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D'ÉTUDES PROGRESSISTES

Austerity is not the solution!

CONTRIBUTIONS TO EUROPEAN ECONOMY POLICY

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A COMMON PROGRESSIVE VISION FOR EUROPE.

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Austerity is not the solution! Elements of an effective European Economic Governance

Keynes teaches us that we should not slow down growth in periods of already sluggish growth!

Persistently urging austerity measures and cuts from the most affected Eurozone countries in the South is not the appropriate policy. At the root of the current European economic crisis are the macroeconomic imbalances within the Eurozone. What are the consequences of this verdict? Austerity will deepen these imbalances. The countries in the South of Europe (but also others) will probably go through further tough periods in the near future. These countries will not be able to recover, because there is a lack of coherent European economic policy and coordination. Therefore a missing effective European Economic Governance.

The crisis has shown two major problems of the political, economic and fiscal architecture of the European Union. This should teach us that we have the responsibility to develop solid and effective responses in order to provide alternatives to the current austerity policies in Europe.

Action to reduce the deficit or a substantial current account deficit in one country usually involves increasing exports or decreasing imports. Firstly, this is generally accomplished directly through import restrictions, quotas, or duties, or subsidising exports. The emphasis lies on the short term. However in Europe we have a single market, so restrictions, quotas, subsidies from one member state to another are not possible. The second possibility is influencing the exchange rate to make exports cheaper for foreign buyers. This will indirectly increase the balance of payments. This is also impossible within the Eurozone. We are living in a single currency zone.

So Europe does not have a sovereign debt crisis. Europe is facing a balance of payments crisis and, more specifically, a current account crisis in the 'peripheral' economies as well as in the central countries which are still doing relatively well. But current account deficits can only be reduced by promoting an investor friendly environment and adjusting government spending to favour domestic suppliers as a possible policy-action.

The handling of the crisis has shown the two major problems of the political, economic and fiscal architecture of the European Union. Strengthening the current framework such as, for example, the Growth and Stability pact will not bring about better results. So it is also a question of a Political Europe and a question of a proper assessment of the crisis for developing alternative policies. In other words it is a question of our common European future.

Joseph Stiglitz is right in saying that public-sector cutbacks today do not solve the problem of yesterday's profligacy; they simply push economies into deeper recessions. And on the political level we face "a post-democratic threat of an executive federalism" as the German philosopher Jürgen Habermas analyses in his new book.

These should be the overriding reference points for the development of an effective European Economic Governance. Inequality is the inherent cause of the problem in Europe which we now call "sovereign debt crisis". It is extremely urgent that we re-establish social justice. This means re-orienting our economic policies in the sense that these policies serve the people and not in the sense that the people serve the economy. Such a policy has to be more environmentalist, and more respectful towards the rights of all workforces and definitely more socially balanced and democratic. Now is the perfect opportunity for Europe to develop investment in green technology and to create more employment in this sector, thus providing a long term sustainable growth-pattern.

We cannot cut our expenses and diminish our sovereign debt in the short and medium term while running a huge risk of having to raise it in the long term. We should increase income as a result of a sound fiscal policy which puts employment at the centre of our preoccupations. This creates further income, growth and welfare.

Therefore Europe needs an economic investment and industrial policy with accompanying instruments such as investments in the public sector, facilitating credit lines for small and medium sized industries to invest, Eurobonds to finance and coordinated labour market policies to avoid social dumping. Europe should therefore develop a common fiscal policy and differentiate policies in terms of the sectorial and geographic needs.

The largely deregulated financial markets created products which were risky beyond imagination. Lower taxes heightened inequalities in many of the Eurozone countries as incomes of middle and lower wage earners deteriorated significantly. These policies have decisively contributed to the "contagion" which the financial markets brought to Europe. Moreover, this is at the very core of the crisis.

Yet the macroeconomic coordination mechanisms established in Europe since the beginning of the crisis in 2008 are in reality nothing more than simple austerity policies. Coordination therefore means alignment. You only need to look at the reform of the European growth and stability pact, the introduction of the European semester, the European 2020 strategy and all the instruments for financial stability established recently.

There is a clear need for our economic policies to cure these macroeconomic imbalances! If politicians impose savings programmes all over Europe, they recognise that the mechanism of public borrowing is pushed to its limits, but they are not asking for the reasons behind it. Aggregate price stability is simply not sufficient at all. Austerity programmes all over Europe mean contagion and deep recession.

The articles in this publication analyse the problem of Europe within this perspective. I am grateful to all the contributors and I am very pleased that it was possible to collect different opinions but in the end they are all pointing in the same direction: Austerity is not the solution for Europe!

Matthieu Méaulle,
Senior Research Fellow, Foundation for European Progressive Studies, Belgium

Imbalances and Governance

When the crisis began to be visible in 2007-2008, the assessment was clear. The crisis was seen as the symptom of the appearance and development of imbalances which proved to be unsustainable. These imbalances appeared in particular between richest and poorest, between the over-development of a financial system in comparison with the needs for the real economy, between private and public debt, between net exporting and importing economies, etc...

The treatment of these imbalances and the questioning of the economic policies at the base of these developments were the proposed objective of G20 in November 2008. It implied a redefinition of the principle of coordination, and of the content of the economic policies in Europe, a strong regulation of the financial sector and a reinforced European sovereignty especially for monetary issues. Three years later... where are we going?

The reinforcement of macroeconomic policy coordination actually means a strengthening of the liberal, i.e. pro-market, and mercantilist policies at the root of the crisis. The proposals in terms of banking and financial regulation are very weak and are still based on the principle of the self-regulating character of the economy while systemic risk is being wrongfully interpreted as the aggregation of the risks of the individual financial institutions. Monetary policy, having as its only objective the maintenance of price stability and, carried out by a Central bank independent of the political power, is absent except in very temporary or under-developed operations.

As stated in the Euromemorandum (2012)[1], "austerity programmes in Eastern European countries (Latvia, Romania and Hungary) and the euro area serious recessions and major fiscal cuts have been accompanied by demands for privatisation and the deregulation of labour markets". Indeed, the recommendations of the Troïka are based on the assumption that a decrease in public expenditure, which is thought to be the primary factor in the crisis, coupled with wage moderation, could imply an increase in growth. However, as will be shown, Europe, and more precisely the Euro-zone, needs a coherent and complementary set of policies, in geographical and sectoral senses, backed by European institutions, for recovering, not a global austerity package which can only lead to a decline in growth.

I. Macroeconomic Policy:

Although the governments and the European institutions showed a commitment to coordinate their macroeconomic policies it appears that the coordination is understood as an alignment of the economic policies towards simultaneous programmes of austerity on a European scale. Policy tools are the agenda 2020, the European semester and the new coordination process of fiscal, economic and social policies at European level, the reform of the Stability and Growth Pact, the new procedure of macro-economic surveillance, the new single market agenda, the Community budget, the new instruments for financial stability (EFSF, ESM), the Euro-Plus Pact and the intergovernmental Treaty on Fiscal Stability, Economic Coordination and Governance[2].

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1 *European Economists for an Alternative Economic Policy in Europe – EuroMemo Group – "European Integration at the Crossroads: Democratic Deepening for Stability, Solidarity and Social Justice".*

2 *See M. Joao Rodrigues (2012), "Shaping the Economic Union: For a Progressive Reform of the EU Economic Governance", in this volume.*

The desire to coordinate macroeconomic policies is more than welcome, but it seems that without a truly European government on the issue, this desire is limited to the alignment of the macroeconomic policies towards pro-market and mercantilist policies, or towards the policies defended by the most powerful Member States within the euro area, which ultimately brings about the same result. It is a negation of the comprehension of the mechanisms at work in the appearance of imbalances which proved to be unsustainable. It attests to an ignorance of the basic mechanisms in macroeconomics. Indeed, macroeconomic accounting identities prove the difficulty of having trade surpluses without an excess of savings if the public accounts must be in balance. The reinforcement of European competitiveness is thus looking like a race towards the bottom at the expense of the construction of a European internal market for which demand policies have a role to play. Indeed, one should not believe that the mechanism working in the appearance of the crisis in Europe is to be found in the laziness of the Greeks or the bad management of the Spanish or Irish public finances. In relative terms productivity in Greece has increased more than in Germany over the last ten years. In addition, the Greeks work on average 1900 hours per annum, which is the greatest number of working hours in Europe. In addition, before the crisis Spain and Ireland scrupulously respected the stability and Growth pact criteria. It should not then be towards these issues that adjustment policies within the Eurozone are directed.

From a very basic model of aggregate demand in a Keynesian model, it is possible to identify an accounting identity which will help our comment:

$$Y = (C + I) + (G - T) + (X - M)$$

where

$$C = Y - S$$

which gives

$$Y = (Y - S) + I + (G - T) + (X - M) \text{ or}$$

$$\mathbf{(I - S) + (G - T) + (X - M) = 0}$$

Where Y is GDP, I is private investment; C is consumption, S is saving, G is public expenditure, T is taxes, X is exports and M imports.

If Greece must refund its private debt, that means that S must be higher than I. This implies that (S - I) = (X - M) - (T - G) is positive, which is already problematic given the low level of savings in some countries, which in the second place implies obtaining such a result by the fall in the investment and thus the consecutive fall in the level of saving. If Greek public finances must also be balanced, that means that T must be greater than G which then implies that (X - M) > (T - G) and that the future of Greece depends on its exports. However Greek exports go mainly to Germany, which also has to respect the Stability and Growth pact, whereas the possibility of devaluation within a monetary union is impossible. If that is not done in the short term, which is probable, it seems difficult to balance the public accounts and to pay the private debts at the same time: "In the eurozone, the only way to pursue austerity while avoiding a crippling slowdown—which would cause a rise in private sector debt—is to facilitate a corresponding reduction in current account deficits in the periphery. But this will only be possible if Germany reduces its external surplus. We cannot sensibly lecture Greece about reducing its debt ratios without asking Germany to move towards a current account deficit. So far, political authorities have refused to consider expansionary policies for creditor nations like Germany. With a common currency, this leaves deflation on the periphery as the only means of restoring competitive balance. But deflation itself imposes huge costs on debtor nations. It increases the value of their nominally denominated debts, making default, and an EMU breakup, more likely. Until policymakers see these facts clearly, no amount of austerity will prevent the collapse of the European project in its present form"[3].

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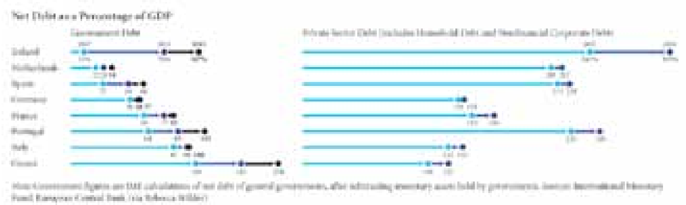
3 *In Papadimitriou & Wray (2011), "Confusion in Euroland", Levy Economics Institute of Bard College One pager.*

In other words, if Greek creditors want to be paid, the Member States of the euro area who have a trade surplus with Greece must increase their consumption of Greek products or lend sufficiently to Greece in order to pay off its debt. Without that, the national programmes of budgetary adjustment will not attain their objectives and the crisis will be reinforced, which is already what is happening.



In Papadimitriou & Wray (2011)

This is precisely the message Semeniuk & al.[4] have put forward stating that, out of their model depicting the European interconnected goods and financial markets, the current national stability programmes “may lead to the opposite of the desired stability by exacerbating areas of imbalance”. In addition, their study suggests that even if the necessary rebalancing did occur, “a more expansionary fiscal policy will most probably be required to maintain growth rates”.

This is what Greece did before the crisis, but logically, by the appearance of a trade and fiscal deficit financed by the German and French banks. This lead to a growth in incomes lower than the growth rate of consumption, to a low level of saving and to an increased debt/GDP ratio: “Credit expansion in the Eurozone generated a demand expansion in PIIGS. The increase in demand included

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4 G. Semieniuk, T. Van Treeck & A. Trueger (2011), “Reducing Economic Imbalances in the Euro Area: Some Remarks on the current Stability Programmes, 2011-14”, Levy Economics Institute of Bard College, Working Paper n°694.

the increase in the demand for imports. The import demand increase in PIIGS allowed for rapid growth of German exports. On the other hand, German aggregate demand (and in particular, import demand), was severely constrained by a strict wage restraint policy. As a result, Germany's trade surpluses increased. Export-oriented growth, based on stagnating domestic demand and wages, also implied deteriorating overall wage-shares and income distribution for Germany"[5].

The alignment of the economic policies at European level setting at the same time the objective of balanced public finances and trade surpluses implies a fall in investment and thus of the growth and income in the economy. This in turn implies a fall in revenue from taxes and thus a rise of the debt/GDP ratio. It is a vicious circle which destroys the internal market and the euro area. This was a clear message already pronounced two years ago: "In other words, the European Union as a whole cannot simply blame Greece for its poor management over the last 5 or 10 years. The deterioration of its current account meant some European countries benefitted, both because they were relatively more competitive and because workers had the money to buy goods and services from abroad: "In particular, ***the loss of Greece's competitiveness*** (and a number of other countries, including Spain and Ireland) ***is the mirror image of an increase in relative competitiveness of others, notably Germany, Austria and the Netherlands.*** In addition, the latter countries could not have increased their net exports without the faster demand of expansion in the former group, which, it is often

5 In J. Buzaglo (2011), "The Eurozone crisis: Looking through the financial fog with Keynesian glasses", Real-world Economic Review, n°58. On income distribution, see Biewen and Juhaz (2010), "Understanding Rising Income Inequality in Germany", IZA Discussion Paper n°5062, reporting that the ratio between the 90% and the 10% quintile increased from 3,3 in 2000 to 3,9 in 2006 while the Gini coefficient increased from 0,-26 to 0,30. On wage policy, see Global Wage report 2010/2011, ILO.

forgotten, was also responsible for much of Europe's economic and job growth in recent years, while demand and output growth in the surplus countries has been sluggish. The problem is symmetrical and the solution must be as well"[6]. Thus, it seems undue to now insist that Greece cures its problems on its own by cutting expenditure only, without any stimulus coming from the European Union, following the principles: "we keep our own house in order and if others do not, then too bad for them"[7]. Moreover, as the private sector deleverages and attempts to rebuild its balance sheets, consumption and investment demand have and will surely continue to collapse, bringing output down with them"[8].

II. Financial Policy:

Advances in European policy in terms of financial regulations are quite limited. Europe mainly implemented supervisory bodies for banking and insurance activities and for systemic risk. It is currently working on the standards of prudential regulation, Capital Requirement Directive IV, on the quantity and the quality of equities of the banks.

That said, it seems that the banking institutions and international organisations do not differentiate the microeconomic risk from the systemic risk. Indeed, whereas the new standards of regulation relate to the protection of a particular financial institution (a bank), it does not tackle the problem of the diffusion of the systemic risk

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6 P. Arestis & G. A. Horn (2010), "Open letter to Europen policymakers: The Greek crisis is a European crisis and needs European solutions beyond emergency packages".

7 In T. Padoa-Schioppa (2010), "The debt crisis in the Euro Area: Interest and Passion", Policy Brief, Notre Europe.

8 In Méaulle (2010), "Greece: Recovery, austerity and international imbalances", FEPS Working Paper.

in the economy. The macroeconomy is not the aggregation of the individual decisions it is the result of the interactions of individual choices. In particular, the banking regulation is not treated in relation to the regulation of the parallel financial system (shadow), which, by definition, is a non-regulated unit.

Indeed, one could think that systemic risk is seriously understood and taken into account by the will to regulate SIFIs (Systemically Important Financial Institutions), described as large institutions with regard to their size and monetary links in value with other financial partners. This is misleading. The financial system could be made of a multitude of really small but very interconnected financial institutions, the way they are establishing links together is the way financial risk is passed and diffused into the system and becomes systemic. This is the way systemic risk arises and which should be tackled as a priority.

A first stage could thus consist not in controlling the shadow financial system but at least the links which it establishes with the banking system. An alternative could be to separate commercial and investment banks.

Another problem relating to the banking practices, in relation to the development of a non-regulated financing environment of the economy and the diffusion risk, is the development of a very short term market for the financing of long-terms investments. Within this framework, the anticipation of liquidity can easily be misunderstood as a crisis of solvency. They are the same self-fulfilling prophecies as those experienced during the debt crisis. One way of differentiating risks, suggested by the Geneva Report, would be to limit "maturity mismatches", by the implementation of a "mark-to-funding" method as a means of limiting short term financing for long term investments.

It could also be convenient given the impossibility of determining the risk of an investment, to set up a system of "Asset-based Reserve Requirements", differentiating capital requirements according to the sectors in which the capital is invested. In addition, cooperative, public-sector and other kinds of non-profit banks should be implemented and finance local socially and environmentally friendly businesses[9].

Finally, a limit on the capacity of the banks to increase their return on equity by increasing leverage without risk weighting would be welcome.

A global increase in taxes in the banking system should be proposed. It is unsustainable and thus undesirable economically to post a rate of return on equity of about 20% to 50% in an economy which is hardly growing. Such a difference implies a movement of transfers of capital from the real economy to the financial system reinforcing the rising trend on the financial markets. In this respect, the introduction of a financial transaction tax is very welcome.

Let us finish by noting that the rise in the stockholders' equity of the banks (thus a mechanical fall of the leverage effect) does not imply necessarily a fall of the loans to the economy and a fall of the growth and employment, especially if the banks and financial institutions are properly regulated[10].

III. Monetary Policy:

Europeans, for the most part, did not live beyond their means. Indeed, the richest saw their total contribution decreasing and this during a period of sluggish growth characterised by high levels of unemployment, financed by private or public debts in Europe.

In addition, the financing of the debt being done since 1973 exclusively on the deregulated capital markets, part of public expenditure

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9 On issues related to systemic risk limitation and financial regulation, see Méaulle (2011), "The Basel III Agreement: A Critical Survey", FEPS Working Paper.

10 See Méaulle (2011).

is in fact done to the benefit of a small minority of fortunate savers who have limited resources given the low level of demand and therefore the low incentive to invest and employ, and a decreasing level of taxation in a deregulated financial environment.

Indeed, as stated by Aglietta (2012)[11] countries which are linked to a foreign currency with a fixed exchange rate generally cannot manage to maintain this regime when they are under strong pressure by their creditors. And this governance principle is fundamentally linked to an ideology on the nature of money, contesting its legitimacy by the guarantee of the political power. This prevents the bank from acting as a lender of last resort, and this, following Aglietta, endangers the very existence of the Eurozone.

As an alternative the ECB could act as a lender of last resort in the euro area to break the instability of the bond market. Indeed, such a move, by itself would prevent the ECB from intervening. This should give room for manoeuvre for liquidity management but would require, according to Aglietta, the implementation of a permanent budgetary authority in a new governance framework between national and European institutions allowing a shared sovereignty on the aggregate Eurozone budget.

This suggestion that allowing a strong intervention of the ECB on the European bond market would represent the opportunity of preventing Greece and some other Member states from defaulting which would enable them to continue to treat public indebtedness as a non-risky activity. The opposite would make public debt a risky asset increasing interest rates on lending, would act as a disincentive to institutional investors to finance public spending and finally would give some margin of manoeuvre for national budgetary policy.

A final solution, stated by many commentators and raised in some respects through the many recent European mechanisms for debt resolution, is the implementation of Eurobonds, which would

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11 *M. Aglietta (2012), Zone Euro : Eclatement ou Fédération, Michalon.*

certainly necessitate a proper European – at least economic - governance more inclined to suggest balanced policies for imbalanced states and sectors, in many respects. This would give some margin for manoeuvre in industrial policy. They could be implemented together with project bonds and other increased European structural funds and European investment bank credits reallocated in priority with respect to their impact on the environment and job creation. But this could require a high level of European commitment … of federal commitment.

Gustav A. Horn,
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Problems of the Euro area: A German Perspective

I. Introduction

The pressure on German politics is high. If there is any consensus among observers of the present crisis of the Euro area, it is that the key to the solution lies in Germany. In the end the economically strongest member country of the currency union will have to take the decision whether it will save the Euro area in its present composition or not. An affirmative answer to that question means that financials risks of significant size have to be taken at least in the first round. A non-affirmative one will mean a break-up of the currency union at least in several parts, if not a total break–down. Both developments involve severe economic risks.

Therefore, it is of no surprise that a heated debate has begun as to Germany's role in the Euro area. In the following the related policy debate will be outlined and assessed. Its line of reasoning can only be understood against the backdrop of recent German economic performances. These have been dominated by export successes – at times Germany was the country with the highest global exports, before it has been overtaken by China – and import restraint caused by slack domestic demand. For quite some time Germany was the country with the lowest domestic demand alongside Japan. Both tendencies were the result of a deliberately chosen economic policy path that placed utmost importance on achieving and maintaining very high international competitiveness. Germany perceived itself as a nation that was in danger of losing out to globalisation. This perception resulted from the relatively slack growth following German unification combined with high unemployment. At the beginning of the last decade, Germany was therefore widely seen as the sick man of Europe.

The reaction of the then German government consisted of a wide range of reforms of the social security system and a significant deregulation of the labour, product- and financial markets as well as lower taxes. This was perfectly in line with the dominating macroeconomic view that the growth process could only be re-accelerated by supply side measures. As it turned out the results were mixed. While Germany was very successful in improving its international competitiveness, domestic demand remained relatively weak until the beginning of the financial market crisis. It showed up in soaring exports and weak imports leading to a high and ever rising surplus in the German current account.

II. The Neglect of Euro Area Stability

The German strategy of improved international competitiveness took no regard of any specific Euro area requirements. They were simply not seen since the general view was and still is that the German economy is in competition with any other economy on the globe – among them all other countries within the Euro area. From this perspective the Euro Area is an association of economies that compete with each other. The area of competition reaches from low wage costs over low taxes to low regulation. It is a competition that ensures favourable conditions for firms and wealthy people. The promise was that these conditions would in the end lead to higher growth and employment in such a way that the rest of the population would benefit too.

The result is well known by now. In fact this policy approach has decisively contributed to the adverse impact of the financial market crisis in the Euro area. Furthermore, it is at the root of the present debt crisis. Largely deregulated financial markets created risky products beyond imagination, lower taxes fostered inequality in most countries to new highs, whereas income perspectives of the middle and lower wage earners deteriorated.

In particular, this economic strategy puts the stability of the Euro area at risk. What has been neglected right from the beginning of the Euro area is that current account imbalances within the Euro area may severely endanger its stability. Aggregate price stability is simply not sufficient. The European Central Bank (ECB) ensured that Euro area inflation was on average well in line with price stability. However, some countries showed permanently higher inflation rates, others permanently lower. The former, by now well known as the countries in crisis, lost their competitiveness and showed a permanent deficit in their current account. The latter, mainly Germany, the Netherlands, Austria and Finland, gained trade advantages and a much welcomed current account surplus.

For quite some time this was not seen as a problem. However, the deficit countries accumulated an ever rising debt burden whereas the surplus countries accumulated foreign wealth. This was not sustainable and the impact of the financial market crisis revealed it.

Almost all of a sudden the debt burdens of Greece and afterwards those of Ireland, Portugal and Spain were seen as unsustainable and risk premiums on public bonds soared. And it turned out that there was no Euro area institution in place that could deal with this situation. This critical institutional gap is at the root of present market turbulences. Markets simply do not know how the Euro area will react in such a situation. Uncertainty emerges with all the damages to asset values we have already seen several times during financial market crises. How to overcome this dismal situation from a German perspective?

III. How Germany should react to the crisis

The most important long-term contribution of Germany to a solution to the Euro crisis would be an end to the permanent devaluation against the other economies of the Euro area. In other words, German inflation rates should be close to 2 % and not constantly below that value. This puts wages into the limelight, because their development significantly influences prices. What is necessary is that wages behave in such a way that they ensure that national inflation is in line with the ECB inflation target. For Germany that means wages must rise more strongly than in the recent decade. This is not easy to achieve, since wages are not set by the government. It is even a constitutional clause that the government must not interfere with wage setting in Germany. It can only be done in an indirect way by stimulating the domestic economy and influencing the balance of power on labour markets. Firstly that means German fiscal policy should be relatively expansionary. Secondly, labour market reforms in Germany should now strengthen the bargaining position of labour by e.g. introducing a minimum wage. Obviously, such a strategy would need some time before it became effective, but it is nevertheless necessary.

Then domestic demand in Germany should be more dynamic than before. This gives all the other Euro area members more opportunities to export to Germany leading to more balanced accounts for Germany and the other countries. If all Member States follow this approach, any further debt crisis could be avoided. If not, the Euro area faces debt, more crises time and time again.

This long term strategy must be accompanied by short term emergency measures. The fundamental decision to be taken in this respect is whether any member country indebted in the Euro could default. The question is whether the Euro is a domestic currency for any member country or a foreign currency. To ensure the future stability of the Euro and to establish the Euro as a currency on equal terms with the US- Dollar and other leading currencies, the former solution is preferable. This is also a sign that the European members perceive themselves as an economic unity. Given this, it is of utmost importance that two measures are taken. Firstly the European Financial Stability Facility (EFSF) and later on the European Stability Mechanism (ESM) must be equipped with sufficient financial resources and should have the right to trade with government bonds in order to stabilise their value. This has already been decided upon. But there should be limits. The ESM should only buy governments bonds up to 60 % of GDP of a Member State. Thus there is a strong incentive not to accumulate an excess debt burden. As an intermediate approach, the German council of economic advisers suggested the ESM could put government debt above 60 % into a joint fund financed by Eurobonds. But each member country must define a tax where revenues are transferred to the ESM to run down the debt during the coming years. This measure would in the short term provide relief in particular for very needy Member States. At the same time the obligation to save is strengthened.

Secondly, the ECB must declare that it will buy bonds to an unlimited extent, should the resources of the EFSF or the ESM be exhausted at some stage of a crisis. The ECB can do so as long as price stability is preserved, which can be achieved by sterilising its operations. If these measures are taken, there is no necessity to leverage the EFSF – a rather doubtful procedure, since it puts public finances at higher risk. ***The ECB has recently followed a different but less efficient approach by yielding huge amounts of liquidity to banks. This helps to stabilise confidence but the bond buying approach would have tackled the debt problem more at its root.*** Then public finances would have been stabilised and in due course banks too.

This situation is sustainable since the ECB possesses the ultimate credibility. A Central Bank has no restriction on its means in its own currency. Therefore it is more powerful than any other investor on the market. Since everybody knows this, a declaration as outlined above will immediately stop any speculative attacks and markets will calm down very soon. Therefore it is highly probable that the ECB will never have to use its power to a large extent. That is the dividend of credibility.

If the outlined strategy is followed, the Euro area will have finally set up an institutional framework that addresses the neglected problem of internal current account imbalances. It is in the end also the acceptance that the Euro area is more than an association of competing economies: It is a political and economic union.

Sergio Rossi,
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Replacing recession and austerity with growth and solidarity across Euroland

I. Introduction

The euro-area crisis has exposed a number of deep structural flaws of the monetary union. It thus calls for advances in European integration, considering also the so-called "Europe 2020" strategy as well as the European Economic Recovery Plan aimed at fulfilling the objectives of the European Union (EU) as laid down in the EU Treaty (see Commission of the European Communities, 2008; 2010).

This paper presents some ideas to halt the crisis and relaunch European integration in a way that supports economic growth and enhances solidarity across the EU. The paper focuses on the euro area, but its proposals could and should be extended to the Union as a whole before long. The next section addresses the most urgent decisions that EU institutions have to take in order to stop the perverse dynamics that are encumbering several so-called "peripheral" countries in the euro area at the time of writing. The third section elaborates on the political-institutional setting that the EU requires in order for all its member countries to converge in economic terms so that growth and solidarity will spread across Euroland. The last section concludes briefly.

II. Halting the crisis within Euroland

The "original sin" of the European monetary union was to create a single currency without any form of political

INTEGRATION APPENDED TO IT (see Padoa-Schioppa, 2004). Money and politics should therefore be reconciled at the level of the euro area as a whole. The first step in this direction needs to involve the European Central Bank (ECB). Without going as far as to modify its statutes (a task which will have to be considered in a not too distant future in order for it to converge towards the mandate of the US Federal Reserve), the ECB has to make sure that any euro-area banks benefiting from its lender-of-last-resort facilities increase their credit lines to both the private and general government sectors of the relevant country, for an amount, maturity, and interest rate that are consistent with those of the ECB facilities thus exploited. If so, then the ECB should reduce its policy rates of interest, moving close to zero the interest rate on its main refinancing operations and in the negative domain the rate of interest on its deposit facility. Besides, the ECB should accept as eligible assets for its monetary-policy operations only sovereign bonds of those governments that rebalance the national tax pressure so as to reduce the burden on labour income, the taxation of which has to be calibrated in order to support consumption and home-ownership of "middle-class" wage earners. National fiscal policies should be coordinated among themselves and with the monetary policy carried out by the ECB, in order to reduce Germany's trade surplus through higher German imports of other euro-area countries' products. The rebalancing of intra-euro-area foreign trade should indeed allow for an expansion, rather than a contraction, of economic activity across Euroland.

In this respect, wage-earners' compensation in Germany has to increase according to the productivity improvements in the relevant sector, and above the ECB's inflation target – which should also be increased to a minimum of 3 per cent.The ECB's monetary-policy strategy also needs to become symmetrical, reducing policy rates of interest when there is an expected reduction in inflation rates. (To date, in fact, there is an anti-growth bias in the monetary-policy decisions of the ECB, as, "in practice, we are more inclined to act when inflation falls below 1% and we are also inclined to act when inflation threatens to exceed 2% in the medium term" (Duisenberg, 2003, p. 13, emphasis added).)

As regards fiscal policy, the introduction of the so-called "golden rule" of public finance in national constitutions or similar legislation needs to consider the fundamental difference between consumption and investment expenditures by the general government sector. In fact, the "fiscal compact" agreed by the heads of State or government of 25 EU member countries in January 2012 needs to be focused on this crucial point. As any investment expenditure provides a number of public goods or services for several fiscal generations of taxpayers, it would be wrong on both ethical and economic grounds to ask the current generation of taxpayers to entirely finance this expenditure. Public investment should be financed by public debt, to be served according to the pay-as-you-use principle, which implies that each generation of taxpayers has to contribute through their own taxation to financing the amortisation and interest payments of the relevant public debt.

Fiscal policy coordination should also replace tax competition with tax harmonisation in the whole euro area, particularly as regards taxation of business profits. The rush-to-the-bottom competition that has been observed in this domain, in fact, has spoiled the public sector of tax revenues that could have supported economic growth and solidarity across euro-area countries. Tax incentives can be introduced so that both financial and non-financial businesses contribute to reorienting their economic activities towards a sustainable, investment-led production system based on life sciences, clean technologies, and urban renewal considering the social and economic problems elicited by an ageing population. Minimum standards must be introduced so that businesses hire young people and enable senior workers to transfer their own human capital to them before retirement. Job agreements should be of unlimited duration, both to reduce workers' uncertainty (hence increasing their propensity to consume, as a growth-enhancing factor) and to reduce the incentives for business relocation. Increasing the number of employment contracts of indefinite duration will reduce the firms' mark-up over factor costs, inducing businesses to increase their research and development activities in order to re-establish their mark-up by innovation and investment in human capital. If so, then the resulting dynamics on the labour market could contribute to raising employment levels and households' well-being, with positive consequences for both economic and financial stability across the whole euro area.

III. Moving towards the United States of Europe

The idea of setting up the United States of Europe, first outlined by the founding fathers of the EU back in the 1950s, should be revived as the thread capable of blending "policies, politics, and polity", in order to achieve the ultimate objectives laid down in article 3 of the EU Treaty. In particular, it is through a (partial) harmonisation of fiscal policies that the euro area could progress in the interests of all its member countries. The first step in this direction might be a pan-European tax levied on financial transactions recorded by any bank within the whole EU[12] as well as a carbon tax on non-renewable resources: the tax revenue generated will then need to

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12 *A financial transactions tax could raise a number of issues over the short term in a framework which is already highly volatile and characterised by fundamental uncertainty about the future: it could reduce liquidity in European financial markets, increase asset price fluctuations, and dislocate various financial transactions to more deregulated markets (especially if the United States does not levy a similar tax in its jurisdiction). Over the medium-to-long term, however, the financial and macroeconomic stability brought about by this tax is likely to attract foreign capital and stimulate economic growth within the EU.*

be shared between the "federation" (that is, the EU as a whole) and its Member States in order for the EU to dispose of a budget that is consistent with the size and scope of the Union, and for every member country either to contribute to or to benefit from a fiscal equalisation transfer mechanism aiming at averting excessive real economic divergences across EU countries (measured by per-capita income levels in real terms, and by unemployment rates for the most problematic categories of wage earners, namely, the young, women, and senior workers).

Providing that an EU budget between 10 and 15 per cent of the Union's GDP can be put together as explained above, it will then make sense to ask some EU institution, such as the European Financial Stability Facility or the European Stability Mechanism, to issue euro-bonds in order to support an investment-led sustainable recovery throughout the EU, replacing austerity with solidarity. As Holland (2010, p. 53) notes in this regard, "if the investments [financed through euro-bonds] were in the social domain, in areas such as health, education, urban renewal and the environment, they could lift the cost of this from national budgets and enhance the ability of lower-income Member States to align their investment, employment and welfare levels with those of more advanced Member States, without recourse to a common fiscal policy."

Euro-bonds will thereby provide productive investment opportunities for those savings within (and beyond) the EU that are looking for sustainable returns on assets on a long-term basis (such as pension funds, owing also to the problems of an ageing population in this respect, requiring these funds to look for reliable income streams over the long run). As this approach alleviates the upward pressures on spreads concerning government bonds of several "peripheral" countries in the euro area, it will protect them from speculative attacks from market players, since the latter will no longer be in a position to impose the "market rule" at the taxpayers' expense.[13] Issuing euro-bonds will notably provide an interesting choice for private as well as institutional investors, as it will enable creditor countries, in Asia as well as in Europe, to diversify their reserve assets.

As issuing euro-bonds does not require mutualising the EU countries' debt, the ECB will be in a position to buy them without infringing either upon its current statutes or the EU Treaty. Its purchases of euro-bonds issued by some European institutions (see above) will mimic the open-market operations carried out by the US Federal Reserve when it purchases the various bonds, bills, and notes issued by the federal government of the United States (as a way of advancing a future income that the US Treasury will collect through taxes, and pay back to the national central bank). The ECB intervention on the primary market for euro-bonds will be a clear signal to any market participants that these bonds can be used as eligible assets in their refinancing operations. As a consequence the liquidity of the euro-bonds market, as well as its geographical extension, will be massively increased, enabling both the ECB monetary policy and the EU-wide fiscal policies to be carried out more efficiently.

IV. Conclusion

Financial-market pressure on euro-area countries and their governments are pushing for more rather than less European integration. The euro-area crisis is a unique opportunity to dispose of a number of major flaws within the monetary union, restoring the essential

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13 This argument could convince in particular German taxpayers (hence the country's political authorities), so much so if one explains to them that there is an essential difference between a fiscal transfer such as funding a European institution's "own resources" and an issue of bonds as a means of channelling savings into productive investments (Holland, 2010, p. 57).

link for money and politics to be steered together and towards the same economic-policy goals.

This paper has pointed out two main areas of urgent intervention. On the one hand, the ECB has to contribute to macroeconomic stabilisation, without the need for a modification of its statutes in that respect. On the other hand, national fiscal policies must rebalance the tax burden to enhance investment-led, job-creating economic growth in areas that are promising for sustainable development.

Furthermore, in the medium-to-long term the EU needs to design and introduce a number of pan-European taxes to finance the Union's budget up to 15 per cent of the Union's GDP – as this will substantiate the issue of euro-bonds by some EU institutions. The design of a transfer mechanism for financial equalisation across the EU will make sure that the less advanced and competitive countries can reduce if not close the gap separating them from the leading countries within the EU. Real convergence of all EU member countries is indeed crucial for enhancing economic growth and solidarity across the whole Union. It can be achieved through a political-institutional process that alleviates the burden on a number of national governments' budgets, thereby freeing up resources to be invested in those countries most in need of a recovery, which will thus be in a position to reimburse maturing debts and to pay for those goods and services they need to import in order for them to grow and develop further (see Rossi and Dafflon, 2012, for elaboration on this).

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Adjustment and Growth in a New EU Economic Governance

The Euro area is facing one of the most difficult periods in its history. The current sovereign debt crisis is the real test of the solidity of the Euro's future and of the construction of Europe itself. What is at stake today is not only the stability of the European economy, but the survival of the entire integration process of Europe.

The crisis has revealed two major flaws in the Euro architecture. Firstly, a failure of surveillance instruments, since the SGP (Stability Growth Pact) has not been able to ensure fiscal discipline and the macroeconomic monitoring system, the BEPG (Broad Economy Policy Guidelines), has not been able to avoid excessive imbalances within the euro area. Secondly, the crisis demonstrated that the euro area was not ready to face a sovereign debt crisis in one or more of its Member States, due to a lack of crisis management provisions. Furthermore, the crisis has revealed that threats to economic stability could originate, not only in government fiscal policy, but also in behaviour within the private sector.

To fill these gaps, after a series of important decisions in little more than one year, the new economic governance framework was definitely approved last September by the European Parliament. It comprises significant innovations in terms of rules and procedures for adjustment policies and macroeconomic coordination. More recently, a European agreement on the strengthening of fiscal discipline and the coordination of fiscal policies was signed. On the 8th and 9th of December 2011, the Member States, with the exclusion of the United Kingdom, signed the so-called 'fiscal compact' in Brussels.

It was presented as a fiscal union but this is a misleading term, since we are dealing with budget rules and sanctions, certainly stronger, but not dissimilar to those approved as part of the new European governance.

Despite the new Governance framework serious questions remain unresolved. I emphasize the importance of the lack of crisis management in relation to countries and banks, on the one hand, and the persistent weakness of the growth regime, on the other hand. A serious comprehensive approach to crisis resolution and governance problems requires an agreement on well-identified policy priorities both at EU and national level, by tackling the two above mentioned challenges

I. A crisis of private debts

First, one should point out that the main cause of the present debt problems in the euro zone cannot be linked to – with the exception of the special case of Greece - the fiscal irresponsibility of European countries, but it was the unsustainable accumulation of debts of the private actors (households and banks) linked to the large and persistent imbalances in the euro area. For many years exceptionally favourable financing conditions have concealed the differences between Member States' underlying conditions, economic policies and the absence of really binding common rules. In this regard European surveillance of national budgetary policies proved to be inadequate. In Ireland, Portugal and Spain the debts of household and firms, in the years immediately preceding the crisis were between one and a half and two times the average of the euro area. In Ireland the largest national banks had arrived at an active budget five times larger than its GDP.

During the years preceding the global financial crisis, the euro area as a whole has remained relatively close to external balance, while the current account balances and the competitive positions of individual Member States have widely diverged. In particular the northern countries (especially Germany) built up significant surpluses while the southern euro area countries accumulated very large deficits. External divergence also took the form of a steady widening of differences in the competitive positions of the two groups of countries.

For many years, little attention has been paid to these imbalances, by national authorities and European institutions. The assumption was that changes in competitiveness and current accounts are not necessarily bad in a monetary union. For instance, catching-up countries have strong investment requirements that call for inflows of foreign capital and consequently current account deficits. Furthermore, increased integration of capital markets is likely to result in large current account deficits. In such a context, countries in deficit shouldn't take measures to reduce their imbalances. This is supported by early studies on this specific subject.

Especially, since large current account deficits in the euro area have been easily financed for many years by net private capital flows of surplus countries that bought deficit countries assets including debt obligations. The core European countries' banks had hundreds of billions at risk from the government debt of Greece, Ireland, Portugal and Spain. And some German and French banks are currently among the most involved in the region, according to the last Report from the BIS (Bank for International Settlements). In other words, the banks of the strong countries (mainly Germany and France) have heavily financed the excess demand in the peripheral countries, thus promoting the accumulation of large macroeconomic imbalances within the euro area, reflected by high differential productivity and competitiveness, together with current account deficits and surpluses in others as high.

The financial crisis in 2008-2009, has revealed weaknesses in the architecture of the Union. It has accentuated the investors' perception of risk and has marked a generalised plunge in the intensity of the euro area cross-border financial flows. Private funding of the imbalances dried up and the system of euro area central banks has to replace – with a series of steps in a financial crisis well described long ago by economists like Irving Fisher and Hyman Minsky - the banking sector as a key source of funding of current account imbalances and capital movements. This massive intervention was to a certain extent successful, but the cost was the dramatic increase of public deficits in most countries. Highly indebted EMU countries with large external deficits have experienced the highest sovereign bond yield spreads, and imbalances were placed at the heart of the Eurozone crisis. As a result, the Euro system has become exposed to the risks of sovereign and bank defaults.

Suddenly we have discovered that, imbalances in the first ten years of the Euro were not the temporary outcome of an overall European economic convergence process as early studies have claimed. The divergences in competitiveness and current accounts in the euro area were mainly fuelled by various domestic economic imbalances, including excessive credit growth in the private sector and housing bubbles. While in some other Member States, like in Germany, the accumulation of large current account surpluses, reflected structural weaknesses in wage and domestic demand dynamics.

In the meantime, ***fiscal austerity measures have been introduced everywhere in the EU, by extending them from Greece's unique fiscal complications, to countries such as Spain and Ireland which had banking, not fiscal, crises.*** Growth has thus suffered, and together with the EU's inability to handle the relatively small problems of Greece, also contributed to a weakened market confidence in Spain and Italy. Interest rates soared and bond prices fell in Italy and Spain, which led to further deterioration in the perceived soundness of banks holding these bonds. The decline in government bond prices has exposed the banks' undercapitalization and the prospect that governments will have to finance recapitalization has driven up risk premiums on government bonds. The sovereign debt crisis in the periphery is thus bound up with a banking crisis across the euro area as a whole. As a consequence the banking crisis and sovereign debt crisis have so far been interacting with one another in a perverse way. It is thus very clear that the financial system's fragility in combination with the sovereign crisis represents the biggest threat to the long-term stability of the Eurozone economy. But European governments have so far been reluctant to confront such a problem, even though this is becoming a very risky game.

II. The strengths and weaknesses of EU Economic Governance

The new European economic governance is trying to respond to the flaws and the new problems of the Euro architecture which have been highlighted by the global crisis. It seeks to extend and complement the EU's existing focus on fiscal surveillance with a macroeconomic surveillance mechanism concentrating on the external position and international competitiveness above and beyond budget deficits. A series of important decisions were taken in just over a year in relation to many important topic areas such as:

- To prevent and correct imbalance more strength was given to the SGP;

- To assess macro-financial stability, the Excessive Imbalance Procedure (EIP) was created and the European Systemic risk Board was established;

- To manage and solve crises, a new special vehicle, the European Financial Stability Facility (EFSF) and a European Stability Mechanism (ESM) were set up, the former to provide sovereign liquidity assistance and the latter to provide a sovereign crisis resolution regime from mid-2013;

- Finally a new European semester was put in place, to monitor and evaluate the National Reform Programmes (NRP's) presented by all member countries and related to the EU2020 growth strategy.

Looking ahead, the steps that have already been taken to tackle the weaknesses of the European governance are important. The extension of rules similar to those governing national budgets to the surveillance of macroeconomic imbalances, with special consideration for the state of member countries' external accounts, is a very positive development. It is also very important that structural reforms aimed at boosting economies' competitiveness and growth potential is now considered a top priority on the policy agenda.

In many ways one can represent the new governance measures as a toolbox, some new and others revised, which are potentially very useful for reinforcing the economic coherence and policy coordination in the euro area. A set of tools able to be used in various ways and directions, producing different results and impacts. It is like an economic model characterised by a multiple equilibrium, which can offer more solutions at the macro level, depending on how these measures (policies) are formulated.

Nonetheless, there are still many weaknesses and missing elements in this governance toolbox. These are not details but key elements with the possible capability of coping with the current crisis and offering Europe and its Eurozone a stable financial future. None of the rules contained in the more recent fiscal compact could help bridge these gaps. This agreement will oblige the Eurozone members to adopt the constraints of a balanced budget by including them in their constitutions, giving the European Court of Justice the power to check their correct implementation in national legislation. The countries that will experience excessive deficits must submit detailed structural reform programmes for a lasting effective correction of their deficits. Supervision and monitoring powers are defined to prevent and correct deficits with a sharp strengthening of the intergovernmental methods. Nonetheless, due to previous European experiences, the difficulty within the execution of the EU policy should be kept in mind. Whether these new or revised policies will be respected this time will remain uncertain.

To highlight the weaknesses of the present Euro governance let me first focus on the actual crisis management of the euro member countries, led by the German and French governments. It could be summed up in three sets of initiatives.

Firstly, as we know in the wake of the crisis euro member countries ensured the provision of liquidity under stiff conditions to highly indebted states and tried to prevent contagion to other vulnerable economies. Initially the conditions for disbursement of the funds to troubled countries remained punitive in terms of financial costs and duration of the adjustment processes imposed. Since last July they have been significantly revised in much better terms. Secondly, ambitious fiscal austerity plans and economic-social reforms have been imposed to peripheral highly indebted countries to ensure their return to primary budget surpluses and put them on a sustainable medium-term growth path. Finally, any major restructuring of unsustainable debts - both within the sovereign and private sectors - have been postponed at least until European banks are in a position to withstand any losses.

The key question is whether this strategy could succeed in solving the solvency challenge and restoring confidence in the euro area. So far it hasn't been very effective, but Germany and the creditor countries seem to believe that it will be. On their reading, the crisis in the Eurozone was the product of countries' fiscal laxity and lack of competitiveness. There is a banking crisis, but this is not central. Thus the adjustment should be based on fiscal consolidation and structural reforms in the peripheral indebted countries.

But this approach is extremely risky and prone to a large economic or political accident. It stems from the illusion that a monetary union can be sustained through a simple set of rules for monetary and fiscal policy and that current account imbalances do not matter. As outlined above, the root cause of the Eurozone crisis is to be found in the unsustainable debt accumulation of the private sectors (household and banks). Therefore, the diagnosis of Germany and other creditor countries can be considered as being too simplistic. Moreover, the medicine prescribed will fail even in the narrow sense of avoiding a country's default — and the fact that it will not work will become obvious sooner rather than later. At that point, Europe's stronger nations will have to make a fundamental choice: either stand by and see some Member States default on their debts, or finally implement a serious comprehensive approach to crisis resolution.

The first option will be dramatic and will put the future of the euro and the European construction at risk, so it is better to concentrate on the second option and assess the elements of a comprehensive response to the crisis and its challenges.

III. A new approach to crisis resolution and economic governance

A serious comprehensive approach to crisis resolution and governance problems requires an agreement on well-identified policy priorities both at EU and national level, by tackling the following broad challenges: firstly, fragilities in the euro area's banking system; secondly, worrying dynamics of public debt in some Member States and contagion effects; thirdly, the weak euro adjustment and growth regime.

First, one should focus on a comprehensive European Union-wide plan to restructure and/or recapitalize and/or shrink troubled banks. Only very recently - could we finally say - we have been talking openly about the need to implement a plan to restructure and recapitalise banks, that should be large, comprehensive and extended to the whole European area. Of course, for this purpose we will be prepared with adequate resources (not less than 200 billion euro) and effective mechanisms for recovery of banking systems in some countries. The plan should be managed at a common European level and not on a national scale, as planned in the recent October summit. We already made such a mistake at the beginning of the crisis, in October 2008, by requiring each country to save their banks with their own resources. It stimulated the rise of the public deficit of the weaker countries and an increase in the interest rate. This led to a vicious circle: recapitalisation undermined the creditworthiness of governments and then this fed back into the banks, which saw the values of their asset decline further. The reinforced EFSF, instead, should support weak banks in weak countries. Capital buffers can also be built up through enacting a moratorium on bonus and dividend payouts.

A complementary fundamental pillar is a new bank resolution legislation making it possible for any bank, including large cross-border banks, to fail and thus not fully reimburse their creditors and equity holders – with the sole exception of insured (retail) depositors. Such a system would introduce strong incentives for bank managers and equity holders to limit risk-taking and create much more stringent market discipline also extending to sovereign borrowers.

E' evidente che di fronte a questi problemi la generosa offerta di liquidità operata dalla Bce a favore delle banche Europee servirà a guadagnare solo del tempo per attuare le riforme necessarie sopra richiamate e non rappresenta certo una soluzione ai problemi esistenti.

Secondly, it is evident that no restructuring and/or recapitalisation could save European banks and stop the panic in the banking system if the solvency/liquidity capability of peripheral member States, and in particular Italy and Spain, is not restored. One should address this challenge by imposing, of course, though conditionality – i.e. an austerity package - but at the same time by giving a sufficiently long period of time and offering reasonable concessional interest rate funds so that economic growth gets a chance and countries are allowed to fulfill their national reform plans and adjustments. Without economic growth no fiscal adjustment is conceivable. This approach has not yet been adopted.

Sorting our sovereign insolvency from liquidity is another key issue, even more so since euro area partners are not ready to finance all debts. Indeed, in the case of Greece, the primary surplus required to service their rising debts would be too much to afford. Greece clearly needs an orderly gentle restructuring – very different from the one formulated in the February summit - because a disorderly default could cause a meltdown. The real question is how to avoid such restructuring from spreading to Spain and Italy, which have been suffering a serious crisis of confidence due to liquidity problems rather than insolvency conditions. A default (or haircut) on these countries' debts would lead to the collapse of the euro-zone financial system, given the huge amount of Spanish and Italian debt held by European banks and institutional investors.

Now the present bailout mechanism (EFSF-ESM), supplemented by loans from the IMF, even in its enhanced form, remains inadequately sized to deal with the further intensification of the Eurozone debt crisis and given the scale of the funding requirements of Spain and Italy. Among the recommendations generally given today is an increase in the size of the European financial stability facility. But the fundamental problem of the EFSF is that every country guarantees every other in a game of dominos with a significant deterioration of all the countries' creditworthiness. Even the alternative way – as proposed in the recent October European summit - to boost the firepower of the EFSF by turning the fund into a bond insurer, able to guarantee a given percentage of new sovereign debt issued by highly indebted Eurozone member countries, will be a highly complex and difficult political compromise to achieve.

As a matter of fact, the only viable solution today is the monetisation of the public debts of struggling euro zone members - such as Spain and Italy - by purchase of this debt by the European Central Bank. In another words the ECB should keep providing support to illiquid countries and refinance their debt at affordable rates. It is the only Institution capable of implementing it because it can create money without limit. The example of various Quantitative Easings in the United States shows that this policy is effective and presents very low and affordable risks. Of course, in order to convince the markets of the usefulness of this approach, both Italy and Spain need to demonstrate that their medium to long term fiscal paths are credible and improving.

In perspective the crisis management facilities such as the EFSF and its successor, the ESM could become potentially powerful instruments to replace the ECB's role, if adequately reinforced in terms of their legal status (through the adoption of joint and several liability) and the increase in their own resources. This means ultimately that the liabilities of the system should be shared jointly by all Member States. In other words, the euro zone countries should take a fundamental step towards fiscal union if they want to solve the crisis.

IV. Effective adjustment and stronger growth

As argued above, the core of the euro crisis can be considered as a combination of an unsustainable accumulation of private debts (households and banks) and the large and persistent imbalances within the euro area, rather than solely a fiscal crisis. Large losses in competitiveness with a persistent accumulation of large current accounts of member countries' deficits-surpluses, characterised the first ten years of the euro. In contrast to some previous assumptions, they cannot be sustained for too long in Europe and should be reversed. Europe is not like the US where nobody cares about current account imbalances among federal states. It follows that unless the economies of Europe are brought into better balance, the region could get stuck in a low-growth pattern that could make the debt crisis harder to resolve and would threaten the future of the entire monetary union. Especially, as trade and financial spillovers across the Member States, large macroeconomic imbalances may also hinder the functioning of the EMU and weigh on the confidence in the euro. The huge challenge today is to make the management of the crisis compatible with the adjustment of these external imbalances. Austerity measures, and/or indefinite financing of them, would not be a solution. The former will exacerbate the recessionary trends in the Eurozone, while the latter will create economic and politically unsustainable tensions among countries.

In the present economic governance, insufficient attention has been devoted to policies capable of favouring these economic adjustments apart from financing them. In order to introduce effective adjustment mechanisms a broader political deal on economic governance is needed to restore confidence in the future of the Eurozone and the Union. This requires agreement on well-identified economic policy priorities, both at EU and national level, taking full account of the different positions of the members in terms of growth, external imbalances and competitiveness. An effective approach requires a closer look at both, competitiveness (Euro area relative performance) and stronger growth (Euro area absolute performance) in order to introduce:

- Structural reforms, to strengthen key markets (products, service, housing) to increase investments and boost growth;

- Effective mechanisms, to address long term external imbalances, including the countries with a surplus, since current account imbalances lead to asymmetric adjustment in monetary unions too;

In this perspective, a complex set of problems should be addressed both on the demand side (asymmetric adjustment in surplus and deficit member countries) and the supply side (structural adjustment). In this regard the market alone cannot produce a demand recovery rapidly by itself, due to current imbalances and divergent growth patterns in Europe (Strong and Weak Country Groups). It is incapable of producing structural adjustment until a demand recovery can already be noticed. Even as structural reforms are implemented, results caused by reforms only show in the long term, but slow growth in the short to medium term tends to fuel austerity fatigue and political risk.

Therefore, the traditional demand management policies and pure supply-side economics are both inadequate and there is a need for a policy somewhere between the two. In other words, the huge challenge is how to implement simultaneously a sort of mix between Keynesian demand and Schumpeterian supply side policies. A classic example in this direction is a substantial increase in investments for the single market infrastructures. It would bring great benefits by boosting demand in the short term and by raising the Union's potential output in the long term. A development that would be facilitated by a substantial issuance of Union bonds by various Community institutions.

At the same time for the issue of ongoing depressed aggregate demand, there is no doubt that policymakers should avert generalised fiscal austerity and provide additional short-term stimulus since quantitative easing could help but is not enough. The present fiscal austerity measures applied on a large scale, are determining recessionary effects on output in the advanced economies. This is even more the case with the lack of aggregate demand at global level, given the deleveraging of households and governments and the glut of capacity due to the massive overcapacity in China and other Asian countries. This is particularly true in the eurozone where the ongoing austerity measures will ultimately hinder growth, especially in the most distressed economies like Greece. In turn, ***low growth in Europe will damage tax revenues, which***

WILL IN TURN UNDERMINE THE PROCLAIMED GOAL OF FISCAL CONSOLIDATION.

V. Concluding remarks

To summarise, the European Union and the euro area are at a fundamental crossroads: either deciding to push firmly along the road to greater economic and political integration, or at the risk of experiencing a gradual global marginalisation and economic disruption.

Exclusive emphasis on restoring sound public finances will not suffice. The European Union needs a comprehensive political deal, not only to stabilise public finance, but also to provide liquidity and raise growth on a sustainable basis. The financial stability of Europe certainly has to be based on price stability and fiscal discipline, but also needs the other two pillars. Either Europe finds ways to create an effective European Monetary Fund and return to growth or its design integration risks failure. It is from a balanced mix of austerity, liquidity and growth measures that a solution for the crisis of the euro might result.

The ultimate and most important goal to be achieved is how to foster growth revival in crisis countries and in Europe as a whole. What is needed is a substantial increase in the EU output growth rate, which has been persistently low for a long period of time. In the end, the ultimate objective of EMU, and the measure of its success, is its ability to promote growth, economic and social welfare. The space for a possible compromise still exists, though time is running out. Everything will depend on the next twelve months.

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For a new Investment strategy in Europe
Ending the obsession with competitiveness

The Eurozone is in trouble. Most European countries have entered into a vicious circle of low growth and high public deficit. Within the eurozone, the spread between the "good pupil", Germany, and others has exploded. For the latter, structural adjustments are asked by the markets, followed by the European Commission and by the governments themselves. But these policies are based on a wrong diagnostic: the obsession with competitiveness and the need to reduce costs by any means. The only option for those countries is to adopt similar reforms to the ones adopted by Germany one decade ago. But are we sure it is a good model for the Eurozone?

I. Is the improvement in price-competitiveness the panacea?

Policies aiming at reducing the unit labour cost and getting more flexible labour markets have become the panacea for European governments. These reforms are inspired by the example of Germany and the relatively good performances of this country. Lots of observers consider that these performances are explained by the "courageous" reforms made and the launching of the 2010 agenda by the Schröder government in 2002. These reforms were based on a liberalisation of the labour market with the aim of reducing labour costs and increasing the number of low-wage jobs. ***Lots of governments consider that if it worked for Germany, it should work for other countries and the German model of growth tends to become the European benchmark. But***

THE EXTENSION OF THIS STRATEGY TO OTHER EUROPEAN COUNTRIES IS A REAL DANGER FOR FUTURE GROWTH OPPORTUNITIES.

A first observation is that the effect of these reforms on current export performances is discussed. The causality link is unclear. Structural characteristics of the German economy remain the first factor of performance: a strong comparative advantage is high-quality goods, high investments in research & development and investments, high skill-level of the labour force and strong implication of workers. As shown in a study based on firms' data (Berthou & Emlinger 2011), "quality" of exports is the main determinant of these performances, and not the fall of unit labour costs. It is too early to see the impact of the German reforms on such characteristics but one cannot exclude the possibility that it might weaken such strengths in the long-run.

Despite this observation, the fall of unit labour cost in Germany is a reality and can be explained by changes in rules of collective bargaining and reforms of unemployment benefits which had a negative impact on the reservation wage[14]. But real levels of wages should reflect levels of productivity and a growing disconnection between productivity gains and wages is not necessarily a good thing. A consequence of this evolution was an increase in the share of capital in the value-added, and the counterpart was an increased level of inequalities. Overall, too large current account surpluses can also be considered as a source of imbalance within a monetary union. And if a disconnection between productivity and wages contributes to these surpluses, it may also be seen as a source of competitiveness distortion. The whole problem does not come from the lack of competitiveness of "lazy countries".

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14 The development of low wage jobs has little impact on the unit labour cost of export firms. Most of these "mini-jobs" are in the service sector, in non-exporting firms.

Lastly, one fundamental factor of competitiveness is workers' productivity. And there are many other ways to increase this productivity. Working time reduction for instance has proven to be an effective tool in increasing the productivity per hour. Reducing real wages is a bad option but remains popular among European governments due to this obsession with short-term price-competitiveness.

II. The illusion of the trade balance

This evidence is reinforced by a simple observation. Some considers that the symbol of this divergence in competitiveness is the increased level of trade deficit in some countries and the increased trade surplus observed in Germany at the same time. But trade balance is a very poor predictor of international competitiveness.

First, trade deficit in countries such as Spain was mainly explained by a vigorous growth and a rapid increase of internal demand which have increased the level of imports and thus the level of trade deficit. Germany was one of the first winners of this increased level of demand in these countries. In other words, German performances would have been completely different if all European countries had adopted the same strategy of demanding moderation. In a basic framework of game theory, it is what we call a "non-cooperative strategy" ... which can only work if others do not share it! One statistic which is often forgotten in the debate is the export performance measured by the market share of firms in international trade. The market share of Spanish firms remains remarkably stable between 2000 and 2009[15]. During the same period, the share of British firms has decreased by 33% although this country also promoted the development of low-wage jobs...

Secondly, what does matter on an international level is not the trade balance but the overall level of balance of payments. As noticed

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15 See Berthou and Emlinger, ibid.

by Paul Krugman (2012), large capital inflows in those countries after the creation of the euro (due to low real interest rate) may explain such a deficit. The initial problem cannot be explained by problems of firms' competitiveness in some European countries.

III. Wrong diagnostic, dangerous solutions

The recent adoption of the treaty on stability, coordination and governance in the Economic and Monetary Union, together with the conditionality imposed on Greece in the context of the rescue plan, are two symbols of the wrong diagnostic made by European leaders. The goal is to ensure a decrease of fiscal deficit and restore competitiveness by all means. The combination of the budget austerity and policies promoting competitiveness leads to the promotion of more flexible labour markets, lower real or even nominal wages (-22% for the minimum wage in Greece!), budget cuts and tax increase. If the effect of such policies on the competitiveness is uncertain, their adverse effects on growth are direct. In the case of Greece, the European Union and the IMF imposed a brutal "internal devaluation". The success of such a policy is very unlikely. In countries with a strong level of foreign debt, lower levels of income through internal or external devaluation leads to an automatic increase of the ratio of debt over GDP (because of a lower level of GDP). Also, austerity measures have negative effects on the level of output, which also leads to a higher level of debt...[16] Of course, the situation of Greece is different from other countries. But the vicious circle of austerity will lead to the same adverse effects on the European economy. In that context, giving the priority to fiscal cuts, whatever their effects on growth is a losing strategy. Reducing public deficit would be impossible without restoring economic growth. Moreover, the competitiveness measures would not have the expected effect if they were adopted conjointly by all European countries. By contracting demand all over Europe, the only possible strategy of growth in the short-term is to increase the level of exports. But how can a country increase the level of exports without reducing the exports of its European neighbour? Intra-European trade is the major component of trade. As the example of Germany in the 2000s shows, an increase of exports in one country leads to a decrease in other European countries. And if all European countries adopt the same strategy, it would be completely counterproductive, with no export increase and a global decline of internal demand. By adopting this strategy, European countries will trap themselves in a long-period of low growth... and high public deficit, because of this low growth.

16 *Cafiso and Celinni (2012) showed that fiscal consolidations have had adverse effects on debt-to-GDP ratio in most European countries, at least in the medium term. Cotarelli (2012), director of the IMF fiscal affairs department argued that some countries might be going too fast in fiscal consolidations. Moreover, Delong and Summers (2012) have shown that the multiplier effect was stronger in a depressed economy with liquidity traps. Auerbach and Gorodnichenko (2010) found similar results for economies in recession. Austerity policies are therefore likely to be counterproductive in terms of debt-to-GDP ratio, but also to have persistent effects on unemployment.*

IV. Investing rather than depressing the economy

The Eurozone faces two main challenges. How to avoid the growing imbalances between members of the eurozone? What common strategy of growth can we adopt?

For the first challenge, as we saw, imbalances can come from two directions. Excessive surplus from one direction, and excessive deficit from the other direction. The first obvious answer is to solve both imbalances, which means those too large surpluses are also problematic for the European Union as a whole. A common and coherent strategy within Europe goes through a higher German contribution to the European growth. The high level of current account surplus allows them to have a more expansionary policy. They should not contract their level of internal demand but expand it. This would be a positive externality for all other European countries. On the other hand, deficit of competitiveness in the so-called "peripheral countries" should be compensated by fiscal transfers and stronger investments in such countries; not through internal devaluations such as have been made in Greece. Internal devaluations are risky strategies with furthermore dangerous consequences for the social stability of such countries. The European Union should promote another strategy based on an increase of productivity and innovations. Such a strategy requires more investments in infrastructure, education, vocational training, green innovations… In fact, there are two main options: an exit from the top or from the bottom. An exit from the top is the only option to maintain the level of wages, internal demands and social cohesion. But it requires a higher level of investment. A European strategy for social investments may contribute to this move. It is well known that a monetary union is not viable without fiscal transfers to compensate asymmetric shocks between countries. The "fiscal union" called by Chancellor Merkel is just the opposite: by institutionalising fiscal austerity without increasing the European budget, we just impede such a dynamic of stabilisation within the Eurozone.

V. For a social investment strategy at European level

In opposition to the current measures, short-term solutions to this crisis are numerous and broadly discussed among Europeans. Direct interventions of the ECB, as all other major central banks in the World are doing, may calm down speculative movements on the bonds markets. The creation of Eurobonds, to take charge of one part of national debts, is a solution which would decrease the spread of bond yields between European countries. But a broader vision is needed to stimulate a sustainable growth in the medium and long term. If fiscal transfers are needed to face asymmetric shocks within the eurozone, a new strategy of investment is also needed to foster growth at European level. The financing of ecological transition in European countries is an example of what can be done at European level. We know that the transition towards a low-carbon economy may create employment and wealth in the long-run but may also be costly in the short-term, justifying such investments.

VI. A revenue package for the European Union

Eurobonds financing an increased common budget would be the first solution to finance such investments. ***The aggregate level of debt in the European Union is still affordable (around 85% of the GDP), less than in the United States, or Japan.*** But the debt burden limits policy leeway and additional resources should be found to finance these investments. The adoption of a revenue package within the European Union should therefore be encouraged. In a paper prepared for FEPS[17], I argue that such a package including a financial transaction tax, a European carbon tax, a common corporate tax and a European strategy against tax fraud may yield between €300 and €500 billion per year. This revenue package may have multiple uses, and may be useful to avoid excessive austerity programmes in the Member States. It should also be an opportunity to finance new European strategies and promote an exit to the crisis from the top.

The current evolution of the economic situation in Greece has shown that the current approach based on this obsession for competitiveness failed. It is time for European leaders to radically change their vision and promote an exit strategy from the top rather than the current race to the bottom, consequence of the institutionalisation of austerity.

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Europe from the Periphery

I. Introduction

These days, Europe appears to be a cold place viewed from the periphery in Ireland. We are being bailed out and supported in many ways by the Troika of the EU, ECB and IMF, but the terms imposed upon citizens largely reflect the liberal economic perspective. We are four long years into austerity. Indicators are no longer falling, but little is rising, particularly green shoots.

At this inauspicious time, my vision for Europe demands a strong focus by progressive parties and organisations on the European Social Model and a clear understanding of what is meant by the abused word “competitiveness.” Thirdly, I set out a view from a small western island which was laid low by liberal economics and which, with European solidarity and support, rather than punishment and austerity, will rebound as a model member state. Finally, I set out the urgent need for progressives to consciously set out to restore the wage share in national income to improve equity, social cohesions, personal income distribution, longer term wealth distribution, macroeconomic stability and the composition of aggregate demand.

II. Persuading Voters that the Post-War European Social Compact is Alive and Well.

Economic and social progress in Europe since the war has been remarkable. Living standards and improvements in housing, health and peoples’ security have been excellent. There had been a consensus with conservatives that national income and wealth would be shared, but with the prolonged crisis, growing numbers of conservatives no longer want to share. The cake is no longer growing – thanks to their policies - and they want to keep more of it for themselves.

But the best way to grow national income is though social solidarity, education, investment, efficient public services and equitable incomes.

Re-building the European Social Model must be the priority of all progressive forces in Europe. Many Europeans fear that governments are neglecting citizens and are obsessed by appeasing the financial markets; have a very narrow view of "competitiveness"; and with fiscal rectitude. This means that the Post-War European Social Compact appears to be dying or dead for increasing numbers of European citizens.

Apparent confirmation of its death was given by the key unelected European leader, Mario Draghi, who "said Europe's vaunted social model is "already gone"."[18] Thus a clarion call for all progressive parties must be that the European Social Model is very much alive. Not alone will it continue to be a core objective in progressives' policy implementation in government, but we should guarantee that the Social Model will be enhanced in line with economic and social progress.

The prolonged ineptitude of European leaders, predominantly conservatives, in dealing with the crisis effectively has undermined public confidence in the European project. The failure of austerity measures has led the same leaders to pursue them with more vigour, instead of learning from their mistakes. ***The Fiscal Compact will exacerbate the problem.***

Mr. Draghi also argued that "austerity, coupled with structural change, is the only option for economic renewal". Like ancient Greek

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18 *Wall Street Journal, 24th February, 2012.*

priests, appeasing the gods with sacrifices, he wants to feed even more of our living standards to the markets, saying "Backtracking on fiscal targets would elicit an immediate reaction by the market."

On top of this deep crisis, there are great challenges with ageing populations straining pensions, rising health costs, environmental issues and much more. There is a hollowing out of the middle with the growth in "Cool Jobs and Crap Jobs" worldwide. Solid pensionable jobs like banking, computing, parts of accounting, engineering etc. are being de-skilled and outsourced from Europe. The polarisation of jobs is a vital area which has to be addressed.

Some of these challenges may mean doing things very differently, but all can be overcome. Revitalising the Social Model is the key to rebuilding confidence in Europe. One step in this direction is to have a clear understanding of one of the most abused concepts in modern economics- "competitiveness."

III. Competitiveness is Poorly Understood

The most abused word in modern political economy is "competitiveness." It is not just that each economist has a different definition, but even the same economist may define it in several ways. For most of them and for many institutions it is simply a description of short-term movements in wages. A more sophisticated definition is of short run movements in unit labour costs, but both are too often ideological, using easily available data to beat up workers and trade unions. This is now a tired abuse of what can be a helpful concept in modern economics in measuring national economic progress. Unless we all subscribe to the same understanding, we must avoid this abused word/concept.

A good definition is "Competitiveness is understood to mean high and rising standards of living of a nation with the lowest possible level of involuntary unemployment on a sustainable basis."[19] But this does not inform on how to measure it.

I suggest the complexity of the issue is best understood by examining the work of Ireland's tripartite[20] National Competitiveness Council. It produces an annual Benchmarking or Scorecard report covering Ireland's competitiveness performance in a comprehensive and coherent way. It has a collection of statistical indicators against a whole-of-economy comparison to 17 other economies and the OECD or EU average. Costs and labour costs are included but they are only a small part of the overall measurement of a country's competitiveness.[21] It is deeply disappointing that sophisticated analysts such as the OECD, IMF etc. still define competitiveness only in terms of unit labour costs. But perhaps it is deliberately ideological?

It is worth remembering that only 9% of EU GDP is exported (measuring the exports in value added, not gross, terms), which means EU countries are very largely competing with themselves. We do buy European, already! However, competitiveness is worth benchmarking, if done properly.

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19 European Commission Report on Competitiveness 2003

20 Unions, employers and Government, albeit with only one-eight union representation. http://www.competitiveness.ie/media/Forfas060911_Irelands_Competitiveness_Scorecard_Report.pdf

21 The areas covered include macroeconomic sustainability, quality of Life, environmental sustainability, business performance, business investment, trade, productivity and innovation, prices and costs including pay C osts, non-pay costs, employment and labour supply, employment and unemployment, the business environment, taxation, access to finance, regulation and competition, physical and economic infrastructure, ICT, Education, and research and development infrastructure.

IV. A View from a Troubled Western Island

It is essential to avoid the core/periphery break up in Europe. ***Ireland grew from one of the poorest of the poor in Europe to one of the richest in twenty years, thanks in no small part to its membership of the Union.*** It is facing enormous economic problems at present, but provided we get support in facing our staggering and perhaps insurmountable private banking debts, Ireland will recover and revert to become a net contributor to the Union's funds.

Ireland's economic collapse in 2008 was not due to poor competitiveness, nor to public sector profligacy, but to gross irresponsibility by a small elite in the private sector, operating within what had become an ultra-liberal economic system. It was the private banking collapse, which the government foolishly under-wrote which brought Ireland down. Commissioner Rehn demanded, in Latin, "pacta sunt servanda" and in English that the Irish taxpayers "respect your commitments and obligations"[22]. But these debts are not ours, but those of the private defunct banks, which our sacked government guaranteed, in our name, without our consent.

Prior to this, European banks queued up to lend to our reckless banks, while the ECB looked on benignly. Tax policy – cutting direct taxes on incomes and profits, tax breaks especially for property investment and tax-shifting – also contributed substantially to Ireland's current economic crisis. The third factor was de-regulation.

Today Irish taxpayers are repaying the bank creditors (EU banks and hedge funds) of the six Irish banks which were socialised. This is an impossible task for 1.8 million people at work, where GDP has collapsed by over 13 per cent between 2008 and 2011, GNP by over 16 per cent and domestic demand by a staggering 24.9 per cent and is still in decline. Unemployment is at 14.6 per cent. When discouraged

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22 *Irish Times, front page 14th March 2012.*

workers, those who would like to work full time, are included the official figure rises to 25 per cent. Youth unemployment is soaring and long term unemployment is 60.3 of the total.

When the Trade Unions first met the ECB, EU, IMF Troika in late 2010 when Ireland was placed in Examinership, we pointed out that Ireland has many core strengths, but that the bailout package agreed by the Government with them made the economic recovery very difficult. We said that the deflationary impacts of the measures in the package are such that growth has little chance of reviving. This has been proven to be correct.[23]

The previous government tried an experiment in Internal Devaluation because there could be no devaluation in a single currency area. Fortunately, this strategy failed.

Had it worked, the recession would be even worse. It would have sucked more demand out of the economy. Overall, the average employee who remained in work saw no decline in real hourly earnings from the beginning of 2008 when the Crash began. For some workers, in the export and other dynamic sectors, there have been small wage rises. The real losses were the considerable numbers (a huge 14 per cent fall) who lost their jobs. A recent study of how employers dealt with the total wage bill found that there had been cuts, but "however, these cuts were primarily achieved though employment reductions with relatively low contributions at the

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23 Unless one believes the technical definition of "the end of recession" with a few recent quarters of very weak growth in GDP. It will take many years to makes up for the fall of 13 per cent at current rates, especially with citizens' taxes diverted to fund the apparently endless private bank bailout.

aggregate level from changes in average hourly earnings and average weekly paid hours." [24]

This relative stability in real incomes of those who kept their jobs since the Crash of 2008 has also been extremely important in ensuring that the terrible collapse in domestic demand – of one quarter in less than four years – was not worse. This is because averagely paid workers generally spend most of their incomes. The last government also cut the minimum wage by 12 per cent but the new government reversed this immediately. It also did not cut welfare rates and there is a deal with the public service whereby there will be no further pay cuts (two of which averaged 14 per cent) provided there is support for substantial change, which is occurring.

This relative stability in real incomes, in welfare rates and in public employment is the key to the explanation of why there has been no rioting in Ireland, despite our travails. It is crucial that the core economies which are performing well, act in solidarity and not in punishment to the underperforming peripherals.

Nor should we entertain the idea of – a 'two speed' Europe, which could allow an inner core to move towards closer economic and political union supposedly "to protect the Union as a whole." To move in that direction is to abandon solidarity and to miss this opportunity to build a cohesive Europe.

V. Restoring the Wage Share of National Income.

The share of national income going to wages has fallen considerably in most developed countries since the early 1970s. There has

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24 Walsh, Kieran "Wage bill change during the recession: how have employers reacted to the downturn?" Statistical and Social Enquiry Society of Ireland, February, 2012 http://www.ssisi.ie/wage_bill_change_ssisi_kw_9feb_v5.pdf been a slight reversal in recent years, but it is forecast to fall back again. One explanation for the falling labour share and rising share to capital might be that there has been an intensification of capital investment. However, against that, there has been a huge improvement in human capital with all countries seeing major increases in educational and skills attainment. It seems that the investment in human capital is not being rewarded by increases in labour's share of national income. As less national income is going to workers, this has a secular impact on aggregate demand and thus on growth.

The issue of the decline in labour income share involves equity, social cohesion and personal income distribution, longer-term wealth distribution, macroeconomic stability and the composition of aggregate demand.

The "American Dream" of the next generation enjoying a higher standard of living than their parents has been dead since the early 1970s. Since 1975 US workers' median incomes have not risen. There are hard lessons to be learned from America. The stagnation in incomes was masked for some time because the working and middle classes borrowed against their homes. Now the home ownership dream has turned into a nightmare for many with negative equity and big debts. It was also masked by a dramatic fall in the prices of many goods now imported from Asia which reduced the cost of living. It was further masked by the growth in dual-income families, where there had only been one earner in the past. Male, unionised and in well paid manufacturing, these American workers had previously seen themselves as firmly in the "middle class."

The fall in labour's share of national income was also driven by globalisation, accelerated by technology, falling prices in transport and instant communications. In turn, these trends were accentuated by the liberalisation of borders and markets, especially labour markets.

The value of the fall between 1973 and 2011 is substantial in monetary terms. Even with the smallest decline which is in France of 3.5%, it is still a transfer of €71bn from labour's share of GDP to capital. For Germany it is €137bn.

Table: Fall in Labour Share of National Income

	1973	**2011**	**Fall**
France	62.2	58.7	3.5
Germany	63.2	57.9*	5.3
Italy	67.3	55.1	12.2
Ireland	65.3	52.5	12.8

*Source: Ameco. * West Germany only until unification.*

The decline of trade unions and the paucity of vision and lack of ambition in progressive parties, which should be counterforces to such trends, also facilitated the stagnation of incomes of the majority, in spite of economic growth and growth in labour productivity.

There is also a view that corporations and the rich should not have to pay "too much tax" as it is a disincentive to investment. Simultaneously, people are demanding more and better public services, but have been increasingly unwilling to pay for them through taxation. The aversion of many governments and major institutions like the IMF and OECD to progressive income taxes which they now pejoratively term "taxes on labour" means that if acted upon, taxation will fail to be a redistributive mechanism. It also means that the great polarisation of incomes will continue unchecked and citizens will grow even more angry and frustrated.

A Common Fiscal Policy is the key to addressing inequality, sorting out the banks and boosting demand by underwriting an EU-wide stimulus programme. It may begin with a small budget overall, but a small budget in EU terms is still a lot of cash. I would go for tax coordination[25] rather than harmonisation where Member States can set rates, within bands, though a common tax base for companies makes sense in a single market.

VI. Conclusion

The real irony in Europe is that this deep crisis was caused by neo-liberal economic policies. Yet it is conservatives who are in power in most Member States. They are prolonging the crisis with the same old failed policies and general incompetence. Some are even reverting to narrow nationalism. Instead, bold action with an EU-wide stimulus and policies informed by a longer term vision of European solidarity is required.

There is a lesson in this for us all. That is to replenish our vision by going back to core ideas, sticking to them in a principled way and being innovative in our policy responses.

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25 Sweeney, Paul, 2010, "Ireland's Low Corporation Tax: The Case for Tax Coordination in the Union." Transfer, European Review of Labour and Research, ETUI.

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For a European Wage Standard[26]

The crisis in the European Monetary Union cannot be attributed simply to the growth of government deficits in its member countries. Current account imbalances between Eurozone members and the resulting accumulation of external private and public credit and debt appear to be further causes of instability. The gap between unit labour costs seems to be one of the determinants of trade imbalances. Germany in particular, despite its systematic current account surplus, has adopted a policy of relative wage deflation in recent years that has increased this gap. The adoption of a "European wage standard" may prompt countries with surpluses to generate higher growth in nominal wages, prices and wage shares, thus helping to restore the balance in trade and safeguard European unity.

I. Current account imbalances and the crisis of European unity

The crisis of the Eurozone that began in 2010 has been interpreted and tackled on the basis of the belief that the sustainability of the European Monetary Union (EMU) is threatened by excessively high levels of public debt and deficit. This view has prevailed in the thinking of EU institutions and led nearly all of the member countries to

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26 This article represents a simplified version of E. Brancaccio (2012), "Current account imbalances, the Eurozone crisis and a proposal for a European wage standard", International Journal of Political Economy, 41, 1. The proposal for a "European wage standard" has already been included in the National Reform Programme 2011 of the Italian Democratic Party.

adopt measures aimed at slashing their state deficits drastically. Not everyone is, however, convinced by this interpretation of the crisis and the action it prompts. Numerous observers have put forward the alternative view that the crisis affecting the EMU cannot derive simply from a problem of sustainability of public finances but is associated rather with a problem of external indebtedness, both public and private. On this view, the crisis is regarded as stemming from a permanent imbalance within the Eurozone that leads to growing current account surpluses above all for Germany and systematic current account deficits for the "peripheral" countries of the EMU. This alternative interpretation arouses no particular surprise among economists of the critical schools of thought. Since the birth of the EMU it has been presented in many studies and from a variety of angles (Graziani 2002). Recently too, numerous economists of this persuasion have put forward interpretations of the Eurozone crisis in which the trade imbalances between the member countries are assessed in different ways but never disregarded (Arestis and Sawyer 2011; Bellofiore and Halevi 2011; Parguez 2011; Cesaratto and Stirati 2011).

Observation of the figures establishes beyond doubt that current account imbalances between the Eurozone countries have reached unprecedented levels during the last decade and have not narrowed in the slightest since the great recession of 2008–09. Italy's current account deficit as a ratio of GDP was 3.5% in 2010 against 4.5% for Spain, 9.7% for Portugal and 12.3% for Greece, whereas Germany had a current account surplus of 5.8%. Moreover, no substantial move towards restoring balance is expected for the end of 2011 (Eurostat AMECO estimates). But what is the empirical evidence demonstrating a relationship between trade imbalances and the instability of the Eurozone? Before the outbreak of the European crisis, numerous studies had already pointed out the importance of foreign debt as an indicator of a country's potential insolvency (Manasse and Roubini 2005) and others had highlighted the existence of a link between current account and spreads. In the case of Italy, for example, the spread between national government bonds and German Bunds has generally proved more sensitive to the current account deficit than the government deficit (Brancaccio 2008). More recently, among the studies specifically devoted to the European crisis, Barrios et al. (2009) have found that the current account has a significant influence on risk premia and the IMF (2010) that it is as important a predictor of credit default swap spreads as the fiscal deficit. The German economist Daniel Gros (2011) has also put forward a debated contribution drawing attention to the correlation between the current accounts of 17 EMU member countries in the period 2007–09 and the spreads with respect to the interest rates on German Bunds as calculated in February 2011. The statistical link is expressed by a relation that is not linear but quadratic, on the basis of the idea that the country risk incorporated into the spreads can increase more than proportionally to a rise in the trade deficit.

Gros's empirical result has the apparent merit of immediacy with respect to the evidence available in the literature but proves to be based on a rudimentary regression. As at least some of the aspects of the relationship between current account and spreads suggested by Gros thus require further examination, a deeper test has been carried out on the Euro12 countries. The complete analysis is available in Brancaccio (2012). In what follows are reported its basic results. First, a relationship between government deficits and current account imbalances on the one hand and spreads on the other appears to emerge clearly only in phases of crisis characterised by stagnation or depression of GDP. Second, among the possible determinants of spreads, foreign debt and deficit seem to be more relevant than public debt and deficit. A typical explanation offered for these results is that the spread incorporates a risk of collapse of the Eurozone and hence of exchange rates. The current account deficit can be seen as an indicator of insufficient competitiveness of the national productive system. Above all in a situation of prolonged stagnation or depression, the country in question can opt for the abandonment of the single currency and exchange-rate devaluation in order to attempt to regain some margin of competitiveness and detect new sources of demand abroad. Creditors will then be prompted to demand higher rates of interest in order to cover themselves against the risk of the devaluation of the national currency being accompanied by default and hence a fall also in the value of the bonds in their possession. Foreign indebtedness is therefore associated once again with greater risk. And it is important to emphasise that the debt in question may be accumulated not only by the public sector but also by the firms and banks constituting the private sector of the country in question.

II. The causes of intra-European imbalances: the role of the countries with surpluses

What are the causes of trade imbalances within the Eurozone? Why does Germany continue to accumulate surpluses while Greece, Portugal, Spain and Italy as well as France to a lesser degree tend systematically towards deficits in their current accounts? Until the outbreak of the recession in 2008 at least, these imbalances were examined by mainstream economists in the light of a model of intertemporal partial equilibrium with complete future markets representing a small open economy (Bergin and Sheffrin 2000). Models of this type made it possible to conjure up a somewhat optimistic vision of the prospects for the EMU, as exemplified by an influential work by Blanchard and Giavazzi (2002). The authors maintain that the increase in trade imbalances accompanying the creation of the single currency should be regarded not as a cause for anxiety but as a virtuous phenomenon attributable to the greater degree of financial integration between the EMU countries. The theoretical basis for this view is the typical neoclassical assumption that spontaneous mechanisms of convergence exist between higher-income and lower-income economies. According to the neoclassical theory of growth, the countries characterised by a lower level of production per capita will in fact be those in which capital is scarcer and hence better remunerated. These countries will therefore attract and accumulate capital, experience quicker growth of labour productivity and competitiveness, enjoy higher growth of the income, and hence be in a better position to obtain and repay loans. On the basis of this vision, Blanchard and Giavazzi claim that the increase in the trade deficits of the European countries characterised by low per capita income is no cause for concern and that no corrective action is called for. In their view, the phenomenon reflects the strong potential for growth of the countries with trade deficits and the resulting possibility for them to take full advantage of the channels of foreign debt created by the higher degree of European financial integration.

This optimistic vision of the Eurozone's internal imbalances has, however, given rise to various misgivings, not least due to its evident clash with the empirical evidence. Suffice it to say that the model of intertemporal equilibrium is based on the idea that a high foreign deficit must be accompanied by high future growth of labour productivity and hence also of income and the ability to repay debts. The figures have shown instead that the countries characterised by a marked tendency towards deficit in their foreign accounts present very modest growth of productivity and an increase in costs that is much higher than the other members of the Eurozone (Brancaccio 2008). The problem of at least partial modification of the approach to the EMU's internal imbalances has thus arisen inside the mainstream itself, giving rise to the suggestion that the markets are not capable of perfectly foreseeing future trends in the productivity, unit costs and incomes of countries with trade deficits, which may give rise to excessive foreign debt that cannot be repaid. From the theoretical standpoint, this interpretation seems to reflect the abandonment of the intertemporal analysis with complete markets and a return to the old models of temporary equilibrium (see Petri 2004 for the differences between the two). In any case, its advocates have reached the conclusion that the markets may have made a mistake in forecasting and that the current account imbalance may prove unsustainable. The upshot in terms of economic policy, in their view, is that the countries with trade deficits must endeavour to eliminate them both on the supply side, by reducing the unit costs of labour so as to increase competitiveness, and on the demand side, by a cut in deficit spending, the overall aim being to increase net exports and reduce foreign debt. This new and more problematic mainstream reading of the European situation has won the support of Roubini (Roubini et al. 2007) among others and Blanchard (2006, 2007) also appears to have been convinced in the end. At the same time, there are also implicit connections at the political level, as the interpretation offers analytical support for the most recent trends in European policy, which recognise the dangers caused by excessive imbalances in current accounts and call upon the countries with foreign deficits to shoulder the burden of remedying the situation, above all by means of austerity measures and steps to increase the flexibility of the labour market (European Council 2011).

Unlike its predecessor, this new mainstream interpretation does not overlook the implications of the Eurozone's internal imbalances and therefore appears more in line with the empirical evidence regarding the link between current account imbalances and spreads. Like its predecessor, however, the vision has a limitation in that it underestimates the problems arising from a shortage of effective demand for the EMU as a whole. Among other things, this has led to a one-sided economic policy that places the entire burden of restoring the balance of trade exclusively on the countries with current account deficits and does not involve the countries characterised by foreign surpluses in the slightest. There are, however, numerous works in the critical literature that identify the deflationary policies of the countries with trade surpluses as the primary source of the intra-European imbalances. In particular, Germany is explicitly accused of a neo-mercantilist approach aimed at the systematic accumulation of trade surpluses also through control over wages and domestic demand (Cesaratto 2011). This interpretation has indeed won a great deal of support in recent times. In an analysis expressly devoted to the current accounts of the Eurozone's member countries, the European Commission itself has identified major elements of imbalance in the policy of relative wage deflation and restricted internal demand characterising some countries with trade surpluses, above all Germany (European Commission 2009, 2010). According to this view, Germany and the other countries with surpluses should therefore also be called upon to help restore the balance in current accounts. Any attempt to place the burden of intra-European adjustment solely on the countries with trade deficits will generate further decreases in effective demand and is ultimately bound to fail.

III. The possible paths of adjustment: effective demand and unit costs of labour

Any contribution from Germany towards restoring the intra-European balance could obviously be made either on the supply side, by relaxing the policy of wage moderation, or on the demand side, through fiscal expansion or acceptance of a federal policy of transfers inside the EMU. But which of the two would be more effective? One thesis in this connection is that internal demand has a greater impact on net exports than the dynamics of unit costs (European Commission 2010). On this reading, if Germany rejects the idea of an economic policy of expansion and in more general terms the constitution of an authentic federal policy for the EU, the imbalances between the member countries are highly unlikely to be remedied. This thesis appears correct. At the same time, however, there is good reason to believe that expansionary policies would have to be backed up by action on costs. The unit costs of labour in the member countries of the Eurozone have in fact diverged strongly ever since the creation of the single currency. The case of Germany is once again emblematic. The nominal unit cost of labour registered an increase of 22.6% for the Euro17 countries between 2000 and 2010 as against only 4.3% for Germany. While this is explained to a large degree by the relative increase in German productivity, the policy of wage moderation in Germany also contributed significantly to widening the gap. Nominal salaries rose in the Euro17 countries by 27. 2% over the same period but by no more than 11.5% in Germany (Eurostat AMECO data). After countless alarms about the perils of Chinese dumping, it may prove somewhat surprising to discover that the major driving force of wage deflation is to be found inside Europe and indeed in the leading country of the EU.

According to the most recent empirical literature, differences in costs of these proportions have anything but negligible effects on current account imbalances. The tests show that variations of 1% in the real exchange rate can generate variations of the opposite sign in the current account of no less than 0.2% (Arghyrou and Chortareas 2008) and can therefore prove unsustainable in the long run (Dullien and Fritsche 2009). Among other things, these estimates are confined to examining the divergence in labour costs solely in terms of its effects on prices and hence the respective levels of competitiveness of the Eurozone countries, thus disregarding the possibility that changes in monetary unit costs may also have an effect on profit margins and hence the distribution of income. For example, if the monetary labour cost per unit produced falls in Germany, German firms may decide to reduce their prices but may also choose to leave them unchanged in order to increase their margins. Now, any increase in the profit margin alters the distribution of income with a drop in the wage share and a rise in the profit share. As a result, since the propensity to consume is generally much higher in the case of wages than profits, the shift in distribution towards the latter will lead in Germany to a decrease in demand and imports, and hence to a further increase in the German trade surplus. In addition to the customary effect on prices and competitiveness, we therefore have another unbalancing effect that operates through the distribution of income and demand for goods. While this effect cannot be regarded as exceptional, according to the most recent empirical analyses, it does not appear negligible either. In the case of Germany, for example, an increase of 1% in the wage share is associated with an increase in consumption as a ratio of GDP ranging from 0.39% in 1970 to 0.44% in 2005, and a drop in net exports as a ratio of GDP ranging from 0.13% in 1970 to 0.27% in 2005 (Stockhammer, Hein, Grafl 2007). For the Eurozone as a whole, an increase of 1% in the profit share is associated with a 0.37% drop in consumption, a 0.11% increase in net exports and a 0.19% decrease in total private demand, all expressed as ratios of GDP (Stockhammer et al. 2009). The divergence between the unit costs of labour therefore appears important also because it can affect the current account from both the supply and demand side.

IV. For a "European wage standard"

We have therefore seen that any proposal to reform the European Monetary Union should assign countries with surpluses a crucial role in redressing the balance of current accounts. These countries would be required either to shoulder the burden of implementing expansionary fiscal policies or helping to finance a federal policy of transfers. Moreover, we have also seen that if it is to be fully effective, a reform of the Monetary Union would also need to involve measures to reduce the divergence in unit costs of labour fuelled by the wage moderation policies of the countries with surpluses. Let us now examine one of these possible measures, which we shall call the European wage standard.

The hypothesis of a European wage standard originates in the broad sector of studies devoted to wage bargaining inside the EMU. In this connection, the mainstream literature focuses above all on the identification of institutions capable of ensuring that every member country has the wage flexibility needed in order to offset the effects of a centralised monetary policy. This means that any asymmetric shocks would be absorbed through the flexibility of wages in each member country (Obstfeld 1998; Calmfors 1998, 2001; Calmfors et al. 2001). It should be noted that the mainstream studies are usually based on the idea that employment and real wages converge in the long term on a "natural" equilibrium that cannot be influenced by the dynamics of nominal wages or by economic policies. These analyses therefore tend to rule out problems of effective demand for the EMU in the long run and do not address the depressive and unbalancing effects of policies of relative wage deflation in countries with surpluses. Being based on a critical theoretical approach that denies the existence of a "natural" equilibrium, the European wage standard is instead designed to address the problems overlooked by the mainstream literature. The hypothesis of a standard is based in this sense on three key rules: 1) First, all the EMU countries would be required to guarantee that the growth of nominal wages with respect to the growth of labour productivity is such as to generate a convergence of wage shares towards an objective level of the wage share that acts as an "attractor" for all the member countries, which must therefore be no lower than the level existing in each of them. The objective is to halt what is now a 30-year fall in the wage share in Europe: the wage share fell by 12.7% in Italy, 11.2% in Spain and 9.7% in France between 1980 and 2007 as against 6.5% in Germany between 1991 and 2007 (AMECO database). In this way, it should be possible to contrast the resulting tendency towards recession (Stockhammer et al. 2009), and foster a tendency towards alignment of the wage shares in the EMU in the long term. 2) Second, above the minimal level of growth, the standard would link the growth of nominal wages with respect to labour productivity to the balance of trade so as to foster a return to equilibrium between countries with trade surpluses and those with deficits. In particular, the countries characterised by systematic current account surpluses would be required to accelerate the growth of nominal wages with respect to labour productivity. The countries in current account deficits would be required to keep nominal wage growth with respect to productivity below that of countries in surplus. This increase can contribute to the absorption of trade surpluses in two ways. First of all, on the assumption that a rise in the nominal wage is accompanied by a rise in inflation, the country in question will tend to lose competitiveness. Furthermore, if the growth in nominal wages determines growth in the wage share, the average propensity to consume, aggregate demand and imports will all increase. Either the effect on prices or the effect on the wage share will obviously tend to predominate depending on the speed of renegotiation and the degree of wage indexation. 3) The final element concerns powers of compulsion. Countries where nominal wages diverge from the dynamics imposed by the standard would be subject to sanctions similar to those envisaged in the European treaties for countries with "excessive" levels of public deficit (the reference is to the well-known article 104 of the Treaty of the European Union and the associated protocol on excessive public deficits).

In short, the first cornerstone of the European wage standard concerns social redistribution and the second the balancing of trade surpluses and deficits. At the same time, however, both are designed in overall terms to stop relative wage deflation and stimulate European demand and income. More specifically, the first pillar of the standard sets a wage share higher that those currently existing, which should act as a long-term "attractor" for the wage shares of all the member countries. The second is designed to act on inflation and/or wage shares, which should help in turn to restore the balance of current accounts (a formal representation of the working of the wage standard is in Brancaccio (2012)).

It is important to note that the obligation to increase nominal wages is not the only way for the country in question to absorb its trade surplus. What counts in this connection is that the country will be obliged to allow wages to rise until it has managed to absorb its trade surplus. This in itself already constitutes a deterrent against deflationary strategies and a stimulus to help restore the balance in trade through a broader range of expansionary policies. For example, in order to avoid the inflationary dynamics imposed by the wage standard, a country with a foreign surplus may be prompted to focus its entire strategy of economic policy on restoring the balance in trade. The standard is thus conducive to the adjustment of current accounts also indirectly, by stimulating a broader spectrum of policies.

The effectiveness of the wage standard is directly proportional to the extent to which the dynamics of nominal wages in relation to labour productivity is guided by collective bargaining on wages and working conditions. A strengthening of national collective contracts and their coordination at the European level therefore appear to be necessary conditions for the determination of a framework of industrial relations in line with the logic of the standard. The result is an endogenous change in the institutions of the labour market moving in the opposite direction from the one called for by the mainstream literature and imposed by the present tenets of economic policy (European Council 2011), which place the entire burden of restoring balance on the countries with trade deficits and hence focus on flexibility of the labour market and weakening the trade unions' bargaining powers.

V. Origins and features of the wage standard

As already noted, the European wage standard constitutes in various respects an invitation to reverse the approach to wage bargaining within the EMU usually advocated in the mainstream literature. It should be clarified at the same time, however, that the idea of the wage standard is not born out of nothing. It can be regarded as a synthesis of the scarce currency clause – originally put forward by Keynes (1980) and then incorporated in a weakened form in the statutes of the International Monetary Fund – and the "labour standard" clauses whose inclusion in international trade agreements has long been advocated by the International Labour Organisation (ILO). What is drawn from the former is the crucial Keynesian insight that crisis can only be averted and peace between the nations guaranteed if the burden of redressing the balance of trade is shifted from the shoulders of the debtor countries onto those of the creditor countries through an expansion of demand in the latter rather than a contraction in the former. The element drawn from the labour standard is instead the need to impose sanctions on the countries that fail to provide certain minimal conditions of protection for workers.

The wage standard also presents some innovations with respect to the clauses from which it draws inspiration. It differs from the scarce currency clause in that, with a view to safeguarding the European single market, it envisages pecuniary sanctions rather than restrictions on trade for countries failing to meet the set levels. With respect to the ILO labour standard, the wage standard does not focus on protection for labour but more specifically on wages. At the same time, unlike the ILO's proposal, the wage standard does not confine itself to setting a minimal level of protection in absolute terms but seeks rather to set a minimal growth for nominal wages and wage share in comparative terms with respect to the dynamics of the current account of the country in question. This characteristic has important consequences in that while the logic of the labour standard mostly tends to impose sanctions on the less developed countries – and has often been criticised for this very reason – the wage standard can penalise the richer countries (especially those that persist in relative wage deflation even though they are in a position of strength characterised by a constant accumulation of trade surpluses).

Finally, there is one further characteristic of the European wage standard that should be taken into consideration. As we have seen, its purpose is to determine convergence at the European level as regards wage shares alone. It is not designed to make the real wage levels of the EMU member countries converge. It should be recalled in this connection that in the presence of divergent levels of labour productivity, any convergence of real wages would entail an automatically widening gap between the prevailing profit margins in each of the EMU member countries. This gap would ultimately accelerate the processes of capital centralisation and "mezzogiornification" of the EMU periphery (Krugman 1991; see also Brancaccio and Fontana 2011). The possibility of a convergence of real wages can therefore only be conceived within the framework of a different and far more ambitious regime of European economic and industrial policy aimed primarily at securing an alignment of labour productivity. In the absence of this, the objective of the convergence of wage shares envisaged by the European wage standard already appears quite demanding enough. The proposals for a setting a lower threshold for real wages, such as the initiatives for a European minimum wage, are a different matter (Schulten et al. 2006; Schulten 2010). There is no reason, however, to consider that these proposals are incompatible with the logic of the wage standard.

VI. The wage standard and European economic policy

It should be made clear that the wage standard cannot be conceived as a "foreign body" to be inserted into an unchanged European institutional palimpsest. Its adoption would in fact have unavoidable consequences on the overall framework of EMU economic policy. In order to bring both into line, it would first be necessary to reform monetary policy by raising the ceiling on inflation, which is currently set at a maximum of two percent in the medium period. Moreover, in order to avoid structural trade imbalances affecting the EMU as a whole, a more general "wage and labour standard" would have to be adopted in relations with non-EU countries. Finally, it should be recalled that intra-European balance cannot be restored solely through action on wages but requires above all the adoption of adequate expansionary economic policies on the part of the countries with surpluses and indeed of the EU as a whole. ***The wage standard should therefore be seen as a small part of a broader approach to economic policy designed to jettison the logic of wage and social dumping and develop an "internal" driving force of European economic and social development.***

The wage standard ultimately constitutes a mechanism of coordination that implicitly calls the treaties now in force and the present European political and institutional system into question to a by no means negligible extent. So, what reasonable grounds are there for thinking that it could ever be implemented? Without going into the details of a problem that is essentially political, it may be interesting to note that the standard highlights a possible link between the general interest in European unity and the interests of European workers, be they German, Italian or Greek. In point of fact, the standard appears capable at the same time of guaranteeing Europe a new and more balanced form of development and generating potential convergence of objectives among workers from different countries even in the event of divergence in their respective labour productivities. This would be something completely new in a European scenario where labour negotiations have seldom gone beyond national borders and there has sometimes been open conflict between the workers of the different European countries. The standard would turn this scenario upside-down in a certain sense. For this reason, it does not appear in any way exaggerated to describe it as an unprecedented concrete and not merely rhetorical example of new internationalism of labour, a characteristic that may also account for the attention it has received in some political circles. The signs of interest do not of course make it reasonable to suppose that we are just a step away from a turning point in EU economic policy. On the one hand, the attention to alternative tools of European political coordination still appears to be limited. On the other, there does not appear as yet to be any focus on the problem of trade imbalances.

Attention should be drawn, however, to the new development at the level of political awareness. The prolonged continuation of the crisis appears in fact to be accompanied by a growing realisation that European unity is threatened, among other things, by centrifugal forces that are widening the trade imbalances to potentially unsustainable levels. Any attempt to counter these forces by means of the customary laissez-faire prescriptions could have results opposite to those expected and do potentially irreparable damage. Regardless of the survival of the present Eurozone, an alternative platform of economic policy is the only logical basis upon which the lost sense of unity can be regained.

VII. References

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This article represents a simplified version of E. Brancaccio (2012), "Current account imbalances, the Eurozone crisis and a proposal for a European wage standard", International Journal of Political Economy, 41, 1. The proposal for a "European Wage Standard" has already been included in the National Reform Programme 2011 of the Italian Democratic Party.

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A role for wage setting in a new EU economic governance architecture after the crisis

I. Introduction

Important lessons for wage setting in Europe need to be drawn by policymakers, including trade unions, from the economic crisis and the period that preceded it. This is the case particularly within the euro area, where the absence of exchange rates means that the competitive position of domestic firms is determined by relative goods prices of which the most important driver is unit labour costs (ULCs). The existing governance regime has clearly failed. A new institutional architecture is currently being developed in Europe in a process itself driven by political crisis. The outcome of that process is far from clear at the time of writing. This contribution focuses on a possible contribution for wage-setting or 'wage policy' as part of a broader reform of economic governance.

Macroeconomic imbalances have been shown by the crisis to be a serious problem, also within a monetary union. Prior to the crisis some countries ran large and persistent trade and current account deficits, others surpluses. These necessarily require financial transfers from surplus countries to those running deficits. The only question is what form such transfers take. Before the crisis they consisted primarily of a piling up of financial claims on the private and public sectors of deficit countries on the southern and western 'periphery' of the euro area in the banks of countries in the 'North', above all, Germany. The crisis led to doubts as to whether these debts could be repaid, and lending dried up ('sudden stop'). The authorities had to step in, channeling public funds in various forms (ECB support for banks, the European Financial Stability Facility etc.) to the deficit countries.

Unable to devalue to restore price competitiveness, but lacking the benefits of the automatic transfers that normally assist adjustment in monetary unions[27], the 'peripheral' countries faced the major challenge of consolidating their public finances while at the same time needing to improve their competitiveness relative to the core. This relative improvement could be achieved via European investment support (to raise productivity, although this takes time) and expansionary policies on the part of surplus countries (especially Germany). However, lacking leverage over core countries, and increasingly under the political diktat of these countries, they have so far been forced into deflationary policies, condemning them to a long period of recession and stagnation. Moreover, this is also having negative implications for the currently more resilient, but export-dependent, economies in the euro area and beyond. This risks condemning the European economy as a whole to an extended period of fiscal austerity, slow growth and high unemployment. This is precisely the opposite of the vision of smart and inclusive growth set out in the EU 2020 strategy (Leschke/Theodoropoulou/Watt, 2012).

A look at the facts clearly confirms the close empirical link between wage setting (specifically nominal unit labour costs) and current account imbalances.

27 *In a monetary union such as the US or UK the national income tax, unemployment benefit and other systems 'invisibly' transfer resources from wealthy regions to poorer ones with high unemployment without the need for an explicit bail-out.*

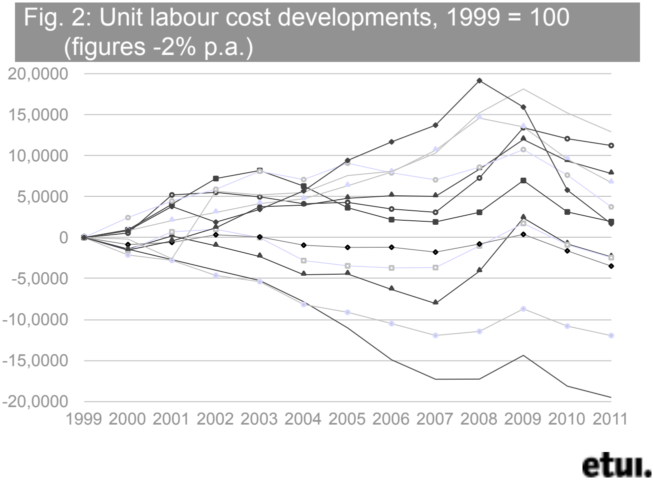
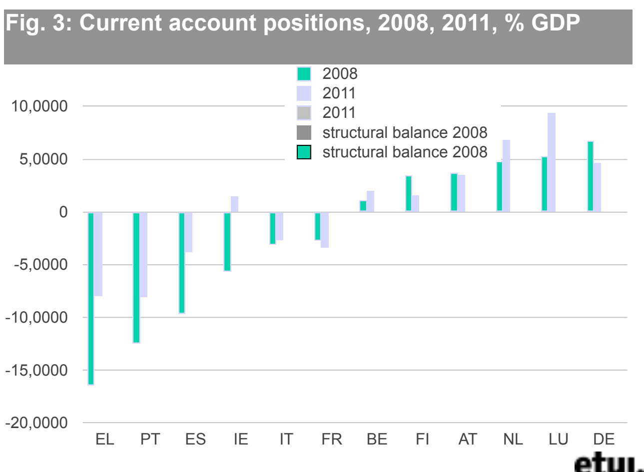


Figure 1.



Data source: AMECO

Figure 2.

Euro area countries in which unit labour costs – the labour costs in current euros of producing one unit of GDP – rose faster than the average (such as Greece, Ireland, Italy, Portugal Spain – the 'GIIPS') were those countries that had the largest deficits by 2008, when the crisis hit. Conversely Austria and, especially, Germany had below-average unit labour cost growth and large current account surpluses.

II. The causes of macroeconomic imbalances

One must beware of drawing premature conclusions from this correlation, however. It is vital to understand how the imbalances came about and how they can be avoided in the future. Too often the simplistic conclusion is drawn that excessive wage growth has ruined the competitiveness of the southern euro area countries, making it impossible for them to recover from the crisis and service their public debt, and requiring bail-outs by countries that have followed 'prudent' wage policies. The solution, widely considered self-evident, is to cut wages in the GIIPS countries. And the appropriate way to do that is supposedly to decentralise wage bargaining in order for wages to be set at a level closer to 'the market' and thus in a way that is sensitive to competitiveness considerations.

Let us start with unit labour costs. For a given rate of productivity growth the growth of nominal wages determines the pace of growth of nominal unit labour costs. Both empirically and theoretically these are in turn closely linked to the rate of price increases (Watt, 2007). Within a monetary union, that is where there is no possibility of a nominal exchange-rate adjustment, changes in relative nominal unit labour costs are equivalent to changes in the real exchange rate, the measure of a country's international price competitiveness. Thus the gap in ULCs in figure 1 can be interpreted as a measure of the change in price competitiveness of countries within the euro area since it was established.[28]

Correlation does not necessarily imply causation, however. It is argued here that the problem of macroeconomic imbalances arose as a result of the whole structure, the 'rules of the game', of EMU. Curing such imbalances and preventing them occurring in the future needs a more effective and balanced system of economic governance for EMU, within the framework of which wage-setting also needs to be considered as a 'matter of common concern' across national borders and is coordinated.

How did the institutional structures and economic characteristics of EMU generate imbalances?[29] On joining EMU, previously high-inflation countries which had had high interest rates benefited from a sharp fall in borrowing costs, setting off a – seemingly – virtuous circle: these fast-growing, high-inflation economies enjoyed relatively low real interest rates (the common ECB-rate minus their high inflation rates), while slow-growing, low-inflation countries were in a vicious circle (suffering from relatively high real interest rates). This dichotomy was exaggerated by the one-sided nature of the Stability and Growth Pact (SGP): slow-growing economies were up against or over the 3% limit and prevented from pursuing expansionary fiscal policies, while faster-growing economies were not constrained to run tighter policies: Spain and Ireland had no problem sticking to the Pact thanks to their much faster pace of nominal GDP growth.

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28 *Of course EMU countries also trade with countries outside the monetary union. We focus, though, here on intra-EMU trade. This is not only to simplify the exposition: the overall current account position of the EA has consistently been very close to balance throughout its history. It is the intra-area imbalances that are key.*

29 *For an early analysis of this problematic and warning of trouble to come, see Allsopp/Watt 2003.*

On the back of low interest rates, asset (especially house) prices rose rapidly in the peripheral countries, creating wealth and confidence effects that further stimulated spending and borrowing. Capital was channelled from the core to the periphery to finance asset purchases and, more generally, to finance the current account deficits. This dynamic spilled over into the labour market. Employment growth was strong – Spain created more than one third of all the net jobs created in the euro area up to 2007 – and unemployment fell significantly, by around 4 percentage points in Greece, Spain and Italy (although this only brought it down from very high to still rather high levels). By contrast – and this fact is now often overlooked – Germany's labour market performance was extremely weak during the pre-crisis EMU period. Unemployment remained broadly constant at an elevated level (above 8%) and German job creation was weak (especially considering the fact that many of the job creations recorded in the statistics consisted of 'mini-jobs' offering very short working hours and low wages).

This situation led to a situation of sustained nominal wage/price 'spirals' – wages and prices chasing themselves upwards – that span faster in some countries than in others. The combination of faster-rising prices and a stronger dynamic of domestic demand in deficit countries restrained their exports while fuelling import demand; current accounts moved inexorably into deficit, by 2008 to more than 10% of GDP in Greece, Portugal and Spain (Figure 2). The reverse happened in surplus countries. In Germany domestic demand was essentially stagnant – as were real wages – and such economic growth as it achieved was driven solely by higher net exports. From 2004 on Germany, the largest economy in the euro area, accounting for almost a third of output, posted a current account surplus of 5% of GDP, steadily rising to peak at almost 8%.

It is worth emphasising that the differentials in the rates of price or unit labour cost inflation between EMU countries in any one year were not very large – typically one or two percentage points. The wage-price 'spirals' cannot be compared with those of the 1970s. The problem was that they were repeated year after year, without correction. Thus the competitive imbalances built up inexorably over time. It is also vital to recognise the symmetrical nature of the imbalance. The deficit countries had ULC growth above the benchmark of 2% p.a., the surplus countries below it (Figure 1 above).[30] This is why it is incorrect to argue, as so frequently occurs in the public debate, that the deficit countries are the only ones that need to adjust, or, put simply, that everyone must become like Germany.

Competition between Member States on product markets was supposed to act as a brake on this cumulative causation. The dampening effect of higher internal prices on deficit-country exports would weaken overall demand, forcing wages and prices down. Conversely, stronger exports in surplus countries would boost growth and push up wages and prices. This mechanism proved very weak, however, and year after year the same countries posted substantial and indeed growing deficits and surpluses. In sum, over time competitiveness deteriorated in the former group of countries and improved in the latter group. Current account imbalances built up.

Other factors also played a role. Differential demand dynamics on foreign markets have been invoked (Janssen, 2011). Germany, in particular, certainly benefited from dynamic demand in China and other emerging markets for capital goods, in the production of which it has a comparative advantage. Meanwhile, southern European countries, many of whose exports were in competition with emerging economies seeking to move up the value chain, struggled to maintain market share. Given that this trend has to be taken as a

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30 The reason that 2% is taken as the ULC benchmark is that this is the rate of inflation targeted by the ECB. As noted before price inflation and ULC developments are very tightly correlated. Thus ULC growth at this benchmark rate stabilises inflation at the rate targeted by the central bank. We return to this important point in the next section.

‘given’, though, this fact does not alter the conclusion that a competitiveness crisis had arisen that requires a correction in relative prices and wages; in fact it strengthens that conclusion. It is also true that the mirror-image deficits and surpluses were readily financed by a liberalised financial sector which exhibited typical ‘financial accelerator’ properties: the rising price of assets such as Spanish housing led to yet more lending and a steadily inflating bubble.

Be that as it may, the developments in current account imbalances were clearly unsustainable. A persistent deficit has to be financed by borrowing from abroad while countries running surpluses pile up financial claims year after year on deficit countries. In the crisis these capital flows came to a sudden stop. At the end of the day the imbalances manifest themselves as a competitiveness crisis. The competitiveness constraint then suddenly became binding as the internal dynamic reverses: virtuous circles turn vicious. Private lenders are no longer willing to finance deficits. Deficit countries are forced to cut domestic consumption and relocate production in favour of tradable goods (i.e. raise net exports). Meanwhile the financial institutions in the surplus countries face substantial losses on their foreign loans. This dynamic was a key element in the unfolding of the economic and financial crisis in Europe from the second half of 2008. It is a process that, at the time of writing, has not ended.

In short we see that, on the one hand, wage-setting was inextricably tied up with the emergence of current account imbalances. However, the relationship is not a simple line of causation from wage policy to competitiveness differentials to current account imbalances and then crisis. Rather the whole design of EMU was such that it gave rise, given the starting conditions, to both the imbalances and the wage and price differentials. This strongly suggests that wage policy was one factor behind the imbalances, but that given the other failings of the economic governance regime, it could not in the past, and in future also will not be able to, resolve the competiveness issues and current account imbalances on its own. "Cut southern wages" is a specious policy response to the competitiveness crisis.

We now consider the implications of this analysis for wage-setting in a monetary union in more detail. We first take a theoretical and subsequently a more practical approach to this question.

III. A role for wage setting in a policy mix for growth and jobs

Improving and deteriorating international competitiveness is actually a matter of prices (and especially those of traded goods). Even so, the pace of aggregate *nominal* wage increases is a decisive factor for macroeconomic imbalances because nominal wage and price increases tend to move together, as the one drives and justifies the other: faster price increases feed higher nominal wage demands, while faster wage growth pushes up domestic firms' costs, while at the same time creating scope on the demand side for higher prices. And it is not just wage developments in the tradable sector (often approximated by manufacturing) that are crucial. This is because manufacturing buys in many domestic services that therefore influence its cost base (Horn et al., 2007). And even in the sheltered sector the pace of wage growth is important for import dynamics. [31]

It is important to emphasise a related point in this context. The fact that *nominal* wage and price increases are closely correlated also means that *real* wage increases – which is what workers and the unions that represent them are ultimately interested in – are not closely linked to the pace of nominal wage growth; decisive for real wage increases is, rather, the rate of productivity growth.

These theoretical interlinkages (and their limitations) can be seen in the figures for the euro area countries collated in Table 1.

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31 It is surprising how many commentators focus solely on exports, forgetting that imports are just as important in determining the current account position.

Table 1: Wage, price and productivity variables, %-change 2000-2008

	NW	RW	Pdty	ULC	P
BE	25.6	5.8	6.4	18.0	18.7
DE	8.9	0.5	8.9	0.0	8.3
IE	56.4	25.7	10.4	41.6	24.4
EL	52.1	16.7	18.7	28.2	30.4
ES	35.9	0.4	3.9	30.8	35.4
FR	25.0	5.6	6.0	18.0	18.4
IT	27.2	4.4	1.3	25.7	21.9
LU	26.7	-4.9	1.8	24.5	33.2
NL	33.1	9.3	11.7	19.1	21.8
AT	21.0	5.7	11.8	8.2	14.5
PT	30.0	3.8	5.7	23.1	25.3
FI	30.7	17.7	13.7	14.9	11.1
EA-12	22.2	3.3	6.7	15.7	18.2

Notes: NW ('nominal wage') = nominal compensation per employee

RW ('real wage') = real compensation per employee, GDP deflator[32]

Pdty ('productivity') = GDP per person employed, constant prices

ULC ('nominal unit labour costs') = Ratio of compensation per employee to real GDP per person employed

P ('prices/inflation') = GDP deflator

Source: AMECO

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32 The GDP deflator is used to measure prices and calculate real wages. Unlike the consumer price index this measure focuses on the prices and costs of domestic production. (See earlier footnote.) The period 2000-2008 was characterised by rising energy prices: consumer price inflation was rather higher.

Looking first at the EA-12 aggregate we see the roughly parallel increase in prices and unit labour costs. Real wage growth was much closer to productivity gains (although still lower) than to nominal wage growth. With some exceptions these patterns hold broadly across the countries. Picking out some examples we see that despite the fact that nominal wage growth in Spain was about four times the rate in Germany, the rate of real wage increases in the two countries was almost identical. Germany differs from the rest – and given its weight this affects the euro area average – in having a substantial difference between productivity and real wages and between nominal unit labour costs and prices. We will return to this below: suffice it to say here that this reflected a major shift in national income away from labour and in favour of capital in this period.

Summing up two important findings for nominal wages, these interlinkages imply that faster nominal wage growth to the extent that it is associated with faster price inflation does not raise real wages. Conversely, nominal wage moderation does not reduce the pace of real wage growth provided and to the extent that it is reflected in slower price inflation. If we now recall that wage bargains are always struck in nominal (cash) terms, we can draw some stylised conclusions for wage policy in a monetary union.

Let us first consider a situation where national economies within a monetary union are 'in balance', implying that each has low unemployment, stable inflation, and small current account deficits and surpluses. Then suppose that nominal wages grow at a rate equal to the sum of medium-run national labour productivity growth plus an allowance for the rate of inflation that the monetary authority considers compatible with price stability.[33] In such a situation all countries experience the same rate of growth of unit labour costs and this rate is close to what the monetary authority considers

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33 For a more detailed and technical exposition of this section see Watt 2007.

compatible with 'price stability'. If, furthermore, there is no shift in national income between profits and wages, then domestic price inflation will increase at the same rate as ULCs.

For as long as these conditions hold the central bank can allow the economy to grow vigorously and keep unemployment low or drive it down. Indeed, in the case of the ECB, it would be obliged to do so by its secondary mandate (to support the goals set out in the Treaty), given that its primary mandate (price stability) would be assured. This remains true for all that the ECB has sought to downplay this obligation. Meanwhile, real wages in each country grow in line with the medium term rate of productivity in that country and workers' share of national income is stable.

Taking medium term productivity growth helps to smooth out cyclical fluctuations. Using the central bank inflation target as a guideline, rather than current price inflation, does the same, and, crucially in the light of the above discussion, prevents nominal wage and price developments in member countries diverging over time. Taking national productivity growth promotes social and regional cohesion within countries. Yes, in a physical sense the rate of productivity growth differs between sectors. But the outcome outlined here – uniform increases across sectors – is compatible with that due to changes in the relative prices of goods produced by different sectors. Indeed, this is what we see in practice: the price of, say, haircuts, rises relative to those of mass-produced widgets, while substitution between, say semi-skilled hairdressers and widget makers tends to balance their wages. Meanwhile individual producers have an incentive to raise their productivity: if they beat (underperform) the sectoral average they earn higher (lower) profits. This is not the case in a stylised 'superflexible' wage-setting system idealised by some liberal economists and policymakers: if workers' wages responded immediately and completely to the productivity of the individual plant there would be no incentive at all to raise productivity.

Overall, this is a policy mix, with wage-setting at the centre that not only avoids macroeconomic imbalances but also maximises growth and employment opportunities and real incomes, while maintaining price stability. It does not ignore differentials of productivity levels or growth, nor country's different production and export specialisations. All countries should indeed strive to raise productivity and adapt their specialisations. To the extent that productivity-enhancing policies are successful, the pace of both nominal and real wage growth can and should increase. Productivity is the cloth from which the cloak of real living standards is cut.[34]

Now let us consider the case where the starting point is one of substantial current account imbalances. If these are to be corrected[35], the rate of nominal wage growth should be lower than indicated by the above formula in deficit countries and higher in surplus countries to bring countries back into equilibrium. This wage norm – nominal wage growth in each country equals medium term national productivity growth, plus the target inflation rate of the central bank, plus/minus a competitiveness correction in surplus/deficit countries – can be seen as the "Golden Rule" of a monetary union (Watt 2010).

It would be sensible to apply a cut-off point or floor to this rule, such that negative nominal wage growth (i.e. pay cuts) in deficit countries should be avoided in order to avoid the risk of cumulative deflation (as opposed to relative disinflation). To put it another way,

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34 Clearly, it is a highly stylised model. Among other things it assumes high mobility of labour within a country (which to some extent in Europe is an arbitrary geographical area from an economic point of view), and limited labour mobility between countries.

35 The existence of small current account imbalances even in the long-term may well be considered an 'equilibrium' feature of economies in a monetary union, reflecting economic catch-up, demographic factors etc. I do not enter the debate here as to exactly when an imbalance should be considered excessive.

a nominal wage freeze would be the most severe adjustment path envisaged under such a rebalancing strategy. ***A somewhat higher overall inflation target would facilitate inter-country adjustment while avoiding costly deflation, by permitting faster wage and price increases in surplus countries*** (Allsopp/Watt 2003, Blanchard 2010).

We have thus outlined a model under which, if its conditions are met[36], current account imbalances can be reduced while, in the short-term, maintaining output and employment as far as possible in both deficit and surplus countries. Moreover, in the medium and longer term it would avoid the creation of imbalances between countries and keep the whole currency area on a balanced growth path with low inflation and high employment.

So much for theory.

IV. Wage setting in practice

Wage-setting, as is well known, is decentralised within the monetary union, while it is centralised and/or coordinated at national level, but to varying degrees. There is a very limited set of institutions and procedures all of them extremely weak, to monitor and guide wage setting in the Member States at transnational level (see Schulten 2005 and Glassner/Watt, 2010 for an overview). Examples include: the ETUC Coordination of Collective Bargaining (CCB) Committee

36 An obvious question is whether (domestic) price rises above the rise in ULCs (and thus a shift in national income from wages to profits) can be avoided. As we have seen, this trend was prominent in Germany during the 2000s. Briefly, in conditions of close-to-full employment this should not occur over an extended period. Specific flanking policies (touched on below) might be advisable to limit firms' pricing power and/or to stabilise and strengthen collective wage bargaining systems. For more details see Watt 2007.

and the CCB Committees of some sectoral European Trade Union Federations, the Doorn process bringing together the metal sector unions of Germany and the Benelux countries, and formal or informal 'benchmarking' by some countries against, in particular, German ULC developments. At the EU level there are a number of relevant institutions and processes: the Macroeconomic Dialogue (Koll, 2005 and Watt, 2006), which brings together the European Commission, the ECB the social partners and a number of Council committees, statistical monitoring of wage developments by Eurostat and the ECB, and wage monitoring within the Economic Policy Committee of the ECOFIN Council. Most recently the Excessive Imbalance Procedure has been initiated as part of the so-called 'six-pack' of economic governance reforms. Under it nominal unit labour cost developments (and thus implicitly nominal wage growth) are to be monitored (Watt, 2010b and Janssen, 2011b).

A sober analysis and the experience of the years leading up to the crisis show that none of these weak coordination instruments, neither those within European trade unionism, nor the existing external technical and political bodies, has been able to exert a significant influence on nominal wage setting in the face of those forces within EMU (asymmetrical fiscal policy, free capital flows), which create the pressure for diverging nominal wage (and price) trends. This strongly suggests that additional efforts would be needed to strengthen existing coordination instruments, and possibly establish new ones, as part of a broader-based move towards more coordinated economic policy setting in a post-crisis euro area. Clearly wage coordination cannot sensibly be pursued on its own and will certainly fail if, for example, national fiscal policy is not similarly constrained to reduce divergences in the pace of demand growth with respect to domestic supply and financial flows between countries are allowed to be driven untrammeled by shifting market sentiments.

V. The challenges of the economic and political context

For European trade unions the current constellation represents a serious threat. The question is whether it can also be grasped as an opportunity.

The threat is very real. It is what we have seen unfolding across the euro area in the past two to three years. The public authorities are seeking a deflationary solution. They are attacking collective wage setting against the background of high unemployment and fiscal austerity. This is particularly the case in countries in need of external support: Greece, Ireland, Italy, Spain and Portugal. Essentially these countries are being blackmailed into 'reforms' under the pretext that this is necessary (indeed: the only way) to correct imbalances and re-launch growth. The surveillance of macro-imbalances under the Excessive Deficit Procedure promises to be applied in a one-sided and thus deflationary way and without representation from the side of workers. Adjustment will be sought through wage (moderation) policies without due regard to the need for other policies (especially national fiscal policy) to ensure balanced development across the euro area.

It is, admittedly, hard to see at present, but the situation could give trade unions an opportunity to put themselves forward as key, indeed indispensable, macroeconomic actors to ensure the smooth functioning of the monetary union, which in turn would increase their ability to realise trade union goals of more and better jobs, ensuring rising living standards for working people and avoiding beggar-thy-neighbour strategies. If they can deliver wage outcomes that approximate to the 'Golden Wage Rule' they have something with which to bargain with other actors. Ultimately this requires changes in the political leadership of key Member States and the European institutions. Assuming that a major break-up of the euro area can be averted in the meantime, there are signs that this may be occurring. The complete failure of the dominant centre-right parties to resolve the crisis is becoming every day more and more apparent, which can be expected to open up avenues for progressive change and reform.

If European trade unions want to journey down this road they would, as a precondition for playing that role, need to 'invest' more than has previously been the case in their own autonomous cross-border wage-coordination activities. At the same time they would need to campaign effectively and alongside political allies for institutional changes in order to strengthen the effectiveness and inclusiveness of national bargaining systems and move towards a coordinated economic governance framework. Such a framework must be one in which appropriate fiscal and other policies are combined with appropriate (in the sense of the Golden Rule) nominal wage setting to deliver balanced and growth-friendly overall outcomes.

Even if it is unclear how feasible obtaining such a conductive political environment in the EU might be, it is useful to envisage the contours of a possible progressive consensus about a new economic governance structure emerging in which wage-setting would play an important role. What could such a structure look like?

VI. A 'grand bargain' for greater economic policy coordination centered on a golden wage rule

Based on the lessons from the crisis, the empirical and theoretical insights described above and in the light of the current economic and political constellation in Europe, a 'grand bargain' could be envisaged in which greater economic policy coordination goes hand in hand with a strengthening of wage policy coordination with the aim of ensuring regionally and socially balanced, job-rich growth throughout the euro area. Cornerstones of such an approach can be set out as follows.

- All policymakers recognise that macroeconomic imbalances have arisen in the euro area as a result of design faults within economic governance that need to be rectified symmetrically in the direction of greater policy coordination. Within that framework greater coordination of wage-setting is a necessary but far from sufficient component.

- Europe's trade unions recognise the centrality of wage-setting within the EU and especially within the monetary union in order to ensure balanced economic development and promote high levels of employment and rising living standards.

- Trade unions have the competence and the responsibility for nominal wage setting, a role cannot be played by other actors. It is recognised that attempts to weaken existing collective bargaining institutions are not the way forward. On the contrary such institutions need to be strengthened if nominal wage setting is to fulfill its needed function within EMU and nominal wage outcomes are to be in line with the above "Golden Wage Rule".

- Consequently Policymakers refrain from attempts to impose one-sided and top-down constraints on wage setting. Labour must be adequately represented on all technical and political decision-making and advisory bodies at both the European and national level dealing with wage-setting.

What would be the implications of such an approach for the different actors and policy areas?

Within such a framework the ETUC would commit itself to working both with other European actors and in its autonomous actions with affiliates towards strengthening the coordination of wage policy in Europe in pursuit of the above goals. Within a more coordinated policy framework it would seek wage developments in which real wages move in line with medium term productivity and nominal wages are set responsibly such as to contribute to avoiding imbalances and rectifying existing imbalances and underpinning price stability from the wages side ("Golden Rule"). In this context it insists on the need for such wage norms to be respected in a symmetrical way and for other actors to avoid beggar-thy-neighbour strategies and policy recommendations.

National fiscal policy needs to be considered within the macroeconomic imbalances framework. Guidelines for and constraints on national fiscal policy must be symmetrical, decisively breaking with the tradition of obsessively focusing on current (or even structurally adjusted) deficits. A country's current account should be an important determinant of its appropriate fiscal stance. A mechanism must be introduced that excludes public spending that raises future potential output from consideration in the analysis of the current budget position.

The Macroeconomic Dialogue (MED) needs to be brought out of the shadows and decisively strengthened in the direction of a permanent secretariat. It should be mentioned explicitly as an actor as part of the process of enhanced European policy coordination foreseen under EU2020 and the proposed economic governance reforms and be in a position to contribute as an institution to the public debate. A specific MED for the euro area should be established. MEDs could be established at national level, organised in different ways depending on the national traditions and ensuring a real dialogue. Appropriate articulation between the national and European levels is needed.

The social partners should be given observer status at euro group meetings and on all technical committees (EPC etc.) addressing wage issues. A social partner advisory board to the ECB should be established, as exists in a number of EU Member States' central banks. Trade unions require support from public authorities in their efforts to rebuild collective bargaining institutions at national level and governments and EU policymakers must desist from enacting and recommending policies that serve to weaken them.

Alongside wages it is vital that EU policymaking bodies and technical committees also address issues of price setting and take distributional matters into account – both functional and personal distribution – when setting policy. Underpinning the concern with distributional fairness, ***Europe should commit to an open method of coordination to render effective a European wage norm so that the lowest wages in each EU country should be at least 50% of the national average.***

VII. Conclusion

The ideas underpinning this paper have been developed over a long period with a view to making the 'actually existing' monetary union work better overall, and especially to make it work better for ordinary workers from all the member countries. Yet now the very future of the monetary union is at stake. Only a further integration of policy offers lasting answers to Europe's challenges and can generate higher living standards and employment opportunities for Europe's workers. Constructing a grand bargain along the lines proposed here is difficult. It requires cooperation from a variety of actors. The fundamental threat to the existence of the monetary union we now face seemingly makes a move to a progressive alternative more difficult. Unfortunately recent proposals coming from European-level authorities and conservative-run Member States seem to suggest that they continue to favour an approach that is top-down and asymmetrical. Such an approach clearly will not work.

There is a window of opportunity, at least, to try a more constructive path forward. It would be a tragedy if the monetary union would first have to fail for Europe to change course.

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Greece: A Question of Moral Responsibility

Athens is a city on the edge, and not just because of the protests. It was the empty storefronts, the sleeping addicts, the beggars and the squeegee men that caught my eye. And there was the polite conversation with working professionals about their forty percent pay cuts, their escalating taxes, and moving their money out of the country while they can. The data shows a total output falling at a five per cent annual rate, but specialists are sure the final figures will be worse. The business leaders I have spoken with all said there is no hope at all.

Greece is a country with weak institutions and they are being destroyed. The schools, the hospitals and the universities were never first-rate; now they are getting worse. It is a country with fairly low wages and they are being driven down. It is a country that had improved its infrastructure, thanks to easy credit and EU assistance and no doubt the good work of German engineering firms – but the improvements cannot be maintained. Greece has never been a very attractive spot for foreign investment, and it is becoming less so. Unemployment has always been high for young people; now there are practically no jobs at all.

It is obvious that nothing is happening today in Greece and that they will produce economic recovery or forestalls default on the debt, on the contrary. Even though the Greek government refuses to take the step of defaulting, it will be forced into that position whenever the Germans and French pull the plug on new loans, which they are preparing to do in the near future. Meanwhile, they are punishing the Greeks – in order to make sure that when Greece is permitted to default and restructure, the other peripheral countries and especially Italy will not be tempted to go down the same path. This is called "ring-fencing." It is also called the principle of collective guilt, destroying the livelihoods of thirteen million people for political reasons.

It is true that the Greek government was always a weak credit. It is true that the country has a large civil service, patronage-based politics, aggressive unions and dubious accounts. Anyone who has worked there will tell you this. It is also true that this was no secret during the boom years. ***The lenders knew. Just as they knew that in Ireland commercial development was out of control, that in Spain it was housing, and in the United States it was liar's loans to borrowers who could never pay.*** This is the way credit works. In the boom standards fall and in the slump they are stiffened, while the lenders pompously proclaim that "no-one could have known."

The Greek government has accepted the terms imposed upon it, admitting more than its share in responsibility, especially given that this government was not in power during the boom years. It has cut, cut and cut again. But the cuts and tax increases are never enough, and the "troika" comes back time and again for new measures, such as breaking the national wage bargain or (as I heard) using up funds held in reserve to protect the banks(One has to ask: who would not move their money out, under such conditions?). Looming in the background is a plan to place nearly all of Greece's public assets under private management from abroad, asset-stripping in plain words. Though floated by a consultant, this was described to me, by a high European official, as the "secret German plan."

This is economic policy as moral abomination. It is not designed to succeed as economics. It is failing because it is designed to fail. Europe's leaders know what they are doing. The policy is not intended to restore growth and prosperity; a policy whose clear effect over years and years is decline and destruction must have been actually intended to achieve that effect. So one must infer that when M.

Barroso and M. Trichet and now M. Draghi prate on about "restoring the confidence of the markets," that this is for the edification of children and dolts. The only other possibility is that these leaders are incompetent beyond all reasonable imagining.

The purpose of punishment is two-fold. First, it is to meet political needs in Germany and France, reaffirming the righteous self-senses in the upper-crust of those countries, who cannot accept that the lender is anything other than the offended party, the violated paragon of virtue and hard work. This parallel standard is historical mythology for France, but Germans should know better, after having been saddled with sole responsibility for the First World War at the Treaty of Versailles, and then the consequences of that. Keynes quoting Hardy comes to mind:

"Nought remains/But vindictiveness here amid the strong/And there amid the weak an impotent rage."

The second purpose is to preserve the French and German banks from the failure that will ensue when losses on all their bad loans have to be recognised. The banks can withstand a Greek write-down, more so in Germany than in France, which is why the German government is more open to this outcome than the French. But they cannot withstand a cascading series of defaults in the other peripheral countries, at least not all at once or in short order.

That cascade will come, sooner or later, as the debt burdens on Ireland, Portugal, Spain, Italy and ultimately Belgium and France mount. Once Greece defaults, that Rubicon will be crossed, and it will be only a matter of time. Time however is important. What the policy may achieve is to string out the destruction, as it proceeds eventually from Greece to Ireland and on to other countries. The game is to destroy only one country at a time, keeping up the austerity programmes and the debt payments in all the others for as long as possible, so that the effect of the popular rebellion now getting under way does not shake the foundations of the Eurozone.

But then again, maybe it won't even do that. Keynes again:

"If the European Civil War is to end with France and Italy abusing their momentary victorious power to destroy Germany and Austria-Hungary now prostrate, they invite their own destruction also, being so deeply and inextricably intertwined with their victims by hidden psychic and economic bonds."

There are technical solutions. The proposals, which have been worked over by men and women of earnest good will in all the European countries, involve European bonds, bank recapitalisation and an investment programme. The solutions can work and in their minimalist forms they are within the current framework of European law. They do require recognising that the previous economic ideology of the European Union must be abandoned, and that the financial sector must bear losses that will require it to be restructured in whole or partially.

But the obstacles are political, insofar as important constituencies in Germany and France oppose these measures, alongside outspoken fellow-travellers in Finland, Slovakia and elsewhere. And they are financial, insofar as they would require recognition of losses to European banks that the banks and other parties continue to believe they can deny.

The issue therefore is whether the political leadership in Berlin and Paris is interested in technical solutions. It is plain enough that they are not. ***It is plain enough that Europe's leaders give priority to their own political survival, the survival of their banks is in second place, that of the European project third, and the people of the periphery dead last.*** That being so, it is only a matter of time before desperate populations erupt in revolt, forcing a change of course, or a crack-up.

And the moral question in that case will come down to: which side are you on?

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Transforming the Financial Sector from a Bad Master to a Good Servant

In the last few decades deregulation of the financial sector has made crisis the norm. But this is not inevitable. The financial sector must be reformed to ensure it contributes to fair and long-term growth;

The financial sector, both national and international, should have two main functions. Firstly it should serve the needs of the real economy. Secondly, it should help manage and mitigate risk. In the last three decades the private financial sector has done neither, especially since it was liberalised.

The financial sector has not provided sufficient sustained finance for key sectors like the green economy, small and medium enterprises (SMEs) and infrastructure. It has often not financed housing in a way which permanently benefits poorer people as shown in the US subprime crisis.

Furthermore, instead of mitigating and managing risk, it has created risk through its attempt to maximise short-term profits. In the last few decades numerous and costly crises started after financial markets were liberalised and many regulations stripped away.

This was seen first with the 1980s debt crisis in Latin America which led to its lost decade of development. These crises continued in East Asia in 1997/8 as well as in numerous other countries. Since 2007 there has been a major crisis in the North Atlantic region.

Financial crisis has become the new norm, rather than the exception.

This is not inevitable. When the financial sector has been well regulated and controlled – and when well-run public banks have played an important role – the financial sector has played a positive role to support and not undermine the real economy. Examples of this include post-World War II USA and Europe – and more recently India – where major crises were avoided and growth was strong.

Currently a lot of the focus of the financial sector is on making exorbitant profits and salaries for its employees. Instead countries need a far smaller, simpler, transparent and accountable financial sector focused on lending to the real economy.

If this transformation does not happen it will make it very difficult to finance sustained and equitable growth. A weakened and crisis-prone real economy will continue to serve the interests of the financial sector and not the reverse as it needs to be!

So what should be done?

Firstly, the financial sector needs to be regulated in a way which would have prevented the current crisis – and future ones – from occurring. This includes comprehensive equivalent regulation of the entire financial sector, including the shadow unregulated banking sector, which in the US and Europe is larger than the existing regulated banking sector.

Secondly, regulation of capital adequacy, leverage and liquidity must be rigorous and counter-cyclical. It must be counter-cyclical to compensate for the natural boom-bust pattern of financial markets and banks, so damaging to the real economy. For example, regulators could require banks to make sufficient provisions to insure against potential future losses based on the current level of loans.

Thirdly, speculative activity should be limited – and ideally eliminated – where the risks created outweigh any possible benefits to the real economy. Banks should also be divided. The more important part of banking, so called utility banking, should be separated completely from more risky activity, as was done in the 1930s with the Glass-Steagall Act.

Fourthly, remunerations for bankers should be reformed to significantly reduce their level of income. Bonuses could be eliminated

– or be linked to long term performance – instead of rewarding short-term gains.

If the profits and remunerations in the financial sector were reduced this would also limit the unhealthy power and influence that the financial sector has over regulators and politicians. Together with the reform of funding for political parties, this would give greater autonomy for politicians to serve their electorate and not the interests of the financial sector.

As a complement to regulating tightly and comprehensively the private financial system, the time has come for a significant expansion of efficient public banks. They can finance investment in sectors poorly served by the private financial sector, such as SMEs and the green economy. Where markets fail, governments need to act effectively.

There are many positive examples of this within institutions in Europe, such as the European Investment Bank (EIB) at a regional level and by the German public bank KfW at a national level. There are also many positive examples of public banks around the world, such as BNDES in Brazil.

Where banks have been nationalised due to the crisis, often at high cost to the taxpayer, they should be used to serve the public interest. Where public banks already exist – like the EIB – their capital and lending could be considerably expanded to support growth and job creation. Where public banks do not exist, they need to be created.

Finally, if the private financial sector continues to resist or evade strong regulation, then larger parts of the financial sector should become publicly owned. The financial sector must be a means to fair and sustained growth and not an end for its own exclusive benefit and that of a small elite.

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A circumstantial treaty, pointless and dangerous

Confronted with the debate, the EU is usually evasive: you are either for or against, there is no in between. Thus, gradualism is the only feasible approach. Europe, as tradition has it, is being built step by step, through the different crises, without any particular goal, but by specific projects initiated by men and consolidated by the institutions. It is strange, according to this logic, to resort to a treaty to solve a problem of economic policy. But, so be it. And what if, by rejecting one course of action and being led by esteem, Europe was led astray, like in Bruegel's parable? "If one blind man guides another, they will both fall into the ditch" said the Gospel. The fact that Mrs. Merkel is facing real difficulty in convincing public opinion is understandable. But the chosen path, that of establishing a pact on asymmetric budgetary discipline, is a serious mistake. That Mr. Sarkozy is also making a mistake in his haste to realise the European Stability Mechanism, and lastly that the French-German duo are involving the European Council, does not necessarily mean that it is a good policy for Europe. Tactics prevail over strategy. The treaty raises three questions: firstly, why has no major country – the United States, Japan, China and in particular the United Kingdom, ever implemented it for balancing public finances? There must certainly be a reason, as no sensible economist would hesitate to recognise the ethical, political, and economic value of a structural budgetary balance, at least in relation to current revenue and current expenditure. Yet, no State worthy of its name is willing to reduce its power, discretionary by definition, in order to prioritise growth and employment over budgetary balance when there is a threat of a depression. The consideration of economic waste, human cost and political instability created by massive unemployment takes precedence over all other priorities. Furthermore, making a policy irreversible by casting it in the marble of a treaty means constitutionalising a legal regulation that applies not to the decision-making procedure but to its content, which is not relevant here. In this instance, there are three reasons why the treaty is an inappropriate instrument. Firstly, macroeconomic policy requires both stability and flexibility, non-rigidity; secondly, a community regulation should suffice to ensure that budgetary discipline between the Member States is respected; and lastly, recourse to a treaty establishes the "tyranny of the majority" by making it difficult for the minority to undertake a change in direction when it comes to correcting a policy that is deemed harmful and inoperative. In addition, as regards the essence of the policy, the treaty on budgetary discipline raises a number of objections. Firstly, its timing is bad because there will undoubtedly be a pro-cyclical effect, in other words recessive. Secondly, its asymmetry requires deflation in deficit countries, without requiring, on the other hand, expansion in countries that have debt margins such as Germany. Thirdly, if it is accompanied by a decrease in salaries in order to align itself with German price-competiveness, its deflationary effect will be even greater. Fourthly, is it not absurd to impose budgetary regulations on all countries while allowing tax competition on the taxation of savings and business profits in the EU, undermining efforts to return to stability and fair taxation? To break with the rule of unanimity in fiscal matters, now that would definitely justify a treaty! Fifthly, how will national parliaments, and their citizens' views they closely reflect, react to the intrusive bureaucratic supervision of Brussels in wage and budgetary policies solely because of the single currency? As regards the pact, there remains one objection that is not without substance: ***HOW WILL THE REST OF THE WORLD, AND IN PARTICULAR THE UNITED STATES, CHINA AND THE OTHER BRIC COUNTRIES, COPE***

WITH THIS BUDGETARY HIBERNATION OF THE LARGEST MARKET IN THE WORLD? Do we think that the credibility of the EU as a reliable partner will gain from this? Will the third countries not worry, and with good reason, about the protectionist risks that will inevitably develop if growth continues to falter? And how can there be an upturn without the problem of public and private debt, hanging over the European economy like the sword of Damocles, being resolved? The only credible response that is capable of re-establishing the confidence of businesses and households is to cross the threshold of coherence in economic policy in the Euro-zone, by unifying public debt and centralising financial regulation and monitoring for the whole zone: a single currency, a single debt, financed by a Euro-zone budget funded by its own resources and, of course, completed by a centralisation of the power to issue public debt. The greatest contribution to world growth that the EU could make today would be to transform the Euro-zone into a Euro-community within which the ECB would recover all the margins of manoeuvre it needs to help to reduce the cost of the debt and to ensure the smooth operation of the credit market. In fact, if the Euro-zone does not need a budgetary treaty, it does need a Constitution. Until this prospect begins to take shape, Europe will increasingly become a symbol of dissent between European citizens. It may be as a result of this debate that the conscience of a European demos will emerge.

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Return to growth in Europe

A broken promise is how most of our citizens regard the Euro, even though it was created to make Europe strong and prosperous, as underscored by the title of a report ("Efficiency, stability, equity") by Tomaso Padoa-Schioppa, which presented us with a picture of monetary union. A recent survey shows that over 60% of French people believe the Euro has been no help in alleviating the effects of the crisis[37]. This feeling is widely shared in the Euro zone, where 50% of the people interviewed expressed the same opinion. They cannot be blamed for thinking that way because the Euro zone has now become the weak link in the global economy. A sovereign debt crisis, growth at half mast, growing imbalances within the zone: all the potential risks announced across the Atlantic, not least by those opposed to the Euro, have now become a reality. Chapter one in the story of the Euro, the age of innocence, has now drawn to an end.

The coming risks are patently clear: first of all an economic recession, with a political regression hard on its heels and, finally, the edifice itself under threat. The way these risks are tackled must differ from today's approach of merely offering to drop budgetary policy as a way out of the crisis. Everything that is happening gives the impression that European leaders are now convinced that the

37 Eurobarometer, July 2011, http://ec.europa.eu/public_opinion/archives/eb/eb75/eb75_cri_fr.pdf policy is fundamentally ineffective. Destabilising the Euro zone, this austerity-oriented budgetary approach, underpinned by increasingly tougher rules, condemns the Euro zone to a lengthy period of sluggish growth, if not a recession. It is wrong to claim, as those of the right-wing tendency and some neo-Liberal economists do, that cutting deficits is the only way to return to growth. Where could this lead to in the present climate? To a renewal of "confidence"? That is hardly likely because the austerity policies all European governments are simultaneously conducting are having a powerful recessionary impact and not just in the short term. They risk permanently hampering the European economy's potential for growth: the dole queues will not disappear nor by some miracle will the closed factories open their doors again when the drastic budgetary retrenchment is over. They will be gone forever if the slow rate of growth is long-lasting, as everything now seems to suggest. Most importantly, budgetary austerity leads the European economies away from the very goal this approach seeks to attain: debt reduction is possible only if the European economies succeed in restoring a sufficiently sustained and steady rate of growth. As the rating agencies themselves have underscored, pointing to poor growth prospects as one of the main factors prompting them to downgrade the rating of countries such as France.

Renewed growth in Europe involves a root-and-branch reform of the crisis management system, and hence of the governance of the Euro zone. To this end, what benchmarks can be identified as reflecting a bold and realistic approach, mindful of our partners' points of view? These partners are not in fact as disadvantaged or divided as people are saying. This may have been overlooked for a long time in Europe, but there is a large measure of agreement about the shortcomings of the Euro zone and what action is likely to alter this state of affairs. The problem is how to combine the requisite measures with the practical ones, given the current political power struggles within the Euro zone. This text seeks to define the shape of a system of European governance that is compatible with these two restrictions.

I. The Euro zone is not an optimum monetary area

Americans economists, such as Martin Feldstein, Paul Krugman and Joseph Stiglitz, have long expressed feelings of reluctance or even actual hostility as far as the Euro is concerned.

This attitude has often been misunderstood in Europe. They have been accused of seeking to safeguard the Dollar's monopoly against its new European rival, or failing to recognise Europe's specific political and economic features. These objections may have been justified at times but they nonetheless prevent an in-depth debate being held in Europe about the weaknesses of the Euro zone and its system of governance.

As a result of the difficulties the Euro zone now has to contend with, these controversies need to be re-examined. In an article published in 2011, Feldstein reviews what he wrote in the 1990s in the light of the first 12 years of the Euro zone's existence. According to his harsh assessment the Euro is a failure. The ultimate aim of the Euro's architects, economic and political unification of Europe, has not been achieved, as underscored by the sovereign debt crisis in Europe, the re-emergence of balance of payments crises, the political hostility creditors have adopted towards countries running deficits, the conflicts about the role of the Central Bank... The crisis is not "an accident, nor is it due to bureaucratic mismanagement; it is the unavoidable consequence of having imposed a single currency on a mixed bag of countries, whose diversity includes not only the economic structures but also the fiscal traditions and social attitudes".

Feldstein believes the cause of these setbacks is obvious. ***The Euro was primarily a political decision. The idea was to anchor Germany in Europe***, at a time of deep concern that the country's reunification might take it in another direction. It was not an economic decision. Similarly, the Americans never contemplated creating a single currency within the free trade area between Mexico, Canada and the United States. ***There is no point in creating a single currency owing to the fact that the European countries have created a single market.*** The arguments against the Euro zone since its inception have almost all turned out to be right. They are three in number.

The diverse nature of the Euro zone

A common monetary policy is invariably too strict for some and not strict enough for others. A country with higher-than-average inflation enjoys lower real interest rates, thereby fuelling inflation. The opposite will be true for a low-inflation region. In the final analysis, the economic conditions may drift apart in the long term before painful adjustments are made, as in the case of the real estate bubbles in Spain and Ireland, fuelled by negative real interest rates during the greater part of the

2000s. Conversely, Germany, which boasted near-zero inflation throughout the decade, has had to contend with soaring real interest rates, resulting in a sustained downturn in consumption and investment but also the lack of any property bubble.

No financial solidarity

It was obvious from the outset that Europe is not a budgetary and fiscal union. An ailing region cannot be certain of being able to benefit from the direct or indirect solidarity of the other Member States. The Maastricht Treaty even went as far as to ban such mechanisms ("no bail-out" rule). It should be stressed how very different the situation is in a federal state such as the United States. California today or New York yesterday may not, admittedly, have directly enjoyed the solidarity of the other American states but a silent cogwheel is being set in motion and powerfully so. When an American state goes into recession, tax revenues are reduced but the federal spending it enjoys is not, however, affected. Each Dollar of GDP lost in a given state owing to a recession triggers off a compensatory budgetary transfer from the federal budget of roughly 40 cents on average. In exchange for this automatic buffer, the American states, in common with local authorities in France, are beholden to constitutional rules placing significant limitations on potential deficits. California, whose budgetary crisis is often similar to Greece's, has a debt equal to no more than

4% of its GDP, as it can only run up debts to finance public investments…

No labour mobility

The Euro zone's final fundamental shortcoming, as far its opponents are concerned, reflects Mundell's arguments about optimum monetary unions. With devaluations becoming out of the question in the monetary area it is vital that restoring forces be applied to adjust the imbalances between the regions.

Mundell claims one of these key forces is mobility of the elements of production, particularly labour. When an area suffers a negative shock, employees have to be able to leave their homes and travel to areas where they can find a dynamic rate of growth. As labour mobility is weak in Europe, particularly for obvious linguistic reasons, a Greek worker does not find it so easy to go and live in Bavaria… The crisis in Greece becomes all the more harrowing for its inhabitants.

And yet, the Euro exists… Its record has been marred over the last three years but it cannot be dismantled. The former governor of the Bank of Argentina recently referred to all the disasters that would result from leaving the Euro: runaway inflation, the disappearance of credit, sharp devaluations and a corresponding decline in purchasing power. The sole option would be a reform of the Euro zone, to allow it to recover the growth potential it showed in the wake of its inception. Let us reconsider each of the preceding points to show which direction is best to take.

II. Economic policy: coordinate rather than give up

How can asymmetrical situations amongst the Euro zone countries be avoided? Answering this question means going back over a few basic tenets of economic theory.

A division of tasks between a federal monetary policy guaranteeing the macroeconomic stability of the zone and a national budgetary policy responsible for reacting to the shock specific to each country is, on the face of it, the right place to start. This is in line with the thinking behind the Mundell-Fleming economic theory, according to which monetary policy is effective in the context of a floating exchange rate, which is the case in the Euro zone as a whole in relation to the rest of the world. Hence it is a sound policy for the ECB to guarantee the macroeconomic balance of the entire zone. According to the Mundell-Fleming theory, solely budgetary policy is effective within the context of a fixed exchange rate: the various Euro zone countries represent an exchange rate area that is, irrevocably, fixed. Accordingly it is a perfectly sound policy for the Member States to seek to stabilise their own economic cycles via their budgetary policies. This task-sharing system obviously calls for close macroeconomic cooperation between Member States. Should a shock affect the entire zone, rather than a specific country, the best solution is to avoid relying on budgetary policy and allow monetary policy to take over. Driven by a more lax monetary policy, the lower rates result in a depreciation of the European currency, leading to a revival of exports and growth. Conversely, a shock affecting only one country should be managed by the budgetary policy of that country alone.

How governance applies to the Euro zone is a far cry from these tenets of economic theory. The Treaties creating the Euro state that monetary policy's sole purpose is to guarantee price stability, while budgetary policy should primarily aspire to achieve "balance in the medium term". Budgetary policy was admittedly engaged to underpin demand during the 2008-2009 crisis (a sharp increase in national deficits) but it triggered off the sovereign debt crisis in 2010. Without a “lender of last resort”, the Euro zone was plunged into a sovereign crisis when the misgivings of the markets began to make themselves felt.

So what can be done to avoid abandoning budgetary policy, while taking account of the specific public finances of the Euro zone members?

First of all, in the case of the transition that is supposed to rebalance public finances by 2017, it is vital to escape the threat of a self-sustained spiral where budgetary consolidation curbs the level of growth so budgetary belts have to be tightened even further to offset the lost income caused by the economic slowdown… The right approach would be to fix a predetermined spending norm, for the next five years, say, along with the level of taxation required to pay for the spending, on the assumption of a realistic average rate of growth. This public finances path has to be given credibility from the outset as a result of announcing and launching a set of measures that are tough and specific enough to achieve the desired results. If the unexpected should happen on the growth front, steps would have to be taken to avoid getting involved in a destructive high-speed chase. What is at stake is not deciding if the deficit will be bigger or smaller in a specific year but ensuring the authorities appear credible in their efforts to apply the programme decided upon.

Spain and the Italy have now stated their resolve not to commit themselves any further than the measures already announced, in the midst of a succession of austerity plans likely to lead their economies into a recessionary spiral. Should the views expressed by these countries enjoy French backing, other countries will no doubt follow suit. This group of countries would be in a better position than now to change the strictly legal and punishing positions that have been adopted by Angela Merkel and Nicolas Sarkozy. The outcome of these attitudes was the potentially risky Treaty agreed on 2 March.

In the case of the permanent arrangements, once the transitional phase has been completed, there has to be a review of the way economic policies are coordinated. Ideally, a common management authority should be set up. The European Commission could take on this role, provided it receives a firm mandate which will ensure it does not cling to its current view of the purpose and aims of budgetary policy, focused too exclusively on complying with the nominal debt and deficit thresholds. Consequently, the "European semester" would no longer primarily be a formal legal process for checking that national budgetary programmes are keeping to the path decided upon without any regard for the situation, but become an authentic economic policy coordination instrument bringing a new level of understanding into the debate. It would also provide an opportunity for making a distinction between common shocks and those applying to one particular country.

III. Pooling and vetting the financial risks.

The lack of a lender of last resort has sown panic in the Euro zone about sovereign debts. Without a change to the ECB's articles of association, an idea which Germany refuses to contemplate, new institutions have to be created to rule out speculation against sovereign debt. We are still paying now for the consequences of the French/Germany Deauville agreement (October 2010), which was a serious mistake on this score, as it specified that a programme of support for an ailing country should be backed by a debt reform plan, thus spreading a wave of distrust about sovereign debts, which is the opposite of what was needed.

Top of the agenda now is the European Stability Mechanism (ESM), but this instrument has limited intervention capabilities. Boasting prepaid capital equal to €80 billion, and overall capital of €700 billion, the system may commit a maximum of €500 billion, while factoring in a related financial security coefficient. Merging these resources with the European Financial Stability Facility (EFSF) funding still available would produce a total of €750 billion, which is better but definitely not enough to meet the possibility of a sovereign crisis in Spain and Italy.

Several other creative solutions have also been put on the table with a view to boosting the Member States' weak support capabilities. If the ECB cannot provide loans directly to the Member States, many experts suggest providing the EFSF or its successor, the European Stability Mechanism (ESM), with a banking licence to grant credit lines to countries experiencing difficulties, while being free to obtain refinancing from the ECB.

In line with one of Romano Prodi's suggestions, the gold stocks now being held by the central banks could be used as capital for this banking institution. Put at over €400 billion these reserves would be sufficient, hence this involves a capital and not just a lending capacity. The idea of using gold lying idle in the central banks has been taken on board by the five "German wise people", the government's independent economic advisors, who are, nonetheless, hardly suspected of having outlandish economic views.

They recommend offering guarantees for the "excessive" (more than 60% of GDP in their opinion) European debt in proportion to these unused gold stocks until it is written off (along the lines of the CADES model in France). Chancellor Merkel closed the door on this bold proposal, even though Mr Schauble apparently took a shine to the idea. It should be taken on board.

In addition to providing direct support to Member States, the new European mechanism should also serve to guarantee the Eurozone's stability. The situation in Ireland and, to a lesser extent, in Spain, shows what not to do. The situation in Ireland is the opposite of what is happening in Greece. The Irish government's public finances were beyond reproach until the crisis broke out. The country's level of debt dropped from 55% of GDP when the Euro was launched to 25% in 2007 but, driven to some extent by the property bubble, the banking system became bloated, with the banks' balance sheets of the accounting for 900% of GDP ... When the bubble burst the government was anxious to avoid an Iceland-style panic so it offered a guarantee on all bank deposits and became guarantor for its banks' senior debts, nationalising the biggest three banks into the bargain. The level of Irish debt skyrocketed to reach 105% of GDP by late 2011.

In common with the Spanish crisis, the Irish one has nothing to do with a public finances crisis. What it does show is the need for the Euro zone to be completed with financial risk sharing and vetting mechanisms. There is a vital need first of all for the Euro zone to have common banking rules going further than what is provided now in Basle 2, soon to become Basle 3. For one thing, these common rules should guarantee that risks resulting from banking funding and investment activities should not jeopardise the retail activities of private persons and SMEs. Several measures may be taken towards this end, such as the Vickers report proposal to separate these two types of activity. Another idea is to emulate the American "Volcker rule" to deter banking speculation. Whatever option is chosen, it has to be remembered that the Euro zone's financial system is predominantly bank-based, so the rules have to be designed with a view to helping businesses, particularly SMEs that cannot finance themselves on the markets.

The rules for combating systematic risk have to be amplified by the creation in due course of a European regulator which enjoys more powers than the current European Banking Authority. The regulatory authority would be responsible for directly overseeing the major systemic-scale banks and penalising any failures to comply with the rules.

The ESM itself, or a specific fund fed by contributions from the banks themselves, should have the legal and financial means to limit the scope of a banking crisis, in particular by guaranteeing deposits and arranging for an establishment to be restructured if necessary. It is worthwhile making a comparison with California at this point: the state may go bust but not Wells Fargo, as it is protected by federal institutions such as the FDIC… To start with the fund could be the ESM, enjoying the aforementioned gold guarantee for this purpose, until the fund based on the banks' contributions has sufficient resources. Under this system, the gold guarantee could be a provisional measure only.

Some headway has been made, but in the case of oversight and the financial resources for ensuring the establishments' solvency, the responsibility continues to be a national one. A system for Euro-wide financial risk-sharing therefore still has to be implemented. In view of the United Kingdom's likely opposition it should be possible to resume the debate on a 17-sided basis as part of the process for renegotiating the Treaty on Stability, Coordination and Governance in the EMU (TSCG), in order to invest the Euro zone with its own powers to guarantee financial stability.

IV. Reduce the imbalances of payments within the Euro zone

The initial challenge of the Euro was being able, theoretically, to ignore the question … Nobody cared about knowing if Brittany had a balance-of-payments deficit vis à vis Normandy… Within a monetary union, the balance of payments situation becomes an antiquated statistic, with the surpluses of some parties being automatically recycled to finance the debts of others. This recycling did take place during the Eurozone's first 10 years but in the worst way, because German surpluses were deployed to pay for the other countries' bubbles. The Euro's major negative gamble was failing to allow the surpluses to be recycled productively.

A balance has to be struck once more between savings and productive investments in order to restore the Euro's good points. The need to promote a Europe of productive investments should not be the sole responsibility of the markets, as the crisis has, unfortunately, demonstrated. The authentic system that has to be found for bringing investment funding into the Community sphere would involve, in particular, issuing “project bonds”. The European Commission-sponsored measure would help to create the soft conditions for funding private investment projects that would make a positive impact. The European Investment Bank’s lending capacities could also be boosted. Lastly, “prudent” investments by Member States could be regarded as “good deficits”, thereby falling outside the budgetary disciplinary rules to an extent limited to 1% to 2% of GDP, so as to give the impression of growth whenever necessary.

Should balance of payments imbalances re-emerge this would, however, be for a fairly mechanical reason, underscoring the competitiveness imbalances that have built up within the space of 10 years. A chart regularly commented on in the press shows that Germany unit costs are now 20% lower on average than those of France or Italy. This explains why the French trade balance, which was balanced in 2003, is now 75 billion in the red.

The diverging paths of Germany and France have been endlessly commented upon. Germany’s industry seems to have found the key for resisting the downward trend affecting employment in the industrial sector everywhere. One of the oft-cited arguments has to do with the huge increase in Germany’s trading activities with the former Eastern bloc countries being used as a rear base for Germany’s industry (much more than the former Eastern Germany).

As a result of being situated close to the new European Union members, Germany has relocated the intermediary links of its manufacturing base, keeping the assembly process in Germany, thus helping to maintain the top-quality brand policy to which German goods owe their prestige.

Nonetheless, the differing European trajectories have less to do with the divergent trend in productivity growth rates than with changes in labour costs. The outcome is the same irrespective of whether the analysis is focused on the entire economy or on the manufacturing sector alone, on a per-worker or per-hour worked basis. Since the advent of the Euro, or even earlier, since 1993, German output has not changed to any greater extent than in France (the hourly output rose 2.8% per annum in the two countries between 2001 and 2008).

The trend in unit costs (wage inflation adjusted for increases in productivity) is completely different, however. Unit costs in Germany have risen more slowly in Germany than in France over the last 20 years. The gap between the pair widened between 2001 and 2008: unit wage costs fell in Germany (hourly wage costs were up 2.1% while output rose 2.8%) but continued to rise in France (up 3.4% while output was down 2.8%). The widening gap between the two countries during 2001-2008 was equal to about 10 points in favour of unit wage costs in Germany. The twofold impact of wage restraint in Germany has sharpened the country's competitive edge, while boosting its export performance. At the same time, there has been a decline in the amount of disposable income, hence lower consumption and fewer imports. These two factors taken together explain why the current account position has so successfully recovered. Germany boasts one of the largest surpluses in the world: more than 5% of GDP (only the Netherlands fares better, with a surplus equal to 7% of GDP!).

On the basis of a comparison of levels, the German one is almost equal to China's and very much higher than Saudi Arabia's, for example.

Wage restraint in Germany is driven by several factors. The cost of reunification meant that German competitiveness had declined by the time it joined the Euro zone. The threat of businesses being relocated to neighbouring countries played a key role, with the trade unions showing restraint in return for pledges that jobs would be maintained.

The Hartz 4 measures under Chancellor Schroeder's agenda 2010 initiative also played a key role. The lower employment benefits decided upon led to an increase in part-time employment and a rise in instability. It is also worth mentioning that unlike the other European countries, Germany has been spared by the property bubble. As property prices continued to be reasonable, wage restraint was more readily accepted …

The solution to the problem is outside the scope of economic policy but is nonetheless to the fore: German wage bargaining. German wages have risen by 1.7% since 2000, compared with 2.8% in the entire Euro zone, according to the trade union institute IMK (quoted by Le Monde on 6 March). The demands now being made are focused on increases of between 5% and 7% in industry. If the negotiations are successful they will do more to solve the European crisis than all the other measures being contemplated … For the want of a zone in which labour mobility is a genuine possibility, the Euro zone could prove that it does indeed have the restoring forces required to ensure it functions smoothly.

Wage convergence in Europe requires the launch of the debate about a minimum European wage, adapted to each country's situation but featuring specific clauses. A common minimum wage and wage increase framework would provide a means of avoiding wage deflation, on the one hand, and, on the other, offer a context for discussing changes in each country.

V. Conclusion

The Euro is directly descended from the debates held in the wake of the crisis during the 1930s. During the Bretton Woods conference, Keynes was keen to turn the page on the gold standard, which the author of The General Theory of Employment, Interest and Money called a "barbarous relic". In order to tackle the system whereby countries running foreign deficits have to cut their imports while those in surplus are not required to boost theirs in return, Keynes sought to create a World Bank (an "international clearing union"). He proposed the name of bancor for this institution issuing a supranational currency and called upon to oversee the recycling of the surpluses produced by countries whose trade balances are in the black to those running deficits.

The Americans spurned this idea, believing the Dollar would be perfect as the world currency. However, the plan for a supranational currency survived in Europe, particularly thanks to the writings of the Belgian economist Robert Triffin. The debate gave rise to the Euro.

There is something tragic about seeing the Europeans now in a situation that is reminiscent of the 1930s in many respects. In order to maintain their gold parity, the European countries stepped up the number of austerity programmes designed to restore market confidence before finally dropping gold parity, one after another. Currently seeking to hold onto their rating as they did their gold parity in the past, they are undermining growth, which is, after all, the basis for their solvency. Europeans need to refresh their memories about what drove them to create a single currency and rediscover the meaning of their joint venture in order to find the energy and the will to apply the measures required to rescue the Euro.

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Why the new Stability and Growth Pact is the wrong answer to the crisis

I. One-sided fiscal austerity - a cure for the Eurozone crisis?

After more than three years of crisis, one view that has gained ground is that the Eurozone will only survive if courageous steps towards a much deeper European integration are taken and if the austerity measures enacted by European economies are counterbalanced by a bold investment initiative. At this stage there is no doubt that the measures taken by Heads of State or Government of the Euro have not helped to reassure anxious markets. On the contrary, credit spreads are rising even in high performing economies showing the growing mistrust financial actors have in the problem-solving capacity of national leaders. With a crisis management philosophy that can be summed up by the phrase 'too little, too late' and their reluctance to shift competences to the European level, Heads of State or Government of the Euro find themselves trapped in the hands of financial market power. The only fire brigade at the disposal of the Eurozone is the European Central Bank (ECB). Nevertheless, its bond-buying programme faces severe criticism - notably from a German government that has been known to sacrifice the European interest over the outcome of regional elections.

The introduction of "Eurobonds" that would allow the refinancing of a portion of European debts on reasonable terms is a red rag to German Chancellor Merkel, just as much as a banking license for the EFSF bailout fund. The idea of a financial equalisation scheme in Europe faces equally strong opposition - the term 'transfer union' ranks amongst the least popular in German public opinion. In the absence of these anti-crisis instruments, much hope has been placed in the reform of the Stability and Growth Pact (SGP). Restoring fiscal discipline in Europe was originally seen by many as the cure for the crisis. But is the reformed Pact able to bring the public debt evolution under control? Is the approach imposed by the conservative and liberal majorities in the EU institutions the one needed? Can their agenda of drastic budget cuts and a toughened sanctions regime help European economies regain competitiveness and push them back to a growth path? What this approach clearly lacks are incentives for safeguarding public investments as a crucial growth driver –the major point of criticism raised by European social democrats. In our view European economies will only get out of the crisis if they are able to generate growth and to refinance themselves at reasonable prices. Therefore, a proper balance between budgetary consolidation and a growth enhancing investment strategy is of crucial importance.

II. The third reform of the Stability and Growth Pact in 2010-2011

Adopted in 1997, the SGP was intended to serve as a form of fiscal life insurance when introducing a single European currency amongst heterogeneous economies. Its principal rules establish that Member States must keep their national budgets within the debt limit of 60 per cent of GDP and the deficit threshold of 3 per cent of GDP to avoid fiscal shortcomings endangering the Eurozone. In the light of the euro crisis it has become clear that the Pact was consistently breached and has failed to deliver on its objective of ensuring sound fiscal finance.

Shortcomings of the Pact

In 2003 Germany and France were breaching the fiscal rules but the Council decided not to impose sanctions. Furthermore in 2005, Commissioner Almunia flexibilised the rules on budget deficits following Franco-German pressures. The "horse-trading" within the Council and the flexibilised fiscal rules faced severe criticism. While representing an important failure of the old Pact, they are by far not the only shortcomings: According to the rules of the Pact, countries like Ireland with a pre-crisis ratio of debt-to-GDP of 25 per cent and Spain with 36 per cent in 2007 were judged as role models - the Pact did not have the tools to detect real estate bubbles and rising private indebtedness. In addition to its blindness to macroeconomic imbalances its main weakness lies in its incapability to survey the quality of public finances. The Pact failed to distinguish whether a country was allocating its resources to military equipment and an over-sized bureaucracy or whether it was forming the basis for future growth by investing in research, education or energy efficiency. The reason: the strictly quantitative monitoring of debt and deficit ratio could simply not make a distinction between good and bad expenditure. In the absence of such an investment safeguard, fiscal adjustment pressures have been constantly followed by significant cuts in the level of public investments in Europe. This worrying trend is likely to continue if the reformed Pact fails to secure adequate investment levels.

Negotiations between the EU institutions: Investment safeguards versus austerity

The reform proposal of the European Commission in 2010 paid little attention to the main shortcomings of the Pact. Instead, the proposal sought to apply sanctions not only if Eurozone countries breached the debt and deficit criteria in the corrective arm but also at an earlier stage, in the so-called preventive arm, in cases when the expenditure growth does not remain below the growth rate (‘principle of prudent fiscal policy making’). The Commission opted for a procedure of semi-automatic sanctions whereby the Council can only reject a sanctioning proposal of the Commission by a qualified majority. In addition, a rigid and pro-cyclical rule of debt reduction was presented, whereby a debt level exceeding 60 per cent of GDP needs to be reduced by 1/20 in three years. Notwithstanding this, one true lesson was learnt from past mistakes: the SGP was ultimately complemented by a second pillar comprising a surveillance procedure for macroeconomic imbalances.

The discussions during negotiations on how to reform the Pact exemplify the left-right disunion present in European politics in terms of economic recovery theory: The centre-right in the European Parliament, made up of the EPP[38], ALDE[39] and ECR[40] groups, has bought into the idea that the only cure for the crisis is to force governments into drastic budgets cuts and in case they do not comply, to enforce this through an intimidating sanction regime. The S&D[41] group has condemned this one-sided approach as severely threatening for growth and future competitiveness. Social Democrats advocated an alternative way that stresses the importance of strict fiscal consolidation and, at the same time, acknowledges the need for economic stimulus: Temporarily running a higher deficit based on smart investments could be justified if it is counterbalanced by deficit reductions in boom times. Accordingly, during negotiations the S&D campaigned for a golden rule that would have only allowed a temporary deviation from the deficit criterion if this divergence is invested in growth-enhancing measures. In order to avoid abuse, the Commission should be entitled to define the types of public investment eligible for the special treatment. Furthermore, the S&D called

38 *European People’s Party*

39 *Alliance of Liberals and Democrats for Europe*

40 *European Conservatives and Reformists*

41 *Progressive Alliance of Socialists and Democrats*

for the Europe 2020 strategy for growth and jobs to be anchored in the Pact. By making the growth requirements legally binding and therefore subject to the same surveillance procedure as the fiscal objectives, Member States would be encouraged to attain country-specific investment targets. Meanwhile, the debt reduction rule as proposed by the Commission should be modified, with the bench-mark of 1/20 of debt reduction satisfactory if the lesser reduction is due to public investment increases in line with the Europe 2020 strategy. In addition, Social Democrats called for the introduction of Eurobonds in order to ensure reasonable borrowing costs for the Eurozone and for the introduction of a Financial Transaction Tax to increase fiscal income and prevent short-term speculation.

The centre-right majority in the European Parliament decided to reject the socialists' demands of promoting investments and growth. Instead, they became fixated on the idea of tightening the sanc-tions regime and toughening up the budget consolidation policies. In their view, the low degree of automaticity of sanctioning rules was the main failure of the Pact. Hence, they approved a slightly modified reversed voting system for sanctions as suggested by the Commission. Furthermore, they endorsed the Commission proposal for rigid fiscal consolidation policies because they considered that the European debt crisis was solely caused by states having lived beyond their means. Notwithstanding the fact that the financial crisis had a crucial impact on the countries' debt situation: in 2007 the pre-crisis debt level of the Eurozone was at 66 per cent of GDP - in 2010 it rose to 86 per cent of GDP. As a general rule, the ALDE group was following the Commission line, asking for its powers to increase vis à vis the Council while the EPP group was largely echoing the demands of Dutch, Finnish and German Council delegations to toughen the sanction rules by all means and to impede any fiscal space for stimulating public investments. After lengthy and tricky negotiations on the automaticity of sanction rules, finance ministers concluded a deal with the European Parliament. This agreement was pushed through the Plenary by a small centre-right majority on 28 September 2011.

III. Outlook: what needs to happen now

The Stability and Growth Pact is an important element of the European economic governance framework. Its third revision - which included for the first time the European Parliament as a co-legislator - could have been used as one of the tools to remedy the critical situation of the Eurozone. With profound changes in its architecture - the Pact could have contributed to more financial stability in Europe by introducing a culture of growth oriented fiscal policy making, as advocated by the Socialist group in the European Parliament. But this momentum was lost. Conservative and liberal majorities in the European institutions pushed through one-sided austerity policies that will burden low and middle income classes with the crisis costs. Their austerity measures pose a severe risk to the economic wealth and social cohesion of the European Union and are likely to cause a lasting recession.

At the current stage it is critical to counterbalance the malfunctioning Pact with an exit strategy from the crisis by moving to Maastricht 2.0. This will require sharing far more competences and responsibility in fiscal and economic policies at the European level. This is the only way the Eurozone will overcome its birth defect - enshrined in the Treaty of Maastricht - of sharing a common currency but keeping fiscal and economic policies a national competence. ***Intergovernmentalism is not the answer to Europe's woes. Only the Community method, fully involving the European Parliament at all stages, will ensure efficiency and democratic legitimacy.*** In fact there is no way around bundling the debt stock in Eurobonds and creating an economic government. Resolving the crisis is not just an economic matter. Political credibility is even more at stake.

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&
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Renaissance for Europe – The Common Progressive Vision

"All truth passes through three stages. First, it is ridiculed. Second, it is violently opposed. Third, it is accepted as being self-evident." Arthur Schopenhauer, could have been describing the journey of financial transaction taxes (FTTs) which is somewhere between stages two and three. Exactly where will be revealed at the European Finance Ministers meeting in Brussels on Tuesday, where the European Commission proposal, of a 0.1% tax on bond and equity transactions, and 0.01% on derivatives, will be on the table.

Before the Great Contraction began in 2007, bankers had succeeded in painting Financial Transaction Taxes as the concept of naïve idealists who knew little about the real workings of finance. This was quite a feat given that the idea had towering intellectual credentials. Keynes had recommended it in the General Theory and Nobel Prize-winner James Tobin later developed it.

Before the financial crisis, rather than looking to 'throw sand in the wheels of finance', in James Tobin's colourful phrase, the story propagated by the industry was that those wheels should spin ever more quickly. The faster money moved, the more efficiently it would be allocated, we were told. Bankers and hedge fund managers would grow super-rich, but that was a minor distraction because the economy would be stronger and jobs more plentiful. That story has been rumbled by the financial crisis.

Today, FTTs are no longer ridiculed – how could they be when the world's most dynamic economies, like Brazil, South Korea and India, use them, when last year approximately USD$38bn was raised by FTTs in the 40 countries that have them, when Europe's most successful large economy wants to adopt one, along with eight other EU states. Since 1986, and before in other forms, the UK government has unilaterally, without waiting for others to follow suit, levied a Stamp Duty Reserve Tax of 0.50% on transactions in UK equities. Despite not updating this tax to take into account derivatives and other innovations, it still raises US$ 5bn per year. The reason why these FTTs work is that they are stamp duties on the transfer of ownership and not based on tax residence. If the transfer has not been "stamped" and taxes paid, the transfer is not legally enforceable. Institutional investors who hold most assets around the world do not take risks with legal enforceability. Forty percent of the UK Stamp Duty Reserve tax receipts are paid by foreign residents. Far from sending tax-payers rushing for the exit, this tax gets more foreigners to pay it than any other.

Having lost the argument on feasibility, the financial sector and their political friends are now vigorously opposing FTTs with ever more outlandish claims about their negative impact on the wider economy. They have latched on to very preliminary estimates by the EU Commission that a 0.1% FTT on equities and bonds could reduce GDP by 1.7%, without waiting for the final analysis. In its latest iteration, the European Commission model takes into account that the overwhelming majority (85 per cent) of investment comes from retained earnings or bank loans not subject to FTTs. Furthermore,as the European Commission analysis said from the start, the proposed FTTs would apply only to transactions between financial institutions and would not cover companies issuing new shares. Once these factors are taken into account, the Commission's model indicates that the estimated negative effect of FTT on GDP would fall to just 0.1 per cent.

But this is not the complete story. It is necessary to add that the tax would fall heaviest on short-term holders of securities such as high-frequency traders, hedge funds and bank proprietary trading desks and fall least on long-term holders such as pension funds, life insurance companies and private equity firms. This would likely trigger a shift away from short-term trading in favour of long-term holding that will reduce misalignments in markets and their subsequent abrupt adjustments or crashes. FTTs would therefore somewhat decrease the likelihood of future crises and indeed those countries that have them were disproportionately amongst those least affected by the crash.

If we conservatively estimate that the probability of crisis would decrease by only 5% as a result of the FTT, which is very low, and we take into account that on average financial crises decrease GDP by around 7%, we would have a positive impact of +0.35% of GDP due to a smaller likelihood of future crisis. The total net effect of an FTT would be an estimated boost of European GDP by +0.25%, not a reduction. A more detailed version of this analysis can be found in our recent report presented to the European Parliament (http://policydialogue.org/publications/network_papers/financial_transaction_taxes/).

At a time when many European governments face large deficits, to a large extent as a result of bailing out the financial sector, it seems reasonable to expect the financial sector to support the balancing of the books as well as adopting measures to help reduce the likelihood of future crises. To us and hundreds of other economists, the evidence is clear that an FTT at EU-27 or at Eurozone level would help strengthen Europe's finances and reduce the likelihood of crises. And being one of the first international taxes, a proportion of its revenues should be ear-marked for helping to finance solutions to some of the world's most difficult international problems like poverty and climate change. Thus an FTT could help somewhat fairer and more sustainable growth in Europe and globally.

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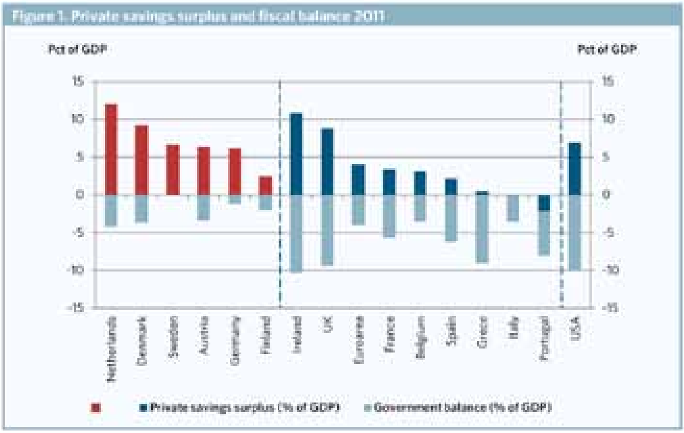
Great Potential in the Realisation of Private Savings Surpluses

The economic crisis has put pressure on the European public finances resulting in large budget deficits and increased debt. But the European countries entered the crisis with different starting points, which means that not all public finances in the European countries are equally badly hit today. Despite the fact that many of the European countries are struggling with public finances, a lot of the countries have large private savings surpluses (private savings minus private investment). Figure 1 shows the private savings surplus and the fiscal balance in 2011 in several European countries.



Remarks: The countries marked with red in the figure, are countries that have a relatively large savings surplus and relatively small public deficits and public debt. (Source: AE based on OECD.)

Figure 1 shows that the vast majority of European countries have high private savings surplus, with the exception of the most indebted countries of southern Europe. The large private savings surpluses indicates that liquidity and capital are present, but that European consumers and investors generally do not have much confidence in the European economy and therefore prioritise savings and repaying debt rather than consuming and investing.

The figure also shows the general government balance in percent of GDP. According to EU's Growth and Stability Pact the public deficit may not exceed 3 percent of GDP. With the newly adopted fiscal pact, the requirements for the budgets are tightened further, as countries have agreed that the deficit on the structural budget balance must not exceed ½ percent of GDP.

Several of the Scandinavian countries, Austria, Germany and the Netherlands have relatively large private savings surpluses, while neither very large government balance deficits nor large public debt (the countries are marked in red in Figure 1). These countries have the (though limited) option to stimulate the economy and at the same time there is great hidden potential in the large savings surplus. If the confidence returns and consumers and investors begin to consume and invest again, it may very well be what is needed to get the European economy back on track.

I. Positive scenario: Modest fiscal stimulus creates increased confidence in the European economy

As previously described, several European countries still have a good starting point, with relatively healthy public finances and a large private savings surplus. In other words, several European countries still have the option to stimulate the economy, though this option is limited. The large private savings surpluses in several European countries shows that liquidity and capital is present, but that confidence in the future and fear of further deterioration of the crisis discourages investors and consumers from spending.

If the current situation is turned around and more optimism and positivity is spread throughout Europe, it can create a chain reaction of positive confidence. A relatively modest fiscal stimulus may be the "recipe" that triggers the European economy, acting as a catalyst to create confidence and optimism.

In the following we use the international macroeconomic model HEIMDAL to calculate the welfare and employment effects of a modest fiscal stimulus, where the stimulus generates positive confidence in the European economy and part of the European private savings surplus is realised. A more thorough discussion of the assumptions behind the scenario can be found in Box 1.

Box 1. The positive scenario - Fiscal stimulus and increased confidence in the economy

In the positive scenario it is assumed that the European countries that have room for fiscal maneuvering stimulate the economy by ¼ percent of GDP in 2012 and an additional ¼ percent of GDP in 2013. Countries considered to have room for fiscal maneuvering, are countries with neither very large public sector deficits nor large public debt in Figure 4, but with large private savings surpluses. These countries are marked with red in Figure 1

It is assumed that the fiscal stimulus generates positive confidence in the before mentioned economies, resulting in increased consumption and investment ratios corresponding to an increase in GDP growth by ¼ percentage point in 2012 and ¼ percentage point in 2013. The European countries that are not part of the fiscal stimulus, will also experience higher growth and prosperity through trade effects that are created when demand increases in the countries they trade with. Confidence effects for these countries are not included. Inclusion would result in greater effects.

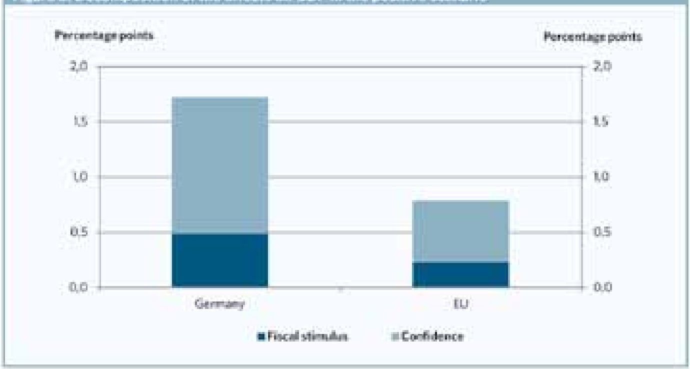
Figure 2 shows the wealth effects of fiscal stimulus and increased confidence in the economy in Germany and in the EU. By stimulating the economies and increasing confidence, countries like Germany can potentially create more than 1 percentage point higher GDP growth in 2012 and approx. ½ percentage point higher GDP growth in 2013. At the EU level, the effort could create approx. ½ percentage point higher GDP growth in 2012 and just under ¼ percentage points in 2013. Even though only a few EU countries are participating in the effort, most of them small countries, these countries are still able to create significantly higher growth in the EU overall.

Figure 2. GDP effects in the EU in the positive scenario

Source: AE based on the international macroeconomic model HEIMDAL.

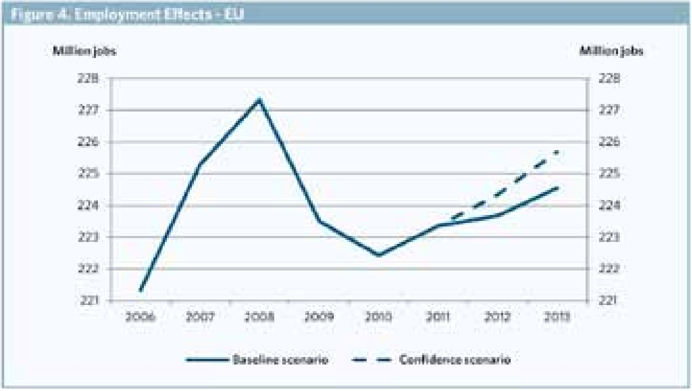
In Figure 3 the total GDP effect is decomposed into the effect caused by fiscal stimulus and the effect caused by the positive confidence in the economy. As stated, it is the increased confidence and thus the inclination to consume and invest, which creates the largest share of the wealth effect. The fiscal stimulus acts as a kind of catalyst boosting consumption and investment.

Figure 3. Decomposition of the effects on GDP in the positive scenario



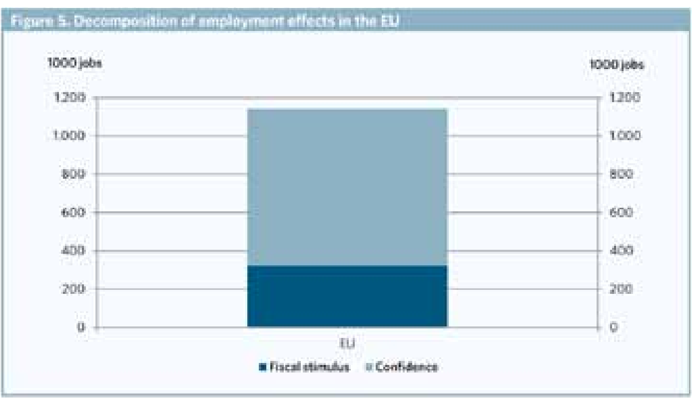
Source: AE based on the international macroeconomic model HEIMDAL.

Figure 4 shows the employment effects of a fiscal stimulus and increased confidence in the European economy. Overall, the effort could create 1.1 million jobs in the EU in 2013. The positive scenario of increased consumption and investment propensity in the European economy can thus be precisely what is needed to get the European economy back on track.



Source: AE based on the international macroeconomic model HEIMDAL.

Figure 5 shows a decomposition of the employment effect caused by the fiscal stimulus and the employment effect caused by the positive confidence in the economy. Once again the majority of jobs created stems from consumers and investors increased willingness to consume and invest. Almost 800,000 jobs out of a total of 1.1 million jobs are created by the positive confidence – this corresponds to approx. 2/3 of total job creation in the EU.



Source: AE based on the international macroeconomic model HEIMDAL.

Table 1 shows the welfare and employment effects in several European countries. The effects are greatest in the countries participating in the effort, but also non-stimulating countries, such as Britain, Spain and Poland will experience positive economic effects, since demand is rising in a series of the countries they trade with. The calculations do not include confidence effects for the countries not participating in the stimulus. The effects seen in non-stimulating countries are therefore the pure trade effects. The effects would be larger if the confidence effects were also included in non-stimulating countries.

Table 1. Growth and employment effects in selected European countries

	GDP (percent)	Employment (thousands)
Ex of countries that are part of the effort		
Denmark	1.8	41
Germany	1.7	426
Sweden	1.7	41
Finland	1.9	28
Ex of countries that are not part of the effort		
UK	0.2	66
Spain	0.2	32
Poland	0.5	57
Total effects		
EU	**0.8**	**1,142**

Source: AE based on the international macroeconomic model HEIMDAL.

II. Europe's way out of the crisis

The model calculations have shown that there is an alternative way for Europe. ***If Europeans restore confidence in the future and greater willingness to consume and invest the future may look brighter.***

The positive scenario clearly shows how a more nuanced approach to Europe's consolidation plans, where the most severely afflicted countries continue to consolidate, while the countries with room for fiscal manouvring relaxes a bit and stimulates consumption and investment, can potentially be a catalyst for growth and job creation in the economy. The increased demand will have spillover effects on countries that continue consolidating because of the integration of the European countries' economies.

The latest IMF World Economic Outlook Update (late January 2012) emphasises the importance that not all European countries consolidate simultaneously. ***"Importantly, not all countries should adjust in the same way, to the same extent, or at the same time, lest their efforts become self-defeating.*** Countries with relatively strong fiscal and external positions, for example, should not adjust to the same extent as countries lacking those strengths or facing market pressures. Through mutually consistent actions, policymakers can help anchor expectations and reestablish confidence". At the same time it is emphasised, that some European countries should postpone their consolidation. "Among those countries, those with very low interest rates or other factors that create adequate fiscal space, including some in the euro area, should reconsider the pace of near-term fiscal consolidation. Overdoing fiscal adjustment in the short term to counter cyclical revenue losses will further undercut activity, diminish popular support for adjustment, and undermine market confidence".[42]

But one thing is certain; the future challenges for Europe are both to put an end to the debt crisis and to create trust which in turn can generate growth and jobs in Europe. Hopefully, the newly adopted fiscal pact will help restore some confidence, although the strict requirements for the government balance could result in further consolidation in Europe in the coming years.

With the enormous uncertainty that is present in Europe, both in the financial markets and among consumers and investors, it is very likely that a more credible and binding cooperation on fiscal

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42 *World Economic Outlook Update January 2012.*

policy in itself could stimulate growth. By reducing uncertainty in financial markets and among consumers and investors in the future, growth can be obtained despite the fact that the fiscal pact does not include stimulants in itself. However, the fiscal coordination should reach further and have more perspective than the newly adopted fiscal pact and even more importantly it should be accompanied by initiatives stimulating growth and employment.

One way to maintain the tight budget requirements, while increasing countries' ability to stimulate the economies during economic downturn, is by dividing the public budget into an operating-related part and an investment-related part. It makes good sense to have strict rules for the operating-related part of the budget, but it seems inappropriate to have very rigid rules on investment – regardless of business cycles. Such a division of the budget, where the requirement for the budget deficit mainly relates to the operating-related part, would, in the present situation make it possible to stimulate growth through investment in countries that have relatively small budget deficits and public debt.

When it comes to future fiscal coordination there should be far greater focus and commitment to tightening and consolidating public finances in times when the economy is doing well. In this sense the requirement for the structural balance (which is cyclically adjusted) is a step in the right direction, as it, unlike the general government balance, is not affected by the state of the economy. It is the lack of discipline and lack of consolidation of public finances up until the crisis, which is the main villain in the far-reaching economic and fiscal crisis that we see at the moment. It is not enough to focus only on whether the deficits are too large from a monetary aspect. When the economy was doing well surpluses should have been much greater and the deficits should have been much smaller than they actually were. The EU must therefore change focus and be much more concerned with the development of the real economy and demand austerity measures when the economy is doing well, rather than when the economy is in downturn.

As shown in the scenario, there is an alternative way for Europe. But a more positive development for European economy requires policy initiatives focusing on growth and employment.

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The Euro-zone Pact: a Governmental Perspective

The last two years have been extremely difficult for all of us. The sovereign debt crisis has made us peer into the abyss. Brave measures, further integration and open minded leaders were needed to first admit the EMU's – European Monetary Union- flaws and then work to overcome them. The Euro-zone Pact is only one example of these measures. It shows how European Governments have dealt with the lack of economic integration within the EU.

I strongly believe the EU will emerge reinforced out of this crisis. Europe has always evolved at the pace of new challenges and on this occasion, again, it shall live up to these expectations. We should look beyond national interests and from a progressive perspective.

I. Shaping the Eurozone Pact

The Spanish Government's policy is an example that illustrates what has just been mentioned. In our fight against the crisis, we have made a triple effort. First, we have acknowledged the Economic Union's imperfections. Second, we have negotiated with our partners the best way of dealing with these deficiencies and applied extraordinary measures to overcome them. Last but not least, we have worked hard to explain to the Spanish society in detail why those measures were needed and why the EU, as it has done in the past, must take a step forward in order to guarantee European, social and economic cohesion.

This paper is focused on the first two efforts, on how we, the European Governments, identified the problems and have worked to solve them. Regarding the third effort, this very paper is a good example of our commitment to transparency and communication with civil society.

In June 2010, during the Spanish Presidency of the Council of the EU, the European Council launched the Europe 2020 Strategy, the new European Strategy for jobs and growth. This framework for smart, sustainable and inclusive growth replaces its predecessor, the Lisbon Strategy. It aims at achieving several quantitative specific targets in five main areas by 2020: jobs, R&D, education, environmental issues and reduction of poverty. The Europe 2020 Strategy is the EU's answer to the structural economic challenges of the 21st century: globalisation, an aging population and climate change. This answer wants to keep Europe moving, in order to build economic prosperity based on increased competitiveness. Since the beginning of the global economic crisis, all European Governments committed themselves with a heavy agenda, in order to conduct structural reforms all over Europe. We know that our own national welfare benefits our partners. It is not solely about smart growth in Spain, the Spanish Governmental perspective is about fostering smart growth throughout Europe.

At the same time, the unfruitfulness of the Lisbon Strategy showed us the need of an improvement of the economic policy coordination to succeed in our targets. ***The economic crisis, unveiling the deficiencies of the European Monetary Union (EMU),*** stressed that reality. We share a common currency; therefore, we should have a better coordination of our economic policies. In this regard, again in June 2010, the European Council launched an economic governance reform of unprecedented proportions. With the endorsement of the European Semester, the Europe 2020 Strategy found its framework to coordinate national structural reforms. 2011 has witnessed the first European Semester, setting the foundations for economic policy cooperation and coordination within the EU, by synchronising macroeconomic and budgetary supervision, as well as the structural reforms agenda.

Within this framework, Member States presented simultaneously, by the end of April, their National Reform Programme (NRP) and their updated Stability and Convergence Programme. Through which a detailed description of each Member State's economic policy commitments was provided. June, the European Council adopted specific economic recommendations for Member States. Yet, in February 2011, the Euro area decided that this was not enough. The European Council's conclusions included a statement of the Euro Head of State and Government (HoSG). According to this statement, in order to guarantee Euro area stability, they launched the so-called 'Euro Pact', following the proposal made by Germany and France. Once again, our Governmental perspective pushed us to more integration and to tighten an already ambitious agenda. More harmonisation and coordination were - and still are - needed to maintain Monetary Union benefits. This is what the Euro area leaders are doing, no matter how tough the measures required to achieve it.

The Euro Pact itself was adopted in March 2011, during the extraordinary Euro Summit. The March European Council endorsed it, changing its name to Euro Plus Pact, due to the participation of six non-Euro members (Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). The Member States concerned had to present their commitments within the NRP and Stability and Convergence Programmes. Spain, together with France, was the first country to do so. The Pact's added value is that it provides an economic tool to coordinate and integrate traditional national policy areas within the existing EU economic governance structures. This makes it possible to guarantee that national commitments go in line with the EU objectives. The Euro area seeks more competitiveness, more jobs, consolidation of public finances, stability in the financial sector and fiscal coordination. This is precisely what the Pact offers: more integration and more Europe.

II. Applying the Eurozone Pact

The Euro Plus Pact Member States have committed themselves to implementing several economic measures in the short, medium and long term. Nevertheless, the most immediate target for 2011 is fiscal consolidation, in order to reinforce growth out of sustainable public finances. In this sense, the main areas to coordinate are the labour market, education, R&D, innovation, infrastructures and productivity.

Spain, as a Euro-Plus Pact member, supports a more integrated approach in the EU Economic Governance. We presented our NRP and its Stability Programme on April 29th, outlining in detail the Government´s eight commitments. These were advanced by Prime Minister Zapatero during the March European Council. The commitments and actions already taken correspond to the four Euro-Plus Pact targets:

i. Regarding *EU competitiveness*, the Spanish Government has taken the following measures:

- They have reformed the collective bargaining system in order to give more flexibility to the stakeholders;

- They have made the commitment to reform the professional services framework in order to boost the Services Directive;

- The Spanish Government has created a Competitiveness Commission. This independent body assesses Spain’s evolution in competitiveness and productivity, contributing to the decisions to be taken by the Government and other social partners;

- The Spanish Insolvency Law has already been reformed, in order to speed up insolvency processes and to help companies to refinance their debt instead of closing the business.

ii. In the field of *job creation*, the Spanish Government, in the first place, has adopted, in close cooperation with the Spanish regions and social partners, the Spanish Strategy for Jobs 2012-2014, implementing specific measures regarding professional training and active employment policies. Secondly, a plan to stamp out undeclared labour has been adopted recently, introducing several incentives for regularisation between June 2011 and December 2012. At the same time, sanctions against social security fraud have been reinforced.

iii. Regarding *financial stability*, last September 30th a reinforced set of capital requirements entered into force. The Spanish Government is committed to use, if needed, the Fund for Orderly Bank Restructuring (FROB) to manage efficiently credit institutions restructuring processes and to enhance their equity.

iv. All in all, these are extraordinary measures, adopted by the Spanish government during the last twelve months.

v. However, the most important and symbolic measure is related to the last great target of the Euro-Plus Pact, *sustainable public finances*. The Spanish commitment with fiscal consolidation and budget stability has led to the Spanish Constitution revision. This has been the second amendment since it has been adopted, in 1978. The first was done to ratify the Maastricht Treaty. The second was needed in order to back our commitments in the Euro-Plus Pact framework. At the beginning of September 2011, the Spanish Parliament passed the amendment of Article 135, enshrining the principle of budget stability at the highest legal level.

III. The Eurozone Pact, the Europe 2020 Strategy and Spain

The Spanish NRP goes further and establishes a set of targets in line with the Europe 2020 agenda. Job creation has always been a main priority for our Government and therefore we have committed to raise its employment rate from 62.5% to 74% (to 68.5% female employment rate). In the field of R&D, Spain will raise its percentage of GDP devoted to that sector from 1.38% to 3% (2% from the private sector).

Regarding climate change and energy, Spain is committed to a 10% reduction of greenhouse gas emissions in diffuse sectors and 21% in non-diffuse sectors (2005 references). This commitment is complemented by the decision to raise the percentage of renewable energies in our final energy consumption from 13.2% to 20%, as well as improving energy efficiency (2% up to 2020).

In the field of education, Spain intends to lower school failure rates from 31.2% to 15% and to raise to 44% the percentage of population between 30 and 44 years old with tertiary studies. Finally, regarding the reduction of poverty, Spain is committed to taking 1.5 million people from the threshold of poverty.

IV. Looking towards the future

The EU and its Member States have taken major action in order to face the present challenges and set the foundations for a stronger Europe. However, let us not ignore the fact that other difficult and important decisions are yet to be taken, in line with the idea of developing a "real economic Government" on the basis of what was agreed on the Euro Summit of October 26 2012.

Furthermore, I believe that Eurobonds would be the most convincing message to the markets about the Eurozone´s determination to stand by its single currency. Setting up a European Debt Agency that would issue "e-bonds" would end with the fears of the markets.

I would like to point out here that I find it surprising that, at this stage, the Conservative German and French leaders did not provide their support to them.

We, Socialists, think that there will be no exit from the crisis without growth and therefore job creation. And for Member States to be able to deliver, taxation is the clue. Raising public revenue, via taxes, is particularly critical in the current context of weak private investment. However, this must be made through the implementation of progressive taxation and the most efficient way to achieve this is taxing highest incomes. On the other hand, last September the European Commission tabled a proposal of a financial transaction tax which could be directly allocated to the budgets of the EU in order to lighten the contribution of each Member State to the EU budget. This would allow for the EU budget to finance economic recovery programmes, adding also an element of progressive burden sharing. Europe is approaching a crucial period in economic politics, where a blunt fiscal change of direction towards progressive taxation must prevail.

Europe does not only react, it creates. The economic crisis presents us with challenges and, at the same time, opportunities. We have to work hard on two fronts: resolving the present critical situation and finding the way to enhance growth.

Decisions taken during the October 26th Euro Summit go precisely in this direction. Indeed, the Euro HoSG took unprecedented steps to strengthen the economic union and to underpin their common currency. Let me describe briefly these agreements:

i. **Sustainable public finances and structural reforms for growth:** The Eurozone leaders have reiterated their firm commitment to implement the country specific recommendations made under the 2011 European Semester and on focusing public spending on growth areas. Spain's efforts to reduce public deficits, to restructure our banking sector and to reform product and labour markets, as well as the adoption of a constitutional amendment guaranteeing budgetary balance, have been welcomed by our peers.

ii. **Countries under an adjustment programme** will continue to receive support from Euro countries until they have regained market access, provided they fully implement those programmes. Concerning the Greek crisis, critical decisions have been taken in order to support its economic recovery.

iii. **Stabilisation mechanisms:** The decisions taken by the Euro members, concerning the European Financial Stability Fund (EFSF) last July 21st are at present fully operational. Nevertheless, Euro leaders have decided to increase the Fund's financial assistance capacity up to 1 trillion euro.

iv. **Banking system:** The Euro leaders have welcomed the agreement on bank recapitalisation and funding (9% of Core Capital).

v. **Economic and fiscal coordination and surveillance:** In January 2012 the legislative package on economic governance will come into force. The Euro Summit has called for its strict implementation, as part of the European Semester, as well as for rigorous surveillance by the Commission and the Council. The Eurozone Member States have also recalled their commitments within the Euro Plus Pact framework.

vi. In order to reinforce the **Governance structure of the euro area**, the Euro HoSG will meet at least twice a year, in Euro Summits, to provide strategic orientations on the economic and fiscal policies in the euro area. Nevertheless, the Eurogroup, together with the Commission and the European Central Bank (ECB), will remain at the core of the daily management of the euro area.

vii. Finally, the Euro leaders, in order to **further strengthen economic convergence within the euro area**, agreed to improve fiscal discipline and deepen policy coordination, and asked the President of the European Council to present in December 2011 a report identifying possible steps to strengthen the economic union, including exploring the possibility of limited Treaty changes. A report on how to implement the agreed measures should be finalised by March 2012.

I am European by conviction and I strongly believe that the only chance we stand is a more closely integrated Europe. We, Progressive Europeans, must pool together all our forces to attain this aim, not only for the benefit of hundreds of millions of Europeans, but for the whole world.

Toralf Pusch,
Researcher, Halle Institute for Economic Research, Belgium

Could a Debt Repayment Pact lead Europe out of the Crisis?

The strictly conditional solidarity imposed on the crisis countries has cast them into a vicious circle of high public debt, drastic austerity measures and sharp declines in growth. The heightened budgetary supervision has limited scope as a means of stabilising the Eurozone since it does not remedy external imbalances.

- In its latest annual report, Germany's Council of Economic Experts presents an innovative proposal to resolve the euro crisis in the form of a debt repayment pact. It differs from the one-sided approaches that have been predominant so far.

- At the core of the debt repayment pact is the temporary funding of that part of public debt that exceeds the 60 per cent limit laid down in the Stability and Growth Pact. A repayment fund is to be used to reduce Member States' debts over a period of 20–25 years. The yields on these jointly guaranteed debts are likely to be significantly lower than the interest currently required by the market for crisis countries such as Italy and Spain.

- Bringing interest rates down will gain time for a sustainable consolidation path and growth-friendly reforms. However, the instruments of fiscal discipline proposed for that purpose are too rigid and stimulatory schemes are entirely lacking. Furthermore, the debt repayment pact can succeed only if the ECB is authorised to complement debt reduction with a monetary "mantle of growth".

I. The Vicious Circle of Public Debt, Austerity Policy and a Growth Slump[43]

For the European Union, 2011 was an inauspicious year. As the year progressed, it became progressively more difficult for the southern Eurozone Member States in particular to finance their new borrowings, which had increased significantly in the wake of the financial crisis. On the markets for public debt this found expression in mounting yields (yield premiums) on government bonds. According to prevailing opinion, the measures taken by the Member States and the EU so far are insufficient to effectively contain speculation against sovereign debt. Poor communication has done even more to exacerbate the crisis. After a debt haircut had been tabled by members of the German government in summer 2011 and in autumn of that year even the prospect of Greece's exit from the euro, speculation gathered momentum. Finally, even euro-heavyweights Italy and Spain had to pay significantly higher interest rates on newly incurred debt.

The drastic budget consolidation already implemented in the Member States concerned – which in 2011 amounted to up to 6.9 per cent of economic output (deficit reduction in comparison to 2009: see Table 1) – was not rewarded by the financial markets with a lower

43 The author would like to thank the members of the FES working group for helpful comments and remarks on earlier versions of this text.

interest burden.[44] Against the background of the worsening social situation in Greece and Spain, for example, the question of whether the way out of the euro crisis lies in a further intensification of the austerity measures becomes ever more urgent. The institutional innovations currently under discussion in the EU – such as automatic sanctions in the implementation of the Stability and Growth Pact and the introduction of national debt brakes – are clearly heading in this direction. It is questionable, however, whether this approach – which might in any case take years – is practicable, given the previous dynamics of the euro crisis. Finally, even the rating agencies have had to recognise that a one-sided austerity programme cannot end the plight of the crisis countries.

What the crisis countries need are a rapid fall in the interest rates on their government debt and stabilisation of economic prospects. The two are likely to be connected. Although government austerity efforts can at first lead to a reduction in planned new borrowing, as a rule they are accompanied by economic slowdown. So-called negative multiplier effects are unleashed by government austerity policies especially in periods of low economic activity and in many Member States can cause a slump in growth that exceeds the cuts.[45] As a result, incomes and tax revenues fall so that the planned reduction of new borrowing

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44 This had been urged in a joint appeal before the euro crisis summit in December 2011 by Sigmar Gabriel, Frank-Walter Steinmeier, Renate Künast, Cem Özdemir, Claudia Roth, Jürgen Trittin and Peter Bofinger: "Zwölf Punkte gegen Merkels Krisenstrategie", http://www.sueddeutsche.de/politik/punkte-gegen-merkels-krisenstrategie-spd-und-gruene-attackieren-die-kanzlerin-1.1229829

45 For an overview of the fiscal spending multipliers of various EU Member States see: Pusch, T. (2012): Fiscal Spending Multiplier Calculations based on Input-Output Tables – an Application to EU Member States. Intervention 1/2012 (forthcoming).

cannot then be achieved. This can be illustrated among other things by the relative synchronisation of strict budget consolidation and weak growth dynamics in the problem countries (of which Italy, which hitherto has experienced relatively low consolidation, is still in the best position: see Table 1). Budget consolidation in the EU should therefore be undertaken prudently and is unlikely to succeed unless countries do not all impose austerity measures at the same time and the external environment is favourable.[46]

Table 1: Budget consolidation and economic growth, selected Eurozone member states

Crisis countries:	Budget deficit 2011 (% of GDP)	Budget consolidation from 2009 to 2011 (deficit rate reduction in %)	Economic growth from 2009 to 2011 (in %)
Ireland	10,3	–3,9	0,7
Greece	8,9	–6,9	–8,8
Spain	6,6	–4,5	0,7
Italy	3,8	–1,5	2,1
Portugal	5,8	–4,3	–0,5
By comparison:			
Germany	1,3	–1,9	6,7
France	5,9	–1,7	3,1

Source: AMECO (estimate, October 2011).

In fact, many of the actors concerned are aware of this state of affairs. Even the rating agencies justified their recent downgrades of European states in terms of the deteriorating growth prospects, which are undoubtedly linked to budget consolidation. However,

46 See Karl Aiginger and Margit Schratzenstaller (2010): Budget Consolidation in a Difficult Environment – Ten Guidelines Plus a Preliminary Reality Check, WiFo Working Paper No. 381.

also part of European reality is the insistence of the donor countries offering financial support on far-reaching budget consolidation and demands for corresponding readjustments in the event of breached debt targets. The crisis countries are thus compelled to institute supplementary budgets in the course of the year and make further cuts. Due to the continual government austerity efforts, which are not likely to end for the foreseeable future, the economic prospects of the private sector are further destabilised, leading to renewed caution, declining momentum and thus revenue losses.

II. Current State of Budget Policy Supervision in the Eurozone

Since the beginning of the euro-crisis there has been fierce debate on how to overcome it. The European Financial Stability Facility (EFSF), a rescue fund, was set up with the IMF as a short-term measure to assist countries with budgetary difficulties. The IMF and the EFSF currently provide loans to Greece, Ireland and Portugal. The loans have been subject to strict conditions from the outset. The goal of reducing public debt is to be achieved in the medium term via budget cuts, raised taxes and growth-promoting reforms. In practice, this has proved difficult so far. Greece in particular is in a negative economic spiral, such that loan repayments are looking increasingly improbable.

In parallel with the short-term crisis aid in 2011 renewed efforts were put into European instruments to bring about the long-term stabilisation of the Eurozone. Particularly worth highlighting is the so-called "Sixpack" adopted in September 2011, comprising six regulations on limiting government debt and macroeconomic supervision. The Sixpack first of all envisages new rules on tightening up the Stability and Growth Pact. In future, it will be possible to halt deficit procedures that have already been instigated, including possible sanctions, only on the basis of a qualified majority of EU finance ministers (in the ECOFIN Council). Hitherto, a relatively large majority was required in order to impose sanctions. With the new procedure the imposition of sanctions in the ECOFIN Council will be much more likely. Furthermore, the deficit procedure can now only be introduced if the guideline of 60 per cent of government debt – measured in terms of GDP – is exceeded and no adequate consolidation efforts are undertaken to rectify the situation. Such efforts are deemed to be in place when government debt is reduced by one-twentieth each year. At the European crisis summits in December 2011 and January 2012 it was further agreed, as regards intensifying individual states' consolidation efforts, that the Eurozone Member States and some other EU Member States should adopt national debt brakes, to be safeguarded by an international treaty which is yet to be negotiated.

Besides the stricter Stability and Growth Pact the Sixpack also contains a regulation on monitoring macroeconomic imbalances. Such imbalances are to be determined by indicators of price competitiveness, such as unit wage costs and external imbalances. This procedure is very welcome since in the run-up to the financial crisis some of today's crisis countries were by no means running excessive budget deficits. However, marked external imbalances in, for example, Ireland and Spain before the crisis indicated high private debt which turned into a parlous budgetary situation when the real estate bubbles burst. In contrast, countries such as Germany and the Netherlands had large foreign trade surpluses, part of which took the form of problematic investments in the current crisis countries (and in the United States), thus fuelling the real estate bubbles. The link between external imbalances and the euro-crisis makes it clear that budget consolidation has only limited use as a means of bringing about sustainable stabilisation in the Eurozone.

III. A Prudent Proposal: The Debt Repayment Pact

On important economic questions the German government is advised by a Council of Experts (often referred in the press as »the five wise men«). In its recent annual report – 2011/2012 – the Council of Experts proposed a debt repayment pact which could represent an interesting contribution to resolving the euro-crisis.[47] The pact would basically involve temporary joint financing of that part of government debt in EMU Member States that exceeds 60 per cent of economic output. In particular for countries with a very high level of government debt, such as Italy, such a step could provide some relief since the interest on the jointly guaranteed debt, assuming the appropriate institutional design, is likely to be much lower than the yields currently demanded by the market. At the same time, the inclusion of Italy and Spain would take the wind out of the sails of market speculation since the inadequate volume of the EFSF and the ESM for financing these state budgets would no longer be an issue. Countries already in an adjustment programme (Greece, Ireland, Portugal) are not included in the proposal and will remain within the scope of the IMF, the EFSF and the ESM (succeeding the EFSF). The debt repayment pact can thus in the first instance be regarded as a proposal for containing the euro-crisis in the Eurozone's larger economies (France, Italy).

The debt repayment pact envisages that the participating countries be allowed joint financing for a period of five years (roll-in phase). For this purpose, jointly guaranteed debts would be assumed on the financial markets and the funds would be passed on to the participating countries. The credit range thus made available would be predetermined by the extent to which the national debt diverges from the Stability and Growth Pact's 60-per cent criterion at the beginning of the joint borrowing. Italy, for example, could therefore convert around half of its current debt over the five-year period into jointly guaranteed debt securities (the rest would remain under

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47 See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung [Council of Economic Experts] (2011): Verantwortung für Europa wahrnehmen, Jahresgutachten 2011/12.

national guarantee). As of the end of 2011, this corresponds to around half the possible borrowings via the debt repayment pact (see Figure 1). Other participating countries with a considerable financing sum in the fund would be Germany and France. In due course, these debts are to be repaid by the participants in accordance with the level of the sum borrowed. A period of 20 to 25 years is envisaged for this purpose, to make the adjustment path bearable.

The hope invested in the debt repayment pact is that the yields on jointly guaranteed debts would be significantly lower than market interest rates if the right institutional arrangements were established. This would represent a considerable relief for Italy in particular and could enable it to get back onto a sustainable growth path and tackle budget consolidation prudently. For Spain the relief would be somewhat less because hitherto its debt level, at around 70 per cent, is only a little above the 60 per cent threshold. The volume of Spain's financing from the Fund would thus be comparatively low (see Figure 1). We shall now look at the pact in more detail.

IV. Five Pillars of Strict Fiscal Discipline

In its proposal, the Council of Experts strongly emphasises that the structure of the jointly guaranteed debt should give no incentive for individual Member States to unload the debt onto other Member States. Five criteria were formulated for this purpose that must be met to obtain funds from the joint bond issues:

i. The introduction of national debt brakes is supposed to ensure that government debt really is reduced, thus disabling one possible trigger for speculation against EMU Member States. Violations are to be punished by means of European supervision of compliance with these national debt brakes and lead to immediate payment by the affected country to the debt repayment pact. Central bank profits can be deferred for this purpose.

ii. Medium-term paths for debt reduction can be established and supported by laying down national consolidation and growth strategies.

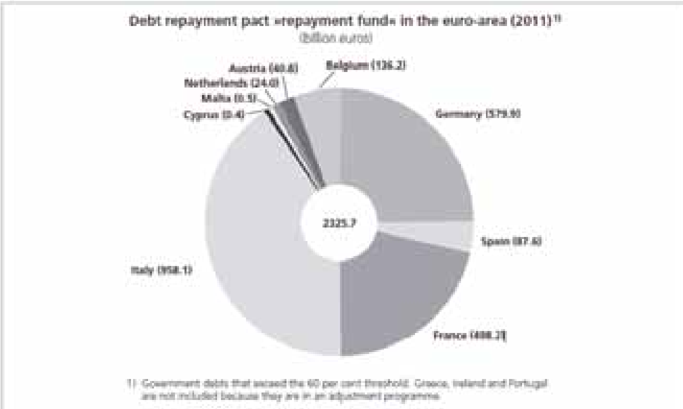
iii. If a country fails to meet its obligations under point (ii) in the course of the roll-in phase the roll-in for this country can be terminated.

iv. Participating countries must commit themselves to VAT and/or income tax increases, which will be used directly for debt repayment to the Fund. In addition, priority repayment of debts from the fund could be written into the constitution.

v. Part of national foreign exchange reserves are to be pledged (in the amount of 20 per cent of borrowings).

Under criteria 1 to 3 participating countries should be obliged as early as the roll-in phase to lay the foundations for long-term budget consolidation. Criteria 4 and 5 should mean that in the repayment phase additional funds are made available to cover repayments and thus help to further limit liability risk.

Figure 1: Maximum financing volumes from the repayment fund (as of the end of 2011)



Contribution of the Debt Repayment Pact to Combating the Crisis

The proposal of a debt repayment pact can make an important contribution to overcoming the euro-crisis. However, it does have weaknesses and should, in particular with regard to boosting growth potential, be adjusted to the countries concerned.

Euro-heavyweights Italy and Spain would receive the requisite liquidity in the short and medium terms so they would not have to continue with austerity measures in the crisis and to limit the cost of their new debts. The interest-deadening effect derives from several sources:

i. A more liquid market would emerge from joint borrowing. Joint debt securities could be traded more easily by investors because of their larger market volume, which would tend to have an interest rate–reducing effect.[48] Market breadth could also be

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48 This is one of the key arguments for the interest rate–reducing effect of eurobonds; see Jacques Delpla/Jakob von Weizsäcker: Eurobonds. Das Blue Bond-Konzept und seine Implikationen. Friedrich-Ebert-Stiftung, June 2011.

increased by not issuing the debt securities for the maximum 25-year term of the debt repayment pact. If the term were limited to 10 years, as is already the case with regard to the bulk of national public debt, the market breadth for the securities would be approximately doubled. Repayment over 25 years would be possible nevertheless by further jointly guaranteed borrowing when the securities reach maturity (on a smaller scale due to the repayment plan).

ii. Joint guaranteeing of the debts in the repayment fund by weaker countries and countries with higher creditworthiness, such as Germany and the Netherlands, leads to a lower credit default risk in comparison to the purely nationally guaranteed debts of Italy and Spain.

iii. The priority servicing of joint debts formulated in the criteria and the pledging of foreign exchange reserves or central bank profits are also likely to keep interest rates down by again reducing the risk of default on joint debts.

The significantly reduced interest rates on their new borrowings would win crisis countries such as Italy and Spain up to five years' grace for growth-enhancing reforms. Countries with considerable foreign trade surpluses, such as Germany and the Netherlands, if given more time could more easily contribute to the economic dynamics in the Eurozone, since presumably their foreign trade surpluses could be reduced only with great difficulty in a short time (this requires structural changes in the economies concerned). The looming negative spiral of austerity policy and ensuing growth slumps in the Eurozone could thus be countered effectively. The provision of a comparatively secure fixed asset (the jointly guaranteed bonds) could also stabilise the European banking sector.

Other proposals for resolving the euro-crisis currently under discussion, such as IMF participation in budget financing and leveraging the EFSF to finance partial coverage insurance of government debt are less convincing. Stronger IMF participation would probably lead to higher risk premiums on government debt due to the priority status of IMF loans. Partial coverage insurance on government debts would indicate that the countries concerned, in the event of a financing bottleneck, would definitely be on their own to cope with it and there would be no interim aid. As a result, the likelihood of a payment default would be significantly higher – this too would be a reason for higher risk premiums. The incentives for austerity measures that exacerbate the crisis thus remain in the case of both stronger IMF participation and a leveraged EFSF. The debt repayment pact differs markedly from the measures to combat the euro-crisis implemented hitherto. On the one hand, one should mention the ongoing adjustment programmes involving Greece, Ireland and Portugal. Not only are they much more short-term than the debt repayment pact, but the countries concerned have to pay much higher interest rates (over 5 per cent).[49] The strict conditions imposed by the IMF and the EU also lead to austerity measures that only exacerbate the crisis. The tightened-up Stability and Growth Pact (see the remarks on the Sixpack in Section 2) starts out similarly, especially with regard to budget consolidation. In the event of rigid implementation the heightened stringency and accelerated procedure could further exacerbate European growth problems in the current troubled economic environment, in particular if the austerity measures are imposed everywhere in the European Union.

The same applies to the decision taken at the EU crisis summits in December and January to introduce national debt brakes in all the Eurozone countries. Here the choice of adjustment path and the

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49 See Rainer Lenz (2011): Die Krise in der Eurozone: Finanzmanagement ohne Finanzpolitik, Friedrich-Ebert-Stiftung, June 2011.

assumptions made in calculating the structural deficit are extremely sensitive. Too restrictive assumptions with regard to tax elasticities and the level of the automatic stabilisers could easily cause the debt brakes to have a procyclical effect.[50]

Need to Adapt the Debt Repayment Pact

Basically, the Pact manages to strike a balance between short-term relief as regards refinancing by crisis-hit states and prudent and long-term budget consolidation. However, the Pact also exhibits a few significant weaknesses that need to be corrected.

First, the Pact should not reinforce the current trend towards drastic and counterproductive austerity efforts. That would represent no improvement over how things are already. To ensure progress, the annual debt reduction envisaged by the Council of Experts of 5 per cent of public debt over the 60 per cent level should not be applied too rigidly, but in accordance with a country's specific economic outlook. Another disadvantage of the proposal is that practically all countries would be subject to a debt repayment programme because almost all euro-countries have national debts above 60 per cent of GDP. As a result, every country would be subject to austerity measures, thereby further exacerbating the growth-dampening spiral. Hitherto, states such as Germany, despite having debts above the 60 per cent mark and pursuing a moderate course of austerity, have been able to function as a growth-engine for the Eurozone. ***Germany could, for example, by boosting domestic demand, help to stimulate demand to the benefit of other euro-countries which at least partly offset their lower growth.*** In order to avoid a concerted euro-austerity policy the pace

50 In particular, the German version of the debt brake appears to be affected by this; see Gustav A. Horn, Torsten Niechoj, Achim Truger, Dieter Vesper and Rudolf Zwiener (2008): Zu den Wirkungen der BMFSchuldenbremse, IMK Policy Brief, May 2008.

of general government debt reduction should not be binding on all states with debts over 60 per cent, but rather for an appropriate selection. Stronger countries with foreign trade surpluses, such as Germany and the Netherlands, would probably obtain no interest-rate benefit from the debt repayment pact, anyway, so there would be little incentive to submit to all of its regulations. In any case, these countries have a comparatively low debt dynamic.

A key institutional weakness of the Pact is the uncertainty concerning whether the rules will be complied with over the long period of 20 to 25 years or considerably diluted. Thus it is not unlikely that a country will abandon the particular debt repayment path it set out on after a number of years for a less demanding one. This could diminish the Pact's institutional credibility. On the other hand, laying down in the first year a binding and inflexible repayment path for the next 20 years, from which no subsequent deviation is possible, is ruled out. The business cycle and global economic environment could necessitate an adjustment of the repayment path over time. This problem can be resolved credibly only if the debt reduction target is fixed for 20 years, but some scope for short-term relaxation (with the repayment path subsequently being speeded up) must be possible. Only in this way can a debt repayment path with breathing space be ensured.

In parallel with debt repayment the Pact must provide for a concrete growth strategy for each country. Only a combination of sustainable financial policy and a strengthening of the forces driving growth can safeguard lastingly low bond interest rates and robust growth prospects. A growth strategy should therefore imply that countries have privileged access to the resources of the Structural Fund. Depending on the debt level at the beginning of the repayment programme a certain portion of the available structural funds should benefit the country.

A European investment programme can also help in combating the growth defects of the crisis countries. This should be tailored to countries' specific needs. Thus, in Greece, for example, support should be provided for industrial locations and business start-ups to overcome its lack of competitiveness. In Portugal, spending on education is urgently required: the rate of those leaving school without qualifications is 37.1 per cent – in Germany, the rate of 2.8 per cent is already considered much too high. Overall, ***an investment programme must put money into infrastructure, education and R&D.*** The investment programme could be financed by increasing the EU budget. Such programmes should comprise a mixture of short-term economic stimulus measures and long-term structural aid.

V. Outlook: Prerequisites of Long-term Budget Consolidation in the Eurozone

Whether the repayment of debts envisaged in the debt repayment pact for the period after 2016 is managed over a 20–25 year period is likely to depend on a number of factors. First, in every economy paying down public debts requires correspondingly lower savings – or higher debt – on the part of the private sector and/or other countries.[51] An increase in external debt is likely to be difficult for the Eurozone overall because it would be accompanied by an improvement in the current account balance of the whole Eurozone. Overseas countries – in Asia, the United States and so on – would have to be willing to buy significantly more goods and services from Europe. The data show, however, that many emerging countries are also trying to strike out on this development path and the United States already has a major problem with excessive current account deficits.

51 For a description of this identity see M. Brecht, S. Tober, T. Van Treeck and A. Truger (2010): Squaring the Circle in Euroland? Some Remarks on the Stability and Convergence Programmes 2010–2013, IMK Working Paper 3/2010.

What is difficult for the Eurozone as a block is nevertheless a condition of sustainable recovery for the southern Member States. The euro-crisis illustrates that lasting current account deficits and thus increased external debt may trigger abrupt withdrawal of capital – right through to flight out of government debt securities. The Southern countries should thus strive to improve their current account balances by exporting more to the rest of the Eurozone and overseas.

Successful public debt repayment would bar the way for more competitive Northern countries to further increase their exports. In the event that the Eurozone is stabilised they would have to live with a relative loss in competitiveness and export markets since the Eurozone as a whole will be able to export less rather than more if the crisis is overcome.[52] In these circumstances, public debt repayment requires mainly lower savings or heightened private sector debt. This can work in particular in the event of robust economic growth if enterprises expand their borrowing to finance investment. Where governments are in a position to do so, they should thus support domestic growth in the Eurozone's export countries. Innovative approaches to supporting the economy, redistribution measures – such as minimum wages – and an effective state spending policy could contribute to this. One European institution in particular is likely to enjoy much higher status than before the financial crisis: the European Central Bank will be a critical factor in properly developing the Eurozone's monetary mantle of growth. Its interest rate policy gives the ECB the means to encourage business investment. There would be no need to limit its autonomy for this purpose. However, the ECB mandate should be extended by European legislation to

52 *This is a consequence of the so-called Triffin-Dilemma, according to which countries with a successful reserve currency experience enhanced international demand for their assets. Long term, therefore, successful euro stabilisation would probably lead to appreciation and, consequently, to a current account deficit for the Eurozone as a whole.*

include an explicit growth target on a par with the goal of price stability, on the model of the US Federal Reserve. Undoubtedly, there is a possible conflict of aims between boosting growth and limiting price rises. This conflict is the object of a long-standing economic debate on the trade-off between unemployment and inflation. More recent research shows, however, that, depending on the relevant labour market institutions, there is scope for using monetary policy to boost growth.[53] With a dual mandate, the ECB, like the Fed, would have to find a constructive approach to this problem. In the current situation, with an ECB mandate focused primarily on price stability it is doubtful whether a constructive approach is possible in the EU with this trade-off. Germany provides a good illustration. While the ECB's bond purchases so far are already considered to pose a major threat to price stability there, elsewhere in Europe there are worries about the continuance of the Eurozone should ECB participation in combating the crisis not prove possible in the last instance. The debt repayment pact, by contrast, foresees no further bond purchases by the ECB. The prospects of success with regard to the consolidation envisaged by the debt repayment pact, however, depend decisively on the other conditions for growth. Ultimately, it is up to the politicians to support the ECB with an appropriate mandate.

53 On this subject, there are a number of neo- and post-Keynesian contributions that start out from alternative specifications of the Philips curve; see Akerlof, G.A., Dickens, W.T., and Perry, G.L. (2000): Near-Rational Wage and Price Setting and the Long Run Phillips Curve, Brookings Papers on Economic Activity, No. 1: 1–60; also Pusch, T. (2009): Policy Games: die Interaktion von Lohn-, Geld- und Fiskalpolitik im Lichte der unkooperativen Spieltheorie, Lit Verlag, Zürich (combined with a game-theoretical argument). Also arguing from a game-theoretical standpoint, Dullien, S. (2004): The Interaction of Monetary Policy and Wage Bargaining in the European Monetary Union: Lessons from the Endogenous Money Approach, Palgrave Macmillan (inter alia).

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Strengthening the added value of the EU budget

I. The nature of the EU budget

The EU budget is unfortunately the victim of many misunderstandings. When I meet my electorate they tend to think that the EU budget is a heavy and growing burden on tax-payers. They hardly believe me when I tell them that the EU budget represents only a little more than 2 % of the European public spending, that most of the expenditure goes back to the Member States – but with a more fair solidarity based profile – and that the rate of increase has been slower than for the national budgets during the last 20 years.

This is true in spite of the rapid development of the EU's responsibilities through several new treaties, and an enlargement that almost doubled the number of Member States! Today, the budget is, as a percentage share, smaller than it was in the 90´s when the EU had only 15 Member States.

It is also true that the profile of the budget has changed radically. The Common Agricultural Policy (CAP) market expenditure and direct payments have fallen from close to two thirds of the budget to less than one third, while more "modern" growth related expenditure – particularly R&D and innovation – has grown rapidly. Cohesion policy (the structural funds) is now the biggest budget heading.

However, in spite of these improvements, to carry out new and growing tasks, and at the same time deliver on a demand for better results, with less resources is about to become an impossible equation. And the new tasks are not optional, they are a part of the treaty!

The Member States, through the Lisbon Treaty, have decided that the union shall be an important tool for meeting vast challenges, such as;

- Common strategies for growth and jobs, not least “green jobs”, through the EU2020 strategy;

- Common strategies to fight climate change and make strategic investments to develop sustainable energy and food production;

- New policies, new economic instruments and shaping new institutions to promote growth and economic stability;

- New instruments in order to defend the rights of workers, consumers, children, immigrants and other vulnerable groups and to fight poverty;

- the EU´s role in the world, in order to promote a new direction for global security, peace missions, development aid, human rights etc. to reach the Millennium Development Goals and other UN goals;

- A new round of enlargement, first with Croatia, and then the rest of the Western Balkans, Iceland, Turkey....

To fulfil these tasks, sufficient economic resources are necessary. Today they are not! So – the crucial question is: are the Member States prepared to live up to their commitments in the Lisbon Treaty, or have they already given up those ambitions under pressure from the economic crisis? For now, unfortunately, nothing suggests that the Member States are prepared to support the new tasks with additional resources - on the contrary! Today they advocate a freeze, or even cut, of the EU budget!

II. Why defend EU spending in times of austerity?

The crisis has put the EU budget in a difficult position, making the negotiations between the two arms of the Budget Authority (the ECOFIN Ministers and the European Parliament) more controversial than they have been for decades. The conciliation on the EU budget for 2011 was concluded just hours before the budget crisis was a fact. This reflects two very different views on the budget.

The Council has – under pressure of the crisis - been taken hostage by some conservative-lead and rather Eurosceptic governments. The British, Dutch and Swedish governments seem to be determined to reduce the budget. The Tory government, for example, declared at an early stage of 2010 that their ambition was to cut back the EU budget to 0.8 % of GDP from the current 1.04 %. Almost a quarter, about 300 billion € per year, would then be removed - more than twice as much as the EU costs for all research, innovation, infrastructure and student exchange together. This would mean slimming down the EU's ambitions and reducing Europe's influence, and thus, through the back door. The EU should return to its passive intergovernmental status, before not just the Lisbon Treaty, but before Maastricht, Amsterdam and Nice, before enlargement, before the Lisbon strategy and the EU2020 agenda.

The majority of Member States have – under pressure of national austerity - accepted a very restrictive development of the budget, basically freezing, even if they don´t share the British/Dutch/Swedish agenda. The huge majority of more or less conservative governments mean that it should be a self-evident effect of the crisis and the pressure on national budgets that the EU budget should be cut – or at least frozen - as well.

Unfortunately that "crisis logic" supports the more strategic agenda from some Member States, focusing on reducing the role of the EU permanently. That of course has to be matched on a political and ideological level, but we should also analyse the pure budgetary arguments, because you cannot compare the EU budget with national budgets, for several reasons:

- While national budgets are mainly used for public spending like welfare system payments, wages for teachers and nurses, running costs for public transport etc., the EU budget is mainly used for cross-border investments, to build the internal market, support long-term development of poorer regions and administer strategic European cooperation, often with a planning perspective of up to 7 years. Cuts in these areas will therefore lead to more long term and strategic consequences than cuts in national budgets;

- The EU budget is a tool for European solidarity, where richer countries support the development of poorer regions. Therefore substantial budget cuts hit the weakest regions and only benefit the richer net-payer Member States;

- The EU budget does not have to be reduced in order to deal with deficits, for the simple reason that deficits are explicitly forbidden by the Treaty. On the contrary – the EU budget every year delivers a surplus back to the Member States!

The European Parliament has, so far, with a broad majority rejected the cuts. Not just social democrats, but also the majority of the other pro-European political groups, believe that it is necessary to defend the EU budget in times of austerity. And for that view there are several reasons. Both the acute economic crisis and a more long term perspective point in another direction.

III. Austerity extremism prolongs the crisis!

First – on the acute crisis: The conservative-liberal majority in the Member States governments often talk about investment, resilience, security, sustainability and growth. However, when it comes to delivering in practice, their agenda is little more than narrow-minded austerity fundamentalism, particularly regarding the EU budget.

It is a depressing exercise to analyse the conservative-liberal economic plan for Europe. According to them Europe's daunting and multi-faceted challenges are to be met by a simplistic, short-sighted austerity response of budget cuts, wage reductions and weakened welfare systems. This equation does not add up. If left unchanged, this policy path will lead Europe into a long period of stagnation, lost competitiveness and environmental degradation. The EU would then need a miracle to reach the ambitious EU 2020 goals of creating a smart, sustainable and inclusive economy.

On investment, Europe has lagged behind its global competitors for years. In theory, the message is that this situation must improve, but in practice, the focus on radical austerity will lead Europe in the opposite direction. By 2015, EU public investment will have fallen from 2.5% in the beginning of this century to 1.5% of GDP as a result of these cuts. The call for down-sizing the EU budget will reduce investments from key programmes in areas such as research, energy, green technologies, job creation, cohesion and SME support, and make it impossible to take advantage of the full potential of the internal market. Moreover, austerity will make it almost impossible to go from today's 2% to the 2020 target of 3% of GDP spent on R&D. The result of this investment squeeze will be a dangerous loss of competitiveness.

On resilience, it is a fact that strong welfare systems are excellent economic stabilisers. The solid welfare structures of the Nordic states have protected these economies in the downturn, while those worst hit by the crisis – Romania, Latvia, Ireland, Greece etc. – are all low-tax societies with limited welfare. Even the Commission acknowledges the resilience of strong welfare states in its Annual Growth Survey. Nonetheless, the right-wing austerity agenda is very much about dismantling welfare systems, which is unfair, but will also reduce Europe's resilience ahead of the next downturn. In fact – they even want to cut the budgets of the recently set up financial supervisory authorities!

On social protection, many right-wing governments pay lip-service to protecting wages, work conditions and the rights of social partners. In reality though, we are now in the midst of a large-scale assault on workers. This is not only unacceptable from a principle point of view, but also completely wrong in economic terms. Scaling down the security of workers does not enhance productivity. The European experience also tells us that wage increases are more modest and stable in countries where wage formation is left to social partners rather than dictated by governments.

On sustainability, most governments now ignore environmental concerns after all the sweet talk on climate action before the Copenhagen Summit. There are almost no resources available for green investments in the austerity plans, and the plans to expand climate action through the EU budget or globally have been put on hold. The crucial green transformation will slow down and green technologies will be largely developed outside Europe. We have already seen China take the lead regarding wind power.

On growth, the combined impact of reduced investments, weakened resilience, insecure workers and a halted green transformation will be very negative. The rhetorics of the right appear to be growth-friendly, but in the real world austerity extremism is aggressively hostile to growth. Even without taking additional austerity initiatives into account, the Commission foresees that the current policy will maintain a terribly low annual growth rate of only 1.5% up to 2020. This will make it extremely difficult to restore public finances and to put Europe back on a healthy development track.

IV. We need joint European strategies for a globalised world

But there is also a more long term and principally important perspective, beyond the crisis. In an increasingly globalised world European joint action through the EU is more important than ever, as the main challenges cannot be met by individual Member States alone – and as no Member State alone can match the influence and competitiveness of old powers like the US and Russia or new powers like the BRIC nations.

Today, we face greater challenges than for many years; not just to end the economic crisis but also to prevent it from re-occurring, to deal with increased globalisation and competition, to fight poverty and unemployment, challenges in environment and climate, sustainable energy etc. All this requires major cross-border investment to make Europe competitive, as well as in education, research, development and innovation. In order to make Europe a world leader, but also to increase investments to reverse the trend towards permanent high unemployment, social exclusion and to make Europe economically and socially sustainable. Key parts of these necessary investments cannot be done by individual Member States, as they are all too small to become world leaders.

The EU budget is a means of serving efficiency and solidarity purposes within the European Union, but should particularly be developed as an instrument for coordination and the realisation of common goals and principles through investments that can really make Europe work as an internal market with 500 million people rather than 27 disintegrated national markets.

In addition to this, it is also a very important tool in the Unions' external policies creating credibility to the EU's single voice with the backing of one single flow of funding. The EU budget is small, but if well spent and allocated to carefully selected purposes EU spending brings strategic added value compared to uncoordinated national investments. Notably in sectors with strong transnational dimensions such as transport, research, innovation, climate change, etc. In case of large cross-border projects, the EU budget acts as a mechanism to ensure appropriate burden sharing and fair allocation between beneficiaries.

Furthermore, the EU budget is a means of mobilising additional funding for important investments through co-financing from national, local and private contributors, and particularly for the future as a lever rising co-funding through PPP (public private partnerships) and from financial instruments like EIB, EBRD and EU project bonds.

V. The political implications of the post-2013 multiannual financial framework (MFF)

The current unfavourable political and economic context means that the future of Europe as a political entity is at stake in the upcoming negotiations on the long-term financial framework. So is the union's ability to adequately address the new global and European challenges and its capacity to adapt itself to an ever changing environment. In other words, the future budget negotiations will settle the capacity of the EU to deliver – or not – on these crucial policies.

The Lisbon Treaty has turned the multi-annual financial framework (MFF), the long-term budget, into a treaty based instrument. The current framework covers the period 2007-2013. Discussions on the next framework have started, notably with the release of the European Commission's proposal for the next MFF, "a budget for Europe 2020".

These negotiations are particularly important as they will preside over the complete reorganisation of EU expenditures. Given the current economic context, now more than ever, the next MFF must reflect our political priorities for jobs and growth, providing a comprehensive European response to the crisis.

In addition, the MFF negotiations are an opportunity to argue for greater flexibility in the handling of the EU's budgetary policy, in particular with respect to the need to address unforeseen events. The adoption of the European Economic Recovery Plan in 2008 showed the lack of built in capacities in EU procedures to respond to such a crisis.

And – finally – the negotiations will also cover the future revenue of the EU budget, and the issue of our own resources.

VI. New own resources for the EU budget

EU revenues have progressively lost the link to their roots. According to the treaty, the EU should be financed "through own resources". But today, the revenue system is more like the national quotas used in international organisations, through the highly unpopular GNI contribution (the so called "membership fee"), which constitutes around 85 % of the total revenue.

The result is a destructive debate between "net payers" and "net beneficiaries", with Member States focusing on their national net results – the "juste retour", in line with Mrs. Thatcher's "I want my money back" - instead of including a European perspective and the idea of a European added value. From a genuine economic perspective it is impossible to quantify the "cost" or "benefit" of European Union membership. And yet this economically unsound approach impacts the decision making process on EU expenditures: decisions on expenditures are based on the supposed return of funds for each Member State rather than the benefits for Europe as a whole.

Moreover, the system of own resources has become increasingly complex, unfair and untransparent, with the introduction of numerous derogations and rebates.

The question of an own resources reform is thus of huge importance. The PES and S&D Groups of the European Parliament have suggested new "innovative financing", in particular a tax on financial transactions and carbon taxes. Different types of European Bond systems (Eurobonds, project bonds) constitute another possibility for the enhancement of the financing capacities of the European budget, by either enabling the EU to borrow on the international bond markets for direct investment needs or by entrusting this task to the European Investment Bank, and widening its current activities on behalf of the EU. These are financing tools that can contribute both to the need to find new sustainable resources and at the same time have positive effects on the economy, making financial speculation and carbon emissions less profitable (the so called "double dividend").

A new system should not increase tax levels in itself, nor should it give the EU new competences. For citizens an own resources reform should be fiscally neutral because national contributions should be reduced accordingly. A reform must respect EU treaty competences and thus respect national fiscal sovereignty.

VII. Some conclusions on key progressive proposals to be made

Even if we fight for a long term increase of the EU budget, we must for the moment focus on protecting the most strategic parts of the budget. The line of the S&D group in the European Parliament for the EU budget 2012 as well as for the coming MFF post-2014 has developed a focus along four lines:

Selective increases of the budget in key areas

For 2012 there are three key areas:

- Central EU2020 strategy parts of the budget, particularly key R&D/innovation programmes, Life Long Learning and funding of the new financial supervisory agencies;

- Key external action programmes, like the Southern Neighbourhood (Arab Spring), Palestine and enlargement (Croatia);

- Front-loading structural funds expenditure in the most crisis hit parts of Europe, like Greece and Portugal.

Reforming existing policies to adapt better to future challenges
Some Member States call for radical cuts in particularly the CAP, and to an extent also the structural funds, characterising these programmes as "obsolete", as protection of less productive and declining parts of the economy, while other Member States defend them as key tools for the EU's concept of solidarity. The way to accommodate these diverging views can be to go for a major reformation of the policies. The CAP should not subsidise agricultural production as such, but rather focus on "public funding for public goods", i.e. support farmers in areas like environment, food safety, climate/energy, rural development etc. The same goes for the structural funds, which no longer protect declining old-fashioned parts of the economy, but support the modernisation of economic structures, including innovation, infrastructure/energy investments etc. in less developed parts of Europe. Not all European regions are in a position to fight for global excellence in R&D, but many regions need to build up a capacity for higher education, research and innovation – and here structural funds can be a major tool.

Develop quality of spending to improve implementation and results
Even if quality has improved in several ways, both as regards less criticism from the Court of Auditors and better implementation of key programmes, there is still a lot more to be done. For that reason we now focus on:

- Flexibility, in order to be able to adapt the budget during the 7-year MFF period to changing conditions and needs;

- Simplification, to respond to vast criticism from people such as EU researchers, against spending the majority of their time on administration rather than research;

- Conditionality, focusing not only on abiding by the formal rules, but more on the actual delivery of results;

- Performance, including the idea of using reserves in order to be able to spend more on those – regions, researchers etc. - which use the EU funding in a particularly effective way.

Focus more on synergies between national budgets and the EU budget

If the EU wants to be taken seriously in its endeavour to implement a new coordinated and common EU2020 strategy, to support public investment and job creation, the EU budget and national budgets should be regarded as complementary. Otherwise, we are collectively running the risk that neither the EU budget (because it is too limited) nor national public budgets - be it at national or local regional level (because they will be struggling against increasing deficits) will be in a position to launch the necessary investments to support the different flagships initiatives of the EU 2020 strategy.

The EU must not be a 28th layer of bureaucracy! It should rather be developed as an instrument for avoiding duplication of policies at the level of Member States and EU level, which could be a great source of savings from a global point of view.

VIII. To summarise:

- The EU and the Member States must accept that austerity alone cannot bring us out of the crisis, and that if the EU budget is well managed it can deliver on key common investments important for growth and jobs;

- We must break the political deadlock on the EU budget. The European Commission and the European Council must show political leadership by developing the budget, not just passively responding to austerity moods. We respect the current limits of the EU's own resources ceiling (1.29 % in commitments and 1. 23 % in payments), but there is a lot more we can do under that ceiling;

- The EU must match its political agenda with a sufficient budget. With the necessary resources we can achieve a more relevant and ambitious European Union. ***The EU competences and political ambitions are growing, whilst the EU budget is decreasing, and this is about to become an impossible equation.*** Downsizing the EU budget even further will make it impossible to give Europe a world-leading position and make the EU less relevant;

- Reform of own resources to get rid of the "juste retour debate" and instead introduce a new system of own resources. It should aim at achieving a stronger and more democratic link between citizens, economic operators and the EU budget. It should be fiscally neutral, so that citizens do not have to pay more taxes, due to the existence of the EU itself, and it should respect EU Treaty competences;

- Create greater synergies between the EU Budget and national public finances, in order for both to improve results and the European added value, and to find savings, through more coordinated action;

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A Europe of Growth and Solidarity

The financial crisis within the eurozone, now in its third year, is not exclusively a crisis of excessive sovereign indebtedness, as it is treated in the so called “fiscal compact”, signed on the European summit of March 2nd. It is as much a crisis of financial transmission inside the eurozone banking system, in which it is no longer possible to use the excessive private savings in the northern Member States to provide for the public and private debts in the south. In fact, the financial part of the Common Market has broken down and financial transmission is only safeguarded by the ECB in their dealings with individual banks – with the results to be seen in the exploding “Target-2-balances”.

And of course there is still a crisis of mountig disparities of economic competitiveness inside the currency union, which is also not addressed by the “fiscal compact” or any other of the policy measures taken by the mostly conservartive governments of Europe. And finally it is a crisis of fairness with ever growing wealth gaps inside all of the Member States, which is also ignored by the anti-crisis-policies, or yet worse: the problem is actively aggreviated by the official austerity-only-policy.

Towards the end of last year, the governments have effectively handed over the active anti-crisis-management to the ECB, which since then flooded the European banking system with 1 trillion € of cheap credit. This was because Member States proved to be unwilling and incapable of providing some appropriate form of common guarantee of the sovereign debts incurred by the Member States.

Admittedly, the emergency action taken by the ECB seems to solve the pressing problem of mounting refinancing needs of banks and sovereigns alike, at least for the three years until the credits have to be paid back. But this "solution", which in fact just pushes the problem into the future, comes at heavy costs – both in economic and in political terms:

- In economic terms this strategy of flooding the market with cheap money just reinacts the policy of the Greenspan-led Federal Reserve in the aftermath of the collapsing dot-com-bubble in 2000/2001, which contributed massively to the start of the next deadly asset-bubble, the mortgage-boom, which then collapsed in the subprime crisis. We can already see this kind of asset-price inflation fueled by the ECB-money in the share prices and also in parts of the housing market e.g. in Germany.

- While the ECB is strictly opposed to lending to ailing Member States because this would reduce the pressure on economic reforms there, the same ECB obviously has no problem with safeguarding so called "zombie-banks" with its credit injections, which came without any preconditions for the use of the money. But without any real consolidation of the European banking system, there will be no chance to revive the inter-bank-business as the financial backbone of a comprehensive Common Market in Europe.

- In the best case, now taxpayers from the already ailing Member States have to pay for the recapitalisation of the european banking systems by the margin between the 1%-ECB-rate and the interest rates countries like Spain or Italy have to pay in the financial markets, which would be genuinely unfair and another impediment to reviving real economy growth, where it is most badly needed. But under more realistic assumptions, the banks will use this risk-free margin they earn with sovereign bonds just to escalate bonus and dividend payments and this is simply another diversion of taxpayers money into the pockets of bankers and their shareholders. And the money not used for this kind of carry-trade will not augment the lending capacity to the real economy in the eurozone, but will be locked up in the ECB, as we can see with the 770bn €, the banks are currently storing at the central bank.

- So we see the eurozone economy shrinking away in a vicious circle of deteriorating domestic demand - especially in the crisis-countries, which are forced into severe austerity programmes – and diminishing capability of risk-bearing in the banking system, which both block the path to the reestablishment of real economic growth in all parts of the eurozone.

To redirect Europe onto the road to growth and solidarity it is necessary to fight the ongoing crisis also in its financial, macroeconomic and social aspects and to give up the one-dimensional and ill-fated focus on only reducing public deficits. With the stress on "only", since of course there is a need to reduce public deficits in the eurozone. But ***the "one size fits all"-approach of the fiscal compact will not achieve its goal, since it does not differentiate between surplus countries such as Germany and deficit countries such as Portugal or Spain.***

The main task is to reestablish a properly working financial market in Europe – a financial market in which the banks are able and willing to take risks in financing real economy growth: What is needed is a kind a of joint guarantee for all sovereign debt in the eurozone to stop the inefficient diversion of funds from investments in the real economy into high-yield sovereign bonds of ailing Member States. ***What is needed is a recapitalisation of banks – but with clear and severe conditions for the restructuring***

OF FINANCIAL INSTITUTIONS. In the end this means reregulation – to force the financial market back into a role of assisting the real economy instead of skimming the cream off it. Without a working financial market in Europe the existing excess savings will continue to finance investment and growth outside Europe instead of inside it and there will be a further enlargement of the current account imbalances.

Another task will be to introduce a redistribution of the fast growing amount of income from wealth by an appropriate change in tax policy. There should be a clear distinction between different uses of wealth with a preference for taking real entrepreneurial risks over fixed-income investments. It is risk-taking by financing real economy innovation which should be rewarded – not the mere preexistence of capital and of course not the use of capital in the financial casino of derivative products, without bearing the underlying risks. The case of Greece, where there is no effective taxation of wealth and the now enforced over-taxation of small incomes, shows thedetrimental economic and social consequences of a misguided tax policy in an extreme case.

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The European Economic Union: Where next?

Back in 2000 the European Monetary Union (EMU) and the Euro were celebrated as the most significant achievements in the European integration process. It was the result of the clear will and commitment, and the intense efforts over the previous decade, of all European governments and societies towards a common objective: attaining a single currency and monetary zone. It was thus the result of the shared conviction that there was no other way for Europe to move forward than together and as one.

However, already at the time when the first steps into the common currency were being taken, many authorised voices claimed that further ones would be required in the years to come, to complete the process of building a real and functional economic union. In this sense, the 1989 Delors report warned that "the economic and monetary union would require a high degree of compatibility of economic policies and consistency in a number of other policy areas, particularly in the fiscal field. These policies should be geared to price stability, balanced growth, converging standards of living, high employment and external equilibrium".

The momentum for reforms progressively vanished after the EMU started working, as the objective of price stability took over any other economic goal. Over the last decade, inflation control has been the only priority for the European Union institutions and despite the Lisbon Strategy process little real progress has been made in deepening economic and social integration, and even less so in the political field. What is more a certain feeling of ¨integration fatigue¨, started taking root in the years leading up to the financial meltdown of 2007-2008, after the failed attempts to advance towards a closer political union and to develop a common growth strategy. There was growing disenchantment of citizens with regards to the actual functioning of EU institutions and what the Union could do to effectively improve their lives.

The global crisis has only forced a long-existing flaw and much delayed pending decisions into the centre stage of the policy and political European agenda, turning them into almost a matter of ¨life or death¨ in recent months. Especially since Greece serious fiscal troubles were exposed, the Eurozone and the euro have endured strong financial pressure. This, coupled with the strict and intense fiscal adjustments imposed by what is now referred to as the German-French Directorate, which threatens to undermine weak European economic and employment growth, and the absence of a strong, quick and coordinated response to eliminating the existing imbalances and protecting our financial area from turbulence has placed the European Union at a crucial juncture.

Since the outburst of the crisis, many leaders, experts and institutions, including Fundación IDEAS, have been advocating deeper reforms to undertake the required steps towards a real Economic Union and common economic governance mechanisms in the four underdeveloped pillars of: (1) financial supervision; (2) new mechanisms to protect the Eurozone from financial turbulence; (3) fiscal coordination; and (4) an effective common strategy for growth.

Some progress on the pillar of financial supervision needs to be acknowledged, with the development and approval of the new Package on Financial Supervision and mostly the creation of the European Systemic Risk Board (ESRB) and three European supervisory authorities for the banking, securities and insurance sectors; the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). In addition, the EU has initiated or completed significant regulatory initiatives in terms of banking, market structures, private equity and hedge funds, rating agencies and accounting. However, this progress has been slow and clearly insufficient to date, since the same damaging activities and incentive structures that led to the financial crisis continue to be in place and freely operating in the EU. The immediate development and implementation of all measures adopted would be crucial in this regard.

The creation of the European Financial Stability Fund (EFSF) aimed at partially covering the gap on the second pillar of new protection mechanisms. Yet, the commitments were too weak and barely credible, and therefore did not help to achieve permanent stability. As a result, further steps have been required due to recently growing financial instability. The last agreement of the European Council has strengthened and widened the Fund from 440 billion to 1 trillion euro (not thanks to new additional cash but through special vehicles and guarantees). The partial haircut on Greek debt (a default in disguise that went from 21% in July to 50% in October 2011), and the bank recapitalisation requirements (that could go up to 100 billion) will certainly help reduce recent instability, but further steps will have to be taken in the future.

At this point it is important to remember that financial instability has been there since the start of the crisis due to liquidity and solvency constraints, both in the banking sector and the public sector. On the one hand, the ESFS should be tackling solvency problems (as it has done with Greece, Ireland and Portugal). To do this effectively, it needs to have more funds (1 trillion may not be enough if big economies of the Eurozone like Italy are affected), and it also needs to act as a European Treasure capable of issuing Eurobonds to finance its actions and provide collateral to weaker sovereign titles. The July and October agreements were positive steps forward, but some further actions may still need to be taken before we have a secure institutional mechanism, capable of solving this crisis and preventing others from happening in the future. On the other hand, the European Central Bank (ECB) is best suited to addressing liquidity problems. The ECB has been providing liquidity to the interbank money market since the beginning of the credit crunch and it has also intervened in sovereign debt markets, but in small numbers. The role of the Central Bank will still be crucial in the months to come until the end of the crisis, not only to solve liquidity problems but also to address any further speculation on the solvency of the major economies of the Eurozone (given that the EFSF may prove insufficient). As a Central Bank it should be playing its role as the lender of last resort (like the Federal Reserve or the Bank of England). This would have avoided an artificial downgrading of sovereign debts, panics, contagion and any additional collapse of major countries. Again, any reform in the European economic governance structure should address this enhanced role of the ECB as well.

Lastly, it is in the two areas of fiscal integration and the establishment of a true common growth strategy, and in ensuring the necessary linkages between them, where less has been accomplished. These aspects are even more relevant today than when the crisis first hit, since stalled economic growth in the European Union threatens to turn negative again with the constraining fiscal consolidation process that all countries are currently undergoing.

Common fiscal policy in the European Union is limited to the criteria imposed through the Stability and Growth Pact (SGP), and the negligent coordination through the Ecofin and the Euro Group. In practice and as we are witnessing today, this coordination is restricted to basically establishing strict deficit control plans over time. It seems obvious that we need a global assessment of the European fiscal stance which is lacking in Ecofin discussions. If all countries apply a simultaneous fiscal adjustment, the overall fiscal position will hurt the economy; it would have been better to induce some core countries to apply fiscal stimuli while the peripheral ones implement strong fiscal consolidations. This coordinated fiscal policy would have already been in place at the beginning of the monetary union, when core countries needed to adjust at the time when peripheral members were expanding. If the Ecofin Council is unable to do this, perhaps the Eurogroup should be given a stronger role, or a European Fiscal Council should be created that designs aggregate fiscal policy and establishes a real conversation with the European Central Bank on the fiscal-monetary policy mix. This enhanced fiscal coordination and the formal discussions on the medium-term 'policy-mix' remained absent within previous reforms in economic governance, and it is clear that they should be part of the next reforms. Finally, our current economic governance design is biased towards inflation control rather than growth and employment. As a result of the ECB's clear mandate to be more worried about the former than the latter. In addition, the SGP does not include a golden rule to allow further margins for productive investments; and last but not least, ***the European budget is too ridiculously small to take any decisive action to stimulate growth in the EU, and is also disconnected from national fiscal policies.*** Unless we change this institutional design, no attention will be paid by the key decision makers to the need to stimulate growth over the economic cycle. This is urgent, at a time when growth is not likely to come from the private sector alone, given two concurring and unfortunate circumstances. First, the existing limitations in global liquidity and credit and the high levels of private indebtedness make it unlikely that domestic demand will increase while public expenditure is drastically cut across sectors and countries. Second, the current crisis has global implications, meaning that not all countries will be able to "grow their way out of the crisis" through domestic austerity accompanied by exports.

The response that the EU institutions have given to the need for improved economic governance that the crisis has uncovered in this area has been limited to date. The recommendations made by the Commission in this regard only concern the following objectives: strengthening the Stability and Growth Pact, with prudent fiscal policy-making, preventing and correcting macroeconomic imbalances, establishing national fiscal frameworks of quality, and ensuring stronger enforcement. This is far from enough. We need to expand the European budget and connect it with national budgets, so that overall fiscal policy is improved and synergies are created.

With limited domestic room for action, the EU should decide on a common strategy that helps stimulate economic and employment growth within the region, counteracting the decrease in activity at the domestic level, with specific common European objectives, budget and new revenues. Therefore, a strategy that is adequately linked with a common fiscal policy that goes beyond imposing deficit limits and allows for the fostering of the kind of economic and social development that the EU citizens request: one that is fairer and more sustainable, based on innovation and ¨human and social wealth¨. In this sense, a European Financial Transactions Tax of 0.05% alone could help raise between 586 and 146.5 billion euro per year (depending on the impact of such a tax on traded volumes). At the same time, a tax on certain operations would act as a disincentive to damage speculation in the area. Other examples of potential European sources of revenue that could help stimulate the kind of growth that we want, namely green taxes.

One must conclude that the situation in the European Union today is not good. ***Euro-scepticism, conservatism and short-term national interest are ruling the response to the most serious crisis that we have experienced since the EU was founded,*** in turn threatening the survival of the European project itself. However, at the same time, another conclusion is clear: we have never been faced before with such an opportunity to move forward. While the current integration process has been a “matter of choice”, we have entered a time when it is becoming a “matter of need”. The urge of the current reality is on our side; let us not allow the prospect of advancing towards a true economic government and policy in Europe slip out of our hands.

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Shaping the Economic Union – For a Progressive Reform of the EU Economic Governance

The current debate and reform of the EU economic governance can open a new chapter in the history of the Economic and Monetary Union (EMU). After an assessment of the current euro-zone crisis, this paper develops a comprehensive view on how we can use the ongoing reforms of the EU economic governance to shape the EMU. Its purpose should be not only to overcome the current euro-zone crisis, but also to pave the way to fostering a new growth model in the EU and all its Member States.

I. Crisis in or of the euro-zone?

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

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

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

The differences in recovery amongst the Member States resulted in an increasing differentiation of the financial conditions within the euro-zone. The differences were even magnified, due to several financial operators holding the capability to extract extra profits from the flaws within the euro-zone… By exploiting the fear of defaulting and offering several Member States over-priced loans. This defence mechanism resulted in a forced recession.

According to the second version 'the crisis of the euro-zone', there are two different explanations for the current situation. First, while some differences in the spreads across Member States can be accepted as normal, these increasing divergences are worrying because they will also turn into divergences of their investment conditions, their growth and employment rates as well as their public deficits and debts;

Second, these cumulative divergences will be magnified by the strong interconnections among banks across the euro-zone, creating a domino effect which will be very difficult to control and can go from fragmentation to an actual breakdown

II. What is at stake: the euro-zone and globalisation?

What is at stake when the euro-zone needs strengthening, while at the same time Europe needs to reposition itself within an emerging global competition? Europe can be considered capable of taking the lead and improving their competitive advantages, especially with the emphasis on a greener, smarter and more inclusive new growth model. What is missing is a stronger launch of this strategy overcoming the major flaws in the euro-zone management.

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

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

As long as new instruments are not available, **macroeconomic stabilisation in the face of strong shocks isn't possible for several Member States. This means that** they can only adjust by lowering wages or damaging employment. As a result, investing in a new growth model will become a close to impossible task for them One can ask these countries to make structural reforms, to foster their structural competitiveness. They certainly need to make more than they are currently doing, in the meantime, they will go into a recession and further risks of insolvency and default. This will increase the systemic risks which were mentioned above for the euro-zone as a whole. **In such conditions, the euro-zone will certainly not be a strong platform for Europe to compete at global level.** It would become instead an interesting area for other global competitors to buy their strategic assets more cheaply.

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

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

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

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

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

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

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

Moreover, the reduction of macro-economic imbalances depends not only on the effort of each Member State, but also on providing the appropriate European general conditions: a reasonable interest rate for all Member States, a higher European growth rate, a European financial supervision framework to ensure responsible lending and borrowing and a European financial support for catching-up regions.The new euro-zone Pact should consider these four priorities and not only the first two, as the initial German proposal was doing. The Euro-plus Pact, adopted in March 2011, has introduced some improvements, but still remains imbalanced and incomplete.

IV. Shaping the euro-zone reforms in the right direction

The current reforms of the EU economic governance should be shaped in order to stimulate progress within these priorities.

In fact, major reforms of the EU economic governance are already being constructed, covering the following elements:

- The Europe 2020 strategy for growth and jobs
- The European semester and the new coordination process of fiscal, economic and social policies at European level
- The reform of the Stability and Growth Pact
- The new procedure of macro-economic surveillance
- The new single market agenda
- The Community budget
- The new instruments for financial stability (EFSF, ESM)
- The reform of the financial system and the new supervision system
- The Euro-Plus Pact as a new general and political agreement for deepening the coordination between the euro-zone members and the others wanting to join

- The inter-governmental Treaty on Fiscal Stability, Economic Coordination and Governance

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

- The **coordination of national policies**, not only budgetary and macro-economic policies, but also economic and social policies in general

- **Stronger European instruments**: not only the European financial supervision bodies, the next Community budget and its programmes, but also the need to create a permanent European Financial Mechanism. Which has to be able to assist in sovereign debt crisis, to improve debt management and to support key investments.

These reforms should pave the way for a highly necessary qualitative leap: the building of an Economic Union, to be coupled with the current Monetary Union.

Central Question: How should these reforms be conducted in order to advance the above- mentioned priorities and to strengthen the euro-zone's sustainability (see Table 1)?

a. The European semester should improve the consistency between the European and national decisions and the coherence between the Stability and Convergence programmes and the National and Reform programmes, creating more positive synergies between growth, structural reforms and fiscal consolidation.

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

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

d. **The Community budget** should fund stronger Community programmes to support the EU2020 strategy and provide structural funds for 'catching-up' countries, with stronger conditionality regarding the EU2020 objectives.

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

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

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

h. The **Euro-Plus Pact** should deepen the coordination between the euro-zone members, regarding not only budgetary, tax and financial policies, but also economic, social and environmental policies for sustainable development.

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

V. Striking new compromises

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

New compromises regarding the Single Market:

- Opening or protecting the national markets? Opening, combined with support to capacity building and protection of better standards.

- Standards harmonisation or flexibility? More convergence, combined with support to capacity building.

New compromises regarding macro-economic surveillance:

- Reducing the imbalances of the deficit or of the surplus countries? Or if necessary both.

- Reducing the current account and competitiveness deficits or the unemployment rates? Or if necessary both.

- Changing countries' behaviour with sanctions or with incentives? Or both.

- Overcoming imbalances by national efforts, but also by improved European coordination

New compromises regarding the Community Budget:

- Less or more resources? The same, but a new kind of resources

- Less or more structural funds? The same, with stronger conditionality

- Focus on excellence or easier access to the Community programmes? Focus on excellence and support to capacity building to be provided by structural funds

New compromises regarding the Stability and Growth Pact:

- Straight fiscal tightening blocking all public investments or keeping fiscal space for investments? Selective spending cuts and fiscal space especially for key EU 2020 investments

- Spending cuts or new revenues? Selective spending cuts and new sources of revenue (financial and green)

    - Tax harmonisation or tax flexibility? Tax convergence

    - Social contributions and retirement age harmonisation or social flexibility? Social convergence promoting active ageing and discouraging early retirement

    - Automatic or discretionary rules for fiscal discipline? Semi-automatic and smarter rules

Finally, new compromises regarding the European Stability Mechanism:

- Providing loans or buying national bonds? Both

- Higher or lower interest rate? Lower, assuming that public creditors are considered senior

- More or less resources? More to minimise use

- Sovereign default or not? To be avoided by a stronger preventive action

- Strong conditionality or not? Strong but balanced, considering fiscal consolidation and growth

- Larger euro-bonds issuance or not? Yes, with a cap and an access price in line with the national risk

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

- the transition from the current EFSF, European Financial Stability Facility to the new ESM, European Stability Mechanism

- the coordination and convergence of national economic policies in the framework of the so-called European semester

VI. The transition to the European Stability Mechanism

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

- Regarding its **roles**: control and prevent sovereign debt crisis; support key investments which cannot find other funding solutions; improve debt management of the euro-zone members.

- Regarding its **instruments**: providing conditional credit lines and loans, buying in the primary and secondary markets, issuing euro-bonds to provide loans; issuing euro-bonds to buy national bonds; special issuing of euro-bonds to fund key investments; to turn a capped section of national bonds into euro-bonds.

- Regarding the **financial base** to ensure triple A rating: national guarantees with senior status; a provisional credit line by the ECB; joint guarantee; own reserves and capitalisation (by buying and selling bonds).

- Regarding **conditionality**: fiscal re-balancing and banks restructuring; fiscal consolidation, sustainable growth and structural reforms.

- Regarding the **interest rate**: higher than German bund, but reasonable enough to enable fiscal consolidation and recovery.

- Regarding the **amount** of resources: large enough to deter financial speculation.

VII. More coordination and convergence of national economic policies

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

- Their Stability and Convergence programmes, indicating their medium term objectives for fiscal consolidation and for macroeconomic re-balancing and their priorities to achieve them.

- Their National Reform programmes, indicating their national targets to meet the EU2020 deadline targets and their priorities to achieve them as well as to implement the EU2020 flagship initiatives.

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

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

a. total unit costs and unit labour costs (low competiveness countries should increase productivity, high competitiveness countries should increase internal demand).

b. growth rates and well-being indicators.

c. public debt rates (MTO's considering different investment needs).

d. reasonable interest rates for private and public investments.

e. minimum investment rates in R&D, education and infrastructures.

f. unemployment rate (general, women, young, elderly people).

g. stress tests indicators.

The following policy measures:

- Coordinated innovation and industrial policy, supported by structural funds with stronger conditionality.

- Framework for public debt sustainability.

- Tax sources and levels (common consolidated tax base, minimum corporate taxes, new sources of taxation).

- Promotion of active ageing and the employment rate, closing the gap between effective and legal age, while considering professional specificities.

- Convergence of minimum social standards (precarious work, minimum income schemes).

- Crisis management regime for banks at national and European levels.

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

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

The Euro-Plus Pact defined in February 2011 was an attempt to deepen this coordination and convergence. Some progress was made, but it remained an imbalanced and uncompleted framework. For a detailed assessment see Table 2.

VIII. Central dilemmas for the European economic policy

Beyond overcoming the sovereign debt crisis, the most daunting challenge in the short term will be ensuring fiscal consolidation whilst boosting recovery. Moreover, recovery cannot be seen as a return to the past, but rather as a transition toward a new low-carbon, knowledge-intensive and more inclusive growth model. Basically, the euro-zone faces two central choices:

- Either to prioritise fiscal consolidation and sacrifice recovery, or to prioritise recovery while paving the way for consolidation. ***Investment and job creation are essential for a more***

EFFECTIVE STRATEGY OF FISCAL CONSOLIDATION AS THEY REDUCE THE COSTS OF SOCIAL PROTECTION AND INCREASE TAX REVENUES. Higher rates of growth and concomitantly higher public revenue, together with returns generated by public investments, can help to reduce public debt. The cuts to be introduced in public spending should not damage this central process.

- Either to impose a uniform pace for consolidation or leave some room for manoeuvre to foster real convergence, accommodating different investment needs, welfare system reforms, patterns of specialisation and their implications for the asymmetric shocks stemming from the financial and economic crisis.

Depending on which choices are made, the euro-zone can expect two different scenarios:

a. If it chooses to move uniformly to attain fiscal consolidation more quickly, it risks internal fragmentation, with many regions stagnating or trapped by recession

b. In order to prevent such tensions, the alternative scenario should combine fiscal responsibility with stronger coordination of economic growth policies and with new European instruments to finance growth.

The Treaty on Fiscal Stability, economic coordination and governance which was defined in January 2012 goes more in the first direction. In order to deal with this central dilemma over the next few years, economic policies should undergo some important changes:

a. improving **surveillance regarding fiscal consolidation** with ex-ante coordination and a stronger focus on the long term sustainability of the public debt.

b. coordinating the re-direction of **public expenditure to promote key investments** to foster a more low-carbon, knowledge-intensive and inclusive growth model and to prioritise job creation, making a clear distinction between "good" and "bad" spending cuts. Member States that are more able to undertake this, shift should have more time to reduce their public deficit and debt. The improvement of the quality of public finances should be rewarded.

c. to **make the best of positive spill-over effects**, increasing European aggregated demand. The starting point should be to estimate the aggregate effect of Member State public investments projected for the coming years.

d. coordinating the shift **of the tax burden to new sources**, notably pollution and financial transactions, so as to avoid overburdening labour costs, which would damage job creation and social fairness. If it is to work properly, this re-direction of tax policies also requires better European coordination.

e. **Development of a new European instrument to create better conditions for Member States to issue national debt**, in order to support new long term investments needed to promote the transition to a more low-carbon, knowledge–intensive and inclusive growth model. The issuing of **euro-denominated bonds** is already happening successfully within the framework of the Community Mechanism to support non-euro-zone EU Member States with balance of payment problems and euro-zone Member States with the recently created EFSF, European Financial Stability Facility and ESM, European Stability Mechanism.

f. **Monitoring and reducing the macroeconomic imbalances in the euro-zone.** Some macroeconomic imbalances were magnified by the crisis and are now more visible in the current accounts and the balance sheets of households and companies. Their underlying causes might be explained by unsustainable public spending, wage developments or by lack of productivity improvements. Nevertheless, in the present conditions, they are also explained by lack of demand for investment and consumption at European level, inequalities in income distribution, increasing unemployment and poverty, deeper regional inequalities and lack of effective instruments to finance public budgets. Therefore, multilateral surveillance should follow-up these different dimensions in order to identify the appropriate and specific solutions. Beyond the national specific solutions, there are general principles which should be implemented. Macroeconomic imbalances can be reduced by better conditions for recovery in all Member States, and this requires more European coordination.

IX. Moving to a new EMU architecture

This final section addresses the **central issue for the future of the euro-zone and European integration**: how can we complete the architecture of the EMU by building on its current features and ongoing reforms? These reforms of the economic governance are now quite comprehensive and involve the coordination of the economic policies as well as the development of new European instruments.

A reference to the experience of federal systems will also be made, not because this is feasible in the EU, but because it can give a sense of direction. There is quite a large variety of federal systems according to the way the **functions of allocation of resources, the redistribution of resources and of macro-economic stabilisation** are performed at the different levels of governance: local, State or Federal level. There are two particular issues in the experience of federal systems which are relevant for the current European debate:

- Is the role of **macroeconomic stabilisation necessary** in one way or another? Yes it is, to ensure a smoother path of sustainable growth while the necessary adjustments take place in allocation and redistribution of resources to cope with new challenges.

- What should be the **response when particular state(s) or region(s) are facing special difficulties?** The central problem is, always to strike the right balance between the effort to make by this State and the one to be made by the Federal level, when it comes to these three main functions.

We urgently need to deepen the European debate about these issues. In retrospective terms, we can note that:

- Before the launch of the single currency, these three functions were mainly played by the national level, with a small complementary role of the Community budget when it comes to allocation and redistribution. Macroeconomic stabilisation could be ensured by the exchange rate, monetary and budgetary policies at national level;

- With the creation of the euro-zone, its Member States can no longer use exchange and monetary policies for macro-economic stabilisation; they are only confined to the budgetary ones, and in a more constrained way according to the limits set by the Stability and Growth Pact.

This incomplete construction is only sustainable as long as there are converging growth rates and interest rates across Member States, and as long as there are no major symmetric or asymmetric shocks disturbing this convergence.

If there is major shock- which is now the case since the financial crisis of 2008, the EMU will be confronted with the two central issues defined above. An effort certainly needs to be made by the hit States themselves, **but this effort should be complemented by new developments at European level**, notably if the macro-stabilisation role of the national budgetary policies is to be reduced in order to diminish the public debt burden, which is the case now. These new developments are particularly:

- A permanent mechanism to ensure **reasonable costs for public debt service** in all euro-zone members, even if some differences are maintained among them;

- A function of **macro-economic stabilisation to be introduced in the community budget** in order to support particular regions or groups under stress;

- More **convergence in tax policies**;

- A **European growth strategy** combining new investments with a coordinated agenda for structural reforms.

These new economic developments require stronger political coordination at European level and therefore, a new political legitimacy at European level, which should be strengthened in the European Council, the Council of Ministers and in the European Council. Against this background, we can now detail the necessary developments of the EMU in the following terms:

a. National budgetary policies:

- In the current EMU, play a role of macroeconomic stabilisation under the limits defined by the SGP;

- In a new EMU, if this role is more limited by national law and by a revised STABILITY AND GROWTH PACT, it needs to be developed at European level;

- We should bear in mind that, in federal systems, this role is more limited at state level because it was transferred to the Federal level.

b. European budgetary and economic coordination:

- In the current EMU, the surveillance of the Member States' budgetary policies proceeds according to the Stability and Growth Pact; the macro-economic imbalances are not under surveillance and correction;

- In a new EMU, there is a revised STABILITY AND GROWTH PACT with stronger prevention and correction procedures of Member States' public deficits and debts and a new macro-economic surveillance is put in place. Moreover, there is a coordination of budgetary and macro-economic policies to maximise sustainable growth at European level;

- We should bear in mind that, in federal systems, the limits of Member States' public deficits and debts are defined at Federal level and the overall budgetary and macro-economic policies are defined at Federal level.

c. Public debt management:

- In the current EMU, public debt issuing and loans are managed by national agencies;

- In a new EMU, debt issuing is also partially managed by a European Public Financial authority (building on EFSF-ESM); the ECB should also play the role of lender of last resort;

- We should bear in mind that, in federal systems, a Federal Treasury can borrow and issue public debt.

d. The Community budget:

- In the current EMU, is mainly funded by national contributions and can finance Community programmes and structural funds to reduce regional divergences;

- In a new EMU, it can be funded more by own resources. Moreover, structural funds can also be used for macroeconomic stabilisation supporting specific regions and groups;

- We should bear in mind that in federal systems, the federal budget has a much bigger size, is funded by federal taxes and can finance Federal programmes supporting specific regions to reduce structural divergences and macroeconomic imbalances.

e. The European growth strategy:

- In the current EMU, is based on coordinating Member States structural reforms complemented by some quite small Community programmes;

- In a new EMU, the coordination of structural reforms at European level becomes deeper and these Community programmes become larger;

- Whereas in federal systems, federal programmes and federal structural reforms complement the Member States' ones.

f. The executive power:

- In the current EMU, is based on Member States' Governments, the European Council, the EU Council of Ministers and the European Commission;

- In a new EMU, is also based on a Eurozone Government at PM and ministerial level, with permanent Presidents. In the current conditions, this is an unavoidable complexity, in the face of:

- Federal systems with a permanent President and Ministers.

g. The legislative power

- In the current EMU, is based on Member States parliaments and governments, the EU Council of Ministers and the European Parliament;

- In a new EMU, it is also based on a Euro-group Council of Ministers; later on, a special committee for the euro-zone in the European Parliament, creating a stronger European democratic legitimacy, beyond the national legitimacy provided by Member States' parliaments and governments. In the current conditions, this is an unavoidable complexity, in the face of:

- Federal systems, where the central democratic legitimacy comes from a Federal Congress with a Senate and a House of Representatives.

In conclusion, the current reforms of the EU economic governance should be shaped bearing in mind a more comprehensive architecture for the EMU. An EMU more suited to the future should be equipped with:

- A European strategy for a new growth model, smarter, greener and more inclusive, to be translated into national policies, budgets and stronger European instruments.

- A Community budget, based on its own new resources and able to provide leverage to a longer general re-allocation of resources focusing on the key strategic priorities of the Union; also able to reduce the regional divergences and the macro-economic imbalances.

- A European public finance authority, monitoring the national budgets in their quantitative and qualitative objectives, ensuring coordinated discipline and providing the basis for:

- A European agency able to issue euro-bonds to finance long term investment needs and to improve debt management;

- A European stability mechanism, able to provide assistance in the event of sovereign debt crisis.

- A European framework for the financial system regulation and supervision.

- A euro-zone pact, deepening the coordination, convergence and external representation of the euro-zone.

This vision shows how the current crisis of the euro-zone and the ongoing reforms of the economic governance can provide an opportunity for a qualitative leap in the EMU, if a pro-European and progressive leadership is more influential.

Table 1

The Reform of EU Economic Governance- Comprehensive Overview
Fine-tuning its policy instruments to strengthen the sustainability of the euro-zone

PRIORITIES FOR THE EUROZONE SUSTAIN-ABILITY **EU POLICY INSTRUMENTS**	**PROMOT-ING A NEW KIND A OF GROWTH**	**ENSURING FISCAL RESPONSIBIL-ITY**	**ENSURING FINANCIAL STABILITY**	**INCREASING INTERNAL CONVER-GENCE**
EU2020 STRATEGY **Community Programmes** **National Reform Programmes**	Beyond GDP measuring growth 3 Strategic priorities 10 guidelines 7 flagships	Structural reforms for more effec-tive and effi-cient public finances	Increasing the attractive-ness for new investments	Generalising the imple-mentation of the EU2020 Strategy
SINGLE MARKET	New market opportunities	New sources of taxation Tax coordination	Financial markets integration and reform	Tax and social convergence
MACRO-ECONOMIC SURVEIL-LANCE AND CORRECTION	Create conditions to implement EU2020 Coordinate spill-over effects	Facilitate budget re-balancing	Strengthening National attractive-ness for new investments	Correcting the macro-economic imbalances with a balanced approach
EU BUDGET **Community Programmes** **Structural Funds** **EIB**	Providing additional financial sup-port to the EU2020	Reducing national budgetary effort	Providing a guarantee to project bonds	EU support to catching-up

STABIL-ITY AND GROWTH PACT	Ensure fiscal space for EU2020 investments	Stronger fiscal discipline Reward the quality of public finance New sources of public revenue	Credibility of the Medium-term objectives	Ensure fiscal space for catching up investments
EUROPEAN STABILITY MECHANISM	Enable key national public investments	Last resort solidarity against sovereign default Mutualisation of debt issuance	Reduce speculative pressures over the euro-zone	Ensure reasonable spreads among Member states
EUROPEAN SUPERVISION SYSTEM **FINANCIAL SYSTEM REFORMS**	Make financial system support Eu2020 objectives	Reducing speculative pressure on public debt	Stess tests, Regulations, reserves, bonus to ensure responsible financial investment	
EUROPEAN CENTRAL BANK	General conditions to promote growth	Ensuring stable conditions for low interest rates	Inflation control	Last resort to ensure access to credit (provisional)

Table 2.

Assessing The Euro-Plus Pact

	POSITIVE	**NEGATIVE**
EMU DEVELOPMENT	Stronger Economic Union Permanent financial stability mechanism Stronger coordination of fiscal and economic policies Concern with internal convergence	No coordination for growth No stronger coordination of social policies Only focus on fiscal convergence The role of the Community budget is ignored in the overall architecture of the EMU

GENERAL PRIORITIES	Employment was added to fiscal sustainability and to competitiveness	Promoting growth and job creation is not a central priority Reforming the financial system neither
SPECIFIC PRIORITIES COMPETITIVENESS	Investment in education, R&D, innovation and infrastructures is mentioned	The relationship between wages and productivity remains central to increasing competitiveness. Risk of making wage and social benefits cuts
SPECIFIC PRIORITIES EMPLOYMENT	Lifelong learning and not only flexicurity	No reference to upward convergence of social standards
SPECIFIC PRIORITIES SUSTAINABILITY OF PUBLIC FINANCES	Convergence on retirement age is more nuanced Financial transaction tax is referred Legal framework rather than constitutional debt break	Debt sustainability is not considering fiscal space to invest There is no real commitment regarding new tax sources to rebalance the budgets
SPECIFIC PRIORITIES FINANCIAL REFORM	More precise bank stress tests	No clear European framework to deal with bank restructuring No clear commitments to pursue the financial reform
GOVERNANCE	More references to community method More references to the role of social partners European Council and not Ecofin taking the lead	Many ambiguities regarding the community method Many ambiguities regarding the role of social partners Imbalance between Council formations. No reference to the European Parliament
FINANCIAL STABILITY MECHANISM	More resources New instruments (buying in the primary market) Possibility of reducing interest rate	No possibility to buy bonds in the secondary markets Interest rate still too high Imbalanced conditionality Role of the IMF No joint guarantee Issue of Eurobonds for too limited purposes

Table 3

Assessing The 21 July 2011 Package

ISSUES	POSITIVE	NEGATIVE
General approach	Recognises for the first time general nature of the eurozone crisis and , implicitly the risks for Europe as a whole	Falls short on a systemic solution, on the quantum leap which is necessary for the EMU architecture. Patchwork approach remains
Greece	Recognises for the first time the need for growth and a Marshall Plan Reduces interest rates and extends maturities	Marshall Plan not clear at all Ambiguities in the way to restructure the debt, involving the private sector but without default. The best solution would be a swap of Greek bonds against EFSF bonds (Eurobonds)
Stop Contagion	Ireland and Portugal will also benefit from lower interest rates and longer maturities Flexibilisation of the EFSF, allowing preventive measures, loans without adjustment programmes and intervention in the secondary markets Recognises for the first time the need to support growth. Decides better combination between structural funds and loans	The reform of EFSF is not strong enough regarding its scope, the absence of a joint guarantee and a larger use of Eurobonds in order to improve debt management. We need a European debt management agency Falls short on new financial means to support investment and growth (Eurobonds, FTT)

General deal on economic governance	Makes a connection between more solidarity, responsibility and coordination (in budgetary, fiscal and economic policies)	The general bias in the reform of the economic governance remains Stability and Growth Pact with no room for investment Macroeconomic surveillance imbalanced Euro Plus Pact without concern for growth, employment and the social dimension

Table 4

Completing The Architecture of the EMU

Main features	**Current EMU**	**New EMU**	**Federal systems**
National budgetary policies	-National budgetary policies play the role of macroeconomic stabilisation under the limits defined by the SGP	-This role is more limited by national law and by a revised SGP	-This role is more limited at State level and it is tranferred to the Federal level
European budgetary and economic coordination	-Surveillance of the MS budgetary policies according to the Stability and Growth Pact -The macro-economic imbalances are not under surveillance and correction	-Revised SGP with stronger prevention and correction procedures of MS deficit and debt -New macro-economic surveillance -Coordination of budgetary and macro-economic policies to maximise sustainable growth	-The limits of MS public deficit and debt are defined at Federal level -The overall budgetary and macro-economic policies are defined at Federal level

Public debt management	-Public debt issuance and loans by national agencies	-Partial debt issuance by a European Public Financial authority (building on EFSF-ESM)	-Federal Treasury can borrow and issue public debt
Community budget	-Funded by national contributions -Financing Community Programmes and structural funds to reduce regional divergences	-More funded by own resources -Structural funds can also be used for macro-economic stabilisation supporting specific regions and groups	-Much bigger size -Funded by federal taxes -Financing Federal programmes -Supporting specific regions to reduce structural divergences and macro-economic imbalances
European growth strategy	-Coordinating MS structural reforms plus some small Community programmes	-These Community Programmes become larger	-Federal Programmes and federal structural reforms complementing the MS ones
Executive power	MS Governments European Council EU Council of Ministers European Commission	Idem plus Eurozone Government at PMs and Finance Ministers level with permanent Presidents	Federal Government with permanent President and Ministers
Legislative power	MS parliaments and governments EU Council of Ministers and European Parliament	-Eurogroup Council of Ministers; -Later on also European Parliament - special committee for the eurozone -MS parliaments and governments	Federal Congress with Senate and House of Representatives

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This book provides contributions from various academic and political leaders engaged in the debate about the framework of the future of economic policy in Europe. They all share the view that austerity measures, only magnified under the "fiscal compact" cannot be the right answer to alleviate the crisis that we have now been experiencing for several years. The authors tend to share the view that a proper recovery plan will need a new macroeconomic framework, through wage, fiscal and public policies, complementary to a much stronger and strengthened financial regulation. A wage standard integrating both the need for social redistribution and tackling trade imbalances should be considered, as well as new sources of financing, such as financial transaction taxes, Eurobonds, or the increase of the EIB capital and the EU budget.

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