ECONOMIC POLICIES IN THE EURO AREA AFTER THE CRISIS[1]

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In 2019, 20 years after the launch of the single currency, the euro area policy framework remains highly debated among politicians, academics, and citizens. The need to improve this framework had been highlighted by the widening of imbalances prior to the 2007 financial crisis, and afterwards by the huge impact of the financial crisis, the sovereign debt crisis in Southern European countries, and the Great Recession. The issues under debate may be divided into four main axes.

An unfinished construction?

The architectures of the European Union (EU) and even more of the euro area are specific and subject to never-ending changes, with disagreement on the plans among EU architects.

For federalists, the EU should become a federation that progressively acquires all the powers and characteristics of a nation. The single market, the single currency, the monetary union (the European Central Bank, ECB, the banking union), the fiscal union (the Stability and Growth Pact, the Fiscal Treaty, the "first European semester") already exist. Fiscal EU should be deepened (a federal fiscal policy), as well as the banking union, the capital markets union, EU diplomacy, social Europe, European taxation, European defence, etc. There is a need to move forward, towards greater integration than in current treaties. At each step,

1. This volume brings together a group of papers, following a reviewing process and based on earlier drafts presented at the 15th EUROFRAME Conference on economic policy issues in the European Union: "Economic Policies and Political Economy in the EU after the Crisis", held in Milan (Italy) on 8 June 2018. EUROFRAME is a network of ten independent European research institutes: DIW and IfW (Germany), ESRI (Ireland), OFCE (France), PROMETEIA (Italy), CPB (Netherlands), WIFO (Austria), ETLA (Finland), CASE (Poland), and NIESR (United Kingdom). Since 2004, every year in June EUROFRAME has been organising a Conference on economic policies in the EU. In 2018, 25 papers were presented. Most of them are available on the Conference web page (http://www.euroframe.org)

Europe remains an unstable construction, which needs to be consolidated through more Europe.

For the proponents of a Europe of Nation-states, the EU should keep an intergovernmental functioning, and decisions should be made by heads of government, under the unanimity principle. EU powers and its size should not be extended. The subsidiarity principle should be respected: decisions should be made at the lowest possible level, and domestic specificity should be allowed to remain.

Each of these strategies raises economic and democratic issues. The federalist strategy does not account for EU countries' diversity in terms of economic and social structure. The Member States (MS) are expected to converge towards a single model, defined through a technocratic process. According to some, the EU should oblige the MS to converge towards a neo-liberal economic model, the only model suitable to globalisation. According to others, the EU should protect the European social model, with its specificities, its scale of social protection, labour laws, etc. The Nation-state strategy is not promising. It does not account for interdependencies between the MS. There is a strong contradiction between on the one hand the single market and the single currency, and on the other hand domestic structures, be it in terms of wage developments, taxation, the social system, or industrial policy. In both cases, crucial decisions are being made at the EU level without democratic debate, without political choices, either within technocratic federalist circles or through compromises reached by governments. This is what we have seen since the 2007 crisis, with the absence of democratic debates at the EU level on issues such as financial support for Greece, the Fiscal Treaty and Brexit.

There are permanent tensions in the euro area between a federalist ambition (*an ever closer Union*) and desires to retain or recover domestic sovereignty (*taking back control*). These tensions may lead to open or hidden crises, like Brexit, or some MS' reluctance to combat tax optimisation or the refusal of some Central and Eastern European countries to open their frontiers to migrants.

A crisis of national cohesions

In addition, in all the advanced economies, national cohesion is being weakened by technical progress, globalisation, financialisation and migration. De-industrialisation, robotisation and automation reduce the number of stable and relatively well-paid jobs for lower- and middle-class workers. Conversely, a small number of people benefit from financialisation and globalisation. Wage and income inequalities increase. While social protection needs grow, the public finances are constrained by tax competition. Temptations towards protectionism and nationalism mount. The fracture between the upper class and the rest of the society widens as the lower class loses trust in the elites. This is not a phenomenon specific to the euro area, as can be seen from Brexit or the election of Donald Trump in the US. In Europe, this often translates into rejecting European construction.

Each advanced country (or area) has to choose between two strategies: strengthening competitiveness and attractiveness, and thereafter relying on job and wage flexibility to allow the invisible hand to restore a satisfactory equilibrium; or strengthening domestic (or EU) protection, either via trade policy, industrial policy, or social policy. Moreover, the ecological constraint requires tough economic decisions. Strategic choices are particularly hard to make in the EU where the MS are in different situations and have diverging interests and ways of thinking. So far, the attempt by French President Emmanuel Macron to promote a "European renaissance" has faced inertia from some MS and clear hostility from other MS, who oppose any move towards further European integration. How to make strong and constructive decisions in these conditions?

Which rules of functioning?

The euro area does not have satisfactory functioning rules. Fears of Northern countries about fiscal laxism leads to the introduction of numerical fiscal rules lacking economic rationale, such as the deficit limit of 3% of GDP and the 60% limit of GDP for public debt, the objective of long-term public structural balance, or the requirement to reduce the structural deficit by an annual 0.5% of GDP. The EU Commission and several MS are refusing to change the rules, although they do not fit the current economic context. A situation with nominal interest rates at the zero lower bound was not anticipated. Some level of public deficit and public debts seem necessary today for the macroeconomic equilibrium. The pre-crisis periods have shown the need for more precise economic policy coordination; it has turned out that the tricky points were wage coordination and the compatibility of external balances objectives.

Fortunately, the principle of the absence of solidarity between MS as well as of the ECB not being allowed to buy public bonds have been forgotten. But more generally speaking, while some progress has been made, this has not resulted in a coherent architecture. The EU institutions assess the economic policies implemented in the MS and provide critical assessments if the latter do not follow EU rules and guidelines, but they do so on a country-by-country basis, with no real overall coherence. It would be illusory anyway to try to reach coherence if the MS that have room for manoeuvre refuse to use it. All in all, the EU can only criticize MS whose fiscal policy does not follow the predefined rules; but this does not at all define an overall fiscal and wage strategy.

In principle, there is a single monetary policy for the whole euro area, but the financial markets increase spreads on long-term interest rates, punishing fragile countries (such as Italy) and lending at low rates to strong countries (such as Germany), which exacerbates divergences. This could be corrected by a macro-prudential policy, which nevertheless conceals an ambiguity: how to control domestic imbalances by imposing credit ratios on increasingly internationalized banks?

On the one hand, one may wish to give the EU authorities more power to steer euro area macroeconomic developments, either by offering them the possibility to play a fiscal role, or by organizing automatic transfers between MS in differing economic situations. On the other hand, this would require that EU authorities abandon rigid fiscal rules and that they set themselves the objectives of full employment and the elimination of intra-zone imbalances. But these are areas where a consensus is very difficult to reach, meaning that national fiscal policies will have to remain autonomous for a long time, with the EU authorities having only an advisory role.

National fiscal policies would be facilitated if a European budget financed investments, and more generally European common goods (such as fighting against climate change), by using common resources (the carbon tax and the financial transaction tax) and by issuing Eurobonds. But this cannot be a pretext for adding constraints on national budgets.

The European institutions believe that they can overcome these problems by two strategies. On the one hand, the capital markets union is supposed to improve financial efficiency and play an automatic stabilizing role, but only if portfolio diversification is sufficient, which is not assured. On the other hand, structural reforms are expected to contribute to the convergence of the European countries. However, will these be sufficient to cope with the divergent trends induced by the polarization of industrial activities? Moreover, the direction of these reforms would probably benefit from a more open debate.

Towards which kind of normalisation?

At the time of the EUROFRAME Conference, in June 2018, EU economic policy was facing two main challenges: monetary policy normalisation and improving the fiscal policy framework. So far, no advanced country has succeeded in bringing their economy back to a normal situation, where real interest rates would be close to long-term output growth and a primary structural balance close to 0. Central banks are considering a move to increase their interest rates and to progressively bring non-conventional policies to an end. Higher interest rates are anticipated, and one may expect that companies and financial institutions are prepared for this. Almost all EU countries already run structural primary surpluses. The issue is more of a macroeconomic order. Will monetary policy normalisation be implemented without being accompanied by more expansionary fiscal or wage policies, which are difficult to coordinate in the EU? The need for an ecological transition could suggest a new orientation of fiscal and monetary policies, gearing them towards joint support for investments made in the ecological transition framework.

More fundamentally, the euro area economic policy framework will need to be redesigned, by taking into account European choices and national choices, in terms of monetary policy but also of credit, fiscal policy, tax policy, and wage policy. Once simplistic solutions, such as a federal unification under the auspices of the EU institutions or such as the full autonomy of the national choices have been removed, a painful compromise will have to be found.

The papers released in this volume address three main topics: fiscal rules, which remain at the core of fiscal policy debates in the EU, euro area governance, and bank stability.

Fiscal rules

Katja Rietzler (Macroeconomic Policy Institute (IMK) at the Hans-Boeckler-Foundation, Düsseldorf) and Achim Truger (University of Duisburg-Essen, German Council of Economic Experts, Wiesbaden, and IMK), in "Is the 'Debt Brake' behind Germany's successful fiscal consolidation?", carry out a comparative analysis of the "structural" consolidation of public finances in Germany from 1991 to 2017. They show that Germany's successful budget consolidation since 2010 is due not to the introduction of the German debt brake, which serves as a model for the European fiscal treaty, but to fiscal stimuli, the progressive reduction in transfers to East Länder, and low interest rates.

Heikki Oksanen (University of Helsinki), in "New output gap estimates for the euro area and elsewhere", proposes a simple statistical method for estimating output gaps: to introduce explicit assumptions about future growth and to smooth GDP by an HP filter. This method would give results that are as satisfactory as the more elaborate methods used by international organizations (EC, IMF and OECD). The author recognizes, however, that the output gap estimates remain subject to revisions, which affect the fiscal effort assessment. Looking at the years 2011-14, the author shows that an undervaluation of potential growth can be self-fulfilling, leading to overly restrictive fiscal policies and thus a decline in effective growth. However, the author argues for transfers between countries based on differences in output gaps.[2]

2. A critique of statistical methods to estimate output gaps, as well as of the use of potential growth for forecasting and for economic policy analysis may be found in: Catherine Mathieu and Henri Sterdyniak (2015): "Should we still use the concept of potential growth?", *OFCE Working Paper*, 2015/30.

Euro area governance

Catherine Mathieu and Henri Sterdyniak (OFCE) in "Euro area macroeconomics—where do we stand twenty years later?" recall recent euro area reform proposals from EU institutions (a convergence and competitiveness instrument, a fiscal stabilization mechanism at the euro area level) and from the Member States (more budgetary discipline supervised by markets or, on the contrary, more solidarity between MS and a euro area budget). The authors present and discuss the different viewpoints of economists: those who trust financial markets to control national economic policies, those who want to strengthen fiscal rules, those who want to improve existing rules, those who want to organize more or less automatic transfers between MS, those who want to establish a euro area budget and finance minister, those who want to move towards a democratized federal Europe, those who propose original measures to reduce public debts, and finally those who advocate a better coordination of autonomous fiscal policies in a Keynesian perspective.

Harmen Lehment (Kiel Institute for the World Economy), in "Fiscal implications of the ECB's public sector purchase programme" analyses the fiscal impacts in terms of the seigniorage gains of the public sector purchase programme (PSPP), which the ECB started in 2015 for monetary policy purposes. The author shows that this programme allowed governments to get funding through banks' excess reserves, i.e. at a short-term and entirely safe interest rate instead of selling longer-term bonds at an interest rate bearing a risk premium. The gain increases as the remuneration on reserves is low and the risk premium is high. In order to compensate for the future rise in the rate of remuneration of reserves, the author recommends increasing banks' reserve requirements and not to remunerate them.

Bank stability

Ilkka Kiema (Labour Institute for Economic Research, Helsinki) and Esa Jokivuolle (Bank of Finland) in "Bank stability and the European deposit insurance scheme" analyse the impact of a deposit insurance mechanism, under the assumption that depositors anticipate the risk that governments may default, and compare the cost of a guarantee with the cost of a loss in reputation. From this perspective, the European deposit insurance scheme would improve bank stability for a limited crisis, but its effects might be ambiguous in a systemic crisis that affects the whole Banking Union (increasing the risk of voluntary default by all MS).