

For a more dynamic economy in the Eurozone

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A monetary union does not by itself create economic convergence. This Scoreboard underlines that the eurozone is a currency area comprising heterogeneous countries with a low level of federalism (their productivity levels, productive specialisation, level of fiscal deficits and indebtedness, and level of labour force skills being very different).

As we have observed, many Member States have relaxed their macroeconomic discipline over the last twenty years and those who played the card of fiscal vigilance turned out to be the winners. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States. In this context, it is important that the implementation of Next Generation EU is a success.

It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth. It is not because budget deficits are monetised that they disappear. In addition, the quality of a state's signature is an essential element of confidence that shall be preserved at all costs for the country's future.

But as long as it is not sufficiently understood, especially in highly indebted countries, that over extended debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe. Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

It is economic growth that eventually solves indebtedness issues. The only way of promoting robust growth in the EU is to implement ambitious structural reforms in all Member States.

If Europe and the euro zone are to correct their growth disadvantage in relation to the United States and China and not be relegated to the rank of second-rate powers, a considerable investment effort in research and development, in industrial equipment,

in decarbonisation, in digital technology, in improving equity financing, the education system and the skills of the population, in promoting selective immigration of "people" who can occupy sufficiently skilled jobs, will therefore be necessary

We must understand that our future – noninflationary – depends on the elasticity of supply, and thus on sufficient investment and a well-trained force. Anything that encourages savings to into liquid investments at the expense of long-term choices must be fought.

As explained by Jacques de Larosière in his latest book, "one day we will have to understand that the narrowing of the output gap between potential and observed growth cannot be reduced to the mere fight against the restoration of production chains, but requires the activation of all the sources that ultimately constitute our eco system: productive investment – penalized for 20 years by lasting very low interest rates – , the development of training, the recovery of the share of wages in income, the revitalization of competition... To revive productive investment, refrain from administratively setting ("or guiding" the market) long term interest rates and accept to let the market remunerate savings in the medium and long term according to supply and demand without which there can be neither productive investment nor productivity gains".

Monetary policy can erase spread differentials but cannot address structural issues and notably the lack of confidence and the persistence of structural discrepancies, which explains the limited capital flows from North to South. Europe benefits from a large pool of savings which could contribute to finance long term investments and especially those related to the green and digital transition, provided that such savings are not taxed but remunerated. However, these savings leave the EU and finance the rest of the world (in particular the United States).

This is notably due to the interest rate differential between the US and Europe (risk taking is more rewarded in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area highlights the lack of a genuine Banking Union and integrated financial markets as well as persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries.

If the divergence of interest rates between the two sides of the Atlantic continues to increase in favour of the United States, the problem of transfer savings to higher interest rate areas could have very negative consequences for Europe.

The result of a too slow monetary normalisation in the euro area, in a context of persistent and very high inflation – HICP inflation is above 2% in the euro zone since April 2021 and increased to 6.9% in March 2023 and core inflation has continued to increase, reaching 5.7% in March – would be an acceleration of inflation and low growth (productive investment would continue to fall as we have seen over the past 20 years in periods of very low interest rates).

Consequently, the eurozone has to embark on the right course: fighting inflation, which requires vision and courage, more fiscal responsibility and more supply reforms geared to increase productivity, as well as steps to complete the Banking Union and implement the Capital Market Union. But this move can only be envisaged if sufficient discipline starts reversing the trend of ever-growing economic heterogeneities across Member States.

Ultimately, the paradox of the Euro is that a single currency and national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy have been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth Pact should help to resolve these contradictions and thus make the euro sustainable.

To be viable, the eurozone needs:

- **To combat very high and persistent inflation without further delay by gradually returning to positive real interest rates.** As the 2022 annual economic BIS report reminds us, the most pressing monetary policy task is to restore low and stable inflation and to sustainably rebuild monetary buffers. Higher rates will also reduce central banks remittances to the governments. The reappearance of spreads should not dominate the decision-making process.
It is usual in times of high inflation to increase nominal and real interest rates to avoid further increases in demand. The recommendation is

therefore to continue to raise interest rates and gradually move to positive real interest rates. This would only not be the case if the economy were in a deep economic crisis with rising unemployment or a risk of deflation, which is not the current situation (nor the one that has prevailed since the beginning of the second quarter of 2021, when inflation returned strongly). Real interest rates in the euro zone are much more negative than they were before the war in Ukraine. It seems difficult to fight inflation with such a debt premium.

We must not allow ourselves to fall into the trap of schizophrenia, *i.e.*, to believe that if we fight inflation, we will worsen the financial crisis by introducing less growth. On the contrary, we can continue to curb inflation by raising interest rates and at the same time provide liquidity to banks that need it. The money creation that would result from this injection of liquidity is not of the same nature as QE because it would not contribute to the credit dynamic.

- **National budgets under control in all parts of the Union.** No responsible state can be expected financing durably current public deficits generated by other eurozone members of the Union that do not follow the rules of the Union. The future – and notably the solution to market fragmentation – depends on a consolidation of present weak fiscal positions (primary surpluses) and a shift towards quality of expenditure and investment. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.

We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – non-productive expenditure – represent almost all public expenditure. As much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt. The revision of the Stability and Growth Pact is of paramount importance in this respect. Postponing discussions on the revision of the Pact delays the solution, exacerbates tensions within the market (due to the lack of benchmarks) and only complicates the resolution of problems that are likely to become even more acute.

- **Domestic structural measures towards enhancing business dynamism increasing growth potential should be encouraged and monitored.** We have seen that the economic and financial model based on monetary abundance, the non-remuneration (taxation) of savings, the financialization in response to structural insufficiencies, the systematic short-termism, and the increase in the – essentially speculative – valuations of financial assets, does not meet the needs of our society. These needs require long-term investments, a response to climate and digital challenges, an adequate return on savings and salaries. Without such a reorientation of our policies, it seems difficult to achieve the “common good” and to correct the major current imbalances.

Reducing output gaps cannot be ensured just by subsidies to the labour markets. This requires more substantially to increase the productivity of the system, which necessitates more competition and long-term investment. Making Next Generation EU a success is therefore essential and should contribute to boost potential growth.

Last but not least, it is necessary to refrain from fixing administratively (“or directing” the market) long-term interest rates and to accept to let the market remunerate medium – and long-term savings – according to supply and demand – without which there can be no productive investment or productivity gains.

- **An active banking and integrated capital market in Europe.** In sum, members of the Monetary Union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn out fine. Ultimately, the fate of euro will depend on the political will to achieve genuine cooperation within the euro area.