# TIME FOR AN ECONOMIC UNION

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A new economic pact is now at the centre of the European debate. After an assessment of the current euro-zone crisis, this paper develops a comprehensive view on how can we use the ongoing reforms of the EU economic governance to strengthen the European Economic Union. Finally it proposes a more detailed compromise to activate the heart of this Economic Union: stronger coordination and convergence of fiscal and economic policies in exchange of a stronger European mechanism to manage sovereign debt.

## 1. Crisis in the euro-zone or of the euro-zone?

There are two different ways to look to the current euro-zone crisis: a crisis in the euro-zone or a crisis of the euro-zone.

According to the first version, the main problem has to do with the lack of fiscal discipline in some peripheral countries which led to unsustainable public debts damaging the credibility of the euro. Hence, the logic solution should be to strengthen fiscal discipline and to impose austerity even at the cost of recession in these countries, which should learn a lesson. Ultimately, if they default, their negative effect can be contained because they are peripheral economies.

According to the second version, the need to strengthen fiscal responsibility is also accepted, but a more comprehensive diagnosis is proposed. Some fiscal and macro-imbalances were already at work before the financial crisis, but they were deeply worsened by its impact leading to a recession, rising unemployment and banks rescues requiring stimulus packages with strong implications for public deficits. This shock has hit the euro-zone as a whole, but the recovery process was easier for the Member states with more fiscal space and/or more reliance on exports to outside Europe.

This differentiation in the recovery was then turned into an increasing differentiation in the financing conditions (spreads) within the euro-zone, which were magnified by some financial operators learning how to extract extra-profits from the euro-zone flaws. First, when exploiting some countries'fears to default by offering them loans at higher price; second, when finally the euro zone could create its defence mechanism, by exploiting some countries's fears regarding its tough conditions leading to a forced recession.

In this second version about what is happening, there are two reasons why we are in face of a **systemic crisis of the euro-zone**:

- first, while some differences in the spreads across Member States can be accepted as normal, these increasing divergences are worrying because they will also turn into divergences of their investment conditions, their growth and employment rates as well as their public deficits and debts;
- These cumulative divergences will be magnified by the strong interconnections among banks across the euro-zone, creating a domino effect which will be very difficult to control and can turn fragmentation into collapse.

## 2. What is at stake: the euro-zone and globalization

In spite of this very difficult situation, the European leadership should keep cold blood and a strategic mindset. Ultimately, what is at stake is **to strengthen the euro-zone in order to reposition Europe for the new emerging global competition**. In its fundamentals, Europe is well placed to take the lead in building the competitive advantages of the future focusing on a new growth model, a greener, smarter and inclusive one. What is missing is a stronger launch of this strategy overcoming the major flaws in the euro-zone management.

The financial and economic crisis has exposed extensively these **flaws**:

- they are not only the **weak coordination** fiscal policies to ensure the necessary discipline in a common monetary zone; they are the need to have more European coordination of tax policy, notably if new tax sources (such as green or financial taxation) need to be introduced to re-balancing the budgets,
- they are also the **lack of instruments to ensure macro-economic stability**, since Member States lost their traditional instruments but these were not replaced by others at European level. When the manipulation of the exchange rate to foster growth is no longer possible by definition, it is crucial to ensure a **reasonable interest rate** to enable recovery. This depends on controlling inflation- the main task of the European Central Bank – but also on improving the public debt management –something which seems to be beyond its normal remit.

As long as new instruments are not available, **macroeconomic stabilisation in face of strong shocks will no longer be possible** at least for some euro-zone countries, meaning they can only adjust by lowering wages or destroying employment. Needless to say that to invest into a new growth model will become for them an almost impossible task. One can reply these countries need to make structural reforms to foster their structural competitiveness; they certainly need to make more than they are doing but, in the meantime, they will go to a recession and further risks of insolvency and default. This will increase the systemic risks which were referred above for the euro-zone as a whole. **In such conditions, the euro-zone will certainly not be a strong platform for Europe to compete at global level**. It would become instead an interesting area for other global competitors to buy some strategic assets cheaper.

More consistent European strategic leadership is needed.

## 3. The priorities to strengthen the long-term sustainability of the euro-zone

To overcome this outlook, we need to have a more comprehensive view on the priorities to strengthen the long-term sustainability of the euro-zone. They seem to be:

a/ **Fiscal responsibility** coupled with a last resort **solidarity** regarding sovereign debt

b/ A **reformed financial system** to ensure financial stability and foster growth

c/ A stronger coordination of economic policies combined with structural reforms to promote a new kind of **growth**

d/ The reduction of the internal divergences. On the long term it is difficult to ensure the nominal **convergence** between the euro-zone members without increasing their real convergence.

This last issue has been overlooked in the management of the euro-zone. Its internal divergences do not have only to do with different commitments with fiscal discipline or with structural reforms, but also with different stages of competitive development and with different patterns of industrial specialisation. These differences involve different risks of asymmetric shocks, requiring adapted solutions to be supported at European level.

Moreover, the reduction of macro-economic imbalances depend not only on the effort of each Member State, but also on providing the appropriate European general conditions: a reasonable interest rate for all Member States, a higher European growth rate, a European bank framework to ensure responsible lending and borrowing, a European financial support for catching-up regions.

The new Euro-zone Pact should consider these four priorities and not only the first two ones, as the initial German proposal does.

## 4. Shaping the euro-zone reforms in the good direction

The current reforms of the EU economic governance can **create the opportunity** to progress in these priorities.

In fact, major reforms of the EU economic governance are already underway, covering the following building blocks:

- The European semester and the new coordination process of fiscal, economic and social policies at European level
- The new procedure of macro-economic surveillance
- The reform of the Stability and Growth Pact
- The Europe 2020 strategy for growth and jobs
- The new single market agenda
- The new instruments for financial stability
- The Community budget
- The reform of the financial system and the new supervision system

We need to have a **comprehensive view** of all these building blocks to shape the overall direction of these reforms and set a new compromise to strengthen the euro-zone. There are **two major strands in these reforms**:

- The **coordination of national policies**, not only budgetary and macro-economic policies, but also economic and social policies in general
- **Stronger European instruments**: not only the next Community budget and its programmes, but also the need to create a permanent European Financial Mechanism, able to assist in sovereign debt crisis, to improve debt management and to support key investments.

These reforms can pave the way for a very much needed qualitative leap: building an Economic Union, to be coupled with the current Monetary Union.

<u>Central Question</u>**: How should these reforms be conducted in order to advance the above mentioned priorities to strengthen the euro-zone sustainability** (see Table 1)?

**a/ The European Stability Mechanism** should reduce speculative pressures over the euro-zone, ensure reasonable spreads among Member States, work as a last resort solidarity against sovereign default and enable key national public investments which do not find other financing alternatives

b/**The European supervision and regulation of the financial system** should ensure stronger financial stability, reduce speculative pressure on sovereign debt and more focus on supporting growth and investment according to the EU2020 objectives

**c/ The revised Stability and Growth Pact** should ensure stronger fiscal discipline, reward the quality of public finances, improve the coordination of tax sources and social contributions and ensure public space for the EU2020 investments and for catching-up investments

d/ **The single market agenda** should open new market opportunities, while actively promoting tax convergence and the upward convergence in social and environmental standards

f/ **The macro-economic surveillance** should reduce the macro-economic imbalances with a balanced approach, focusing on sustainable growth as its main objective; should also improve the cross national coordination of deficit and surplus countries, in order to increase the positive spill-over effects and to counter the negative ones

g/**The Community budget** should fund stronger Community programmes to support to the EU20202 Strategy and provide structural funds for catching-up countries, with stronger conditionality regarding the EU2020 objectives

Against this framework, the **EU 2020** would have better conditions to be implemented, involving all Member States, increasing the international attractiveness of Europe for new investments and strengthening Europe's global competitiveness.

## 5. Striking new compromises

The fine-tuning of all these instruments will face many divergences requiring **specific compromises** which are interconnected in a more **general compromise** (see Table 2).

New compromises regarding the **Stability and Growth Pact**:

- straight fiscal tightening blocking all public investments or keeping fiscal space for investments? Selective spending cuts and fiscal space only for key EU 2020 investments
- spending cuts or new revenues? Selective spending cuts and new sources of revenue (financial and green)
- Tax harmonization or tax flexibility? Tax convergence

- Social contributions and retirement age harmonization or social flexibility? Social convergence
- automatic or discretionary rules for fiscal discipline? Semi-automatic and smarter rules

New compromises regarding the **Single Market**:

- opening or protecting the national markets? Opening, combined with support to capacity building and protection of better standards
- standards harmonization or flexibility? More convergence, combined with support to capacity building

New compromises regarding **macro-economic surveillance**:

- reducing the imbalances of the deficit or of the surplus countries? Both
- reducing the current account and competitiveness deficits or the unemployment rates? Both
- Changing countries' behaviours with sanctions or with incentives? With both
- Overcoming imbalances by national efforts but also by better European coordination

New compromises regarding the **Community Budget**:

- less or more resources? The same, but a new kind of resources
- less or more structural funds? The same, with stronger conditionality
- Focus on excellence or easier access to the Community Programmes? Focus on excellence and support to capacity building

Finally, new compromises regarding the **European Stability Mechanism**:

- providing loans or buying national bonds? Both
- higher or lower interest rate? Lower, if public creditors are considered senior
- more or less resources? More to minimize use
- sovereign default or not? To be avoided by a stronger preventive action
- strong conditionality or not? Strong but balanced, considering fiscal consolidation and growth
- larger euro-bonds issuance or not? Yes, with a cap and an access price in line with the national risk

Two of these issues deserve a more detailed development in the next sections because they are **interconnected at the heart of a new Euro-zone Pact**:

- the transition from the current EFSF and the ESM to the new ESM, European Stability Mechanism
- the coordination and convergence of national economic policies in the framework of the so-called European semester

## 6. The transition to the European Stability Mechanism

The transition from the current EFSF and the ESM to the new ESM, European Stability Mechanism should be stepped up in order to deactivate the epicentre of the financial pressure hitting the euro-zone and restore financial stability for all Member States. This transition can proceed by taking the following steps, in a gradual metamorphosis:

- regarding its **roles**: control and prevent sovereign debt crisis; support key investments which cannot find other funding solutions; improving debt management of the euro-zone members
- regarding its **instruments**: issuing euro-bonds to provide loans; issuing euro-bonds to buy national bonds; special issuance of euro-bonds to fund key investments; to turn a capped tranche of national bonds into euro-bonds
- regarding the **financial base** to ensure AAA rating: national guarantees with senior status; joint guarantee; own reserves and capitalisation (by buying and selling bonds)
- regarding **conditionality**: fiscal re-balancing and banks restructuring; fiscal consolidation, sustainable growth and structural reforms
- regarding the **interest rate**: higher than German bund but reasonable enough to enable fiscal consolidation and recovery
- regarding the **amount** of resources: large enough to deter financial speculation

## 7. More coordination and convergence of national economic policies

The coordination of the national economic policies at European level in the framework the European semester will by translated into the presentation by all Member State of:

- their Stability and Convergence Programmes, indicating their medium term objectives for fiscal consolidation and for macroeconomic re-balancing and their priorities to achieve them
- their National Reform Programmes, indicating their national targets to meet the EU2020 headline targets and their priorities to achieve them as well as to implement the EU2020 flagship initiatives

These two national programmes should be made **mutually consistent in the framework of the integrated guidelines for growth and jobs**, encompassing the broad economic guidelines and the employment guidelines, aiming at a policy mix reaching three main objectives: promoting a greener, smarter and inclusive growth, re-balancing the national budgets and reducing the macro-economic imbalances.

In order to make consistent progress in these three objectives when national economies are strongly interconnected, this coordination should also involve a certain level of **convergence which should engage particularly the euro-zone member states and all the others wanting to join.** This joint convergence effort should notably focus on:

The following indicators

a/unit labour costs ( low competiveness countries should increase productivity, high competitiveness countries should increase wages)
b/ growth rates
c/ public debt rates (MTOs considering different investment needs)
d/reasonable interest rates for private and public investments
e/minimum investment rates in R&D, education and infrastructures
f/employment rate (general, women, young, elderly people)
g/ stress tests indicators

The following policy measures:

- Coordinated innovation and industrial policy, supported by structural funds with stronger conditionality
- Framework for public debt sustainability
- tax sources and levels (common consolidated tax base, minimum corporate taxes, new sources of taxation)
- promoting active ageing, setting a relationship between working life length and life expectancy, while considering professional specificities
- mutual recognition of qualifications at secondary and high level of education
- crisis management regime for banks at the national and European levels

The efforts to be deployed by Member States towards these convergences should be followed up at European level with peer pressure, recommendations, sanctions and incentives to be provided by:

- the Stability and Growth Pact (fines/ more time to consolidate budgets)
- the European Stability Mechanism ( access and interest rate to be paid to use euro-bonds)
- the Community Budget (stronger conditionality related to the structural funds, project selection in the Community Programmes)

## A PACT FOR COMPETITIVENESS, GROWTH AND CONVERGENCE

| | INDICATORS | MEASURES |
|---|---|---|
| MACROECONOMIC IMBALANCES | a/unit labour costs ( low competiveness countries should increase productivity, high competitiveness countries should increase wages)<br><br>b/ growth rates | - Coordinated innovation and industrial policy, supported by structural funds with stronger conditionality |
| FISCAL CONSOLIDATION | c/ public debt rates (MTOs considering different investment needs)<br><br>d/reasonable interest rates for private and public investments | - Frame for public debt sustainability<br><br>- tax sources and levels (common consolidated tax base, minimum corporate taxes, new sources of taxation) |
| STRUCTURAL REFORMS | e/minimum investment rates in R&D, education and infrastructures<br><br>f/employment rate (general, women, young, elderly people) | - promoting active ageing, setting a relationship between working life length and life expectancy, while considering professional specificities<br><br>- mutual recognition of qualifications at secondary and high |

| | | |
|---|---|---|
| | | level of education |
| **FINANCIAL REFORM** | g/ stress tests indicators | - crisis management regime for banks at national and European levels |

**THE REFORM OF EU ECONOMIC GOVERNANCE- COMPREHENSIVE OVERVIEW**
**Fine-tuning its policy instruments to strengthen the sustainability of the euro-zone**

| **PRIORITIES FOR THE EUROZONE SUSTAINABILITY**<br><br>**EU POLICY INSTRUMENTS** | PROMOTING A NEW KIND A OF GROWTH | ENSURING FISCAL RESPONSIBILITY | ENSURING FINANCIAL STABILITY | INCREASING INTERNAL CONVERGENCE |
|---|---|---|---|---|
| EU2020 STRATEGY<br>Community Programmes<br>National Reform Programmes | Beyond GDP measuring growth<br>3 Strategic priorities<br>10 guidelines<br>7 flagships | Structural reforms for more effective and efficient public finances | Increasing the attractiveness for new investments | Generalising the implementation of the EU2020 Strategy |
| SINGLE MARKET | New market opportunities | New sources of taxation<br>Tax coordination | Financial markets integration and reform | Tax and social convergence |
| MACRO-ECONOMIC SURVEILLANCE AND CORRECTION | Create conditions to implement EU2020<br>Coordinate spill-over effects | Facilitate budget re-balancing | Strengthening National attractiveness for new investments | Correcting the macro-economic imbalances with a balanced approach |
| EU BUDGET<br>Community Programmes<br>Structural Funds<br>EIB | Providing additional financial support to the EU2020 | Reducing national budgetary effort | Providing a guarantee to project bonds | EU support to catching-up |
| STABILITY AND GROWTH PACT | Ensure fiscal space for EU2020 investments | Stronger fiscal discipline<br>Reward the quality of public finance<br>New sources of public revenue | Credibility of the Medium-term objectives | Ensure fiscal space for catching up investments |
| EUROPEAN STABILITY MECHANISM | Enable key national public investments | Last resort solidarity against sovereign default<br>Mutualisation of debt issuance | Reduce speculative pressures over the euro-zone | Ensure reasonable spreads among Member states |
| EUROPEAN SUPERVISION SYSTEM<br><br>FINANCIAL SYSTEM REFORMS | Make financial system support Eu2020 objectives | Reducing speculative pressure on public debt | Stess tests, Regulations, reserves, bonus to ensure responsible financial investment | |
| EUROPEAN CENTRAL BANK | General conditions to promote growth | Ensuring stable conditions for low interest rates | Inflation control | Last resort to ensure access to credit(provisional) |
| | | | | |

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|---|---|---|---|---|
| STABILITY AND GROWTH PACT | | | | |

**EU ECONOMIC GOVERNANCE REFORM – MAIN DIVERGENCES**

**In search of a new compromise**

| | | | | |
|---|---|---|---|---|
| Public deficit | Reduce, to eliminate structural deficits 2016 onwards | Reduce, but keep margin to invest | Sustainability and quality of public finances | |
| Public debt | reduce | Reduce, but keep margin to invest | Sustainability and quality of public finances | |
| taxes | harmonise | Keep flexible choices | Tax convergence | |
| Social contributions | harmonise | Keep flexible choices | Social contributions and standards convergence | |
| Rules | automatic | discretionary | Semi-automatic | |
| Sanctions | Stronger including structural funds | Not too strong and no structural funds | Stronger, but not with structural funds | |
| New budgetary resources | No | Financial transaction crisis, green taxation | Coordinate move to new sources of taxation | |
| EUROPEAN STABILITY MECHANISM | | | | |
| Sovereign default | yes | no | No, but with stronger discipline to avoid default | |
| Interest rate | higher | lower | Lower if public creditors are senior creditors | |
| resources | smaller | larger | Larger to minimise use | |
| Instruments | Provide loans | Buy national bonds | Provide loans or buy national bonds | |
| Euro-bonds | No | Yes | Yes with access price in line with the risk | |
| conditionality | Fiscal consolidation | growth | Fiscal consolidation and growth | |
| MACROECONOMIC SURVEILLANCE | | | | |
| indicators | In case of deficits, reduce external debt, reduce wages and social costs | Increase competitiveness and added value | External balances<br>Internal balances<br>Competitiveness | |
| sanctions | Yes in case of excessive imbalances | No | Just in case of non compliance with recommendations | |
| incentives | No | Yes | Structural funds with strong conditionality | |
| | | | | |
| COMMUNITY BUDGET | | | | |
| resources | Less resources | More resources | Some amount but new type of resources | |
| Structural funds | Less | More | Same with stronger conditionality | |
| Community Programmes | Focus on excellence | Easier access | Focus on excellence, with structural funds for capacity building | |
| | | | | |
| | | | | |
| SINGLE MARKET | | | | |
| Barriers | Reduce, open new markets | Keep, if weaker positions | | |

| | | | | |
|---|---|---|---|---|
| Standards | harmonise | Support to increase standards | | |
| European value chains | Lead | Share opportunities | European industrial policy | |
| | | | | |
| FINANCIAL SYSTEM | | | | |
| ECB role | Only conventional | Also unconventional | Focus on conventional Unconventional only if needed | |
| Supervision | | | | |
| Regulation | | | | |
| | | | | |