industrial models now co-exist: a strong industrial base in core countries, export-oriented and with a strong position on global markets, and a less diversified industrial sector in the periphery (Figures 2 and 3). Meanwhile, the increasing integration of the Central and Eastern European economies into the supply chain of German industry speeded up their process of diversification and specialisation. The eastward integration of German industry, combined with the persistent constraints upon internal demand of the major economies of the euro area, has gone hand-in-hand with an impoverishment of the productive matrix of those southern regions that are less well connected to Germany and, more generally, with a general redirection of trade flows (Simonazzi et al. 2013). Crisis after crisis, the process of Europeanisation accentuated the hollowing out or impeded the growth of the productive structure of Southern countries (Gräbner et al. 2018).

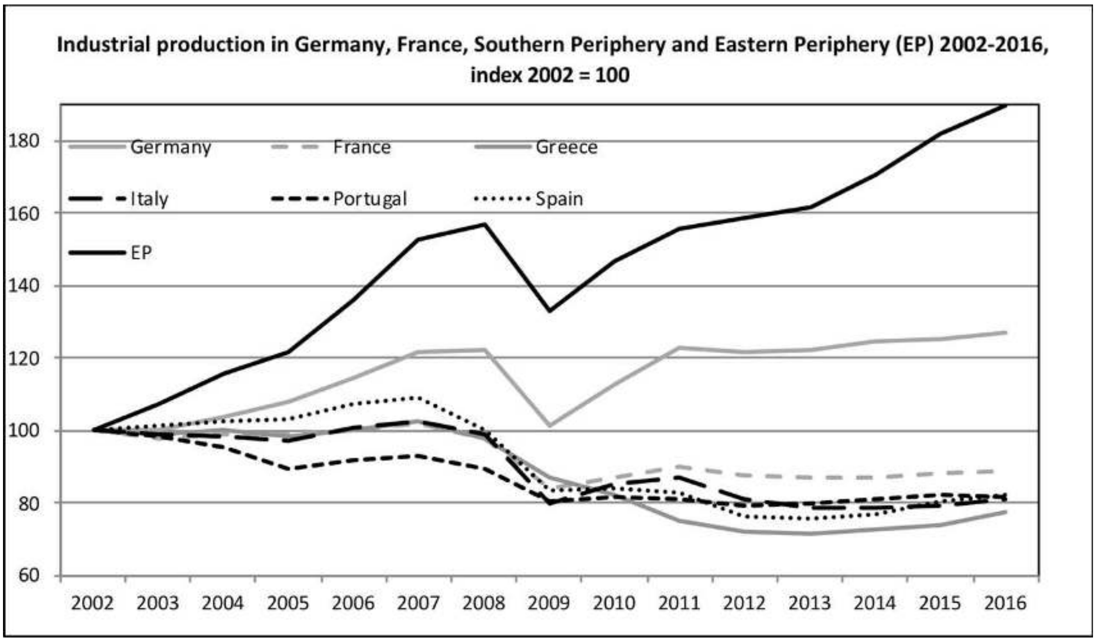

Figure 2: Industrial production in Germany, France, Southern Periphery and Eastern Periphery (EP) 2002-2016, index 2002 = 100 (Source: Celi et al. 2018)

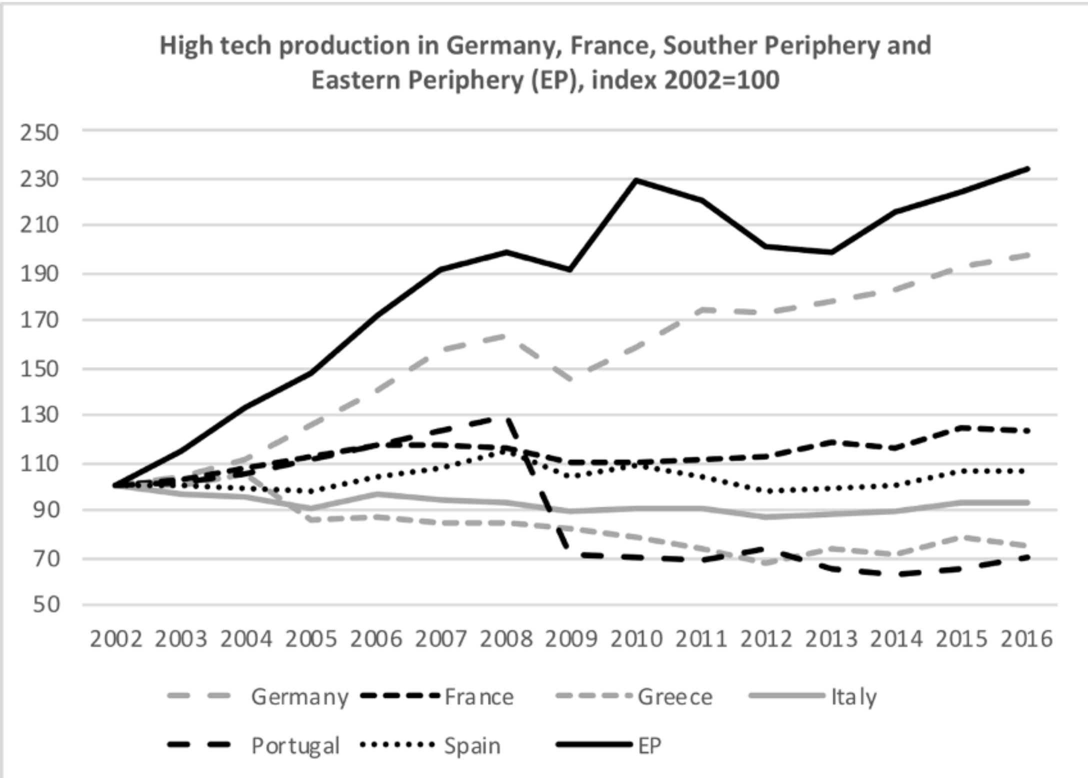

Figure 3: High tech industrial production in Germany, France, Southern Periphery and Eastern Periphery (EP), index 2002=100 (Source: Celi et al. 2018)

The crisis exposed the risks that diverging trends between core and periphery entail for the sustainability of the Union. To reverse this trend, neither domestic devaluations nor generic reflationary policies will do the trick: while internal devaluations have proven to be destructive, the transformations in Germany's trade network have reduced the spill-over effects of any German expansion upon peripheral countries' economies[3]. The latter must be able to ensure their long-term sustainability, via measures geared to reducing the gaps vis à vis the advanced group of eurozone countries. This can be achieved only by a coordinated programme encompassing macro-economic, industrial and regional policies.

The quest for productivity: the role of demand

Europe must compete in a global market with nations that are actively supporting their industries in the innovation race. To meet this challenge, the EC now endorses industrial policy, primarily in favour of innovation as a whole and advanced technologies in particular, and encourages cooperation between EU countries (see Marianne Paasi in this book). To avoid falling behind, the latecomer countries of the periphery must undertake extensive industrial restructuring, addressing the difficult task of moving up to new sectors and more complex products. This process is far from linear. With a more diversified and complex industrial structure, core countries have greater capabilities to move towards new, more complex products/industries. Because of their lower capabilities, peripheral countries can get stuck in "quiescence traps" (Hidalgo et al. 2007), unable to diversify and up-grade their productive structure. Their catching up will prove even more difficult in a depressed, slow growth economy. (The high growth of Greece and Spain prior to 2008 proved unsustainable, based as it was on real estate bubbles or excessive deficits).

The network theory of development stresses the need for a government policy that is called upon to contribute towards developing the capabilities required for producing more complex products. Public investment could play a pro-active role in infrastructure development and act as the catalyst in coordinating the disparate actions of firms and helping them identify new opportunities for differentiation and upgrading. Public officials, firms, financiers and universities can collectively cluster support for networks of firms in targeted sectors, in cooperation with strong and well-integrated industrial development agencies operating regionally and with close knowledge of the warp and weft of the economic structure (Simonazzi et al. 2013).

This view contrasts with the mainstream approach, which focuses on productivity as the main factor holding back long-term economic growth. In this view, the problem of development is primarily grounded in static efficiency: how to better allocate resources by countering the market failures caused by monopolies, asymmetric information, and externalities[4]. Higher productivity can be achieved by freeing resources tied-up in less efficient firms, redirecting them towards more efficient firms/sectors. It follows that, although well-designed structural reforms of product and labour markets may entail costly adjustments in the short run, in the long run a more efficient allocation of resources will result in greater productivity and growth[5].

Leaving aside the problems relating to the concept and measurement of total factor productivity (TFP) (Felipe et al. 2017), two relevant issues need to be discussed. The first concerns the implicit assumption of full employment. Since the existence of sufficient aggregate demand cannot be taken for granted, the exit of less productive firms does not guarantee that the freed-up resources will flow towards new, more efficient uses ('creative destruction'). The increase in productivity will then correspond to a decrease in per capita income and the ensuing reduction in productive capacity (and employment) will constrain long-term growth. Exclusive focus on the efficient allocation of resources disregards the problem of their utilisation, leading to confuse productivity with welfare (proxied by income per capita). If there are idle resources, maximising productivity is not equivalent to maximising welfare.

The second point relates to the underlying theory of the firm. The concept of the firm considered as a self-contained entity is a fiction (Ginzburg 2012). Firms do not produce in a vacuum, nor do they develop production capabilities in isolation (Best 2018). What makes regions innovative is not the existence of individual entrepreneurial firms but clusters of enterprises that collectively act as an industrial experimental laboratory. In this context, even "marginal" firms perform an essential role: they sustain production, employment and income, are part of value chains, produce inputs and innovation, provide training for young workers and contribute towards making the productive fabric thicker and richer as well as providing flexibility to the system in the cycle[6]. It follows that their "measured" productivity may be the outcome of their place in the value chain or in the economy: for instance, the distribution of bargaining power along the value chain can affect the allocation of productivity between the various participating firms. Finally, in an extremely specialised division of labour, there may be good economic reasons for not growing further. Dei Ottati (2018, p. 272) observes that, once they have achieved a sufficient size to perform the functions that enable them to maintain their grip over the market niche in which they operate, medium-sized enterprises generally do not grow any further, as they need to remain flexible so as to adapt to changes in demand and technology. This is not to say that policies should not target firms' efficiency and help them grow, but exclusive focus on the individual tree can lead to underestimating the long-term economic and social costs for the forest. Short-term competitiveness resulting from exit of (less productive) firms can destroy the connective tissue and reduce the productive basis, jeopardising, rather than favouring, long-term growth.

The difference between these two views - the network theory of development on the one hand and the mainstream approach, based on allocative efficiency and the market mechanism, on the other - has important consequences in terms of policies. Competitiveness policies aimed at reducing costs are by definition rivals and, in the end, they convey a deflationary bias to the economic system. All countries are responding to the increasingly difficult environment brought about by globalisation, technological change, and deflationary policies with "competitiveness measures" aimed at reducing costs (subsidising labour, investment, R&D), and attracting foreign direct investment through tax allowances. Fiscal competition between regions and countries qualifies as beggar-thy-neighbour policies; domestic and foreign firms play one country/region off against the other, with negative spill-over effects that represent a dead-weight for society. Moreover, tax incentives are a poor tool to spur innovation, since they have little aggregative impact upon the chain of innovation, which is about the subtle coordination of links cutting across governmental, educational, and industrial spheres. Businesses do not innovate in isolation[7].

Is it possible to devise 'progressive' policies capable of improving the capabilities of one country without damaging other countries? In 1960, Myrdal (1960, p. 122) observed that to defend the achievements obtained thus far by developed countries in terms of building a welfare state would require an effort of greater international integration and he pointed in this regard to the formation of complementary relations in the productive structures of the various countries. Instead of automatisms that push the developed countries to adapt to the external pressures of the market with heavy job losses, he advocated a state-driven structural adjustment, designed to 'make room' for the industrial exports that the developing countries will be prepared to produce. Likewise, a developmental policy for the EU should put more emphasis on reducing the gap between countries and regions, making room for the periphery's products. This requires greater reliance on the domestic market, at the EU and at the national level: export-led (or neo-mercantilist) policies clearly disrupt the long-term sustainability of a union. There are several proposals in this direction: long-term investment plans, not limited to physical infrastructure and prioritising the most deprived regions (Fransen et al. 2018) or a Marshall Plan for European recovery, including the "golden rule" for credit-financed public investment (Saraceno 2017). In the changed international environment, greater weight given to domestic demand at EU level could also suit the surplus countries.

The role of supply: a multilevel European developmental industrial policy

To be effective, innovation, industrial, education and social policies must interact, and must be integrated with policies acting at the various levels of governance (inter-regional, national, European). At EU level, the coexistence of different development and industrial models makes coordination between EU and national policies difficult: the EU must find ways to reduce tensions between European and national competences, prevent the wasteful duplication of big projects and the build-up of excess capacity, curb conflicts between member states, and ensure that latecomers manage to catch up (Dhéret 2014). At national level, attention at linking the inter-related elements of the productive structure distinguishes capability-driven industrial policy from government direct assistance to business. This is what makes developmental policy so difficult and regional development hard to imitate or diffuse more widely. The degree of development affects the kind of policies needed and the capacity to conduct them, as the two polar cases in the periphery reported below show.

European industrial policy

Disregarding the problem of the trifling size of the EU budget, we focus on the issue of non-discrimination, which informs European industrial policy (see the criteria informing the Juncker Plan, Celi et al. 2018, ch. 9). No matter how general it may seem, any policy, or indeed the choice of having no policy, has discriminatory effects that amount to implicit targeting (Chang et al. 2013). Alleged horizontal policies, such as those regarding physical infrastructure, transport and R&D, are location-/sector-specific; tax credits for R&D will have greater effect on research-intensive sectors and will benefit countries with advanced productive structures more than regions with lower densities of research-intensive sectors. Thus, far from being non-discriminatory, horizontal measures may increase divergences when the participants are not on the same level playing field.

The success of the new European industrial policy in reducing the gap between the various regions of the eurozone is likely to fail if the instruments and policies disregard the diverse conditions of the member states. With a weaker productive structure, their policies constrained by the fiscal compact, and their economies on a still uncertain recovery, a common strategy across Europe may have unintended discriminatory effects. Indeed, not only have core countries shown greater promptness in developing their own innovation clusters, but, partly because of their more advanced economic status, and partly as a result of their greater capacity to direct EU priorities, they seem to have been more capable of coordinating EU strategy and policies with their own national and regional policies[8]. They seem also to have been better able to adopt a long-term view when it comes to choosing strategic sectors to invest in (Farla et al. 2016, p. 367). In the periphery, the economic and fiscal crisis, in combination with a still enduring pro-market bias and less ability to coordinate policy/actions, have delayed the adoption of active strategic policies capable of providing firms with a long-term horizon.

This core-periphery polarisation may be heightened by the new radical change popularly known as “Industry 4.0” - designed to renew and reshape manufacturing processes and value chains (VC)[9]. The increase in efficiency and flexibility is likely to spur the productivity and competitiveness of those firms, sectors and countries that are quicker in *absorbing* these technologies and to endow value-chain leaders with new instruments to govern production chains. Since Industry 4.0-related opportunities are maximised when they interact with a closely connected, technologically advanced network, the periphery risks not only lagging behind, but also falling back further in the industrial race: a divide that is aggravated by the fiscal crisis of the Southern periphery. It suffices to compare the size of Germany’s coordinated effort on its "Industrie 4.0" plan with the belated Italian one (Nascia et al. 2018).

The European authorities and national governments have now adopted Industry 4.0 as a common goal (European Parliament 2015). Preventing this policy from becoming an additional factor of polarisation would call for massive investments aiming at strengthening infrastructure facilities, industrial capabilities and technology transfer mechanisms in the weakest areas: investment in digital infrastructures and higher education; European patents allowing generalised (across member states) access to relevant Industry 4.0 technologies; and strategic decisions on where to locate production of Industry 4.0-related goods and services. This is the field where the dimensional adequacy and the strategic vision of EC industrial policy is more obviously lacking[10]. The largest Europe-wide action plan – the Juncker Plan – is far from ensuring a balanced diffusion of Industry 4.0 technologies.

Location-specific industrial policies – the case of Italy

A core region in the periphery. The Emilia Romagna region shares many features of core regions in core countries[11]. It has a high level of innovation and, while severely hurt by the crisis, its GDP per capita is still higher than the Italian and the European average. It has been a model of diffused industrialisation and flexible specialisation, its industrial development intimately linked to the social norms and values of civil society (Brusco 1982). Its relatively good performance in terms of economic and social development is the result of the industrial policies that have been implemented since the 1980s. These policies have tried to anticipate change, supporting innovation and the adoption of new technologies to transform old industrial districts and develop new ones in high tech sectors. The regional government has involved stakeholders - firms and industry associations, trade unions, universities, local agencies - in order to define a shared vision of long-term economic development and devise the appropriate instruments geared to achieving it. Its development institutions sought to strengthen interactions among regional innovative actors and raise the critical mass of research. Finally, social policies have played a crucial role in securing home, health and personal services for families and working mothers as well as education and training to provide the regional labour market with adequate skills. These regionally-based resources are essential complements to the in-house capabilities of firms[12].

The crisis and the wave of technological innovations have put the regional system to the test. The traditional actors of local government have been severely weakened by the nationwide political turmoil; the crisis and its aftermath - austerity, the banking crisis and the credit crunch - have bored into productive systems, already weakened by delocalisation and competition from low-cost countries' in the near and far East. Firms have responded to these challenges by increasing their capacity to produce customised products for niche markets and investing in rapidly expanding countries. However, incremental innovation is no longer sufficient to tackle the wave of new technologies: the next step implies real integration between science and industry in regional networks of innovation to develop proprietary knowledge. Finance is an additional issue. The consolidation of the banking system has transferred banks' decision-making away from any local context, reducing stable and reliable borrower-lender relations and leading to credit rationing for small firms. New forms of financing, necessary to support the evolution of the system - R&D expenditure, investment in foreign markets, firms' expansion and scaling up - are still slow to develop. The fiscal compact reduced governments' capacity to meet the strong demand for public action at various levels – such as reducing the tax burden, the bureaucratic load and the credit crunch, reinforcing public research, innovation and training, providing more infrastructure and coordinating policies in support of networking. The difficulties caused by the crisis fuelled social and political discontent.

South of South

The South of Italy is suffering from the consequences of a two-fold displacement: its growing distance from the North of Italy, and Italy's growing gap with the European core. The latest Svimez reports (Svimez 2018) paint a disheartening picture of the economic situation in the Mezzogiorno: all relevant macroeconomic indicators point to an ever-wider gap with the rest of the country. Studies carried out on the eve of the crisis revealed the great fragility of its productive system and the weak resilience of its firms (Bronzini *et al.* 2013). Compared to the North, substantially fewer southern firms are involved in global value chains. Typically smaller, with limited access to credit and weak bargaining power in sub-contracting relations, they responded to the crisis by squeezing profit margins. The only convergence achieved, in education, may prove counter-productive, since the drain of the more qualified workforce of the southern regions jeopardises development over the longer term.

Structural intervention in favour of Italy's southern regions had been shrunk practically to zero over the last few decades. Political (and cultural) disillusion with direct intervention put an end to the extraordinary intervention by the *Cassa per il Mezzogiorno,* which had marked the only significant phase of relative convergence, between the early 1950s and the first oil shock (1973). It gave way to a more nuanced, ramified approach designed to enhance the economic components of a self-propelling, decentralised development, emulating the successes of the industrial districts of the Centre-North.

The government has recently resumed a policy for the South, implementing special measures: reducing the fiscal wedge; quota of public investment earmarked for the South; special economic zones (ZES). These measures still lack the context of a comprehensive and coordinated project of development. Indeed, this has been one of the problems of the European Structural Funds (ESF). As argued by Best (2013, p. 14), the funds that go to regional governments lacking strategic modernisation plans risk being wasted on fragmented infrastructure projects. ESFs operated as if in silos: aid is directed at companies and human resource programmes that are not joined up within a strategic industrial policy. An unintended consequence is that ESFs finance infrastructures that reinforce socially irrational product systems that deepen structural problems.

To restart growth requires resuming a "systemic approach" to development, where the state takes up again its role of coordinator, defining the priorities and the objectives as well as the strategies, the time-frames and the resources, as other countries are doing. There are different possible drivers for growth, for which the South is well-positioned (for instance those indicated in the Horizon 2020 agenda): the re-qualification of urban areas (green and smart cities), the development of the infrastructure to allow for a deeper integration with the countries of the Mediterranean, the exploitation of the South's natural and cultural heritage and of the natural endowments for green energy; the digital agenda. Business is lacking a sense of where the future opportunities lie. The state could act to reveal areas of desirable intervention, facilitating structural change and collaboration with the private sector, and coordination between national and European policies. State-owned enterprises could play a supportive role, redirecting their investment away from short-term profits (that might lead them to invest in more developed regions) towards long-term developmental perspectives.

However, firms' performance crucially depends on both the structured interrelationships (the linkages) that they can establish upstream and downstream, and the support received from material and immaterial infrastructures, development agencies and financial institutions that sustain the process of innovation over the long term. All these institutions and infrastructures are missing in the case of the South. Public-private cooperation at the various levels of governance should contemplate a combination of protection, administrative guidance, and encouragement of controlled competition, to activate the linkages and fill the holes in the productive structure. Introducing a 'protective' element – that is 'helping losers' by temporarily shielding them from the full forces of the market - may be needed to encourage and sustain the process of structural change and productivity growth, preserve existing capabilities while giving time to develop new ones, developing new products also within 'mature' sectors, and should not be confused with traditional industrial policy that often tried to preserve existing structures (Chang et al. 2013). East Asia's experience shows that import substitution (to recapture shares of the domestic market) and export promotion are complementary policies.

In the past, particular emphasis has been placed on the need to tackle the ills allegedly typical of southern and Mediterranean societies: lack of civic duty, scant endowment of social capital, corruption, organised crime. Although these concerns should be taken seriously, they should not justify inaction: they are as much a cause as a consequence of backwardness. Measures ensuring competition can reduce the risk of rent-seeking behaviours; monitoring can assess results; and targeted policies can enhance the 'human' and 'social' capital of the South. Without measures to restore the regional and industrial balance, the processes of globalisation and Europeanisation will contribute to widening the structural gap between the *Mezzogiorno* and the Centre-North.

Conclusion

EMU's survival demands a more balanced European economic integration. At the macro level, this requires a common undertaking to stop driving emerging and member countries' economies towards adopting low wages and overturn the philosophy of austerity in favour of a policy targeting domestic demand-led growth in all member states. Peripheral countries need a "developmental state" so as to broaden their productive capacity and increase their capabilities. This calls for a multi-level, diversified and coordinated industrial policy. Governments should focus on creating the institutional infrastructures needed to support the production system, business organisation, and skill formation, and their interconnections, rather than subsidise individual enterprises. In an environment dominated by innovation, policies favouring the creation of competences, rather than labour flexibility, are more likely to sustain up-grading.

Persisting with the free market approach, or even pursuing an industrial policy that does not take into account the diversity in the level of development of its members, is likely to reinforce the divergences between EU member states, putting tremendous pressure on the common currency. Even so, adopting the political economy dimension of government action (Peneder 2017) means that difficulties should not be wished away: not only rent-seeking, regulatory capture or corruption, but also the predominance of national forces and interests that lead to the promotion of a culture of competition among EU member states, regions and industries. Nonetheless, the conditions that led to the institutions of EMU and ensured the alleged success of the German export-led model are no longer present. International constraints and self-interest might suggest a reorientation towards domestic markets. Expanding markets require prosperous countries. Rebalancing is in the core's interest and may open the way to a developmental industrial policy. There are, by now, a number of proposals for a radical change in policy that stress the benefits that would accrue to society from the opportunity to finance much-needed public investments at low interest rates and that, by promoting the establishment of a sustainable development path, could also create the prerequisites for the solution of the peripheral countries' debts.

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11

MARIANNE PAASI: CHALLENGES OF EU INNOVATION POLICY – RESEARCH & DEVELOPMENT IN A CHANGING POST-CRISIS WORLD

1. Introduction

The challenges for EU innovation policy are well-known: investment in Research and Development (R&D) is too low in comparison to Europe's main competitors, it is poor at turning its ideas into competitive and innovative goods and services and the innovation performance of the member states (MS) differs persistently (Innovation Divide(s): North-South-East). On top of that, the 2008 financial and economic crisis – the Great Recession - severely damaged the European economy and its investment activities, including in R&D.

The question concerning the EU's innovation and growth prospects is whether the MS' R&D reactions after the Great Recession have reinforced existing challenges and how they relate to post-crisis productivity dynamism. The lowering of already stagnant productivity growth rates together with further diverging productivity growth across the MS can impair the EU's proper functioning.

EU innovation challenges are here analysed by focusing on the dynamics of R&D investment which is of course not the sole but a core element in innovation processes and long-term growth. The specific combination of EU innovation challenges, i.e. standing in the global competitive innovation environment, together with persistent differences in cross-border R&D efforts is explicitly addressed. Therefore, the post-crisis R&D investment of the EU as a whole and that of the EU (innovation) frontier (Denmark, Sweden, Finland and Germany) is analysed vis-à-vis the USA - conceptualised as the global knowledge frontier. The EU innovation and R&D divide is represented by comparing moderate innovators under fiscal pressure (Spain, Greece, Portugal and Italy) on the one hand, and the moderate innovators as represented by the 2004 enlargement countries (EU-10) vis-à-vis the EU frontier.

The main EU-level innovation policy instrument – the Research and Innovation Framework Program (Horizon 2020, Horizon Europe) – together with elements of cohesion policy cannot compensate for declining R&D investment in the MS. Nor did the stabilisation measures vital for EMU and subsequent Juncker Commission 2014-2020 reforms since the crisis 2008 target R&D investment directly but they have had their influence on the European innovation environment.

In conclusion, the paper stresses that much more can be done to strengthen innovation and research efforts both at the EU and MS levels. While the EU itself can allocate more budget spending to knowledge investment and complete the single market and digital agenda, the MS need to foster higher R&D investment together with adaptations in their innovation systems in face of the opportunities of the global and digital innovation environment.

Chapter two starts the paper by describing the EU level innovation policy challenge, i.e. low R&D investment vis-à-vis its global competitors together with the large differences in member states' R&D efforts. The third chapter analyses whether the gaps in R&D investment and government R&D funding have widened since the 2008 crisis up to today. Fourth, the gaps in R&D investment after 2008 are shown to go along with Europe's weak productivity dynamics vis-à-vis the USA and productivity differences across the MS. The fifth chapter discusses the Research and Innovation Framework Program as the main EU innovation policy instrument that is complemented by cohesion policy. EMU macro-stabilisation efforts and the subsequent Juncker Commission (2014-2020) reform policy are analysed with respect to their effect on innovation. The sixth chapter stresses the emerging global digital innovation environment and its link to the new EU innovation policy as well as to reforms in the national innovation systems. Chapter seven concludes.

2. R&D intensity in the global and EU context

The EU is permanently investing less in research and innovation than its main competitors, primarily the USA, while having problems in turning ideas into innovative products and services. This set of problems can best be illustrated by the evolution of R&D intensity (see Figure 1 [1]) which measures the relative importance of knowledge production in an economy and its reliance on knowledge assets as a source of growth and competitiveness.

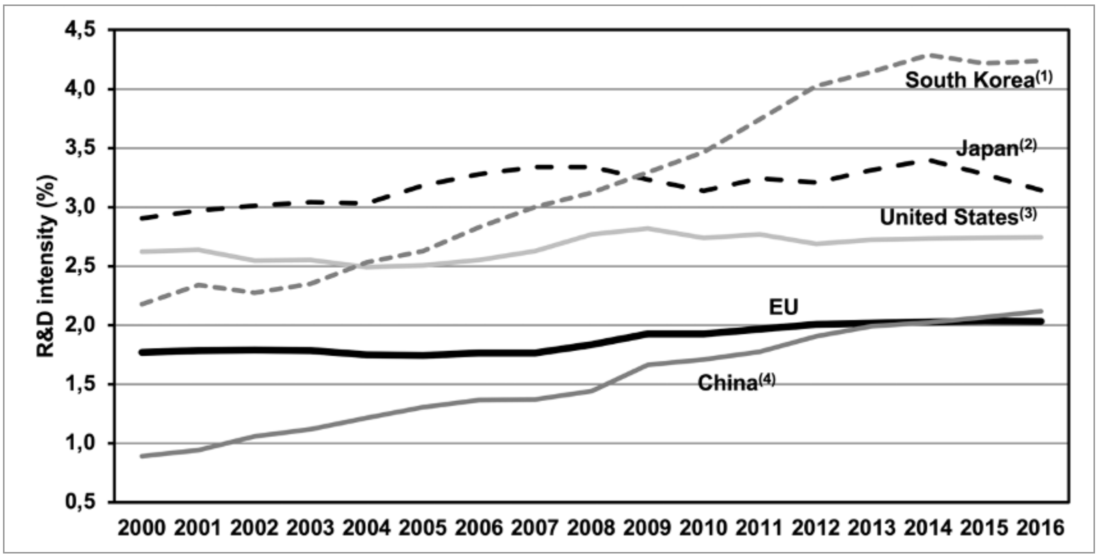

Figure 1: R&D intensity (Total R&D expenditure as % of GDP): EU and global competitors 2000-2016. (Source: European Commission DG RTD 2017b, Figure I.3-A.3, p.80. Data: Eurostat, OECD)

In 2016, EU R&D intensity remained at around 2 percent, i.e. the political objective of increasing European R&D investment to 3 percent of GDP (Europe 2020 headline target indicator) still had not been achieved while new competitors like China and South Korea were catching up and/or moving out of reach in R&D intensity. China's R&D intensity indeed overtook the EU-28's in 2014. Therefore, since 2000 the EU-28 has invested every year a relatively lower share of GDP in knowledge production than the USA and today even less than the new global competitor China.

In particular, the EU-28 business sector annually prioritises much less investment in R&D than all its other main competitors. In 2016, the EU-28 invested 1.32 percent of GDP in business sector R&D, the USA 1.99 percent and China, that has overtaken the EU-28 since 2009 (Eurostat database), 1.59 percent.

The EU's aggregated R&D intensity masks the fact that there is a huge heterogeneity in R&D intensities across the MS. Figure 2 shows that MS efforts in investing in research and knowledge assets relative to GDP differ strongly, with some investing more in research in relation to GDP than the USA while others rank very low.

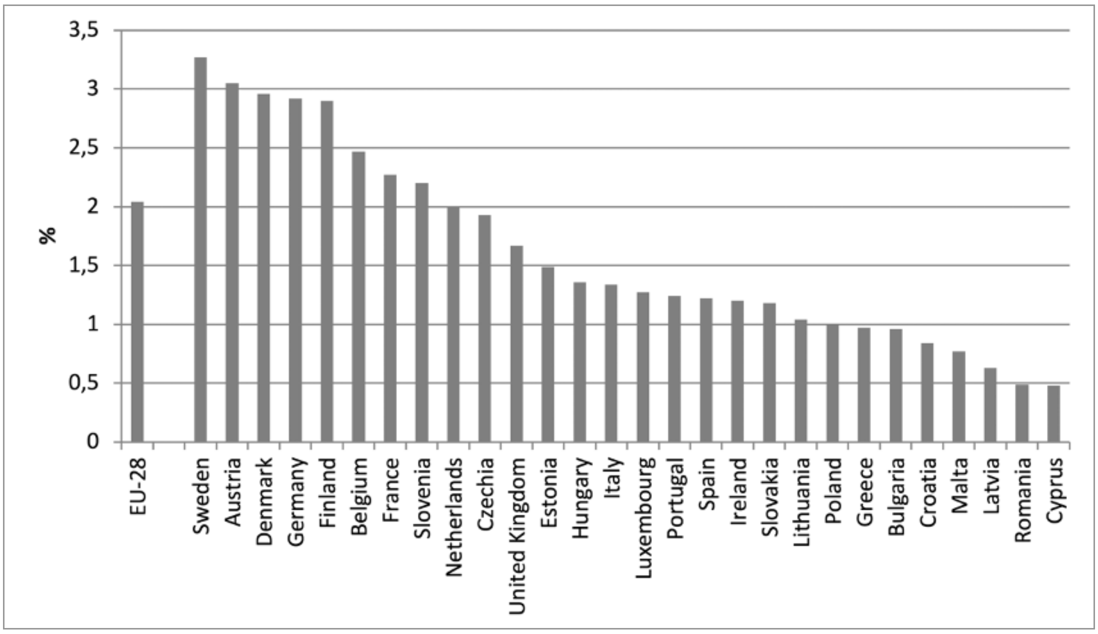

Figure 2: R&D intensity (Total R&D expenditure as % of GDP) across the EU Member states 2015 (Source: Eurostat. Denmark and France: provisional values)

The persistent differences in MS' R&D intensities (innovation divide across Nord-South-East) are an economic and political concern for EU innovation policy.

3. Dynamics of EU R&D challenges

The EU's innovation challenges, i.e. whether it is falling back in global innovation (R&D) competition along with the simultaneous widening of the intra-EU innovation divide post-2008, is analysed here by the dynamics of R&D gaps within the EU and towards the global frontier. First, the USA is conceptualised as the global knowledge frontier which, in an innovation perspective, is a moving target[2]. The EU R&D position towards the global knowledge frontier is assessed in comparing the USA and the EU knowledge frontier identified by "European leaders" (Sweden, Denmark, Germany and Finland) as classified in the 2018 European Innovation Scoreboard (EIS)[3]. Such a comparison reflects the idea that countries closer to the technology frontier need to invest relatively more in R&D in order to stay competitive than countries behind the frontier (e.g. Aghion et al. 2015).

Second, the innovation divide within the EU is measured by the difference in R&D investment between the EU frontier and the "moderate innovators"[4]. All "moderate innovators" have a low R&D intensity (see Figure 2) together with weaknesses in other innovation-relevant dimensions as classified in the EIS 2018.

However, the analysis distinguishes further between the "moderate innovators under fiscal pressure" (Greece, Spain, Portugal and Italy) which should give some insights into whether such pressure induces additional R&D cuts. The rest of the "moderate innovators" comprises the eastern EU countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia) and Malta and Cyprus (the EU-10 in what follows)[5]. It is normal that R&D investment in countries behind the technology frontier lies behind that of the frontier[6] while absorptive capacities, including R&D

investment but also other factors such as education and competition, play a role in relative innovation performances. However, R&D investment should normally increase when approaching the technology frontier (Aghion et al. 2015).

In assessing the EU external and internal R&D divides, the total R&D investment (GERD, per head in euro) is used as an indicator accounting for the strong GDP variations after 2008. In particular, the R&D intensities of the moderate innovators might even increase due to declining GDP after 2008. Figure 3 shows the differences and dynamics across the country groups: first, there are strong differences in R&D efforts (measured by euro per head) – China starting at a very low level of R&D per head is catching up and is close to EU-10 values. The EU-28 shows higher levels of R&D per head but rather low increases while the EU Frontier, with a high level of R&D per head, invested more in knowledge than the USA from 2003 until 2015 – but has since been overtaken by the US.

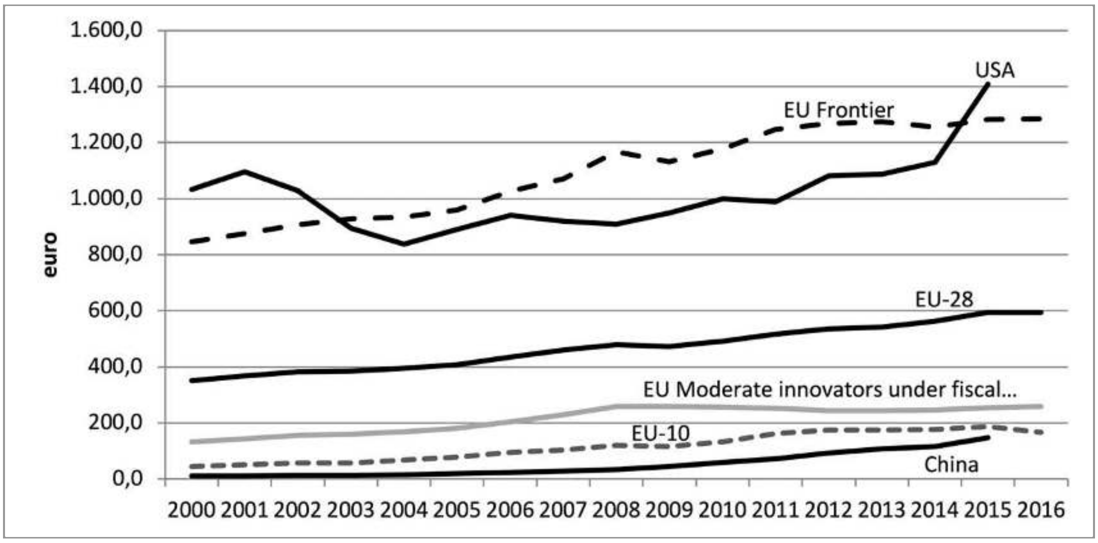

Figure 3: Total R&D expenditure (GERD) per head in euro by country groups 2000-2016 (Source: Eurostat)

Figure 3 also shows that the moderate innovators under fiscal pressure (Greece, Spain, Portugal and Italy) invest persistently less in R&D (euro per head) than the EU frontier which signals the persistence of the divide within EU innovation and lack of any catch-up. EU-10 R&D displays a slight upwards trend.

Widening of EU R&D gaps since 2008

The 2008 crisis and its aftermath were connected with sharp GDP reductions or very low growth rates, a banking crisis linked to a debt crisis and fundamental uncertainty about the future of Europe's economy – investment fell and unemployment increased. All are factors which most likely had a negative impact on the R&D decisions of governments and the business sector. The European economy started recovering only recently.

The specificities of the 2008 crisis and of the European economy influenced the mechanisms determining how the different types of R&D investment were affected, and, therefore, the twin EU R&D gaps. First, European business sector R&D investment went down as reaction to declining GDP (demand) and to related (macro) uncertainty but also due to the banking crisis which constrained access to finance (Hall et al. 2009). This factor was especially negative for small and medium enterprises (SME). Risk capital is generally inadequate in Europe.

Second, governments were faced with decreasing (tax) income and increasing expenditure (for example on unemployment benefits) which may affect negatively both public sector R&D and the higher education sector's R&D activities and funding. In particular, the Stability and Growth Pact's (SGP) fiscal requirements may have, it has been claimed, induced such cuts (Veugelers 2016, 2014a). Governments might reduce their R&D investment in crises (pro-cyclical behaviour) or increase public sector R&D in order to compensate for declining business sector R&D investment in recessions, i.e. act counter-cyclically (Licht et al. 2018, see below 3).

The actual effects of the crisis on R&D investment are an empirical question which can be addressed with a very simple method[7]. First, the R&D gaps (R&D in euro per head) are calculated for the years 2008 and 2016 between the EU frontier and the USA as dynamic technology leader and R&D investor. Further, the R&D gaps (in euro per head) in 2008 and 2016 between the EU frontier and the moderate innovators under fiscal pressure provide information about the innovation divide after the outbreak of the crisis. The EU-10 are expected to catch up (fast) as they start at low levels of R&D investment.

Table 1 shows the closing or widening of the gaps in total R&D investment (euro per head, see also Figure 3) which can be identified by increasing or decreasing values for 2016 in comparison to 2008. It is obvious that the EU-28 and EU frontier R&D gaps towards the USA are substantially increasing while the intra-EU gaps also widen.

Total R&D (GERD)	**2008**	**2016**
EU-28 – USA (2015)	-429.6	-815.4
EU Frontier – USA	+ 258.3	-127.0
Moderate innovators under fiscal pressure – EU Frontier	-908.7	-1026.5
EU-10 – EU Frontier	-1048.1	-1118.3
Of which:		
Government sector R&D (GOVERD)	**2008**	**2016**
EU-28 – USA (2015)	-41.4	-88.1
EU Frontier – USA	-25.9	-75.3
Moderate innovators under fiscal pressure – EU Frontier	-35.5	-43.2
EU-10 – EU Frontier	-51.7	-53.3
Business sector R&D (BERD)	**2008**	**2016**
EU-28 – USA (2015)	-345.8	-625.9
EU Frontier – USA	+193.8	-145.9
Moderate innovators under fiscal pressure – EU Frontier	-713.3	-731.4
EU-10 – EU Frontier	-784.5	-767.5
Higher education sector R&D (HERD)	**2008**	**2016**
EU-28 – USA (2015)	-10.5	-49.3
EU Frontier – USA	+123.7	+147.4
Moderate innovators under fiscal pressure – EU Frontier	-164.6	-251.8
EU-10 – EU Frontier	-210.2	-291.9

Table 1: Gaps in R&D (euro per head) by country group and type of R&D in 2008 and 2016 (Data: Eurostat. Note: USA data for 2015)

An analysis of the differences in government, higher education and business sector R&D provides us with additional information about the sources of the overall R&D gap. First, the government sector R&D gap between the EU frontier and the USA is clearly increasing, while the intra-EU R&D gaps increased only slightly. Second, the R&D gaps in the higher education sector show an increase within the EU in 2016 while the EU frontier has an increasingly positive gap towards the USA. It is above all in business sector R&D investment where large and growing gaps can be observed. In particular, the business sector R&D gap of the EU frontier plunges from a positive value in 2008 relative to the USA to a negative one in 2016. While the R&D gap of the moderate innovators under fiscal pressure relative to the EU frontier countries is already large in 2008 it increases only slightly – probably in view of the sluggish R&D efforts in the EU frontier. In contrast, the EU-10 has been reducing the business sector R&D gap vis-a-vis the (sluggish) R&D at the EU frontier since 2008.

Fiscal pressure vs. public research funding

The crisis hit all European economies negatively but, in particular, countries with high debt and with low R&D faced a challenge to sustain their public research funding. It has been argued that the fiscal requirements of the Stability and Growth Pact (SGP) might – if too tight – constrain growth-enhancing R&D investment (Veugelers 2016, 2014a).

The funding of basic research is a core policy instrument which is directly controlled by governments. Its development can be observed via government budget appropriation or outlays for research (GBAORD). The existence of fiscal pressure would be indicated if, first, the moderate innovators under fiscal pressure make relatively higher cuts in public sector R&D funding compared with the EU frontier and, second, the governments of the EU frontier reduce their R&D funding more than the USA.

Governments in all EU country groups cut R&D funding after the crisis (see Table 2). Indeed, the strongest reductions in public sector R&D funding per head since 2008 have taken place in the group of moderate innovators under fiscal pressure. But the EU frontier has also increased its R&D funding gap relative to the USA and the cuts are considerable also in the EU-10.

Country group	2008	2016
EU-28 - USA	-142.7	-229.5
EU Frontier - USA	-9.8	-44.0
EU Moderate innovators under fiscal pressure – EU Frontier	-163.7	-240.6
EU-10 – EU Frontier	-257.4	-312.4

Table 2: Gaps in government R&D funding (euro per head) by country group in 2008 and 2016 (Data: Eurostat. Note: USA data for 2015)

However, individual governments have reacted very differently since the crisis. Spain, Portugal and Italy acted pro-cyclically by reducing funding (already at low levels) post-2008 while Greece was able to increase its funds for public research. Finland cut its public sector R&D funding while this increased considerably after 2008 in Germany and Sweden.

Country	Change 2004-2008	Change in %	Change 2009-2016	Change in %
Finland	48.1	0.16	-27.4	-0.07
Sweden	8.5	0.03	81.1	0.28
Denmark	110.4	0.41	35.9	0.08
Germany	34.2	0.17	69.5	0.26
Italy	4.0	0.02	-21.7	-0.13
Spain	78.4	0.74	-57.7	-0.30
Greece	42.2	0.83	11.1	0.14
Portugal	61.5	0.70	-3.6	-0.02

Table 3: Government R&D funding by individual countries (euro per head) (Data: Eurostat)

Public sector R&D funding in countries under fiscal pressure reacted mostly negatively but also within this group country reactions differ[8]. Obviously, other factors influence the governments' decisions on public sector R&D funding such as their starting conditions and their overall knowledge strategy.

Reductions in government R&D funding may even be rational in certain situations. However, it is rather the absence of a national strategy that emerges when the moderate innovators country group as a whole behaved pro-cyclically (with respect to both public sector R&D funding and public sector R&D activities) over cycles in the period 1995-2015 (Licht et al. 2018, p. 12). Pro-cyclical behaviour in public sector R&D strengthens cycles and destabilises the public sector research system and can induce a researchers' brain drain (for example in Italy, EC 2018a, p. 43).

4. Productivity dynamics after 2008 – total factor productivity

Theoretically, the observed widening of both EU R&D gaps after 2008, in particular in business sector R&D but also in public sector R&D funding, can be expected to have negative consequences on productivity dynamics and competitiveness within the EU[9].

The contribution of business and public sector R&D spill-overs to innovation and productivity growth has been well-documented in the theoretical and empirical literature (for example, Griliches 1990; Romer 1990; Guellec and Pottelsberghe 2003). Recent empirical productivity research (on sources of growth) shows that total factor productivity (TFP) can be identified as the main source of weakness in European growth and competitiveness (van Ark and Jäger 2017, p. 15). In addition, ICT capital and its use (network effects) are seen as key reasons behind the TFP slow-down in Europe (van Ark and O'Mahony 2016, p. 113)[10].

The dynamics of total factor productivity (2008=100) between the USA, the EU-28 and the EU Frontier are illustrated in Figure 4. It is apparent that, post-crisis, the EU-28 and the EU Frontier are recovering at a weaker pace and later than the USA, i.e. a negative TFP growth gap widens since 2008.

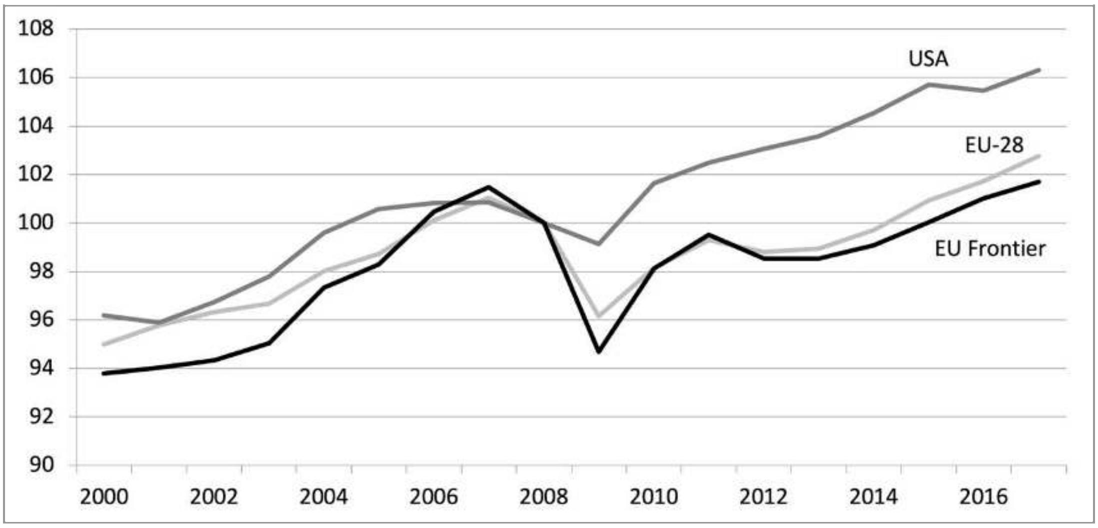

Figure 4: Total factor productivity (2008 = 100) in the EU-28, EU Frontier and USA

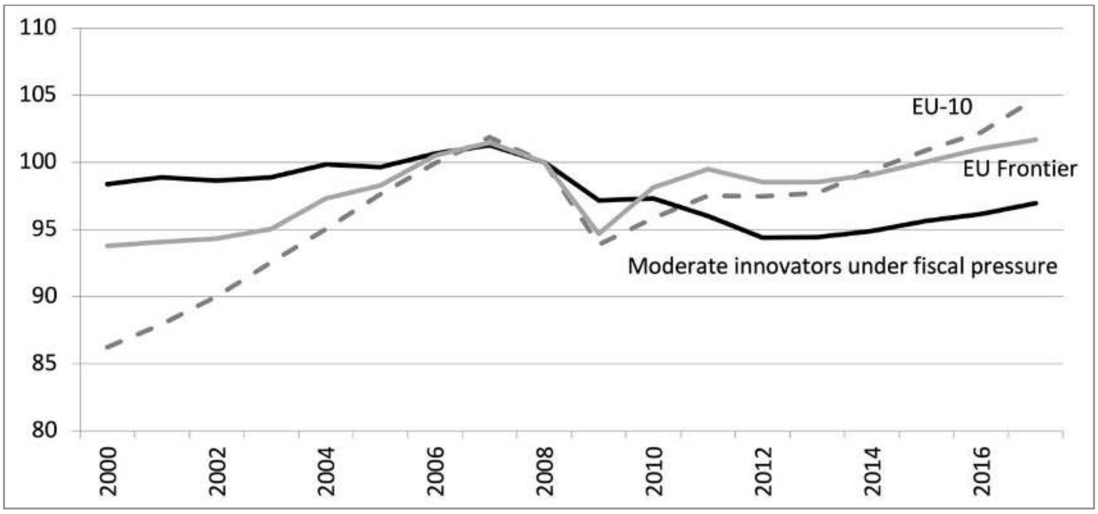

Figure 5: Total factor productivity (2008 = 100): EU Frontier, EU Moderate innovators under fiscal pressure and EU-10 (Source: for Figure 4 and 5: AMECO)

Figure 5 shows the dynamics of TFP across the EU Frontier, the moderate innovators under fiscal pressure and the EU-10. The cross-group productivity dynamisms are positive until the outbreak of the crisis but then decline strongly across the board. However, post-crisis the productivity of the moderate innovators under fiscal pressure falls more slowly but recovers less dynamically than the EU Frontier and the EU-10.

Figure 6 shows that the dynamics of TFP across the MS within the EU Frontier and within the moderate innovators under fiscal pressure differ in the pre-crisis and post-crisis periods.

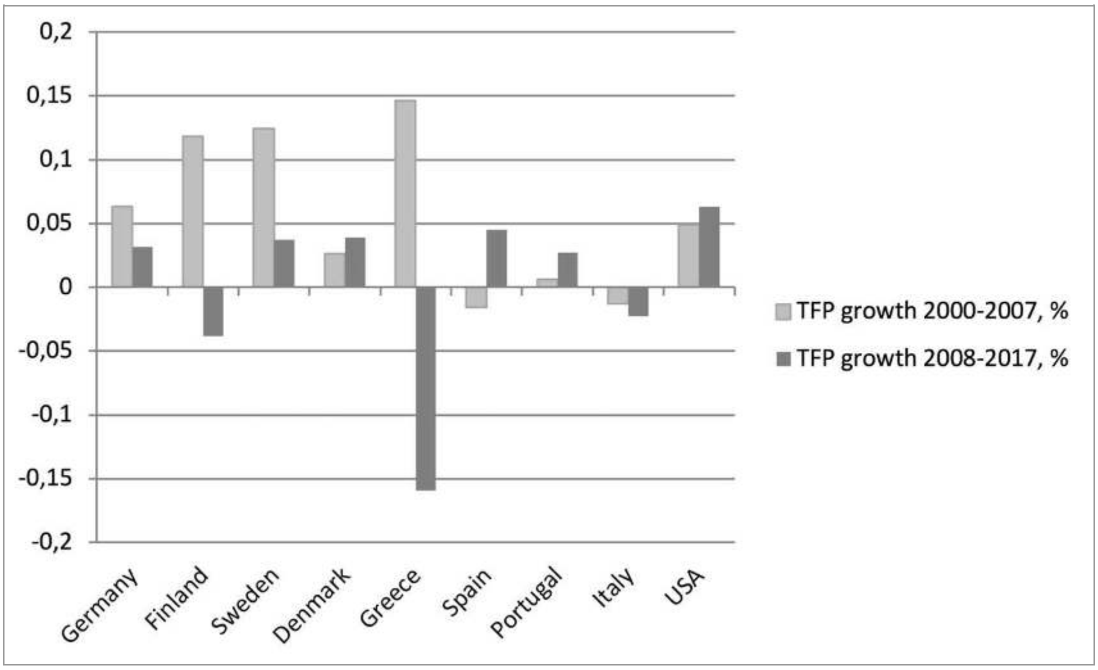

Figure 6: TFP dynamics in the countries within the EU Frontier and moderate innovators under fiscal pressure and the USA, (2008=100) in 2000-2007 and in 2008-2017 (Source: AMECO)

These figures cannot address the many determinants of TFP (see Oulton 2016 for a comprehensive review), including measurement issues. Recent research shows the differences in the intangible assets across EU MS and the USA which are required to turn knowledge (R&D) into innovations: such as skills, training and economic competence (Corrado et al. 2018)[11]. Sectoral specialisation and structural changes between manufacturing and the service sector also matter for productivity dynamism. Firm level research (using the EU R&D Scoreboard data from 2002-2014) indicates that productivity gains from R&D halved in companies located in Spain, Greece, Italy and Portugal. According to this study, this can be explained by an industrial structure based mainly on medium- and low-tech sectors in these countries (Hervas and Amoroso 2016, p. 235). Recently, research has turned its attention to the growing productivity gap between the firms at the frontier and the firms behind the frontier (European Commission, DG RTD 2018).

5. EU policies

These sluggish and diverging productivity developments reflect MS' low or even declining R&D investments (together with other intangibles). In the EU, it is the MS which possess all types of innovation policy instruments[12]. In contrast, EU level innovation policy has only limited funding opportunities for supporting R&D investment while the fragmentation and inefficiencies in many innovation-relevant markets such as the Single Market or Digital Market do not lie within the competence of EU innovation policy.

EU innovation policy is based on Treaty provisions and financed from the EU Budget. Its main instrument[13] is the Multi-annual Research Framework Program which funds mainly cross-border, cross-sectoral research collaboration[14]. The research and innovation funding program is competitive; it aims to improve scientific and technological excellence and critical mass overall in Europe. The specific need to support scientific excellence in MS with poor research and innovation performances is well recognised by the program "Spreading Excellence and Widening Participation"[15].

Cohesion policy[16] and structural funds (European Regional Development Fund (ERDF), European Social Fund (ESF) and Cohesion Fund) have, moreover, increasingly paid attention to research and innovation capacities in Europe's less-developed regions[17]. The cohesion policy funds (2014 – 2020) newly prioritise also research and innovation and ICT activities. New research and innovation-related instruments have equally been developed such as regional smart specialisation strategies which aim at supporting R&D and innovation-based activities in less-developed regions (see dedicated webpage in the footnote)[18].

Juncker Strategy and EMU reforms

Already the Juncker political guidelines include many aspects relevant to innovation such as Digital Agenda and Single Market (Juncker 2014). In particular, the political priorities "Investment, Reforms and Fiscal Responsibility" (EC COM 2015) were translated into measures and programs which can benefit the European business sector's R&D and innovation environment, including the Banking Union and the Capital Market Union.

The crisis induced immediate stabilization measures such as financial support for a number of countries[19] which struggled with debt and/or financial crises and macroeconomic imbalances (Breuss 2015, p. 9). Subsequently, the Juncker Commission 2014-2020 introduced important reforms in EMU architecture and economic policy governance. Important fiscal policy reforms were introduced (six pack, two pack, fiscal compact, European Stability Mechanism) in order to reduce macro-uncertainty and fiscal instability while a certain flexibility in the SGP fiscal rules was also initiated (European Commission 2015a).

Further, the investment pillar "European Fund for Strategic Investment" (EFSI) targets the European investment gap (relative to the pre-crisis period) (European Commission 2015b). Increasing investment and demand in Europe support R&D and innovation in general but EFSI projects can also include R&D and innovation activities. However, the EFSI program has, first, a restricted volume (with leverage of around €315 billion) and, second, there is the issue of additionality and of the selection of the right projects (Veugelers 2014b).

Structural reforms in the MS are an important cornerstone of the EMU reforms which aim to support the resilience of domestic economies, competitiveness and growth. These reforms focus on the areas of public finance and taxation, financial sector, labour markets, education and social policies, investment and competitiveness and sectoral policies[20]. In particular, the investment and competitiveness area is host to discussions on issues that concern country-specific weaknesses in innovation, R&D investment and entrepreneurship but new EU measures are absent despite the widening R&D gaps. However, recently, the productivity and competitiveness dimensions have been acknowledged in EU (macro) growth strategy with the (recommended) introduction of "National Productivity Boards" (see Juncker et al. 2015).

What's more, the Annual Growth Surveys (AGS) which kick-start the European semester, i.e. the yearly economic policy cycle, include productivity, research and other intangibles as part of structural reforms in the country reports. The AGS and individual country reports have urged MS not to cut growth-supporting investment, in particular public sector R&D (for example AGS 2015, p.13). The national 3 percent targets for R&D intensity are more closely monitored through the Research and Innovation Observatory (by Joint Research Centre). The new Policy Support Facility (PSF) organised by DG Research and Innovation provides expertise for national research and innovation policy reforms when requested by a country.

6. EU innovation challenges in the global innovation environment

While Europe's R&D investment is still too low and the innovation gaps are not closing, the global economy is changing fast. New global opportunities and challenges arise as a result of the emergence of China and South Korea as knowledge economies, competitors and partners as well as of digitalisation (see Figure 1). It is important to stress that, while there are more opportunities to use and combine various sources of knowledge (creating competitive assets), competition has become tougher, including at the EU frontier.

The new EU innovation policy, "Open Science, Open innovation and Open to the World," recognises the opportunities arising from emergent global knowledge sources, collaborative tackling of global challenges and cooperative R&D networks and platforms (EC 2015). New types of innovation and innovators (business model innovations, market creating innovations, social innovations and innovations based on the creative potential of the young) have the potential to create new economic activities and empower marginalised groups and regions within Europe. The proposed new Research and Innovation Framework program, "Horizon Europe" (2020-2027), includes a new European Innovation Council (EIC) to support innovative start-ups, including social innovators, and their scaling-up (EC, COM (2018) 435 final). Furthermore, the Widening Programme (now called "Sharing excellence") to reduce disparities in research and innovation performances and support for reforming national innovation systems are strengthened in the Commission 2018 proposal (pp. 74-77).

But it is far from clear that the MS are in a good position to benefit from external sources of knowledge, able to participate in strategic R&D cooperation or to turn global value chains into opportunities for domestic economic activities. Along with public and business sector R&D investment, investment in the well-known absorptive capacities (Cohen and Levinthal 1989) is necessary. However, in the context of digitalisation, this should stress, alongside the importance of quality education for everybody with strong digital skills and the creative capacity to combine technologies and knowledge (intangibles), the key role of strong public sector R&D activities.

In the new global environment, institutions and structures in national innovation systems which worked well earlier and the initial competitive assets of industries can become obsolete – in all European countries[21]. Therefore, increasing R&D without paying attention to other intangibles and without structural reforms in the economy, including innovation systems, will not increase productivity. In addition, in a dynamic innovation perspective, the rate of return on R&D investment stays low if a dynamic reallocation of resources towards new entrepreneurial activities (entry) from less profitable, non-dynamic activities (exit) is blocked (Encaoua 2009). Indeed, low quality institutions, reallocation barriers, misallocation of skills in the MS have been identified as specific European problems which prevent productivity dynamism (Andrews 2015).

7. Conclusions

The EU's innovation policy challenges – the R&D investment gap vis-a-vis the global innovation frontier and the intra-EU innovation divide – have increased since 2008. There are also signs that fiscal pressures have had a negative effect on public sector R&D funding, most obvious in the group of moderate innovators under fiscal pressure. Yet, individual country reactions to fiscal pressures differ within the country groups we have identified. Obviously, country-specific knowledge strategy is the key in funding decisions.

The weak dynamics in R&D investment is an important reason for problems in competitiveness, the low rate of productivity growth but also persistent differences in productivity dynamism across countries. As R&D investment is one of the major sources of growth, even a temporary decline in knowledge investment harms long-run growth.

While the crisis induced important fiscal and structural reforms within EMU, EU innovation policy has not been strengthened, except for an increase in the proposed budget for the next Research and Innovation funding programme and the Policy Support Facility of DG Research and Innovation. The R&D investment and reforms are nevertheless included in the EU yearly policy cycle, i.e. in the European Semester while the recommendation of setting up National Productivity Boards may provide new opportunities to integrate a more strategic R&D and innovation strategy within overall EMU policy.

Indeed, a greater policy focus on R&D and innovation is urgent in view of the fact that new global knowledge producers and competitors are emerging and digitalisation influences the way in which innovation occurs. EU innovation policies – Horizon Europe (together with cohesion policy R&D support) – address these challenges and provide support for turning the increasing variety of knowledge sources into innovation opportunities and new economic activities all over Europe. But more needs to be done in terms of allocating greater resources towards knowledge investment (R&D, education, ICT, even culture) in the EU Budget (MFF) together with reducing fragmentation within the EU's internal innovation environment. Furthermore, formerly well-functioning institutions and economic structures are becoming obsolete in the changing world – visible already in the group of moderate innovators under fiscal pressure but increasingly becoming a problem also in EU Frontier countries. Therefore, an improved productivity performance does not only require higher R&D investment but also appropriate national R&D strategies capable of coping with the new global innovation environment.

The views expressed in this chapter are personal views of the author and not those of the European Commission.

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12

CHRISTIAN CALLIESS: BETTER GOVERNANCE IN THE EURO AREA

Introduction

The financial and economic crisis has confronted the European Union and more precisely the eurozone with its structural and political deficiencies. Existing mechanisms have failed to provide for collective solutions. Decision-making was shifted to bilateral and international levels. The complex, mostly intergovernmental arrangements that have been reached have been criticised for their lack of democratic and constitutional legitimacy.

The fact that the Maastricht Treaty favoured the implementation of an Economic and Monetary Union (EMU) over a Political Union explains the lack of competence for common policies in the fields of finance and economics. It is the reason why the institutional setting for EMU is based on an asymmetric structure: with the introduction of the euro the competences for monetary policy have been transferred to the euro area level (Art. 127 et seq. TFEU), while the competences for economic as well as fiscal policy have largely remained in the responsibility of national policy makers (Art. 4 (1) and 5 (1) and (2) TEU, Art. 5 TFEU, Art. 121 et seq TFEU).

As the Maastricht Treaty of 1992 did not establish a supranational European economic and fiscal policy compatible with the common European monetary policy, member states agreed on a dual system to defend the stability of the euro and the euro area:

- On the one hand they established – as a “first ring of defence” – a rules-based approach: Art. 121 TFEU contains the preventive measures designed to ensure sound public finances through multilateral surveillance. The key concept of this provision is the coordination of national economic policies within a framework set by the Council, today embodied by the European Semester and Country Specific Recommendations (CSRs). Additionally, Art. 126 TFEU contains the corrective measures implementing the Excessive Deficit Procedure (EDP). The Commission is enjoined to monitor the development of the budgetary situation as well as the stock of government debt in the member states having regard to the ratio of government deficit and government debt to gross domestic product.
- On the other hand – as a second “ring of defence” – member states agreed on a market-based approach. The so-called 'No-Bail-Out-Clause ' in Article 125 TFEU states that neither the Union nor the other member states may be made liable for the debts of a particular member state. The intention of this clause is to ensure that member states of the eurozone are sanctioned through the financial markets by higher interest rates on their government bonds in the event of rising sovereign debt.

With the crisis in the euro area it has become obvious that both the rules-based and the market-based tools were incapable of fulfilling their function, which was to prevent a systematically relevant excess indebtedness of eurozone member states. Furthermore, the mere coordination of national economic policies was insufficient to achieve the policy adaptation needed in order to coincide with the common monetary policy of the European Central Bank (ECB).

Against this backdrop, reforms have to address both the rules-based and the market-based tools.

In this regard, the so-called Five Presidents' Report on Completing Europe's Economic and Monetary Union from 22 June 2015 (FPR) and the accompanying communication of the European Commission from 21 October 2015 (COM(2015) 600 final) among others point out the urgent need to

> “move from a system of rules and guidelines for national economic policy making to a system of further sovereignty sharing within common institutions.

The FPR further states that a

> “genuine Fiscal Union will require more joint decision-making on fiscal policy. This would not mean centralisation of all aspects of revenue and expenditure policy. Euro area Member States would continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices. However, as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy. A future euro area treasury could be the place for such collective decision-making.

The proposed Treasury of the euro area (TEA) is to be understood as a placeholder that allows for different institutional concepts to be drawn up. These can range from an intergovernmental approach with the Council and the Eurogroup at its heart to supranational concepts based upon the Commission, ranging from a European economic government (*gouvernement économique*) as proposed by France to a European finance minister as proposed by Germany and the President of the European Commission Juncker. However, the report does not set out a detailed TEA concept and locates its creation in the second stage (up to 2025) of the completion of Europe's EMU.

Moreover, the FPR might be read as intending a political package deal between the treasury and the fiscal stabilisation of the euro area: The latter standing for more risk sharing, the first standing for more sovereignty sharing. By bringing together both aspects the institutional dimension of the FPR enfolds.

Aspects of a reform to be taken into account

Hereafter, different reform proposals aiming at overcoming the deficiencies outlined above will be compared and analysed in terms of their approaches to the scope, institutional ties, mission and competences as well as democratic accountability and financing of a future TEA.

Competences

The FPR states that member states will have to accept more and more joint decision-making on elements of their respective national budgets and economic policies. This implies that the TEA would have to be competent to take all necessary fiscal, monetary and economic measures in order to establish a properly democratic common economic policy. Thus, the TEA would incorporate competences that generally are ascribed to both the finance ministry and the economics ministry at national level. It should have supervisory and managerial functions.

The TEA could have the powers:

- to oversee coordination of fiscal and economic policy, especially to scrutinise and enforce the European Semester
- to support reform processes in the Member States by administrative and financial means
- to negotiate reform packages with Member States undertaking structural reforms
- to ensure the provision of euro area public goods by proposing legislation with regard to the envisaged Fiscal- and Economic Union
- to enforce euro area rules
- to manage crises in the euro area and offset asymmetric macroeconomic shocks via a fiscal capacity
- to decide on bank closures
- to chair the European Monetary Fund (EMF), a transformed version of the ESM (European Stability Mechanism)
- to ensure the unified external representation of the euro area

With regard to these competences, the decision to establish a TEA must not exclude the development of the ESM into an EMF. On the contrary, it might be wise for these two institutions to go hand in hand when it comes to the monitoring, implementation and enforcement of the competences of the TEA: National reforms could be politically monitored by the TEA. At the same time, they could be supervised, supported and (and ultimately) enforced by a future EMF, understood as a technical and politically independent institution equipped with the appropriate competences and expertise.

This "re-integration" of the ESM into the EU framework is explicitly mentioned in the FPR. The new EMF could replace the ESM and take over its functions, while simultaneously extending its mission to encompass preventive action. The latter would mainly revolve around financial, administrative and technical support in close cooperation with the Structural Reform Support Service (SRSS), established in 2016 and residing with the Commission's Secretary General.

In addition to a short-term crisis management facility, the Treasury would therefore dispose over the work of the EMF as a long-term support facility in exchange for reduced budgetary sovereignty of Member States. As a result, the TEA, acting via the EMF, would be able to support economic growth and further convergence by supervising and – where necessary – assisting structural reforms in the Member States.

In the event of any infringement of EMU's legal framework, especially the Stability and Growth Pact, the TEA together with the EMF should be equipped with graduated instruments of intervention in national budgets, including – as *ultima ratio* – the preparation and implementation of Member State insolvency. The development of a state insolvency procedure not only represents the last resort when it comes to excessive sovereign debt but is also crucial for the credibility of the whole system. Within the framework of handling sovereign default, the EMF could grant time-limited credits – should debt have proven unsustainable – in order to secure, in the interest of the financial stability of the euro area as a whole, a structured insolvency of the relevant eurozone member state.

Part of this ("package deal") approach based on more control (sharing sovereignty) would then be more financial solidarity (risk sharing) based on the principle of conditionality (see Article 136 (3) TFEU). In concrete terms, this would mean that the involvement of the TEA together with the EMF in national reform programs could be backed by a fiscal capacity.

The establishment of a fiscal stabilisation function (for example, some kind of "rainy day fund") as part of the TEA might be complex from a political point of view. Some member states would fear increased moral hazard, permanent transfers or mutualisation of debts. However, a fiscal stabilisation function could be designed in such a way that net transfers to each member state remain in the long run close to zero. The definition of transparent criteria for triggering this cyclical support would also go a long way towards meeting moral hazard concerns. Finally, in this context, questions of democratic oversight and legitimacy inevitably arise. Against this backdrop, the FPR emphasised that the establishment of a fiscal stabilisation capacity for the euro area needs to be preceded by a significant degree of economic convergence. Therefore, the convergence benchmarks to define eligibility for the new fiscal instrument would have to be defined.

Finally, any fiscal capacity should contribute to finance European public goods. Therefore, a European investment budget, that provides an incentive for structural reforms identified within the European Semester and Country Specific Recommendations (CSRs), could support investment in European public goods (e.g. in energy infrastructure, border management, security measures or reforms of the labour market). It corresponds to the mission of a euro area stabilisation function as outlined in the FPR.

The deliberate combination of solidarity and conditionality with the objective of safeguarding euro area stability mirrors not only the political package deal found during the crisis in the euro area but also the legal framework agreed with the Treaty of Maastricht in 1992. For the euro area all of these principles are explicitly mentioned in Art. 136 (3) TFEU: the granting of any required financial assistance under a stability mechanism, which may be activated if it is indispensable to safeguard the stability of the euro area as a whole, will be made subject to *strict conditionality*. In its *Pringle* judgment the European Court of Justice stated that "the reason why the granting of financial assistance by the stability mechanism is subject to strict conditionality under paragraph 3 of Article 136 TFEU, (...) is in order to ensure that that mechanism will operate in a way that will comply with European Union law, including the measures adopted by the Union in the context of the coordination of the member states' economic policies"[1].

Art. 136 (3) TFEU 's full legal effect unfolds in the context of the so-called No-Bail-Out Clause, stipulated in Art. 125 TFEU – serving as another core principle of the euro area. In short, this means that any sort of financial assistance granted by the Union or by the member states to another Member State is not generally prohibited by Art. 125 TFEU[2]. However, any voluntary assistance is not generally allowed. As the objective of Article 125 TFEU is to prompt member states to maintain budgetary discipline by remaining subject to the logic of the market when they enter into debt, the provision "prohibits the Union and the member states from granting financial assistance as a result of which the incentive of the recipient member state to conduct a sound budgetary policy is diminished"[3]. This means that, under Art. 125 TFEU, any financial assistance to a member state is only compatible with EU law if it is indispensable for safeguarding the financial stability of the euro area as a whole, while the member state remains responsible for its commitments to its creditors and the strict conditions attached to such assistance are such as to prompt measures to ensure sound budgetary policy[4].

Beyond these core TEA competences, the FPR also aims at establishing a unified external representation of the Euro internationally, especially in the IMF. The 2004 Constitutional Treaty had already provided for this innovation in its draft Article III-90. On the one hand, this could attribute more political weight to the euro area and ensure that its overall interests are expressed. On the other hand, if the particular interests of the member states are too varied, there is a risk that the common position drawn up will simply constitute a weak compromise.

Scope

It is essential to determine whether a Treasury should only represent the euro area or, potentially at least, the EU as a whole, including those member states which do not (yet) take part fully in the EMU. This depends notably on the mission and competences attributed to this institution. Since joining EMU is compulsory for every member state fulfilling the criteria of convergence (except for those with legal opt-outs), it seems logical to include all member states so as to pave their way towards EMU. Considering the close coordination in both fiscal and economic policy which is to be established by the Treasury, an institution which represents euro area member states only could create a deeper gap between euro and non-euro member states and make accession more difficult. However, the goal of the reform will ultimately be the establishment of closer solidarity and sovereignty-sharing mechanisms. If a common European approach is chosen, the accountability of – and the benefits for – non-euro states would have to be evaluated separately.

Position of the TEA in the institutional framework

The position of a TEA in the EU's institutional framework has not yet been defined. However, integration into the existing institutional framework – as opposed to decision-making at an intergovernmental level outside the EU as practised in the ESM or in the Fiscal Compact Treaty – is one of the reform's main goals.

Most proposals share the view that the mechanisms developed during the financial crisis have to be reintegrated within existing structures. The predominance of intergovernmental or supranational elements in the new institution has direct influence on the requirements set out for decision-making (qualified majority vote or veto rights).

There are three principal approaches regarding the TEA's institutional position.

- In the first one, current structures would be left broadly untouched and a new executive authority would be added as part of the Council. This authority could complement or even replace the Eurogroup and raise the profile of economic policy coordination. This approach is based on the understanding that the basis for common decision-making in fields as sensitive as fiscal and budgetary policy has not yet been established. For this reason, the so-called Union Method would be pursued, although with important changes to the principle of unanimity: cooperation in fiscal and economic policy could be modelled on the decision-making process in the EU's Common Foreign and Security Policy (CFSP), as both policy fields are politically highly sensitive. This would mean extending the principle of "constructive abstention" to EMU in order to prevent decisions being blocked by the veto of a single member state, i.e. the analogous application of Article 28 (2), 31 (1) and 36 TEU to the decisions of economic governance. At the same time, this intergovernmental authority would not have any legislative functions but would be limited to adopting operational measures, after consultation with the European Parliament.

- The second approach is to anchor the future euro area Treasury firmly within the Community Method, with a supranational mechanism and a proper fiscal capacity safeguarding the interests of the EU and the euro area as a whole. The TEA would then be established inside the European Commission. Here two models could be distinguished: a European Finance Minister or a European economic government ("*gouvernement économique*"):
- (1) The Treasury could comprise just the Commissioner responsible for monetary union, who then would become a kind of European Finance Minister. To enhance his coordinating role, the function could be "double-hatted" by combining his role as Commissioner and President of the Eurogroup. The new institution would be modelled after the office of the High Representative for Foreign Affairs, representing a mixed administration drawn from Commission, the Council and even member states. This would suggest the European Finance Minister would be elected by the Council by qualified majority vote. Merging

the positions of Commissioner and Eurogroup President would give more political weight to the office, particularly in the implementation of the Excessive Deficit Procedure and the Stability and Growth Pact.

- (2) Alternatively, in a more expanded set up, the TEA could comprise the five Commissioners dealing with the relevant policy fields (e.g. the four responsible for the Monetary Union, the Internal Market, Trade and Financial Stability) along with the President of the Commission (this expanded alternative would be better described as not just a Treasury but an "European Economic Government" for the monetary union). The Commission would then have to be restructured to create a proper treasury facility endowed with the full spectrum of fiscal, financial and macro-economic functions.
- This version prompts a third approach, combining the TEA on lines set out above with a new EMF. This would create a hybrid model which would see the Treasury emerge as part of the Commission, but with guarantees of institutional independence when it comes to control and enforcement by the EMF. The model for that functionality would be a little bit like that of the Single Supervisory Mechanism, now housed within the ECB. The independent, yet Commission-anchored, Treasury would be primarily responsible for matters of budgetary surveillance and fiscal stabilisation where preventing political interference is particularly important.

Democratic legitimacy

An institution like the TEA has to be elected and scrutinised by a parliament. With regard to its envisaged competences questions of legitimacy and democratic accountability arise. In this context, the predecessor to the FPR, the Four Presidents' Report, already mentioned that

> “ moving towards more integrated fiscal and economic decision-making between countries will (...) require strong mechanisms for legitimate and accountable joint decision-making.

The role of the European Parliament (EP)

If the purpose of the TEA is narrowed down to the provision of public goods in the euro area as outlined above, allowing MEPs of non-eurozone member states a vote on matters exclusively regarding the euro area is questionable and should be ruled out.

The body should therefore be staffed with MEPs solely representing eurozone member states. Although a Euro Chamber inside the EP might conflict with Art. 10 (2) TEU according to which the EP is the representative body of EU *citizens* and not of EU member states, the advantage of such a Euro Chamber is that it is based on an existing institution and can be adopted quickly and flexibly

Another possibility would be to create a formally separate parliamentary assembly, made up of directly elected representatives from member states of the euro area. However, this could further complicate the already complex decision-making mechanisms.

Some concepts also aim at enhancing the role of the EP and/or Euro Chamber in the legislative process and in the European Semester. The FPR emphasises that the EP's role in the European Semester has to be strengthened. The assignment of appropriate responsibilities to the EP could complement the decision-making process in the European Council and Eurogroup and endow it with fresh legitimacy.

National Parliaments

As certain competences of the TEA (especially proposing legislation with regard to euro area public goods) would interfere with – in a national perspective – very sensitive policy fields such as economic, fiscal, budgetary and social policy, it might be politically wise and – given constitutional constraints in at least some member states – even necessary to integrate national parliaments into the decision-making process. This would compensate them as well for the implied transfer of parliamentary powers affecting their budget autonomy.

In this context, the FPR emphasises the need to strengthen inter-parliamentary cooperation and to involve national parliaments more closely in the adoption of National Reform and Stability Programmes. There are three different approaches on how to involve national parliaments. All of them would apply only in those policy fields that are affected by the necessary transfer of new competences (e.g. in the field of fiscal, economic and social policy) to the European level.

- The first approach could be to establish a "Euro Chamber" consisting of Members of national parliaments beside the EU Parliament and the Council. This Third Chamber should get involved only when framework legislation is passed on matters that touch upon new competences transferred to EU level in the field of economic, fiscal, budgetary and social policy. Arguably, such an additional institution would make the EU's decision-making process even more complex. Nevertheless, a Third Chamber would buttress the role of the national parliaments (as it is already funded in Article 10 (2), 12 TEU and Article 13 TSCG) into a further integrated multi-level parliamentarianism according to which the EP and national parliaments both contribute to the democratic legitimisation of European decision making. The involvement of national parliaments is necessary to get political and constitutional support for a Treaty Reform that embraces a transfer of powers over economic, fiscal, budgetary and social policy all of them being under scrutiny of national parliaments. Such a Third

Chamber would have to come into being through a treaty change. This approach is mirrored in the proposal for a bicameral parliamentary system scrutinising the proposed European Economic Government. While the right to initiate new legislation would be conferred to the EP (possibly with only euro area MEPs eligible to vote), the second chamber consisting of Members of the national parliaments could take up a role comparable to that of the German *Bundesrat*.

- Another possibility that might even be achieved partly within the Treaty of Lisbon would be to establish a veto (orange or red card) of national parliaments specifically with regard to these sensitive policy fields. The basic idea of such a veto corresponds to the right of national parliaments to raise a subsidiarity complaint (Art. 12(b) TEU). Furthermore, it corresponds to the so-called emergency breaks that exist already in the field of judicial cooperation in criminal matters – another sensitive policy area (Art. 82(3) and 83(3) TFEU). In order to ensure that one national veto cannot block the whole European decision-making-process for an unlimited time, the veto could be suspended for a period. The European institutions would have to consider and take into account the reasoning of national parliament. If a compromise cannot be found after six months, there could be two outcomes: either a minimum of one third of the other national parliaments supports the veto, meaning the proposal is taken off the agenda, or, if this minimum is not reached, the European institutions could continue with the decision-making-process. This would require a unanimous decision in the Council/Eurogroup.
- A third possibility would be to combine the above-mentioned proposals concerning the Third Chamber and the veto card to the effect that it is not national parliaments but the Third Chamber that would have a veto right with regard to the sensitive policy fields of economic, fiscal,

budgetary and social policy. This approach is reflected in the proposal for a Joint Committee comprising 28 delegates from the EP and 56 delegates from national parliaments. However, in order to ensure that a single national veto cannot block the entire European decision-making process for a limitless period, the veto could also be temporarily suspended.

- If a future EMF replaced the ESM, the need for direct decision-making involving the concerned Member States could be met by a co-decision mechanism between the EMF board, voting by qualified majority, and the Joint Committee.
- Democratic accountability is even more crucial when it comes to the TEA's authority to intervene in national budgets. There is here a consensus that the budgetary autonomy of national parliaments has to be respected. Therefore, the right to encroach upon national budgetary autonomy would only be possible on the following conditions: as long as member states comply with their obligations under the common debt rules, only legally non-binding recommendations are possible (as it is the case *de lege lata* or under current law). If a member state, however, infringes the legally binding stability criteria (and therefore disregards European law), it must be possible to make legally binding but still abstract stipulations about how much that country has to save. These abstract stipulations would allow for the national government and parliament to decide where savings were to be made. Only where a Member State depends upon financial aid from the ESM (or a future EMF), would concrete legally binding recommendations be possible. Here, it is only fair to ask to what extent a national parliament of a eurozone member state getting money from the ESM (or a future EMF) has given up its budgetary autonomy voluntarily.

Implementation

According to the FPR, implementation of the so-called second stage of completing EMU was scheduled for 2025. The experiences of the 2004 Constitutional Draft Treaty and the Treaty of Lisbon in 2009 have shown that any treaty revision can be politically fraught. Nevertheless – or even because of this – it is time to design an improved governance of the euro area that can be explained and discussed with member states, citizens and civil society.

Citizens expect the EU and its policies to function properly. If the EU wants to regain their trust, it has to explain the need for reforms and start a transparent debate. The relevant narrative for this reform is obvious: It is about a choice citizens have to make. It is not about "more Europe" but about a better functioning Europe. If member states and citizens want to keep the Euro, drawing lessons from the crises, they should agree to reforms delivering a better functioning and more resilient euro area.

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13

AGNÈS BÉNASSY-QUÉRÉ ET AL.: HOW TO RECONCILE RISK SHARING AND MARKET DISCIPLINE IN THE EURO AREA

After nearly a decade of stagnation, the euro area is finally experiencing a robust recovery. While this comes as a relief – particularly in countries with high debt and unemployment levels – it is also breeding complacency about the underlying state of the euro area. Maintaining the status quo or settling for marginal changes would be a serious mistake, however, because the currency union continues to suffer from critical weaknesses, including financial fragility, suboptimal conditions for long-term growth, and deep economic and political divisions.

While these problems have many causes, a poorly designed fiscal and financial architecture is an important contributor to all of them:

- The 'doom loop' between banks and sovereigns continues to pose a major threat to individual member states and the euro area as a whole. An incomplete banking union and fragmented capital markets prevent the euro area from reaping the full benefits of monetary integration and from achieving better risk sharing through market mechanisms.
- Fiscal rules are non-transparent, pro-cyclical, and divisive,

and have not been very effective in reducing public debts. The flaws in the euro area's fiscal architecture have overburdened the ECB and increasingly given rise to political tensions.

- The euro area's inability to deal with insolvent countries other than through crisis loans conditioned on harsh fiscal adjustment has fuelled nationalist and populist movements in both debtor and creditor countries. The resulting loss of trust may eventually threaten not just the euro, but the entire European project.

The deadlock over euro area reform

The members of the euro area are deeply divided on how to address these problems. Some argue for more flexible rules and better stabilisation and risk-sharing instruments at the euro area level, such as common budgetary mechanisms (or even fiscal union) to support countries in trouble. Others would like to see tougher rules and stronger incentives to induce prudent policies at the national level, while rejecting any additional risk sharing. One side would like to rule out sovereign-debt restructuring as a tool for overcoming deep debt crises, while the other argues that market discipline is indispensable for fiscal responsibility, and ultimately for financial stability. The seeming irreconcilability of these positions has produced a deadlock over euro area reform.

We believe that the choice between more risk-sharing and better incentives is a false alternative, for three reasons. First, a robust financial architecture requires instruments for both crisis prevention (good incentives) and crisis mitigation (since risks remain even with the best incentives). Second, risk-sharing mechanisms can be designed in a way that mitigates or even removes the risk of moral hazard. Third, well-designed risk-sharing and stabilisation instruments are in fact necessary for effective discipline. In particular, the no bailout rule will lack credibility if its implementation leads to chaos, contagion, and the threat of euro area break-up – as euro area members experienced in 2010-12 and again during the 2015 Greek aftershock. Well-designed risk-sharing arrangements and improved incentives, in the form of both better rules and more market discipline, should hence be viewed as complements not substitutes.

Six areas for reform

Achieving this complementarity, however, is not straightforward in practice. It calls for stabilisation and insurance mechanisms that are both effective and do not give rise to permanent transfers. It also requires a reformed institutional framework. In a new CEPR Policy Insight[1] (Bénassy-Quéré et al. 2017), we outline six main areas of reform to the European financial, fiscal, and institutional architecture that would meet these aims.

First, breaking the vicious circle between banks and sovereigns through the coordinated introduction of sovereign concentration charges for banks and a common deposit insurance. The former would require banks to post more capital if debt owed by a single sovereign creditor – typically the home country – exceeds a certain proportion of their capital, incentivising the diversification of banks' portfolios of government securities. The latter would protect all insured euro area depositors equally, irrespective of the country and its situation when the insurance is triggered. Incentives for prudent policies at the national level would be maintained by pricing country-specific risk in the calculation of insurance premiums, and through a reinsurance approach – common funds could be tapped only after 'national compartments' have been exhausted.

At the same time, mechanisms to bail in creditors of failing banks need to be strengthened, supervisory pressure to reduce existing non-performing loans needs to increase (including on smaller banks), and bank regulatory standards should be tightened and further harmonised. To give capital markets union a push, the European Securities and Markets Authority (ESMA) should receive wider authority over an increasing range of market segments, and its governance should be reformed accordingly. Together, these measures would decisively reduce the correlation between bank and sovereign risk and pave the way for a cross-border integration of banking and capital markets.

Second, replacing the current system of fiscal rules focused on the 'structural deficit' by a simple expenditure rule guided by a long-term debt reduction target. The present rules both lack flexibility in bad times and teeth in good times. They are also complex and hard to enforce, exposing the European Commission to criticism from both sides. They should be replaced by the principle that government expenditure must not grow faster than long-term nominal output, and should grow at a slower pace in countries that need to reduce their debt-to-GDP ratios. A rule of this type is both less error-prone than the present rules and more effective in stabilising economic cycles, since cyclical changes in revenue do not need to be offset by changes in expenditure.

Monitoring compliance with the fiscal rule should be devolved to independent national fiscal watchdogs, supervised by an independent euro area-level institution, as elaborated below. Governments that violate the rule would be required to finance excess spending using junior ('accountability') bonds whose maturity would be automatically extended in the event of an ESM programme (the status of the existing debt stock would remain unaffected). The real-time market pressure associated with the need to issue such bonds would be far more credible than the present threats of fines, which have never been enforced. And the cost at which these junior sovereign bonds are issued will depend on the credibility of government policies to tackle fiscal problems in the future.

Third, creating the economic, legal and institutional underpinnings for orderly sovereign-debt restructuring of countries whose solvency cannot be restored through conditional crisis lending. First and foremost, this requires reducing the economic and financial disruptions from debt restructuring – by reducing the exposure of banks to individual sovereigns, as described above, and by creating better stabilisation tools and a euro area safe asset, as described below. In addition, orderly and credible debt restructuring requires legal mechanisms that protect sovereigns from creditors that attempt to 'hold out' for full repayment, and ESM policies and procedures that provide an effective commitment not to bail out countries with unsustainable debts.

When introducing such policies, it is essential that they do not give rise to instability in debt markets. For this reason, we do not advocate a policy that would require automatic haircuts or maturity extensions of all maturing debt in the event of an ESM programme. Furthermore, tougher ESM lending policies and sovereign concentration charges for banks should be:

- phased in gradually;
- announced at a time when the debts of all euro area countries that depend on market access are widely expected to be sustainable, as is currently the case if fiscal policies stay on track; and
- combined with other reforms that reduce sovereign risk, such as the risk-sharing mechanisms proposed in our blueprint.

Fourth, creating a euro area fund, financed by national contributions, that helps participating member countries absorb large economic disruptions. Since small fluctuations can be offset through national fiscal policies, pay-outs would be triggered only if employment falls below (or unemployment rises above) a pre-set level. To ensure that the system does not lead to permanent transfers, national contributions would be higher for countries that are more likely to draw on the fund, and revised based on ongoing experience. This system would maintain good incentives through three mechanisms: 'first losses' would continue to be borne at national level, participation in the scheme would depend on compliance with fiscal rules and the European semester, and higher drawings would lead to higher national contributions.

Fifth, an initiative to create a synthetic euro area safe asset that would offer investors an alternative to national sovereign bonds. 'Safety' could be created through a combination of diversification and seniority; for example, financial intermediaries would purchase a standardised diversified portfolio of sovereign bonds and use this as collateral for a security issued in several tranches. Introducing such assets in parallel with a regulation on limiting sovereign concentration risk would further help avoid disruptive shifts in the demand for euro area sovereign bonds, and hence contribute to financial stability. Risks associated with the introduction of such assets must be mitigated both through careful design and by completing a test phase before the generation of such assets is 'scaled up'.

Sixth, reforming the euro area institutional architecture. We propose two main reforms. The first is an improvement of the institutional surveillance apparatus. The role of the watchdog ('prosecutor') should be separated from that of the political decision-maker ('judge') by creating an independent fiscal watchdog within the European Commission (for example, a special Commissioner) or, alternatively, by moving the watchdog role outside the Commission (though this would require an overhaul of the treaties). At the same time, the Eurogroup presidency role (judge) could be assigned to the Commission, following the template of the High Representative of the Union for Foreign Affairs.

In addition, the policy responsibility for conditional crisis lending should be fully assigned to a reformed ESM, with an appropriate accountability structure. The latter should include a layer of political accountability – for example, by requiring the ESM Managing Director to explain and justify the design of ESM programmes to a committee of the European Parliament. Financial oversight should remain in the hands of ESM shareholders.

These proposals should be viewed as a package that largely requires joint implementation. Cutting through the 'doom loop' connecting banks and sovereigns in both directions requires the reduction of concentrated sovereign exposures of banks together with a European deposit insurance system. The reform of fiscal rules requires stronger and more independent fiscal watchdogs at both the national and European level. Making the no bailout rule credible requires not only a better legal framework for debt restructuring as a last resort, but also better fiscal and private risk-sharing arrangements, and an institutional strengthening of the ESM.

Concluding remarks

Our proposals do not venture into territory that requires new political judgements, such as which public goods should be delivered at the euro area level, and how a euro area budget that would provide such goods should be financed and governed. Their adoption would nonetheless be a game-changer, improving the euro area's financial stability, political cohesion, and potential for delivering prosperity to its citizens, all while addressing the priorities and concerns of participating countries. Our leaders should not settle for less.

Authors' note: All authors contributed in a personal capacity, not on behalf of their respective institutions, and irrespective of any policy roles they may hold or may have held in the past.

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PETER BOFINGER: NO DEAL IS BETTER THAN A BAD DEAL

A team of prominent French and German economists (Bénassy-Quéré et al. 2018) have presented a report, which they regard as "a game changer for the euro area" (see preceding chapter). These proposals have initiated an intensive debate (Bini Smaghi 2018, Micossi 2018, Buti et al. 2018, Pisani-Ferry/Zettelmeyer 2018).

While several shortcomings of the so-called euroreport have been discussed, this contribution argues that the specific insolvency risk of euro area membership is the main risk that should be covered by any joint risk-sharing. The group's modest proposals for public and private risk-sharing are insufficient in this regard. Moreover, with a strengthening of market discipline, this risk could even be increased. So far, there is little evidence that financial markets could play a stabilising role in the euro area. The proposal for an expenditure rule as the main guideline for fiscal policy has its merits as it focuses on a target which governments can control effectively. But it requires a sensible debt to GDP target, for which the completely arbitrary 60 % value of the Maastricht treaty should not be slavishly adopted. For a productive compromise between France and Germany to be reached, the German side has to take the first step by allowing at least some debt financing of public investments within the euro area's fiscal framework.

The specific insolvency risk of euro area membership

Given the focus on "risk-sharing" it is surprising that the authors do not explicitly explain what specific risks they wish to see shared. Their proposals focus on the risk of idiosyncratic demand shocks and that of a national banking crisis. But this neglects the unique and existential risk of euro area membership. Monetary union exposes its member states to an insolvency risk which is absent for similar countries which have a national currency. When a country adopts the euro its debt is re-denominated from the national currency into the euro. Thus, member states are in a similar situation to emerging market economies which can only borrow in a foreign currency ("original sin"). In a crisis they can no longer rely on the support of their national central bank.

This specific risk is aggravated by an easy exit option that the single currency provides for investors. If, e.g., a Japanese pension fund is no longer willing to hold Japanese government bonds and decides to hold US treasuries instead, it is confronted with a currency risk. For institutional investors that are required to hold safe assets this "currency wall" is difficult to surmount. Within the euro area this wall has been removed so that investors can exchange domestic bonds into bonds of other member states without any exchange rate risk.

The combination of the insolvency risk with the easy exit option leads to a denomination risk (Bini-Smaghi 2018) which has manifested itself in the euro crisis. Only thanks to Mario Draghi's commitment to save the euro "whatever it takes", which was regarded as an implicit insurance against this risk, was it possible to maintain the euro area's stability. It is important to note that this risk is not due to "a poorly designed fiscal and financial architecture" as the euroreport authors see it. It is due to the fact that the monetary union is a building which is not yet finished. It would require deeper political integration to become a stable building.

Above all Germany must have a strong interest in the integrity of the euro area. The euro has protected German manufacturing against exchange rate shocks vis-à-vis the other member states. One can also assume that the D-Mark would have been a stronger currency than the euro so that the protection has also been effective vis-à-vis other countries. Thus, one should expect that a proposal by German and French economists for "risk-sharing" would address this risk. But as the euroreport does not even mention it, proposals for such a risk-sharing (e.g. Delpla/von Weizsäcker 2010, German Council of Economic Experts 2011) are also not discussed.

Two not very effective proposals for political risk-sharing

The proposal for a European deposit insurance system (EDIS) envisages insurance premiums which take account of country-specific risks. It also requires that first losses should be borne by the relevant national compartment of the system. Common funds should be provided only "in large, systemic crises which overburden one or several national compartments". But in such a situation the risk-sharing provided by EDIS (with a target size of 0.8% of covered deposits of participating banking systems) would soon reach its limits. An insurance scheme is effective only if risks are uncorrelated. In "large, systemic crises" risks are correlated, and the scheme breaks down. Thus, only the ECB as lender of last resort would be able to stabilise the system effectively.

The second proposal envisages a European fiscal capacity for "large downturns affecting one or several member states". The authors compare it to a "catastrophic loss' insurance". With total annual contributions of 0.1 % of euro area GDP, the size of the fund is limited as a borrowing capacity is explicitly excluded. As a result, even in a severe recession a country would receive rather limited transfers. For an increase in the national unemployment rate by 4 percentage points a one-time transfer of only 0.5 % of the national GDP is envisaged. But this means that a country is only better off if it is hit by the shock within the first five years of the fund's existence. In addition, given the limited size of the fund, the shock must not affect too many member states simultaneously. As a specific hurdle, access to the fund requires that a member state complies not only with the fiscal rules but also with the Country Specific Recommendations (CSRs). In the presence of a very large shock, this is very unlikely. And anyway, for such an ideal country it should be possible to finance a temporary cyclical deficit on the capital market without major problems.

Both forms of risk-sharing resemble the idea of establishing a fire brigade which can only be activated in the case of huge fires. But, at the same time, it is designed with such limited capacities that it will never be able to deal with such fires.

The limits of market risk-sharing

The euroreport proposes market risk-sharing as another stabilising factor. One element is the completion of the banking and capital market union: "Euro area citizens and corporations should be able to hold their savings in instruments whose returns are independent of unemployment and output declines in their home country." But this is already possible under current institutional arrangements. As already mentioned, the single currency has removed the "currency wall" for portfolio investors. And it was excessive cross-border bank lending above all by German and French banks in in the years 2000-2007 which contributed to the crisis. More generally, it is not clear how bond and equity markets can provide significant risk-sharing given the very asymmetric distribution of wealth in the member states. For households with very little or no financial wealth at all, capital market union cannot provide an effective insurance for the risk of unemployment.

The second element of market risk-sharing is the creation of euro area safe assets (ESBies). The authors believe that a "safe asset in the euro area would create a source of demand for euro area sovereign debt that is not 'skittish' in the face of changes in market sentiment." But they also admit that this is only the case "so long as sovereigns do not lose market access since this triggers exclusion from the collateral pool of new issues." And they see the risk that "it may be difficult to find buyers for the junior tranches in time of crisis." In other words, their scheme for "market risk-sharing" would fail precisely in the situation when the fundamental insolvency risk of the area becomes manifest.

Market discipline: Governments under the control of markets?

The authors regard risk-sharing and market discipline as complementary pillars for the euro area's architecture. But this raises the question whether "market discipline" can be regarded as a stabiliser at all. For the authors of the euroreport this seems to be unquestionable. But almost 20 years ago the Delors Report came to the following assessment:

> "(...), experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive.

Developments since the start of the euro have confirmed this prediction. The market reaction to the chronic lack of fiscal discipline in Greece came, very belatedly, in the year 2010 and then the reaction was so sudden and disruptive that the system could only be saved by Draghi's intervention. More generally it is surprising that the economists' trust in market discipline could survive the financial crisis almost unscathed.

In addition, one must ask whether "market discipline" is an adequate concept for the organisation of the euro area. In the context of the banking sector it may have its merits. But in the context of the monetary union it implies that markets are assigned a disciplining role over states. This turns the traditional relationship between state and markets on its head. In the past there was a consensus among economists that markets must be under the control of governments. Market discipline calls for governments that are under the control of markets. This concept is especially questionable as financial markets are dominated by mighty players like Goldman Sachs or Blackrock.

In sum, the whole concept of stabilising the euro area by combining enhanced market discipline with homeopathic elements of risk-sharing is not convincing. While elements of risk-sharing do not address the euro area's most fundamental risk of insolvency, strengthening market discipline might even increase this risk. The authors are aware of this problem, but they regard it as a transition problem only:

> " The main lesson is that the 'transition problem' – getting to a state of more effective market discipline and higher stability, without triggering a crisis on the way – needs to be firmly recognised and addressed in proposals to raise market discipline.

But how shall the transition be managed? The report proposes that the new regime should be introduced "at a time when the debts of all euro area countries that depend on market access – particularly those of high debt countries – are widely expected to be sustainable with high probability (...)." As such a situation is very unlikely for the foreseeable future, this looks rather like an escape clause for the French economists.

An expenditure rule set by wise men and women

A third element of the report is a new framework for fiscal policy. The proposal is based on the assessment that the fiscal rules “have not worked well.” While this is true for Greece which posted sustained large deficits while publishing incorrect statistics, for the large member states this is not so obvious. Comparing the fiscal balances of Germany, France and Italy on the one hand and of Japan, the United Kingdom and the United States on the other, the much lower deficits of member states speak for a pronounced fiscal discipline in the wake of the crisis (Figure 1).

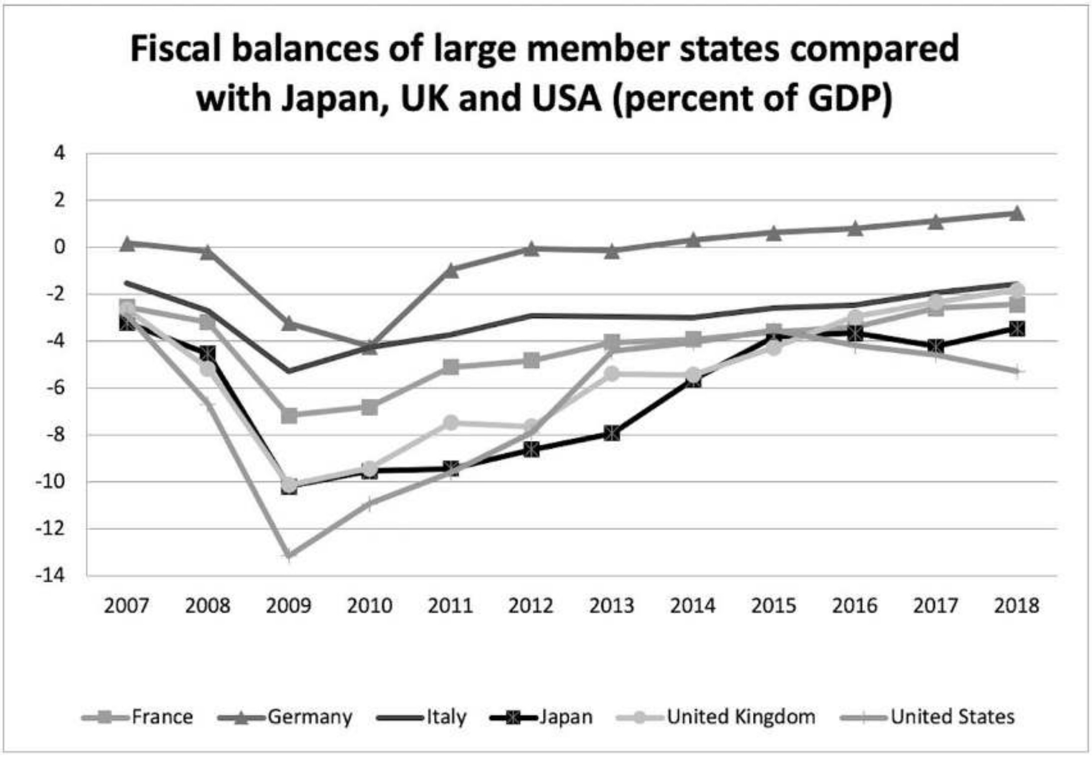

Figure 1: Fiscal balances of large member states compared with Japan, UK and USA (percent of GDP) (Source: International Monetary Fund, World Economic Outlook)

The authors propose a two-pillar approach with a long-term debt target, “such as 60 percent of GDP, or a more bespoke objective” and an expenditure-based operational rule to reach this target. For this purpose, an independent, national-level fiscal council shall be established. It shall propose a rolling medium-term debt reduction target, chart a consistent medium-term expenditure path, and use it to set a nominal expenditure ceiling for the coming year. If a country exceeds the target path all excessive spending must be financed by junior sovereign bonds.

There is no doubt that expenditure rules have their merits as they are easier to follow than deficit rules. But it is not clear why the rules should be set by an expert council and not by an elected government or parliament. Economists have ideological biases which influence the judgements that must be made, given the limitations of the science of economics. Thus, the nomination of specific experts for the council has a strong influence on the outcome of the debt target and the corresponding expenditure path.

In addition, it is far from obvious that the 60 percent target for the debt level is a sensible medium-term target for fiscal policy. For the Maastricht Treaty it was derived as the average debt level of the member states at that time. The attempt by Reinhart and Rogoff (2010) to derive a target scientifically failed. Renowned economists have made the case for evidence-based economics. David Eddy (1990) who coined the term "evidence-based medicine" puts it as follows:

> explicitly describing the available evidence that pertains to a policy and tying the policy to evidence. Consciously anchoring a policy, not to current practices or the beliefs of experts, but to experimental evidence. The policy must be consistent with and supported by evidence. The pertinent evidence must be identified, described, and analysed. The policymakers must determine whether the policy is justified by the evidence.

The Maastricht 60 percent target is obviously based on current practices and beliefs of experts and it lacks any pertinent evidence. E.g., in the UK the long-term historical average (1700-2016) is 99.5 percent (Chart 2). Thus, any strategy that tries to make the euro area more stable should entail an intensive analysis of an adequate debt target for the member states. Substituting the 60 percent target with a target which is closer e.g. to the debt to GDP level for the US could fundamentally change the perception of the financial soundness of the member states.

Figure 2: Debt/GDP ratio United Kingdom (1700-2016) (Source: Bank of England, A millennium of macroeconomic data)

The way forward

The instability of the euro area architecture is not due to a "poorly designed fiscal and financial architecture". It reflects an unfinished building with a supranational monetary policy and 19 independent national fiscal policies. Thus, the only way to make it stable is to go ahead with political integration. This would allow a comprehensive debt mutualisation which would remove the specific insolvency risk of euro area membership. With the transfer of fiscal policy responsibilities to the supranational level, fiscal discipline of the member states would be enforced by a democratically legitimised euro area finance minister and not by myopic financial investors. In the current situation progress towards fiscal policy integration is not very likely. But for economists this is not an excuse for not making explicit what is really required to stabilise euro area architecture.

For a productive French-German compromise, the German side must make a first step by allowing some flexibility concerning the "black zero." This would allow more room for the 'golden rule' in the Stability and Growth Pact so that at least a limited debt-financing of public investments would be possible. As another step forward one could think of projects with large euro area externalities (infrastructure, defence, research, industrial policy, the environment) which are financed by bonds with a joint liability. Finally, a thorough and open-minded analysis of the appropriate targets for public debt to GDP ratios would be very helpful.

The euroreport calls for "a shift in the euro area's approach to reconcile fiscal prudence with demand policies, and rules with policy discretion". But it presents a framework that limits the scope for demand policies by the introduction of fiscal rules and "sovereign concentration charges" on banks seeking to hold domestic government debt. And it reduces the scope for national policy discretion not only by the establishment of independent fiscal councils but also by exposing governments to more "market discipline". The proposal could indeed be a "game changer" but in the wrong direction.

This chapter is a revised version of an article on Vox the CEPR Policy Portal.[1]

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HANSJÖRG HERR, JAN PRIEWE AND ANDREW WATT: CONCLUSIONS: EURO AREA REFORMS – THE WAYS AHEAD

Since 2015 the macroeconomic performance of the euro area has been satisfactory, at least in terms of overall GDP and employment growth and current account reversal in former deficit countries. There is no longer an imminent grave crisis as in 2012 and the second recession (2011-2014) that ensued after the Great Recession (2008-2009) has been overcome. However, progress is limited and vulnerability remains: many economies have only recently reached pre-crisis levels of output and Greece and Italy have still failed to do so; the level of sovereign debt is much higher than earlier, except in a few countries; unemployment is still high in a number of countries; the current account position of the combined euro area is in deep imbalance, and current account balances, as a share of GDP, between members are still extreme, up to ten percentage points; in some countries legacy debt and non-performing loans (NPLs) still stand at a high level, despite the tailwind of the upswing. In particular, Italy as one of the large countries of the European Monetary Union (EMU) is in dire straits after two decades of stagnation under the euro regime while little progress has been made in repairing the massive damage inflicted on the Greek economy.

The upswing is fragile, reliant on unconventional monetary policies. Both monetary and fiscal weapons remain limited as monetary policy still follows a zero-interest rate policy, and fiscal policy space is institutionally restricted. The euro area is neither prepared to cope with a normal recession nor with more severe financial shocks, let alone global political and economic shocks. Recent eurozone reforms have not managed to make our economies crisis-proof, despite many efforts and some progress. Much political capital has been lost and tensions are likely to break out in any renewed downturn.

The reform agenda put forward by the European Commission (EC) in December 2017, endorsed and augmented in some points by the French President, Emmanuel Macron, was after prolonged silence largely rejected by an alliance led by Germany. Ideas of establishing a central EMU fiscal entity with a strong European finance ministry, European taxes and a functioning anti-cyclical EMU fiscal policy do not command the required political support. Only a small rainy-day stabilisation fund for countries hit by asymmetric shocks has won Franco-German consensus. The Meseberg Consensus (Meseberg 2018) of the German and French Government in mid-2018 seems to have buried most of Macron's proposals.

As this book was being finalised, in December 2018, decisions on governance reform were taken both by the Eurogroup and the Euro Summit that brings together the heads of state and government of the EMU member states. Unfortunately they lag behind even the very limited *ex ante* expectations. A green light was given for reform of the ESM and to establish a backstop for the Single Resolution Fund; the outcome remains uncertain, though. More importantly, due to opposition from a group of countries led by the Netherlands, the promised euro area budget will not only be small: the size is not predetermined but it has to be part of the overall EU budget and thus subject to competition for other objectives. It will be limited to addressing issues of competitiveness and convergence. A role for stabilisation has been explicitly ruled out. With all systems on hold until after the elections and the formation of the new Commission, no additional substantial reforms can be expected until at the earliest the end of 2019.

Complacency, timidity, defence of the status quo and a narrow national perspective seem to predominate, paired with faulty economic reasoning, often ignoring standard economic knowledge. Calling for strict obedience to existing but problematic rules, demanding national "structural reforms", often only a label for dismantling welfare states, and subordination of state regulations to market discipline – this agenda has the power to undermine EMU and European integration at large. Too many powerful forces have failed to recognise that the euro system is not yet viable and remains incomplete, as stated not only by critical observers but by the Presidents of the five key European institutions in their 2015 report (EC 2015). We are not out of the woods. Rather, it seems that we are waiting for the next accident.

What are the key problems that need to be tackled?

- The euro system is still more akin to the Gold Standard or a currency board exchange rate system than to a complete monetary and economic union. The key issue here is that member states (MS) lose to a large extent the Lender of Last Resort (LoLR) function of their national central bank, so that the euro is in this respect like foreign currency for them. Further, "internal devaluation" (cutting nominal wages and prices) as a replacement for realignment of nominal exchange rates is extremely costly, especially as current account surplus countries do not support this policy by "internal appreciation" (higher nominal wage and price increases).
- Limited LoLR means that bonds of central governments are not *per se* safe assets. As there is no common safe asset, the euro area therefore lacks a cornerstone for the stability of

the financial system and especially for breaking the oft-bemoaned doom-loop between sovereigns and banks. Within EMU, owners of sovereign bonds have strong incentives to shift their wealth to other euro-denominated sovereign bonds deemed safer than "home" bonds. This in turn has negative repercussions on the liquidity and balance sheets of banks and can freeze the money market. Mario Draghi's famous "whatever it takes" words rescued EMU in 2012, followed up by the Outright Monetary Operations programme (OMT) and the asset purchase programme of the ECB. Whether the ECB in a renewed critical situation can avoid a fiscal crisis in which spreads spiral upwards must be doubted. The asset purchase programme is scheduled to be run down. Support under OMT is conditional on participation in a fiscal adjustment programme under the European Stability Mechanism (ESM). EMU is in a state of limbo which is hazardous because it nourishes uncertainty and triggers self-fulfilling speculation and panics.

- Despite genuine progress, the Banking Union is incomplete regarding two key pillars: the joint EMU-wide deposit insurance system and the backstop for the single bank resolution in the event of default. The absence of the former encourages account holders to shift deposits between banks of different national jurisdictions. The latter case means the sovereign-bank doom-loop remains unbroken.
- Apart from in 2009, fiscal policy in EMU generally has by and large been pro-cyclical or neutral. The shift to fiscal contraction in 2011 was a fatal error, especially given the limited effectiveness of monetary policy at the zero lower bound, and caused the double dip in the same year.
- There is still no effective mechanism for rebalancing, in a symmetrical fashion, current account imbalances and ensuring external equilibrium in all MS; persistent imbalances weaken cohesion and trigger the quest for a

federal "transfer union". The divide within EMU is heightened, and disparities in respect of productivity and living standards remain high or indeed increase for some MS.

- The proposed transformation of ESM into a "European Monetary Fund" (EMF) and its integration within European jurisdiction requires a clear concept which does not seem to be on the agenda. Presently the ESM is a hybrid mix tasked with monetary as well as fiscal assignments. It is an insufficient stopgap for an absent European Treasury and full LoLR function of the ECB and cannot prevent systemic contagion risks as many policy makers still believe.

History shows that currency unions require a certain degree of political integration. Exactly what the minimum requirements are remains controversial. Discovering how much solidarity, risk-sharing is needed, while avoiding "moral hazard effects" and limiting permanent transfers, is a historic experiment. All are agreed that the current degree of integration is insufficient. Normatively, we would support far-reaching moves towards federal structures. But longer-term objectives must not become the enemy of much-needed piecemeal reforms. We build here on a number of different proposals[1] to present a reform agenda which we believe is both effective and politically workable, although it will clearly require a substantial change in the position of key actors.

Towards a full Lender of Last Resort

In the euro system, sovereign bonds of MS are no longer central government bonds, constituting a safe asset, because the euro area does not have a central government. The ECB has room for manoeuvre to set the criteria for the quality of acceptable collateral. It has established the rule that at least one of four certified rating agencies must give an investment grade rating to a country's sovereign bonds (ECB 2016). If specific bonds are subject to speculation or panic, their rating may drop and spreads rise, making refinancing dear or even impossible, weaken banks' balance sheets if they hold these bonds, prompt financial investors and deposit holders to shift their portfolios to other banks or countries, and undermine the traction of monetary policy. From this angle, during the sovereign debt crisis the ECB helped cause the rise of spreads among sovereign bonds (Orphanides 2017).

Insolvency of states differs from corporations, as states continue to exist as legal and political entities while firms can be liquidated or merged with others. The final decision about a government's insolvency is political; if the ECB activates OMT, sovereign bonds of "programme countries" under the ESM can be purchased which would reduce interest rate spreads and guarantee liquidity, though linked to conditionalities. Countries in an ESM programme may fear the stigma of "bankruptcy" and tend to avoid or bypass the ESM as long as possible. Larger countries like Italy are too large to be rescued by the ESM without ECB intervention. For all these reasons, the ECB should take over a comprehensive LoLR function (cp. De Grauwe 2011, Bindseil/Laeven 2017, Winkler 2013).

Only if, in an extreme case, insolvency of sovereign debt is explicitly declared by the political authorities, should the ECB stop acting as an unconditional lender of last resort. In that case, debt needs to be restructured or relieved in other ways, and thus should be subject to the ESM or the prospective EMF. Then the problem becomes a case for European public finance, no longer for monetary policy.

All liquidity issues of banks should be assigned unconditionally to the ECB, not the ESM. If a national government has to bail out banks that threaten its own solvency the task should fall to the Banking Union and the Single Resolution Mechanism. Therefore, insolvency of MS governments should be a very rare and highly unlikely event and sovereign bonds of central governments of MS should in principle be considered safe. Purchasing sovereign bonds of countries to calm down markets before panics set in, and thwarting attempts at speculative attacks, should be the normal and uncontroversial task of the ECB.

The main argument against a full LoLR function of the ECB rests on fears of “moral hazard”: national governments might abuse the protection given their bonds by allowing debt ratios to rise to very high levels. In our view this fear is overblown. In any event, a potential abuse of fiscal policy needs to be prevented by policy intervention, not by market sanctions. Everyone agrees that fire brigades are a necessary public good which should intervene even in case of arson, while arsonists should be prosecuted under criminal law. Similarly, one should accept full LoLR as a public good. An alternative would be the conversion of a proportion of legacy debt into common eurobonds. However, the political obstacles are known to be formidable. One option, proposed by Jörg Bibow in this book, is for a European Treasury to issue *new* mutualised bonds according to a pre-defined rule and allocate the proceeds to MS to finance public investment, while the stock of old debt is managed by national governments.

Completion of the Banking Union including a Capital Market Union

As already mentioned, the Banking Union is incomplete. Up and running is a Single Supervisory Mechanism (SSM) of banks: the ECB now supervises all big banks in the EU directly. Smaller banks are supervised by national agencies but the ECB also has the power to directly intervene in national supervision. The European Banking Authority (EBA), which has no direct supervisory functions as such, is in charge of a European Single Rule Book which is binding for all supervisory agencies. The SSM is a substantial improvement to stabilising the European banking system and avoiding regulatory arbitrage.

The Single Resolution Mechanism (SRM) for liquidating insolvent banks exists as a second pillar. A Single Resolution Board organises together with national institutions the liquidation of insolvent banks following certain rules. For example, owners and buyers of bonds issued by a bank as well as holders of large deposits must be involved in the resolution of an insolvent bank (bail-in) to avoid government bailouts with taxpayers' money. For the eventuality that the bail-in is insufficient or unfeasible, the Single Resolution Fund (SRF) has been established. This fund is built up by contributions of banks and is scheduled to reach a volume of €55billion in 2023. However, in a systemic crisis, the fund is not big enough. For this eventuality the Commission (EC 2017, p. 5) proposes a fiscal backstop. In such a case, the ESM would be tasked with giving loans to the SRF whilst the loans must be repaid by banks. This proposal, endorsed also by the Meseberg declaration of the French and German governments, is sensible and would mark a step forward in the Banking Union.

The establishment of an EMU-wide deposit insurance system is a necessary third pillar of the Banking Union. The Commission has made a proposal for a common European Deposit Insurance System (EDIS), to be phased in towards full mutualisation by 2024 in three stages (EC 2015a). The German government especially opposes EDIS by arguing it comes too early as the "bad debt" problems of several MS have to be solved first. Furthermore, incentives for banks to deal with their problems would be reduced if they could rely on European funds.

However, this rejection mixes up problems of protecting depositors, increasing the capital ratio of banks, dealing with non-performing loans and bailing in creditors in the event of bank resolution. For all four issues specific measures and rules are necessary. For national systemic banking crises within EMU national deposit insurance systems may be too small and need European support – even in countries like Germany or Luxembourg; even more so, if an EMU-wide financial crisis with contagion effects occurs. Therefore, a European solution is necessary, and not only in the long run. Similar to the envisaged ERF, the ECB could become a LoLR for the EMU deposit insurance system (see also Peter Bofinger in this book). An EDIS is both risk sharing and proactive risk prevention and vital to break the doom-loop of banking and sovereign debt (see also Agnès Bénassy-Quéré et al. in this volume).

Another shortcoming of the euro area financial system is the lack of a safe European asset. Traditionally, as in all OECD countries, federal governments' bonds were considered safe, i.e. risk-free assets (see Gabor/Vestergaard 2018). This implies that banks holding government bonds do not need extra equity capital on their balance sheets while this is necessary for all other assets banks hold. If government bonds are no longer considered safe, a "diabolic" link between banks and government debt exists which leads in a sovereign debt crisis to a debt crisis within banks, and vice versa when banks need to be rescued by the government.

There is a debate as to how sovereign bonds can be made safe assets in EMU. One recent proposal of the Commission and also made by several authors (see Bénassy-Quéré et al. 2018 and in this volume) is to create a synthetic asset called Sovereign Bond Backed Securities (SBBS, see ESRB 2018)[2]. SBBS are based on pooled government bonds of EMU/MS, including low-risk senior tranches and more risky junior tranches. The problem is that in critical times when a country is at risk of losing its access to capital markets, SBBSs lose value; for countries at risk they are of no help in times when help is needed (Peter Bofinger in this volume).

Financial market supervision still has several shortcomings. First, the shadow financial system remains only partly regulated as most shadow institutions escape banking regulation. Global banks can still use different national rules and supervision systems to pursue regulatory arbitrage. Second, international capital flows remain fully unregulated – an international financial transaction tax would be required, apart from measures to reduce currency mismatch in balance sheets — and no mechanism has been established to prevent unsustainable current account imbalances. Third, the problem of too-big-to-fail regarding large banks remains unsolved. Fourth, Basel III and

European banking supervision merely restricts the role of risk models for equity holding but did not completely abolish them (see Herr et al. in this book).

Fiscal policy

There is increasing recognition that fiscal policy rules within EMU need to be revised. The current rules are very complex, although more flexible since the new approach adopted by the EC in 2014, as documented in EC (2017b, 2018). There is now more discretion for the EC, but this raises issues of transparency and equal application to all countries. But a clear lack of countercyclical orientation in MS remains. Countries with high debt are considered to have no or only limited fiscal space. What are called structural (i.e. cyclically adjusted) budgetary measures contain, in practice, a large cyclical element, reducing scope for stimulus in countries facing stagnation while inadequately constraining governments whose economies are booming. The predominant goal is reducing the level of debt, rather than fighting output gaps or inflation/deflation. The Fiscal Compact of 2011, calling for near-balance of structural balances and reinforcing the – arbitrary – 60 percent debt goal, proved self-defeating in slow-growing economies (Fatàs/Summers 2016). Most other currency areas run higher deficits in recessions. The expectation that countries with ample fiscal space, like Germany, would offset fiscal constraints on other MS was a – foreseeable – illusion. This implies that EMU's fiscal policy framework lacks a centralised fiscal policy tool against *symmetric* shocks while coordinating a response by member states has proven difficult except in the extreme situation of 2009. In short, economic governance needs to be made much more effective in dealing with both symmetric and asymmetric shocks.

That most EMU countries have in recent years run external surpluses, led by Germany, is just the mirror image of an excessively tight fiscal stance faced with monetary policy stuck at the zero lower bound. A key obstacle to reform is the Fiscal Compact and the old 60 percent rule, which are contradictory. If applied over a long period, given a 3 percent nominal growth trend and the required structural budget deficit (initially 0.5 percent and then 1.0 percent after 60 percent has been reached), a debt ratio of 33% of GDP would result. The mirror image would be bulging external surpluses since both the private and the state sector would run sectoral surpluses. This is an unsustainable scenario.

After the Meseberg Consensus of France and Germany in mid-2018, Macron's proposal for a large euro area budget (several percentage points of euro area GDP) combined with a European Finance Minister has been rejected for now. At the time of writing it seems that only a macroeconomically insignificant fund may win the necessary political support. If this idea cannot be revived, proposals should address more fiscal space in MS and provide some kind of centralised automatic stabilisers such as a European unemployment re-insurance. The debate embraces several concepts of new fiscal rules (cp. Bofinger 2018):

- Keeping the status quo with the EC's opaque but flexible rulebook, providing some decentralised leeway without changing the Stability and Growth Pact and the Fiscal Compact.
- Strict enforcement of the Fiscal Compact targets of a 0.5 percent structural deficit without national discretion by complementing the rule on the structural deficit with expenditure rules (Feld et al. 2018) and an escape clause with discretionary policy in the event of severe economic crises.
- Reinterpreting structural deficits in the Fiscal Compact by excluding public investment so as to follow a golden rule which allows debt-financing of public investment (usually subject to a ceiling, see Truger 2017).
- Replacing the deficit rules by more flexible expenditure rules which are set by national fiscal councils in light of the

need to hit a given debt ratio (such as 60 percent) in the longer term; focusing on public expenditure less interest payments, unemployment expenses and allowing for public investment. Medium-term targets should be set by MS, there should be no sanctions in case of deviation. However, borrowing above the level permitted by the fiscal council would be excluded from all forms of EU-level backing (Bénassy-Quéré in this volume; on this see also Darvas et al. 2018).

- Earlier proposals opted for a fiscal rule solely aligned to the inflation target which is often in line with output gaps (Eichengreen/Wyplosz 2016, Wren-Lewis 2016, in some cases complemented by proposals for debt restructuring regarding "excessive" parts of sovereign debt.
- Establishing a euro area Treasury which issues sovereign bonds on behalf of MS for a given percentage of MS' GDP and transfers' proceeds to MS; proceeds are earmarked for public investment. MS otherwise run balanced structural deficits as prescribed by the Fiscal Compact (see Jörg Bibow in this volume).

Without addressing detailed issues of implementation, in our view focusing on fixed debt ratios is not sensible as there is no optimal debt level. Rather, fiscal deficits (or surpluses) should be deployed towards the ends of keeping national inflation rates close to the overall price target, low unemployment and the reduction of excessive external imbalances (Koll/Watt 2018); furthermore, providing sufficient public goods is key. If these variables are maintained at appropriate levels, ensuring adequate and stable nominal GDP growth, public debt ratios will not rise and can be expected to decline in the longer run. And an effective LoLR can guarantee sovereign debt, as in all advanced countries with own currency.

Reducing current account imbalances

In none of the major proposals for euro area reforms are current account imbalances explicitly addressed, not by the EC, nor by the French President or the German Coalition Agreement of the governing parties. The EU's "Macroeconomic Imbalance Procedure" (MIP) focuses on internal imbalances, but in an asymmetric way. Moreover, doing so while the external surplus of the euro area as a whole is high is unsustainable and risky. Should the euro appreciate again, internal imbalances will reappear. What is needed is to address the fundamental causes of these internal imbalances.

There are five avenues to achieve rebalancing (see Jan Priewe in this book):

- Reform of the MIP: The present asymmetric approach should be changed into a symmetric one, addressing both deficit and surplus countries at +/-3 percent limits, and with similar changes made to other indicators to render them symmetrical in their impact. Sanctions for notorious deviation should be instituted.
- Internal revaluation in surplus countries by labour market and incomes policies: average wages in surplus (deficit) countries should rise faster (slower) than the sum of productivity increase and target inflation during a transition period. Depending on collective bargaining systems, minimum wages and wages in the public sector, extensions of sectoral agreements or other measures can be deployed (Watt 2017: 80ff).
- Medium-term expansionary fiscal policy in surplus countries to boost aggregate demand for the rebalancing period. The public sector as a whole should run deficits if private sectors are in surplus, so as to limit any current account imbalance. As discussed in the previous section, the fiscal stance should in a medium-term perspective be set in

each country with regard to the gap between the expected rate of inflation in that country and the ECB's target rate, which would have the effect of limiting intra-EMU imbalances from the prescriptions of the Fiscal Compact whose "debt brake" is a lever for higher external surplus.
- Reconsidering corporate taxes and VAT in the EMU: Ireland, Luxembourg and The Netherlands in particular have privileged financial institutions and multinational corporations, among others, which adds to the current account surpluses of these countries. To some extent this applies also to Germany. A reduction of VAT in surplus countries, partly compensated by increasing corporate taxes, could be part of the fiscal package to stimulate higher imports in Germany[3]. Reducing hidden mercantilist subsidies for export promotion could add to rebalancing.
- Industrial and innovation policies in MS with a weak export base: the former current account deficit countries of EMU need to strengthen their non-price competitiveness and to halt further deindustrialisation (see Annamaria Simonazzi and Marianne Paasi in this book). The EU budget needs more and better targeted funding for innovation policies in this regard.

Combining many of the above elements, a proposal for institutional reform to achieve a policy mix avoiding and correcting dangerous imbalances has been put forward by Koll/Watt (2018). First, the Broad Economic Policy Guidelines (Articles 120 and 121 of the TFEU) need to play their intended role as coordination instrument, taking precedence over ill-advised fiscal rules that can exacerbate imbalances and an asymmetric MIP; the Guidelines provide for the application of sanctions in case of persistent non-compliance. But what is critical is to improve national "ownership" of the policy recommendations. To this end, the authors propose establishing, at both MS and EMU level, advisory boards for macroeconomic convergence: This can be done by extending the remits of the recently established European Fiscal Board and National Productivity Boards to cover the macroeconomic policy mix: monetary policy (including macroprudential measures at national level), fiscal policy and "incomes policies" (wage and price developments). To support policy implementation Macroeconomic Dialogues – modelled on the existing EU Macroeconomic Dialogue – should be established, also at both levels, that bring together the actors responsible for the macroeconomic policy mix: governments, central banks and the social partners.

Establishing a European Monetary Fund

One of the principal reforms under consideration is the transformation of the ESM into a "European Monetary Fund" (EMF). The risk here is that we will see only a change of names and of some legal issues of integrating the ESM into Union Law without Treaty change (according to Article 352 of TFEU, as proposed by EC 2017a).

The analogy with the International Monetary Fund (IMF) is somewhat misleading. The IMF provides, by and large, balance of payment support and financial assistance for debt restructuring to Fund members when there is an imminent shortage of foreign exchange, mainly US dollars. In a way, the IMF is a limited LoLR in foreign currency, either as liquidity assistance or as rescue support in the rare case of insolvency. The LoLR in domestic currency is everywhere the national central bank. Apparently, the ESM is to play the LOLR role not (fully) played by the central bank, in the absence of a European Treasury. The ESM has, unlike the EU Budget and the Commission, the right to issue bonds.

Five support programmes are available and managed under the umbrella of the ESM, whose ultimate liability in case of default is borne by central governments of 19 countries: (ESM 2018):

1. Sovereign Bail-Out Loans

2. Bank Recapitalisation Programmes, (a) indirect and (b) direct support to financial institutions
3. Precautionary Financial Assistance in order to maintain endangered market access for sovereigns
4. Primary Market Support Facility to help countries in crisis to re-enter bond markets
5. Secondary Market Support Facility targeting the lack of market liquidity when risks of increasing interest rate spreads emerge

In other advanced countries, the need for task 1 has never occurred so far[4], task 2 in other countries is assigned to the Treasury, and tasks 3-5 to the central bank in its function as a full LoLR, whereby task 4 is unnecessary if secondary market support is guaranteed. These tasks are in other advanced countries fulfilled without conditionalities. Tasks 3 and 5 are not considered monetary financing of governments, since they implement liquidity provision and not handling insolvency. This implies that the ESM is a somewhat opaque hybrid of a monetary and a fiscal institution. In the ESM all tasks include conditionalities of different intensity. Tools for 2(b) and 3-5 have so far not been used. Almost 70 percent of total loan disbursement went to Greece. Therefore, the ESM is *de facto* predominantly a sovereign debt restructuring agency.

If the ECB were to adjust to the practice of other leading central banks in advanced countries, many of the problems would, of course, evaporate; but clearly this is not so straightforward in the euro area with its numerous autonomous fiscal authorities. One important step would be to ease the criteria for using the OMT facility which presently applies only to MS which are under ESM-assistance, i.e. in one of the EMS-facilities. Yet, the criteria for using OMT are not very clear – OMT has never been used, not even in the case of Greece. Countries that are under a full ESM structural adjustment programme do not need OMT; countries which have not yet lost market access but suffer from uncertainty about interest rate spreads need OMT, but not necessarily the ESM. And what happens if the ESM does not have enough funds? This problem makes clear that the relationship between the ECB and its OMT and the ESM needs to be reconsidered.

The proposed EMF may be assigned additional tasks. One could be acting as the temporary fiscal backstop for the SRF for over-indebted banks in the framework of Banking Union. This would be a special credit line to the SRF; banks, not taxpayers have to recover the costs.

Also, a Stabilisation Fund for public households in countries hit by asymmetric shocks has been proposed by the EC as a new element of the EMF. However, the last two tasks mentioned should ideally be assigned to a fully-fledged European Treasury, under a finance minister, if the latter is granted the capacity to issue debt. Similar tasks for public investments relating to common public goods of the euro area could and should be assigned to the new Treasury.

The ESM has a mandate with wide discretion, regarding contracting Memoranda of Understanding with MS and in particular regarding conditionalities for its programmes. The institutional setting is problematic: checks and balances, accountability, parliamentary control, are all inadequate. Furthermore, the complex voting rules with a unique "reinforced qualified majority", which gives large countries veto rights that in turn require for some countries consent from their national parliaments, does not correspond to Union Law. Apart from these reservations, the capacity of the ESM is too small for bailing out larger countries, such as Italy or Spain.

Simply shifting the ESM with a new label under the roof of the EC without further parliamentary controls would increase the power of the Commission with too few checks and balances. This transformation is a litmus test for strengthening European democracy and requires sustained debate.

Final remarks

The euro area is clearly in need of substantial reform. The debate is continuing about the nature of that reform. One thing is certain: a major shift towards a fully-fledged European state seems unlikely at present, while the loose confederation-like structures at present have proven inadequate. There is a problem of ensuring effective policy-making, due to poorly designed rules or unanimity requirements that in practice can seldom be met. EMU governance also raises serious and complex issues of legitimacy and democracy. The ill-defined competences, and power, of the informal Eurogroup are a case in point. The European Commission plays a hybrid role, while the splitting of responsibility for fiscal matters *de facto* leads to an over-reliance on monetary policy, with the ECB as, arguably, the only genuine euro area institution. Consequently, any reform proposals need to grapple with such issues of legitimacy. We do not address these in detail here (see Christian Calliess in this volume), but some we favour would at least partially address them.

In the contributions to this volume and in this concluding chapter a range of policy proposals has been put forward. It is hard to know *ex ante* which of these have a chance of securing the necessary political support. Given what we have identified as the fundamental but unresolved institutional problems of the euro area, we would support a reform agenda along the following lines:

- establishing a European Finance Minister with the right to issue bonds and raise certain taxes,
- a euro area budget for common public goods,
- shifting special financial issues related to the euro area under parliamentary control of a dedicated parliamentary body, possibly a special section of the European Parliament, acting as a countervailing power to the Eurogroup and the Euro Summit.

In addition, and crucially, we emphasise the need to focus economic policy coordination on reducing intra-EMU imbalances by ensuring that policies, including wage-setting, are oriented towards high levels of growth and employment subject to the need to keep national inflation rates in line with the overall inflation target. This also implies limiting, in a symmetrical way, output gaps and (internal) trade imbalances.

This debate is complex and far-reaching but it must be grasped, not pushed aside. There is still time to save the euro. But it is high time to implement reforms before the next downturn puts unbearable strain on the entire euro system.

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NOTES

1. Hansjörg Herr, Jan Priewe, Andrew Watt: Introduction – reforms of the euro area and development of its four largest economies

1. The workshop was funded by the Macroeconomic Policy Institute (IMK) in the Hans-Böckler-Foundation and the Friedrich-Ebert-Foundation. We are very thankful for this support.
2. We use here AMECO data line RVGDP which can differ slightly from other data due to different estimations of the population data in Member States.

2. László Andor: EMU deepening in question

1. See here: http://bruegel.org/author/the-eiffel-group/
2. See here: http://bruegel.org/author/the-glienicker-group/
3. Presidents of the European Council, European Commission, European Central Bank and the Eurogroup (Herman Van Rompuy, Jose Manuel Barroso, Mario Draghi, Jean-Claude Juncker).
4. http://www.europarl.europa.eu/sides/getDoc.do?type=REPORT&reference=A7-2012-0339&language=EN
5. Proposals: establishing a European Monetary Fund, integrating the substance of the Treaty on Stability, Coordination and Governance into the Union's legal framework, establishing new budgetary tools for stabilisation as well as a Finance Minister for the euro (Watt 2017).
6. Ironically, Denmark, that has the right to keep its national currency forever, from an economic point of view, is closer to the eurozone than some other non-eurozone countries that maintain floating currencies and inflation targeting regimes, like Sweden or Poland.
7. The first significant appearance of unemployment insurance is the 1975 Marjolin Report. The most recent one is a proposal by German Finance Minister Olaf Scholz based on loans to support national unemployment benefit schemes at times of major crises.

3. Jérôme Creel: Macron's reforms in France and Europe: a critical review

1. Excerpts from the Sorbonne's speech come from the translation on the *France Diplomatie* website

https://www.diplomatie.gouv.fr/en/french-foreign-policy/european-union/events/article/president-macron-s-initiative-for-europe-a-sovereign-united-democratic-europe
2. https://en-marche.fr/emmanuel-macron/le-programme/europe.
3. http://www.elysee.fr/declarations/article/speech-by-m-emmanuel-macron-president-of-the-republic-on-receiving-the-charlemagne-prize/
4. An additional amount of €25 billion would be dedicated to financial and technical support for reforms in euro area countries (or countries willing to join). This amount is not part of a macroeconomic stabilisation tool *per se*. In June 2018, the French and German governments made the so-called "Meseberg Declaration" in which they both backed the establishment of a "Eurozone budget within the framework of the EU to promote competitiveness, convergence and stabilisation in the euro area, starting in 2021 (and) defined on a pluriannual basis". The declaration does not mention the size of the budget.
5. These computations do not include the stimulus package of late 2018 that will positively impact the purchasing power: the waiver on fuel taxes' rise, the increase in the social security benefit that supports the occupation and purchasing power of low-income workers (an employment bonus known as "prime d'activité" in French), non-taxable end-of-the-year wage bonuses and measures towards low-to-middle-income retirees.

4. Sergio Cesaratto and Gennaro Zezza: What went wrong with Italy and what the country should fight for in Europe

1. http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=lfsa_epgar&lang=en

5. Jorge Uxó, Nacho Álvarez and Eladio Febrero: The rhetoric of structural reforms: why Spain is not a good example of "successful" European economic policies.

1. European Commission web page: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction_en
2. European Commission (2017).
3. Macron (2017).
4. Martínez and Urtasun (2017) distinguish four types of consumption products: staple goods; quasi-fixed expenditure (primarily related to basic supplies); non-essential non-durable goods; and durable goods.
5. The cyclically adjusted balance had been increased by 4 p.p. in 2013, but it decreased by 0.9 p.p. in 2015 and 0.6 p.p. in 2016. The contribution of public demand – public consumption and public investment – to GDP growth was negative (-1.3 percent) for the period of 2011-2013, while it has been slightly positive

in 2014-2017. The end of fiscal cutbacks helped the private sector to restart economic growth, activating the fiscal multiplier (see Uxó et al. 2018 for a revision of the potential effects of expansive fiscal policies in Spain).

6. IMF (2017) reports that "except for some fast-growing smaller sectors such as information and communications, the new service-sector jobs are generally in the lower-productivity segment, including in tourism-related activities, and just over half are of temporary nature."

6. Jan Priewe: Germany's current account surplus – a grave macroeconomic disequilibrium

1. Data from AMECO or World Development Indicators (World Bank), unless stated otherwise.
2. BT-Drucksache 18/12197, 02.05.2017. Own translation. Indeed, in-depth reports of the European Commission (EC) did not qualify the German surplus as "excessive" even though the analysis in the report states that the surplus is persistently too high and has clear negative spillover effects. If it were considered excessive, a formal procedure against Germany would have to start. That the current accounts must not be seen at a national level contradicts the "Macroeconomic Imbalance Procedure" of the EC.
3. See data from the US Bureau of Economic Analysis (BEA 2018) and World Economic Outlook (2018).
4. Destatis data sent to author. Data differ from Eurostat which overstates extra-EU trade surplus. Destatis uses a different definition of "country of origin" for assigning imports to specific countries.
5. Income elasticity measures the growth rate of demand for imports relative to the growth rate of national income (or GDP).
6. The price elasticity may change beyond certain thresholds (non-linearity).
7. In 2014 it was 19.4 percent for consumption and 27.5 percent for investment; estimating weights of 0.78 and 0.22 for consumption and investment, respectively, gives an average of 21 percent import content of final domestic demand.
8. Many observers blame the Target 2 payment system for causing deficits. However, the period 1999-2008 shows clearly huge intra EMU imbalances but no Target 2 imbalances. Target 2 imbalances after 2008 have different causes.
9. If the external surplus of EMU were reduced to balance, but the surplus of the four main surplus makers were maintained, the rest of the 15 EMU members would face a deficit of 5.5 percent on average (data for 2017).

7. Hansjörg Herr, Martina Metzger, Zeynep Nettekoven: Financial Market Regulation and Macroprudential Supervision in EMU – Insufficient Steps in the Right Direction

1. According to the Financial Stability Report (2018) which covers 29 jurisdictions representing over 80 percent of global GDP all financial institutions end-2016

held assets of 340 trillion US-Dollar, around 18 times the value of US-GDP in 2016. Of this, 53 percent is held by banks (deposit-taking institutions) and 47 percent by institutions in the group of Monitoring Universe of Non-bank Financial Intermediation (MUNFI), also referred to as non-bank financial intermediation. Of the assets of MUNFI around 62 percent is held by Other Financial Intermediaries (OFI), the rest mainly by insurance corporations, pension funds, public financial institutions, financial auxiliaries (institutions related to financial intermediation which do not take over financial intermediation themselves, e.g. investment brokers, corporations that provide infrastructure for financial markets, etc.) and central banks.

OFI include mainly

- hedge funds (highly leveraged and speculative funds of rich investors investing in all types of assets),

- money market funds (leveraged fund investing in short-term assets that guarantees owners the withdrawal of their shares without losses),

- investment funds (excluding money market funds and hedge funds, with 38 percent of OFI assets the most important group in OFI) (leveraged funds for a large group of investors, partly specialized in certain investment areas, equity funds invested in stocks, fixed income funds in debt securities, mixed funds in both)

- real estate investment trusts (REIT) (leveraged funds investing in real estate)

- structured finance vehicles (SIV) (borrows short-term and invests in long-term assets, creating so-called structured finance products like mortgage-backed or asset-backed securities or collateralized debt obligations/CDOs)

- broker dealers (brokers working on own account)

- central counterparties (CCPs) (CCPs place themselves between buyers and sellers of assets (for example derivatives), they guarantee the obligations under the contract agreed between the buyers and sellers, the two counterparties)

- captive financial institutions and money lenders (CFIMLs) (CFIMLs are usually wholly owned by the parent organization, for example institutions owned by a car manufacturer or retailers giving consumer credit to buyers.)

- finance companies (asset management companies of multinational firms, institutions of big firms to take credit for different subsidiaries of the firm, etc.)

2. If not indicated otherwise the source for European macroprudential institutions is the ESRB website (www.esrb.europa.eu).
3. These are electronic platforms acting as authoritative registries of key information regarding open Over The Counter (OTC) derivatives trades.
4. Some of these capital requirements apply to some investment firms in the EU. Investment firms are included in the broad shadow banking system definition of the ESRB (2018). The EBA (2015) puts investment firms under 11 different categories according to their authorized activities as defined in the Markets in Financial Instruments Directive (MiFID) II (Parliament and Council Directive 2014). Accordingly, large investment firms with a full range of investment services and investment banking activities (category 11) are subject to minimum capital requirements of 8.0 percent just like banks. A significant number of these investment firms in the EU are located in the United Kingdom. Investment firms in the other categories of activity are subject to weaker capital requirements relative to the large firms. The large investment firms are also subject to the different capital buffers. Investment firms which are not authorized to deal on own account and/or to underwrite and place financial instru-

ments are exempted from these buffers (EBA 2015). The European Commission (2017) proposed revising the capital requirements for investment firms in a way that the largest investment firms would still be treated like banks, but medium-sized and small investment firms would be subject to more relaxed capital requirements.
5. The minimum capital requirements and the surcharge on G-SIIs have a phase-in period after which a fully-fledged application will start in January 2019. The discretionary buffers - countercyclical capital buffer and systemic risk buffer - and O-SIIs surcharge have different phase-in periods defined by the Member States (ECB 2018a; 2018b).
6. The exposure includes (a) on-balance sheet exposures; (b) derivative exposures; (c) securities financing transaction exposures; and (d) off-balance sheet items.
7. Available stable funding is based on liabilities' maturities and probability of funding sources' withdrawals with a time horizon of 1 year. Required stable funding of a bank is calculated according to its assets' liquidity risk profile and off-balance sheet exposures (BCBS 2014).
8. The interest-coverage ratio is calculated by dividing a company's earnings before interest and taxes during a given period by the company's interest payments due within the same period.

9. Sebastian Dullien: Macron's proposals for euro area reform and euro-area vulnerabilities: A systematic analysis

1. This enumeration is mostly based on Dullien (2017).
2. This section is mostly based on Dullien (2017).
3. However, he underlines his commitment to existing fiscal rules by saying: "The solidarity required for a budget must be combined with increased responsibility, which starts by observing the rules we have set ourselves [...]"

10. Annamaria Simonazzi, Giuseppe Celi, Dario Guarascio: Developmental industrial policies for convergence within the European Monetary Union

1. The "currency snake" (or "snake in the tunnel") was the currency system of the European Economic Community from 1972 until 1979, followed by the "Economic Monetary System" (EMS), with the ECU (European Currency Unit) as the benchmark. Both systems aimed at fixed but adjustable exchange rates amongst European countries after the breakdown of the Bretton Woods currency system in 1973.
2. The European Dependency School used elements of the Latin American dependency paradigm to explain the European situation in the 1970s and 1980s in terms of core-periphery relations. For many, the European integration process entailed the risk of exacerbating the dependent development of the South thus aggravating the dualism (see Seers et al. 1979 and Weissenbacher 2018 for a survey of the main propositions).

3. Simonazzi and Ginzburg (2015) highlight the role played by income effects (the increase in the share of low-wage employment in Germany) in diverting German imports from the 'luxury' goods produced by the southern periphery to the low-quality, cheaper consumer goods of China. This outcome adds to the negative effects of the growing interconnections of the German industry with the eastern periphery, and declining linkages with the southern periphery.
4. Peneder (2018, p. 829) argues that "the ubiquitous rationalities of failure, be it of markets, governments or systems, are rooted in a peculiar habit of accepting hypothetical perfect states as normative benchmarks".
5. See Bugamelli and Lotti (2018) for an explanation of the Italian productivity problems along these lines.
6. In the last crisis, adjustment in Germany occurred mostly within the firm through working time flexibility; conversely, in Italy, second-tier suppliers bore the brunt of the collapse in demand.
7. In a recent paper, Liu (2017) stressed the cumulative effects of the backward and forward linkages connecting the various sectors. While the author focuses on the cumulative effects of market distortions, which justify government interventions, his analysis holds true also for interventions aimed at dealing with bottlenecks deriving from a hollow productive structure and missing capabilities.
8. Breschi and Cusmano (2004) speak of the unintended creation of an 'oligarchic core' made up of industry, academics, technology leaders and public actors. "The lobbying can mean that funding does not flow to regions and sectors most in need, but rather to those with a strong voice." (Farla et al. 2016, p. 373).
9. With particular reference to manufacturing, Industry 4.0 refers to the technological evolution from embedded systems (ES) to cyber-physical systems (CPS). By means of technologies such as Internet of Things, Advanced Manufacturing and Decentralised Artificial Intelligence, efficiency and flexibility in governing production lines and VCs is expected to rise substantially.
10. Recognition of the threats entailed by uneven adoption of Industry 4.0 across Europe can be found in EC documents (see, for example, the EC Industry 4.0 briefing of September 2015 and the analytical study commissioned by the European parliament in 2016). However, as noted in the text, this awareness has not yet translated into a concrete industrial policy.
11. The ER region compares with Germany's *Mittelstand* business system, which is characterised as a large, dynamic population of SMEs that can leverage a range of non-company resources to facilitate transition to new products and technologies.
12. See Bianchi and Labory (2018) for a description of the thick network of public and private institutions active at the regional level.

11. Marianne Paasi: Challenges of EU innovation policy – Research & Development in a changing post-crisis world

1. Notes to the Figure: (1) KR: There is a break in series between 2007 and the previous years. (2) JP: There is a break in series between 2008 and the previous years and between 2013 and the previous years. (3) US: (i) R&D expenditure does not include most or all capital expenditure; (ii) There is a break in series between

2003 and the previous years. (4) CN: There is a break in series between 2009 and the previous years.

2. South Korea would qualify as the moving frontier in view of the extremely high growth in its R&D intensity at a higher level than that of the EU-28 (see Figure 1).
3. The European innovation scoreboard (2018) classifies the EU countries in innovation leaders, strong innovators, moderate innovators and modest innovators. The group of innovation leaders may vary over the years, also because of new classifications. For example Germany and the UK are not always in the innovation leaders group. As the paper focus is on R&D investment, the UK, Netherlands and Luxembourg – all with rather low R&D intensity (see Figure 2) - in the innovation leaders' group 2018 are not included in the underlying analysis.
4. The countries in the middle group, called the strong innovators in the EIS 2018 classification, are not included in this analysis.
5. Not included are Romania and Bulgaria as so-called "modest innovators" and Croatia that only joined in 2007.
6. Along with the so-called Gerschenkron Hypothesis: it is cheaper to adopt external and internal (existing) technologies than to develop them from the scratch.
7. A proper causality analysis would be needed which is very challenging methodologically.
8. The public sector funding does not include the use of other policy instruments such as governments' indirectly supporting private R&D by providing additional R&D subsidies or R&D tax incentives. Therefore, it is difficult to assess whether the declines relate (fully) to consolidation pressure or to the present trend towards the use of indirect instruments to support business sector R&D investment.
9. This paper concentrates on the productivity dynamism in the post-2008 period in the context of the R&D gaps of the EU and does not deal explicitly with the academic debate on the observed long-term, global decline in productivity growth rates which pre-dates 2008. The convergence of total factor productivity had already slowed down from mid-1995 in the euro area (see European Commission 2013).
10. TFP dynamism is seen as a proxy for technological progress and innovation performance - R&D being one of its main determinants.
11. Data on intangible assets is available from the National Accounts and from a new dataset on intangibles which are not included in the National Accounts and which is called INTAN-Invest.net (www.intaninvest.net).
12. Instruments such as government R&D funding, tax R&D credits, or R&D subsidies.
13. The European Research Area policy (ERA) addresses the fragmentation of the EU science system. Coordination of research policies involves monitoring of the Europe 2020 headline target for R&D (3% of GDP).
14. Today European Research Council (ERC) and the SME program also give individual grants.
15. Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Romania, Slovakia and Slovenia. In: http://ec.europa.eu/programmes/horizon2020/en/h2020-section/spreading-excellence-and-widening-participation
16. Cohesion fund countries comprise: Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Romania, Slovakia, and Slovenia. See: http://ec.europa.eu/regional_policy/en/funding/cohesion-fund/

17. Structural funds can make a large part of R&D funding in the technologically lagging Member States as Veugelers 2014a, 2014b points out.
18. See https://ec.europa.eu/jrc/en/research-topic/smart-specialisation.
19. Ireland, Greece, Cyprus, Portugal and Spain required EU-IMF/ESM financial assistance. Also Hungary, Latvia and Romania.
20. The recently established Structural Reforms Support Service (SRSS) provides support for the preparation, design and implementation of growth enhancing reforms (on voluntary basis and with financial support).
21. For example, see the hypothesis about the negative effect of Italian non-merit based recruitment on its productivity growth since mid-1990s as the global circumstances changed (Pellegrino et al. 2017).

12. Christian Calliess: Better Governance in the Euro Area

1. ECJ, Case C-370/12, para. 69.
2. ECJ, Case C-370/12, para. 130: "It must be stated at the outset that it is apparent from the wording used in Article 125 TFEU, to the effect that neither the Union nor a Member State are to 'be liable for the commitments' of another Member State or 'assume [those commitments]', that that article is not intended to prohibit either the Union or the Member States from granting any form of financial assistance whatever to another Member State."
3. ECJ, Case C-370/12, para. 137.
4. ECJ Case C-370/12, para. 136, 137.

13. Agnès Bénassy-Quéré et al.: How to reconcile risk sharing and market discipline in the euro area

1. Available here:
   https://cepr.org/active/publications/policy_insights/viewpi.php?pino=91

14. Peter Bofinger: No deal is better than a bad deal

1. Available here: https://voxeu.org/article/cepr-policy-insight-91-no-deal-better-bad-deal

15. Hansjörg Herr, Jan Priewe and Andrew Watt: Conclusions: euro area reforms – the ways ahead

1. See Five Presidents Report (EC 2015), European Commission (EC 2017), President Macron in various speeches, Claeyes (2017), Watt and Watzka (2018), Sawyer (2016), Hein (2017), Palley (2017), Eichengreen/Wyplosz (2016), Wolff (2018).

2. SBBS differ from Eurobonds in a variety of versions which are issued by a European public institution as a normal bond. See for an overview EC 2018.
3. Germany increased VAT by three percentage points in 2007. Because exports are not subject to VAT, but imports are, the VAT hike made imports more expensive. The effect is similar to a three percent import tariff. A VAT reduction could reverse such effects.
4. The financial crisis in Iceland may be an exception (2008-11), but it is a case of indebtedness in foreign currency incurred in the course of rescuing banks.