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A contribution to the work on the strengthening of the euro area

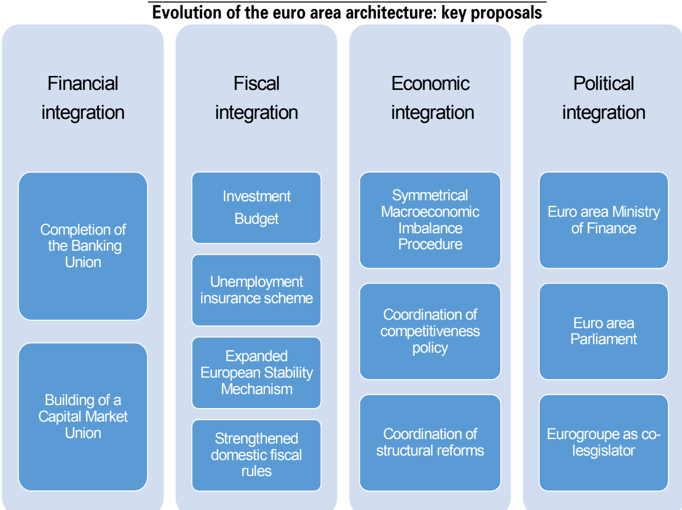
- The euro is an economic and political project like no other. Today, 340 million people across 19 Member States use on a daily basis a stable and credible currency. The euro is the second most commonly held reserve currency, accounting for one-quarter of all holdings worldwide. The economic and financial crisis triggered a raft of reforms that sought to make the Economic and Monetary Union (EMU) more resilient: tougher economic and fiscal governance rules, the Banking Union, and new mechanisms to manage sovereign debt crises.

- Yet the euro area remains a work in progress, with some way to go on financial and fiscal integration, dealing with macroeconomic imbalances within the zone, and strengthening cohesion. Gaps in financial integration are weighing on efficient capital allocation. Euro area fiscal policy – intended to deliver macroeconomic stability and public finance sustainability – is not fully up to the task. Eventually, current unit labour cost trends mean that imbalances within the union are unlikely to be absorbed in the short term.

- The euro area architecture therefore needs to be strengthened, in three areas in particular. Firstly, the EU needs to complete the Banking Union and press ahead with the Capital Markets Union. This, in turn, would boost financial sector integration and see improved private sector risk-sharing. Secondly, the euro area needs its own sizeable budget and domestic fiscal rules need to be tightened. Together, these measures would increase macroeconomic stability, pave the way for convergence, and shore up public finance sustainability. Thirdly, a more coordinated approach to structural reform would help to reduce current account imbalances and boost economic integration within the euro area.

- Such proposals would imply much closer integration and further sovereignty-sharing on fiscal and economic policy. Consequently, the euro area institutional framework needs to be overhauled to provide for a more democratic functioning of the euro area. Yet this would require treaty change – a matter on which Member States do not currently see eye to eye. In the short term, the EU must continue to demonstrate its ability to ensure the cohesion of its members in the context of the withdrawal of the United Kingdom and to address concretely the main concerns of its citizens, in particular within the relaunch of the European project agenda agreed upon at the Bratislava summit of September 2016.

Evolution of the euro area architecture: key proposals



Source: DG Trésor.

MINISTÈRE DE L'ÉCONOMIE ET DES FINANCES

1. Despite far-reaching reforms undertaken during the crisis, the euro area architecture is still a work in progress

1.1 The euro area is more resilient in the aftermath of the crisis

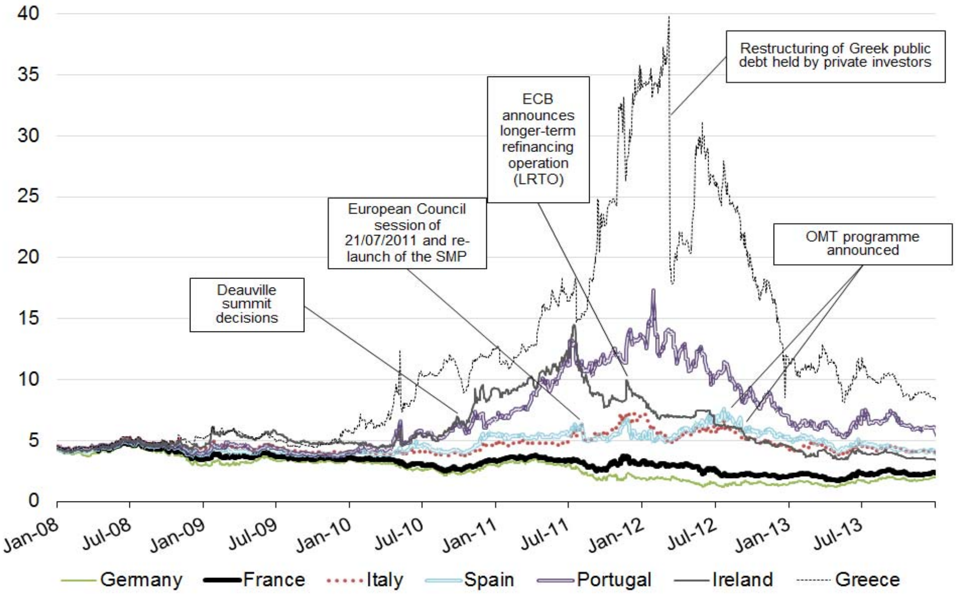
The crisis exposed vulnerabilities in some euro area economies. Prior to the crisis, the introduction of the euro saw nominal interest rates converge, while wages rose at markedly different rates in the core and periphery countries. The core countries, with large current account surpluses, lent vast sums of money in the periphery countries, where current account deficits continued to swell. With no exchange rate flexibility, external adjustment mechanisms or national control on policy rates, it was impossible to stop the overheating. Moreover, the EU had no specific mechanism to prevent macroeconomic imbalances. This left the periphery countries particularly vulnerable in the run-up to the crisis. The crisis also laid bare economic weaknesses in countries where productivity had long been sluggish and where, in the 2000s, governments had failed to establish a sufficient fiscal "safety net" to deal with a major crisis. Countries like Greece, Italy and Portugal – with soaring structural unemployment and already-high public debt – lacked the necessary margins to absorb a shock of this scale.

Gaps in the EMU architecture contributed, in part, to the tremendous scale of the euro area crisis. From 2010 onwards, gaps in euro area financial integration caused a vast capital flight from the periphery to the core, sparking a balance of payments crisis in the periphery countries – something that had previously seemed unthinkable in a currency union. This, in turn, triggered a loss of confidence in domestic banking sectors and raised fears about the potential impact of a massive bank recapitalisation programme on sovereign debt sustainability. With no lender of last resort, tensions began to appear in the periphery sovereign debt markets. Initially confined to Greece and Ireland, these tensions spread to Portugal and, in mid-2011, to Spain and Italy (see chart 1).

Ambitious reforms were introduced to make the euro area more resilient, successfully cooling market tensions. The reforms covered several issues:

- **Economic and fiscal governance rules were tightened.** Successive changes to the regulatory framework tightened up fiscal policy coordination ("Six-pack" in 2011, Fiscal Compact (TSCG) in 2012, and "Two-pack" in 2013). These reforms sought to toughen fiscal discipline and ensure fiscal sustainability across the euro area countries. The Macroeconomic Imbalance Procedure (MIP) – one of the "Six-pack" measures – broadened the scope of economic policy coordination in an effort to prevent and correct current account imbalances in the euro area.
- **New sovereign debt crisis management mechanisms were introduced.** The European Stability Mechanism (ESM) was established to provide financial assistance to vulnerable euro area countries, replacing a previous, temporary instrument – the European Financial Stability Facility (EFSF). The ESM is a permanent, €700bn firewall that provides sovereign bailout loans to solvent euro area countries in the event of a liquidity crisis, provided that the country implements an agreed programme of economic policy reforms.
- **The euro area Member States laid the foundations for the Banking Union,** introducing a raft of new rules on prudential requirements and creating new institutions to supervise the European banking sector. One important measure was the establishment of the Single Supervisory Mechanism (SSM) – a unified body tasked with overseeing the euro area banking sector and supervising systemically important banks. The reforms also ushered in a new Single Resolution Mechanism (SRM) – to stem the negative feedback loop between sovereign debt and bank debt and to prevent bank losses being taken into public ownership – and the Single Resolution Fund (SRF), financed by the banking sector.
- **The European Central Bank (ECB) played a pivotal role in cooling market tensions.** The ECB's Outright Monetary Transactions (OMT) programme allows the ECB to make uncapped purchases, on sovereign bond markets, of bonds issued by euro area countries under a financial assistance programme. Introduced in 2012, the programme relieved tensions in the sovereign debt market. The ECB's credit easing (TLTRO) programme (June 2014) and quantitative easing measures (March 2015) also went a long way in stabilising the euro area.

Chart 1: 10-year sovereign bond yields (%)



Source: Datastream.

1.2 Structural weaknesses continue to undermine the functioning of the euro area

The reforms brought in during the crisis helped to relieve market tensions and protect the integrity of the euro area. Yet they were not sufficient to address the more structural threats facing the EMU. Gaps in financial integration, an ineffective policy mix and persistent macroeconomic imbalances continue to drag on economic performance, raising doubts about the euro area's ability to cope with another systemic crisis.

1.2.1 Gaps remain in financial integration in the euro area, hindering efficient capital allocation

Financial integration – especially perfect capital mobility – is key to a fully functioning currency union. Where a currency union has no barriers to capital and liquidity mobility, savings can be allocated efficiently across national borders and, in an appropriate regulatory framework, excessive imbalances can be curbed. Moreover, financial integration fosters private sector risk-sharing between Member States (through foreign asset ownership and cross-border lending), spreads the impact of economic shocks throughout the zone and, in doing so, makes Member States more resilient to asymmetric shocks. However, estimates vary on the extent to which this channel contributes to stability.[1]

Despite major progress on the Banking Union, full financial integration in the euro area remains elusive. The evidence on this front is clear – interbank market trading and cross-border holdings remain below pre-crisis levels, there are no new cross-border banking groups, and European capital markets remain under-developed, with significant domestic bias.

Moreover, almost a decade on from the outbreak of the financial crisis, banks have yet to finish cleaning up their balance sheets. In some countries, banks still have high volumes of non-performing loans on their books, thus stifling business lending, placing a drag on credit conditions and monetary policy transmission,[2] and impeding financial integration.

Financial markets remain fragmented because of persistent barriers within the euro area to capital and liquidity mobility and to the development of cross-border financial services. As a result, financing conditions differ from country to country within the euro area[3] – and not just because of the inherent performance or risk profile of the projects.[4] This fragmentation hinders the transmission of monetary policy throughout the euro area.

1.2.2 The implementation of fiscal rules results in a sometimes ineffective policy mix in the euro area

Fiscal policy should be aimed in such a way as to maintain sustainable public finances.[5] Yet average public debt levels across the euro area are now higher than before the crisis, with marked contrasts between countries. In 2015, the average debt-to-GDP ratio in the euro area stood at 92.6% (compared with 67.9% in 2002-2006), ranging from 10.1% in Estonia to 177.4% in Greece. Soaring public debt ratios in some countries could have a number of knock-on effects: slug-

(1) In particular, see European Commission (2016), "Cross-border risk-sharing after asymmetric shocks: evidence from the euro area and the United States", *Quarterly Report on the Euro Area*, No. 6(3); and Clévenot M. & V. Duwicquet (2011), "Partage du risque interrégional", *Revue de l'OFCE*, No. 119.

(2) Praet P. (2016), "Monetary policy and the euro area banking system", speech at VII Financial Forum organised by Expansión and KPMG, October 2016.

(3) Barkbu B. *et al.* (2015), "Investment in the Euro Area: Why Has it Been Weak?", *IMF Working Paper*, No. 15/32.

(4) The classic (hypothetical) example is an economic actor receiving different finance terms in core and periphery countries for a project with the same performance and risk profile.

(5) This is especially the case in a monetary union where non-cooperative behaviours ("free-rider problem") could be costly for the all Member States.

gish growth (crowding out of private investment and rising debt refinancing costs spilling over into the private sector), limited fiscal space to cope with future macroeconomic shocks, and rising tensions in sovereign debt markets. With projections pointing to rising costs to support Europe's ageing population (between 1.5 and 3.5 percentage points of GDP), prudent fiscal policy is needed to sustain our social models.

Fiscal policy is also pivotal to macroeconomic stability, both domestically and across the euro area. Fiscal policy should support monetary policy – through the right policy mix – in order to stop hysteresis effects from kicking in (e.g. long-term unemployment and skill erosion weighing on growth). Moreover, the tendency for domestic fiscal policy to spill over[6] into the wider euro area calls for an aggregate view of the fiscal stance within the currency union, in particular since fiscal spill-over effects are exacerbated during periods of economic crisis and when monetary policy is at the zero lower bound.[7] Under the present conditions – low inflation and accommodative monetary policy – Member States must work together to achieve the right policy mix for the euro area, recognising that domestic fiscal policy affects the economies of other countries. And because monetary policy is uniform across the bloc, Member States need to tweak their fiscal policy (still a matter of national sovereignty) to achieve a sufficiently countercyclical policy mix.

Evidence from the financial crisis and its aftermath shows that fiscal policy has mostly failed to deliver on its macroeconomic stabilization objective. Firstly, fiscal policy has been largely pro-cyclical. It was too expansionary before the crisis and overly contractionary in 2011-2013[8] – a period marked by major fiscal consolidation and a deep recession[9] (see chart 2). Other major economic regions took a different approach in the post-crisis period; this may go some way to explaining why, when compared with the United States and the United Kingdom, the euro area's recovery has been slower and weaker. Moreover, while the current euro area's aggregate fiscal stance (slightly expansionary) is broadly appropriate, it could be better shared out between countries facing public finance sustainability issues, and those with untapped fiscal space.

1.2.3 Current account imbalances remain high within the euro area

The crisis laid bare the need to monitor current account imbalances and unit labour cost trends in the euro area. With no exchange rate flexibility, policymakers need to ensure that labour costs rise in line with productivity. The pre-crisis period saw a widening gulf between unit labour costs (ULCs) in the core and periphery countries (see chart 3). Between 2000 and 2009, ULCs rose by 30% in Spain and Italy, compared with just 5% in Germany. As the periphery countries became less competitive, **gaps began to appear between current account balances across the euro area** (see chart 4). By 2015, the gap had narrowed somewhat and the bloc was running a current account surplus of 3% of GDP - although this figure masked marked contrasts between countries. Many periphery countries managed to wipe out their current account deficits between 2007 and 2015 (from –10% to +1% of GDP in Spain, from –1.4% to +2% of GDP in Italy, and from –10% to 0% of GDP in Portugal), chiefly through fiscal discipline at home. Yet other countries, especially the Netherlands and Germany, have added to their large, long-standing current account surpluses in recent years. While Germany has taken steps to redress the imbalance (notably the introduction of the minimum wage) and engaged new expenditure (e.g. towards migrants and increased public investment), it has yet to trim its large current account surplus (which stood at 8.6% in 2015).

These imbalances pose a long-term threat to the euro area economy. In countries with a current account surplus, domestic demand is sluggish (chiefly because economic agents show a preference for savings). This, in turn, is weighing on the external demand for goods and services from other euro area economies. Moreover, ULC trends are not properly coordinated across the union (chiefly because wages are rising slowly in countries with a current account surplus). This situation could cause inflation to remain low (as fiscal discipline in the periphery places a long-term drag on inflation), weigh on growth (because of sluggish demand in these same countries), and prolong rebalancing efforts across the region.

The Macroeconomic Imbalance Procedure (MIP) – designed to correct these imbalances – has contributed to putting pressure on labour costs. The procedure's underlying principle divides countries into two opposing categories – current account surpluses and deficits, seeing the latter category as the more risky. Although the MIP has helped reduce current account deficits, it has done nothing to tackle the rising surpluses in Germany and the Netherlands, thereby driving wages downwards (and keeping demand and inflation low) without narrowing the gap between current account balances on either side of the divide. Notably, the euro area core inflation rate has remained at 1.8% or below since 2010, and has not exceeded 1.2% since 2014.

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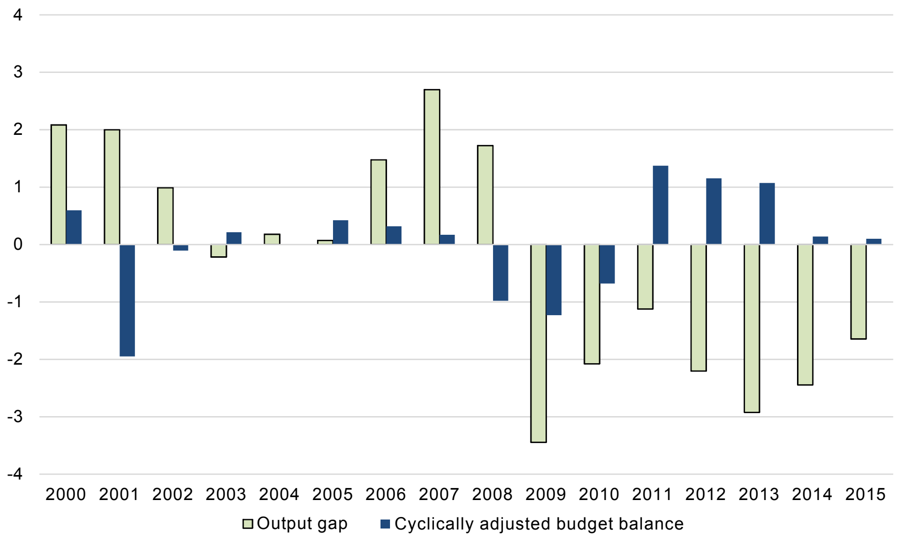
(6) The recent crisis has caused economists to rethink the scale of spill-over to other countries and to the eurozone as a whole. The literature tends to see spill-over happening via two separate channels - the fiscal channel (while economists disagree over the extent of this effect, they concur that it has a bigger impact on countries within a currency union than on those with flexible exchange rates), and the financial channel, through financial contagion (a number of recent articles reveal the sheer scale of this effect within the currency union).

(7) Erceg C. & J. Lindé (2014), "Is There a Fiscal Free Lunch in a Liquidity Trap?", *Journal of the European Economic* Associations, Vol. 12., and In't Veld J. (2013), "Fiscal Consolidations and Spillovers in the Euro Area Periphery and Core", *Economic Papers*, No. 506 show that these effects are much larger when policy rates are low because central banks cannot entirely offset the shocks.

(8) See Aviat A. *et al.* (2016), "Towards a better management of the fiscal stance in the euro area?", *Trésor-Economics*, No. 163.

(9) During this period, Greece, Portugal, Spain and Ireland implemented fiscal consolidation plans and improved their primary structural balances by 10, 8, 6 and 5 percentage points of GDP respectively. Other countries, unaffected by market pressures and with less pressing budgetary constraints, also introduced significant fiscal consolidation plans. The result was a tendency towards a contractionary fiscal stance across the region, with the euro area deficit falling by 2.9 percentage points of GDP between 2011 and 2013.

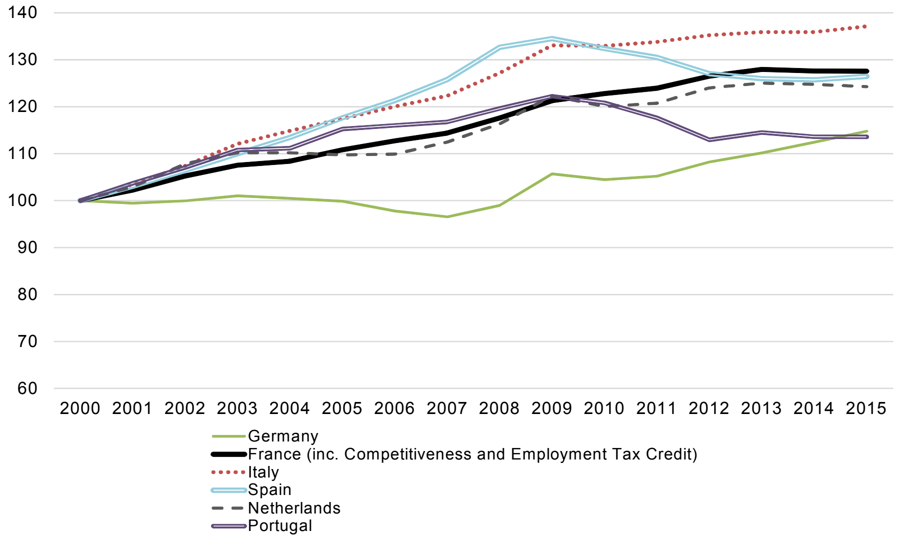
Chart 2: Evolution of the cyclically adjusted budget balance and output gap in the euro area



Source: European Commission (AMECO database).

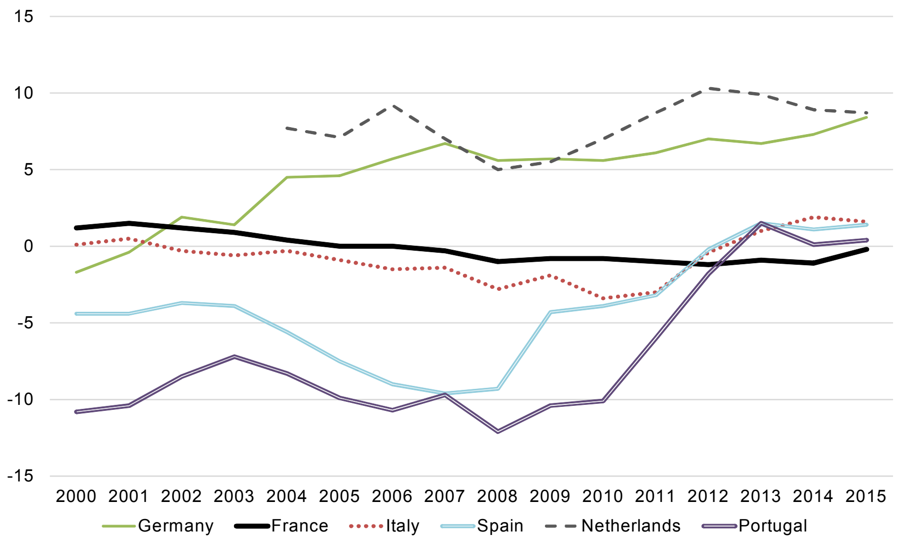
Note: The output gap is the difference between actual GDP and potential GDP, expressed as a percentage of potential GDP. Here, potential GDP is calculated using the European Commission's methodology. Other methods exist, however, and measuring output gap poses difficulties on a number of fronts (see Darvas (2015), "Mind the gap (and its revision)!", http://bruegel.org/2015/05/mind-the-gap-and-its-revision).

Chart 3: Nominal unit labour costs (base 100 = 2000)



Source: Eurostat.

Chart 4: Current account balance (as a percent of GDP)

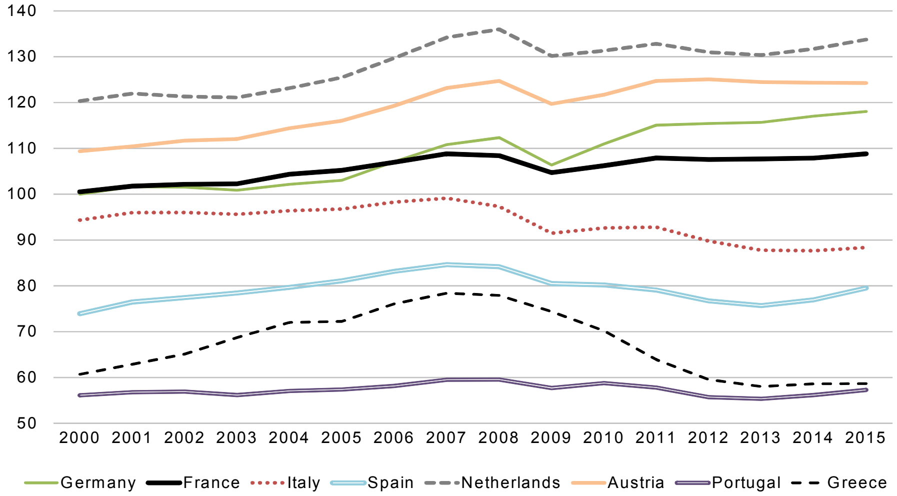


Source: Eurostat.

1.3 The legacy of the crisis raises the spectre of lasting economic divergence between Member States

The euro area was established more than 15 years ago. In that time, the gap between headline rates (inflation, post-crisis sovereign debt yields) and, to a lesser extent, quality of life across Member States has widened (see chart 5). Greece, Portugal, Italy and Spain had lower GDP-per-capita ratios than the euro area average before joining the single currency. Since then, productivity in these southern European countries has fallen even further behind the core country average. One partial (albeit contested) explanation for this divergence is that periphery countries have suffered from crippling capital misallocation[10], or that the core and periphery countries have taken different trajectories when it comes to sectoral specialisation.[11] Yet Italy remains something of an idiosyncrasy, and its weak productivity (which pre-dated the single currency) could be attributed more to structural factors within the Italian economy (poor performance in human capital accumulation)[12] than to sectoral specialisation.

Chart 5: GDP per capita (base 100 = GDP per capita in Germany, in 2000, in euros)

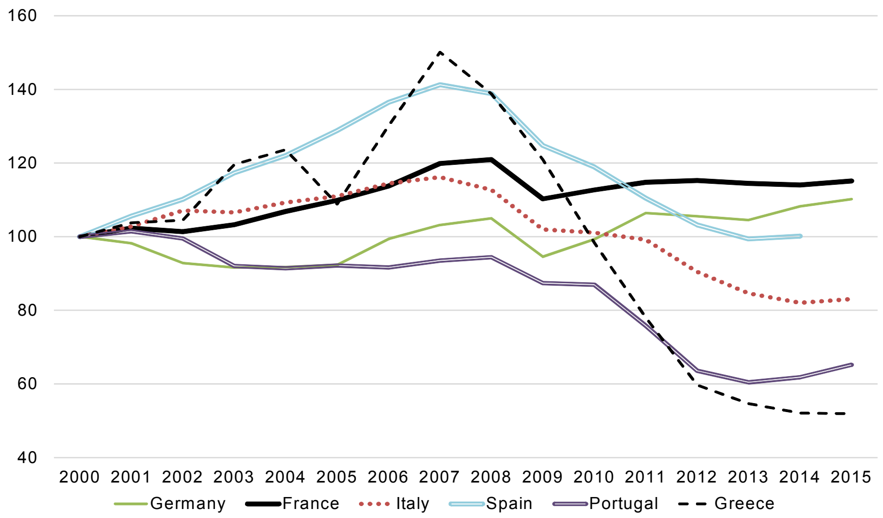


Source: Eurostat, DG Trésor calculations.

In the medium term, the legacy of the crisis could make it harder for the periphery to catch up with the core countries, potentially placing euro area cohesion in jeopardy. Saddled with soaring public debt, these countries lack the fiscal space to cope with another recession, while limited public investment capacity threatens to keep productivity sluggish. Periphery banks still have large volumes of non-performing loans on their books, which weighs on their ability to lend to businesses and support productive investment (see chart 6). Meanwhile, unemployment rates remain high. Taken together, these factors – high unemployment, under-investment and limited business lending – threaten to entrench structural trends and, in the long term, stifle potential growth in these countries. Skilled labour mobility from south to north could, in theory, widen the economic gap. As things stand, however, there is no empirical evidence of this effect in terms of earnings[13], notably because of financial flows running in the opposite direction.

(10) Gopinath, G. *et al.* (2015). "Capital Allocation and Productivity in South Europe", *NBER Working Paper*, No. 21453.
(11) Ballabriga F. & C. Villegas-Sanchez (2014), "Sectoral Structure, Risk Sharing and the Euro", *ESADE Working Paper*, No. 255.
(12) Mrabet, H. (2016), "Why is Italian productivity so weak?", *Trésor-Economics*, No. 170.
(13) Bara YE. *et al.* (2015), "Labour mobility in the EU: dynamics and policies", *Trésor-Economics*, No. 143.

Chart 6: Investment (excluding real estate) in real terms (base 100 = 2000)



Source: Eurostat, DG Trésor calculations.

2. These vulnerabilities are not conducive to a fully functioning and stable union, and there is a strong case for an overhaul of the euro area architecture, with new common instruments and democratic institutions

The coherent set of reforms outlined below is intended to address decisively the euro area's structural vulnerabilities with the lowest possible transfer of sovereignty and fiscal resources.

2.1 Strengthen financial sector integration to improve private sector risk-sharing

Closer financial integration within the euro area is a key priority. It can be achieved in the short term, without treaty change. The most urgent goal is to improve private sector risk-sharing and to reduce market fragmentation, by taking action on two fronts.

Firstly, complete the Banking Union as a matter of urgency[14]. New prudential rules need to be adopted (Basel III full implementation, new loss-absorption requirements, etc.), along with risk-sharing measures (permanent common backstop for the SRF and a common European Deposit Insurance Scheme). This, in turn, should limit potential contagion between banking and sovereign risks and prevent deposit flight in countries where the banking sector faces a crisis of confidence.[15]

Secondly, press ahead with plans – initiated in 2015 – to create a Capital Markets Union (CMU) within the European Union.[16] This would secure further integration, helping to spread risk more evenly across the euro area, make the union more crisis-resilient, and improve the business environment. The ultimate aim is to make it easier for businesses (including SMEs and mid-tier companies) to access funding from a wider range of sources, thereby reducing their reliance on the banking sector. By expanding equity financing and shoring up bankruptcy procedures, the CMU would give businesses easier access to financial markets and cross-border investment, reduce financial markets fragmentation within the EU, and boost resilience by extending the scope of private sector risk-sharing.[17]

2.2 Take an important step towards fiscal integration by creating a euro area budget aimed at increasing macroeconomic stability and fostering convergence, while tightening national fiscal rules

Euro area Member-States have pooled sovereignty on monetary policy but, by and large, have retained control over fiscal policy. Yet when it comes to delivering macroeconomic stability and public finance sustainability, this model is not fully up to the task (see section 1). Maintaining fiscal stabilisation purely at the national level does not seem desirable over the medium-term, in particular because the common monetary policy would be more efficient if it could rely on a fiscal counterpart. A central stabilisation capacity would therefore better protect euro area countries against extreme shocks. For such a central capacity to work, fiscal discipline must be ensured at the national level. Two possible ways forward are currently debated in this regard: (i) abandon rule-based fiscal oversight and give the markets a greater role in curbing domestic public debt, e.g. by introducing a sovereign debt restructuring mechanism; or (ii) establish legally binding fiscal rules at the national level to keep sovereign debt down and to fend off default risk, as is for example the case in most of the US federated states.[18]

The issue, however, is that markets seem unable to accurately assess sovereign default risk. Pre-crisis, the markets tended to see little difference in the quality of sovereign debt across the currency union (despite diverging

(14) ECOFIN Council conclusions of 17 June 2016 on a roadmap to complete the Banking Union.

(15) See for example: IMF (2013), "A Banking Union for the Euro Area", *IMF Staff Discussion Note*, No. 13/01.

(16) Commission Action Plan of 30 September 2015 on building a Capital Markets Union.

(17) Anderson N. *et al.* (2015), "A European Capital Markets Union: Implications for Growth and Stability", *Bank of England Financial Stability Paper*, No. 33.

(18) Notwithstanding that the fiscal rules enforced in the United States do not allow for stabilizing the economic cycle at the state level while the US federal budget is of a much greater size than the investment budget for the euro area as contemplated here.

economic and fiscal trajectories between 2000 and 2010, spreads remained exceptionally low). Then, when the crisis hit, the markets overreacted (as evidenced by soaring spreads in the peripheral countries in 2011-2012). **Because the markets seem unable to correctly determine sovereign default risk, the first of the two solutions above would, in all likelihood, raise the prospect of permanent default risk or even exit from the euro area, thereby causing major financial instability.** In some quarters, the proposals go as far as to impose automatic restructuring when sovereign debt reaches a certain threshold.[19] Yet this approach would herald crises of confidence, preventing Member States from taking robust countercyclical policy measures when needed and hampering monetary policy transmission.

A central fiscal capacity and tightened national fiscal rules would encourage a better policy mix, foster convergence by supporting structural reforms and, ultimately, make the euro area more resilient. A euro area budget would serve two purposes. Firstly, it would provide the area with an effective fiscal instrument to support monetary policy and promote macroeconomic stability where needed, and it would help shield Member States against major macroeconomic and financial shocks. Secondly, it would increase economic cohesion within the EMU, chiefly by boosting targeted investment (in its broadest sense, i.e. including human capital), pushing up productivity and backing the necessary structural reforms. Concurrently to pooling fiscal sovereignty, tougher legally binding fiscal rules will be needed to tighten national fiscal discipline. In turn, this would help trim sovereign debt levels and steer clear of the risks of moral hazard and uncooperative behaviours. Policy-makers will also need to explore the relationship between the euro area budget and the EU budget.

Under our proposal, the euro area budget would comprise three principal instruments: (i) an investment budget to foster economic convergence and offset symmetric shocks affecting the euro area; (ii) a common unemployment insurance scheme to shield Member States against asymmetric shocks; and (iii) an expanded European Stability Mechanism to protect them against liquidity crises.

Accessing to such a budget would require the prior implementation of convergence process comparable to the Maastricht one, based on the compliance with fiscal[20] and structural[21] criteria.

2.2.1 An investment budget funded by cyclical revenue and with sufficient borrowing capacity to support countercyclical fiscal stimulus

Creating a euro area investment budget, targeting projects most likely to foster potential growth, would both pave the way for convergence and help keeping public investment high during times of crisis (see above). The EU's structural funds were successful at driving convergence in the periphery before these countries joined the single currency. Yet, both the way in which these funds are distributed and the EU enlargment lead to a slide of allocations benefiting to Member States at the periphery of the euro area. There is therefore a strong case for dedicating part of the euro area budget for cohesion within the bloc. This budget could come in many different forms – in terms of revenue streams and designated expenditure. The illustration below shows how a euro area investment budget could work, and its potential structure. The macroeconomic and fiscal impacts such a budget would have had if introduced at the same time as the single currency were also simulated (see box).

The proposed investment budget would account for at least 2% of euro area GDP and would finance ongoing public investment expenditure, chiefly in catching-up countries. The funds would be channelled to projects offering the best socioeconomic return, with a particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training). In turn, this new stream of permanent investment would kick-start lasting economic convergence in the euro area. It would also improve macroeconomic stability by preventing massive cuts in public investment during times of crisis (as seen in the euro area since 2010). Moreover, the budget would play a pivotal role in turning Europe into the world's leading knowledge-based economy.

The investment budget could be financed by a fixed percentage of two common consolidated tax bases – VAT and corporate tax. The revenue side would then be used to fund euro area budget expenditures. Moreover, investment capacity would not be constrained by annual balanced budget requirements: the expenditure side of the budget would be generally non-cyclical in nature, while the "revenue" side would be cyclical, as the budget's primary goal would be to support permanent public investment within the currency union, irrespective of the prevailing economic conditions. As such, real-terms expenditure would grow in line with potential growth. During times of crisis (i.e. when the output gap widens), expenditure would then grow faster than GDP. This trend would reverse when conditions were more favourable. Revenue, meanwhile, would be cyclical, generally tracking – or even outstripping - GDP growth.

In a recession, shaving these tax rates would help to shore up the economy. Slashing VAT rates (i.e. one of the investment budget's revenue streams) during times of crisis would indeed stimulate private-sector demand across the euro area. (in a similar vein, policy-makers could alternatively respond by stepping up expenditure). Our simulations (see box) indicate that an instrument of this type would go some way to stabilising macroeconomic cycles within the currency union by shouldering much of the burden of fiscal response to euro area-wide shocks.

(19) For example, see Deutsche Bundesbank (2016), "Approaches to Resolving Sovereign Debt Crises in the Euro Area", *Monthly Report*, No. 41, July.

(20) For example by imposing the tightening of national fiscal rules mentioned above as well as achieving its medium-term objective defined within the Stability and Growth Pact.

(21) For example by promoting labour market convergence in order to gain access to the common unemployment insurance scheme.

Box: **Illustration showing how an investment budget for the euro area would work, and its macroeconomic and fiscal impacts**

A partial transfer of sovereignty over countercyclical fiscal policy from Member States to the euro area's central institutions would make the monetary union more crisis-resilient.[a] The illustration below shows, in simple terms, the revenue and expenditure streams of an investment budget for the euro area. We have also run a simulation to determine how such a budget would work, its countercyclical impact since 1999, and how it would react to future crises. Our simulation deliberately omits the stabilizing effect of unemployment insurance, since this has been dealt with in another article.[b]

In 2015, euro area VAT receipts amounted to approximately €715bn (or 7% of the euro area GDP). Around 15% of VAT receipts (or 1 percentage point of GDP from VAT receipts) could be allocated to the investment budget. Assuming that ongoing negotiations around the Common Consolidated Corporate Tax Base (CCCTB) Directive lead to full harmonisation on corporation tax,[c] allocating around 40% of corporation tax receipts to the investment budget could push up the budget by approximately 1 percentage point of GDP.

We simulated how the euro area economy would have behaved if the investment budget had been introduced at the same time as the single currency. We used fiscal multipliers from the Mesange model (developed by DG Trésor and Insee) to assess the impact of budget-linked countercyclical fiscal stimulus measures. We further considered that fiscal multipliers would be higher during a severe crisis episode. In accordance with the literature, we assumed that recessions reduce potential growth when they have a long-lasting effect on economic activity.[d] Under our model, "severe crisis" designates any period when the euro area output gap falls below –1.5%.

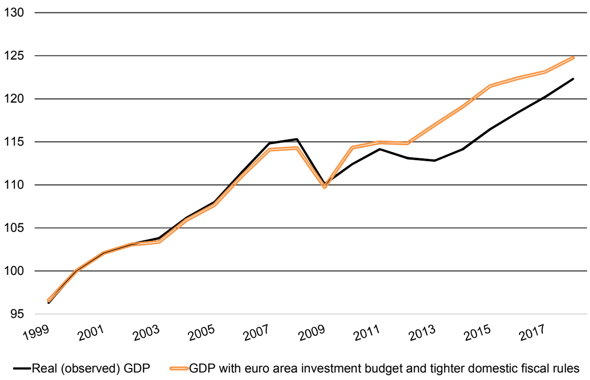
Up to and including 2007, the impact of the investment budget would have been limited (see chart 7). Because there were no severe crisis episodes in the euro area between 1999 and 2007 (growth only dipped below 1% once during this period, in 2003), there would have been no opportunity to harness the fiscal stimulus potential of the investment budget. On the contrary, Member States would have further reduced their sovereign debt burden during this period, because of the tougher domestic fiscal rules. We assume then that Member States would have, in the 2000s, progressively improved the control of their public deficits: thanks to this additional effort, the euro area aggregated public deficit would have been GDP 1.5% in 2001 (instead of 2%), 2% in 2004 (instead of 3%) and 0.5% in 2006 (instead of 1.5%). Our simulation shows that, on balance, the investment budget would have had a marginal negative impact prior to the crisis. However, we did not include other, potentially mitigating effects in our simulation, such as the impact on interest rates (see below).

From 2008 onwards, however, the investment budget would have had a much greater impact because tax relief measures – reserved for severe crisis episodes - would have been triggered. Moreover, these measures would have remained in force each year between 2009 and 2015 (with the exception of 2011). For that period, the investment budget would have cut the VAT levied in Member States (or even entirely cancelled it), leading to a fiscal expansion of almost 1 GDP point a year during this period. At the same time, Member States would have been exempted from applying further fiscal consolidation measures (i.e. an exceptional crisis-related clause built into tighter domestic rules would have been triggered), and would have then contributed to the fiscal stimulus. In our simulation, the aggregated euro area budget balance would have been, on average, more expansionist than the counterfactual by 1.4 percentage points of GDP each year of the period 2009-2015 (i.e. public deficit would have been in the euro area on average 1.4 point higher than in the counterfactual). This would have cushioned the blow of the 2009 recession and the subsequent slowdown, and gone some way to shielding potential growth from hysteresis effects. According to our calculations, euro area GDP would have been 3 percentage points higher in 2016.

Debt associated with the investment budget would have risen during the period, rising from around 0% in 1999-2008 to 7% in 2016 (see chart 8). However, this additional burden would have been offset by the decline of Member States' debt-to-GDP ratio, which is spread over a longer period of time. According to our simulation, total debt across the euro area would have been just 2% higher in 2016 and, as Member States pursued the reduction of their debt-to-GDP ratio, this additional debt would have been wiped out by 2018. In our simulation, the euro area would then have had the same debt-to-GDP ratio as it has now but with a higher level of GDP while having considerably limited the "double dip" of 2012-2013.

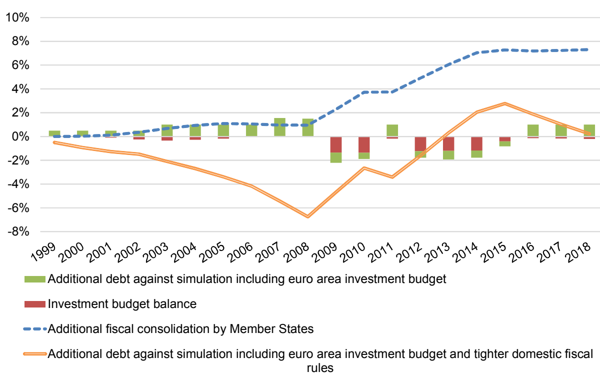
This simulation did not fully account for the contribution of smoother cyclical fluctuations (particularly on investor confidence). Nor did we consider the positive impact of lower pre-crisis debt levels on interest rates. Moreover, because our simulation looked at aggregate effects only, we overlooked the fact that the euro area budget (as a whole, i.e. investment budget + unemployment insurance + expanded European Stability Mechanism) would help reducing liquidity crisis risk – and knock-on economic impacts - in some countries. As such, the full "euro area budget" part of our proposal could have a more significant impact than our simulation would suggest.

Chart 7: Result of our simulation (base 100 = 2000)



Source: AMECO, DG Trésor calculations.

Chart 8: Budget balance and additional debt associated with the investment budget of the euro area (as a percent of the GDP of the euro area)



Source: AMECO, DG Trésor calculations.

a. Caudal *et al.* (2013), "A budget for the euro area", *Trésor-Economics* No. 120.
b. Lellouch T. & Sode A. (2015), *op. cit.*
c. European Commission (2016), "Modelling Corporate Tax Reform in the EU", *Taxation Papers*, No. 66.
d. Regarding hysteresis effects, see in particular Ball, L. (2016), "Long-Term Damage from the Great Recession in OECD Countries", *NBER, Working Paper*, No. 20185, and concerning the calibration of this effect in the euro area see OECD (2014) *Economic Outlook*, Volume 2014 Issue 2 No. 96, November 2014, Issue 2, Box 1.1. "Persistent Stagnation traps: evidence and policy implications". Regarding fiscal multipliers, see for example Gechert *et. al.* (2015) "Fiscal multipliers in downturns and the effects of Eurozone consolidation", voxeu.org. It is considered here that the strongest fiscal stimulus (compared to the counterfactual) is composed both of lower revenues and higher expenditures (public investments are preserved at the level of the euro area budget and, in parallel, Member States' fiscal policy is more expansionary during the crisis).

The euro area investment budget would, by design, have cyclical revenue streams and stable expenditure; it would therefore need a borrowing capacity to make this possible. Domestic fiscal rules would then have to be tightened and central debt to be offset by a lowered national indebtedness. Under steady conditions, this would cause no overall rise in the aggregate public debt of the euro area.

Ultimately, an investment budget of this type would partially replace government budgets, albeit to a limited extent. This could be achieved without increasing the overall tax burden. It would also: (i) help maintain permanent, high-quality public investment (in physical and human capital); (ii) by preventing liquidity crises, remove some of the burden of economic stability and public finance sustainability from domestic policy-makers ; and (iii) improve the policy-mix and, in particular, smooth economic fluctuations further in the event of a major crisis through a more countercyclical fiscal policy.

2.2.2 A euro area-wide common unemployment insurance scheme would make the currency union's economies better able to withstand asymmetric shocks

Partial pooling of unemployment insurance in Europe would help cushion the blow of asymmetric shocks in the euro area (see above, and "An unemployment insurance scheme for the euro area", *Trésor Economics* No. 132 (2014)). This proposal suppose a partial mutualisation of the benefits received by the unemployed at the euro area level, in the form of a common benefits scheme. For example, jobseekers out of work for less than one year (the most cyclical part) would receive a benefit equivalent to 50% of their previous salary. The scheme would be financed through a harmonised base (e.g. total wage bill). Member States would freely top up this scheme as they saw fit, through their own national unemployment insurance systems. Such a mechanism would require a balanced budget over the economic cycle, with sufficient borrowing capacity to ride out cyclical deficits. One way to promote ownership of the scheme among European citizens would be to bypass national systems and pay the benefit directly to jobseekers from the central budget.

2.2.3 An expanded ESM enshrined in EU law

The ESM - enshrined in EU law and with an overhauled governance structure (see below) – would be the third element of the euro area budget. With greater means of action, the ESM would have a more flexible facility to grant short-term loans to Member States that temporarily lost market access, giving them the possibility to implement countercyclical policy. Due to the other components of the proposed euro area budget, this instrument would be of lower priority to make the EMU function satisfactorily. However, this tool should still be retained in view of its utility in the case of an extreme shock and in the light of the limited size of the investment budget.

2.3 Greater economic integration

2.3.1 Reduced current account imbalances and better coordination of wage-setting mechanisms

Greater symmetry in the implementation of the MIP and more effective coordination of wage-setting mechanisms would allow for a long-term reduction of the euro area current account imbalances. These mechanisms play an important role in determining both cost-competitiveness and domestic demand. Indeed, if wages fail to rise in parallel with productivity, major distortions can appear, weighing on competitiveness – especially if a negative shock occurs. Moreover, sluggish wage growth can drag on both domestic demand and inflation, while soaring pay rises can cause an economy to overheat. As such, there is a strong case for a more appropriate euro area framework in which employers' organisations and trade unions could work in tandem across national borders[22] and governments join forces to use the leverage at their disposal[23], in order to ensure greater flexibility into pay negotiations and that wage growth reflects economic reality – moderate growth in some countries to close the gap between pay and productivity, and faster growth elsewhere to meet inflation targets. This type of mechanism seems particularly crucial for the euro area, precisely because cost-competitiveness cannot be obtained through exchange rate flexibility. This important – and necessary – step towards further integration requires a MIP that treats current account surpluses and deficits symmetrically.

2.3.2 A more coordinated approach to structural reforms

Within a convergence process prior to the accession to the euro area budget which would allow transfers between Member States, greater coordination on economic policy and a strengthened governance of structural reforms are necessary to bolster potential growth and keep moral hazard risks at bay. For example, a common unemployment insurance scheme could only be introduced – and would only be politically acceptable – if gaps between the labour markets of euro area Member States were narrowed. In particular, this convergence would prevent a given shock pushing up unemployment in one country and driving down wages in another.[24] Concomitantly, the European Semester could be more explicitly targeted towards policies contributing to raising productivity and developing human capital (education, vocational training, etc.), with the support of the investment budget expenditures.

2.4 Strengthen euro area governance and address the democratic deficit

Creating these new instruments would imply much closer integration within the currency bloc. The euro area's governance needs therefore to be overhauled by creating specific institutions, which would be accountable to a euro area Parliament – something that requires treaty change. Before such a treaty change, reinforcing coordination between the euro area Member States and a greater involvement of parlia-

(22) For example, through the macroeconomic dialogue with social partners and national productivity boards.
(23) Especially on minimum wage matters.
(24) Bénassy-Quéré *et al.* (2016), "Quelle union budgétaire pour la zone euro ?", *Note du CAE*, No. 29.

mentarians would be a first step towards a renovated institutional architecture for the euro area.

Looking further ahead, the proposed euro area budget would need to be overseen by a new political authority, such as a euro area "finance ministry". This new ministry would have the power to use the instruments outlined in this proposal, it would be bound by the mandate and conditions laid down in the revised treaties and within a framework of democratic accountability to both Member States and the European Parliament.

In this context, the Parliament would also need to play a greater role in the euro area governance. As things stand, the Council issues recommendations directly to Member States, while the European Parliament is not involved. The Parliament indeed only co-legislates on legislative acts adopted pursuant to article 121 TFEU and it plays no part in managing the ESM, which is as an inter-governmental entity. If the proposals outlined here are to be implemented, the Parliament would need the power to convene a "euro area-only" session, which would not require separate elections. As the proposals call for extensive resource pooling, another option would be to create a mixed "euro area" parliamentary entity comprising euro area MEPs and MPs from Member States.

If the proposal of creating a euro area finance ministry were to be pursued, it could oversee, under the new governance structure, the euro area budget – including revenue and expenditure planning – and would submit budgetary acts for adoption by the Eurogroup and the European Parliament (sitting in the "euro area-only" session). The ministry would also be tasked with setting the euro area aggregate fiscal stance, overseeing the MIP, monitoring the euro area financial sector (in tandem with the SSM and the SRM), determining and overseeing financial assistance and crisis management programmes (via the ESM enshrined in EU law) and, in the long run, representing the euro area to international financial institutions.

Such a configuration would ensure that economic policy instruments are properly coordinated, establish common ground on economic and financial conditions across the euro area, and create the conditions allowing for a proper articulation of fiscal and structural strategies vis-à-vis monetary policy, while keeping the latter entirely separate, serving its own specific aims. It would go a long way to fostering a more consistent policy mix across the currency union.

Yves-Emmanuel BARA, Lucie CASTETS, Thomas ERNOULT, Adrien ZAKHARTCHOUK

A counterpoint by... Thomas Philippon

The single currency encompasses a fundamental paradox: it is both a guarantee of independence from the rest of the world and a source of new constraints for Member States. This contradiction stands at the heart of the hurdles that the euro area is experiencing[a]*, in particular since the 2012-2013 "double dip".*

The assessment of the situation is quite straightforward. The architecture of the euro area has been adequately overhauled since 2011 so as to overcome financial instability in the short term. However, its overall design is still incomplete. Banking Union is still missing a treatment for the non-performing loans and a common deposit insurance scheme and, critically, the management of public finances is acutely inefficient. Some Member States now appear like emerging countries insofar fiscal policy reinforces the cycle instead of mitigating it. Furthermore, enforcing the fiscal rules is a never-ending source of tensions between the governments of the Member States and the Commission. Nobody is satisfied with the current system, but no consensus has emerged among Member states so far to replace it . The very political stability of the Eurozone is now at stake.

The single currency imposes some specific fiscal constraints. The main issue boils down to designing ways for ensuring rules compliance. There are three major avenues: i) a common budget with parliamentary oversight, which require a "federalist" momentum lacking today; ii) a supranational authority whose political legitimacy will always be fragile; iii) market discipline which is questionable, volatile and entails that Member States can default. There is no panacea and common sense suggests that all three approaches could be combined.

The investment budget proposed here is an excellent proposal. One finding to draw from all the studies, in particular those stemming from the French Treasury since 2012, is that it is simpler to create a common budget of a limited size than establishing ad hoc mechanisms of sovereign debt mutualisation. Moreover, as we can see in charts 7 and 8, a budget with cyclical revenues can stabilize GDP significantly while having a small impact on debt in the medium term. The future of the Eurozone relies on the solutions that Member States will feed the discussion with. This article caters to this need in bringing a critical contribution.

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a. See Philippe Martin and Thomas Philippon "Inspecting the mechanism: leverage and the Great Recession in the Eurozone", to be published in the *American Economic Review* (2017).

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