

EXECUTIVE SUMMARY

An elusive recovery unable to solve the social crisis

Nearly nine years after the meltdown of the financial system of developed countries followed by the euro debt crisis in 2012, recovery in Europe finally started in late 2014. We expect that economic growth is going to slow down in the EU in 2017 (1.6% after 1.9 % in 2016) and in 2018 (1.5%) as tailwinds are turning into headwinds. Brexit is likely to hit UK growth and will have negative, but limited, contagion effects to the rest of the EU. Oil prices are up again and not much more can be expected in terms of competitiveness gains through the exchange rate channel. More importantly the slowdown of international trade and of emerging countries' growth is weakening external demand to the EU and hence another positive factor is waning.

The aggregate fiscal stance for the euro area will be neutral in 2017, but the fiscal adjustment will resume in 2018. This movement will progressively reverse the positive fiscal impulse of 2015 and 2016. A positive fiscal stance has just been recommended by the European Commission. For 2017, they suggest a fiscal expansion of up to 0.5% of GDP. This is surely a welcome change in approach, as it stresses the need to adopt a global view on the policy mix in the euro area. However, this objective is not compatible with the current country level policy decisions. In particular, at the time of writing it does not seem likely that Germany will heed the commission's call and make use of available fiscal space. In 2017 fiscal policy according current national plans will continue to weigh on GDP growth even if the aggregate fiscal stance is neutral: positive fiscal impulses are concentrated in countries where there is no activity slack —leading to a low multiplier effect— while fiscal consolidation persists in countries with significant economic slack and a high fiscal multiplier. This shows that the European Semester should not focus exclusively on the aggregate change of the structural balance, without a comprehensive discussion about its geographical distribution and macroeconomic impact.

The multiplicity of risk sources encourages a wait-and-see attitude on the part of investors, a turning inwards, and discourages risk-taking. In this context, households and businesses prefer savings over investment, retarding growth and capital accumulation and confirming the fears of an economy trapped in low growth. Moreover, the prospect of a Brexit has created a new source of uncertainty in Europe. On top of this comes the Trump election in the USA. This political and institutional uncertainty combines with other sources of macroeconomic (deflationary risk) and financial uncertainty (non-performing loans).

This elusive recovery comes with a severe social cost as the reduction of unemployment is delayed. In 2015, 22.9 million people in the EU were unemployed and among them 10.9 million people were long-term unemployed. At the current pace of reduction, the unemployment rate would take 7 years to return to its pre-crisis level. The problem is particularly acute in the countries hit by the crisis and among young people. This can lead to “scarring”, preventing the accumulation of human capital and creating serious social problems; and in the long run it decreases young people’s sentiment of belonging to EU, fuelling the political crisis.

Europe needs more and better employment and a lower dispersion of incomes. The labour market slack specifically harms the poorer. The gap between the poor and the middle class has widened severely in Southern European countries, but also in Germany despite the decrease in unemployment there, showing that the rise of inequalities has multiple causes. One option, although it depends a lot on national context, is to distribute more equally the overall working time within the labour force in order to lower income inequalities. Whatever, fighting unemployment and creating better jobs must be a number one priority for policy makers.

Financing redistributive welfare states via the taxation of high wealth, high incomes and inheritances promotes economic growth and increases social stability. Increased progressivity in the taxation of incomes is not only a matter of introducing higher marginal tax rates on high incomes: the tax base also needs to be broadened. Moreover, tax compliance has to be improved and aggressive tax optimization as well tax evasion should be eliminated. Finally, well-targeted social spending needs to increase to counteract the rise of poverty rates.

A growth-oriented economic policy is necessary but not sufficient to obtain social progress and individual well-being. Policy makers need to move beyond the predominant, narrow focus on GDP growth, and aim instead at a broader set of economic, social and environmental targets. A slowing

down of GDP growth need not be a disaster as GDP is a partial measure of well-being. It ignores non-market flows such as domestic work, damages to nature and social inequalities. A good society should reach a fairly distributed material well-being, full employment and good jobs, quality of life and ecological sustainability. Furthermore, we propose four other subsidiary targets that aim at providing a stable economic framework: financial stability, stable state activity, price stability and external balance. A council responsible for monitoring well-being composed of economic, social and environmental experts could enrich the debate.

A new policy mix for the euro area

The accommodative monetary policy implemented by the ECB has been supportive of the euro area economy. The decrease in interest rates during the financial crisis and the unconventional policy decisions (the “Quantitative Easing” program) have provided a strong boost to investment. Even so, total investment in 2015 was 13 GDP points below its 2008 level. Yet this does not signal a monetary policy failure: our analysis shows that, without the ECB intervention, the investment rate would have been even lower, by 5.5 percentage points of GDP. Moreover, monetary policy has not so far led to bubbles on financial and housing markets in the euro area, contrary to a widespread belief.

However, monetary policy has now reached its limits. The current weakness of investment is not due to tight credit conditions but to low aggregate demand, on which unconventional monetary policy does not act directly. The marginal benefits of an additional round of quantitative easing in terms of new private investment seem very low. Moreover, the asset purchases of the ECB already represent a very large fraction of the flows of newly emitted public debt—though the stocks of debt are far from being exhausted.

Monetary policy should therefore be complemented with active and coordinated fiscal policies. However, Europe’s fiscal rules are too rigid and procyclical, preventing the attainment of these objectives. The method used by the Commission to estimate the cyclical part of the deficit leads to an overly procyclical fiscal policy under the rules of the Stability and Growth Pact (SGP). Domestic fiscal policies are fettered and passive, except at the margin under quite bad economic conditions, thanks to EU rules and national “debt brakes” introduced as part of the fiscal compact. Public investment has suffered disproportionately under the austerity policies, in the absence of special SGP provisions protecting and supporting it.

We identify two promising reform paths for the SGP: the golden rule of public finance and a modified expenditure rule. The golden rule is a traditional public finance concept that deducts net public investment from both the headline and the structural deficit, so that net public investment would be financed via deficits. The spending rule implements a limit for non-cyclical nominal expenditure growth, that is determined by the medium-term growth rate of real potential output plus the ECB target inflation rate of 2%, stabilizing the expenditure-to-GDP ratio over the business cycle. The spending rule and the golden rule of public investment should be the major point of reference of the preventive as well as the corrective arm of the SGP. Both rules together avoid the procyclicality of the current framework while at the same time ensuring fiscal sustainability.

The Juncker plan is broadly positive, but neither the needed stimulus in the short term nor the increase in potential growth in the long term are going to happen in the current form of the plan. The new doctrine behind the Juncker plan was that a stimulus was needed at the euro area level and that an investment stimulus would achieve simultaneously a short-term macro boost to escape the secular stagnation trap, and a longer-term effect through higher productivity levels and assets build-up, that ensure the sustainability of public debt and pension systems in the long run. The Juncker plan is clearly under-sized, with not enough fresh money on the table; more fundamentally, it is essentially a rather small extra insurance on investment projects, which is not different in nature from the already present effects of conventional and non-conventional monetary policy.

A strong public investment push is needed, and is to some extent possible even under current fiscal rules. Net public investment was negative in 2015 in the euro area: depreciation was larger than gross investment. But investment in public infrastructures—either installation of new capacities or maintenance of the existing ones—can significantly benefit long term growth, while providing a short-term boost to activity, given the large fiscal multipliers. Other expenditure categories, like education, health, child care, social work and integration, can also increase labor supply and productivity. We show that public investment financed by public debt can significantly increase net public worth. Due to short term Keynesian effects, amplified in a time of low inflation and high unemployment, allowing for 1% GDP of public investment that raises public debt by the same amount in 2035 would lead to an accumulation of more than 1.6% of GDP of public assets. Provided that public investment projects are well managed, the long-term effect on potential growth will improve the balance sheet of the public sector.

Accelerating the path into the transition to a zero carbon economy is another way to produce the needed stimulus in the short term while building up sustainability in the long term. As we argued in the iAGS 2015, market oriented instruments like emission trading schemes (ETS) and a carbon tax could be used to increase the rate of return on private investment in the transition. Third party financing in the field of energy efficiency of residential buildings is another way to solve the short termism of households stuck in lasting crisis. Compensation of “brown” capital holders, exposed households or declining sectors could then be a public investment in the transition. Dealing with the issue of competitiveness toward economic zones where carbon has a zero or low price could be implemented with border tax adjustments.

Tackling macroeconomic and financial imbalances

The rethinking of the mix between monetary and fiscal policies is not enough to tackle all the challenges faced by the euro area. Current account imbalances, that were at the heart of the crisis that begun in 2009, are still present and threaten the very survival of the monetary union. Financial instability—notably the issue of non-performing loans—constitute another decisive challenge. Moreover, there is some degree of conflict between the various economic objectives: trade-offs must be identified and hard choices should be made.

Almost all euro area countries posted a current account surplus in 2015 and intra-EMU trade imbalances have been reduced, but this does not mean that macroeconomic imbalances are no longer important. The current account improvement in Southern countries is largely due to a compression of internal demand through austerity policies, and much less to an improvement in exports; faster demand growth, needed to bring unemployment down, risks widening deficits once more. Many northern countries, and especially Germany, are running huge current account surpluses that could lead to a euro appreciation, with negative consequences on the competitiveness of all euro area countries. Substantial nominal adjustments are therefore still needed to correct for these imbalances; what is critical is that they are achieved as far as possible symmetrically.

The reconvergence of the euro area could be achieved through two pillars: a nominal one —via a golden wage rule— and a structural one. The golden wage rule implies that nominal wages increase at the rate of domestic productivity augmented by the ECB inflation target of 2%. In the short run the rule

should be amended to correct for the existing nominal imbalances, *i.e.* wages increasing faster than the rule in the North, and slower in the South. Tools for the implementation of this coordinated wage policy include: generalization of wage floors and cross-country coordination of their increases, recentralization of wage negotiations and generalizations of collective agreements. Other tools relating to changes in indirect wages costs could also be mobilized. In parallel, policies centered on the convergence of productive capacities and standards of living must also be implemented; in the South, this includes structural investment in export capacities to raise productivity, improve non-cost competitiveness and, promote alternative energy production allowing full exploitation of comparative advantages.

The Macroeconomic Imbalance Procedure (MIP) should be made symmetrical and should be completed by an analysis highlighting the link between different imbalances and the policy tradeoffs. So far, the adjustment has remained asymmetric, weighing mainly on deficit countries. The MIP should be made more symmetric so as to encourage reflationary policies in countries with high current account surpluses. A bottom value should be introduced for nominal unit labor cost growth, and the same absolute value should be used for upper and lower thresholds for the current account. More fundamentally, the scoreboard hides the fact that some imbalances are linked—for example that surpluses in some countries have the same root cause as deficits in others—and that tradeoffs exist between the policy objectives. Reducing the internal current account imbalances makes it more difficult for deficit countries to achieve debt stabilization and full employment, because of the deflationary effect and the consequent rise of the real interest rate. Moreover, the correction of the external imbalance of the whole euro area—*i.e.* its high current account surplus—through a euro appreciation, would increase the internal divergence of the zone. Procedurally, the MIP should therefore be expanded with a broader and more systemic economic analysis. Substantively, the policy to mitigate such tradeoffs is a full utilization of fiscal space in all countries combined with an increase of inflation in surplus countries.

In the medium run convergence with balanced, non-inflationary growth would require ambitious changes to the institutional design of the euro area. A reform agenda, that as far as possible makes use of existing procedures, could start by revitalising economic policy co-ordination as laid down in Article 121 TFEU, with the Broad Economic Policy Guidelines as its central element. This change would enable the policy mix between aggregate-level monetary policy and predominantly national fiscal policies and incomes policies to be evaluated within a common and consistent framework. Member states should

use a mix, appropriate to the country in question, of fiscal and incomes policies, in order to ensure demand and nominal wage and price developments consistent with overall policy goals. The recently established European Fiscal Council and the envisaged productivity boards at national level should be given an extended remit to analyse the overall macroeconomic policy mix. In order to ensure the linkage between expert analysis and effective policymaking the existing Macroeconomic Dialogue (MED) - which brings together the social partners, the central banks and representatives of the Commission and national fiscal policy at EU level should be substantially strengthened, with a MED at the level of the Euro Area and each Member State.

Financial risks weigh on future prospects, making it urgent to solve banking system troubles. Solving the non-performing loans (NPL) problem should be a top priority for policy makers. NPL have reached ? 1 132 billion in the euro area and, more worrisome, they are concentrated in some countries. Bad bank schemes appear particularly well-suited to deal with large portfolios of NPL, even if some implementation details should be discussed (whether the bad bank should be at the European or national level; whether a European Fund should guarantee the new institution). Developing a secondary market for NPL—through securitization of those assets—is appealing. However, the subprime crisis has also shown that, if not properly structured, securitization can magnify financial instability and inflict serious damage to the wider economy. Insolvency frameworks should also be improved and the tax system should incentivize banks for building adequate provisions.

While the basic diagnosis of fragmented and bank-centered capital markets is widely shared, there is no agreement about the relevance of the Capital Market Union (CMU). The main objective of the CMU is to diversify Europe's financial system, to supplement bank financing with a sophisticated array of capital markets, and to overcome fragmentation, with the ultimate goals of "freeing up" inactive capital and stimulating the real economy. Yet, credit sluggishness is mainly explained by the lack of demand for loans on the part of companies, which face fundamental uncertainty and substantial excess capacity. Moreover, our research suggests that a deepening of financial interrelationships implicit in securitization can lead to higher systemic risks. In the medium and longer run this could well turn out to be counterproductive for economic performance. In addition, the inherent complexity of the interrelationships cast doubt on the claim and intention of the Commission's proposal that the new securitization markets can be kept simple, transparent and standardized.

