Ensuring a viable EMU: are we on the right track?

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Executive summary

By December, leaders should have been presented with a comprehensive package for a financially stable and economically resilient Economic and Monetary Union. The completion of financial integration, the symmetric adjustment in countries with large current account imbalances and the creation of a common fiscal capacity represent the key lines of action for deepening the EMU, alongside decisive structural reforms in all the euro area Member States.

1. The euro area in the process of steady repair

After a decade of poor economic performance and increased divergence, economic fortunes have improved significantly in recent years in the euro area, which is enjoying a sustained expansion with growth well exceeding potential, increasingly supported by vigorous investment and improving job creation. However, in a few countries (Italy in particular), growth remains anaemic and fragile.

Fiscal positions in most euro countries have improved visibly since 2016. All Member States, except Spain, have exited the Excessive Deficit Procedure (EDP), compared to 24 Members in EDP in 2011. About two-thirds of Member States have reduced or stabilised their government debt since 2011, but well above 60% of GDP in many Member States. At the same time, a number of countries (in particular France, Italy, and Spain) continue to face substantial fiscal imbalances: their fiscal deficits remain close to 3% of GDP, they are still far away from their Medium Term Objectives and they exhibit high, and often further increasing, government debt.

2. The eurozone economy is still facing structural challenges and looking for a new equilibrium

The Eurozone is characterized by three main structural weaknesses:

Growing heterogeneity in productive specialisation: As is normal in a currency area, the Member States of the Eurozone have divergent productive specialisations with consequences on relative productivity and potential growth rates. The elimination of foreign exchange risks encourages productive specialization within the monetary union because it mainly benefits exporting countries. Some countries specialise in upmarket industry, which is more profitable, while others focus on mid-range industry or tourism. This process also leads to a divergence of per capital levels between the euro-zone countries. Hence, the Netherlands per capita GDP is today three times higher than the Greek one, with 45 000 € per year against 16 000 € for the latter[2]. In 1999 it was only two times higher.

Moreover, the position of the best performing and most productive countries tends to improve further as a result of the monetary union itself: the economies of the best performing countries benefit from the fact that the external value of the euro represents an average for the entire economic area and appears undervalued in relation to their economic performance, resulting in an additional competitive advantage. For example, it is estimated that Germany's exchange rate is 20 % undervalued (in terms of a real effective exchange rate towards the euro area). Its correction would imply arithmetically a 2% annual inflation rate in Germany and a 0% inflation in the other countries for a decade, which would be unrealistic and probably misconceived.

Cross-border capital flows are almost inexistent: Since the financial and sovereign debt crisis, financial flows between Eurozone countries have declined. There has been a fall in cross-border loans in the euro area and the share of government bonds held by non-residents has dropped. Investors' and banks' portfolios have increasingly become national following the sovereign debt crisis.

Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita countries (Spain, Italy, Portugal, Greece). The euro area exhibits a savings surplus of more than €300 billion, or 3,5% of GDP, in 2017, which is no longer being lent to the other euro-area countries but to the rest of the world.

[1] We are also grateful to Servaas Deroose for helpful discussions and comments.
[2] Source: Datastream, AMECO, Natixis.

Rebalancing within the Eurozone remains essentially asymmetric: Virtually all Member States faced with major current account deficits prior to the crisis have managed to obtain a remarkable turnaround. All these – except France[3] – have been able to achieve a balance or surplus in their external transactions. This has however been at the price of a collapse in domestic demand, in turn resulting in high unemployment. At the same time, the "Northern" part of the monetary union has been running persistent excessive surpluses (Germany 8,7% of GDP, Netherland 10%), but this has not benefitted the Eurozone as a whole and has had negative externalities for the economies of other countries. This results in a "fundamental disequilibrium" within the Eurozone.

3. Lines of action to deepen the EMU

The relatively favourable current economic environment provides a unique window of opportunity for improving the resilience of the eurozone economy and tackling remaining fault lines in the EMU architecture. A certain number of actions are underway, but should be reinforced or enhanced.

Implementing structural reforms within each Member State with a view to achieving steady convergence towards resilient economies is fundamental for improving the functioning of the EMU. Reducing vulnerabilities whilst enhancing the capacity to absorb shocks and reallocate resources will require comprehensive structural reforms. These internal adjustments efforts in the Eurozone become even more urgent with the long term drag of ageing populations and higher projected pension expenditure. Furthermore, Eurozone fiscal rules should be more effective and binding. This would help to rebuild buffers and ensure debt sustainability. A monetary union cannot work without fiscal discipline and the enforcement of the Stability and Growth Pact has been too lenient since 2003. It is difficult to make progress as long as existing rules have not been observed by all Member States.

Improving the Banking Union and advancing the Capital Markets Union is also essential. This would foster a more effective allocation of resources across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing across the EU. Banking and financial integration has virtually stalled since the crisis. It is therefore of paramount importance for public decision-makers to strengthen the Banking Union by setting up a meaningful backstop to the Resolution Fund, as proposed, but addressing the concerns of host countries regarding the EU crisis management framework in order to eliminate the present ring fencing of capital, liquidity and bailinable liabilities which is hindering the operation of true transnational banking groups in the Union is also essential.

Correcting the current disequilibrium in the monetary union is necessary for sufficient progress to be possible.

The pattern of euro area rebalancing that predominantly relies on "adjustment in weaker countries" is not sustainable either politically or economically. Lack of solidarity and an unjustified mistrust towards countries with lower productivity will indeed feed populism in Europe and undermine the cohesion of the euro area. In addition, lasting and excessive current account surpluses are not sustainable within a monetary union because they result in effect in creating currency advantages for the best performing countries. This is true also at the international level, as illustrated by the recent complaints of the US administration. Symmetric economic adjustment both in deficit and surplus countries is therefore a prerequisite for a durable rebalancing in the euro area.

This means that as long as deficit countries have embarked on the structural reforms needed to address their competitiveness gap, surplus countries should accept to reduce their surpluses and for example accept some degree of higher relative unit labour costs. Furthermore, if surpluses are persistent and excessive (for example above 3% to 5% of GDP), it could, for instance, be imagined at the level of the euro zone, to tax surpluses on balances of payments, symmetrically to the internal adjustments that are required from deficit countries when their economic situation is not improved. These taxes could then feed into a Rainy Day Fund and thus help to equalise cyclical divergences between euro area countries.

This is not a matter of fiscal redistribution or of creating a "union of transfers". It is the correction of a "fundamental imbalance" which jeopardises the survival of the euro area and threatens the functioning of the international financial system It is up to the Eurogroup to deal with these malfunctions and to create automatic compensation mechanisms in the event of persistent current account deficits or surpluses.

Two Commission proposals are on the table in order to contribute to an improved implementation of the necessary structural reforms and fiscal consolidation: a stabilisation function and a reform delivery tool, within the Multi-annual financial framework (MFF)[4].

[3] France is now the only European country that has run a current account balance deficit for the last 10 years, has increased still further its record level of public expenditure, runs a primary deficit (around –1.5% of GDP) and has the highest level of tax and social security contributions. So long as this situation prevails, the influence of France to galvanise its partners on macro-economic coherence in Europe will necessarily be limited.

[4] The Reform Support Programme is a new instrument designed to foster the implementation of reforms in all EU Member States, starting with priority reforms identified at the European Semester. It would provide financial and technical support for the pursuit and implementation of reforms and improve Member States' administrative capacity. The European Investment Stabilisation Function linked to the EU budget would represent an embryonic Central Fiscal Capacity and would complement existing instruments at national and European levels to absorb large asymmetric macroeconomic shocks in the euro area and countries participating in the European Exchange Rate Mechanism (ERM II). The EU budget would guarantee back-to-back loans of up to €30 billion (about 0,2% of euro area GDP) in 2021.

But steadfast and balanced efforts both in deficit and surplus countries are necessary to galvanise growth and stability in the euro area.

Until this has been achieved, private risk sharing through financial markets has to be complemented by public risk sharing. Indeed a **Central Fiscal Capacity** (CFC) would provide additional fiscal space for bad times, dampening any repeat of the recent crisis when countries were forced to raise taxes and cut spending, which further deepened the economic slump. Such a CFC will be politically acceptable only if it does not generate permanent transfers or debt mutualisation and minimises moral hazard. The recent Commission proposals are an interesting set of proposals in this perspective, usefully enriched with other proposals like those from the IMF and should be discussed without delay within the Eurogroup.

Detailed summary

After a decade of poor economic performance and increased divergence, economic fortunes have improved significantly in recent years. The euro area is enjoying a sustained expansion with growth well exceeding potential, albeit moderating, increasingly supported by vigorous investment and improving job creation. This favourable environment provides a unique window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture.

If the Economic and Monetary Union is a system in the process of being repaired, the Eurozone economy is still facing structural challenges and still looking for equilibrium. A coordination of economic policies is called for. The completion of financial integration, the symmetric adjustment in countries with large current account imbalances and the creation of a common fiscal capacity represent the key lines of action for deepening the EMU as long as domestic adjustment is taking place in all parts of the euro area.

1. A monetary union requires a sufficient degree of economic convergence for its sustainability

In the EMU, monetary policy is centralized but important parts of economic policy remain national. It is a genuine monetary union whose sustainability depends on the degree of convergence of economic performances, and consequently of national economic policies. The experience of recent years has shown how the lack of resilience in one or several economies in the euro area can have significant and persistent effects not only on the countries concerned but also on other countries and the euro area as a whole.

Sharing the same currency and a common monetary policy does not create by itself economic convergence and cannot solve structural economic problems (see 3.1). However, the introduction of the euro was never intended to solve the structural problems faced by the economies of the euro area. It was not conceived as a machine for equalizing diversified economic structures. The Union is not a Union in which fiscal transfers are supposed to equalize automatically all the evolutions of revenue discrepancies in the zone. Member States are liable for the increase of their potential output and the harnessing of their comparative advantages within the currency union. It was thought that the introduction of the euro would act as catalyst for structural reforms but this did not happen.

Countries can successfully function in a Monetary Union even with different income levels as long as they avoid excessive macroeconomic imbalances. The purchasing power catch up can therefore take place only at the same pace as the productivity catch up. In sum, the convergence of living standards cannot go faster than the increase of per capita productivity[1].

The balance of payments remains national. The Euro area is not a federal state. Since external adjustments are not an option anymore, the correction in divergence in competitiveness can only be achieved through internal devaluation, meaning cuts in labor costs for real wages. This requires further elaboration.

2. The euro area in the process of steady repair

With some delay and after a lost decade of divergence, significant improvement was seen in the system as of 2010.

2.1. Conformity to Maastricht criteria and to the macroeconomic imbalance procedure (MIP) has improved in the Eurozone

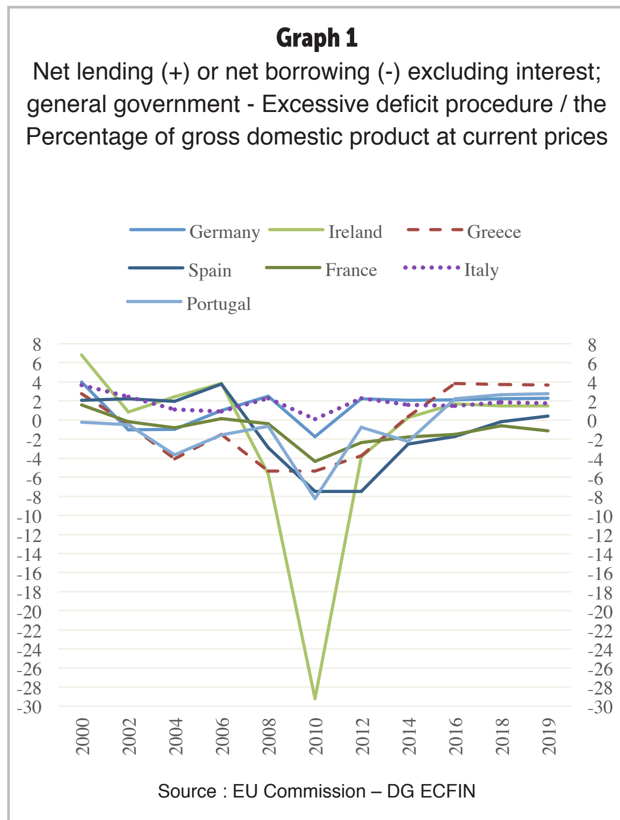
2.1.1. The fiscal position of most Eurozone countries improved in 2017

Fiscal positions of countries have improved visibly since 2016. All Member States, except Spain, have exited the Excessive Deficit Procedure (EDP), compared to

[1] Federalism, i .e. automatic income transfers from the high-income countries to the low-income countries, contributes to the convergence of living standards in a monetary union: the larger the purchasing power differentials, the larger the transfers would have to be. But in the Eurozone, the degree of federalism is low.

24 Members in in EDP 2011. The public deficit of the euro area Member States is now forecast to fall to 0,7% of GDP in 2018 and 0,6% in 2019.

Most Member States achieved a primary fiscal surplus in 2017, notably Greece and Portugal where it represented respectively 3.98% and 0,91% of their national GDP (see Graph 1 below). This is mainly due in particular to the structural reforms conducted in Southern European countries and Ireland[2] following the sovereign debt crisis.



Graph 1

Net lending (+) or net borrowing (-) excluding interest; general government - Excessive deficit procedure / the Percentage of gross domestic product at current prices

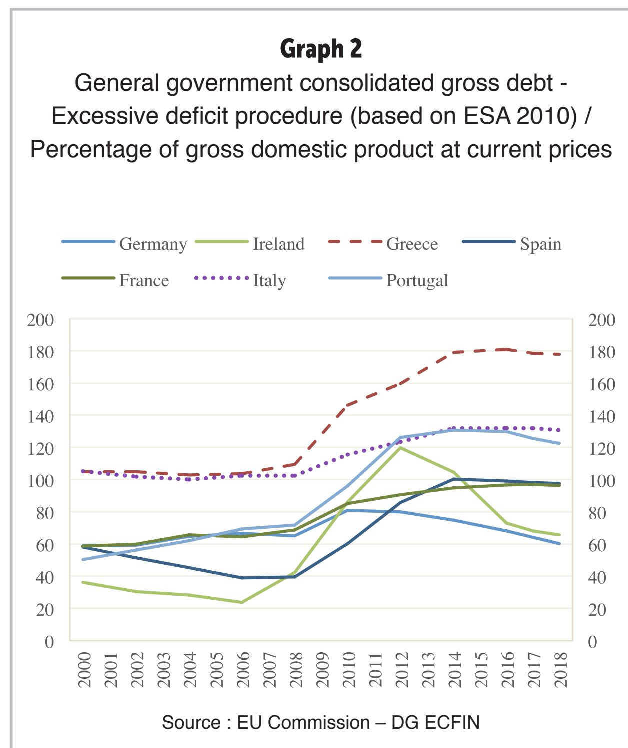
Source : EU Commission – DG ECFIN

The vast majority of Member States have visibly progressed, or achieved, their medium-term objective (MTO) and about two-thirds have reduced or stabilised their government debt since 2011, but well above 60% of GDP in many countries.

As described in the graph 2, following a significant increase between 2010 and 2016, gross debt levels are stagnating or slightly decreasing in most Eurozone countries. And public finances in the Union are set to continue improving[3], as general government debt fell to 83.1% of GDP in the EU in 2018 and is projected to continue its steadily declining path.

However, they remain high and above 60% of GDP in most countries, except Germany and Ireland: France's general government consolidated gross debt represented for instance 96.35% of national GDP in 2018[4], and the Italian 130.72%.

Countries with high debt loads should use the opportunity provided by the still splid economic real expansion and still low borrowing costs to rebuild buffers. If monetary policy normalisation were to coincide with a perception that vulnerable countries are not doing enough to address their underlying problems – or are considering reversing reforms or implementing policies that would harm debt sustainability – sovereign spreads could again increase abruptly, with possible contagion effects.



Graph 2

General government consolidated gross debt - Excessive deficit procedure (based on ESA 2010) / Percentage of gross domestic product at current prices

Source : EU Commission – DG ECFIN

2.1.2. Current transaction balances, which give an idea of relative competitiveness, now appear more consistent in the euro area

Since the crisis, the disparities in competitiveness have been significantly reduced. In 2016-2017, all countries in the Monetary Union -except France- were in fact able to achieve a balance or surplus of their current accounts (see graph 3 below).

The surplus current account is particularly high in Ireland due to the role played by the subsidiaries of US firms in particular and in Germany, showing its performance in the export on industrial goods within and outside Europe thanks in particular to the Euro.

[2] The Irish public deficits during the period 2008 – 2012 were entirely due to costs for banking support

[3] European Commission, 2018 European Semester, Country Specific recommendations

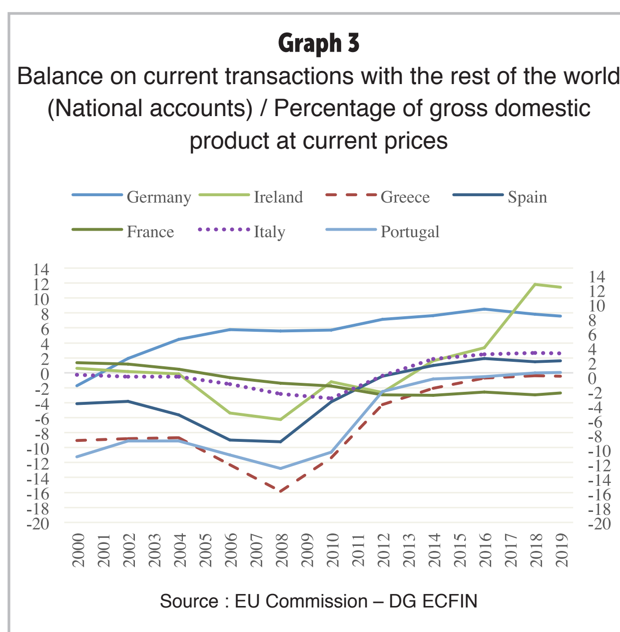
[4] Mainly due to the debt-increasing stock-flow adjustments as the primary deficit and interest payments were broadly offset by the debt-reducing impact of real growth and inflation.

It may be objected that this improvement has only come about because of a policy of "austerity", which hits countries with high unemployment (such as Spain) particularly hard. However, it can be observed:

- Firstly, the notion of "budget austerity" needs to be put into perspective: broadly speaking, public spending has been reduced in peripheral countries to the level attained before the 2007-2008 crisis, which was already substantial. All the same, debt sustainability in some of these countries still poses problems. As a result, irrespective of the very existence of the Eurozone, a budget correction would in any event have been unavoidable.
- Secondly, the real challenge for successful monetary union seems to him to go far beyond the budget issue.

Graph 3

Balance on current transactions with the rest of the world (National accounts) / Percentage of gross domestic product at current prices



Source : EU Commission – DG ECFIN

So long as productivity gains in Southern Europe are below those in the North (as at present), there is no way – whatever the chosen monetary framework – of isolating and fully "protecting" income in the South. In reality, the only growth-promoting solution would have to follow a twin track:

- Accept a degree of wage restraint in the South whilst undertaking essential structural reforms; and
- Optimize the Banking Union and deliver the Capital Market Union. This is an important point. The solution adopted in the US usefully clarifies the issue. In the United States, unlike Europe, monetary union works to a large extent because of the significant role played by the financial market in redressing economic imbalances between regions. "Surplus" capital moves freely towards areas looking for investment.

The federal budget of the US, with its "automatic stabilizers", undoubtedly helps to redress imbalances arising from asymmetric shocks and, from this perspective, Europe would work better if it had a slightly larger federal budget commensurate with the scale of the problems. But the bulk of the adjustment (around 80%) in the US can be explained by market forces.

Hence the importance of encouraging an active banking and capital market whereby the North's surplus savings could find their way to investment in the South. This push for capital mobility will of course not bear fruit unless the ecosystem is conducive, especially as regards the training and skills of young people and the development of new technologies.

3. The Eurozone economy is still facing structural challenges and still looking for a new equilibrium

The Eurozone is characterized by three main structural weaknesses: there is a growing heterogeneity in productive specialisation between Member States, cross-border capital flows are almost inexistent, and rebalancing with the Eurozone remains essentially asymmetric.

3.1. The divergence of productive specializations

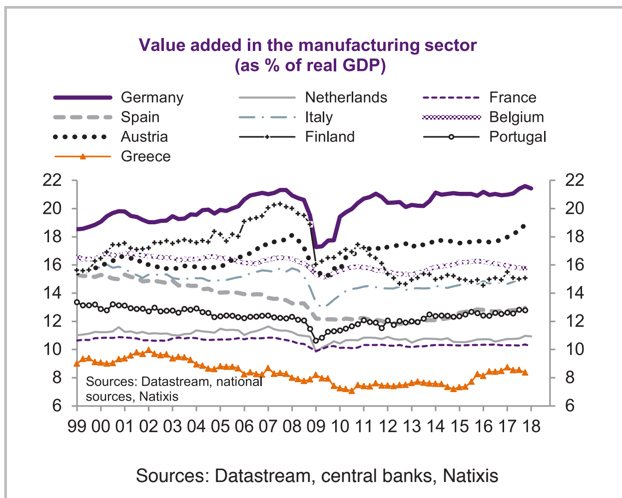
Economic heterogeneities do not come only from cyclical events or policy mistakes but in large part from structural factors e.g. globalisation and digitalisation have led to specialisation and geographical concentration (cf urban/city divide), not only in the euro area but globally (also very much in the US).

As it is normal in a currency area, the Member States of the Eurozone have divergent productive specialisations with consequences on relative productivity and potential growth rates. The elimination of foreign exchange risks encourages productive specialization within the monetary union because it mainly benefits exporting countries. Some countries specialise in upmarket industry, which is more profitable, while others focus on mid-range industry or tourism.

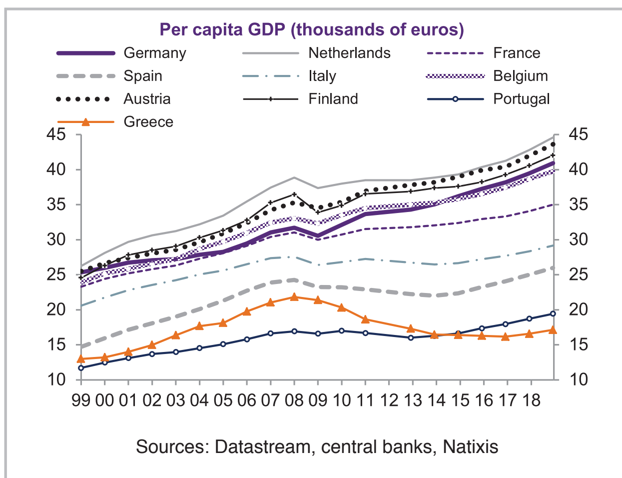
This process also leads to a divergence of per capital levels between the euro-zone countries. Hence, the Netherlands per capita GDP is today three times higher than the Greek one, with 45000 € per year against 16000 € for the latter[5]. In 1999 it was only two times higher.

The following charts show the example of the diverging weights of industry in the economies and how per capita income levels have diverged between the euro-zone countries since the 2008-2009 crisis.

[5] Datastream, AMECO, Natixis



Sources: Datastream, central banks, Natixis



Sources: Datastream, central banks, Natixis

The position of the best performing and most productive countries tends to improve further as a result of the monetary union itself: the currency of the best performing countries benefits from the fact that the external value of the euro represents an average for the entire economic area and appears undervalued in relation to their economic performance), resulting in an additional competitive advantage.

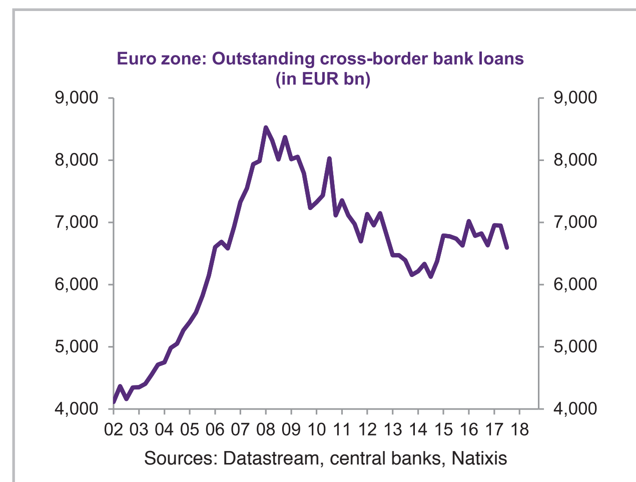
The divergence of income levels between Eurozone Member States has already had serious political consequences: the rise of Euroscepticism and populism in countries with low relative income (such as Italy) on the one hand, and the rejection of federalism in countries with high relative income on the other (Netherlands, Austria…). It is also a vicious circle: a higher level of transfers between Member States would be needed to reduce the heterogeneity of income levels between the Member States and prevent them from diverging, but as the income gaps still continue to widen, the cost of moving towards more federalism gets higher and higher for the richer countries, making them less and less favourable to the Economic and Monetary Union project, particularly to any form of permanent transfer mechanism (common budget, …).

This structural diversity must be addressed if we want to avoid policy divisions between the Union. Cost-competitiveness gaps are corrected only via wage austerity in the countries in difficulty. Faster wage increases in the highly competitive countries are never considered: adjustments in countries' relative competitiveness levels are asymmetrical and borne solely by the countries in difficulty. This is indicative of the lack of coordination of economic policies in Europe.

3.2. Capital mobility cross border capital flows have not been restored in the Euro area

During the decade from 2000 to 2010, there was a high level of capital mobility within the Eurozone but it mostly resulted from inter-bank funding which supported the financing of inefficient investments (e.g. in real state bubbles, sub-optimal business ventures and infrastructure projects notably in Spain, Italy, Portugal, Ireland and Greece). The 2011-2013 sovereign debt crisis halted the circulation of capital flows among Eurozone and EU countries.

Since then, financial flows between the Eurozone countries have declined; there has been a fall in cross-border loans in the euro area . The share of the government bonds held by non-residents has dropped. Investors' and banks' portfolios have increasingly become national following the sovereign debt crisis.



Sources: Datastream, central banks, Natixis

Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece).

The euro area exhibits from a savings surplus of more than €300 billion, or 3,5% of GDP in 2017, which is no longer being lent to the other euro-area countries but to the rest of the world excluding the euro area. Developing cross-border financial flows within the euro area is essential. The true objective of a currency area is that savings may flow to finance the most productive investments throughout the currency area.

[6] P. Artus, The reasons why capital mobility between euro-zone countries should be restored, Flash Economics, Natixis Research, 4 April 2018

P. Artus reminds us[7] that, the elimination of currency risk should allow savings from the countries that have a high level of per capita capital (Germany, Netherlands, France) to finance investment in the countries with lower per capita capital and higher marginal productivity of capital (for example Spain, Italy, Portugal). Income convergence therefore normally stems from the transfer of savings from high per capita income countries to low per capita income countries. But, as mentioned above, these transfers disappeared in 2008-2010.

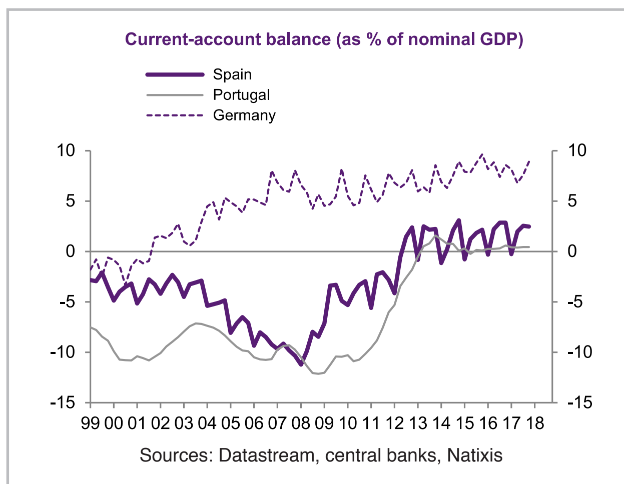
The fact that Germany's and the Netherlands' external surpluses are no longer lent to the other euro-zone countries reduces the capacity of peripheral countries to invest as well as their potential growth, and increases the per capita income heterogeneity.

Again, by contrast in the US, it is the private market flows that take care of some 80% of the adjustment in case of asymmetrical shocks while fiscal federal transfers are only very limited, less than 20%. When regions are sagging with low productivity, investors can step in to improve production conditions.

This is why the Banking Union needs to be optimised and the so called "Capital markets Union" should be concretely worked on.

3.3. The "asymmetry of adjustments" within the Eurozone further increases economic heterogeneities

While, over the last three years, all the peripheral countries (contrary to France) have swung from current account deficits (sometimes huge in terms of GDP) to balance and even surplus, the "Northern" parts have been running excessive surpluses (Germany: 8,7% of GDP, Netherland: 10%) that are the manifestation of a "fundamental disequilibrium" and entail negative externalities for others.



In a recent note[8] Jacques de Larosière stressed that in a way, the remarkable adjustment realized by the "weaker" countries through a containment of their domestic demand in the face of still high unemployment, has been annihilated – in global terms – by the explosion of surpluses. It has been calculated that in terms of "real equilibrium exchange rates", Germany has an undervalued rate of 20% versus the average of the Union the correction of which would imply arithmetically a 2% annual inflation rate in Germany and a 0% inflation in the other countries for a decade[9], which would be unrealistic and probably misconceived.

This can, and must, be dealt with by adequate measures and not only by relying on lasting reductions of revenues and costs by those countries that have achieved external balance.

If more symmetrical adjustment and some kind of risk-pooling are not put in place, there would be worrying consequences:
- The savings of rich countries would no longer flow towards the poorest
- The potential growth of the Eurozone would be impacted, accentuating differences in income and leading in some cases to a rentier economy.

4. Different proposals have been made to reach a greater economic consistency in the Eurozone focusing on temporary support mechanisms but applying symetrical adjustments in deep surplus countries should also be a key priority

Overall, after 10 years of divergence, the European economic system is gradually coming together again. This provides a window of opportunity to correct the imperfections of the Eurozone notably by achieving a much stronger enforcement of the economic and fiscal rules, strengthening the Banking and Capital Markets Union, reflecting on what could be an acceptable "fiscal union" and restoring a coherent Monetary Union in macro-economic terms.

Without public or private risk sharing, the burden of absorbing shocks and the costs linked to the lack of convergence fall solely on the budgets of the Member States. Such a configuration is unsustainable in the event of a major shock, as we saw during the 2009 - 2011 crisis.

In a recent speech M. Draghi noted[10] that "We lack a truly level playing field for cross-border banks and investors, and this stand in a way of deep financial integration. A single financial market should have one set of rules and all market participants should be able to operate freely within it. Yet that is not the case at present".

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[7] P. Artus, "The absence of capital mobility between euro-zone countries is a disaster", Flash Economics, Natixis Research, 4 April 2018
[8] Jacques de Larosière, "The Future of the euro area", CEPII, April 2018
[9] CEPII, "Some unpleasant Euro Arithmetic", Policy Brief No 21, January 2018
[10] M. Draghi, Risk-reducing and risk sharing in our Monetary Union", The European University Institute, Florence, 11 May 208

In such a context, It becomes urgent to strengthen the Banking Union and eliminate the present regulatory ring fencing of liquidity, capital and bailinable liabilities, which is hindering the operation of true transnational banking groups in the Union (see Eurofi paper on "Optimizing the Banking Union", which proposes keys to break the locks that prevent the integration of banking markets). Given the high degree of banking intermediation in Europe, compared to other jurisdictions around the world, striving for a smoother movement of capital and liquidity, across EU countries, is key in order to integrate banking markets. It is also essential that the Eurogroup and the ECOFIN should concretely work on the so called Capital Markets Union (See also the Eurofi paper on "Building an effective CMU for the EU27 post-Brexit").

Developing private risk sharing via the the banking and capital market channels would indeed foster a more effective allocation of resources across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing across the EU.

Moreover, the significant adjustments of the "weaker countries" should be recognized and be a source of progress. The pattern of adjustment that would rely only on "weaker countries" is not feasible anymore either politically or economically. We now need to start applying symmetrical adjustments in deep surplus countries.

But as long as domestic adjustment in taking place in peripheral countries, public risk sharing must be actively worked upon. Indeed a central fiscal stabilisation capacity would provide countries with additional fiscal space for bad times, dampening any repeat of the recent crisis where countries were forced to raise taxes and cut spending, deepening the slump. Such a Central Fiscal Capacity (CFC) would be politically acceptable only if it does not generate permanent transfers.

4.1. European countries need to accelerate their homework and the EU should incentivize strong and credible domestic reforms

Implementing structural reforms within each Member State represents the starting point of a stronger Eurozone and the condition for improving public risk sharing. An acceptable fiscal union requires a high degree of acceptance of domestic structural reforms and trust among members of the Union.

Indeed only domestic structural reforms (e.g. reducing public spending in relation to GDP, reducing the regulatory burden on firms, taking steps to encourage innovation and technology diffusion, shifting taxes away from labour, encouraging apprenticeship programmes, modernizing social safety nets to reduce discentives to work, enhancing public administrative capacity and procurement frameworks…) can solve structural weaknesses in Member States, raise output and productivity growth, contribute to more income convergence and reduce competitiveness problems and recourse to debt. These internal adjustments efforts in the Eurozone become even more urgent with the long term drag of ageing populations and higher projected pension expenditure.

Moreover better compliance with and enforcement of the fiscal rules are needed. Eurozone fiscal rules should be more effective and binding. This would help to rebuild buffers and ensure debt sustainability. A Monetary Union cannot work without fiscal discipline and the enforcement of the Stability and Growth Pact has been too lenient since 2003. It is difficult to make progress as long as existing rules have not been observed by all Member States.

In the meantime, instruments at the EU level should incentivize strong and credible domestic reforms. Structural reforms should be coordinated at the EU level notably because a number of aspects of these measures have cross-border effects. Incentivising compliance with existing rules could be done for instance with a mutually agreed contract, the costs of enforcement of which would be smoothed by financial support[11]. Such an approach is achievable in the short term, as it would not necessarily require changes in the EU Treaties. It requires leadership and to take into account the limitations on further sovereignty sharing within the existing legal framework[12].

More recently, on 31 May 2018, the European Commission adopted in view of the period 2021-2027:

- A proposal to establish a Reform Support Programme
- A proposal to establish a European Stabilisation Function

Both legislative proposals make use of the EU budget to strengthen the performance and resilience of the EU interdependent economies.

The Reform Support Programme is a new instrument designed to foster the implementation of reforms in all EU Member States, starting with priority reforms identified at the European Semester. It would provide financial and technical support for the pursuit and

[11] According to this line of action, a federal fiscal incentive would be provided to countries that really embark on credible structural reforms: more fiscal transfers with more conditionality would be the idea

[12] In this line, a relevant proposal is the introduction of a 'Convergence and Competitiveness instrument' supported by the Commission in 2013. It consists in a mutually agreed contract, the costs of enforcement of which are smoothed by financial support. One key benefit of such a proposal would be to foster the national ownership of reforms and break a political stalemate, i.e. when reforms involve near-term costs

implementation of reforms and to improve Member States' administrative capacity. It is composed of three separate but complementary instruments:

- A Reform Delivery Tool to provide financial support for key reforms identified in the context of the European Semester, with €22 billion available to all Member States.
- A Technical Support Instrument to help Member States design and implement reforms and to improve their administrative capacity[13].
- A Convergence Facility that will provide dedicated financial and technical support to Member States that have made demonstrable steps towards joining the euro, with €2.16 billion extra available to these countries.

The European Investment Stabilisation Function linked to the EU budget would complement existing instruments at national and European level to absorb large asymmetric macroeconomic shocks in the euro area and countries participating in the European Exchange Rate Mechanism (ERM II). The EU budget would guarantee back-to-back loans of up to €30 billion (about 0,2% of euro area GDP in 2021). The loans would be available to Member States experiencing a large asymmetric shock and complying with strict eligibility criteria for sound fiscal and macroeconomic policies.

4.2. Restoring a coherent Monetary Union on macro-economic terms

A coordination of economic policies is urgently called for: we cannot continue to turn a blind eye to externalities stemming from some policy actions, – or inaction. Adjustment has to be more equitably divided among internal devaluations but also re-evaluations.

Weaker countries cannot carry alone the weight of Eurozone adjustment as long as they are achieving meaningful budgetary adjustments at home (peripheral countries have already made significant progress in this field, see section 2 of this note).

The large net creditor countries should take steps to limit their excessive current account surpluses. A symmetrical adjustment mechanism in which structural surpluses have to be adjusted in the same way as deficits needs to be put in place.

German exports – heavily geared towards high-end products – are standing up well to global competition and also benefiting from the additional competitiveness they gain from the euro in comparison with a situation where each country had an equilibrium exchange rate. From this collective perspective, Germany must commit – particularly through increased investment in infrastructure, education and research development, support for domestic demand and acceptance of European solidarity mechanisms – to placing the "abnormal" portion of its structural surpluses at the service of the overall growth of the Union.

Germany could use some of their ample fiscal space to finance well-targeted reforms and investments. Such actions would enhance potential growth, raise the returns of private investment at home, and lift current wages, thereby facilitating relative price adjustment with respect to trading partners.

This is not a matter of fiscal redistribution or a "union of transfers", but of correcting a "fundamental imbalance" which threatens to put the survival of the Union in jeopardy if nothing is done to counteract it and threatens the functioning of the international financial system. We cannot expect the Southern countries – which have balanced their current accounts – to be the only ones indefinitely adjusting their income downwards to compensate for the growing and problematic surpluses of the Northern countries.

Lack of solidarity would maintain an unjustified mistrust towards countries with lower productivity and consequently feed the populisms in Europe and threaten euro-area cohesion.

France must play an active part in these transformations if it wishes to regain credibility and leadership. It should be pointed out, however, that France is now the only European country which:

- has run a current account balance deficit for the last 10 years;
- has increased still further its record level of public expenditure;
- runs a primary deficit (around −1.5% of GDP);
- has the highest level of tax and social security contributions.

So long as this situation prevails, the influence of France to galvanize its partners on macro-economic coherence in Europe will necessarily be limited.

4.3. A Central Fiscal Capacity for macro-economic stabilisation

An additional way to deepen the EMU is to set up a macroeconomic stabilization function in the Eurozone to absorb asymmetric economic shocks across euro area countries without creating additional permanent transfers and without debt mutualisation. There are two approaches: a central fiscal capacity without permanent transfers or a common budget with permanent transfers. The lack of political consensus makes the

[13] This builds on the experience of the Structural Reform Support Service which has supported over 440 reform projects in 24 Member States in recent years. The tool is available to all Member States and has a budget of €0.84 billion.

second approach unrealistic in the short term. Since the disparities in competitiveness among Member States have now been significantly reduced a political agreement on a Central Fiscal Capacity is within reach. This stabilization function must be coupled with a stronger enforcement of fiscal rules to make sure public finances remain sustainable.

Option 1: a central fiscal capacity without permanent transfers (Rainy Day Fund, Euro-wide unemployment insurance scheme) : an acceptable "fiscal union"

A macroeconomic stabilisation function (or a limited fiscal capacity) without creating additional permanent transfers and without debt mutualisation should be envisaged in order to better absorb the costs of internal adjustments of a Member State in the case of an asymmetric shock (e.g. Ireland was not able to manage oo its own the severe 2008 crisis followed by a recession despite having a sound budget). The central fiscal function would be designed to temporarily cushion economic fluctuations, and not to persistently transfer resources for re-distribution. It would not aim to correct structural differences among Member States, such as competitiveness or specialization gaps.

Jacques de Larosière pointed out that there are two self-reinforcing approaches here:

- make sure that members are achieving meaningful budgetary adjustments at home (peripheral countries have already made significant progress in this field);
- create some adequate and limited form of central fiscal stabilization in the case of asymmetrical shocks.

"But here we must be careful: the Union is NOT a Union in which fiscal transfers are supposed to equalize automatically all the evolutions of revenue discrepancies in the zone. This has never been the Maastricht concept nor should it be introduced in the backdoor. Nevertheless, some limited forms of fiscal stabilizers can and should be conceived in order to deal with some shocks and to take into account negative externalities produced by some unacceptable aspects of the existence of the Union (e.g. huge current account surpluses facilitated by an unrealistaic set of virtual exchange rates within the euro). In this regard, one could think of a somewhat bigger budget that seems appropriate if only because of the necessary upcoming political evolutions of the Union".

The project of a Central Fiscal Capacity was first acknowledged as a possible way forward in the 'Four Presidents' Report' published in 2014. Its role would be to provide enhanced risk sharing without creating permanent transfers or debt mutualisation.

Different institutional set-ups have been envisaged for such a macroeconomic stabilization function:

First, the simplest way of arranging temporary transfers would be through a '**Rainy Day Fund**'. Such a fund would collect revenues from Member States at all times and make transfers to countries when they experience negative shocks. Disbursements could be either triggered on a discretionary basis or on the basis of indicators of the position of the Member States in the business cycle. With a dedicated flow of revenues, the fund might even be able to borrow at low cost to smooth the impact of downturns throughout the union. It would not involve any devolution of spending responsibilities to the center and would provide ex-ante support, namely before the shock turns into a funding crisis.

The symmetric adjustment mechanisms described above (section 4.2) could usefully help finance such a Rainy Day Fund. Indeed, the existence of lasting very excessive and "abnormal" balance of payments surpluses (Germany and the Netherlands have annual surpluses in excess of 8% of GDP) is partly the product of the Monetary Union. Indeed the currency of the best-performing countries benefits from the fact that the external value of the euro represents an average for the entire economic area and appears undervalued in relation to their economic performance. Calculations by Centers for research such as CEPIIshow that Germany's virtual currency is significantly undervalued, giving an additional advantage to its exports.

It is up to the Eurogroup to deal with these malfunctions and to create automatic compensation mechanisms in the event of current account deficits or surpluses. It could, for example, be imagined at the level of the euro zone, to tax surpluses on balances of payments as soon as they are excessive (for example above 3% to 5% of GDP). These taxes could then feed into the Rainy Day Fund and thus help to equalise cyclical divergences between euro area countries.

If the situation were to persist in terms of current account surpluses, we could also imagine a mechanism that would tax the "excessive" exports of the companies of the country concerned by these excesses. These are only ideas, but they must be addressed because the international situation will not tolerate this kind of excess indefinitely. The American administration is already raising the problem of exchange rates within Europe.

Conversely, if a euro area country were to experience a persistent and significant current account deficit, it would have to be submitted to a symmetric mechanism. Such a member state would have to adjust and achieve a current account balance in the year following the identification of the deficit.

Regarding the organisation of these processes, one may wonder whether the Commission, the EMS or a Minister of Finance designated for this purpose or any other structure should not be considered.

The IMF has also proposed in March 2018 a central fiscal capacity (CFC)[14] that could help smooth both country-specific and common shocks: a "temporary cushion and not a permanent pillow".

Specifically, it proposes a macroeconomic stabilization "rainy- day" fund financed by annual contributions from countries that are used to building up assets in good times and making transfers to countries in bad times, as well as a borrowing capacity in case an exceptionally large shock exhausts the fund's assets but any borrowing would be repaid by members 'future contributions.

To address moral hazard risks, transfers from the CFC -beyond a country's own net contributions-would be conditional on compliance with the EU fiscal rules. This is a safeguard for the fund and an incentive for prudent national fiscal policies. Ideally, the fiscal rules would be overhauled in conjunction with the creation of the CFC, to simplify the rules and make their enforcement more automatic.

To ensure that CFC support is nondiscretionary, transfers from the CFC to countries would be triggered automatically by a transparent cyclical indicator.

The CFC would prevent permanent transfers between countries through several mechanisms. First, it would have a "usage premium" where a country pays a premium in good times based on transfers it got in bad times. It is a bit like raising the cost of insurance after a car accident. Second, it would have a cap on how much countries need to contribute, so that countries do not become large net contributors. Third, it would cap how much a country can receive, so that transfers do not substitute for necessary policy adjustment.

The IMF analysis shows that moderate annual contributions could finance a meaningful stabilization capacity. If countries contribute 0.35 per cent of GDP per year, it could build up assets of about 2 per cent of euro area GDP during a typical expansion. In a large region-wide shock, with constrained monetary policy, the fund could finance sufficient transfers to reduce the negative effects on output by more than 50 per cent.

This IMF note also stresses that all countries would likely benefit from the fund. For example, if the fund had existed since the euro began, Germany would have received gross transfers of about 2.5 per cent of GDP during the downturn of 2003-06. This would have left Germany in balance with the fund before the global financial crisis, while Spain and Italy would have been net contributors before the crisis (see bow A at the end of this document, which summarizes the IMF Central fiscal capacity proposal).

Another option would be to set up a **Euro-wide unemployment insurance scheme**. This supplementary mechanism should be used to finance cyclical (and not structural) unemployment insurance expenses related to exceptional economic shocks, when the national unemployment rates exceed a threshold.

This common basic benefit scheme could, for example, provide those who have been out of work for up to one year (the most cyclical component of unemployment) with benefits worth 50% of their previous wage. Financing for the scheme could be levied on a harmonized tax base, such as the total wage bill. To reduce the risk of moral hazard and incentives to reduce structural unemployment, the initial Member States' contributions could be individualized and updated periodically on past trends. In the interval between two updates, joint debt issuance to cover the potential cash requirements of the common scheme would enhance stabilization capacity. The basic benefit scheme could be topped up by a national benefit in accordance with the preferences of each Member State.

The size of this fiscal capacity that can absorb asymmetric shocks would not overburden Member States' public finances, as 1-2% euro area GDP would constitute a sufficient buffer that could be accumulated over a number of years.

The implementation could be achievable in the short to medium-term, as it would not necessarily require changes in the EU Treaties. The framework should be such that moral hazard and free-riding behaviour should be avoided making the proposal broadly acceptable by all parties. A stronger enforcement of fiscal rules (a more binding process) to make sure public finances remain sustainable would certainly facilitate an agreement on a Rainy Day Fund or on a Euro-wide unemployment insurance scheme.

Option 2: a common budget with permanent transferts and a "Finance Minister for the Eurozone"

Some propose a more ambitious option: Sharing fiscal sovereignty with the appointment of a European finance minister empowered with a common budget. This Minister would chair the Eurogroup and could also chair the Economic and Financial Affairs Council (ECOFIN) according to the ideas of the EU Commission. With the support of a Eurozone Treasury, he would coordinate national fiscal policies and would be empowered with a common budget. Such developments would require a change to EU treaties and the abandonment of a certain degree of fiscal sovereignty.

The rationale is to pool some risks while sharing more economic sovereignty. In this vein, the 'finance minister

[14] Nathaniel G Arnold, Bergljot B Barkbu, H. Elif Ture, Hou Wang, Jiaxiong Yao, "A Central Fiscal Stabilization Capacity for the Euro Area", IMF, March 26, 2018

of the Eurozone' could be empowered with a common budget in particular to absorb regional shocks or even offset the negative effects of reforms. He could also coordinate the issuance of a common safe asset. A complementary option would be to place the European Stability Mechanism under the supervision of the 'Finance Minister'.

Such a budget would necessarily entail changes in governance. A 'finance minister' would be in charge of the budget and be accountable to a Eurozone Parliament. The budget could finance on-going public investment expenditure and be channelled into projects offering the best socioeconomic return, with a particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training). It would therefore prevent cuts in public investments during times of crisis and improve macroeconomic stability. If chiefly aimed to catching up countries, it could also kick-start lasting economic convergence in the euro area.

Financing for the euro zone budget could come either from the euro zone bailout fund, the wider EU budget, or from separate sources like each country contributing a share of its GDP or tax income based on 2 common consolidated tax bases (VAT and corporate tax), or from direct borrowing on the market. In case the budget is financed by a fixed percentage of a common consolidated tax base, shaving these tax rates would help to shore up the economy in a recession.

Such developments would require a change to the EU treaties or a new intergovernmental treaty and abandonment of a certain degree of fiscal sovereignty. With more decisions taken at the euro area level, it will also be essential to ensure greater parliamentary control of common economic, social and financial instruments and policies.

A political agreement on such mechanism seems unlikely, provided that economic and fiscal fundamentals are not strong enough to avoid the risk of disproportionate support. Strict and lasting compliance with fiscal solvency is a prerequisite to progress towards a transfer union in the Eurozone. Additionally, structural differences (e.g. social security systems and labour market regulations) between Member States are currently a major obstacle for the creation of such a stabilization function.

Conclusion

If nothing is changed in the current functioning of the euro zone, recent political developments suggest the zone should be expected to have some unpleasant features in the future; widening per capita income gaps between the countries, leading to the juxtaposition in the euro zone of increasingly poor countries and increasingly rich countries, due to the absence of a symetrical adjustment process; weak growth, if the countries with savings surpluses continue to lend them to the rest of the world outside the euro zone (i.e. if capital mobility between the euro-zone countries is not restored).

Without institutional change, the prospect is therefore for an unattractive euro zone with serious political consequences (rise of euroscepticism, rise of populism).

But after 10 years of divergence, the European economic system is gradually becoming more coherent. This favourable current environment provides a unique window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture. Now is the time to improve the functioning of the Eurozone and to address issues that Europe has not been able to deal with in the past because of the economic crisis.

Reducing vulnerabilities whilst enhancing the capacity to absorb shocks and reallocate resources will require comprehensive structural reforms. Furthermore, Eurozone fiscal rules should be more effective and binding. A monetary Union cannot work without fiscal discipline and the enforcement of the Stability and Growth Pact has been too lenient since 2003. Fiscal rules need to be enforced vigorously. This would help to rebuild buffers and ensure debt sustainability. Monetary policy has supported growth to a certain extent but it cannot be a substitute for structural reforms, which are essential in many Member States to improve the business climate, raise potential output growth, close the competitiveness gap and reduce unemployment. In sum, Implementing structural reforms within each Member State (e.g. reducing public spending in relation to GDP, reforming the job market, health systems, pensions, professional training, encouraging innovation and technology diffusion etc.) represent the starting point of a stronger Eurozone. These internal adjustments efforts in the Eurozone become even more urgent with the long term drag of ageing populations and higher projected pension expenditure.

Improving the Banking and advancing the Capital Markets Union also become urgent. This would indeed foster a more effective allocation of resources across the Eurozone, help to achieve a better diversification of risks thus contributing to private risk sharing across the EU. Banking and financial integration has virtually stalled since the launch of the euro. It is therefore of paramount importance for public decision-makers to strengthen the Banking Union by setting up a meaningful backstop to the Resolution Fund and addressing the concerns of host countries regarding the EU crisis management framework in order to eliminate the present ring fencing of capital, liquidity and bailinable liabilities which is hindering the operation of true transnational banking groups in the Union.

The symmetry of economic adjustments should also be a priority focus. Excessive surplus is not sustainable within a balanced monetary area. Within a monetary

union, there must be a symmetrical adjustment mechanism to prevent a long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. The design of EMU presupposed that market forces would provide for fairly rapid self-adjustment. This has not materialised. Since the deficit countries have embarked on the structural reforms needed to address their competitiveness gap, surplus countries, which are receiving a massive currency advantage, would be expected to accept some degree of higher relative unit labour costs through higher real wages. This is not a matter of fiscal redistribution or a "union of transfers", but of correcting a "fundamental imbalance" which jeopardises the survival of the euro if nothing is done to counteract it and threatens the functioning of the international financial system.

Lastly a Central fiscal capacity without creating additional permanent transfers and without debt mutualisation should be envisaged in the euro area to better absorb the costs of internal adjustments of a Member State in the case of an asymmetric shock and to support national structural reforms, provided that a minimum economic convergence is achieved. This would supplement member 'own fiscal efforts, which will be the first and main line of defense in any downturn. Moreover it offers a prime opportunity to deliver something that may directly impact people's lives and is appropriate if only because of the political evolutions of the Union.

By December, leaders should be presented with a comprehensive package for a financially stable and economically resilient Economic and Monetary Union. The completion of financial integration, the symmetrical adjustments in countries with large current account imbalances and the creation of a common fiscal capacity represent key lines of action to assuring a viable Economic and Monetary Union as long as domestic adjustment is taking place in all parts of the euro area.

Lack of solidarity and an unjustified mistrust towards countries with lower productivity will feed populism in Europe and undermine the cohesion of the euro area. Only steadfast and balanced efforts both in deficit and surplus countries reinforced by actions to deepen the EMU will galvanise growth and stability in the euro area and assure that Europe will become a beacon of hope and a place of prosperity in a troubled world.

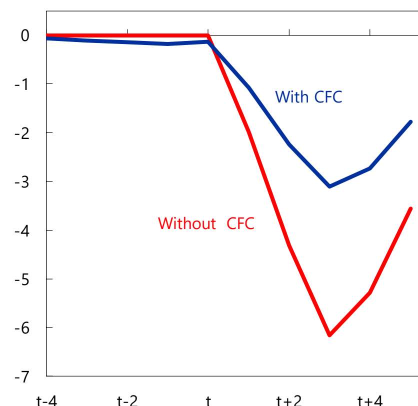
Box 1. A Central Fiscal Capacity for Macroeconomic Stabilization

Staff's proposed CFC would be a macroeconomic stabilization fund. It would be financed by annual contributions from national budgets—used to build assets in good times—and would make transfers to countries in bad times. It would have a borrowing capacity in the event of an exceptionally large shock that necessitates transfers so large as to exhaust the fund's assets. Transfers would be triggered automatically by a cyclical indicator: the deviation in the unemployment rate above its moving average, which avoids triggering transfers in response to structural increases in the unemployment rate.

To address moral hazard risk, transfers from the CFC beyond a country's own contributions would be conditional on past compliance with the fiscal rules. For example, in a downturn, if over the past five years a country was only compliant in three years, the transfer rate would be reduced proportionally. The complexity and opacity of the current EU fiscal rules, however, open up the assessment of compliance to significant discretion, making them less than ideal for linking with a CFC. Ideally therefore, the rules would be reformed in conjunction with the creation of a CFC, to make them more transparent and enforceable.

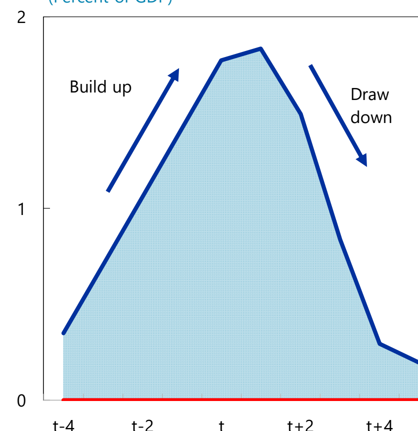
Several mechanisms, which could be combined, are proposed to help prevent permanent transfers. These include a "usage premium," a cap on cumulative net transfers to a country, and a cap on cumulative net contributions from a country. The usage premium would be paid based on a country's past receipts of net transfers from the CFC, but only once its economy has recovered. The cap on cumulative net transfers would help limit the risk of permanent transfers, but would also limit the support for economic stabilization. The cap on net contributions would limit the size of the asset build-up in good times, increasing the likelihood of needing to invoke the CFC's borrowing capacity.

Impact of Large Shock on Output Gap
(Percent of GDP)



Source: IMF staff calculations.

Size of Fund
(Percent of GDP)



Source: IMF staff calculations.

Staff's analysis shows that the CFC could provide meaningful stabilization at moderate cost. With an annual contribution of 0.35 percent of GDP and a transfer rate of ½ percent of GDP for each percentage point of unemployment gap, simulations suggest the CFC could help smooth 30–60 percent of a common shock, depending on whether monetary policy is constrained or not. It could also help smooth up to 50 percent of country-specific shocks. Simulations also confirm that the assets built up during a typical expansion should be sufficient to cover the prescribed transfers in all but the most severe downturn.

Source: IMF, Euro area policies, Article IV, July 2018