Can euro area governance be improved?

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Abstract

The economic crisis which started in 2008 led to a strong rise in public debts. The sovereign debt crisis in euro area southern countries broke the unity of the euro area and weakened the 'single currency' concept. The paper shows that this situation is not due to a lack of fiscal discipline in Europe, but to drifts in financial capitalism and to an inappropriately designed euro area economic policy framework. Public debts homogeneity needs to be resettled in Europe. European public debts should become safe assets again, and should not be subject to financial markets' assessment. EU Member States should not be requested to pay for past sins through austerity measures, and should not strengthen fiscal discipline through rules lacking economic rationale. The paper deals with recent proposals which have been made to improve euro area governance (redemption fund, European Treasury, euro-bonds, public debt guarantee by the ECB). The paper advocates for a full guarantee of government bonds for the Member States who commit to an economic policy coordination process, which should target GDP growth and coordinated reduction of imbalances.

Keywords**:** EU fiscal policy, EU governance.

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1. The drawbacks of the current framework

The drawbacks of the euro area framework have been highlighted by the widening of divergences and imbalances between euro area Member States (MS) from 1999 to 2007 and the 2007-2013 crisis. Prior to and after the beginning of the crisis, the European institutions and the MS have been able neither to implement a common economic strategy nor a satisfactory economic policy coordination. The single currency suffers from seven original sins, which are difficult to correct:

- According to economic theory, there cannot be a single currency between countries with different economic situations and independent economic policies. The single currency requires the implementation of precise, well-defined and binding constraints, solidarity mechanisms or economic policy coordination. How to prevent otherwise the emergence and persistence of imbalances between some countries running large external deficits and some others running large surpluses?

- These mechanisms cannot consist in rigid numerical rules enshrined in a Treaty and lacking economic foundations (such as: public deficits should not exceed 3% of GDP, public debts should not exceed 60% of GDP, structural government budgets should be in balance in the medium-term). These mechanisms must be both soft (the objectives should be agreed between countries accounting for the current economic context) and binding (everyone must comply with decisions agreed in common). But how may governments with necessarily different interests and analyses reach agreement on economic policy strategies? How to convince a country to change its economic policy in order to meet common rules?

- The rules of the game should have been set by clearly considering all possibilities of symmetric or specific shocks, accounting for different objectives. What should be done if a country wishes to build current account surpluses? What should be done after a common or a specific shock? How to define the nature of the shock? But no such rules were settled and it is difficult for rules to fit all situations. For instance, no one could imagine in 1997 a situation where monetary policy would not be able to cut nominal interest rates, where public debts would have risen due to banking rescue packages, etc.

- On the one hand, there cannot be unconditional solidarity between countries with different social and economic systems. For example, Northern countries may refuse to support Southern countries, blaming them for not having undertaken the necessary structural reforms, for having let imbalances grow and for being unable to meet their commitments. On the other hand, such solidarity is a prerequisite for the single currency to be guaranteed.

- According to the EU Constitution, the ECB is not entitled to finance directly governments (Article 123, TFEU); financial solidarity between MS is forbidden (Article 125, TFEU). Thus, each MS has to borrow on financial markets without any guaranteed support from a central bank acting as a "lender of last resort". This raises the risk that some MS may not be able to fulfil their commitments and may default. MS public debt is no longer a safe asset. Financial markets started to realise this from mid-2009. After the experience of the Greek default, they

requested unsustainable interest rates to countries in difficulty, which increased further their difficulties.

- Euro area MS are now under financial markets' judgement and they do not control anymore their interest rates unlike Anglo-Saxon countries or Japan. But financial markets have no macroeconomic expertise, they are – and know that they are – self-fulfilling. However, Northern countries refuse a collective guarantee of MS public debts. They consider that the discipline imposed by financial markets is necessary. But disparity among interest rates is arbitrary and costly. In the long term, for instance, a country like Italy, with a 2 percentage points interest rates spread with France, would pay financial markets a premium of around 2.4% of GDP as a guarantee to an alleged default risk.

- The 2007-2009 crisis is a deep crisis of financial capitalism, which would have requested a strong policy response from governments to reduce the weight of finance and the reliance on public and private debts, to implement a macroeconomic strategy aiming at full employment (see Mathieu and Sterdyniak, 2009)., But European authorities have denied any questioning of the pre-crisis strategy. This strategy is based on three postulates: the power of national governments should be reduced and handed over to European authorities; fiscal policies should be paralysed; growth should be sought through liberal structural reforms. This strategy has not delivered so far: the euro area remains in depression.

A single monetary policy for countries where GDP growth rates and inflation rates structurally differ inevitably generates imbalances. Before the crisis, disparities had been growing in the euro area between two groups of countries implementing unsustainable macroeconomic strategies: Northern countries (Germany, Austria, and the Netherlands) implemented neo-mercantilist strategies which allowed them to accumulate competitiveness gains and large current surpluses, while Southern economies were accumulating large current account deficits due to robust growth strategies boosted by negative real interest rates (Deroose *et al*., 2004; Mathieu and Sterdyniak, 2007). The economic policy framework of the Maastricht Treaty was unable to prevent the rise in imbalances which became unsustainable when the crisis burst. The Commission made exhausting efforts in a vain battle against countries in economic depression which were not fulfilling the 3% of GDP limit for deficits (in particular France and Germany in 2003-06) without seeing that the danger lay in the rapidly growing countries, and that balanced public finances at the cost of a strong increase in private and external debts.

In 2007, several euro area countries were running large current account surpluses (Table 1): The Netherlands (8.1% of GDP), Germany (7.9%), Finland (4.9%), Belgium (3.5%), and Austria (3.3%), while other countries were running large deficits: Portugal (8.5% of GDP), Spain (9.6%), and Greece (12.5%). The 230 billion euros surplus in Northern economies initiated and financed the 180 billion euros deficit in Mediterranean countries. There is a relationship in the euro area, between one the one hand 'Germany-Netherlands-Austria' and on the other hand 'Spain-Portugal-Greece' which is similar with the 'United States' *versus* 'China' relationship at the world level and involves similar unsustainability. It raises the same

question: how to convince 'virtuous' countries to spend more and increase their real exchange rates so that 'sinner' countries can reduce their external deficits without depressing domestic output? The financial crisis put an end to the debt accumulation process.

Table 1. Current account balances in 2007

	Billion euros	% of GDP
Luxembourg	3.8	10.1
Netherlands	48.6	8.1
Germany	192.1	7.9
Finland	7.3	4.9
Belgium	12.8	3.5
Austria	9.1	3.3
Denmark	1.6	0.7
Italy	-27.7	-1.7
France	-43.0	-2.2
Slovenia	-1.6	-4.6
Slovakia	-2.8	-4.7
Ireland	-10.1	-5.3
Portugal	-16.0	-8.5
Spain	-105.1	-9.6
Greece	-33.4	-12.5
Total	39.4	0.4

Source: IMF.

The 2007-2013 crisis is first of all a banking and financial crisis, due to hazardous and unregulated financial innovations, in a context of financial liberalisation and globalisation. Markets were greedy, blind, and volatile. The crisis is also due to the huge increase in capital stocks coming from neo-mercantilist economies, raw material exporting economies, pension funds, or the wealthiest in emerging and advanced economies, tracking the most profitable financial opportunities. Monetary policies allowed private debts, financial and housing bubbles to rise, which supported output growth without higher wages or social incomes. Last but not least, the world economy became more fragile due to the strategies run by mercantilist countries (like China and other Asian emerging economies, Germany, and other Northern Europe economies) pursuing competitiveness gains and cumulating external surpluses. Financial globalisation has allowed the rise of imbalances which eventually burst.

The crisis is not due to the rise in public debts and deficits. In 2007, the public deficit for the euro area as a whole amounted to 0.6 % of GDP, well below the level ensuring debt stability. Nevertheless, the crisis led to a huge rise in government debts and deficits. Initially this rise in debts and deficits was due to government measures implemented to rescue banks, later to measures implemented to support output, and finally to the automatic fall in tax revenues resulting from lower output growth. From 2007 to 2013, public debt increased by 29 percentage points of GDP in the whole euro area in terms of Maastricht debt, less rapidly than

in the US (+41 percentage points), in the UK (+50 percentage points) or Japan (+60 percentage points, Table 2).

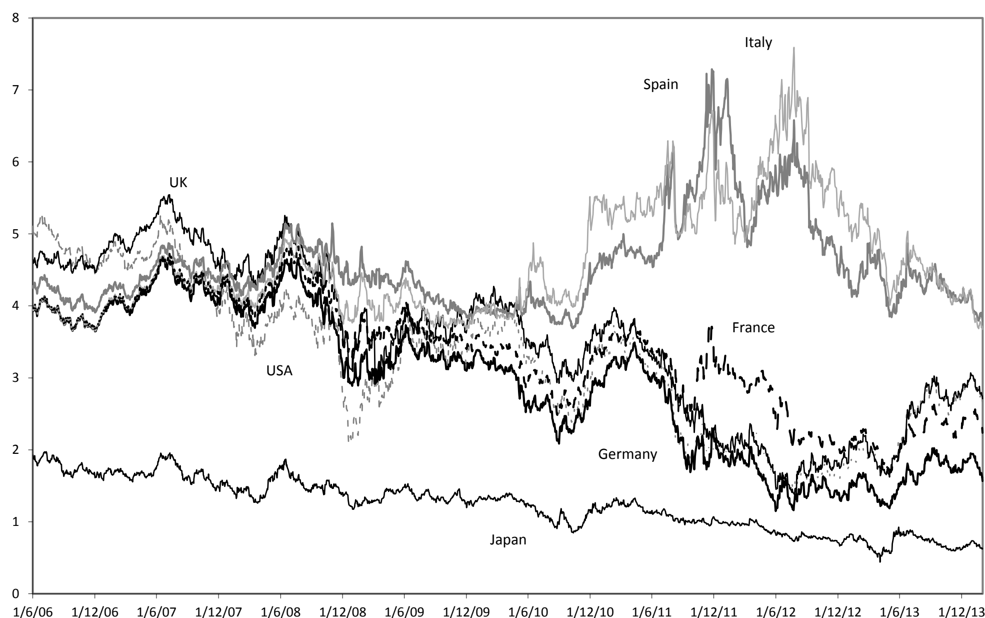
Table 2 Public debts in 2007 and 2013, as % of GDP

	Gross debt, Maastricht definition		Net debt	
	2007	2013	2007	2013
Germany	65	80	43	49
France	64	95	36	73
Italy	103	133	91	117
Spain	36	95	18	67
Netherlands	45	75	27	45
Belgium	84	100	73	83
Austria	60	75	31	51
Greece	107	176	86	123
Portugal	68	128	50	90
Finland	35	58	-73	-52
Ireland	25	124	0	89
Euro area	*66*	*95*	*43*	*68*
UK	44	94	26	74
US	64	105	44	82
Japan	183	243	81	144

Sources: European Commission DG-ECFIN, AMECO, autumn 2013; OECD, *Economic Outlook*, December 2013.

Figure 1. 10-year government interest rates

In percent



Source: Financial markets, Datastream.

During the crisis, monetary policies have become strongly expansionary, with central banks' interest rates having been cut down to almost 0. In view of the depth of the recession, markets expect interest rates to remain durably low, and hence long-term interest rates have fallen (Figure 1). Thus, the 10-year government bond rate decreased from 4.6% in 2007 to 1.8% in 2012 in the US, from 5% to 1.9% in the UK, from 1.7% to 0.8% in Japan, despite the rise in public deficits and debts. In the euro area, interest rates fell also in Germany (from 4.2% to 1.5%), in France (from 4.3% to 2.6%), but financial markets fearing or betting against sovereign debt default in Southern economies requested exorbitant interest rates, i.e. on average in 2012: 5.5% for Italy, 5.9% for Spain, 6.3% for Ireland, 11% for Portugal, 22.9% for Greece. Markets are self-fulfilling; they requested interest rates weighing on public finances stability and economic growth. They break the unity of the euro area, and destroy the 'single currency' notion: a Spanish company cannot borrow at the same rate as a French one. The interest rates that European countries have to pay are now conditional to financial markets fears or speculation.

Should States pay back their past sins by a redemption period? Should States aim to bring debts back to their pre-crisis levels? The answers to these questions depend on the diagnosis made on the roots of the crisis: is the crisis due to a general lack of fiscal discipline, to drifts in financial capitalism or to a euro area inappropriate framework? Section 2 criticises the lack of fiscal discipline diagnosis. Section 3 discusses the reforms introduced since the beginning of the crisis: Fiscal Pact, European Semester, ESM, OMT, consolidation strategy. Section 4 deals with the different recent proposals made with a view to bring the debt crisis in euro area countries to an end: more federalism, a European redemption fund, a European Treasury, eurobonds, public debt guarantees by the ECB. It is difficult, not to say impossible, to have simultaneously solidarity and autonomy. We advocate for a full guarantee of government bonds for the MS who commit to an economic policy coordination process, which should target GDP growth and coordinated reduction of imbalances.

2. A lack of fiscal discipline?

In order to assess public finance management before the crisis, one must go back to 2007. According to the OECD assessment released in the June 2008 *Economic Outlook*, the euro area output gap was nil in 2007; most euro area countries were close to potential output. Euro area inflation was stable at 2.1% per annum; the euro area unemployment rate had come down to 7.4%. In autumn 2012, the OECD revised its assessment: the euro area was now considered to have been running at over full capacity in 2007 with a positive output gap of 3.3%. But in 2007, there was no element on which such an assessment could be based; there was no sign of such imbalances.

In 2007, most Member States (MS) were running a primary government surplus, i.e. a 1.9% of GDP surplus for the area as a whole (Table 3). France and Portugal were the only countries running a primary balance slightly below the level requested to stabilise the debt-to-GDP ratio. The euro area primary balance stood 1.8 percentage point above this level. In fact, some

countries like Spain, Ireland, and even more Greece benefited from very low interest rates as compared to their robust GDP growth. Their public debts were stable, but this was fragile, because it was relying on the spread between interest rates and GDP growth. The post-crisis public deficits do not reflect pre-crisis structural fiscal imbalances.

Table 3. Public debt stability in 2007

	Government balance, % of GDP	Primary government balance, % of GDP	Net debt, % of GDP	Real interest rate less trend GDP growth, Percentage point	Stability gap, Percentage point
Germany	0.2	2.7	42.5	2.0	1.8
France	-2.7	-0.2	35.7	0.3	-0.3
Italy	-1.6	3.1	87.1	0.9	2.3
Spain	1.9	3.0	17.7	-2.5	3.4
Netherlands	0.2	1.8	27.8	0.2	1.7
Belgium	-0.1	3.6	73.1	0.0	3.6
Austria	-1.0	1.0	31.4	0.1	1.0
Greece	-6.8	-2.3	82.4	-2.8	0.0
Portugal	-3.2	-0.6	49.7	0.5	-0.9
Finland	5.3	4.7	-72.6	0.1	4.8
Ireland	0.1	0.7	-0.3	-4.0	0.7
Euro area	*-0.7*	*1.9*	*40.1*	*0.3*	*1.8*
UK	-2.8	-0.8	28.3	-0.3	-0.7
US	-2.9	-1.0	48.0	-0.6	-0.7
Japan	-2.1	-2.1	80.5	0.9	-2.2

Explanatory note: the stability gap is measured as the difference between the primary government balance and the balance required to stabilise debt (net debt*long-term interest rate corrected from trend growth).
Sources: OECD *Economic Outlook*, 2008/1 and 2012/2, authors' calculations.

In 2012, the depth of the recession made it difficult to estimate potential output growth, if this concept makes any sense, and hence to assess structural government balance levels. According to the EC estimates, euro area potential output growth would be 0.5% only per year in 2012-13 and the euro area output gap would be -2.3%. All countries except Germany still have to make fiscal efforts in order to meet the objective of structural budgets in balance (Table 4). According to us, under the assumption that the financial crisis did not affect potential growth, the output gap is around -11 percentage points of GDP; the objective should be to run a primary structural budget in balance, which will be sufficient to stabilise the debt-to-GDP ratio, if the interest rate equals (or is lower than) the nominal GDP growth rate. Under the assumption that countries will be able to recover half of the output loss due to the crisis (Table 4, column 4), only Spain and Ireland need to make budgetary efforts, while most MS (Germany, Italy, Greece) run excessive structural balance surpluses. The priority is to recover the output lost since the beginning of the crisis. Euro area countries are in a better fiscal position than the US and Japan. The euro area does not suffer from past insufficient fiscal discipline. The roots of the crisis lie in the drift in the wage/profit shares in value added and in

the rise in inequalities which have led some MS to increase government deficits to support output. Deficits have risen since 2008 because of the magnitude of the crisis and of the inappropriate euro area economic policy framework.

Table 4. Government balances in 2012

% of GDP

	Gov. balance*	Structural balance* (EC)	Primary balance*	Structural primary balance**
Germany	0.1	0.1	1.9	3.0
France	-4.8	-3.6	-2.4	0.0
Italy	-2.9	-1.3	2.3	5.3
Spain	-8.0	-6.0	-4.5	-0.7
Netherlands	-4.0	-2.7	-2.8	0.1
Belgium	-3.4	-2.7	0.3	2.0
Austria	-2.5	-2.4	-0.8	1.0
Portugal	-6.5	-4.8	-2.4	0.9
Finland	-2.2	-0.8	-1.5	2.5
Ireland	-8.1	-7.6	-5.2	-1.2
Greece	-7.0	-1.2	-2.1	5.6
Euro area	*-3.4*	*-2.3*	*-0.7*	*2.1*
United Kingdom	-8.6	-4.7	-5.8	-2.6
United States	-9.3		-7.4	-5.6
Japan	-9.5		-8.6	-6.7

*Corrected for one-off measures; **Authors' estimates. Assumption: Countries will be able to recover half of the output loss due to the crisis.

Source: European Commission, *Winter Forecasts, European Economy*, February 2013.

3. The four-pillar EC strategy

1) Strengthening fiscal discipline

The Commission persists in keeping two points of view: the crisis is due to fiscal indiscipline; the functioning of single currency requires structurally budgetary positions in balance. On 29 September 2010, the Commission released a set of six directives (the Six-Pack) aiming at "strengthening economic governance", in other words the SGP fulfilment, without questioning its relevance. The Six-Pack contents were involved in the Fiscal Pact, ratified on 2 March 2012.

This Pact is a new step forward from liberal views against Keynesian economic policies and from EU authorities against domestic fiscal policies. Article 3.1 states that: "The budgetary position of the general government shall be balanced or in surplus. This rule shall be deemed to be respected if the annual structural balance of the general government is lower than 0.5% of GDP. The MS shall ensure rapid convergence towards their respective medium-term objective. The time frame for such convergence will be proposed by the Commission […]. The MS may temporarily deviate from their medium-term objective or the adjustment path towards it only in exceptional circumstances. A correction mechanism shall be triggered automatically in the event of substantial deviations from the adjustment path. The mechanism

shall include the obligation to implement measures to correct the deviations over a defined period of time".

Thus, running budgetary positions close to balance is enshrined in the Pact although it has no economic rationale. The true 'golden rule of public finances' justifies on the contrary that public investment is financed through borrowing, since investment expenditure will be used over many years. Besides, households, insurance companies, financial institutions wish to own public debt. If the desired public debt stands at around 80% of GDP and if nominal GDP grows by around 3.5% per annum (i.e. by 1.75% in volume and 1.75% in prices), it is justified to run a public deficit of around 2.8% of GDP. Besides, a public deficit is necessary when it allows reaching a satisfactory demand level leading to the highest output level not accelerating inflation, at a real interest rate close to GDP growth. There is no guarantee that running a government budget in balance is optimal. Since countries do not control anymore interest rates and exchange rates, they need degrees of freedom in the conduct of their fiscal policy.

The Pact requests MS to converge rapidly towards this objective, at a pace defined by the Commission, without accounting for the cyclical context. A temporary deviation would be allowed in case of exceptional circumstances, if "the deviation from the reference value results from a negative growth rate or from a cumulated fall in output over a prolonged weak period of growth as compared to the potential growth rate" but corrective measures should be taken rapidly. The Commission refuses to recognise that most euro area countries have been in such a situation since 2009, and persists to require the implementation of policies intended to cut rapidly deficits.

The Pact is based on the structural deficit notion, i.e.: 'deficit corrected from the cyclical component, excluding one-off and temporary measures'. But measuring such a deficit is problematic, especially in the event of strong macroeconomic shocks. In practice the estimates and methods of the Commission will have to be used. But they have two drawbacks. First, these estimates are always close to observed output, since the methods used consider as structural the fall in capital resulting from the investment fall during the crisis: this underestimates the cyclical deficit and will impose pro-cyclical policies. This will oblige MS to implement pro-cyclical policies, as we could observe since 2010.

Second, the estimates vary strongly over time. Hence, potential output estimates for 2006 were revised substantially downwards in 2008. In spring 2007, the Commission estimated that there was a negative output gap of 1% in France in 2006, i.e. the French economy was operating at below its potential. France had not yet reached back its potential output level since the 2002-2005 slowdown. Estimated potential growth for 2008 was 2.3%. In autumn 2011, the Commission considered that France had in 2006 a significantly positive output gap of 2.3% and that potential growth in 2008 was 1.6%. The French economy was therefore at a peak of activity. The potential output level estimate for 2006 was revised downwards by 3.3%. For 2012, what is the French output gap? The Commission (spring 2013) estimates it at -2.8%, implying that, due to the crisis, the French potential growth rate

decreased from 2% to 1.2%. The OECD estimate is -3.4%. If one assumes that the crisis did not affect potential growth, then the output gap is -8%. With the Commission's estimates, the French structural government deficit is 3.1% of GDP in 2012 and therefore France should pursue at least four years of budgetary efforts in the order of 0.75% of GDP per annum. These efforts will weigh on GDP growth and the 1.2% potential growth estimate will probably be validated. With an output gap estimate of -8%, the structural deficit is only 0.5% of GDP, well below the 2.4% of the "true golden rule" for France; clearly, the objective today should be to support output so that it reaches its potential level.

According to paragraph 3d, the structural deficit target can be lowered to 1% if debt stands below 60% of GDP. Let us consider a country with nominal GDP growing by 3.5% per year. If this country runs permanently a 1% of GDP deficit, its debt will come down to 28.6% of GDP. But nothing guarantees that the macroeconomic equilibrium may be ensured with *a priori* set values: public debt = 28.6% of GDP; public deficit = 1% of GDP.

According to article 3.2, MS should introduce in their constitution the balanced budget rule and an automatic correction mechanism if the public balance deviates from its target, or, if this cannot be done, a binding and permanent correction mechanism. Thus, unenforceable, vague and lacking economic rationale rules would have to be enshrined in the Constitutions.

MS will have to set up independent institutions in charge of verifying that the balanced budget rule and the adjustment trajectory path are met. This is one more step towards full technocratic management of fiscal policy. Will these independent institutions be entitled to question the fiscal rule or the adjustment path if they do not match the cyclical needs of the economy?

Article 4 repeats the rule according to which public debts should come down below 60% of GDP. This rule was already part of the SGP, but the Commission could not impose it. Thus, a country running a higher than 60% of GDP debt ratio will have to reduce this ratio by at least one twentieth of the gap with 60% each year. This rule assumes that a 60% of GDP ratio is optimal for and can be reached by all countries. But in Europe, countries like Italy or Belgium have run for a long time public debts of 100% of GDP (without mentioning Japan where it has reached 200% of GDP), without imbalances because these debts correspond to high domestic households savings (see also Box 1). However, for a country with a debt-to-GDP ratio of 90% and a nominal growth of 3% this implies that the public deficit is less than 1.115% of GDP. Hence this does not introduce additional constraints in the medium-term as compared to the balanced budget target.

According to article 5, a country under an EDP will have to submit its budget and its structural reform programmes for approval to the Commission and the Council who will also exert surveillance on their implementation. This article is a new weapon to impose liberal reforms to MS populations. A country under an EDP has to follow the expected adjustment path for its nominal deficit. Therefore it has to implement all the more restrictive policies than domestic growth is low.

Box 1: A Keynesian perspective

From a Keynesian perspective, a certain level of debt and deficit are necessary to ensure that demand equals potential output.

If $y = g + d + cy - \sigma r + kh$, with *y*, GDP, *g* public deficit, *d*, private demand, *r,* real interest rate, *h*, public debt, full stabilisation implies that in the short-run: $g = -d + \sigma r$

If this policy is implemented and if stabilisation is perfect, there is no link *ex post* between the deficit and the output gap. Let us note also that, in this case, g, government borrowing, is considered as structural according to the OECD or the EC methods, which makes no sense.

In the long run, g = 0 and $h = -(d - \sigma r)/k$

The long-term public debt level is not arbitrary, but depends on private agents' wishes: debt must equal desired debt at the optimal interest rate, i.e. the rate equal to the growth rate.

This simple model shows that a fiscal rule like: $g = g_{\circ} - \lambda y - \mu(h - \overline{h})$ cannot be proposed, since it would not allow for full stabilisation and since the government cannot set a debt target regardless of private agents' saving behaviour.

According to article 7, the Commission's proposals will be automatically adopted unless there is a qualified majority against them, the country concerned not voting. Thus, in practice, the Commission will always have the last word.

The Treaty does not introduce effective economic policy coordination, i.e. an economic strategy using monetary, tax, fiscal and wage policies to reduce economic imbalances in the MS and to come closer to full employment.

The Pact obliges MS to run quasi-automatic fiscal policies, prohibiting any discretionary fiscal policy. But the latter are needed to reach full stabilisation. Let us assume that the tax rate is 50% and that the propensity to spend is 1; then the multiplier equals 2. If private spending falls by 10 e*x ante,* GDP will fall by 20 and the public deficit will rise by 10 without active fiscal policy response. An active expansionary policy, which increases public spending by 10, leads to the same public deficit, but prevents the output fall. This is prohibited by the Pact, which is based on an implicit but wrong theory: automatic stabilisers must play, but discretionary fiscal policies to support growth should be prohibited.

According to the Pact, each country should run restrictive measures without accounting for the domestic economic situation and policies in the other MS. The Pact assumes implicitly that the Keynesian multiplier is zero, that restrictive policies have no impact on GDP. If we consider the situation in early 2013, this implies that all countries should run austerity policies even if their public deficits are due to insufficient output levels following the burst of the financial bubble. Also, the Pact may impose austerity policies in Europe for a long time, which will impede euro area growth and will increase imbalances in the most vulnerable MS.

2) Improving economic policy coordination

In 2011 a first 'European semester' was introduced, during which MS present their fiscal plans and structural programmes to the Commission and the European Council, who both give

their opinion before the vote in their national parliament in the second semester of the year. Such a process could be useful if the objective was to define an agreed economic strategy, but, in fact, this semester increases the pressure on each MS to implement austerity measures and liberal reforms. No agreed plans to reduce imbalances between MS or to support growth have been implemented in 2012, 2013 or 2014.

The Six-Pack allows the Commission to exert surveillance on the excessive macroeconomic imbalances in each country by following a scoreboard of relevant variables (competitiveness, external current account, public and private debts). A Macroeconomic Imbalance Procedure (MIP) has been introduced. Recommendations will be sent out to countries running imbalances. Fines may be decided. So far the Commission does not recommend coordinated strategies to support growth or to reduce imbalances. Until 2013, countries were criticised for running excessive public or external deficits, but not for running surpluses. In November 2013, for the first time, the external surpluses of Germany and Luxembourg were questioned by the Commission.

In June 2012, the Growth and Jobs Pact could be seen as re-orientation of the European Strategy, but it was not included in the EU major policies. A 120 billion euros amount was mentioned, i.e. 1% of euro area GDP, but these measures apply to an undefined time period, while fiscal consolidation policies amount to 2% of GDP per year. The European Council decision in January 2013 to cut the EU budget (in percentage of GDP) brought the hope of fiscal expansionary measures to an end.

3) *Implementing some degree of financial solidarity*

Financial solidarity increased progressively since the beginning of the crisis, despite the reluctance of Northern economies, especially of Germany. However, solidarity remains conditional and limited. In 2013, three mechanisms are in place.

The European Stability mechanism (ESM) launched in October 2012 introduces some degree of financial solidarity between the MS, but this solidarity is limited and has a very high price. The ESM can lend up to 500 billion euros. It may lend to governments or buy public debt on primary and secondary markets. Countries may benefit from the ESM if they have adopted the Fiscal pact and have fulfilled it. The ESM support will be conditional: a country needs to commit to fulfil a drastic fiscal adjustment programme imposed by the Troika, and will therefore lose all domestic fiscal autonomy and have to accept a long austerity period. The Greek example shows that this type of plan is not the way out of the crisis. The solidarity which is being implemented does not consist in donations but in loans.

The ESM debt will be considered prior to private ones. Public bond issuance should involve a collective action clause, i.e. in case of default, stated by the Commission and the IMF, the country will be entitled to agree with creditors on a change in payment conditions, the agreement applying to all creditors if a majority agrees. Euro area government debts will become speculative as was the case for developing economies, and will not be considered

anymore as a safe asset by financial institutions. The interest rate on public debt will rise, be more volatile and less easy to control. Why build the euro area to reach such a situation?

On 6 September 2012, the ECB announced a purchasing bonds programme on the secondary markets, for short-term bonds (1-3 years), the so-called OMT (outright monetary transactions). No quantitative ceiling has been set. The ECB does not set a target in terms of acceptable interest rate spreads. The ECB announces that it will not be a preferred creditor in order to show that it takes the same risks as private creditors. But the ECB interventions will be subject to strict conditionality. Countries will have to agree on an adjustment programme with the Commission and the European stability mechanism, the programme being coordinated by the IMF. The ESM will support the country through buying bonds on the primary market. Supported countries will have to make commitments in terms of fiscal consolidation and structural reforms. Since the bonds concerned have short-term maturities, the ECB will be able to stop buying them if the countries concerned do not fulfil their commitments.

Financial markets' fear was self-fulfilling: markets were afraid that Spain would default. Thus, they were refusing to lend to Spain or were requesting high interest rates, which was reinforcing default risks. Since these rates were also applying to companies, this was contributing to deepen the recession in the country. In putting no ceiling to its interventions, the ECB reassured markets on default risks in the concerned countries, on the risks of a euro area break-up. The ECB broke the spiral of self-fulfilling expectations, so that finally it did not have to intervene. Lower interest rates can help to boost activity. Conversely, countries will have to pursue severe austerity policies. The ECB imposes its views on the economic strategy to be implemented. It requests product and labour markets structural reforms; the full commitment to government balance targets despite the recession; the rapid implementation of the Fiscal Pact. There is a risk that austerity implemented simultaneously in the euro area leads the area to remain durably in crisis.

Although the OMT has not been used in practice, the simple fact that it exists has been sufficient to reduce substantially interest rates spreads to (considering the Dutch rate as a benchmark) 1.65 percentage points for Spain and 1.75 percentage points for Italy in January 2014. But this decrease in risk premia remains fragile. The cost of financial markets' distrust remains heavy (more than 2 percent of GDP for Italy). The euro area remains in permanence under the threat of financial markets' renewed defiance after election results or the release of a fiscal imbalance.

Moreover some German economists (see Doluca *et al*, 2012) consider that the ECB has gone beyond its mandate in committing itself to support public debt in some countries, that this is not an incentive for countries to implement the necessary reforms, and that the ECB should focus strictly on price stability.

Table 5: 10-year government interest rates

	February 2012	February 2013	May 2013	January 2014
Greece	40.8	11.1	9.6	7.9
Portugal	12.3	6.9	5.5	5.1
Spain	5.05	5.15	4.2	3.7
Italy	5.5	4.45	3.9	3.8
Ireland	7.8	3.1	3.45	3.2
Belgium	3.65	2.3	2.05	2.35
France	2.95	2.2	1.85	2.2
UK	2.1	2.1	1.9	2.8
Sweden	1.8	2.0	1.8	2.4
US	2.0	1.95	1.85	2.8
Austria	2.85	1.9	1.7	2.1
Netherlands	2.2	1.8	1.6	2.05
Finland	2.3	1.8	1.5	1.95
Germany	1.9	1.6	1.35	1.75
Japan	1.0	0.7	0.6	0.7

Source: Financial markets.

4) *Fiscal austerity in the euro area*

In 2012, the output gap remained significantly negative in all euro area countries. At the euro area level, the estimates varied at that time from -2.2% according to the Commission, to -3.7% for the OECD and -11% for OFCE. At the beginning of 2013, the Commission estimated euro area potential GDP to have grown by around 0.5% per year since 2009 (see EC Winter 2013 forecast). Such estimates suggest that Europe has no other choice but accept low growth and high unemployment. But there is no explanation as to how supply factors would have induced such a reduction in potential growth. If the only explanation is: "potential growth was affected by effective growth", then a growth recovery would lead to higher potential growth. Hence the potential growth concept has no meaning and is not useful for the conduct of economic policy.

Notwithstanding economic developments since the beginning of the 2007 crisis, the Commission pursues its strategy: requesting MS to maintain restrictive fiscal policies, independently of the economic situation, and to boost growth by structural reforms. Although this strategy failed to deliver, the Commission refuses to change its orientations, even though partly due to them, growth has fallen. Euro area GDP was forecast to grow by 1.8% in 2012 according to the Spring 2011 EC forecasts but turned out to fall by 0.6%; for 2013, GDP was forecast to grow by 1.3% in the Spring 2012 EC forecast, versus -0.4% in the Spring 2013 forecast (see Table 6). It may also be noted that the EC has revised downwards once again potential growth estimates in the recent period, for instance for 2012: from 1.1% according to the Spring 2011 forecast, to 0.8% one year ago and 0.3% in the Spring 2013 forecast. No

explanations are given for these revisions which are very surprising as many MS did undertake the required structural reforms supposed to increase their potential growth.

Table 6. Euro area GDP growth forecasts, according to DG ECFIN Forecasts

	2010	2011	2012	2013	2014
Spring 2011	1.8	1.6	1.8		
Autumn 2011	1.9	1.5	0.5	1.3	
Spring 2012	1.9	1.5	-0.3	1.0	
Autumn 2012	2.0	1.4	-0.4	-0.1	1.4
Winter 2013	2.0	1.4	-0.6	-0.3	1.4
Spring 2013	2.0	1.4	-0.6	-0.4	1.2

Source: *European Economic Forecast*, European Economy, European Commission.

Under the pressure of financial markets, of the European Commission (and of the Troika as concerns Greece, Ireland, and Portugal), all euro area MS have implemented fiscal consolidation policies starting from either 2010 or 2011. According to our estimates based on pre-crisis trend output and on the latest EC Forecast, these policies amount on average to around 1.7% of GDP in 2011, 2.0% in 2012 and 1.1% in 2013 (see Table 7). From 2010 to 2014, the cumulated negative fiscal impulse will reach about 24.5% of GDP in Greece, 14% of GDP in Portugal, 12 % in Ireland and in Spain. Fiscal tightening weighs mainly on the expenditure side: 80% at the euro area level, with two exceptions, Belgium and France, where tax increases are more substantial.

Table 8 shows the impacts of the tightening fiscal plans as described in Table 7, using a small Keynesian model. The model accounts for the 'direct impact' of these policies, on the basis of domestic multipliers (slightly above 1 for the larger economies). It also accounts for the impact through external demand of fiscal plans announced in the euro area countries, the UK, the US and Japan (the global multiplier is 1.4). It assumes that interest rates will not be affected as these restrictive policies will not improve strongly debt ratios. The cumulated negative GDP impact would reach 8.0 percentage points for the euro area, but 16 percentage points in Spain, 17 percentage points in Portugal, 32 percentage points in Greece. The ex-ante favourable impact of restrictive fiscal policies on public balances would be strongly reduced by this depressive effect. The public debt-to-GDP ratio would increase in many countries, due to the strong fall in output.

Countries having to implement restrictive fiscal policies suffer from large output falls and high unemployment. In such circumstances, government deficit targets are not met, which will justify additional restrictive measures, etc. Each quarter, governments are required to introduce additional austerity measures, mainly cuts in social and public expenditures, which depress consumption and activity.

Table 7. Fiscal impulses

In % of GDP

	2010	2011	2012	2013	2014	Total	Spending	Receipts
Germany	1.5	-1.4	-1.2	-0.4	0.0	-1.5	-1.4	0.1
France	-0.5	-1.8	-1.5	-1.4	-0.8	-6.0	-2.1	3.9
Italy	-0.7	-1.2	-3.3	-1.2	-0.7	-7.1	-5.5	1.6
Spain	-2.6	-2.2	-4.3	-2.2	-0.7	-12.0	-11.2	0.8
Netherlands	-0.6	-1.3	-1.8	-1.7	-1.4	-6.8	-4.2	1.6
Belgium	-1.3	-0.1	-1.9	-0.7	-0.4	-4.4	-1.4	3.0
Austria	0.3	-1.7	-0.2	-0.9	0.0	-2.5	-2.0	0.5
Portugal	0.8	-6.1	-3.5	-3.7	-1.8	-14.3	-12.4	1.9
Finland	0.1	-1.9	-0.9	-1.7	-0.8	-5.2	-3.8	1.4
Ireland	-3.8	-2.0	-2.1	-3.0	-1.3	-12.2	-12.5	0.2
Greece	-8.4	-6.8	-4.5	-2.5	-2.2	-24.4	-17.5	6.9
Euro area	*-0.7*	*-1.7*	*-2.0*	*-1.1*	*-0.8*	*-6.3*	*-4.5*	*1.8*
UK	-1.8	-2.7	-0.3	-0.9	-1.3	-7.0	-5.9	1.1
US	0.1	-2.0	-1.1	-2.1	-1.2	-6.3	-4.1	2.2
Japan	0.4	-0.5	0.5	0.4	-2.0	-1.2	-1.0	0.2

Explanatory note: Fiscal impulses are calculated as changes in structural primary balances, based on pre-crisis trend GDP growth. Source: Authors' estimates.

Table 8. Fiscal impulse impacts on GDP, public deficit, and public debt 2011-2013

In % of GDP

	GDP						Public balance	Public debt
	2010	2011	2012	2013	2014	Total	2014	2014
Germany	1.2	-1.7	-1.6	-0.7	-0.2	-3.0	+0.2	+2.6
France	-0.7	-2.4	-2.2	-1.9	-0.8	-8.0	+1.6	+2.2
Italy	-0.9	-1.8	-4.0	-1.6	-1.0	-9.3	+2.6	+3.8
Spain	-3.1	-3.2	-5.65	-3.0	-1.1	-16.1	+4.8	-0.7
Netherlands	-0.55	-1.3	-1.8	-1.7	-1.2	-6.3	+3.6	-3.2
Belgium	-1.0	-0.5	-1.8	-0.85	-0.5	-4.7	+2.0	-2.2
Austria	0.35	-1.9	-0.7	-1.0	-0.1	-3.4	+0.8	0.0
Portugal	0.4	-6.7	-4.4	-4.2	-2.0	-16.9	+6.7	+2.1
Finland	0.0	-2.0	-0.9	-1.7	-0.8	-5.4	+2.3	-2.6
Ireland	-3.1	-2.0	-3.0	-2.6	-1.2	-11.9	+7.4	-9.7
Greece	-9.2	-7.9	-9.5	-3.1	-2.6	-32.3	+9.9	+12.6
Euro area	*-0.7*	*-2.25*	*-2.9*	*-1.4*	*-0.8*	*-8.0*	*+2.3*	*+0.7*
UK	-2.15	-3.5	-1.0	-1.45	-1.7	-9.8	+2.6	-0.2

Explanatory note: The fiscal impulses, as shown in Table 7, reduce euro area GDP growth by 0.7% en 2010, …, 0.8% in 2014. In 2014, the cumulated impact on euro area GDP is -8.0 %; the public balance is improved by 2.3 percentage points of GDP, but the debt/ratio increases by 0.7 percentage point. Source: Authors' calculations

Before the crisis, the development of neo-classical or DSGE models at the expense of *old* Keynesian models, in particular in international institutions (IMF, ECB, EC) spread out the

idea that the fiscal multiplier is very low, even in a rather closed economy, in the order of 0.5 in the short-term and nil after 2-3 years. In many of these models, restrictive policies do not have any detrimental impact on output, thanks to three assumptions (see also Creel *et al.,* 2005). Households anticipate that a permanent decline in public expenditure will reduce their taxes in the future and therefore they immediately increase their consumption, which offsets the decline in public expenditure (Barro-Ricardian effect). Sometimes, the expected decline in taxes leads households to anticipate that labour supply (and then GDP) will increase: the rise in consumption is higher than the cut in public spending, which induces a negative multiplier. The economy is always operating at full capacity, or very close to it, thanks to price flexibility and monetary policy: a decline in output would induce a strong fall in inflation, and then a strong decline in interest rates which supports activity.

The crisis has shown that the output level depends on the demand level, that a strong decrease in demand, like in 2008, is not offset by automatic mechanisms. Economists (and international institutions) have re-discovered that the Keynesian multiplier is large, in the order of 1 to 1.5; that the multiplier is larger in a situation of high unemployment than when the economy operates at full capacity (but why implementing a fiscal stimulus in a full employment situation?); that the multiplier is higher for public consumption, investment and social transfers than for tax cuts[1].

In the case of expansionary-fiscal consolidation episodes, described by some economists, restrictive fiscal policies where accompanied by elements which are not available today for euro area MS, such as exchange rate depreciation, interest rates cuts, increase in private borrowing thanks to financial deregulation, or a strong rise in private demand due to economic shocks (such as joining the EU).

In a depressed economic situation, restrictive fiscal measures have no impact on inflation and interest rates. Barro-Ricardian effects are unlikely in this context since austerity measures reduce households' incomes, since liquidity constraints are heavy on firms and households, since banks will not lend massively to private sectors in a low-growth/high uncertainty situation, and since austerity strategies imply that governments consider that potential output growth will be durably lower, which contributes to depress investment. There is no certainty that risk premia will decrease since public debt ratios will not decrease substantially and since fiscal policies implemented make the euro area fragile and worries markets. In a depressed situation, high unemployment puts downwards pressure on wages, which lowers households' incomes and thus their consumption. Low wages do not strongly increase profits because the fall in demand induces overstaffing. Higher profits do not induce firms to invest, given the weakness of production perspectives. No country benefits from competitiveness gains if the depression hits the whole area.

Can fiscal exit strategy ignore the causes of the crisis? The crisis is due to growth strategies based on downwards pressure on wages and social benefits. The fall in demand was offset by competitiveness gains in neo-mercantilist countries, by rising financial and real estate bubbles and households borrowing in Anglo-Saxon and Southern Europe countries. The failure of

[1] See *repentance* papers: Coenen *et al.* (2012); Holland and Portes (2012); IMF, *World Economic Outlook* (October 2012); Blanchard and Leigh (2013).

these two strategies has forced to use public deficits to support growth. Reducing public deficits requires the implementation of another growth strategy based on the one hand on wages and social incomes distribution, and on the other hand on a new industrial policy, on implementing and financing investment geared towards an environmentally sustainable economy. Before the crisis, public finances also suffered from tax evasion and tax competition. Restoring public finances requires to combat tax evasion and tax havens, to raise taxes on the financial sector, on higher incomes and wealth.

4. Towards a real and deep economic and monetary union?

The proposals made by the Commission in November 2012 in *A blue print for a deep and genuine monetary and economic and monetary union* suggest new steps towards technocratic federalism:

- 'All major economic and fiscal policy choices by a MS should be subject to deeper coordination, endorsement and surveillance process at the EU level'. The possibility of different economic or social strategies is forgotten or prohibited.
- The needs for strengthened fiscal discipline and for *ex ante* fiscal coordination are asserted. But, after the fiscal pact, what remains to be coordinated since all fiscal policies have to be run in autopilot mode?
- The Commission wants to have the power to suspend programmes payments to MS not taking the corrective action required by the Commission.
- The euro area could have a fiscal power to absorb asymmetric shocks (with is rather ironic once national governments have been deprived of the ability to implement specific fiscal policies).
- The EMU could be entitled to support structural reforms, i.e. to have a "convergence and competitiveness instrument", within the pseudo "golden rule" framework, i.e. balanced budgets. A country could sign an agreement with the Commission, according to which it would implement structural reforms (concerning, according to the Commission, the performance of labour and products markets, the efficiency of the public sector, employment and social inclusion, ...) and would therefore get a financial reward from other MS. But can we imagine that a country would get subsidies in order to abolish its minimum wage, or its public pensions system?
- The Commission wants to be able to oblige a MS to revise its national budget or to change its budget execution.
- The Commission considers the possibility for the euro area to have its own resources and to issue bonds.
- Short-term debts (Eurobills) could be mutualised under a EMU Treasury.
- A common European Redemption Fund (ERF) could be introduced to amortise public debts, with strict conditionality (see below).
- The role of the vice-president of the Commission in charge of economic and social affairs in the euro area should be strengthened; he will be in charge of the euro area Treasury; a Euro Committee should be settled in the European Parliament, the Euro-Group should be strengthened.

- The proposal to issue euro-bonds guaranteed by all MS or by the ECB has not been considered. Germany refuses to make unlimited and unconditional commitments to support the other MS. But how to strengthen the euro area without such commitments?

Many questions remain:

- Can we imagine all major economic and social decisions being made at the EU level, by the Commission without accounting for national votes and debates?
- Can we image a federal power able to account for domestic specificities in a Europe made of heterogeneous countries? Can we imagine a single policy implemented in different countries? Or different policies implemented through a central process?

We do not think that EU powers should be strengthened as long as the EU works as it currently does, as long as the EU does not implement a growth strategy, as long as it remains focused on liberal structural reforms, on public expenditure cuts and on absurd public finance criteria. EU institutions must show first that they can implement an efficient strategy before peoples and MS agree to enlarge their power.

Towards fiscal federalism?

Since the Fiscal Pact prevents in theory MS to implement stabilisation fiscal policies, some economists and the Commission have proposed to implement at the European level a system of transfers between MS to ensure that countries in good economic situation finance the MS in depression (see European Commission, 2013). In the spirit of these promoters, this system should avoid permanent transfers, each country should alternatively be paying or receiving transfer. Some (like Enderlein *et al.,* 2013) propose to base these transfers on output gap differentials, since, for a given country, the sum of output gaps is nil, by construction, over a long time period, forgetting that it is a vague concept, with a questionable and variable over time measurement: should there be refunds whenever the Commission revises its estimates? Should a country in depression wait for European funds to support its output and, meanwhile, run a restrictive pro-cyclical policy?

Some propose the unification of unemployment allowance systems, since they are pro-cyclical public expenditure, but national systems are currently very diverse and are often managed by social partners. The unemployment concept should be standardised (what about vocational training, disability pensions, or early retirement schemes?). A country having made efforts to reduce its unemployment rate will refuse to pay for high unemployment rates countries, and will blame the latter for not having undertaken the necessary reforms. Others propose transfers between countries based on differences in unemployment rates levels or variations: this raises the same problems. The proposed transfers are generally of small size and vanish if depression is widespread. Some economists estimate that the Commission could centrally manage stabilisation policies tools, but this is an illusion as the Commission minimises the negative output gap and prevents discretionary fiscal policies. According to us, MS do no need fiscal federalism, but they need to regain full freedom to undertake stabilisation fiscal policies.

5. Redemption?

Public debts in advanced economies have strongly risen during the crisis (Table 2). This results from the depth of the crisis itself and not from over-expansionary fiscal policies which would have been implemented, before or during the crisis, except in the case of Greece. There is no reason to exert redemption for implemented policies. The rise in public debts was implicitly desired (by households who wish to own safe assets, who do not want to bear financial markets risks while companies wish to deleverage), it is useless to try to reimburse debt as long as the factors which have caused the debt to rise remain. Given the current interest rates levels on public debt for major countries, the public debt level does not induce any rise in interest rates.

The rise in public debt increases the risk that public finances will be under financial markets supervision in the years to come. But this supervision is not satisfactory: financial markets have no macroeconomic perspective; they are pro-cyclical (they will impose efforts in bad times); their opinions are self-fulfilling which they are aware of; they do not incorporate all relevant piece of information, but mainly the piece of information which are 'in the mood of time'; they are schizophrenic, they request consolidation and growth policies at the same time. They have their own judgement on the needed appropriate economic policy, but is this necessarily the relevant one? There is a huge risk that MS set the objective of trying to escape financial markets' surveillance in cutting too rapidly and too massively government borrowing which would postpone the economic recovery indefinitely. MS ability to run active fiscal policies will be reduced. What would have happened if countries had refused to rescue banks in 2009, in order to avoid them to borrow on financial markets? Can financial markets be given the responsibility to assess public debt sustainability and public deficits usefulness?

Two strategies can be implemented today. We advocate for a first strategy: the possibility to run fiscal stabilisation policies should be maintained (or rather re-established), monetary policy should remain expansionary, public debt guarantee by the ECB should allow to bring interest rates below their growth rate in all euro area countries; wages should be increased in countries where the wage share in value added has substantially decreased; specific measures designed to support both public and private investment, as part of the environmental transition should be implemented. The debt-to-GDP ratio will fall thanks to growth recovery.

The second strategy consists in setting a binding agenda in terms of debt-to-GDP ratios with a view to bring the ratios back to their pre-crisis levels (see IMF, 2010). This raises three issues: it requests a negative fiscal shock, which will be substantial in the first years in order to be in line with the requested strategy, but such a shock leads GDP to fall which leads debt to rise. The debt reduction path is inconsistent with short term fiscal stabilisation needs, and may lead the commitment to be out of reach, or at a very high cost. There is no guarantee that the final debt ratio target, set *a priori*, is consistent with macroeconomic equilibrium.

The German Council of economic experts (2012) suggested the introduction of **a European Redemption Pact**, i.e. to set a redemption fund (RF) in order to guarantee the repayment of

the share of the debt above 60% of GDP. Countries where debt exceeds 60% of GDP (Germany, Austria, Belgium, Cyprus, Spain, France, Malta and the Netherlands), at the exception of countries under an adjustment programme (Greece, Ireland, and Portugal), would place in the redemption fund the share of their debt over 60% of GDP and, in counterpart, would transfer tax revenues allowing for a debt repayment over 25 years. France, for instance, would thus be able to transfer a debt share amounting to 27% of GDP, transferring revenues of 1.3% of GDP. Countries would transfer guarantees to the fund, like some part of their gold resources. Moreover, they would have to implement structural reforms programmes. This would reassure markets, who would agree to own this debt at an interest rate below current market rates (the authors consider a 4% interest rate, which is pessimistic since France borrowed in February 2013 at 2.3% for 10-year government bonds). Besides, countries should commit to the Fiscal Pact, i.e. bring rapidly their structural deficit to 0.5% of GDP. Thus the debt ratio would rapidly fall: in 2035, it would stand at 58.5% in Belgium (against 97% today), 53.5% in France (against 88%), 50% in Germany (against 82%), 60% in Italy (against 120%). However, countries would commit to strongly restrictive policies in 2012-2015, amounting to, according to the authors' calculations, 6.3% of GDP for Spain, 4.2% for France, 4% for the Netherlands.

The paper assumes that the Pact will allow interest rates to fall, as compared to a catastrophic basis scenario, where countries would implement similar austerity measures, while markets would continue to request high interest rates. Thus, it can be claimed that RF would have expansionary effects as compared to the catastrophic basis scenario. But it does not draw any lesson from the effects on past austerity policies on output, assuming implicitly that the fiscal multiplier is nil. What will happen if MS are unable to cut the public deficit by as much as initially requested, due to the impact of these generalized restrictive policies on growth and on fiscal revenues? The German Council of economic experts' paper does not consider the possibility that Europe goes through economic slowdown episodes in the next 25 years, which may require to soften restrictive policies and to abandon the Fiscal pact. What would happen then with the redemption pact? MS fiscal policies would have to negotiate their fiscal policy with the RF, in addition to the Commission and Council monitoring. During the RF existence, the coexistence of national debts with the RF debt will allow speculation on the capacity of individual MS to fulfil their commitments. The Pact does not question the factors which led public debts to rise. And how to be sure that, in some future, another crisis will not require public deficits and higher public debts?

We do not see what a redemption pact would add to the fiscal pact, since the fiscal pact already implies public deficits to be cut to 0.5% of GDP as long as debt is higher than 60% of GDP, 1% if debt falls below 60% of GDP, which, assuming a potential nominal growth rate of 3% per year would already lead the debt-to-GDP ratio to converge towards 33%.

On December 2012, the Commission Communication (2012) envisages the creation of such a fund, although its annex 3 criticizes its principle (in particular, a temporary fund cannot solve a structural issue: the integration of euro area government bond markets). On 12 march 2013,

nevertheless, the EU parliament agreed to vote the ‘Two-Pack’ in exchange of a commitment of the European Commission to settle a high level experts group to assess the feasibility of such a European Redemption Pact. There is a risk that new *a priori* constraints on fiscal policies are thus added.

5.1. The euro-bonds and debt agency proposals

The euro area needs to choose between two frameworks: relying on markets to implement fiscal discipline or introducing measures to re-establish the unity of public debts. The first option has several drawbacks: maintaining interest rates spreads in Europe for an undefined time period, undermining the impact of fiscal policies and letting financial markets play an excessive role. On the one hand, Europe would declare that: the Greek case was an exception, from now on, no euro area country will default. On the other hand, it would rely on financial markets to judge how serious this commitment is. The second option can be implemented in two ways: either through an ECB guarantee of always refinancing public debts or by issuing euro-bonds. It requires an issue to be settled first: according to which criteria and up to which level can a MS public debt be guaranteed by its partners? Several projects have not entirely made a choice between the two frameworks.

The simplest solution consists in introducing a European debt agency (EDA) which would be in charge of issuing a common debt for all euro area countries. This debt would be guaranteed by all euro area countries; it would be considered as a safe asset by financial markets; it would be very liquid, with a wide market, hence it could be issued at low interest rates. The difficult point is that the EDA council would supervise domestic fiscal policies and would be entitled to deny financing *too lax* countries, which would then have to issue bonds on markets. The EDA would raise the same problems as the SGP. What would be its assessment criteria? What would be the democratic and economic legitimacy of its Council? How would the EDA decide that a country runs an excessive deficit, if the country considers that such a deficit is necessary to support activity (like in Germany and France in 2002-2005) or to rescue banks? Would it implement strict rules (a country would be entitled to loans from the EDA up to 60% of its GDP) or softer ones? The EDA would benefit neither virtuous countries (which have no difficulty to get financing) nor countries in difficulty, which the EDA would refuse to finance and which would have to issue domestic bonds, without any European guarantee, without any potential financing from the ECB, in other words risky assets, bearing a high interest rate. The EDA makes sense only if it accepts to consider all public debts, but then what to do against lax countries?

Delpla and von Weisäcker (2010) have suggested the introduction of a ‘blue debt, collectively issued and guaranteed, with a ceiling at 60% of GDP’. Each year, national parliaments will have to vote on new public debt issuance (which means that the German parliament would have to agree on the French deficit for instance and vice versa). Each MS would also be allowed to issue a red debt under its own responsibility. Since such a red debt would bear a high interest rate, this would be a strong disincentive to issue public debt above 60% of GDP.

This proposal would generate permanent tensions between euro area MS if each country has to make judgements on their neighbour's deficits. It is almost similar to the EDA proposal and does not account for economic stabilisation needs. The 60% level is arbitrary and breached in 2013 by 10 of the original euro area MS (except Luxembourg and Finland). The gap between blue and red debts would allow financial markets to speculate in permanence. De Grauwe (2012) suggested than each country would have to pay a different interest rate on its blue debt, according to its debt level, as if public debt was always a sin which must be punished.

Palley (2011) suggests creating a European public finance authority, which would issue euro-bonds and lend to governments. Thus, a limited part of the debt would be mutualised. The ECB would be able to buy such bonds in order to influence the interest rate level. The euro area Council of finance ministers would decide on debt issuance. What would be the assessment criteria? Besides, countries would still issue national bonds, which would be subject to financial markets' moods.

Schulmeister (2013) suggests introducing a European Monetary fund (EMF) which would finance member states though issuing euro-bonds guaranteed by the MS and the ECB. The EMF would maintain long-term interest rates slightly below GDP growth. Each MS financing would not be subject to a numerical constraint, but would be decided within the EMF by the MS Finance ministers. The same questions may be raised again. This project hands over to finance ministers the responsibility of agreeing on public deficit targets for each country, which is problematic (what should be done in case of macroeconomic strategies divergences between countries?), not democratic (each finance minister would impose to its national Parliament the fulfilment of the target set at the European level), difficult to implement (what to do in case of a specific or global shocks?).

5.2. Can the single currency contradictions be overcome?

For developed countries, the system which worked until 1999 lied on unity between the government, the central bank and commercial banks. The central bank is the lender of last resort for the government and banks. The government guarantees banks; it can issue unlimited public debt. This debt is considered as safe and benefits from as low as possible market interest rates. Of course this unity was to some extent undermined by the independence of the central bank, which could have generated conflicts between the government (caring about supporting output or specific spending) and the central bank (caring about maintaining low inflation). These conflicts could have led public finances to become unsustainable (see, for instance, Sterdyniak *et al.,* 1994). But such situations did not occur before 2007. They did never question government solvency.

The introduction of the euro area led to a particularly difficult situation. On the one hand, countries need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. Since 1973, the macroeconomic equilibrium has been requiring a certain level of public deficit and debt. The 2007 crisis strengthened this need. On the other hand, due to the single currency, current imbalances in one country affect the other

countries of the area. Therefore excessive deficits (or surpluses) should be avoided. What is acceptable in the national framework where some ‘instinctive’ solidarity prevails is no more acceptable at the EU level, where citizens from Northern countries have no spontaneous solidarity with unemployed people in Southern economies, where most EU citizens have no solidarity with Spanish, Irish, UK or Cypriot banks. Last, financial markets’ functioning makes it necessary for public debts to become safe assets again, while at the same time Northern countries deny to give unlimited guarantee to their partners. Europe is also paralysed by the German constitutional court decision, which forbids any guarantee not expressively agreed by the German Parliament.

The solution adopted so far by Europe, i.e. the Fiscal pact consists in ensuring solidarity to countries agreeing to implement an absurd fiscal rule: keeping structural deficits below 0.5% of GDP. But such a target is not optimal, and there is no certainty that it can be reached.

Euro area countries should be able again to issue safe sovereign debt, at an interest rate controlled by the ECB. They should be able to run a public deficit in line with their macroeconomic stabilisation needs.

Public debt mutual guarantee by the ECB or by eurobonds must be entire for countries accepting to submit their economic policies to a coordination process. Therefore the procedures implemented since 2010 should be reviewed and their aims should be modified.

Economic policy coordination cannot consist in fulfilling automatic rules (like the SGP rules), and so a coordination process needs to be organised between MS. Coordination should target GDP growth and full employment; it should account for all economic variables; countries should follow an economic policy strategy allowing to meet the inflation target (at least to remain within a target of around 2%), to meet an objective in terms of wage developments (in the medium-run real wages should grow in line with labour productivity), in the short-run adjustment processes should be implemented by countries where wages have risen too rapidly, or not sufficiently; increases or cuts in social contributions may be used to facilitate the adjustment process; countries should announce and negotiate their current account balance targets; countries with high external surpluses targets should agree to lower them or to finance explicitly industrial projects in Southern economies. The process should always reach a unanimous agreement on a coordinated but differentiated strategy. As shown in Box 2, it is not so easy to define such a strategy. Public deficits resulting from this process should be financed through debt issuance guaranteed by all euro area countries and by the ECB. The Treaty needs to maintain an effective process in the event where no agreement is reached. In that case, the new debt issued by countries outside the agreement would not be guaranteed, but such a case should never occur. Europe’s survival requires that the European project becomes popular again, therefore is a source of growth, social progress and solidarity. It is only within this framework that institutional progresses could be made.

Box 2: Fiscal policy in a closed or in an open economy

1) Let us consider first a closed economy. The IS equation is: $y = g + d - \sigma r$, with y, the output gap, r, the interest rate (in difference with the rate of growth), d, private demand, *g*, public demand. The optimal fiscal policy after a purely demand shock is therefore to maintain: $g = -d$ and r = 0. The government balance should offset private demand shocks.

If households are Ricardian and offset any increase in the public deficit by lowering their consumption, then the economy cannot be stabilised:

$$y = g + d - \sigma r \quad with \quad d = d_0 - \lambda g \quad et \ \lambda = 1$$

The same applies if markets request excessive risk premia:

$$y = g + d - \sigma r \quad with \quad r = r_0 + \mu g \quad and \ \mu > 1/\sigma$$

Households' or markets' expectations on fiscal policies being inefficient are then self-fulfilling.

2) Let us now consider an open economy. The equilibrium in the goods market and the trade balance are written as: $y = g + d - \sigma r + b \qquad b = n(y^* - y) - n\delta(w - s - w^*) + b_0$, with *w,* the wage level*, s* the exchange rate.

The country should have a trade balance target, b_I . A small country in the world does not have to worry about its partners' balance. It should therefore implement: $g = -d - b_I \qquad w - s = w^* + (b_0 - b_I)/n\delta$

If the country wishes to run a trade balance in surplus, it must cut public spending and the level of its wages, either through exchange rate depreciation or through a period of high unemployment.

3) Let us now consider a monetary union with two countries. The model is written as:

$$y_1 = g_1 + d_1 - \sigma r + b$$
$$y_2 = g_2 + d_2 - \sigma r - b$$
$$b = n(y_2 - y_1) + n\delta(w_2 - w_1)$$

In the event of a domestic demand shock, each country must be able to stabilise domestic output using fiscal policy. If the interest rate is at its optimal level, fiscal stabilisation is a better strategy than monetary policy, as the shock is specific. If demand is excessive in Spain, Spain should implement a restrictive fiscal policy rather than having the ECB raising its rate, implying that Germany would need to run an expansionary fiscal policy.

The problem is the compatibility between the current account targets of the two countries. If country 1 targets a trade surplus, while country 2 aims at maintaining full employment, this leads to the pre-2007 crisis situation: Germany cut domestic wages and demand in order to reach a certain level of external surplus, which meant that Spain had to raise its domestic demand. $d_1 = -b_I$; $d_2 = b_I$; $w_2 - w_1 = b_I / n\delta$. No equilibrium can be reached if Spain wishes to run a current account in balance.

Conversely, a country can choose to run a trade deficit, imposing his partner to run a surplus which needs to be offset by a restrictive fiscal policy.

Fiscal policy coordination is required, but trade balances (and not the public deficit) should be the target and the wage level would be the instrument.

4) Let us now consider a monetary Union consisting of two countries in the world. The model is written as:

$$y_1 = g_1 + d_1 - \sigma r + b_1 \qquad b_1 = n(y_2 - y_1) + m(y^* - y_1) + n\delta(w_2 - w_1) + m\delta(w^* - s - w_1)$$
$$y_2 = g_2 + d_2 - \sigma r + b_2 \qquad b_2 = n(y_1 - y_2) + m(y^* - y_2) + n\delta(w_1 - w_2) + m\delta(w^* - s - w_2)$$

Let us assume that country 1 wishes to run some trade surplus. It will therefore cut domestic wages. Its trade surplus will be achieved on the rest of the world and on country 2. Country 2 will therefore have to choose between running permanently a certain deficit and lowering its domestic wages. This contributes to insufficient demand at the world level.

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