22nd Conference on Alternative Economic Policy in Europe

EuroMemo Group

University of Coimbra, 15-16 September 2016

The Economic Situation in the EU

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Introduction

Earlier this year, the euro area seemed at last about to recover from the two major shocks which hurt the economy in 2007 and the early 2000’s - the financial crisis followed by austerity policies. More than 10% of GDP were lost during the crisis. Divergences widened between Northern and Southern euro area economies. For instance: unemployment rates vary from 4,4% in Germany, 5.8% in Austria; 11,3% in Italy, 12,1% in Portugal, but 19.8% in Spain, 24% in Greece.

The positive factors – low interest rates, low oil prices, low exchange rate of the euro did not succeed to impulse a robust recovery (except in Ireland and Spain).

The Commission did not wish to modify its strategy: « fiscal austerity/structural reforms ». Some positive steps were however made recently: policies to tackle climate change, the Juncker Plan, combating tax evasion.

In 2016, the EU was hit by two new shocks: first the migration crisis, and then Brexit. The strategy of strengthening European integration, of inserting EU in globalisation faces opposition from populations and governments, like the failure of TTIP also shows. Should the EU be more integrated, at the risk of it being technocratic and liberal?

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2015: GDP still below pre-crisis levels

In %	Pre-crisis Trend GDP growth	Output loss in 2015	2008	2009	2010	2011	2012	2013	2014	2015
Germany	1,6	-6,7	3,4	0,8	-5,6	3,9	3,7	0,6	0,4	1,6
France	1,8	-11,9	2,4	0,2	-2,9	2,0	2,1	0,2	0,7	0,2
Italy	1,2	-18,3	1,5	-1,1	-5,5	1,7	0,6	-2,8	-1,7	-0,3
Spain	2,4	-24,2	3,8	1,1	-3,6	0,0	-1,0	-2,6	-1,7	1,4
Netherlands	2	-14,9	3,7	1,7	-3,8	1,4	1,7	-1,1	-0,5	1,0
Belgium	2,4	-15,0	3,4	0,7	-2,3	2,7	1,8	0,2	0,0	1,3
Austria	2	-12,4	3,6	1,5	-3,8	1,9	2,8	0,8	0,3	0,4
Portugal	1,8	-20,9	2,5	0,2	-3,0	1,9	-1,8	-4,0	-1,1	0,9
Finland	2,4	-25,7	5,2	0,7	-8,3	3,0	2,6	-1,4	-0,8	-0,7
Ireland	2,5	-12,3	5,5	-2,2	-5,6	0,4	2,6	0,2	1,4	5,2
Greece	2,4	-47,1	3,3	-0,3	-4,3	-5,5	-9,1	-7,3	-3,2	0,7
UK	2,2	-11,7	2,6	-0,5	-4,2	1,5	2,0	1,2	2,2	2,9
US	2,4	-11,0	1,8	-0,3	-2,8	2,5	1,6	2,2	1,5	2,4
Japan	1,8	-14,4	2,2	-1,0	-5,5	4,7	-0,5	1,7	1,4	0,0

Source: IMF, WEO April 2016, own calculations

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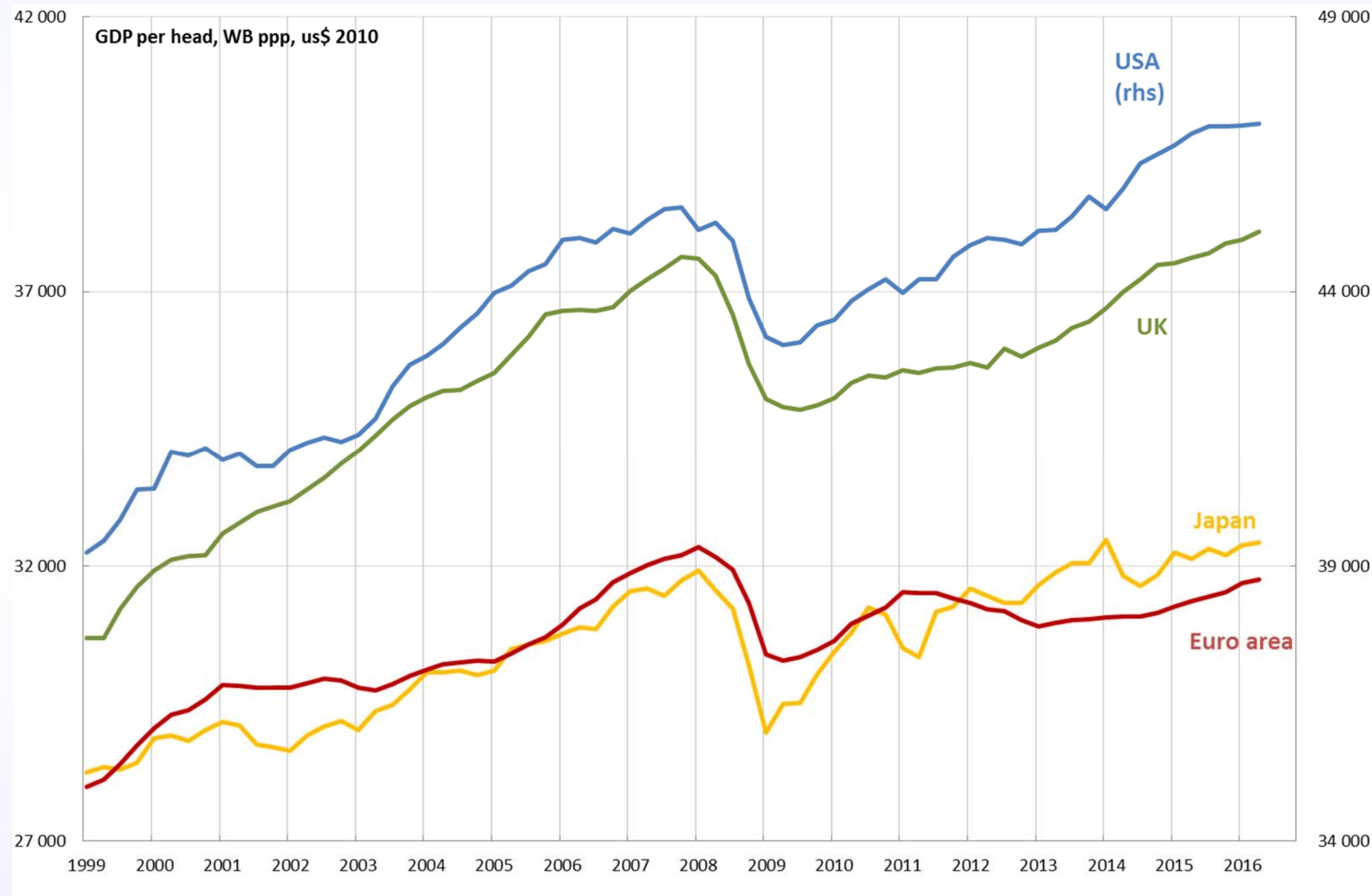
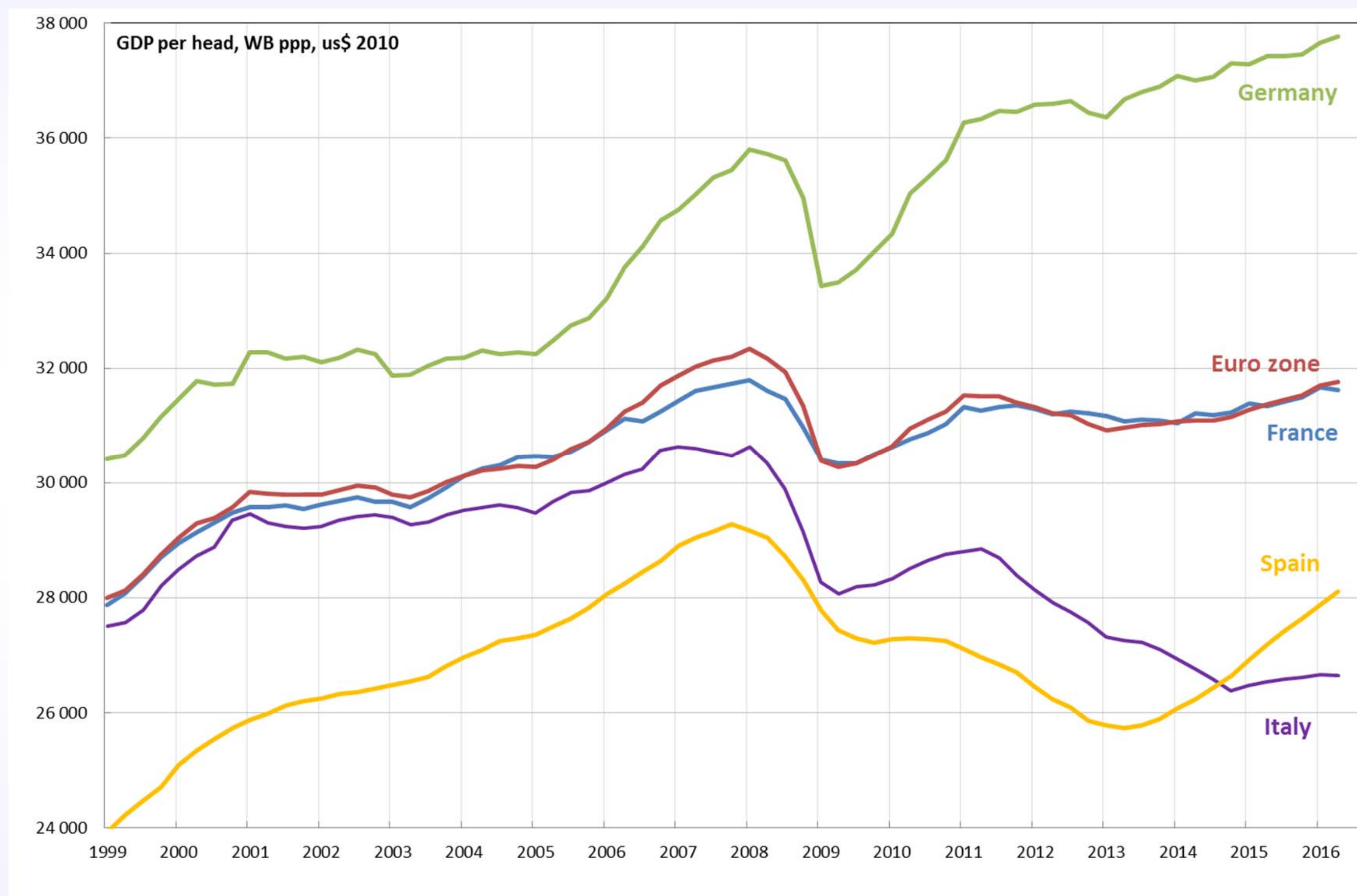
GDP per head: euro area lagging behind…



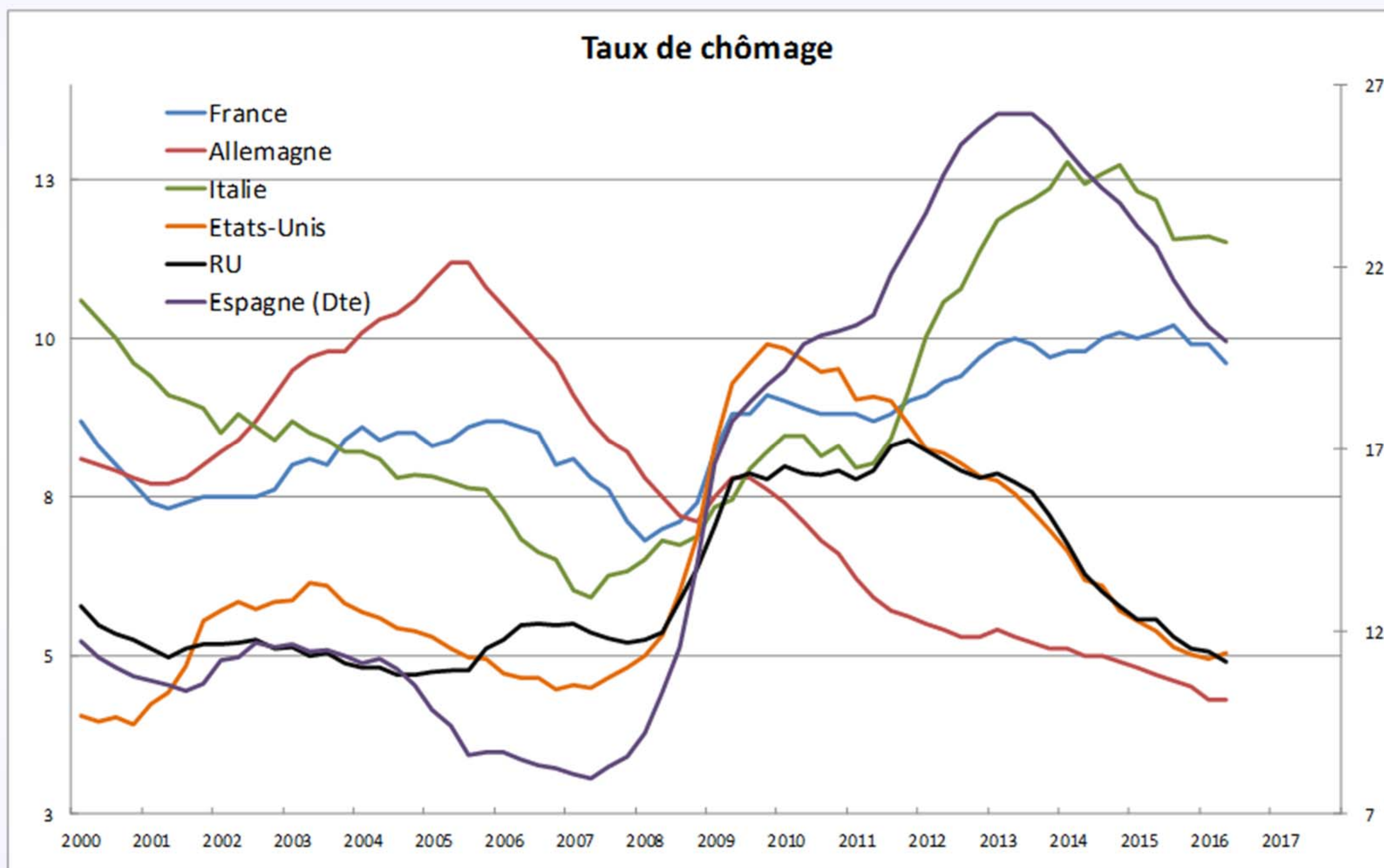
Source: National accounts, OFCE calculations

GDP per head within the euro area: uneven developments, even more since 2009



Source: National accounts, OFCE calculations

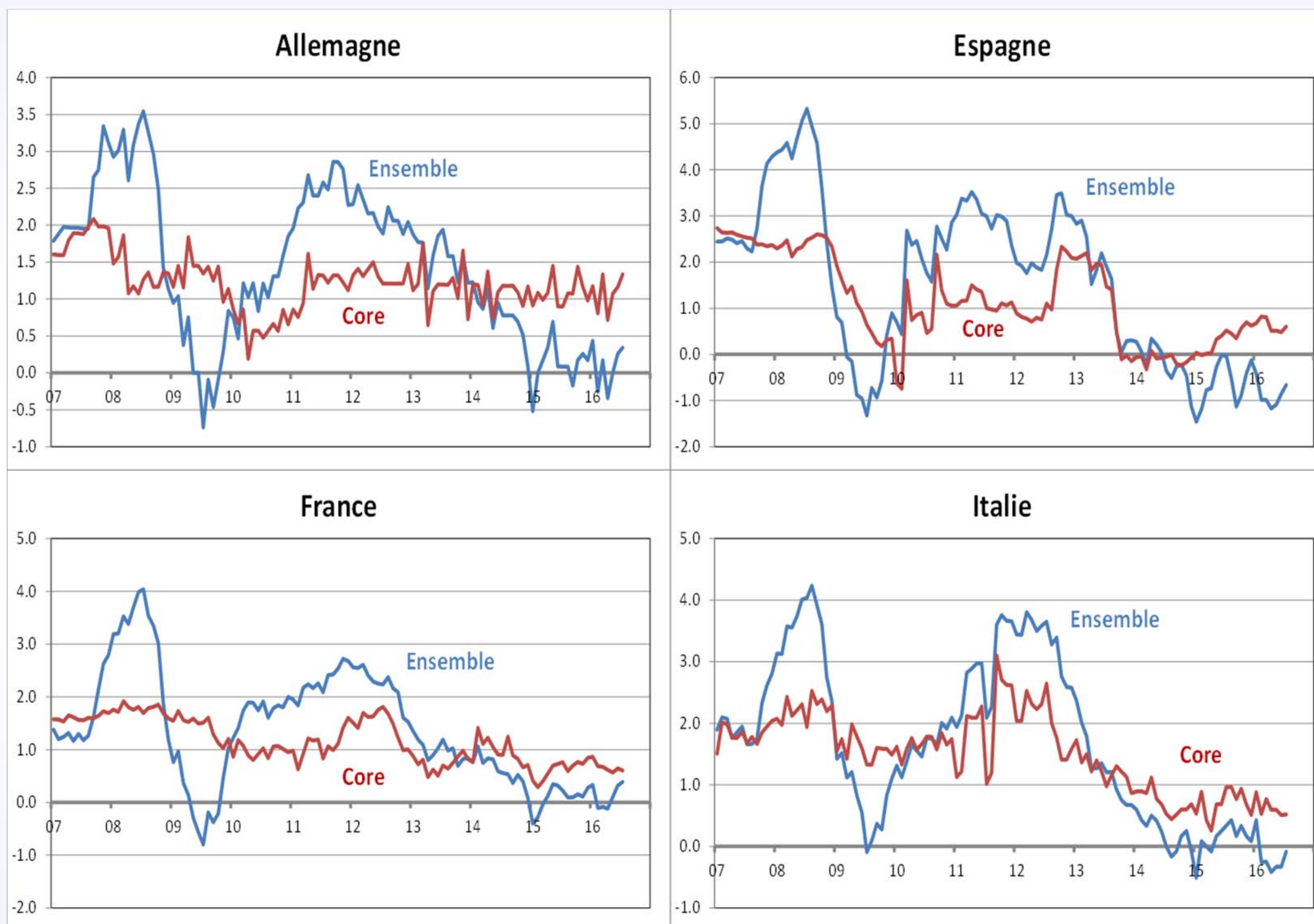
Unemployment declining, but remaining high, especially in crisis countries



Source: EUROSTAT.

Persisting Low inflation

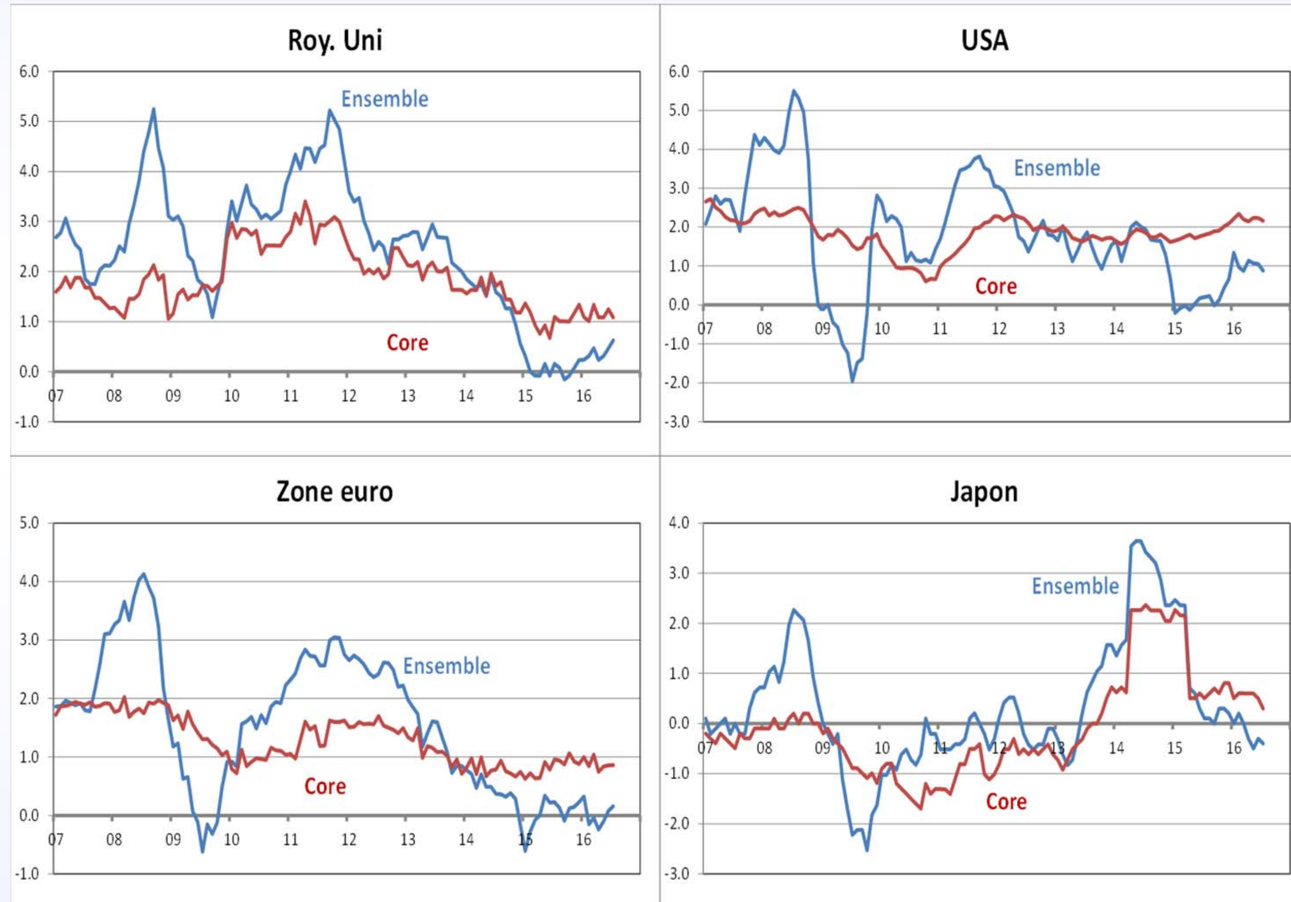
HICP and core inflation, M/M-12, %



Source: EUROSTAT.

Persisting Low inflation

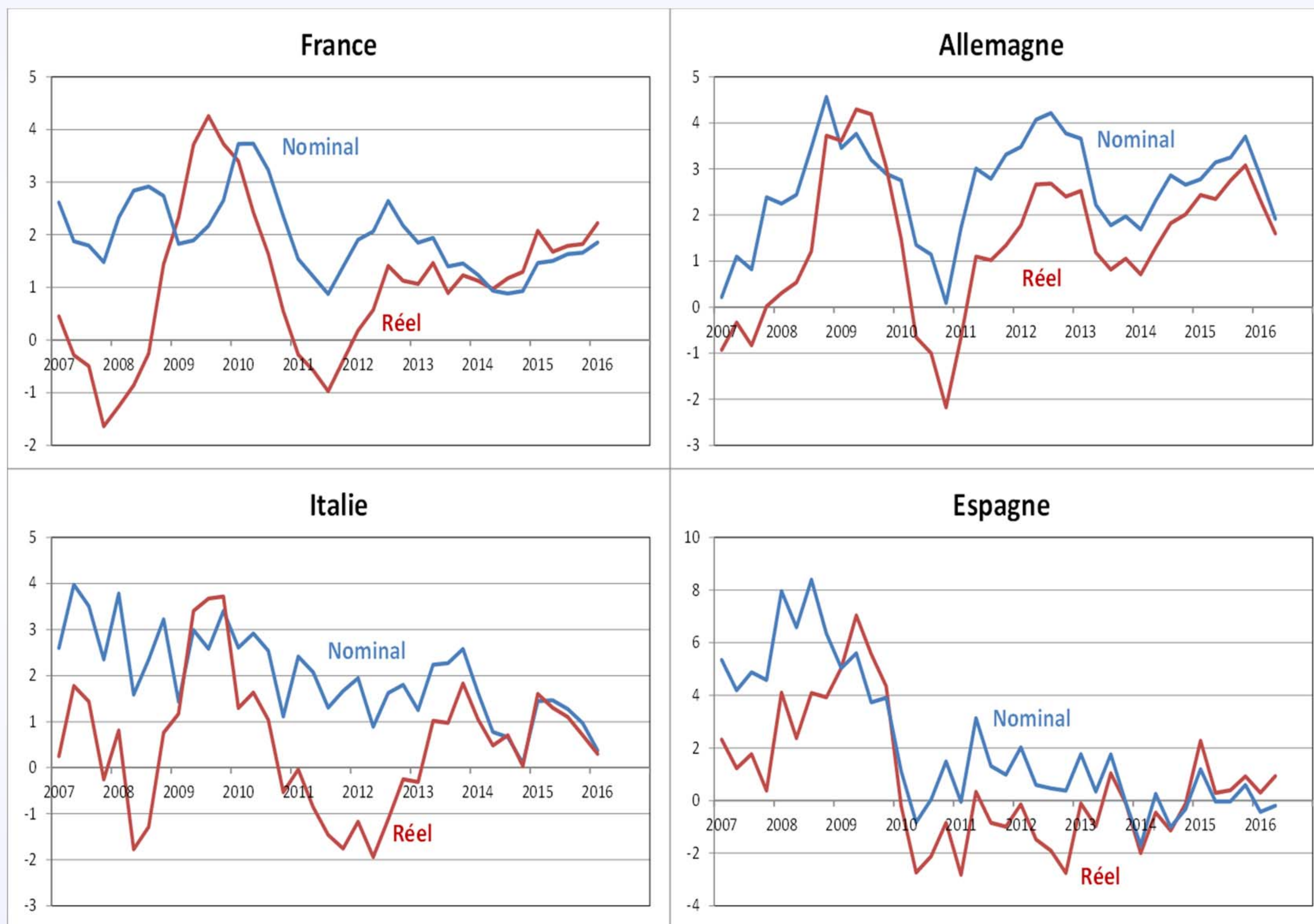
Inflation and core inflation, M/M-12, %



Source: EUROSTAT, BLS.

Persisting wage growth moderation

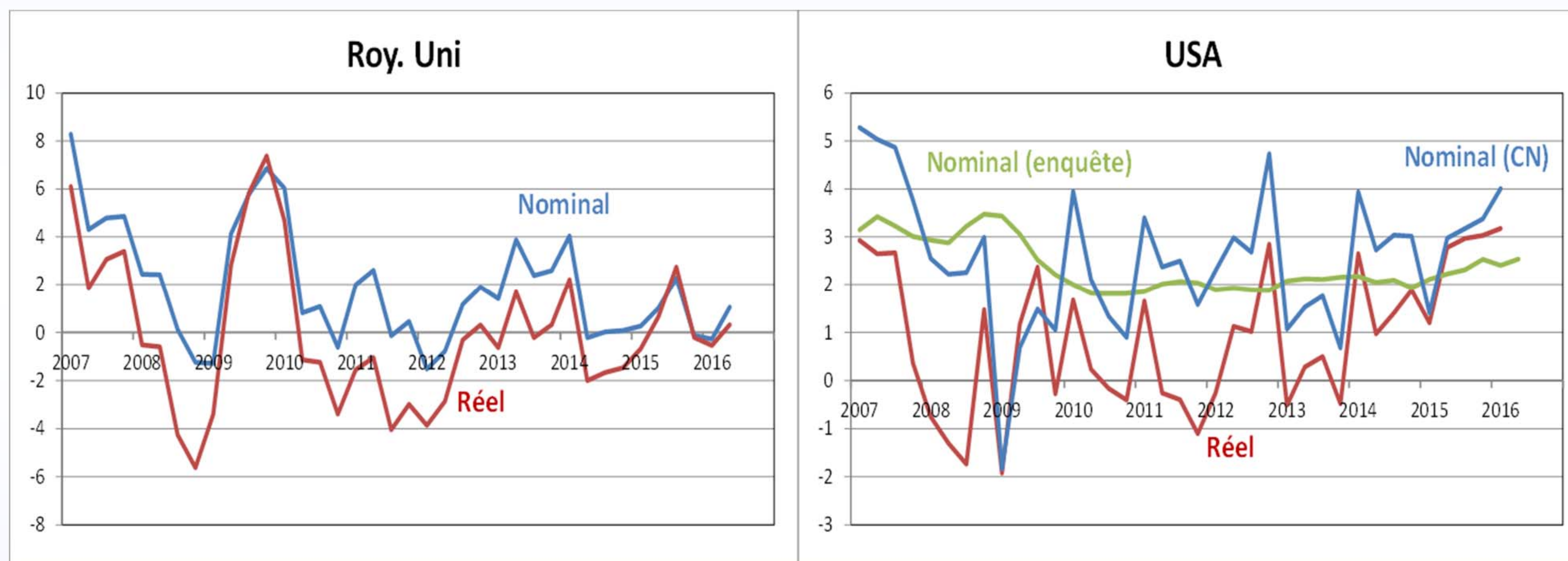
Market sector wage growth (National accounts), %, Q/Q-4



Source: EUROSTAT, National accounts, OFCE calculations

Persisting wage growth moderation in the EU…but not in the US

Market sector wage growth (National accounts), %, Q/Q-4



Source: EUROSTAT, National accounts, OFCE calculations

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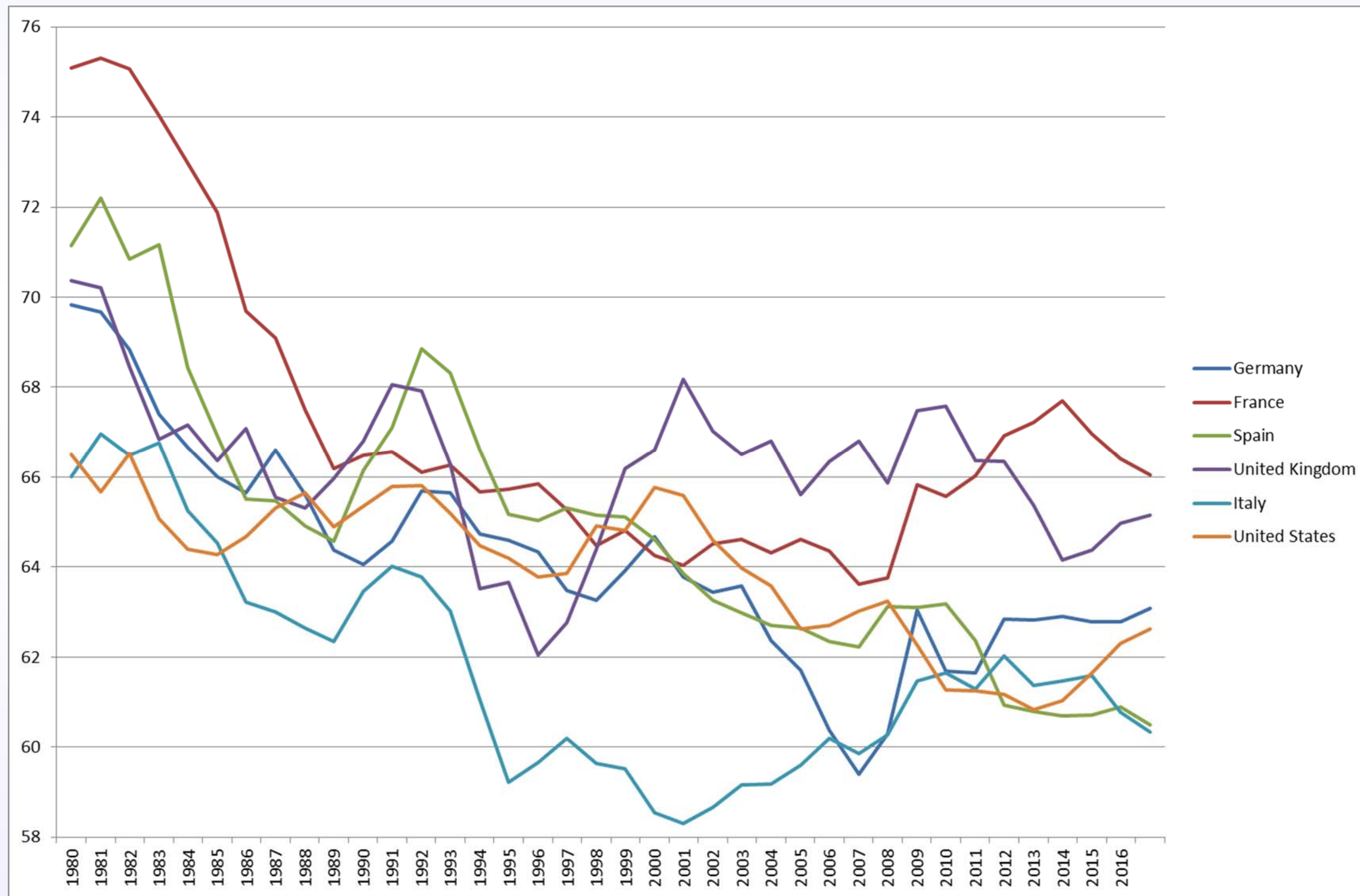
Wage share in value added: declining trend, some recovery in Germany and France since 2008, but still declining in Italy and Spain



Source: European Commission, Ameco

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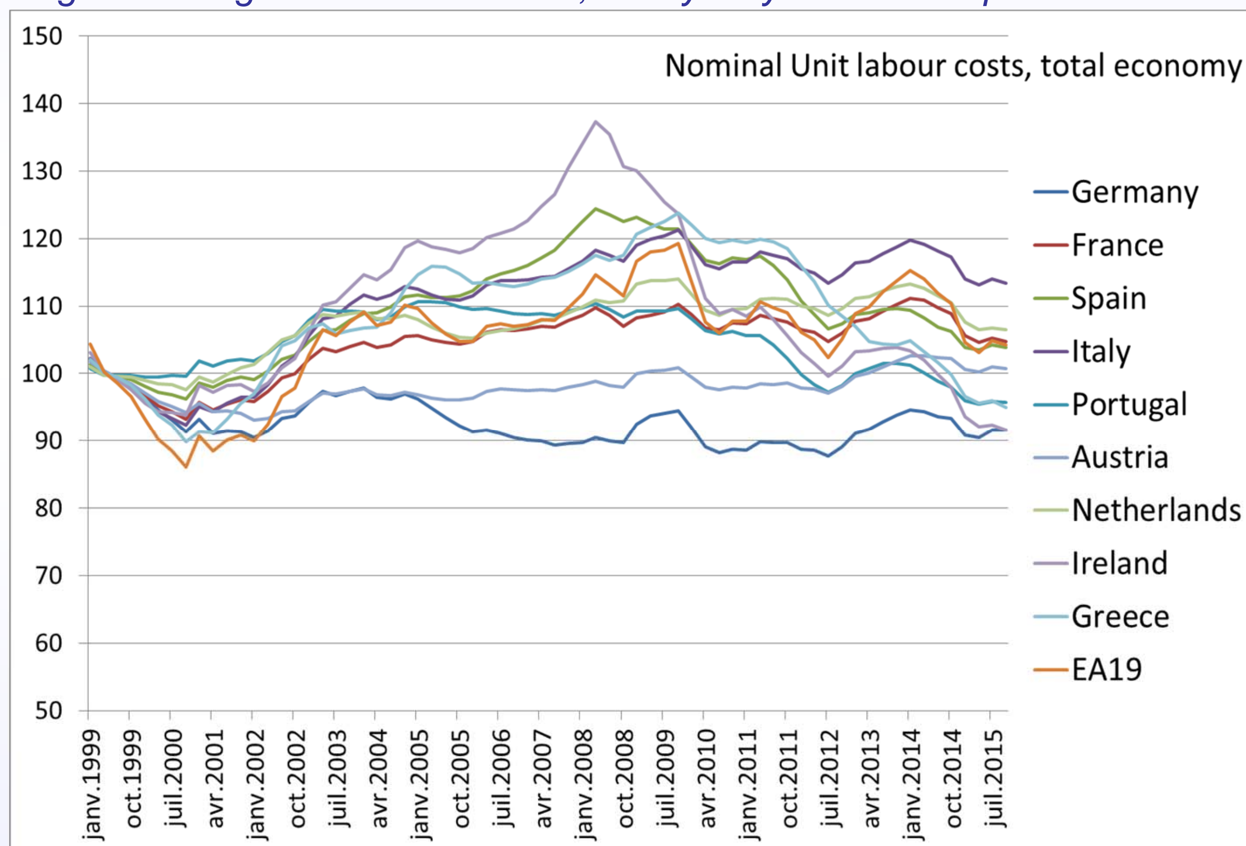
Price Competitiveness

Since the introduction of the Euro:

1) 1999- 2007 Rising divergences in price-competitiveness
2) From 2008: All countries following the German example of wage moderation and gains in price competitiveness –

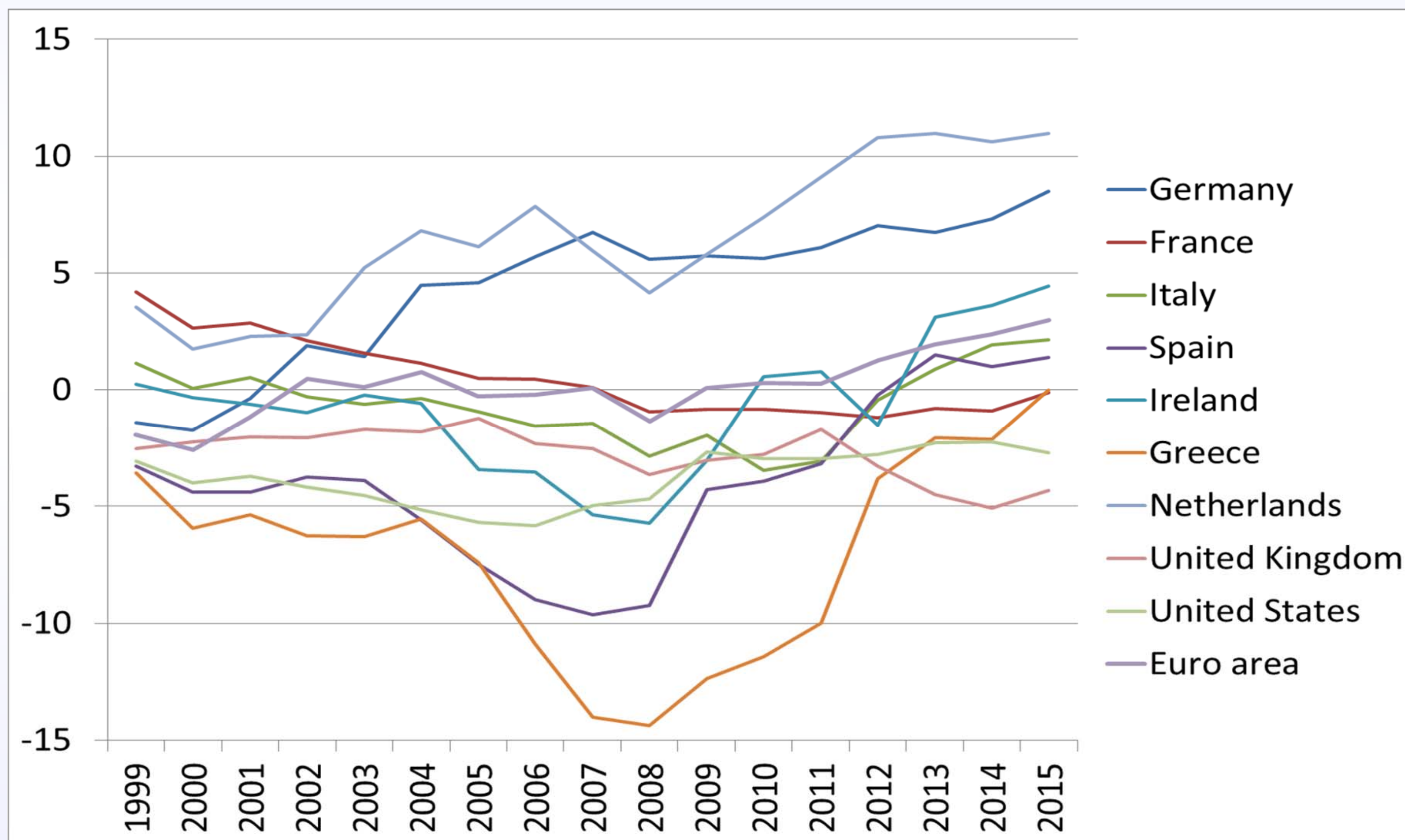
Cutting down wages and labour costs, hardly any effect on export market shares.



Source: European Commission, Quarterly report on price and cost competitiveness

Current account balances, % of GDP: no rebalancing

Surpluses continuing to rise in surplus countries (Germany, Netherlands), lower deficits in Spain, Greece, Italy, but due to lower imports (and not to higher exports)



Source: IMF, WEO April 2016

About fiscal policy

- European treaties include 'stupid' fiscal policy rules to deprive Member States of any fiscal autonomy: public deficit must be below 3% of GDP, public debt below 60% of GDP, each year, the fiscal effort must be larger than 0.5% of GDP until structural public deficit is below 0.5% of GDP.
- But in a monetary union, Member states, deprived of any possibility to run independent exchange rate or monetary policies, should be allowed to run independent fiscal policies.
- The current crisis of financial capitalism induces a structural lack of demand. Even with negative interest rates, countries need to run public deficits and high public debt. This is the case for instance in the United States, the United Kingdom, and Japan.

About fiscal policy

- However, eurozone MS were obliged to run restrictive fiscal policies amounting to 5.7% of GDP on average from 2011 to 2014, which can be estimated to have cut GDP growth by 2% per year (0.4% instead of 2.4%).
- During this episode, some economists (and international institutions) have re-discovered that the Keynesian multiplier is large, in the order of 1 to 1.5; that the multiplier is larger when unemployment is high than when the economy operates at full capacity (but why implement a fiscal stimulus in a full employment situation?); that the multiplier is larger for public consumption, investment and social transfers than for tax cuts.
- Fiscal policies have become less restrictive since 2015, even if the European commission did continue to call for restrictive policies, irrespective of domestic economic situations, for Italy, Spain, Greece, France, Portugal.

About fiscal policy

- As this has often been written, one cannot set *a priori* rules for debt or deficits without accounting for the economic situation.
- Not only the rules set in the EU lack economic basis, but their implementation in practice is worsened by the potential growth estimates method imposed by the Commission. According to this method, potential output is always close to actual output. Thus, potential growth would have been negative in Italy, Spain, Greece and Portugal in 2011-14. Whether potential growth is estimated to be 2% or -1% (1%), the size of the fiscal effort differs by 1.5 percentage point (0.5 percentage point). The Commission therefore imposes pro-cyclical fiscal policies.
- According to the Commission, Greece, Spain, Portugal, Belgium, Italy, the Netherlands, Finland, France, still have to make fiscal efforts.
- The only rule should be to allow countries to run an expansionary policy as long as there is excessive unemployment, and no excessive inflation.

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% of GDP	Gross Public debt, Maastricht definition		Public balance	
	2007	2016	2015	2016
Germany	64	68	0.7	0.3
France	64	97	-3.5	-3.4
Italy	100	133	-2.6	-2.3
Spain	36	100	-5.1	-3.7
Netherlands	42	65	-1.8	-1.6
Belgium	87	106	-2.6	-2.9
Austria	65	86	-1.2	-1.6
Greece	103	177	-7.3	-1.9
Portugal	68	128	-4.4	-2.9
Finland	34	66	-2.7	-2.4
Ireland	24	89	-2.3	-0.7
Euro area	*65*	*92*	*-2.1*	*-1.8*
UK	44	90	-4.4	-3.8
US	64	108	-4.4	-4.3
Japan	183	248	-5.4	-5.1

Source: OECD Economic Outlook, June 2016

Fiscal impulses (our estimates)

	2010	2011	2012	2013	2014	2015	2016	2017	Total
Germany	1,4	-1.3	-1,1	-0,2	-0.4	-0.2	0.5	0.2	-1.1
France	0,1	-1,5	-1.1	-1,0	-0.5	-0.4	-0.4	-0.3	-4.1
Italy	-0.8	-0.8	-3.8	-0.7	-0.5	-0.5	0.1	0.1	-8.9
Spain	-2,6	-2.0	-5.0	-2.5	-0.8	0.4	-0.5	-0.5	-9.9
Netherlands	-0.4	-0.3	-1.9	-2.1	-0.9	0.0	0.1	-0.5	-6.0
Belgium	-0.5	-0.4	-1.2	-1.0	-0.3	-0.5	0.4	-0.3	-3.8
Austria	-0.2	-1,1	-1.4	-1,0	-1.2	-0.7	0.5	-0.2	-5.3
Portugal	-0.5	-4,3	-3,3	-3.0	-1,9	-0,4	-0,9	-0,6	-13.9
Finland	0,4	-1,1	-0,9	-0.8	-0,5	-1.2	-0.6	-1.0	-5.7
Ireland	-2.3	-1.8	-2,4	-2,2	-1.2	0.1	0.2	0.1	-8.5
Greece	-7,5	-7,4	-5,8	-3,8	-0,1	-2,4	-1,3	-1,4	-29.7
Euro area	-0.6	-1.6	-2,3	-1,1	-0,7	-0.4	-0.1	-0.3	-7.1
U K	-1.4	-1.8	0.1	-0.8	0.1	-0.7	-0.8	-1.2	-6.3

The Commission's Estimates

	Potential growth	Output gap	Structural balance
	2012-14	2015	2015
Germany	1,3	-0.3	0.9
France	0,9	-1.8	-2.5
Italy	-0.9	-2.9	-1.0
Spain	-0.6	-3.7	-3.1
Netherlands	0.2	-1.4	-0.9
Belgium	0.9	-0.7	-2.2
Austria	0.9	-1.0	-0.6
Portugal	-0.9	-2.3	-3.2
Finland	-0.1	-2.3	-1.4
Ireland	2.1	1.6	-3.2
Greece	-3.3	-7.7	-3.5
Euro area	0.4	-1.7	-1.2
U K	1.1	0.2	-4.5

2015, a turning point?

- Two decisions appear to signal a certain change of strategy in the euro zone. The Juncker Plan should finance 315 billion euro investment over 3 years (500 billion in 5 years according to yesterday's proposal). This represents only 0.6% of EU GDP. At the same time, the Commission continues to call for austerity plans in the order of 0.5% of GDP in most EU countries. European peoples cannot accept such a deal: restrictive policies by reducing domestic public and social expenditures and liberal reforms against the promises of a rebound of investment at the EU level.
- The Juncker Plan creates a European Fund for Strategic Investments, within the EIB which will in fact only have 21 billion of capital (5 from the EIB, 8 from funds not spent by the Commission and 8 by savings on future European budgets). These 21 billion would allow to finance 63 billion of loans which would be used to serve as a collateral to get 252 billion from private investor funds, so a multiplier of 15. As stated by the Commission, the project is based on "innovative financial packages", where public funds are expected to assume the risks and ensure strong profitability to private investors.

2015, a turning point?

- Most of these projects establish Public-Private-Partnerships where governments and local authorities, under the financial constraints imposed by European rules, have to attract private investors by ensuring attractive financial conditions.
- Projects are to be selected by an EIB-Commission Steering Committee, a European investment Committee and a European Investment Advisory Hub to establish "a vast programme of technical assistance to identify projects and to make them more attractive for private investors". Thus, the Plan is a new opportunity for the Commission to strengthen its powers.
- France intends to finance already planned projects such as a direct train connection between Paris and Roissy/CDG airport for instance. We fear that many of these projects would have been implemented regardless of the Juncker plan; new projects will amount to much less than 315 billion.

2015, a turning point?

- As of 19 July 2016, approved projects amounted to 21 billion euros, which are expected to induce 116 billions investment; but, only 11 billion were signed. In Greece for instance, 1 project signed (21 million); projects approved for only 400 millions.
- According to Bruegel's analysis also, most of these projects would have been financed without the Juncker Plan.

2015, a turning point?

- On 15 January 2015, the Commission issued a communication relaxing the rules of the Stability Pact.
- Countries may deviate from their path of reference or get a delay to move below the 3% of GDP deficit if they implement significant structural reforms. But the absence of structural reforms will be an aggravating factor.
- Countries with a structural deficit above 0.5% of GDP had to undertake a minimal effort of 0.5% of GDP each year. This effort will now depend on the economic situation: for countries with debt above 60% of GDP, the required effort will be 0 if growth is negative or if the output gap is larger than -4%; 0.25% if OG<-1.5% and growth below potential; 0.5% in normal times; 0.75% if OG>1.5%; 1% if growth exceeds potential.
- If the euro area is hit by a severe recession, the Commission could suspend the Pact.
- The EC maintains rigid rules that often imply pro-cyclical policies. It refuses any expansionary policy, whatever the MS economic situation. The fiscal impulse can never be positive. The EC wishes MS in a difficult situation to implement so-called structural reforms.

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2015, a turning point?

- In 2016, six MS remain under an EDP (Croatia, France, Greece, Portugal, Spain, the United Kingdom).
- In July, Spain and Portugal were blamed by the Commission for not fulfilling their targets but escaped any fine. Both countries are threatened to see cuts in their structural funds. Like France, Spain and Portugal had to promise to cut their public deficit in 2016-17. It is a non-mobilizing compromise.
- Portugal ran a public deficit of 4.4% of GDP in 2015 (against a 2.5% target). It must bring the deficit down to 2.5% of GDP in 2016 (with means a fiscal effort of 1.5% of GDP).
- Spain ran a public deficit of 5.1% of GDP in 2015 (against a 4.2% target). It must reach a public deficit of 4.6% in 2016, 3.1% in 2017, 2.2% in 2018.

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What coordination for fiscal policy?

- For developed countries, the system which worked until 1999 lied on unity between the government, the central bank and commercial banks. The central bank is the lender of last resort for the government and banks. The government can issue unlimited public debt. This public debt is considered as safe and benefits from as low as possible market interest rates.
- The introduction of the euro area led to a particularly difficult situation.
- On the one hand, countries need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. Since 1973, the macroeconomic equilibrium has required certain levels of public deficit and debt. The 2007 crisis increased these levels.
- On the other hand, due to the single currency, current imbalances in one country affect the other MS. Therefore excessive deficits (or surpluses) should be avoided.
- Last, financial markets' functioning makes it necessary for public debts to become safe assets again, while at the same time Northern countries deny to give unlimited guarantee to their partners.
- Euro area countries must become again countries able to issue safe sovereign debt, at an interest rate controlled by the ECB. They should be able to run a public deficit in line with their macroeconomic stabilisation needs.

What coordination for fiscal policy?

- Public debt mutual guarantee by the ECB or by euro bonds must be entire for countries accepting to submit their economic policies to a coordination process. Therefore the procedures implemented since 2010 should be reviewed and their aims should be modified.
- A coordination process needs to be implemented between countries. It cannot consist in fulfilling automatic rules.
- Coordination should target growth and full employment; it should account for all economic variables; MS should follow an economic policy strategy allowing to meet an inflation target and a wage target (in the medium run real wages should grow in line with labour productivity). In the current situation, adjustment processes should be implemented by countries where wages increased too rapidly, or not sufficiently; rises or cuts in social contributions may be used to facilitate the adjustment process;
- Countries should announce and negotiate their current account balance targets; countries with high external surpluses targets should agree to lower them or to finance explicitly industrial projects in Southern economies.

- The process should always reach a unanimous agreement on a coordinated but differentiated strategy. Public deficits resulting from this process should be financed through debt issuance guaranteed by all euro area countries and by the ECB.
- The Treaty needs to maintain an effective process in the case where no agreement is reached. In that case, the new debt issued by countries outside the agreement would not be guaranteed; but this case should never occur.
- In this framework, the ECB should maintain the interest rate below the rate of growth to reduce the public debt weight. It should strongly encourage banks not to run speculative activities (in particular through financial transactions taxation), to avoid financial bubbles, to finance productive activities (in particular re-industrialization and ecological transition).
- The euro area needs to regain the 10 percentage points of output lost due to the crisis. This would make MS public debts and deficits sustainable. Abandoning this goal would mean accepting the persistence of European mass unemployment. European institutions and MS should promote an economic strategy, based on demand recovery – consumption, public spending like ecological transition investments – and on a coordinated resorption of current account imbalances.

Public debt issues

- Public debts in advanced economies have strongly risen before and during the crisis. This results from the expansion of financial capitalism and from the depth of the crisis and not from over-expansionary fiscal policies, before and during the crisis (except in Greece).
- There is no reason to exert redemption for implemented policies. The rise in public debts was implicitly desired (by households who wish to own safe assets, who do not want to bear financial markets' risks) while companies wish to deleverage.
- It is useless to try to reimburse debt as long as the factors which caused the debt to rise remain.
- Given structural inflation and interest rates levels on government bonds in major economies, the public debt level clearly does not induce any rise in interest rates.

- The rise in public debt increases the risk that public finances will be under the supervision of financial markets in the future.
- But this supervision is not satisfactory: financial markets have no macroeconomic perspective; they are pro-cyclical (they request efforts in bad times); their opinions are self-fulfilling which they are aware of; they do not try to incorporate all relevant pieces of information, but mainly the pieces of information which are 'in the mood of time'; they are schizophrenic, they request fiscal consolidation and growth policies at the same time. They have their specific judgment on the needed appropriate economic policy, but is this necessarily the relevant one?
- There is a huge risk that MS set the objective of trying to escape financial markets' surveillance by cutting too rapidly and too massively government borrowing which would postpone the economic recovery indefinitely. Their ability to run active fiscal policies will be reduced. What would have happened if countries had refused to rescue banks in 2009, in order to avoid to have to borrow on financial markets? Can financial markets be given the responsibility to assess public debt sustainability and the usefulness of public deficits?

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A European debt agency ?

- Many European economists suggest to introduce a European debt Agency (EDA) which would be in charge of issuing common debt for all euro area countries. This debt would be guaranteed by all euro area countries; it would be considered as a safe asset by financial markets; it would be very liquid, with a wide market, hence it could be issued at low interest rates.
- But the EDA council would supervise national fiscal policies and would be entitled to refuse financing *too lax* countries, and the latter would then have to issue national bonds on markets.
- The EDA would raise the same problems as the SGP. What would be its assessment criteria? What would be the democratic and economic legitimacy of its Council? How would the EDA decide that a country runs an excessive deficit, if the country considers that such a deficit is necessary to support activity (like Germany and France in 2002-2005)? Would it implement strict and arbitrary rules (a country would be entitled to loans from the EDA up to 60% of its GDP) or softer ones? The EDA would benefit neither virtuous countries (which have no difficulty to get financing) nor countries in difficulty, which the EDA would refuse to finance and which would have to issue domestic bonds, without any European guarantee, without any potential financing from the ECB, in other words risky assets, bearing a high interest rate. The EDA makes sense only if it accepts to consider all public debts, but then what to do against lax countries?

About public debt default

- Some authors propose that MS cut their public debts in a discretionary manner by an arbitrary percentage at the expense of their creditors.
- But this would have no economic or legal justification. It would be done at the expense of economic agents who trusted European countries and often lent them without risk premium. It would destroy market confidence in euro zone MS, whose public debt would be, for a very long time, considered as risky.
- MS public debts are not *illegitimate* since they have been issued by democratically elected Governments. Even if one may question some tax cuts and some public spending implemented by a country, creditors should not be requested to pay for them, as it would legitimate the right of financial markets to judge national fiscal policies.
- Public debt is not *unsustainable* when EU countries can borrow at 1% interest rates for 10 years, with a higher than 2.5% trend nominal growth, implying the primary balance required for the stability of the debt-to-GDP ratio is negative.

About public debt default

- However, the concept of *illegal debt* can apply to the share of public debt resulting from tax evasion or to the share resulting from debt issued to support by private banks. If rich depositors benefited from exorbitant interest rates and helped some banks to contribute to financial and real estate bubbles (like in Iceland, Ireland, Spain, Greece, Cyprus), it is not legitimate that their assets become public debt. It is legitimate that banks' shareholders and important creditors bear losses (like in Iceland).
- Moreover, public debts result partly from the excessive interest rates of the 1980-2005 time period, partly from tax competition and tax evasion, partly from banks debts, partly from the great depression, and so from neo-liberalism games. It is socially unfair and an economic nonsense to ask austerity efforts to peoples to reduce public debts. The only possible strategies for public debt reduction are on the one hand to increase taxation on wealthy households and large multinational companies, to combat tax evasion and to avoid tax competition, and on the other hand to maintain interest rates below the rate of growth, which should be accompanied by a robust macro-prudential framework to avoid financial bubbles rise.

About public debt default

- A country (like Greece) with a large public debt must (although it equilibrates its primary public balance) needs to renew it each year. In there is no more a Central Bank acting as lender of last resort, the country it always at the mercy of public and private creditors that may force him to accumulate a huge primary surplus to reduce the debt burden.
- As in the short term, this leads to a drop in GDP, an increase in the debt ratio and interest rates, it is quickly counterproductive.
- In the present situation, where interest rates are very low and demand for government bonds of ‘strong' countries is very high, the latter should take strong measures to ease the debt burden of Greece (and Italy, Spain, Portugal): the ESM should redeem a substantial part of these countries' debt (through loans from richer countries) and turn it into a very long term debt (if non perpetual).

About monetary policy

- The current monetary policy stance is as expansionary as possible:
- The ECB's main refinancing rate is at 0; the deposit rate at -0.4%.
- Since July 2013, the ECB has communicated that it expects key ECB interest rates to remain at present or lower levels for an extended period of time
- In July 2012, ECB announced that it will do 'whatever it takes' to save the euro and by the OMT had the capacity to act.
- In March 2016, with the TLTRO II, the ECB provides a four-year refinancing at zero or negative rates to banks that increase lending to firms and households.
- In January 2015, the ECB has introduced quantitative Easing, a huge plan to purchase assets, EUR 60 billion per month between March 2015 to 2016, 80 billion until may 2017. This plan should last until inflation comes close to 2%. Government bonds are purchased on the secondary market according to each country's share in the ECB's capital (so not according to needs), without risk sharing (each NCB will be responsible for 80% of domestic securities); but may not exceed one third of the public debt (so no Greek debt). But banks already have a lot of liquidity; countries have no difficulties to sell their bonds.

About monetary policy

- The ECB cut its interest rate down to 0, but fiscal and wage policies impulsed by the Commission maintain the EA in depression, so that inflation remains very low: in August, 0.2% for effective inflation; 0.8% for underlying inflation, much lower than the target level proclaimed the ECB: inflation near but below 2%. GDP growth is 1.6. It will be hard to raise inflation.
- 10 Y interest rates are nil for core MS. Risk premia are now relatively low: 1 percentage point for Spain , 1.1 percentage point for Italy ; 3 percentage points for Portugal.
- In fact, the ECB is 5 time-powerless: it cannot do anything against intra-zone imbalances; it is not entitled to buy directly government bonds, it does not control long-term rates; It cannot cut nominal rates below 0; it can do nothing if the credit market is blocked, due to lack of demand for credit.
- The ECB has however succeeded to lower the exchange rate of the euro against the dollar from 1.37 in the first quarter of 2014 to 1.12 (-18%), which has the needed inflationary and expansionary effect. But European economic policy is thus unbalanced: an area with high unemployment and net external surplus should run an expansionary fiscal policy, rather than a policy depreciating its exchange rate.
- Annual credit growth rate remains at 1.8 % by mid-2016.

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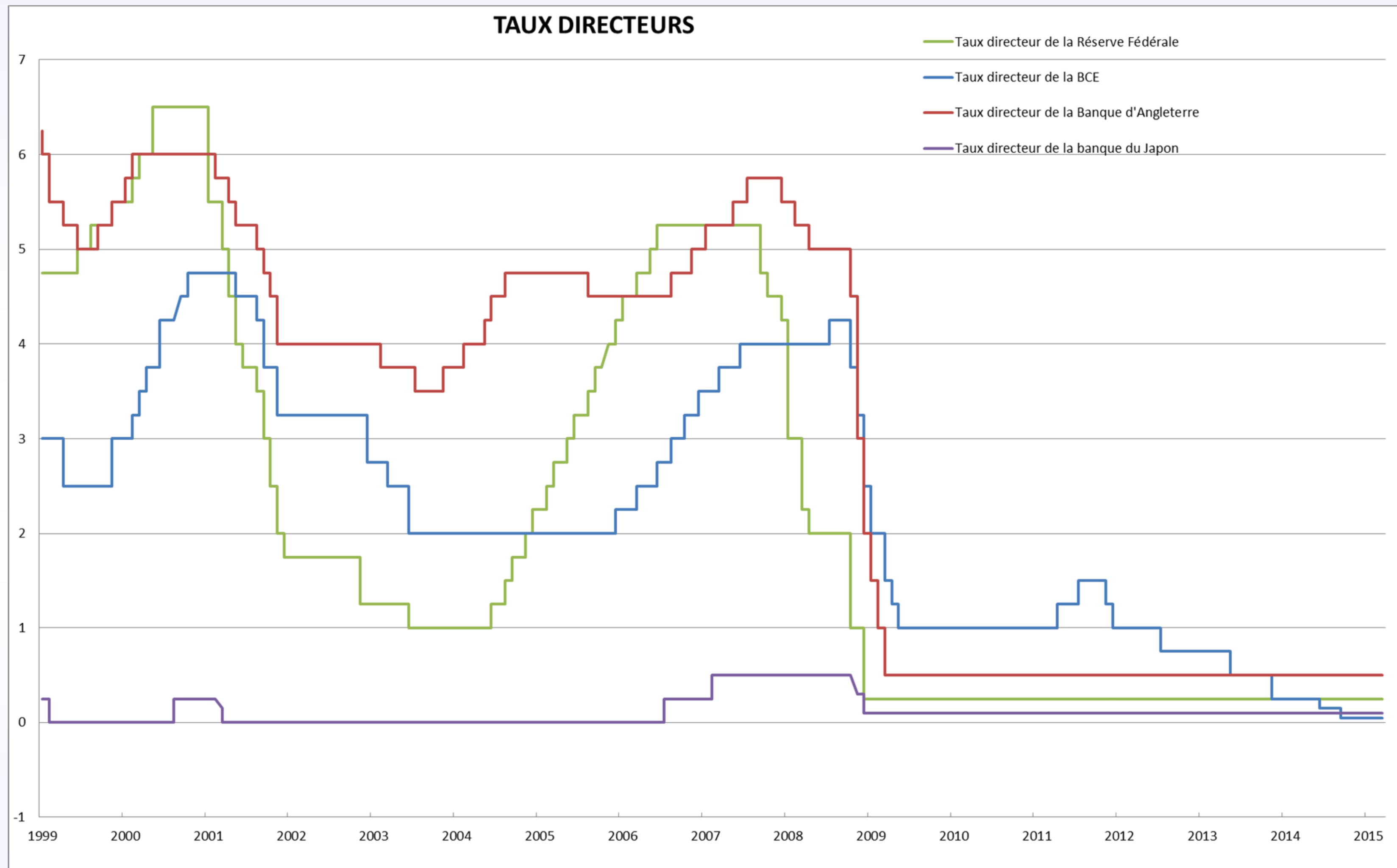
And now?

- At the September 2016 ECB's press conference, Mario Draghi acknowledged once more that monetary policy alone cannot raise inflation. He asked MS to accelerate structural reforms, but the latter often lead to reduce further inflation. Mario Draghi asked for fiscal policies to support economic recovery, while remaining in compliance with the European rules (?).
- Some propose to extend QE by allowing the ECB to buy bank bonds (but the ECB is the banks supervisor) or equities (which may destabilize stock markets).
- Others propose to completely get out of orthodoxy. The ECB would directly distribute money to households. But this would be fiscal policy and the ECB's balance sheet would be in deficit, which would be a form of creative accounting to hide public debt.
- In our view four tools are needed: MS should be allowed to run the needed public deficits; wage increases, starting with surplus countries should be coordinated; public investments useful for ecological transition should be launched; macro-unprudential policy should be launched for banks.


TAUX DIRECTEURS
Taux directeur de la Réserve Fédérale
Taux directeur de la BCE
Taux directeur de la Banque d'Angleterre
Taux directeur de la banque du Japon
7
6
5
4
3
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1999
2000
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2003
2004
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2006
2007
2008
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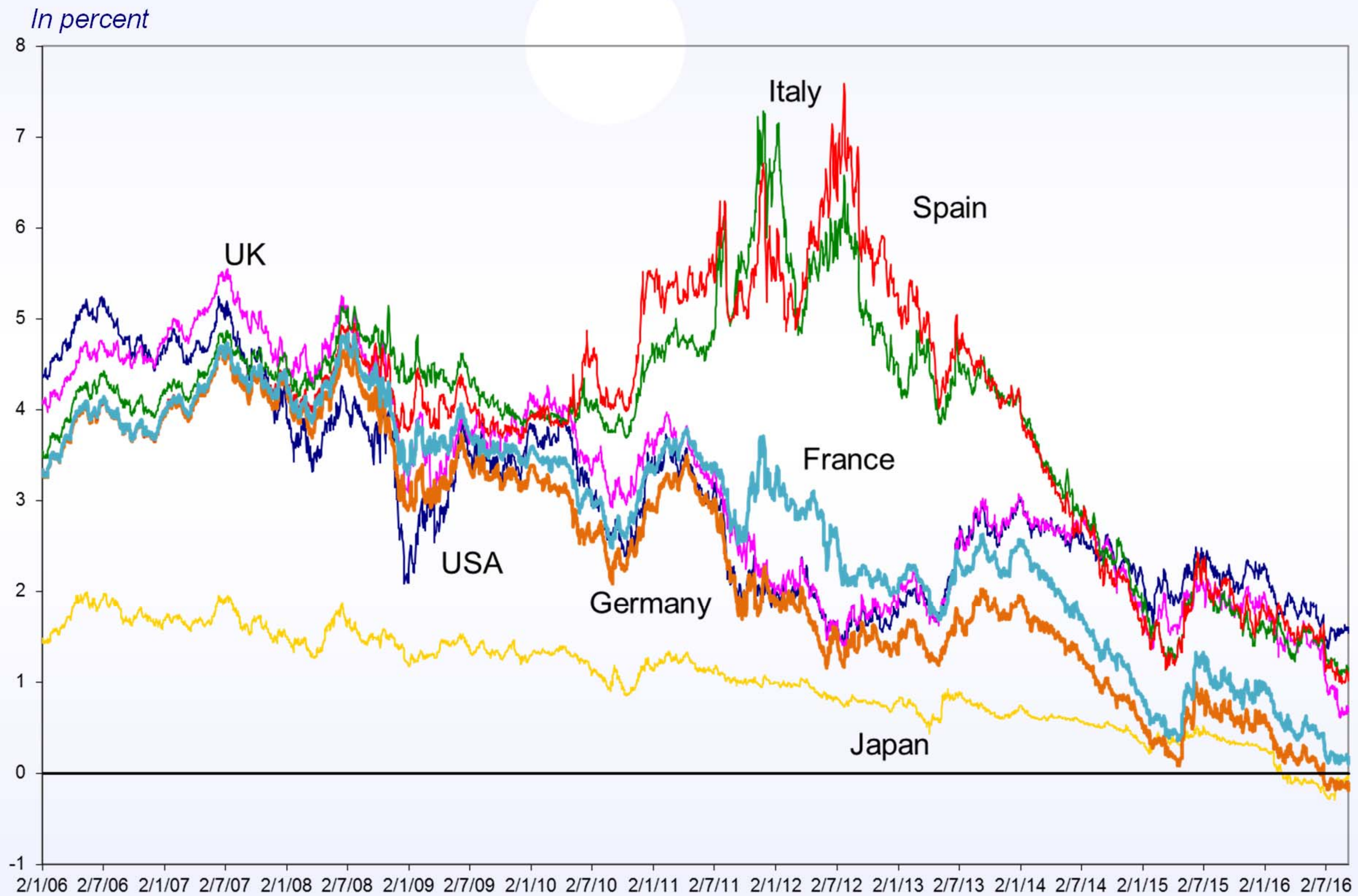
2010
2011
2012
2013
2014
2015

10-year government interest rates

	February 2012	May 2013	January 2014	March 2015	September 2016
Greece	40.8	9.6	7.9	10.8	8.25
Portugal	12.3	5.5	5.1	2.25	3.1
Spain	5.05	4.2	3.7	1.25	1.0
Italy	5.5	3.9	3.8	1.3	1.15
Ireland	7.8	3.45	3.2	0.8	0.4
Belgium	3.65	2.05	2.35	0.5	0.1
France	2.95	1.85	2.2	0.45	0.2
UK	2.1	1.9	2.8	1.55	0.75
Sweden	1.8	1.8	2.4	0.4	0.15
US	2.0	1.85	2.8	1.9	1.6
Austria	2.85	1.7	2.1	0.4	0.1
Netherlands	2.2	1.6	2.05	0.3	0.05
Finland	2.3	1.5	1.95	0.4	0.0
Germany	1.9	1.35	1.75	0.2	-0.05
Japan	1.0	0.6	0.7	0.3	0.3

10-year government interest rates



Sources: Financial Markets, Datastream.

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10-year government interest rates

Sources: Financial Markets, Datastream.

The adequate interest rate level?

- According to the Taylor rule, a Central Bank should set its interest rate as:

  $r = \pi+g+0,5\ (\pi-1.8)+0,5\ {*}EP$

where π is the underlying inflation rate, 1.8 the inflation target, g the potential growth rate, EP, the output gap.

- EA potential growth is 1% according to the OECD and the European Commission; 1,8% according to us. The output gap is -1.5 % for the OECD; -1.1% for the EC; -7% for us.

- So, in the middle of 2016, with a interlying inflation rate of 0.8%

  r= 0.8 + 1 -0.5 -0.8=0.5 % for the OECD ;

  r= 0.8 + 1 -0.5 -0.6= 0.7% for the EC ;

  r= 0.8 +1.8 -0.5 -3.5=-1.4% for us ;

The ECB is nearer from us than from the EC.

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Euro/dollar exchange rate

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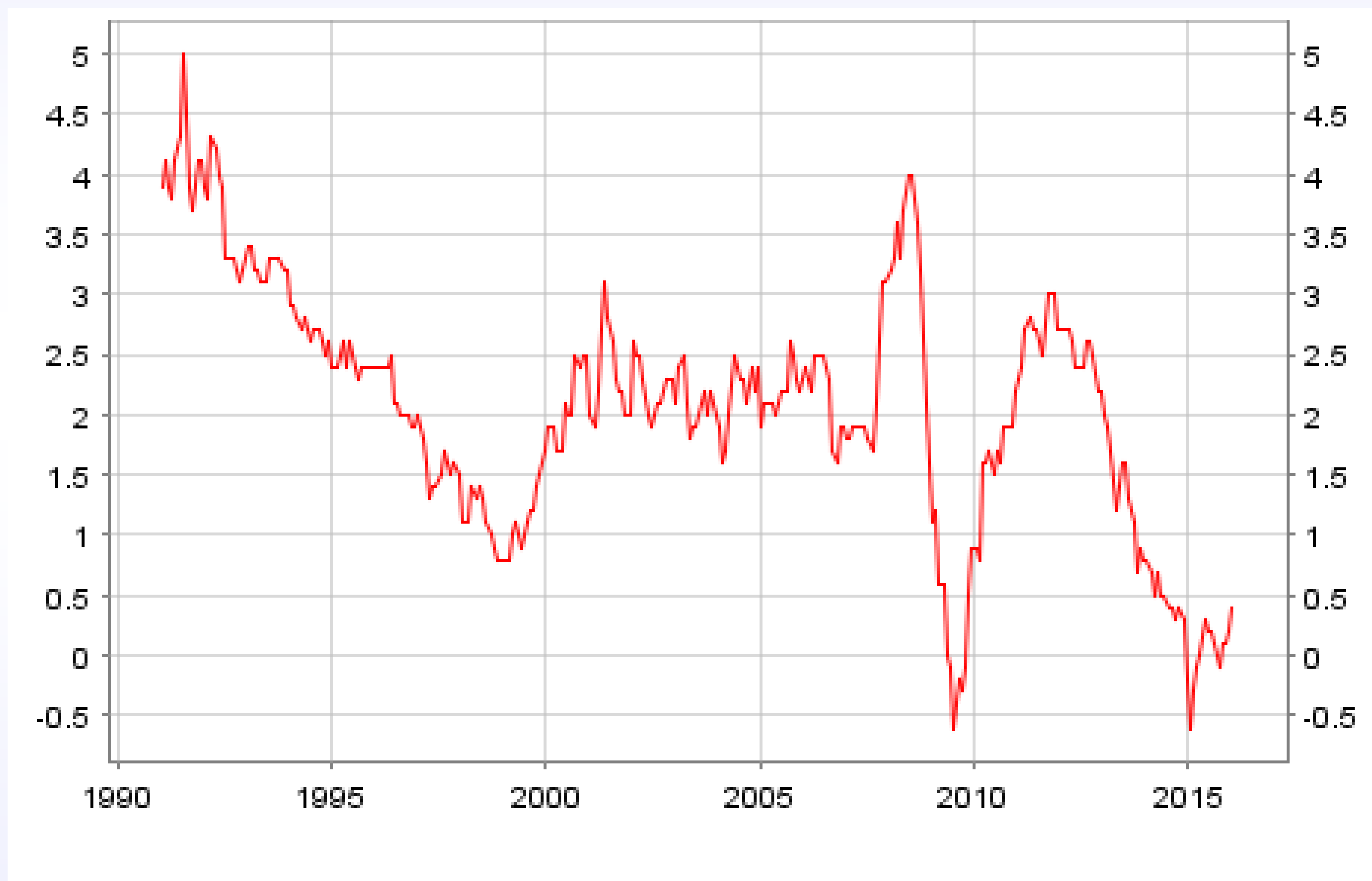
Euro area Inflation rate



The Athens' meeting

- Mediterranean EU countries (France, Italy, Spain, Greece, Portugal, Cyprus, Malta) met on 9 September 2016 in Athens. It could have set the outline of a common front, but the final communiqué is disappointing.
- It asserts "the commitment to the process of European integration, it proposes to "foster Growth and Investment in Europe", to double the "Juncker Plan", "to pursue decisive growth-oriented structural reforms in order to improve the functioning of markets, enhance competitiveness and create jobs", "to complete the Banking Union"; "New steps should be taken to increase growth, convergence and stability in the Euro area". It however writes that our social model should be protected.
- Leaving the Euro is not a credible alternative. The first alternative is to accept in words the strategy driven by the European Commission and Germany and to try to slightly deviate from it (this is the French Strategy), which is not effective, not mobilizing.
- The second is to open a front to refuse austerity policies, to question the fiscal rules, to clearly re-orient structural reforms and the banking union, to put forward ecological transition like the defense of the social model. This will open a crisis in Europe.

Brexit: Causes and consequences

- 23 June 2016: British people voted (by 52% to 48%) to leave the European Union. After having criticized for a long time the functioning of the EU and the constraints weighing on the United Kingdom, on 19 February 2016 David Cameron reached an agreement with EU countries intended to allow the UK to remain in the EU – but this was not enough to convince voters.
- The results of the referendum came as a surprise - British people's concerns went beyond economic issues and their desire to maintain (or regain) their political sovereignty played a major role in the decision.
- The exit from the EU is, to quote David Cameron, "a leap in the dark". From an economic point of view, we can only draw scenarios based on assumptions on the outcome of the negotiations to be undertaken with the EU: from a rosy scenario in which both sides want to maintain as much as possible of the existing relationships, to a dark scenario where the EU wants to set an example and the UK possibly becomes a tax and regulatory haven.

Brexit: A leap in the dark

- Political situation in the UK unclear immediately after the Brexit: resignations of Brexit campaign leaders, resignation of David Cameron, new government formed.
- The UK did not announce plans for leaving the EU. It will probably announce it formally leaves the EU (by triggering Article 50) next January.
- So far Teresay May says: Brexit means Brexit (ie?)

- Immediately after the vote:
- Financial markets plunged: equity markets (but rebounded soon afterwards); the pound lost more than 10% against the euro and 12% against the dollar and stabilized since then (even slightly recovered).
- Immediate overreaction of markets, but generally speaking, short-term indicators have recovered in August – after strong falls in July.
- In the short term, depending on the assumptions made, Brexit could have a slightly negative impact for the British economy, in the order of 0.2 percent of GDP in 2016.
- The risk of an immediate recession suggested by the UK Treasury and others (IMF, OECD,..) before the referendum seems excluded.

Brexit: A leap in the dark

- In 2017 and in the longer term:
- Scenarios vary from a positive impact (Oxford economics) to a recession reaching several percentage points of GDP after two years, with the UK Treasury (Osborne, before the referendum) having the gloomiest estimates (-3.6% to -6%).
- In our view, the assumptions of a sharp decline in British trade (main transmission channel) are exaggerated.

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Brexit: What kind of agreement may be reached with the EU-27?

- The UK wishes to:
- - keep access to the EU market of goods and services
- - develop its own model (not a swiss one, Norwegian or Canadian) of free trade, and become a 'free-trade world champion'
- - control immigration of workers from the EU -which is not consistent with EU rules.

- Bargaining power of the UK?

Brexit: What kind of agreement…

- EU-27 response:
- A tough attitude intended to punish London so as to set an example and deter future candidates from leaving would instead require the UK to renegotiate all trade treaties from scratch (i.e. from WTO rules) so as to encourage multinational companies to relocate their factories and headquarters to continental Europe and close British banks' access to the European market in order to push them to repatriate euro zone banking and financial activity to Paris or Frankfurt. But it would be difficult for Europe, a supporter of free movement of goods, services, people and business, to start erecting barriers against the UK. The euro zone runs a current account surplus of 130 billion euros with the UK: does it want to call this into question? European companies exporting to the UK would oppose this. Industrial cooperation agreements (Airbus, arms, energy, etc.) could only be challenged with difficulty. It seems unlikely that London would erect tariff barriers against European products, unless in response to trade barriers erected by the EU. Conversely, London could play the card of setting up tax and regulatory havens, particularly in financial areas. It could not, however, avoid international constraints (agreements such as at COP21, on fighting tax avoidance, on the international exchange of tax and banking information, etc.). The risk would be to start a costly game of mutual responses to attacks (it would be difficult for Europe, where there is division among countries with different interests, to lead).

Brexit: What kind of agreement will be reached?

- No obvious answer at all.

- Calendar
- 16 September 2016: Bratislava Summit – EU-27, without the UK
- Any agreement and specific demands to be expected from the EU-27?

- January 2017: UK triggering Article 50 – 2 year period
- UK requests?

- 2017: Elections in France May - and Germany - October
- 2018: Bulk of the negotiations
- January 2019: Formal exit from the EU
- But negotiations may be extended if there is unanimity from the EU-27
- 2019: European elections
- 2020 (at the latest) general elections in the UK

Brexit: What kind of agreement?

- -If the EU-27 agrees with UK demands, minimum impacts in the short-term both for the UK and EU economies; maintains the influence of the UK 'liberal model' leader in the EU
- - But this would open the door for other MS to request an 'à la carte' Europe.

- - The EU-27 remains firm on free movement of labour as a condition for access to the single market; the UK negotiates on trade and financial issues, risk of prolonged negotiations.

- But: the UK is not the only member critical about Europe
- Visegrad countries (Poland, Hungary, Czech Republic, Slovakia)
- Risk of demantling / fragmentation in Europe
- Or revival (?)

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Brexit: New proposals

- A ‘continental partnership’ (Pisani-Ferry, Rüttgen, Tucker and Wolff, Bruegel 29 August 2016)
- “We propose a new form of collaboration, a continental partnership. The UK will want to have some control over labour mobility, as well as leaving behind the EU’s supranational decision-making. The proposed continental partnership would consist in participating in goods, services, capital mobility and some temporary labour mobility as well as in a new system of inter-governmental decision making and enforcement of common rules to protect the homogeneity of the deeply integrated market. The UK would have a say on EU policies but ultimate formal authority would remain with the EU. This results in a Europe with an inner circle, the EU, with deep and political integration, and an outer circle with less integration. Over the long-run this could also serve as a vision for structuring relations with Turkey, Ukraine and other countries.”
- “The CP should involve:
- Participation in a series of selected common policies consistent with access to the Single Market;
- Participation in a new CP system of inter-governmental decision making and enforcement;
- Contribution to the EU budget;
- Close cooperation on foreign policy, security and, possibly, defence matters”

Brexit: New proposals

- The authors argue in favour of ‘a new form of collaboration’, considerably less than EU membership but close to a simple free-trade agreement.
- Specific model suitable for the UK

- Close to the agreement reached in February 2016: free access to the markets of goods and services, temporary control of workers’ movement, political sovereignty

Taxation

- Europe is the world region with the highest tax-to-GDP ratio, with very wide disparities, from 30% in Ireland to 50% in Denmark.
- Since 15 years, several countries have introduced liberal policies, of cutting tax rates (Finland, Sweden, the UK, Slovakia), but many have increased them to reduce their public deficits (Italy, Portugal, Greece, Spain).
- In a period of strong increase in incomes and highest wealth, the priority should be to raise taxation. But, because of tax competition, the opposite occurs.
- Freedom of capital, goods and services, and people movement, like the lack of tax harmonisation favoured tax competition.
- From 2000 to 2015, the average top statutory personal income tax rate decreased from 45.2 % to 42.1 in the EA19, from 44.6% to 39.3% in the EU28. The average top statutory corporate income tax fell from 33.3 % to 24.6% in the EA19, from 32.0 % to 22.8 for the EU28. This trend will continue since the United Kingdom announced its intention to cut its CIT rate to 17%.

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Taxation

- The Commission advocates to reduce labour taxation. This would be relevant if in counterpart taxes on energy or pollution were increased. It is illusory if the counterpart is a VAT rise (as VAT is not levied on capital goods and is a tax on labor incomes only): this allows for competitiveness gains at the expense of employees and pensioners if wages and pensions are not fully price-indexed, but this internal devaluation should be restricted to MS with specific competitiveness problems in the euro area. It is a dangerous strategy if the counterpart is a decline in social protection.
- Of course, tax harmonisation is a necessity in Europe. But the risk today is that it entails lower taxes on firms and wealthy people.
- Countries willing to protect their tax revenues should refuse any progress in the free movement of capital and people in Europe as long as measures are not taken to ensure their rights to tax their residents, their citizens and the profits made in their countries.
- In the fight against tax evasion and tax avoidance, some progress has been made in recent times, thanks to the involvement of the United States, the OECD and the G20.

Taxation

- For wealthy people, MS should be entitled to introduce legislation against tax exile (such as taxing unrealised capital gains of the newly tax exiles).
- For businesses, Europe should ask the countries concerned to remove all provisions that allow for tax evasion of multinational companies. Europe should set CIT minimum rates, depending on the country level of development.
- The Commission advocates a common consolidated corporate tax base (CCCTB), which would be distributed among countries according to non-changeable criteria (employment, capital, turnover). This scheme is likely to question the coherence of national tax systems.

Tax-to-GDP ratio

	2014	2000-2014
Denmark	*50.9*	*+4.0*
France	45.2	+2.1
Belgium	44.7	+1.1
Finland	43.9	-1.9
Italy	43.6	+3.0
Austria	43.0	+0.9
Sweden	*42.7*	*-6.3*
Hungary	*38.7*	*-0.2*
Netherlands	36.7	-0.1
Germany	36.1	-0.1
Portugal	34.4	+3.2
Czech Republic	*33.5*	*+1.0*
Greece	33.2	+2.7
Spain	33.2	+2.1
UK	*32,6*	*-2.1*
Poland	*31.9*	*-1.2*
Slovak Republic	31.0	-2.6
Ireland	29.9	-1.0
Japan	30.3	+3.7
United States	26.0	-2.2

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Towards a federalist Europe?

- The proposals made by the Commission in November 2012 in A blue print for a deep and genuine monetary and economic and monetary union and by the four presidents in December 2012: Towards a Genuine Economic and Monetary Union, suggested new steps towards technocratic federalism:
- ‘All major economic and fiscal measures made by a MS will have to be subject to a coordination, approval and surveillance process at the EU level’. The possibility of differences of economic or social policy was denied.
- The need to strengthen fiscal discipline was reasserted. At the same time, the need for *ex ante* fiscal coordination was asserted. But, after the fiscal pact, what remains to be coordinated since fiscal policies have to be run in autopilot mode?
- The Commission wanted to be able to oblige a MS to revise its national budget or to change its budget execution, to be able to suspend programmes payments to MS not taking the corrective action it required.
- “The EMU could have a fiscal power to absorb asymmetric shocks” (which is rather ironic once governments have been deprived of their ability to implement specific fiscal policies)

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Towards a federalist Europe?

- The EMU could be entitled to support structural reforms, i.e. to have a "convergence and competitiveness instrument". A country could sign an agreement with the Commission, according to which it would implement structural reforms and therefore would get a financial reward.
- The euro area should have its own resources and be able to issue bonds.
- Short-term debts (Eurobills) could be mutualised under an EMU Treasury.
- The role of the vice-president of the Commission in charge of economic and financial affairs in the euro area should be strengthened; he would be in charge of the EMU Treasury.
- A Euro Committee should be settled in the European Parliament, the Euro-Group should be strengthened.
- The proposal to issue national euro-bonds guaranteed by all MS or by the ECB has not been considered. Germany refused unlimited and unconditional commitments to support the other MS. But how to strengthen the euro area without such commitments?

Towards a federalist Europe?

- A new report was proposed by the Five presidents on June 25, 2015: Completing Europe's Economic and Monetary Union.
- Progress should be made on four fronts : a genuine Economic Union, a Financial Union, a fiscal Union, a Political Union.
- The report advocates new transfers of competence from national to European level. "MS must accept that more and more decisions are taken at the European level, which would allow to move away from today's governance by rules".
- It recommends a stronger Macroeconomic Procedure (to encourage structural reforms, but also to correct external deficits or surplus), with a focus on employment and social performance.
- National economies must become more flexible to offset the loss of national economic policy tools. They must converge towards common standards for labour market, business, environment, tax policy.
- The report proposes a new network of independent advisers: Competitiveness Councils, which could be interpreted as a good new (coordination of wage evolutions) or a bad one (a technocratic tool against social partners, a pressure for lower wages).

Towards a federalist Europe?

- According to the Report, Europe needs a Financial Union: there should be a single financial system like a single banking system, with single bank supervision, single bank resolution and single bank insurance (European Deposit Insurance Scheme).
- “It may make sense to review the treatment of bank exposures to sovereign debt”
- The objective is to cut all links between national banks, firms, and States, to strengthen cross-border risk-sharing, which is inefficient according to us and a new loss of national tools.
- Rather than facilitate firms’ financing by banking credits, the report calls for the development of a Capital Markets Union, with *high quality securisation*. It acknowledges that this will increase the risk of financial instability. It will therefore asks for a macro-prudential toolkit and a single European capital markets supervisor.

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Towards a federalist Europe?

- The report estimated the ‘six-Pack’, ‘the Two-packs’, and the TSCG have brought improvements in the fiscal policies framework in the EMU. It does not make any critical assessment of fiscal austerity.
- It proposes the introduction of a European Fiscal Council to *coordinate* national councils, but under the Fiscal Pact rules.
- Later, a global fiscal stabilization mechanism could be put in place, but it should neither allow for permanent transfers, nor reduce incentives to run a sound fiscal policy, nor help countries in crisis.
- The ESM and the Eurogroup should be integrated within EU Treaties. A euro area Treasury could be settled in a future step.
- The project is disappointing in terms of both institutional reforms and policy content.

Towards a federalist Europe?

- The project is disappointing in terms of both institutional reforms and policy content.
- A delicate point in the current European debate today is that any major reform (for example, to create transfer mechanisms between MS in exchange for an increase in the control of national fiscal policy by European institutions) require a change in Treaties, therefore MS unanimity and, in some countries, a referendum whose result is not ensured, accounting for the current unpopularity of the European construction.
- The project is at a standstill because many MS refused to move towards more federalism, virtuous States refused to provide greater solidarity.

Towards a federalist Europe?

- In march 2016, the Commission launched a consultation on a European Pillar of Social Rights, with 20 objectives, such as:

- the right to education; flexible and secure labour contracts ; secure professional transitions; right to vocational training, employment or apprenticeship for young people; dismissal of a worker is to be motivated with adequate compensation; a decent minimum wage; workers participation and information.
- universal health care, decent pensions (but financial sustainability requires to postpone the retirement age), adequate unemployment benefits (but keeping incentives for a quick return to employment), minimum income (but with requirements for participation in active support to encourage labour market (re)integration)
- Nothing on family policies.

Towards fiscal federalism?

- Since the Fiscal Pact prevents MS to run fiscal stabilisation policies, some economists and the Commission estimate that the eurozone could implement cyclical stabilisation mechanisms, managed at the European level.
- According to us, it is illusory as the Commission minimizes the output gap and prevents discretionary policies.
- Some have proposed to implement at the European level a system of transfers between MS to ensure that countries in good situation finance the MS in depression. This system should avoid permanent transfers, each country should alternately be paying or receiving.
- So some propose to base these transfers on output gap differentials, since, for a given country, the cumulated output gap is nil, by construction, on long time-period, forgetting that output gap is a vague concept, which measurement is questionable and variable over time. Should a country in depression wait for EU funds to support its activity and, meanwhile, run a restrictive pro-cyclical policy?

Towards fiscal federalism?

- Some propose the unification of unemployment benefits, since the latter are pro-cyclical public expenditure, but national systems currently differ widely and are often managed by social partners. A country having made efforts to reduce its unemployment rate will refuse to pay for high rates of unemployment in countries which it will blame for not having undertaken the necessary reforms. Some economists suggest this unification to be conditional to labour markets reforms, implemented by a European Minister.
- Some propose transfers between countries based on differences in unemployment rates or in variation in unemployment rates or only on the gap between unemployment and structural unemployment (?).
- To avoid permanent transfers between countries, current projects suggest schemes applying only to the recently unemployed, for a limited time period (Dullien, 2014)
- Proposed transfers are generally of small size and disappear if depression is widespread. As they must be balanced at country-level in the long run, they can only have a negligible impact

Towards fiscal federalism?

- There are two views about federalism: a German view where a federal power will impose rigid fiscal discipline to MS and a transfer federalism.
- According to us, the functioning of the euro area cannot be built sustainably on huge permanent transfers between Northern countries (in good economic health and running large trade surpluses) and Southern countries (in a situation of mass unemployment). Northern countries' citizens will not accept it. Southern countries cannot offset a situation of economic distress by transfers which would submit them to the dictates of Northern countries and European institutions. Transfers between Member countries can be implemented only in exceptional circumstances or to finance productive development policies. Each country must have the objective to find a satisfactory economic model, which today requires differentiated strategies.
- MS do no need fiscal federalism, but to regain full freedom to undertake fiscal stabilising policies and specific structural strategies.

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A democratic federalism?

- Some propose a political union in the euro area where most decisions would be made democratically by a Government and a elected Parliament of the euro area. Can we imagine the decisions on the French pension system be taken by a European Parliament? Or a Finance Minister of the area imposing social spending cuts in member countries (like the Troika does in Greece)? Can we image a federal power able to account for domestic specificities in a Europe made of heterogeneous countries? Can we imagine a single policy implemented in different countries? Or different policies implemented through a central process? In our opinion, accounting for current disparities in Europe, economic policies must be coordinated between MS and not decided by a central authority.
- We do not think that EU powers should be strengthened as long as the EU works as it currently does, as long as the EU does not implement a growth strategy, as long as it remains focused on liberal structural reforms, on public expenditure cuts and on absurd public finance criteria. EU institutions must first show that they can implement an efficient strategy before peoples and MS agree to enlarge their power.

Some other points for discussion…

- The TTIP : At the end of August, Sigmar Gabriel, German minister for economic affairs, then Matthias Fekl, French minister for foreign trade opposed further negotiations. At the G20, Jean-Claude Juncker said that negotiations were continuing. But the chance of success in the short term are now zero. Protectionist measures also progress in the US. The question of the CETA (the trade agreement with Canada) ratification remains.
- The issue of migration has generated great divisions in Europe between MS who, for demographic reasons, have a large immigration policy, MS against immigration for national homogeneity reasons or due to a high unemployment rates. The initial choice of Germany to open its doors, followed by the European proposal to split refugees between MS have created new tensions in Europe. Fiscal austerity policies and high unemployment rates are not incentives for generous policies. Immigration should not serve as a pretext for lowering minimum wages; induced public expenditure should not be taken into account in the fiscal rules. Here again, the differences in point of view are large in Europe. Should they be respected?

Some other points for discussion…

- The issue of posted workers shows the contradiction between workers and firms movements on the one hand, workers' rights protection on the other hand. So far the directive on posted workers (which dates from 1996, and was amended in 2014) requires that posted workers receive at least the minimum wage and benefit from part of labour laws in the countries where they work, but social contributions are paid to the origin countries. In fact, legislation is turned (firms don't have any activity in their country of origin, posted workers have never worked in the origin firms, skilled workers are paid at the minimum wage, social contributions are not paid, working time legislation is not respected).
- In March 2016, the Commission proposed new rules to impose that posted workers must have worked in the company in the country of origin, before being posted and must receive the same pay as local workers. This project is supported by France and Germany against Central and Eastern countries.
- It is a difficult debate between workers in Western countries who want to protect their wages and their jobs and workers ready to work at lower wages.

Conclusion

- Europe needs to think about its future.
- Using the current crisis to move forward towards an “ever closer union” without careful thinking would be dangerous. Europe must live with a contradiction: national sovereignties that peoples are attached to have to be respected as much as possible, while Europe should implement a strong and consistent macroeconomic and social strategy.
- Europe has no meaning in itself, but only insofar as it implements the project of defending a specific model of society, developing it to integrate ecological transition, eradicating mass unemployment, and resorbing imbalances within Europe in a concerted and united manner.
- But there is no agreement within Europe on the strategy needed to achieve these goals. Europe has been unable to bring Member countries out of recession or to implement a coherent strategy to deal with globalisation and has become unpopular. Only after a successful change of policies will it regain the support of the peoples and be able to make institutional progress.