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EURO AREA MACROECONOMICS WHERE DO WE STAND 20 YEARS LATER?¹

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Sciences Po, OFCE

For almost 20 years, euro area countries have been sharing a single currency. The drawbacks of the euro area framework were highlighted by the widening of imbalances prior to the 2007 financial crisis, and thereafter by the huge impact of the financial crisis, the public debt crisis in Southern European countries, and the Great Recession. Prior to and after the crisis, EU institutions and Member States (MS) have not been able to implement either a common economic strategy or satisfactory economic policy coordination.

This led neither to a bursting of the euro area, nor to a substantial change in its functioning. Euro area institutions were adapted, through the European Stability Mechanism, the Fiscal Treaty, the “first semester”, the European Central Bank’s support to MS, and the banking union. These adaptations were painful.

In mid-2018, the economic situation had clearly improved at the euro area level. However, the following question remains unsolved: can the functioning of the euro area be improved, accounting for divergent situations, interests and views in MS?

The paper recalls proposals from EU institutions and from MS. We present and discuss a number of proposals made by economists to improve the euro area policy framework: relying on financial markets to control domestic economic policies, introducing a euro area budget and a minister of finance, moving towards a federal EU with increased democracy, and last, improving economic policy coordination.

Keywords: Fiscal policy, policy coordination, EMU governance

1. An earlier draft was prepared for the EUROFRAME Conference, Milan, 8 June 2018. We would like to thank especially John FitzGerald, the discussant, all participants at the session for their comments and suggestions, and an anonymous referee. The usual disclaimer applies.

For almost 20 years, euro area countries have been sharing a single currency. The drawbacks of the euro area framework were highlighted by the widening of imbalances prior to the 2008 financial crisis, and thereafter by the huge impact of the financial crisis, the sovereign debt crisis in Southern European countries, and the Great Recession. Prior to and after the crisis, EU institutions and Member States (MS) were not able to implement either a common economic strategy or satisfactory economic policy coordination (see, for instance, Mathieu and Sterdyniak, 2014).

This led neither to a break-up of the euro area, nor to a substantial change in its functioning. Euro area institutions were adapted, through the European Stability Mechanism (ESM), the Fiscal Compact (TCSG), the “European semester”, the European Central Bank’s (ECB) support to MS, and the banking union. These adaptations were painful: Southern MS public debt remained under the threat of speculation for a long time period; economic recovery was delayed by the fiscal austerity recommended or requested by EU authorities; and several MS were placed under surveillance. Greece is still in a difficult situation. This is also the case to a lesser extent for Italy.

In 2018, the economic situation had clearly improved at the euro area level: euro area GDP grew by 2.7% in the last quarter of 2017 on a year-on-year basis, but GDP grew on average by a mere 0.6% per year from 2007 to 2017 (against 2.3% per year in the previous decade). The unemployment rate hit 7.8% in December 2018 (against 7.3% in early 2008, but 12.2% in early 2013). The scars of the crisis remain: unemployment rates are still elevated, especially in Greece (+11 percentage points as compared to 2007), Spain (+6 percentage points), and Italy (+4.5 percentage points); public debts have risen sharply; income inequalities and precariousness have risen in many countries; and many countries (France and the Southern countries) are suffering from de-industrialisation.

Can the functioning of the euro area be improved, accounting for divergent situations, interests and views among MS? Section 1 recalls proposals from EU institutions and from MS. Section 2 presents and discusses several proposals made by economists to improve the euro area policy framework. Some economists rely on financial markets to control domestic economic policies, some are in favour of the introduction of both a euro zone budget and a minister of finance, some are in

favour of moving towards a federal EU with increased democracy, and last, some advocate better economic policy coordination.

1. Projects from EU institutions and from Member States

EU Treaties and reforms implemented since the crisis have led to a complicated and unsatisfactory euro area architecture. Euro area economic policy is run by the ECB, a federal institution, by the European Commission (which deals with the whole EU), by the Euro zone Council and the Eurogroup (two informal intergovernmental bodies), by the European Council and the Council of the European Union (two intergovernmental bodies involving non-euro area countries), by the European Parliament (democratically elected, but at the EU level, and with limited powers), by the Fiscal Pact and the ESM (which result from inter-governmental treaties) and, when needed to help and supervise MS in difficulty, by the quartet of the European Commission, the ECB, the IMF and the ESM. The main decisions are made through agreements between the European Commission and MS, without any real democratic debate.

This framework, the financial crisis and the Great Recession, followed by the debt crisis in Southern economies, have initiated numerous project reforms of the EMU, by EU institutions, MS, policy makers and academics. Projects emanating from EU institutions generally tend to increase their powers. They face reluctance from MS, who wish to keep their powers and autonomies: Northern MS reject any increases in EU transfers; smaller countries wish to keep their specificity, and refuse the hegemony of larger MS. EU institutions generally tend to place MS under surveillance as concerns macroeconomic management or structural reforms, which comes into contradiction with domestic democratic sovereignty, as can be seen from the Greek crisis or Brexit. Besides, EU institutions do neither want to question the Stability and Growth Pact and the Fiscal Compact, nor the absence of explicit coordination between fiscal and monetary policies.

1.1. Towards a deep and genuine economic and monetary union?

Several texts by EU institutions (EC, 2012, Van Rompuy *et al.*, 2012, Juncker *et al.*, 2015) suggest substantial steps towards more 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 not accounted for.

- The need for strengthened fiscal discipline is reasserted, together with the need for *ex ante* fiscal policy coordination. But, with the Fiscal Compact requesting fiscal policies to be run in automatic mode, how coordination could be implemented is unclear.
- The Commission wishes to be entitled to oblige an MS to revise its budget plans or to modify its budget implementation and to be entitled to halt EU payments to MS that do not take the corrective action requested by the Commission.
- Short-term government borrowing could be mutualised under the auspices of a European Treasury. But as MS have no problem to borrow in the short-term, they cannot agree to lose this freedom.
- The "euro area should have a fiscal capacity to absorb asymmetric shocks". Specific discretionary policies should be raised at the EU level. This is an awkward suggestion, once MS have been deprived of their ability to implement discretionary fiscal policies. But MS cannot accept to lose entirely their fiscal autonomy.
- "An insurance mechanism aiming to absorb specific shocks could be settled within euro area MS, based on output gaps or unemployment insurance schemes. However, transfers should be temporary, each MS would be alternatively beneficiaries or contributors from time to time. This mechanism should neither introduce moral hazard, nor reduce incentives to implement structural reforms".
- The macroeconomic imbalance procedure should become more binding and would recommend structural reforms and also tackle the case of MS with excessive surpluses.
- A new convergence and competitiveness instrument (CCI) should be introduced in the EMU. MS would sign an agreement with the EU, committing to implement structural reforms, which would allow them to benefit from a financial reward or from indulgence for their fiscal deficits.
- "[MS] need flexible economies, yet relative price adjustment will never occur as quickly as exchange rate adjustments. Financial markets prevent MS to use the fiscal tool. So, euro area countries need to pool private risks via the banking and financial union. In the medium term, when economic structures have converged,

a mechanism of fiscal stabilisation of the euro area as a whole could be established.” Thus the European Commission recognises that the euro area framework will remain unstable for a while; many conditions need to be met before setting up a satisfactory stabilisation mechanism. Business cycle convergence would be achieved through financial diversification. Should a country suffer from economic imbalances, this would not be a problem, since economic agents would hold financial assets from other MS. However, empirically the economic impact of this channel is very weak (Clévenot and Duwicquet, 2011).

- The banking union should be achieved (since the de-nationalisation of banking systems would lower the risks of financial fragility and instability). No financial transaction tax (FTT) or separation between deposit banks and markets and business banks is suggested.
- The achievement of the capital markets union would be the priority, as it would facilitate risk diversification and giving SMEs access to finance (but it is the role of banks to finance SMEs). EU institutions recognise that eliminating national barriers could create new financial risks. Therefore, they advocate a single supervisor for European capital markets.
- The EU should have a single seat at the IMF (although this request may look surprising, after Greece, Ireland and Portugal were requested to ask for IMF support during the crisis, which showed a lack of solidarity and homogeneity in the area).

The proposals to issue Eurobonds guaranteed by all MS as well as the ECB's guarantee for public debt were not kept, due to the German veto of unlimited and unconditional commitments. But it seems difficult to strengthen the euro area without such commitments.

On 26 September 2016, the EU Council agreed on the implementation of National Productivity Boards responsible for the diagnosis and analysis of productivity and competitiveness developments, which is problematic in the light of current national institutions of negotiation and bargaining between social partners. It remains unclear if each national council will be expected to make recommendations to improve domestic competitiveness or if, in the case of Germany for instance, the German council will be expected to recommend substantial wage increases in Germany to reduce intra-area imbalances.

In May 2017, the Commission published a *Reflection paper on the Deepening of the Economic and Monetary Union*. The paper points out the disagreements between MS in favour of more solidarity and those claiming more responsibility of each MS; the text recognises the persistence of economic and social divergences, and growth weakness in some MS, but does not draw any conclusions in terms of global economic strategy. The text recognises that the euro area architecture and governance have become complex and difficult to manage. The reform proposals address mainly three axes:

- The Commission wishes to complete the banking union by setting a common fiscal mechanism to support the Single Resolution Fund and the European Insurance Deposits Scheme. However, some MS refuse any additional solidarity, especially if unlimited; other MS wish to keep the capacity for rescuing domestic banks; it would be costly to set up a sufficiently large fund able to intervene in any event, without “using public money”. These issues arise only because euro area countries lost their monetary sovereignty; because there is no clear separation between deposit and credit banks and market banks; and because some MS (Greece, Italy, Spain) still suffer from the crisis, or are condemned to low growth, which weakens their banks.
- The Commission is proposing the capital markets union, with the view that firms will have access to more innovative and diversified funding, but the 2007 crisis has shown the risks entailed by financial innovations and diversification.
- The Commission suggests lowering the share of public debt held by domestic banks, and to consider this debt as risky, which should have a counterpart in banks’ capital requirement. EU banks would thus have the incentive to reduce and diversify their public debt portfolios. Thus, in theory, a government could restructure public debt without putting domestic banks in trouble.² Simultaneously, one or several, synthetic assets would be introduced, supposed to be safe and relying on government bonds securitized portfolios. These assets would be owned by banks or EU financial institutions. Financial engineering would be relied upon to build and assess such safe portfolios, with senior

2. However, this measure would not have prevented the crisis. In Spain and Ireland, domestic banks held very little amounts of public debt before the crisis. They have diversified too much away from government debt to more profitable lending to households (thanks to John FitzGerald for pointing this out).

tranches containing necessarily a lot of German, Finnish, and Dutch bonds, and few Italian, Portuguese or Spanish bonds. The report admits that the two former measures would however lead banks to reduce the share of government bonds in their balance sheet, which could “disrupt not only the functioning of their home financial systems. It would potentially also impact on financial stability for the euro area as a whole”. Obviously, interest rate spreads would rise strongly in the euro area if Italian or Spanish banks were buying huge amounts of Northern countries’ bonds.

These proposals would contribute to fragmenting the euro area between countries considered as safe or unsafe. It would undermine government borrowing, which would be deprived of a guaranteed funding by its domestic banks and financial institutions. This fragility would enhance speculation. Fiscal discipline would rely on financial markets’ surveillance and on financial engineering, although the 2007 crisis showed the limits of this approach. How would one assess the probability of events such as a sovereign default by France, Spain or Italy, which depend not only on the domestic situation but also on the ECB’s and other MS responses? The Commission seems to try to break the link between national Treasuries and domestic financial intermediaries, so as to restrict their ability to issue bonds.

- The text advocates MS convergence, but often confuses convergence, coordination and compliance with arbitrary rules. The Commission wishes to set “...a strong link between related reforms, the use of EU funds and access to a potential macroeconomic stabilisation function”. The CCI is again envisaged as “a dedicated fund to provide incentives to Member States to carry out reforms”.
- The text envisages a macroeconomic stabilisation mechanism for the euro area, under such conditions that it would play a very limited role: “The function should not lead to permanent transfers, minimise moral hazard, and not duplicate the role of the European Stability Mechanism (ESM) as crisis management tool. Access to the stabilisation function should be strictly conditional on clear criteria and continuous sound policies, in particular those leading to more convergence within the euro area. Compliance with EU fiscal rules and the broader economic surveillance framework should be part of this”.

- The EU architecture should be strengthened and more democratic. However, the text does not suggest the introduction of euro area specific institutions, but rather hopes that all MS will join the euro area. The Eurogroup could become an instance of the Council, with a full-time president. The ESM could become a European Monetary Fund (EMF), incorporated in the legislative framework of the Treaties. A euro area Treasury could be in charge of fiscal and economic surveillance in the euro area, of managing the macroeconomic stabilisation mechanism, and of coordinating the issuance of safe European assets. Fiscal rules could be simplified.

1.2. A strengthened project?

Recently, the European project was strengthened by four elements. Since 2015, some economic recovery had been underway in the euro area. Greece refused to leave the euro area. The UK did not succeed to define a clear and dynamic Brexit strategy, which discredits the alternative of leaving the EU. The EU showed unity in both the Greek crisis and Brexit. In both cases, strong positions won.

Last, the EU strategy has been strengthened by Emmanuel Macron's victory in the French Presidential election in 2017. Macron's projects for a European overhaul, in particular in his Sorbonne speech (26 September 2017) attracted a lot of interest in Europe: "The time when France proposes is back".

According to Emmanuel Macron, France, viewed as the "bad pupil" of the euro area class, should commit to a strict fulfilment of its European commitments, cut its public deficit and implement structural reforms, to show the euro area that France is a reliable partner. However, France cannot be blamed for having run policies with harmful effects for euro area partners: France did not run an excessive external surplus; domestic competitiveness neither improved nor deteriorated strongly; and the French public debt was not subject to speculative attacks.

In a second stage, renewed trust between France and Germany will allow them to lead a "group for European overhaul", i.e. a group of euro area countries agreeing to move towards a rapid convergence in fiscal, taxation and social areas.

Emmanuel Macron proposed, in his electoral programme in 2017: "to create a budget for the euro area with three functions (investments

for the future, emergency financial assistance and responses to crisis). Access to this budget will be conditioned on fulfilling common rules in tax and social areas (to avoid dumping in the euro area). A Minister of Economy and Finance of the euro area will be responsible for the euro area budget, under the control of a Parliament of the euro area, bringing together European parliamentarians of the Member States". This budget would be funded by digital and environmental taxation, a financial transactions tax and a fraction of the corporate income tax (CIT). It seems unlikely that France may obtain the implementation of a substantial euro area budget, with an explicit stabilization target, after having agreed to pass under the "Caudine Forks" of EU constraints. The risk is that MS should abandon as a counterpart any independent fiscal policies. The euro area Minister, responsible for stabilization, would have a right of control on national budgets and could ask for budget corrections if he considers them not to comply with the treaties. But EU institutions have always denied the need for and the effectiveness of fiscal stabilization policies and claimed instead that MS reach full employment by fiscal consolidation policies and structural reforms. Will this Minister be able to impose expansionary fiscal policies in countries running excessive current surpluses? Emmanuel Macron did not clearly question the fiscal rules of the Maastricht Treaty and of the TSCG. However, he asked Germany to abandon its "fiscal fetishism".

Establishing a Parliament of the euro area is supposed to democratize the area, but it would not be possible to complicate the EU framework by introducing euro area specific institutions.

At the same time, Emmanuel Macron still supports the traditional French proposals. The European Pillar of social rights should define minimum levels for health coverage, unemployment insurance and a minimum wage (taking into account the unequal development of MS). A common base and harmonisation of CIT rates should be settled to combat tax optimization, but this proposal will face opposition from several MS (Ireland, the Netherlands, Belgium).

The euro area would be split into two, between countries accepting the renovation project, in particular tax and social convergence, and those refusing it, which is difficult to imagine, since Europe would then have three circles, even four if Brexit leads to create around the EU a circle of countries linked by a customs union. Moreover there is currently no agreement among EU people (not even among core countries) to move towards more integration. In the current situation, few

peoples will agree that their budget, taxation systems and reforms of their social systems should be decided by a federal body.

Emmanuel Macron has two contradictory positions. On the one hand he wants to drastically transform the French economy and move it towards a more liberal functioning. On the other hand, he asks the other MS to get closer to France, in setting floors for tax rates, social protection, and minimum wages, and in settling protectionist measures and industrial policies.

The Meseberg declaration, signed by Angela Merkel and Emmanuel Macron on 19 June 2018, is a compromise text. Germany supported the French proposal to set up a euro area budget to promote “competitiveness, convergence and stability”. However, the size of this budget is not specified. Expenditure should come in substitution to national expenditure; public debt reduction remains a priority. It is not said that this budget could be run in deficit. The stabilisation function would not mean permanent transfers. Strategic decisions on this budget would be made by euro area MS, but expenditure would be managed by the Commission.

Eight MS (the Netherlands, Finland, Ireland, Estonia, Latvia, Lithuania, Denmark and Sweden), dubbed the New Hanseatic League, criticized the euro area budget proposal;³ they refuse any increase in EU expenditure and transfers, and any EU-level taxation, as well as far-reaching transfers of competence to the European level. For these countries, the priority is to meet the requirements of existing fiscal rules and to implement structural reforms at country level. They propose to complete the single market and the banking union, to develop the capital markets union (to foster cross-border private risk-sharing). A framework for sovereign debt restructuring should be explored. The EU budget should account for budget constraints and provide incentives for structural reforms.

Hence, sharp contradictions remain among MS on many issues. Some stress the need for macroeconomic coordination, social and tax harmonisation and solidarity between MS. Others stress the need to fulfil the current fiscal rules and to accept financial markets’ discipline. A euro area ministry is considered either as a way to impose fiscal discipline and structural reforms, or as a way to centralise fiscal policies, or as a coordination instrument for autonomous economic policies.

3. Austria, Belgium, Luxembourg and Malta express similar considerations.

In June and December 2018, the Eurozone Summits brought together all EU27 leaders. The principle of strengthening the banking union was enacted, but in order to meet the German request, the risks of current national banking systems will have to be reduced before they are shared. The ESM should establish a credit line, as a safety net to the Single Resolution Fund, of the same size as the Fund itself. Any contribution from the ESM to banks should be reimbursed by the banking sector in three (or possibly five) years. Its introduction, after 2020, will depend on the evolution of risks in national banking sectors. Political negotiations on the European deposit guarantee scheme could begin, but its implementation will also depend on risk reduction. The plan to limit government bonds in banks' assets and to encourage banks to hold a securitized asset was not mentioned. Ambitious steps should be made by mid-2019 for the capital markets union.

The name and the statute of the ESM will not change. The ESM will be able to open a credit line to MS in trouble, provided they have run sound fiscal policies and are not under a macroeconomic imbalance procedure. The ESM Treaty will oblige introducing a collective action clause (CAC) in government bonds. Finally, the ESM is supposed to facilitate dialogue between a MS in trouble and its private creditors, without a strict obligation of debt restructuring. The ESM and the Commission will collaborate in assessing the situation and in negotiating measures requested from a MS requesting ESM assistance. The euro area budget will be a part of the EU budget; its size is not specified. It will be limited to the competitiveness and convergence instrument. No agreement was reached on public investment or macroeconomic stabilization schemes (particularly as concerns unemployment insurance). In short, *much ado about nothing*.

One challenge for any major reform (such as implementing transfer mechanisms between countries in counterpart for increasing EU institutions' control of domestic fiscal policies) is that it would require a change in the Treaties, MS unanimity, and in several countries a referendum, with no guarantee as to the results, as EU construction is not currently popular.

2. The debate among economists

Economists have diverging views on European issues. Should MS live with high public debts or should they try to reduce them? Should the objective be to place MS under surveillance and to compel them to

implement structural reforms, to avoid non-cooperative policies inducing negative externalities, or to facilitate economic policy coordination? Economists have diverging views on the reliability of national governments, EU institutions and financial markets, but also on the political project: should the EU move towards a federal union or remain a Nation-States union?

2.1. Financial markets supervision?

Public debts in advanced economies have risen sharply during and since the 2008 financial crisis. The rise was smaller for the euro area as a whole than for other economies (the US, the UK, Japan, Table 1). The rise in public debts was due to developments in finance capitalism and to the deepness of the crisis, and not to over-expansionary fiscal policies run before and since the beginning of the crisis (Greece being the only exception). Public deficits and low interest rates offset insufficient private demand, which was weakened by the decrease in the wage share in value added, by the fall (in relative value) of needed investments, and by a rise in income inequalities. In view of low interest rates and inflation, current public debt levels are not generating higher interest rates or any crowding-out effect for private investment. It would be detrimental for output growth to cut public debts as long as the reasons why debts rose remain and as long as public debt cuts cannot be offset by significantly lower interest rates. The euro area already runs a large current account surplus and cannot expect to be able to offset a fall in domestic demand by a higher external surplus, without destabilising the world economy.

Many economists and policy makers (especially in Germany) rely on financial markets to ensure fiscal discipline in Europe. The high public debt levels and the memory of the Greek partial default make it more likely for public finances to remain under financial market supervision in the coming years. But this surveillance is unsatisfactory: financial markets have no macroeconomic perspective; their views are self-fulfilling, and they are aware of it; they do not try to account for all information available, but only for elements which are “in the mood of time”; and they are schizophrenic, requesting simultaneously economic growth strategies and fiscal consolidation. They have their own judgement on appropriate economic policies, with a liberal bias. There is no evidence that financial markets are able to judge public debt sustainability and the relevance of public deficits. Financial market

regulation is necessarily imperfect. A country may run an over-expansionary policy for some time, but markets will react only when they estimate that the debt level is excessive, i.e. too late. Macroeconomic regulation cannot be restricted to fiscal discipline: markets cannot oblige countries running too restrictive policies to borrow. Markets were blind in the case of Greece before 2007, and have been too strict for Italy and Spain since 2011.

Table. Public debts and deficits

% of GDP

	Public debt, Maastricht criteria		Public balance		
	2007	2017 (and max.)	2007	Highest deficit 2007-17	2017
Germany	64	65 (81)	0.2	-4.2	0.9
France	64	97	-2.5	-7.2	-2.6
Italy	100	132	-1.5	-5.3	-2.1
Spain	36	98 (100)	1.9	-10.5	-3.1
The Netherlands	42	58 (68)	0.2	-5.4	0.7
Belgium	87	104 (108)	0.1	-5.4	-1.5
Austria	65	79 (84)	-1.4	-5.3	-1.0
Greece	103	180	-6.7	-15.1	-1.2
Portugal	68	126 (131)	-3.0	-11.2	-1.4
Finland	34	63	5.1	-3.2	-1.4
Ireland	24	70 (120)	0.3	-32.1	-0.4
Euro area	65	89 (94)	-0.6	-6.3	-1.1
UK	44	87	-2.6	-10.1	-2.1
USA	64	108	-3.5	-12.7	-5.0
Japan	183	240	-2.8	-9.8	-4.3

Source: Ameco.

Letting markets freely set public debt interest rates, according to their default fears, would maintain arbitrary interest rate spreads in the EU. It would restrain fiscal policy (a country could be prevented from running the needed policy, in order to reassure markets), and it would reduce monetary policy efficiency. On the one hand, the EU would claim that the Greek case was an exception, and that from now on no euro area country will default. On the other hand, the EU would rely on markets to assess how serious MS commitments are. Interest rate spreads would be arbitrary, costly (should Italy pay each year 1.2% of its GDP to financial markets to offset an alleged default risk?) and may

become self-fulfilling. Conversely, the financial markets' weight is considered today by leading classes, Northern countries, and the EU technocracy as a guarantee against deviating policies, and hence they refuse to reduce the financial markets' power.

A country that is keeping monetary sovereignty, and issuing bonds in its own currency, is of course subject to the financial markets' judgement, but the effect is different. Markets do not fear government default, and hence do not anticipate a crisis, but may anticipate a currency depreciation, which is a normal phenomenon. This will not inevitably raise interest rates (which would lower growth) but may induce exchange rate depreciation (which may be expansionary).

Numerous proposals aim to strengthen financial markets' surveillance. German economists and policy makers demand that principles of no-solidarity between MS and no-guarantee by the ECB be re-asserted, that the possibility for a country to default (and even to exit the euro area) be explicitly written in EU Treaties, and that a MS supported by the ESM be automatically obliged to restructure its public debt; so, strong signals would be sent to financial markets to be more vigilant.

In May 2018, 154 German economists (including Hans-Werner Sinn and Jürgen Stark) refused a "Europe of liabilities" or a "Europe of transfers".⁴ Under the principle of the responsibility of each country, they refuse an EMF, which would help countries that did not undertake the necessary reforms; and they refuse a Single Resolution Fund for bank failures and a European Deposits Insurance Fund, which would relieve bankers and national supervisory bodies of their responsibilities. They propose to promote structural reforms, to consider the possibility that a country leaves the euro area, to declare that public debts are risky. The ECB should end its programme of buying government securities; voting rights of the largest MS in ECB bodies should be increased; and Target2 balances should be regulated. Asymmetric shocks would be offset by portfolio diversification allowed by the capital markets union.

Delpla and von Weisäcker (2010) and De Grauwe (2012) had suggested that public debts be split into two categories: a "blue" debt, collectively issued and guaranteed, with a ceiling of 60% of GDP for each MS, and a "red" debt. Each MS would also be allowed to issue a red debt under its own responsibility. Such a red debt would bear a high interest rate, which would be a strong disincentive to issue public

4. In an open letter published in the *Frankfurter Allgemeine Zeitung*.

debt above 60% of GDP. But the 60% limit is arbitrary. It was breached since 2007 by almost all euro area countries, for legitimate reasons. According to us, one should not offer speculators new possibilities to bet against different kinds of public debt.

Fourteen German and French economists (Bénassy-Quéré *et al.*, 2018) published a text on 17 January 2018: “Reconciling risk sharing with market discipline: A constructive approach to euro area reform” which recognizes “the persistent financial fragilities” of the euro area, but in fact proposes to accentuate their causes by weakening even more the States and by increasing financial markets’ influence. In order to account for an especially widespread view among German economists and policy makers, the fourteen economists accept the strengthening of a so-called “market discipline”, as if markets were not the ones to be disciplined. These economists make six proposals, which are in line with the Commission’s views:

- 1) *Penalise banks having too much debt of their origin country in their assets.*
- 2) *Provide a device for an orderly restructuring of public debt.*

Like the Commission, the fourteen economists propose claiming that euro area MS public debts are risky, that they may be restructured, and that banks holding these bonds take risks that should be assessed according to the MS considered. Such a declaration would have three consequences: public debts would effectively be more fragile, MS would not be sure to issue safe bonds anymore, and speculation on public debts would be encouraged. The authors propose bank deposits to be guaranteed at the EU level, but the insurance premium paid by banks on these deposits would vary depending on the “specific risks of the country”.

- 3) *Replace the current fiscal rules by a new simple one (see below).*
- 4) *Set up a Fund to help Euro area MS to absorb the most serious economic crises.*

Countries could benefit from this Fund only if they followed a fiscal rule defined as in point 3) and the European semester recommendations. To avoid permanent transfers, this Fund would receive national contributions, which would rise with previous help received from the Fund. Thus, countries having previously experienced difficulties would finance countries currently in difficulty. A country having requested support from the Fund would pay higher contributions for a long time period, and so it would hardly be supported.

5) Offer investors a synthetic risk-free financial asset alternative to national public debt (see above).

6) Reform the institutional architecture of the euro area.

The paper makes no recommendations on how to improve the coordination of euro area economic policies, to reduce imbalances between MS, to launch a large investment programme required by the ecological transition, to reduce the instability induced by financialisation, or to refocus the banking and finance sectors' activity towards lending to public and productive investment rather than speculating on public debt.

The 14 economists' proposals were criticized by Messori and Micossi (2018), two Italian economists, with arguments close to ours: "their proposals heighten the risk of financial instability and weaken euro area defences against financial shocks".

2.2. Public debt centralisation?

A simple solution would be to introduce a European Debt Agency (EDA), which would issue a common debt for all euro area countries. This debt would be guaranteed by all MS and would be considered as safe by financial markets; its market would be broad and liquid, hence it could be issued at very low interest rates. The proposal of an EDA may be seen from two different perspectives: either as a way to impose EU fiscal rules on MS or as a way to ensure MS autonomy in fully protecting them from financial markets. In the first perspective, the EDA would supervise domestic fiscal policies and would be entitled to deny financing to *over-lax* countries, leading the latter to have to sell domestic bonds on markets, at higher interest rates. The EDA would raise the same problems as the SGP, even more strongly. What would be its democratic and economic legitimacy? What would be its assessment criteria? How would the EDA decide that a country runs an excessive deficit, if the country considers that such a deficit is necessary to support domestic output or to rescue domestic banks? Would it implement rigid automatic rules (a country would be entitled to loans from the EDA of up to 60% of its GDP) or softer ones (a country would be entitled to loans from the EDA, except in exceptional circumstances)? The EDA would benefit neither virtuous countries (the latter have no difficulty to borrow) nor countries in difficulty, which the EDA would refuse to lend to. The EDA makes sense only, in the second perspective, if it accepts to finance all public debts. Northern countries

refuse such a system on moral hazard grounds: lax MS would have no more incentives to cut their public debts.

Schulmeister (2013) suggested the introduction of a European Monetary Fund (EMF), which would finance MS through issuing euro-bonds guaranteed by the MS and the ECB. The EMF would maintain long-term interest rates below GDP growth. Individual MS financing would not be subject to a numerical constraint, but would be agreed within the EMF by MS Finance ministers. This proposal 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 divergent macroeconomic strategies?), and undemocratic (each finance minister would impose in its national Parliament the fulfilment of the target set at the European level).

The German Council of Economic Experts (Doluca *et al.*, 2012) had suggested the introduction of a European Redemption Pact, *i.e.* a fund to guarantee the repayment of the share of public debts above 60% of GDP. Countries with debt exceeding 60% of GDP would place the share of their debt over 60% of GDP in a Redemption Fund (RF) and, in counterpart, would transfer irremediably tax revenues allowing for debt repayment over 25 years. Countries would transfer guarantees to the fund, such as a fraction of their gold reserves. Moreover, they would commit to implement structural reform programmes and would fulfil the Fiscal Pact in bringing rapidly their structural deficit down to 0.5% of GDP. With these guarantees, the fund could borrow at interest rates without risk premium. The debt-to-GDP ratio would thus fall rapidly. But the proposal does not address the impacts of these restrictive policies on output, making the implicit assumption that the fiscal multiplier is nil (Mathieu and Sterdyniak, 2014). Similarly, the proposal does not consider the possibility that euro area economies might go through slowdown episodes in the next 25 years, which may require softening the restrictive stance of fiscal policies. The proposal resides on a postulate: optimal fiscal policy consists in stabilising the structural deficit at 0.5% of GDP (and hence government debt at 14.3% of GDP under a nominal GDP growth at 3.5%) and refusing any discretionary fiscal policy.

The ESM was introduced through an inter-governmental agreement. It could be enshrined in the EU Treaties and transformed into an EMF (European Monetary Fund). According to some authors, the EMF would control (and impose) that fiscal policies fulfil the SGP and the Fiscal Pact.

This surveillance would be done via an automatic process, *i.e.* without accounting for the economic situation, without any political intervention from MS. MS would entirely lose their fiscal autonomy. In the same vein, other authors propose introducing a Euro Area Finance and Economy Minister, a Commission's vice-president, who would chair the euro group. The minister would manage a euro area Treasury, to finance euro area common public spending, macroeconomic stabilisation spending and transfers within MS. This raises a question of democracy: how would this minister be appointed: through a democratic political choice or on the basis of the current technocratic consensus? For some authors, this ministry should facilitate the coordination of MS economic policies. For some others, the euro area minister should have the capacity to oblige countries to modify their budget plans if they are not in conformity with EU rules. Last, for some other authors, the euro area ministry would define the policy needed at the euro area level, and then policies needed at each country level, with no fiscal autonomy for MS, which is not acceptable from a democratic point of view and is not realistic if MS economic situations differ.

Bofinger (2018) wrote: "The monetary union is an unfinished building with a supranational monetary policy and 19 independent national fiscal policies. Thus, the only way to make it stable is to go ahead with political integration. With the transfer of fiscal policy responsibilities to the supranational level, fiscal discipline of the member states would be enforced by a democratically legitimised euro area finance minister and not by myopic financial investors". But Bofinger does not explain the principles under which the Minister would set MS fiscal policy and what would be his democratic legitimacy to intervene to impose this fiscal policy on MS.

3. Changing the fiscal rules?

The SGP and TSCG fiscal rules are arbitrary. They can oblige countries with insufficient demand to run restrictive fiscal policies, although the latter cannot be offset by lower interest rates. Fiscal policy should target employment (keeping it at or bringing it back to a satisfactory level), while allowing inflation and interest rates to remain at satisfactory levels. According to the functional theory of public finance, public

debt and deficit should be derived from this target (see Box 1 and Mathieu and Sterdyniak, 2012), and not from arbitrary rules.

Box. Functional theory of public finances

A certain level of government debt and deficit may be necessary to ensure a satisfactory demand level. If one writes:

$$y = a + d + cy - \sigma(r - g) + k(h - l) \quad \dot{p} = \pi y \quad \dot{h} = d,$$

with y , GDP level (in deviation from potential level), d , public deficit, a , private demand, r , the interest rate, g , nominal growth trend, h , public debt as a % of GDP, l the public debt desired by the private sector (when $r=g$).

Two situations should be distinguished:

The country controls its interest rate. Then full stabilisation can be obtained without the fiscal tool, with the interest rate:

$$r = g + (a + k(h - l))/\sigma.$$

A negative demand shock or an increase in the desired public debt allows for an interest rate cut (which can increase investment, and then growth). A positive demand shock can be offset by a rise in the interest rate (which is detrimental to investment) or by a restrictive fiscal policy (which is more relevant). The rule is: fiscal policy must allow to maintain unemployment at its natural level and an optimal interest rate.

In the long run, the debt ratio is stable so: $d=0 \quad r=g + k(h-l)/\sigma$. The country has a trade-off between interest rate and public debt levels. A restrictive fiscal policy may be implemented if it allows for the interest rate to decrease.

The country does not control its interest rate, because the interest rate is already at 0 or because the country belongs to the euro area, short term fiscal policy is: $d = -a + \sigma(r - g)$

If this policy is implemented and if stabilisation is perfect, there is no link *ex post* between the deficit and the output gap, which remains nil. Let us note also that in this case government borrowing is considered as structural according to the OECD or the EC methods, which does not make sense.

In the long run, $g = 0$ and $h = l + \sigma(r - g)/k$. 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 $d = \bar{d} - \lambda y - \mu(h - \bar{h})$ cannot be proposed, since it would not allow for full stabilisation and since the government cannot set a debt target independently of private agents' saving behaviour. The public debt level desired by private agents is likely to have increased during the crisis, since households wish to hold fewer risky financial assets and companies wish to deleverage. In structural terms, population ageing implies that demand for safe public assets increases.

Some economists have proposed accounting tricks to circumvent SGP rules and the Fiscal Treaty. For instance, not to account for unemployment-related expenditure or public investment in the 3% GDP rule for the deficit, to set up temporary funds in good times to allow for higher deficits in bad times, or to introduce a temporary debt in bad times to be redeemed in good times, etc. According to us, it would be better to write simply: a public deficit is acceptable if the inflation rate is below the target, when the interest rate is below the normal level (*i.e.* according to the golden rule, potential growth plus the inflation target), and when the external deficit is below the target.

Claeys *et al.* (2016) propose that public expenditure (excluding interest payments, unemployment insurance benefits, exceptional expenditure, public investment, but including fixed public capital consumption) may not rise more rapidly than the ECB's inflation target (2%) plus medium-term potential growth less a correcting term of 0.02 times the share of the debt above the 60% target. However, a country may choose to raise its public expenditure if it raises tax revenues at the same time, or to cut tax revenues if public spending is cut at the same time. This rule is in fact a structural balance rule. A country, such as France, where public debt stands at 100% of GDP, should set a target for public expenditure growth 0.8 percentage point below potential output growth, *i.e.* it should improve by 0.4 percentage point each year its primary structural government balance, until its debt comes down to 60% of GDP. This rule may seem relatively satisfactory, since it lets automatic stabilisers play, and since it becomes less binding if inflation is below 2% (1 percentage point of inflation below the target allows to increase public spending by 1%, *i.e.* an additional 0.5 percentage point for the structural deficit). But the arbitrary 60% of GDP target for public debt remains. Should the main objective of French fiscal policy be to bring debt down to 60% of GDP within 20 years, *i.e.* to run average primary fiscal surpluses of 2 percentage points of GDP, when the 60% figure is arbitrary and below debt ratios in countries outside the euro area? These 2 percentage points could be better used (for example, for the ecological transition). The impact of permanent fiscal consolidation on output is not assessed. Discretionary fiscal policies remain forbidden. The rule does not set an equilibrium level for the primary fiscal balance and so does not bring debt to a long-term equilibrium. A country with a 100% of GDP debt ratio and a primary structural deficit of 1% of GDP will have to increase its primary structural balance each year. After 18 years (under the assumption that

the interest rate is equal to output growth), its debt will fall below 60% of GDP and the primary structural surplus will reach 4.5% of GDP. The rule gives no indication on what should be done once the debt reaches 60% of GDP: keeping it at that level, which means bringing rapidly the structural surplus to balance, or maintaining a substantial structural surplus forever.

Bénassy-Quéré *et al.* (2018) suggest replacing existing fiscal rules by a new *simple* rule: “nominal [public] expenditures should not grow faster than long-term nominal income (that is, the sum of potential output growth and expected inflation), and they should grow at a slower pace in countries that need to pay down their debts.” But the authors also say that countries would be entitled to raise their expenditures, if they raise their structural tax revenues. The rule is thus equivalent to: “the structural deficit should remain stable, and even diminish in countries where the public debt level is too high”. But will a country be entitled to increase public expenditure or cut taxes to support output in times of economic slowdown? The rule should clearly state that discretionary, and defined as temporary, measures are allowed. Let us assume that a country wishes to promote pension funds. In the short and medium term this may lead households’ savings to rise, and, at fixed interest rates and exchange rates, this may require a rise in the equilibrium structural public deficit. This is not taken into consideration in the proposed rule. How should excessive debt ratios be defined, knowing that public debts rose since the crisis because of the needs of macroeconomic regulation? Then the text says: “If a country passes a budget with spending above the target, all excessive spending must be financed by junior sovereign bonds, first to be restructured in case a debt reduction is deemed necessary”. But the so-called excessive expenditures should be financed by a guaranteed public debt, if these reflect the need for output stabilisation. Financial markets should not be asked to fine countries raising public expenditures even if the latter are needed for macroeconomic stabilisation or for rescuing banks or companies in a difficult situation. The proposal relies on an irrelevant financial innovation: advanced economies would issue sovereign bonds, while announcing there are unsafe assets. No advanced economy outside the euro area ever did such a thing. How can it be imagined that a large economy, such as France, may default, even partially? According to which criteria? The enforcement of the rule would be done under the control of an independent fiscal committee, itself supervised by an independent committee at the area

level. Will this authority have to comply with the Commission's estimates and stick blindly to the rule, or will it be able to have its own estimates and evaluate policy based on macroeconomic relevance? Besides, like the previous rule, this rule does not have any long-term stability. It simply tells us: once a satisfactory debt ratio has been reached, the structural balance may be stable, but its level is not defined. Any fiscal rule should lead to stable debt and deficit levels consistent with the macroeconomic equilibrium.

3.1. A euro area fiscal capacity?

Some economists consider that the euro area could implement stabilisation mechanisms at the euro area level, managed by a euro area minister, but this is an illusion, as the European Commission minimizes the size of output gaps (Mathieu and Sterdyniak, 2015), denies the implementation of discretionary policies and sticks to automatic fiscal rules. But many shocks or imbalances are country-specific. Implementing stabilisation tools at the euro area level would be dangerous if, as a counterpart, countries have to abandon stabilisation policies to bring their structural budget (as measured by the EC) in balance and should wait for the Commission's green light to implement a stabilisation fiscal policy.

A two-step procedure is often proposed: The Commission would set the broad fiscal stance of the euro area, and would then verify the compliance of all MS budgets. But this could make sense only if the SGP and the Fiscal Treaty were abandoned, and the full-employment target in the euro area re-affirmed. However, this proposal is irrelevant if euro area cyclical developments and objectives differ too much. Why say that fiscal efforts should be neutral in the euro area if countries with fiscal room for manoeuvre refuse to run expansionary policies, while countries in depression have to fulfil EU constraints?

Some propose implementing transfers between MS to ensure that countries in good economic situations finance countries in depression. Accounting for Northern countries' reluctance, this system should avoid permanent transfers, and each country should be in turn a net contributor or receiver. Can a system on average in balance have a visible macroeconomic impact? Some propose basing these transfers on output gap differentials, since, for a given country, the output gap is

by construction nil over a long time period. But they forget that the output gap is a vague and unobservable concept, a measure that can be criticized, and fluctuates over time (Mathieu and Sterdyniak, 2015). As could be seen after the 2008 crisis, when a crisis occurs at year N , potential output growth estimates are reduced for year $N-1$, $N-2$, ... Should there be re-payments each time the Commission's estimates are revised? Should a country in depression wait for EU funds to support its economy, and meanwhile implement a pro-cyclical restrictive policy? Last, potential output growth, according to Commission estimates, fluctuates very closely with observed output growth, and hence transfers would necessarily be small.

Some propose the unification of unemployment insurance systems, unemployment expenditure being the most pro-cyclical category of public expenditure. But national systems differ widely from one MS to another (allowance levels and duration; accounting or not for the family situation), and in many MS are run by social partners, who would not agree on a unification done under the Commission's leadership. The unemployment concept would have to be standardized (what about recipients of vocational training, disability pensions, early retirement schemes, or part-time unemployment schemes?). A country having made efforts to reduce its unemployment rate would refuse to pay for countries with high unemployment, blaming these countries for not having undertaken the necessary reforms.

Some propose transfers between countries based on the differences between the observed and the structural unemployment rates. But how to assess the structural unemployment rate, which according to the Commission's estimates varies like the observed unemployment rate? Transfers based on differences in unemployment rates would entail permanent transfers between countries. To avoid this, proposals restrict transfers to unemployment regimes, applying them only to the newly unemployed and for a limited time period (Dullien, 2017). Transfers are generally small and become nil if the depression lasts and hits all euro area MS. Transfers are expected to be nil for each country in the long term, and thus may have only a limited impact. Others suggest a reinsurance unemployment system, based on short-term unemployment developments, normalized according to their past volatility, with MS contributions depending on the extent to which they previously resorted to the Fund (Dolls and Lewney, 2017, Aparisi de Lannoy and Ragot, 2017). Social transfers cannot be based on

complicated mechanisms, so re-insurance would have no direct impact on unemployment benefits, but only an *ex post* impact on the financial equilibrium of unemployment regimes.

The proponents of this proposal argue that it would have had stabilisation properties in the past. In particular, Germany would have been a net beneficiary in the beginning of the 2000s, which assumes that the other MS would have agreed to pay for the German internal devaluation strategy. Also, this system would have softened the recession in Southern economies after 2010, as if the EU, requesting fiscal austerity, would have offset it at the same time by unemployment benefit transfers. These authors assume that these transfers would be entirely consumed by households (Dolls and Lewney, 2017). Let us consider the case of France. Unemployment benefits were not cut after the crisis, despite the rise in the public deficit; and they would not have been larger if the EU mechanism had been in place. At best, the mechanism would have reduced the UNEDIC's financing needs. So, its impact on activity would have been weak, if not nil.

Some economists (CAE, 2016) admit that the implementation of this mechanism requires the convergence of domestic labour markets, to be implemented by a European minister of labour. But a convergence towards which model and decided by whom? Should labour market flexibility be promoted (labour contracts revised in permanence, precarious jobs, flexible wages) or a stable labour market (companies and employees linked with long-term contracts, companies caring for maintaining their workers' skills and investing in specific skills). Should wage flexibility be promoted through wage bargaining at the company level, or on the contrary through sector agreements or national agreements based on the "golden rule" of wage growth, i.e. the inflation target plus average productivity growth in the economy, as the European Trade Union Confederation recommends?

3.2. A federal and democratic euro area?

Some economists recommend a move toward a more and more federal EU (or euro area). They admit that technocracy currently prevails in the EU, with a lack of democracy and a liberal bias, but they consider that a more democratic federalism could be introduced. The euro area would have a substantial budget and own resources; it could finance EU common goods (military defence, research, infrastructure, migration policy), and transfers between countries, both structural and cyclical, including to deal with all or part of macroeconomic stabilisation.

In *"Pour un traité de démocratisation de l'Europe"*,⁵ Hennette et al. (2017) propose a new Treaty. It would establish a Parliamentary Assembly of the euro area, involving members of the national parliaments and of the European Parliament. This Assembly would supervise the euro area summit and the Eurogroup. But there is already a European Parliament. It is not realistic to introduce a new structure and duplicate all EU institutions with euro area institutions. This assembly would vote the various documents of the European Semester (the Report on Mechanism Alert, MS Stability Programmes and National reform programmes, EDP reports), directives, ESM assistance programmes and Memoranda of Understanding. This would represent on the one hand many elements that are dealt with at the EU level, and so the process would duplicate European Parliament activities; and on the other hand, it would cover fields that are currently domestic prerogatives: should EU Parliament members be asked to vote on each MS Stability programme and National reform programme? The proposal does not clearly set out the powers that would be attributed to the euro area, as compared to the EU and to countries. It does not say if the SGP and the Fiscal Treaty would continue to apply. What would be the assessment criteria for national budgets: adequacy with the economic context, or with the Fiscal Treaty? The proposal plans to put public debt below 60% of GDP in common, which implies necessarily that countries with debts higher than 60% of GDP launch a redemption process, without any economic justification. Should unmanageable constraints be accepted to ensure Germany's agreement? The authors claim that their project could be adopted by a subset of member countries, which makes no sense, given the powers of their new assembly on the Eurogroup. Contrary to what the authors suggest, this Treaty would need to be ratified by European citizens. According to the project, the Parliament would manage a common euro area budget. This budget would be financed by four taxes levied at European level: a corporate income tax, a high income tax, a high wealth tax and a carbon tax. It would represent 4% of euro area GDP, of which 2 percentage points would be used to finance the ecological transition, to host migrants and to finance higher education, and 2 percentage points would be given back to national budgets to reduce national taxes and help the poorest. The text specifies that net transfers between countries would be limited to 0.1% of GDP, probably to convince Germany, but how would net transfers be

5. Information in English about the proposal may be found at: <http://tdem.eu/en/treaty>

measured if taxes and half of the expenses are common? The proposal does not clearly say whether the euro area budget could be run in deficit if needed for stabilisation purposes.

Aglietta and Leron (2017), in *La Double démocratie* (The twin democracy), make a proposal for a European budget amounting to 3.5% of GDP, which would finance European common goods (such as fighting against climate change), would have own resources (such as a carbon tax and a financial transaction tax), and could issue euro-bonds. A European Fiscal Agency would assess the economic and fiscal situations of MS and would make recommendations for necessary adjustment, which would be determined by a fiscal commission (bringing together elected national parliament representatives), adopted by the Council and implemented by MS governments. This will allow changing the Fiscal Compact. But what principles would guide this process: debt or deficit criteria, or full-employment targets, and what scope (how to handle differences in competitiveness)? Although the second element of the proposal is problematic, the first element is interesting, setting up a specific field for EU action, with dedicated funding.

Fourteen European economists (Andor *et al.*, 2018) published a call for a “democratic renewal of the eurozone”. They propose a jump to democratic federalism, to a “real European executive that is democratically accountable before a parliament of the eurozone and leads economic policy with expertise and a larger degree of political autonomy”. The call however did not deepen the meaning of democracy in a federal EU: can a population be constrained by decisions made in a Parliament where its representatives are a minority? How to account for different interests, situations and institutions in MS? Should the subsidiarity principle be forgotten? The text suggests the appointment of a European Commissioner, in charge of fiscal and monetary affairs for the area, who would chair the Eurogroup and make executive decisions. But the extent of his/her powers is not defined: would he/she be able to amend budgets voted by National Parliaments? Certainly, the Commissioner would be accountable to the euro area Parliament, but how can one imagine that peoples would agree to entrust to a foreign Commissioner and to such a Parliament powers over their budget, public expenditure and their taxation? Moreover, it is unclear if current budget rules would be maintained. Will the Commissioner be a watchdog verifying that budgets are consistent

with the European rules, or a conductor who will coordinate all countries' economic policies? For the rest, the project is unrealistic. The euro area budget should start with a small size, of the order of 1% of GDP, but it should secure the financial system, and finance a new cohesion policy for countries facing structural competitiveness problems (education, university, training, justice), doing this without duplicating European structural funds; it should encourage surplus countries to run social policies; it should finance defence, innovation, and the environment, and be open to non-euro area members. "While under the control of the Commission, this budget should, however, sit outside the EU budget". This budget would basically duplicate the budget of the Union, to do what the EU does not currently do. But why would governments, reluctant to increase the budget of the Union, create a parallel budget? This budget would be financed by taxes and by issuing debt, the text saying strangely that it will be a risk-free asset, "complementing the constrained capacity of MS to issue safe assets. This will be crucial if member countries were to default on their national sovereign debt": the non-guarantee of national public debts is not questioned. The financial sector is expected to "perform its stabilizing and risk-sharing function"; this is hardly what it has done in the past. Finally, the text includes the project of a small unemployment insurance scheme at the euro area level. On the whole, the text offers little reflection on economic policies coordination, on the linkage between national and European democracy.

3.3. A Europe with more solidarity?

Many economists claim for more solidarity, with more transfers, in the euro area. According to us, the euro area's functioning cannot durably rely on transfers between Northern countries (in good economic situations and with large current account surpluses) and Southern countries (with high unemployment rates). Northern countries' populations would not accept it. Southern countries cannot offset bad economic situations with transfers, which would place them under the control of Northern countries and of the European Commission. Transfers between countries should take place only in exceptional circumstances or in the framework of development policies. Each country should find a satisfactory economic model, which today requires differentiated strategies.

The EU is not a country. There is no European solidarity, contrary to national solidarity. National characteristics remain, and people are attached to them. There is no agreement today between MS citizens to move toward a social Europe, a taxation Europe, a fiscal Europe, a political Europe, insofar as this would imply undermining national institutions.

Accounting for current disparities in the EU and for the willingness of EU institutions to cut public expenditure, it may not be obvious to raise common EU expenditure. Many countries are reluctant, either because they do not want to pay for the others, or because they want to keep their national specificities. In military defence, for instance, France and East European countries may not have the same priorities. Migration policies differ, due to demographic and labour market prospects. In higher education and research, there is a contradiction between spending EU funds where they are the most efficient and the desire of each country to develop them at home.

The EU hesitates between an intergovernmental functioning and a federal model, which the Commission and the Parliament tend to promote. Can we imagine that major economic and social decisions be made at the EU level, by the Commission, the Council or even the Parliament, without accounting for national votes and debates? Can we imagine a federal power that is able to account for domestic specificities in a EU made of heterogeneous countries? In our view, accounting for current disparities in the EU, economic policies should be coordinated between MS and not decided by a central authority. EU institutions should first show that they are able to implement an efficient strategy, before the peoples accept to increase powers at the EU level.

3.4. A Europe with several circles?

Brexit, the deviations of some Central and Eastern European countries (Poland, Hungary), and the reluctances of Denmark and Sweden could be incentives to move towards a EU in several circles.⁶ The first circle would include euro area countries agreeing new sovereignty transfers, and would build a political, social, taxation, and fiscal union. This would be a step toward a democratic progress: a euro area Parliament, a EU Commission accountable to the Parliament. The second circle would include EU countries that would not wish or be able to join

6. This is what Emmanuel Macron advocates in his speech at the Sorbonne.

the first circle. Last, a third circle would include countries linked to the EU with a free-trade agreement: Norway, Iceland, Liechtenstein, Switzerland, as of today, and the UK and other countries (Turkey, Ukraine...) tomorrow.⁷

This project raises many problems. The Commission is not in favour of it because it would undermine the EU move towards “an ever closer union”. Non-euro area countries are hostile to such a project where they would be marginalised as “second-class” members. EU institutions would have to be split between euro area institutions functioning in a federal mode, and EU institutions continuing to function in a Union of Member States mode, with a EU Parliament and a euro area Parliament, EU and euro area commissioners, EU and euro area budget and financial transfers, etc. There is no certainty that all euro area MS would wish to be in a first circle where tax and social harmonisation would be imposed; one would have to choose between accepting compromises so that Ireland, the Netherlands, Luxembourg, and the Baltic countries agree to join or have a euro area itself with two circles. The members of the third circle would be in an even more difficult situation, if they had to comply with regulations over which they would have no say. Thus many issues would have to be tackled four times (at the restricted euro area, euro area, EU, and free-trade agreement levels). Depending on the issue, a member state could choose its circle, and it would rapidly become an “à la carte” Europe. This is hardly compatible with democratisation at the EU level, which would rapidly require a different Parliament for each field. Besides, there is no agreement among the people of the EU, even in the euro area, to move towards a federal Europe, with all the convergences and losses of democratic control that this would entail. In the current situation, few peoples will accept that a federal body decides their budgets, tax systems, and reforms of their social systems.

3.5. Unconventional proposals

QE for people proponents suggest that the ECB should support economic activity, by giving a given amount of money to each euro area citizen each month. This proposal does not make much sense. The ECB cannot distribute money without a counterpart. This is not the Central Bank’s role; this is the role of fiscal policy. Such a policy would

7. See proposals by Pisani-Ferry *et al.* (2016) or Demertzis *et al.* (2018).

have to be agreed between MS, and be a transfer payment from domestic budgets. A bank must have assets equal to liabilities. The ECB's balance sheet would be in deficit, i.e. a debt that would be affected to MS, the ECB's shareholders, and would come on top of government debt.

For the same reason, the proposal asking the Central bank to buy a substantial amount of public debt, before cancelling them (or keeping them at a 0 interest rate forever) cannot be implemented. Because this proposal implies that in counterpart the ECB would issue bonds, hence transforming government debt into ECB debt (see for instance the PADRE proposal, by Pâris and Wyplosz, 2014). Here too, the ECB's balance sheet would show a deficit, which would be added to government debt. The ECB would not pay dividends to MS, but would be subsidized by them. The savings in terms of interest payments for MS would be offset by the loss of dividends received from the ECB and from the amount of the subsidy that would be paid to the ECB. This would be a mere accounting trick.

Some consider that a fiscal money should be issued by the government and accepted for tax payments (Bossone *et al.*, 2015, Kalinowski *et al.*, 2017⁸). The government could thus support output, by paying civil servants, social benefits and suppliers, with this money. However, contrary to what the proponents of this proposal claim, this money would be part of the public deficit and debt. The authors do not specify whether this money would be a full currency, or whether retailers would be obliged to accept it in payment even for imported products. There is no guarantee that economic agents would be ready to own it. It would be either fully convertible (agents would exchange it rapidly for euros as it would not yield any interest rate); or not convertible, which would mean that two currencies would circulate, with parallel exchange rates, a black market, instability risks, and complications for transactions. This is only a way to circumvent the deficit and debt criteria.

3.6. Coordinating policies in the EU

In advanced economies, the system, which worked until 1999 and still works in the US, the UK and Japan, is based 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 govern-

8. The project is part of the programme of the new Italian Government under the name of "mini-bots".

ment can issue sovereign bonds without limit; these bonds are considered as safe and benefit from as low as possible market interest rates. This system allows the State to guarantee the banking system.

The introduction of the euro area had led to a hardly manageable structure. MS need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. In addition, since 1973 and even more since 2008, the macroeconomic equilibrium requires a certain level of public deficit and debt. However, in a single currency union, current imbalances in one country may affect the other MS. Therefore, excessive deficits (or surpluses) should be avoided, but how to define them? Last, financial markets' current functioning makes it necessary for public debts to become safe assets again, while at the same time Northern countries deny giving unlimited guarantees to their partners.

Euro area countries should again become able to run the public deficits needed for their macroeconomic stabilisation needs and to issue safe public debts, at an interest rate controlled by the ECB. The mutual guarantee of public debts should be entire for countries agreeable to submitting their economic policy to a coordination process. This coordination cannot consist in fulfilling arbitrary rules. It should be done through a negotiation process between countries. Coordination should target GDP growth and full employment; it should account for all economic variables; and countries should follow an economic policy strategy allowing them to meet the inflation target (at least to remain within a target of around 2%, which may be increased in time periods when a strong recovery is needed), to meet an objective in terms of wage developments (in the medium-run real wages should grow in line with labour productivity), and in the short-run adjustment processes should be implemented by countries where wages have risen too rapidly, or not sufficiently.⁹ Internal devaluation strategies (such as offsetting employers' social contributions cuts by increases in VAT) should be implemented only by countries having a specific competitiveness problem. Countries should announce and negotiate their current account balance targets; and countries running high external surpluses should agree to lower them or to finance explicitly industrial

9. But the adjustment should not be done through the introduction of an automatic link between the minimum wage and the current account, as proposed by IAGS (2014). If a country runs of current account deficit due to a financial or housing bubble, the effort should not bear first on lower paid workers.

projects in Southern economies. The process should always reach unanimous agreement on a coordinated but differentiated strategy. The Treaty should 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.

The ECB should maintain interest rates below the GDP growth rate to reduce the public debt burden. Simultaneously, the ECB should give incentives to banks both to abstain from speculative activities (in particular by a financial transactions tax and by the separation of deposit banks from market activities) and to finance productive activities (especially re-industrialisation and the ecological transition).

National fiscal policies would be facilitated if a European budget financed public investment and more generally European common goods (such as fighting against climate change) by common resources (such as a carbon tax and a financial transaction tax), and by the issuance of euro-bonds. But this should not be a pretext for adding constraints on national budgets.

Economic policy coordination should not raise difficulties after negative demand shocks (global or specific); it should not target objectives lacking an economic rationale (such as a structural public balance in equilibrium or a public debt below 60% of GDP). Coordination may be harmful for a country having to implement a supply side policy after a negative supply shock. On the contrary, coordination will be impossible if a group of countries set non-cooperative targets, such as large competitiveness gains or a large current account surplus.

Besides, a political choice needs to be made. Does the EU want to maintain and develop its social model, with its specificity in terms of social and fiscal systems, with labour rights, and with ecological objectives, or is its project to oblige reluctant countries to accept the constraints of a liberal globalization?

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