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HANS KUNDNANI CONSIDERS THE TROUBLING TRANSFORMATION OF THE EUROPEAN UNION

EUROPE NEEDS A BROADER DISCUSSION OF ITS FUTURE, ARGUES GUNTRAM WOLFF

JEFFRY FRIEDEN WRITES THAT SUBSTANTIAL IMPROVEMENTS ARE NEEDED TO SAVE THE EURO

THE GLOBAL TRADE PLATFORM

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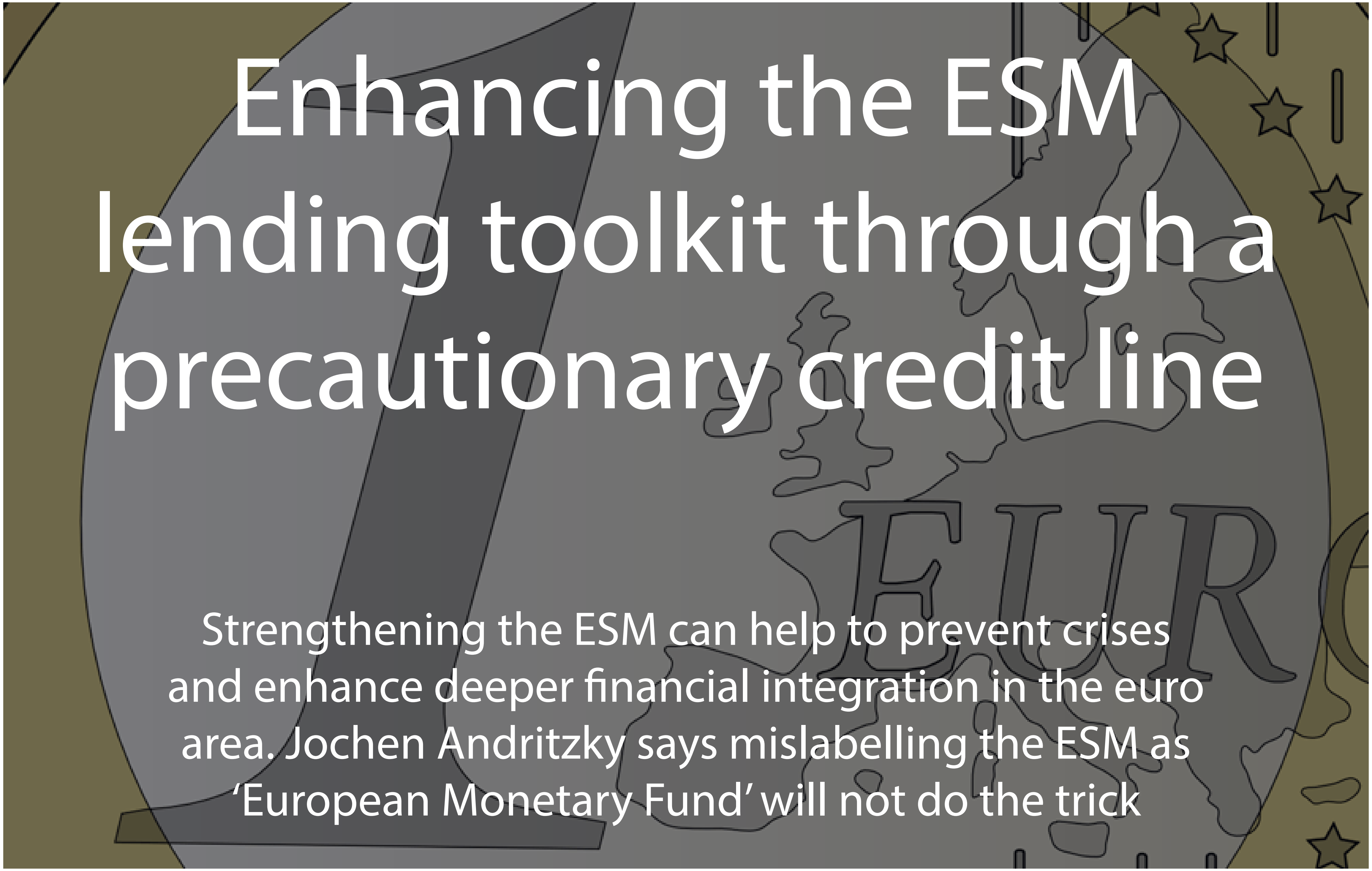

Enhancing the ESM lending toolkit through a precautionary credit line

Strengthening the ESM can help to prevent crises and enhance deeper financial integration in the euro area. Jochen Andritzky says mislabelling the ESM as 'European Monetary Fund' will not do the trick

Introduction

Transforming the European Stability Mechanism (ESM) into a 'European Monetary Fund' has come to dominate the debate on euro area reforms, albeit no one has actually proposed it to become 'monetary'. Instead, in a recent interview, Germany's chancellor Angela Merkel raised the idea of a short-term credit facility for member states hit by external shocks. Countries satisfying certain conditions could receive an ESM loan for maybe five years, with the loan size capped and repayable in full.

While hardly a leap forward for euro reform in the eyes of most, this augmentation of the ESM's lending toolkit could be quite meaningful – if it is done right. By providing a stronger backstop against coordination failures in financial markets, it better guards against crisis. And by rewarding compliance with European rules and sound economic policies, it sets the right incentives.

Needless to say, an ill-designed instrument can be dangerous. If conditions for access to the credit line are watered down, the ESM may have to lend to member states that pursue inappropriate policies or pose a credit risk. At the same time, the ESM may find itself between a rock and a hard place if it has to fear that cutting the credit line may trigger a crisis. Too-easy terms may lead to overuse of the facility, so that the ESM becomes a regular source to satisfy member states' financing needs. But also the opposite may occur – that no member state ever signs up for the facility, a fate that has already befallen some existing precautionary instruments.

This blog post outlines some principles for incentive-compliant lending instruments before delving into some of the details of the design of a precautionary credit line. This may serve to inform the debate that is likely to unfold in anticipation of the euro summit at the end of this month. However, fleshing out the details of a new instrument's design will take much longer. Hence, this blog post can only provide a starting point for a deeper debate.

The power of ex-ante conditionality

The ESM is a crisis mechanism to prevent and resolve coordination failures in financial markets that can lead to a financial crisis. Sovereign debt crises typically start with a loss of access to market financing. Such losses of market access may arise from a sometimes irrational financial panic unrelated to a country's long-run solvency or policies. For example, a country may be hit by contagion from crises elsewhere. In these cases, crisis lending by the ESM is clearly welfare-enhancing (Mussa *et al*. 2000; Jeanne *et al*. 2004).

... a revamp of its precautionary credit line could create a meaningful instrument, built on the existing policy framework, by incentivising strong economic policies and guarding against financial market turbulence. The design of such a facility has to be well thought through, to navigate difficult trade-offs

In practice, crises are hardly ever unrelated to policies. Hence, it is important to consider the incentive effects of a financial safety net. Just as airbags in a car might induce less-careful driving, so a crisis mechanism may induce politicians to adopt unsound policies, or financial markets to continue to finance misconceived policies. Avoiding adverse incentives is even more important in the euro area, where member states retain substantial sovereignty in economic and fiscal policymaking.

Policy conditionality describes the set of fiscal and structural policies which are agreed with the member state and monitored by the crisis lender as a condition for providing a safety net. Conditionality can be applied ex ante, in the form of preventive policies, and ex post. Lending facilities using ex-ante conditionality are often referred to as precautionary credit lines.

While much attention is paid to ex-post conditionality – the policies agreed upon for crisis programmes – ex-ante conditionality offers a way to provide positive incentives for strong policies: Only member states continuously following sound economic policies receive access to a precautionary credit line on which they can draw when a (not self-inflicted) shock hits and financial markets go awry.

Rather than correcting policies, the aim of ex-ante conditionality is to incentivise good policymaking. Since it is aimed at preventing crises, the ex-ante approach can improve welfare compared to a purely ex-post approach (Jeanne *et al*. 2001).

Generally, the situation of the euro area is well suited for a wider use of ex-ante conditionality. In many areas, common policies such as fiscal rules already bind national policymaking. Ex-ante conditionality can be fitted to common policies and provide an additional incentive for compliance. The ESM could build on this.

Getting the design right

Currently, the ESM offers two types of precautionary credit lines, the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL). To date, no member state has yet requested a credit line.

This mirrors the experience of the IMF, for which two key reasons have been identified. First, signing up to a precautionary facility is seen as sending a negative signal that a country believes it may become a victim of crisis. Second, while the idea is that a subscribing country is prequalified for emergency lending, access may be limited or additional conditionality may apply. This may induce policymakers to remain unconstrained by ex-ante conditionality, and negotiate conditionality only once in need of emergency lending (Enderlein and Haas, 2015).

These lessons highlight two important trade-offs to consider in the design of the credit line's conditionality: between overuse and underuse, and between automatic access and case-specific access.

On one hand, member states should not rely on the credit line for normal funding needs or draw on it too frequently. This would transform the ESM from a crisis lender to a common financing instrument, which is not the idea of the proposal. Hence, strong institutional safeguards are needed to ensure the credit line is only drawn on under exceptional and unintended circumstances.

On the other hand, member states should not apply for the credit line only once they are at the verge of a crisis, as this would signal vulnerability and stigmatise the instrument. Instead of signalling a vulnerability, signing up for a credit line should be perceived as a stamp of approval for strong policies. As part of this, the analysis provided by the ESM in monitoring ex-ante conditionality adds to transparency and bolsters confidence of markets.

Moreover, member states satisfying the credit line's ex-ante conditionality could be granted higher access, longer maturities, or lower interest rates under other ESM facilities. In other words, if more crisis funds are needed and the country decides to apply for other facilities (with ex-post conditionality), a more comprehensive backstop and more gradual adjustment could be offered given the country's track record of strong policies. If markets reflect this more robust backstop in the pricing of government bonds, in particular at times of elevated risk, governments may be convinced of the credit line's benefits and sign up in advance.

With regard to the second trade-off, the question is to what extent ex-ante conditionality follows an explicit 'check list' or remains case-specific, and whether conditions can be adapted over time. The choice of criteria should be limited to those relevant for preventing economic crises, limiting their scope, and ensuring debt sustainability. Overloading the criteria with too many issues should be avoided, much like conditionality for crisis programmes (Tumpel-Gugerell, 2017; Wyplosz, 2017).

While there must remain scope to adjust the set of policy conditions, the credit line must remain credible in the sense that both member states and financial markets can trust the backstop. Otherwise, there is no advantage vis-à-vis the existing instruments with ex-post conditionality. However, compliance with a clearly defined set of rules – as in the proposal of a 'discount window' by Enderlein and Haas (2015) – may be too automatic and too weak to protect the ESM from credit risk. Finding the right balance is an important detail that needs to be worked out.

Conditions of the credit line

The idea of a credit line is to offer bridge financing if a member state's market access to issue sovereign bonds is inhibited for a short period. The facility does not replace other ESM facilities, in particular macroeconomic adjustment programmes to overcome deeper-rooted problems. If the credit line is drawn down and market access remains lost, the member state can still choose a macroeconomic adjustment programme.

Maximum access under the credit line should therefore be limited, for instance to one year's gross financing needs. The total gross public funding need for all euro area member states amounts to about €1 trillion during one year. This exceeds the ESM's current lending capacity of €500 billion. However, not all member states would draw at the same time, and not all countries would qualify for the credit line.

The Bagehot principle postulates that crisis lending is temporary and should take place at high lending rates to reduce reliance on crisis lending. Over the course of the euro-area crisis, the Bagehot approach for macroeconomic adjustment programmes was replaced by one in which solvency support through lower lending rates and management of debt-related cash flows dominated (Wyplosz, 2017).

However, for a precautionary credit line, there is no reason not to apply Bagehot's principle, at least in a tiered manner. Given its nature as bridge financing, interest for larger amounts drawn under the credit line could include a sizeable margin over the ESM's cost of funding to discourage overuse. In the short run, the solvency implications for member states would be manageable. There is no doubt that the loan would need to be repaid in full, as the facility is not a transfer mechanism.

Precautionary credit lines are usually granted for a limited time, such as one year, and can sometimes be renewed. As opposed to the current ESM precautionary instruments, a facility as described here should be repeatedly renewable. A requirement to reapply for the facility annually (rather than an automatic extension) could reduce political pressure to soften ex-ante conditionality and overcome the challenge of withdrawing access to the credit line during difficult times. Besides the annual check-up before the ESM's top decision-making body takes a decision on approving the credit line, continuous monitoring would ascertain whether any policies are being implemented that could severely alter the qualification assessment.

Conclusion

A precautionary credit line could be a small but meaningful addition to the ESM's lending toolkit which looks fairly easy to implement. Such an instrument enhances the ESM's credibility as a backstop in a sovereign debt crisis and delivers a more substantial contribution to euro area financial stability than changing the ESM's legal statute, a questionable focus of the ongoing discussion.

However, the devil is in the details that can make or break the credit line's success. A facility subject to ex-ante conditionality suits the current framework of common policies well, and could strengthen incentives to comply with good policies. However, a clever design needs to be found to navigate the difficult trade-off between overuse and underuse. While sufficient assurance for crisis assistance must be provided to member states signing up to the credit line, the ESM must be protected from pressure to water down ex-ante conditionality, and must be enabled to curtail or suspend access when policies deteriorate. ■

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Addressing Europe's infrastructure gaps

Adequate infrastructure is essential for growth. Philipp-Bastian Brutscher and Andreas Kappeler consider recent data and find fiscal constraints and planning capacity matter

Adequate infrastructure is essential for growth. Since the financial crisis, however, public sector infrastructure investment in the EU has been scaled back. This column uses data from a recent survey to explore the causes of Europe's infrastructure gaps. The results suggest that more coordination and planning are needed for infrastructure projects, both at the EU and national levels. Efforts to attract private investors also need to continue.

The need to invest more in Europe's infrastructure has been heavily discussed in the context of the EU's post 2020 Multiannual Financial Framework. And rightly so – the longer-term economic performance of the EU and the global economy critically depends on the availability of adequate and state-of-the-art infrastructure (EU 2018). A large body of literature has underscored the importance of infrastructure for productivity growth (Berg *et al*. 2012, Calderon and Serven 2014) and for making economic growth more inclusive and sustainable (Woetzel *et al*. 2016, UN 2016).

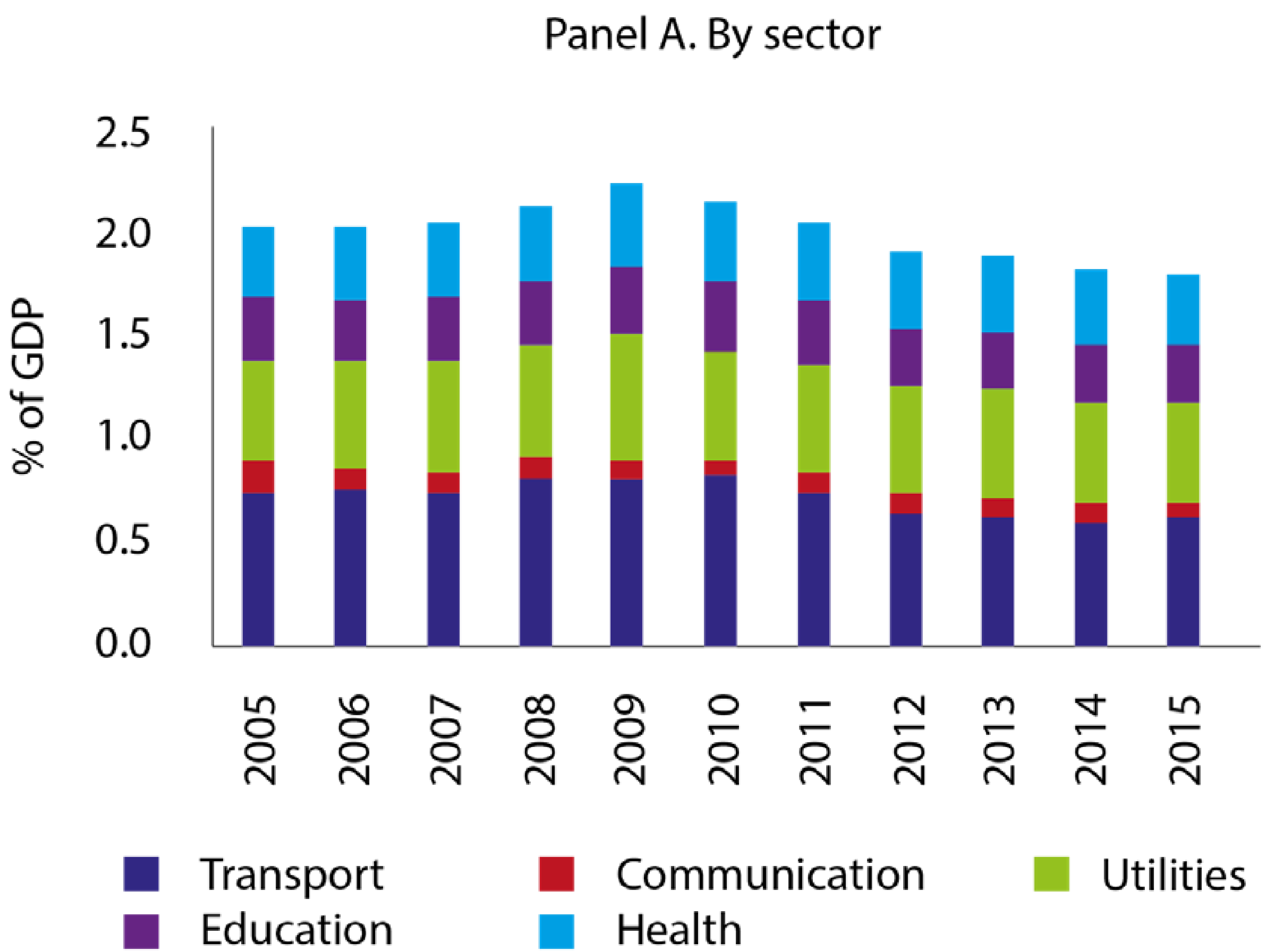
Investment in infrastructure in the EU is today at 1.8% of GDP, according to the *EIB Investment Report 2018*. This is 20% below pre-crisis levels, though the fall in infrastructure investment in recent years seems to have levelled off. The decline was most-pronounced in the transport sector (EIB 2017).

Whether this decline in infrastructure investment is desirable or rather reflects a worrisome gap is at the core of a heated debate. Infrastructure investment gaps are typically defined as the difference between infrastructure investment needs, or how much countries should be spending on infrastructure and actual infrastructure investment. Some argue that the decline in infrastructure investment reflects a healthy saturation effect – key transport, communication, and social infrastructures are already in place in the EU. However, this perspective risks overlooking the need to replace old infrastructure, complete long overdue connections, and respond to technological advances.

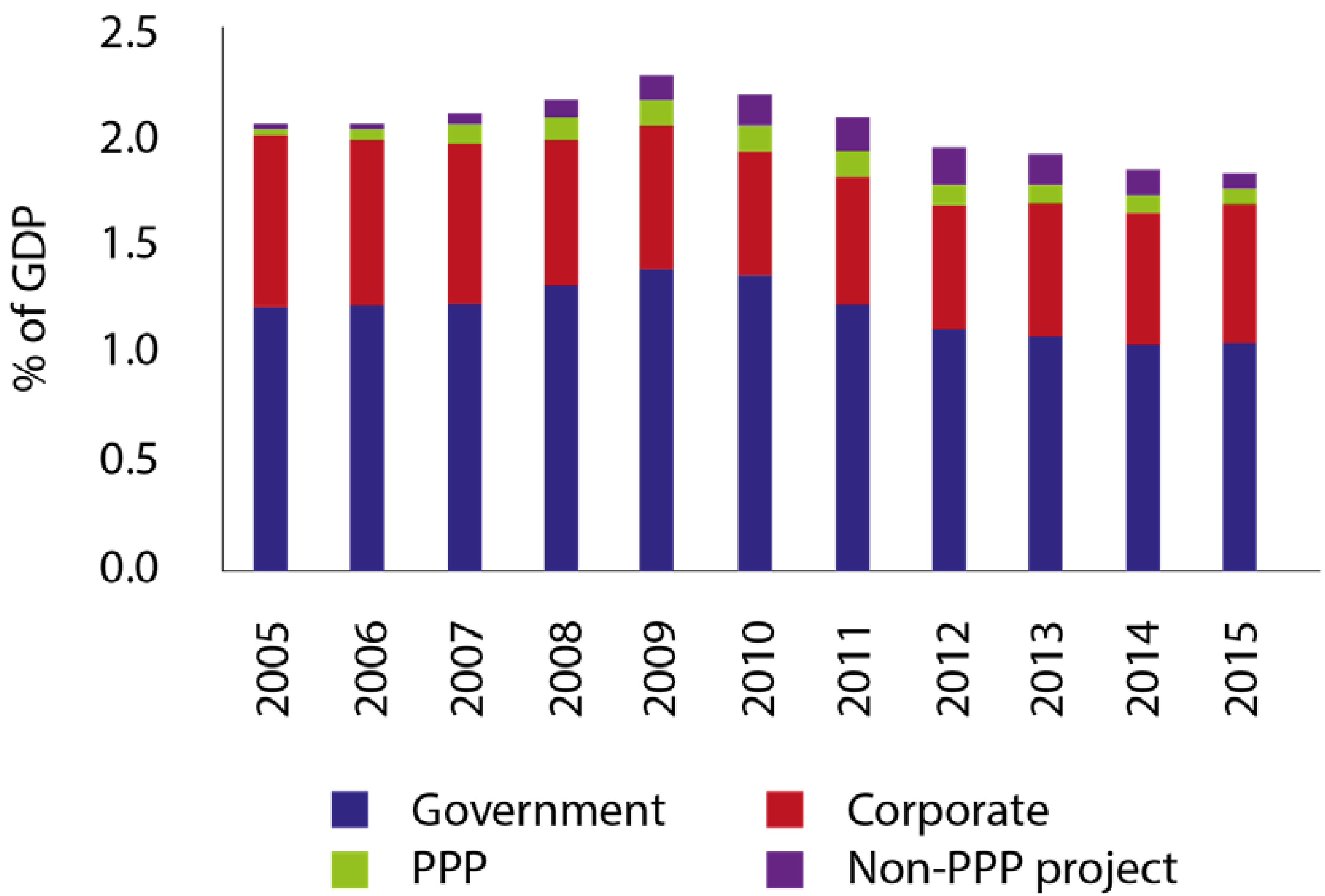
Several papers have attempted to estimate infrastructure investment needs and identify substantial gaps. For the world as a whole, estimated infrastructure investment needs range between 3.9% to 9.7% of GDP annually (OECD 2017, Bhattacharya *et al*. 2016, Woetzel *et al*. 2016, GCEC 2014). Annual infrastructure investment needs in Europe are estimated at 4.7% of GDP for energy, transport, water and sanitation, and telecoms (EIB 2016). The underlying methodologies vary substantially and often depend on assumptions about potential GDP growth and elasticities of infrastructure spending to growth (OECD 2017a).

While there is little doubt that more investment in the EU's infrastructure is needed, it is equally important that the planning and implementation of infrastructure projects is strengthened at the EU, national, and sub-national levels

Figure 1. Infrastructure investment by sector and source, 2005-2016

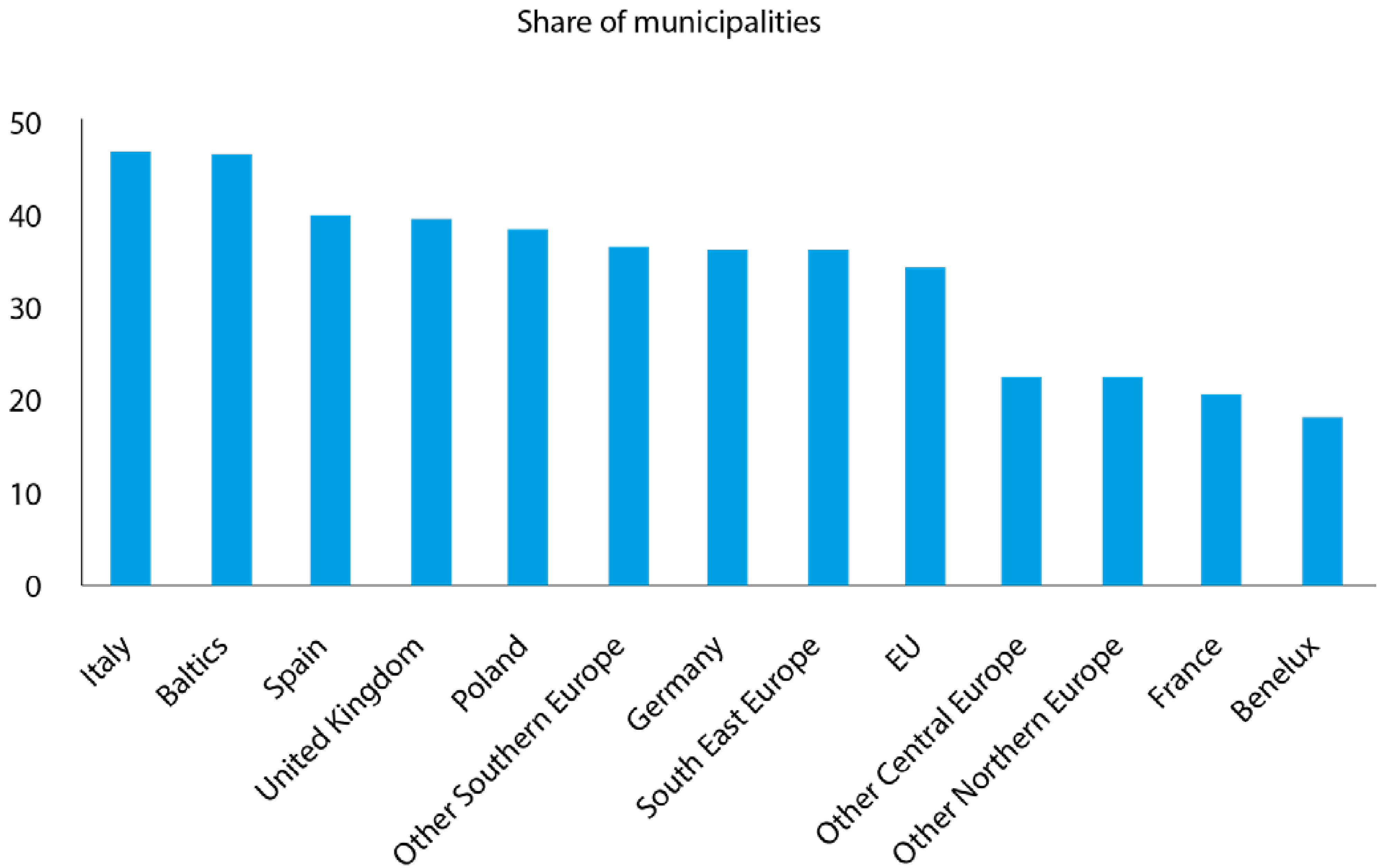


Panel B. By source



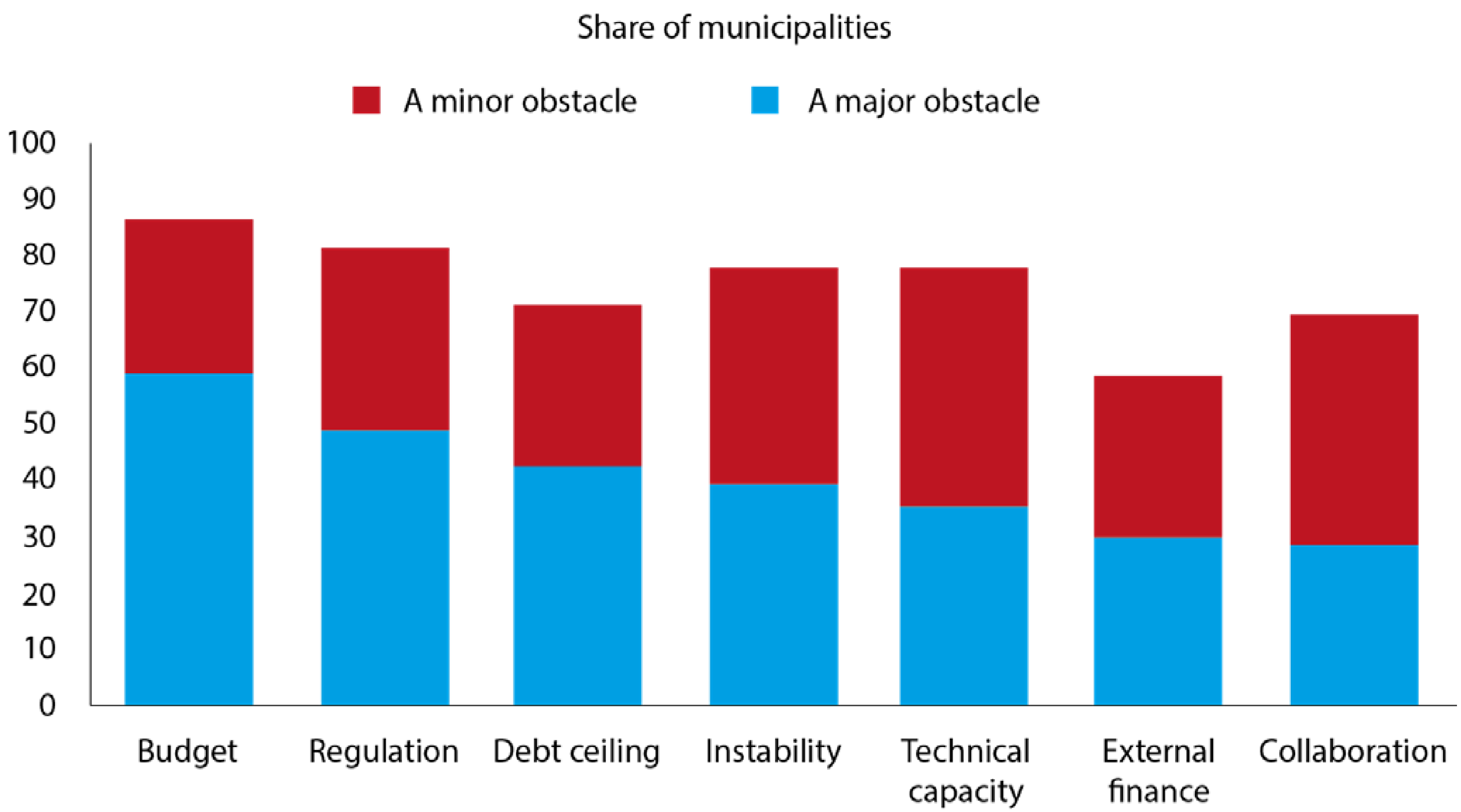
Sources: EIB estimates based on Eurostat, Projectware, EPEC.
Note: Based on EIB Infrastructure Database. Data are missing for Belgium, Croatia, Lithuania, Poland, Romania, and the UK. 2016 figures are preliminary. PPP: public-private partnership.

Figure 2. Perceived under-provision of infrastructure



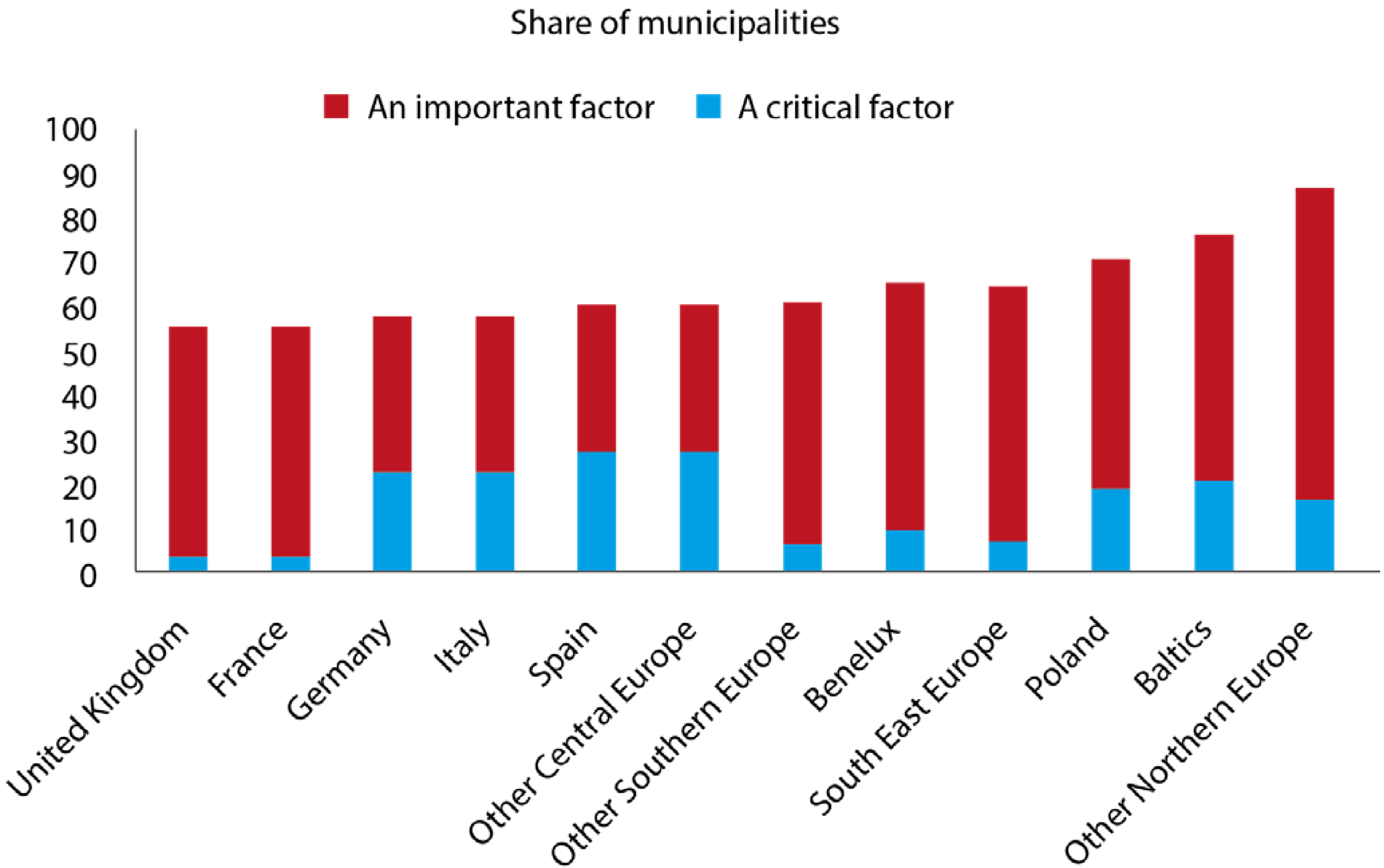
Question: For each of the following, would you say that, overall, past investment in your municipality has ensured the right amount of infrastructure, or led to an under provision or over provision of infrastructure capacity?
Source: EIB Municipality Survey 2017.

Figure 3. Obstacles to infrastructure investments reported by municipalities



Question: To what extent is each of the following an obstacle to the implementation of your infrastructure investment activities? Is a major obstacle, a minor obstacle or not an obstacle at all? (1) Balance between revenues and operating expenditure; (2) Limit on amount of debt the municipality can borrow; (3) Access to external finance (excluding funding from other government bodies); (4) Technical capacity to plan and implement infrastructure projects; (5) Co-ordination between regional and national policy priorities (including among municipalities); (6) Length of regulatory process to approve a project; (7) Political and regulatory stability.
Source: EIB Municipality Survey.

Figure 4. Importance of ex ante assessments of infrastructure projects



Question: And how important would you say are the results of the independent assessment/s when deciding whether or not to go ahead with a project?
Source: EIB Municipality Survey.

Municipalities in Europe report substantial infrastructure gaps

To contribute to the discussion on infrastructure investment needs in Europe and add a new perspective, the EIB conducted a representative survey of 555 municipalities in 2017. A key motivation for carrying out this survey was that municipalities should be well placed to assess infrastructure investment needs, gaps, and impediments in their jurisdiction.

According to the *EIB Municipality Survey*, one third of municipalities reported underinvestment in infrastructure in recent years (Figure 2). It is important to note that this refers to infrastructure investment overall and not just the part of the infrastructure that municipalities are in charge of themselves. Municipalities particularly often perceive infrastructure gaps in urban transport, ICT, and social housing.

Poor infrastructure investment risks undermining convergence and competitiveness

Poor municipalities over-proportionally report infrastructure gaps. This imbalance in infrastructure investment gaps weighs on the convergence process in Europe. Macro-data support this finding by showing that the decline in infrastructure investment is particularly pronounced in countries with the lowest infrastructure quality to start with (EIB 2017).

Upgrading Europe's infrastructure is also key to preserving Europe's competitiveness. Linking the quality of local infrastructure in the areas of transport and ICT to firms' investment activities, a clear pattern emerges – poor local infrastructure hampers firms' ability to respond to global growth opportunities and keep up with competition (EIB 2017, Revoltella *et al*. 2016).

Fiscal constraints hold back government investment in infrastructure…

What is behind the decline in infrastructure investment in Europe? Figure 1 shows that government investment in infrastructure has declined particularly strongly. At the core of this decline is a shift in public outlays from gross fixed capital formation towards current expenditure. While in some countries, governments have recently presented plans to reverse this trend, in others, budgetary outlooks suggest a continuation of this negative development.

In line with this finding, when asked about the main obstacles for infrastructure investment, 70% of municipalities report fiscal constraints (budget and/or debt ceilings, see Figure 3). Among municipalities that report infrastructure gaps, 75% consider fiscal constraints to be a major obstacle. The length of regulatory processes to approve a project is mentioned by close to 50% of municipalities as a major obstacle.

… but effective project planning and execution is key to reviving infrastructure investment

Loosening fiscal constraints requires, however, mechanisms that ensure that additional investment goes into the projects with the highest social, economic, and environmental impact.

The *EIB Municipality Survey* suggests that there might still be room for improvement in this respect – at first glance, municipalities seem to be aware of the complexities associated with an efficient allocation of resources. More than 80% of municipalities state that they have an urban development strategy. However, not all municipalities take these strategies into consideration when it comes to actual infrastructure planning. Of all municipalities that have an urban development strategy, only 72% consult this document in the process of planning infrastructure projects.

Examining the importance that municipalities attribute to ex-ante assessments of infrastructure projects reveals a similar picture. Of the roughly 60% of municipalities that carry out some type of ex ante assessment, only about two-thirds consider it a critical or important factor. Consequently, less than 40% of the surveyed municipalities assess the quality of infrastructure projects prior to implementation and consider this information important in decision-making.

Also, when it comes to the coordination of infrastructure investment activities with other bodies, there is room for improvement. Only 45% of municipalities say that they coordinate their infrastructure investment activities with the region in which they are located; and only 37% coordinate with neighbouring municipalities.

More efforts are therefore needed to strengthen coordination and the planning and implementation of infrastructure projects at the EU, national, and sub-national levels to ensure effective use of public funds.

Making infrastructure investment more attractive for institutional investors

The combination of substantial infrastructure gaps and fiscal constraints may require a greater involvement of private investors in infrastructure financing.

Infrastructure investments have many characteristics that should appeal to institutional investors. They have a long duration, facilitate matching of long-term liabilities with cash flows, and provide opportunities for portfolio diversification because of the low correlation of returns with other assets (OECD 2011). Yet average infrastructure investment by these investors, in the form of unlisted equity and debt, accounts for only 1.1% of total assets under management (OECD 2016).

The limited involvement of private investors can partly be explained by practical issues. For instance, low returns have held back corporate sector investment (Grayburn and Haug 2015). Unlike in the US, it seems that regulators in Europe did not sufficiently account for the increase in equity risk premia, which should have pushed up allowed returns. Moreover, pension funds and insurers are dis-incentivised from investing in infrastructure by a lack of data, some solvency and funding regulations, and limited investment and risk management expertise (Della Croce and Yermo 2013, OECD 2017b).

It is also likely that a clear planning and prioritisation system of infrastructure projects also matters for potential private investors' willingness to engage in infrastructure projects through PPPs or corporate infrastructure projects.

Conclusion

While there is little doubt that more investment in the EU's infrastructure is needed, it is equally important that the planning and implementation of infrastructure projects is strengthened at the EU, national, and sub-national levels. Effective use of public funds has to be ensured by strong coordination, planning, and implementation procedures. This is also key to attracting private investors. Just like taxpayers, private investors want to be sure that the projects they invest in are sound and well executed.

In 2017, the EIB provided €18 billion to support infrastructure projects worth €55.5 billion, drawing in public as well as private investors. The European Public-Private Partnership Expertise Centre and the European Investment Advisory Hub are two initiatives that helped raise the technical capacity of many of these projects and, together with EIB financing, made them bankable. ■

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A glass half-full

The Commission's proposal for the next MFF provides a good basis for subsequent negotiations. But it has a number of deficiencies. Grégory Claeys and Zsolt Darvas make proposals as to how to improve them

On May 2nd the European Commission published its proposal for the broad outline of the next seven-year EU budget, the Multiannual Financial Framework (MFF) for the period 2021-27. The proposal is the subject of intense debates. Politicians form various member states and across the political spectrum expressed deep concern about various aspects of the plan, while others rejected it entirely.

In this column we provide our overall assessment of the proposal and make recommendations on how to improve it in the coming negotiations. Our assessment can be summarised as 'glass half-full', a cautiously positive assessment. We highlight a number of shortcomings of the proposal, yet given the various constraints we regard a number of elements of the proposal as reasonable, and some of them even as innovative.

Squaring the circle

Spending more with fewer resources is mission impossible, but this is the trade-off that EU countries are currently facing.

On one side, a number of spending priorities have gained importance in recent years – such as border control, migration, security, defence, external actions, research, digital transformation and youth mobility. This could be compensated with deep cuts in the two largest traditional EU programmes – the Common Agricultural Policy (CAP) and cohesion policy – but some countries reject this strategy.

On the other side, Brexit will leave a large hole in the EU budget (see our calculations) but some net contributor countries reject the idea to increase their contributions as a share of GNI. Therefore, the Commission faced major constraints and challenges when drafting the proposal.

Positives of the Commission proposal

We list seven positive elements in the MFF proposal. First, increased spending was proposed in a number of spending categories that really constitute European public goods: huge increase in border control and defence; significant increase in research/innovation/digital fields; some increase in migration spending. For example, the way Greek and Italian borders are protected has an impact on the arrival of illegal migrants in Denmark or the Netherlands. There are also major synergies in pan-European projects, like research for example. Some projects would perhaps be unfeasible at the national level, like the EU's satellite programme. The details need to be discussed and properly analysed, but the direction and the boldness of some of the proposals are clearly welcome.

... the Commission's MFF proposal provides a good basis for subsequent negotiations, but many details are unclear and it has a number of deficiencies which require improvements

Second, considering the impossible task of spending more with fewer resources, we find the reallocations across spending categories reasonable. CAP is proposed to be reduced by 5% in nominal terms and even more so if we consider inflation, ie. in real terms (15%), while cohesion policy is proposed to increase by 6% in nominal terms, but reduced by 7% in real terms (see our calculations). In our March *Policy Brief* we assessed the rationale of these two main spending areas and the empirical experience of their implementation: we concluded that they have major weaknesses, especially the income subsidy component of CAP. Therefore, we welcome the attempt to shift resources away from these two traditional programmes (and especially from CAP) towards new priorities.

Third, it is also welcome that the Commission aims at a major reform of CAP, by shifting the focus from compliance to results, by supporting more small farmers, and by correcting the imbalances in country-allocations. We look forward to seeing the details of these proposals, which are to be published in the coming weeks.

Fourth, increased national co-financing of spending in cohesion and CAP pillar II is also welcome. Given the improved economic situation, member states have the resources to complement EU funding at a higher rate. While EU funding ultimately comes from member states too, an increase in national co-financing would require an overall larger contribution to EU spending programmes from member states, while the political perspective of money coming from the EU budget or directly from the national budget might be different.

Furthermore, a comprehensive literature survey (done by Benedicta Marzinotto in 2012) found that EU cohesion funds have a growth potential, but may not always deliver in practice either because they are poorly managed or used for the wrong types of investment. Larger national contributions might improve project selection, ownership and the management of these funds.

Fifth, the proposal includes increased flexibility and emergency tools, including extra flexibility between headings and years, possible re-programming at mid-term, and programme reserves within each programme. Such flexibility would help redirect EU spending in case of unforeseen developments.

Sixth, we welcome the attempt to formally monitor the rule of law in EU countries. The respect of the rule of law is a fundamental value of the EU, and a pre-condition to enter the union in the first place. Deficiencies on this front could hinder the proper implementation of the EU budget and therefore the rule of law is an essential precondition for managing EU funds.

The proposed procedure would assess, among others, whether investigation and public prosecution of fraud or corruption works well, if judicial review by independent court is effective, and whether member states cooperate with EU's Anti-Fraud Office and the EU's Public Prosecutor's Office.

Good aspects of the proposal are that it would apply to all funds managed by member states and thereby all EU countries could be subject to that, while an eventual sanction under this proposal should not disadvantage non-governmental beneficiaries of EU funds. The Commission would draw on the opinions of the EU Court of Justice and the European Court of Auditors.

A major criticism raised by some member states is that deficiencies to the rule of law cannot be measured objectively. However, ultimately member states would decide collectively and we have to trust in the collective wisdom of various European institutions and member states.

Nonetheless we call for a much broader approach to the rule of law: a regular analysis of all EU member states, similar to the EU's fiscal surveillance and the Macroeconomic Imbalances Procedure (MIP), as recommended earlier by Maria Demertzis and Inês Gonçalves Raposo (see here and here). As they argue: *"Despite its compliance problems, the MIP has emphasised the need for monitoring policies, identifying risks and even considering penalties when countries are in clear breach of agreements. The same must happen when it comes to the quality of institutions."* Such a regular monitoring would ensure equal treatment of member states.

Seventh, the Commission also made some proposals to change the revenue side of the EU budget in the next MFF, many of which appear to be quite reasonable.

Gradually phasing out 'rebates on rebates' and other revenue correction mechanisms is the logical outcome of Brexit, since the UK benefitted from the largest rebate and some rebates to other countries were introduced with a view to reducing the increased burden originating from the UK rebate. National contributions to the EU budget should be based on a commonly agreed formula, to which ad-hoc corrections (like the rebates) are not necessary. In our view, moving national contributions even closer to the distribution of GNI is sensible, given the proposed increase in the provision of truly European public goods that benefit every European country.

Another good proposal is to introduce a basket of 'genuine' own resources, which could represent as much as 12% of revenues over the next MFF. This would originate from three main sources: a share of corporate taxes collected by member states with a 3% call rate based on the Common Consolidated Corporate Tax Base (CCCTB); 20% of the revenues of the EU Emission Trading System [ETS]); and the introduction of an EU plastic-packaging waste tax.

An agreement on CCCTB would help tax avoidance, which is a major goal of the EU, while a plastic-waste levy, along with the ETS, would contribute to the EU's climate goals. Therefore, these proposals would make a step towards aligning some objectives of the EU with the revenue sources of the EU, which we find sensible.

The Commission also proposes an increase of the revenues from customs duties: currently, a 20% share of customs duties is retained by member states in the form of 'collection cost', which is proposed to be reduced to 10% (the level from 1970 to 2000). Since the EU is a customs union with common external trade policy, we find it reasonable to direct customs revenues to the EU budget. We note, however, that 10% for collection costs would be still much higher than actual costs and therefore we recommend a much more ambitious approach – reduce the retained value to that of the actual cost.

Negatives of the Commission proposal

We also list seven drawbacks and make suggestions on how to improve. First, while the proposal includes some simplifications, like reorganising several spending programmes and reducing the total number of such programmes, the structure of the proposed budget remains complex. Also, the continued distinction between 'commitments' and 'payments' makes the structure thorny.

No other country, federation or international organisation – like the United Nations, IMF, OECD, and also organisations that make long-term investments, like the World Bank and the European Investment Bank – uses such a complex budgeting framework. A fundamental reform is badly needed, such as a proper accrual-based multiannual budgeting framework augmented with a cash budget, according to best practices of international organisations.

Second, while a stated principle of the proposal is improved transparency, it does not include a proper comparison of the spending priorities of the current and the proposed next MFF. Such comparison is made somewhat difficult by Brexit, because the UK should be excluded from the current MFF for a proper comparison with the next MFF.

Another complicating factor is inflation, because a stable 2% inflation was assumed when the current 2014-20 MFF was approved, but inflation has been much lower (which has led to higher spending in real terms in the current MFF than planned). Also, the spending programmes of the proposed next MFF somewhat differ from the current MFF, so one has to be careful in comparing the old and new frameworks. But these difficulties should not hinder a proper comparison under transparent assumptions.

In fact, the Commission presented and widely popularised current-price comparisons for seven main spending categories (by excluding the UK from the current MFF) – but it did not do this for the two largest spending categories, CAP and cohesion policy, which is astonishing (see our own calculations). Furthermore, even for the seven categories for which a current price comparison is made, constant comparison (ie. inflation-adjusted) is not made. Proper facts should form the basis of negotiations. We suggest to present clear comparisons along the lines of (a) current prices, (b) constant prices, (c) the share of total EU spending, (d) the share of GNI.

Third, there is little European value added in direct income transfers to farmers. As the renowned Sapir report noted as long ago as 2003, *"The current EU budget is a relic of the past"*, a conclusion that still largely characterises the next MFF proposal. Certainly, CAP has a number of crucial goals with pan-European value – like food security, biodiversity and limiting climate change. But the goal of providing a fair standard of living for the agricultural community is clearly a social policy and is limited to one particular sector.

For example, the health-care sector is crucial for the health of European citizens, but the EU budget does not provide income support for hospitals, doctors and nurses. Equally, the educational sector is crucial for raising our children and the youth, but schools and teachers do not get income support from the EU budget. Why provide EU income support to one particular sector, even if that is an important sector, if other important sectors do not receive income support?

A radical change would be the renationalisation of direct transfers along with the amendment of state aid rules to make this possible. A less radical solution would be the introduction of national co-financing of direct transfers, as proposed in our March *Policy Brief*, similar to the national co-financing of the CAP pillar II rural development fund. National co-financing would allow for the lowering of the EU budget contribution to that policy and thereby free up resources for other spending areas.

Unfortunately, neither full nor partial renationalisation of income support has been proposed, and in fact the proposal suggests an unfortunate increase of the share of direct payments and a reduction of the share of the rural development fund in total CAP allocations.

Fourth, we find the increase in external action commitments too timid. The Commission communication shows that certain elements of this spending category are multiplied by a factor of either 1.2 or 1.3 compared to the current MFF (at current prices, excluding the UK form the current MFF). Yet EU27 GNI is expected to increase by a factor of 1.28 (again, at current prices), so an increase with a factor of 1.2 implies a decline as a share of GNI.

The EU has a responsibility for helping its less-fortunate neighbours and other parts of the world, and has an interest in doing so if it wants to reduce the migration pressure in the long run. Instead of a relative decline, we propose a relative increase in external action commitments (with resources coming from the reduction of EU-financed direct transfers to farmers, as we argued in the previous point).

Fifth, while we welcome the attempt to propose a euro area stabilisation instrument, its actual design is disappointing. If approved as proposed, it will be ineffective. A loan instrument has been proposed that could be granted to countries facing a large shock, who followed sound fiscal and macroeconomic policies before the economic downturn. The volume of such loans could total €30 billion and could be potentially interest-free.

However, no country likes to take a financial assistance loan from official lenders like the EU, and this facility could be seen as such. Countries with sound fundamentals are less in need of financial assistance as they can borrow themselves, unless they suffer a liquidity crisis – but in such a case, the ECB's Outright Monetary Transactions (OMT) programme should be used.

Moreover, €30 billion is a very low amount (compared, for example, to the decline in investment after 2008), and the use of this facility would take resources away from other financial assistance facilities (see our detailed analysis here).

How to improve this proposal? There is an extensive discussion of various options for a euro-area stabilisation instrument – a discussion we do not wish to enter here. Yet we highlight a (modest) possible design not that far from the proposal of the Commission, which might be politically feasible: accumulating all ECB profits in a rainy-day fund, which would be used in a crisis to foster investment throughout the euro area.

Sixth, the reform delivery tool to foster structural reforms will likely be ineffective. There are major implementation problems with the European Semester recommendations (see here). It's hard to see how, for example, Germany and France would be more eager to implement the recommendations to obtain a few million euros from the EU budget.

We do not see how the EU budget could incentivise implementation, and we suggest this limitation be recognised. Instead, the best hope for a higher rate of implementation is to increase reform ownership, in which the already-proposed national competitiveness councils should play a large role, because such councils must comprise a trusted group of domestic experts.

And seventh, the euro-adoption tool is conceptually weak (and also too small in size, but that's a secondary problem). Countries like Sweden, the Czech Republic and Hungary will not change their mind about adopting the euro just because a few hundred million euros is offered for preparation – ie. money will not incentivise euro membership, in our view. And countries wishing to join will do so even without this small financial facility.

For example, ever since Bulgaria joined the EU in 2007 its major aim was to join the euro area. But Bulgaria was not allowed to enter the European exchange rate mechanism (ERM II), which is a precondition to enter the eurozone. While there are clear criteria for entering the euro area (the so-called 'Maastricht criteria', enshrined in the EU Treaty), the decision to join the ERM II is based on a non-transparent discretionary decision. If non-euro countries are to be encouraged to join the euro, the very first step should be a transparent clarification of the conditions to enter the ERM II.

Overall, in our view, the Commission's MFF proposal provides a good basis for subsequent negotiations, but many details are unclear and it has a number of deficiencies which require improvements. ■

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Europe's future: the value of an institutional economics perspective

To reform the European project which institutions and rules are needed and when? Nauro Campos and Jan-Egbert Sturm introduce a new eBook that makes the case that such questions are of fundamental importance for the future of Europe

One can no longer be sure whether Europe is just at a crossroads or on the brink. The multi-faceted economic crisis has deepened. It has also become a widespread political crisis. There is little disagreement that the European integration project needs to be reformed and that this needs to be done now, before the next economic downturn. The costs of doing nothing are large and rising, and we must think of innovative ways to make reform happen in a democratic, efficient, and sustainable manner.

Economists have debated what to do and how[1] but have been mostly silent on who and when. Which institutions and agencies are needed? In our view, not even asking the question, *"Which institutions should be redesigned or even created from scratch to carry out reform in Europe?"*, goes a long way towards explaining why reforms have not been implemented.

This column introduces a new eBook (Campos and Sturm 2018) making the case that addressing such institutional questions is of fundamental importance for the future of European integration.

The individual chapters distil the lessons from the Bretton Woods institutional framework and from the globalisation wave that followed it. The overarching questions that motivate the eBook are: is a European Monetary Fund (EMF) sufficient? Are other institutions needed? How should these other institutions be designed and implemented? And how should they fit into the existing institutional framework?

The eBook is organised into five parts. The first examines the Bretton Woods system and European integration. The second looks at prominent European institutions (the European Parliament, the Structural Funds, and the ESM). The third focuses on financial institutions and on labour mobility. The fourth discusses key institutional aspects of monetary union. The fifth and final part highlights strategies for, and obstacles to, redesigning European institutions.

Bretton Woods and European integration

Harold James argues that the idea of an EMF has been with us for the last four decades and remains a source of lessons for Europe, chiefly regarding current account imbalances, debt sustainability, conditionality, and security. Axel Dreher examines the lending operations of the Bretton Woods institutions to distil lessons for the design of European institutions. He warns that an EMF risks ending up providing funds to those who need the least or to those that are politically connected. Nicholas Crafts evaluates the economic benefits from European integration

The European integration project needs reform and it needs it now. The next economic downturn may have severe political and economic consequences if it finds Europe unprepared. The costs of doing nothing are enormous in light of the UK's sojourn. He argues that the political sustainability of those positive net benefits was due to enhanced social safety nets (eg. the rise in social transfers as a share of GDP).

Giuseppe Bertola argues that the European integration project can only be properly understood from a political economy perspective. Nationalistic political sentiments have challenged a mode of operation based on trust that in the past discouraged opportunistic behaviour and prevented open conflict. Harald Badinger provides a critical perspective on the debate on the future institutions of Europe. He argues that economic theory suggests different optimal levels of centralisation for different policy fields.

European institutions

Simon Hix, Abdul Noury and Gerard Roland study how the workings of the European Parliament have changed recently. They argue it has experienced a shift away from the traditional left-right divide towards a new cleavage between anti-globalisation/EU (mostly on the extreme right and extreme left) and pro-globalisation/EU. Sascha Becker, Peter Egger, and Maximilian von Ehrlich revisit structural funds as the key institutions for convergence.

They find their effects on per capita income growth have been smaller than before the crisis, while the effects on employment have been larger. Kari Korhonen offers a history of the European Stability Mechanism (ESM). He shows how it has acquired various new tasks over time and how it gradually developed closer coordination links (for example, the April 2018 cooperation agreement with the European Commission).

Financial institutions and labour mobility

Isabel Schnabel and Christian Seckinger argue that the disintegration of the European banking sector after the crisis was at least partly triggered by regulatory intervention and it has proven to be very costly. Mathias Hoffmann, Egor Maslov, Bent Sørensen and Iryna Stewen postulate that cross-border interbank lending is not sufficient for better risk sharing. Following the crisis, banking integration was reversed, and this exacerbated macroeconomic asymmetries across countries.

Hence, deep cross-border financial integration is highly desirable. Chris House, Christian Proebsting and Linda Tesar show that differences in austerity policies across countries can account for roughly two-thirds of the observed variation in GDP after the crisis. They also argue that if Europeans were as mobile as Americans, the variation in unemployment rates across euro area countries would have declined by almost 40%. Davide Furceri and Prakash Loungani show a convergence of adjustment processes in Europe and the US, reflecting a fall in interstate migration in the US and a rise in Europe.

Overall, mobility has picked up since the crisis and played an important role in labour market adjustments. Yet migration runs into political headwinds: recipient countries threaten with barriers, despite ample evidence on the economic benefits of migration.

Monetary and fiscal union

Jakob De Haan and Patrick Kosterink argue that fiscal discipline is a necessary precondition for national fiscal policy to play a role in the stabilisation of both idiosyncratic and common shocks. They note the need for fiscal risk sharing hinges on the relevance of idiosyncratic shocks and the potency of national fiscal policy to stabilsze the effects thereof.

Paul De Grauwe and Yuemei Ji argue that financial engineering cannot cure the fundamental instability in the euro area sovereign bond markets that is created by national governments issuing debt in a currency not their own.

They believe that real stabilisation can only be achieved through a backstop of the ECB and the introduction of Eurobonds that are based on the participating national governments' joint liability.

Philippe Martin notes that the European fiscal rules have allowed for too lax a policy during good times and forced too much austerity during the crisis. Stronger rules on the financial architecture and more effective fiscal rules are needed. Creating fiscal capacity at the EU level to help countries when facing large negative shocks can also prevent a situation where the ECB is the sole institution capable to provide macroeconomic stimulus.

Lars Feld argues that fiscal competences of the EU should be introduced after its transition into a democratic federal system with sufficiently well-developed legal control. The euro crisis has shown that national responsibility for fiscal policy is not sustainable unless the doom loop between banks and sovereigns eases. Hence, a genuine Banking Union is needed.

Redesigning euro area institutions

Xavier Vives argues that the attempt to impose fiscal and market discipline through the Maastricht Treaty and Stability and Growth Pact has failed. The game now is to find a solution in which countries remain sovereign and engage in risk sharing, while maintaining market discipline in order to control moral hazard. The EMF could build a sufficient amount of risk sharing while keeping market discipline but it should then be responsible for liquidity and solvency problems of countries, thus allowing the ECB to concentrate on liquidity help to banks in need and on monetary policy.

Clemens Fuest agrees that while financial stability and resilience to economic shocks requires risk sharing, hard budget constraints and incentives for sound policies need to be preserved. There is a worrisome lack of trust both between member states and in European institutions. Trust grows with the experience of successful common undertakings in areas like defence, border protection, migration, and education that offer huge opportunities for adding value over and above what individual member states can achieve. Yet relying on current institutions until trust has grown is risky.

What have we learned and what should we do next?

A serious omission in the future of Europe debate, in our view, is that the institutional question has not been raised. It must be. Thinking about 'who' may unlock the difficulties in compromising on 'what' and 'when'. We studied a few selected institutions above, but this list was not exhaustive and there are many we have not touched upon, such as labour market institutions (Blanchard 2018). An institutional map of Europe should be a priority for future research.

How does the 'institutional approach' compare with others in the future of Europe debate? The main difficulty in answering this lies in the multitude of different proposals, suggestions, and policies that have emerged in the last five years or so. Indeed, the European Parliament created a website that tracks such proposals and prepared a report comparing them (European Parliament 2018a, 2018b). Yet the most important proposal in our view is that from the '7+7' French and German economists (Bénassy-Quéré *et al*. 2018), many of which contributed to the eBook.

Their proposal encompasses reforms of the financial, fiscal, and institutional architectures. In our opinion, the reform of the institutional architecture should receive greater priority and greater weight and should have been fleshed out more ambitiously.

The European integration project needs reform and it needs it now. The next economic downturn may have severe political and economic consequences if it finds Europe unprepared. The costs of doing nothing are enormous. We must be creative, determined, and able to implement the needed reforms in a democratic, efficient, and sustainable manner.

We are aware this eBook cannot fully address the many issues surrounding the institutional question of how to design a new framework for the European integration project. We are convinced, however, that if it succeeds in raising and adding these issues to the current debate on the future of Europe, our task has been accomplished. ■

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Endnotes

1. See, for example, the VoxEU debate on euro area reform here.

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Download the Vox eBook Bretton Woods, Brussels, and Beyond: Redesigning the Institutions of Europe here.

How large is the proposed decline in EU agricultural and cohesion spending?

Zsolt Darvas and Nicolas Moës consider the next MFF, the gradual convergence of the regions and the reduction in the need for cohesion spending

In this article we focus on a special aspect of the new proposal from the European Commission for the 2021-2027 EU Multiannual Financial Framework (MFF): by how much have proposed spending commitments on agriculture and cohesion policies changed, compared to the current 2014-2020 MFF?

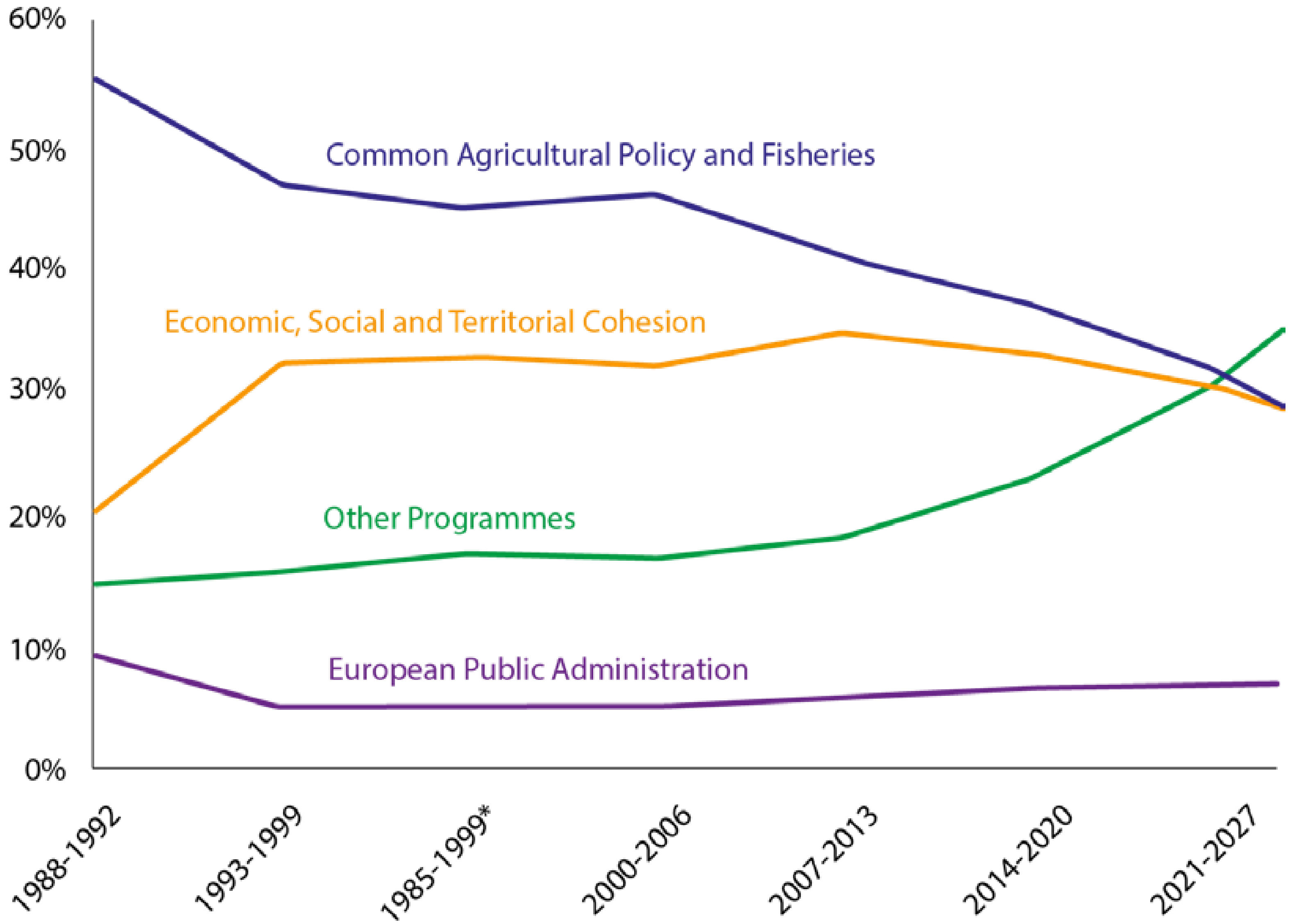
While the European Commission's main communication and the various accompanying factsheets clearly compare the current and the next MFF for many spending items – like research, investments, digital transformation, migration and border management, security, defence, and neighbourhood and the world – no document presents a comparison of current and future spending on agriculture and cohesion spending. This is more than surprising, given that these two areas together account for 60% of the proposed EU spending in 2021-2027, and one of the key principles of the proposal is transparency.

Such lack of clarity on the actual changes to the EU's agricultural and cohesion spending could potentially lead to confusion, partly because there are at least three different ways to measure the changes in spending between the current and the next MFF:

- euro values ('current prices'),
- inflation-adjusted euro values ('constant prices' or 'real terms'),
- share in total EU budget spending.

We therefore clarify these numbers in this post. The shares of agriculture and cohesion in the total EU budget spending clearly goes down according to the MFF proposal, as an interesting chart of the Commission report shows (see page 23 here or page 2 here).

Figure 1. Evolution of main policy areas in the EU budget



* Adjusted for 1995 enlargement

Source: The chart on page 23 of the 2 May 2018 European Commission communication.

However, the story merits more detail. Since total spending increases a lot from 2014-20 to 2021-27, the reduction in the share of EU spending might not necessarily mean a reduction in the euro value of spending. Total planned commitments in the current 2014-2020 MFF total €1,087 billion, of which about €61 billion could be planned to be committed to UK spending, leaving €1,026 billion for the remaining 27 EU member states.

The proposed commitment ceiling of the 2021-2027 MFF is €1,279 billion, which amounts to an increase of 25%. This increase is close to the 28% gross national income (GNI) increase of the EU27 from 2014-20 to 2021-27 that we projected in our March Policy Brief on the next MFF. By multiplying, for example, the share of cohesion spending in total EU spending by the euro values of total EU spending, we see that cohesion spending in terms of current-price euros is in fact increased.

If forecasts are right... the share of EU citizens living in regions with GDP per capita below 75% of the EU27 average will decline from 29% in 2014 to 22% in 2027

In order to properly calculate the change in euro values (at both current and constant prices), we focus on the most important individual funds: for the Common Agricultural Policy (CAP) the pillar 1 European Agricultural Guarantee Fund (EAGF – which mostly proves direct transfers to farmers) and the pillar 2 European Agricultural Fund for Regional Development (EAFRD), while for cohesion the European Regional Development Fund (ERDF), the European Social Fund (ESF) and the Cohesion Fund (CF). Since four smaller funds, which are separate funds in the current MFF, are proposed to be merged into the European Social Fund for the period 2021-27, we add these four funds to the ESF for the 2014-2020 period in our calculations.

We also separate out the planned commitments on spending in the UK from the 2014-20 period, because the next MFF is for the 27 remaining members only.

A complicating factor is the inflation rate used to calculate the constant price value of EU spending. In the MFF regulations, a fixed 2%-per-year inflation is used to convert current and constant price numbers from one to the other, irrespective of actual inflation. However, inflation in the past years was well below 2%, implying that the actual increase in the real value of EU spending was larger than what was foreseen in 2013, when the current MFF was adopted.

For a correct economic comparison of constant price values, actual inflation has to be used. Therefore, in our calculations we use actual inflation, measured as the GDP deflator of the EU27 not including the UK. The May 2018 European Commission forecast includes this indicator up to 2019, while the IMF April 2018 World Economic Outlook presents forecasts up to 2023. We use these forecasts, and assume that the 2023 inflation will prevail in 2024-27, which is essentially 2% – practically identical to the value used in MFF calculations.

The results of our calculations are included in Table 1. Overall, cohesion spending commitments are planned to be increased by 6%, so there is no planned 'cut', in contrast to many reports in the media. However, inflation erodes the real value, leading to a reduction of 7% in real terms (if inflation will be 2% per year, as the MFF calculations assume and the IMF forecasts). The proposed realignment between the three main funds of cohesion policy is also notable. While the Cohesion Fund (CF) is proposed to be reduced by 37%, the European Regional Development Fund (ERDF) is proposed to be increased by 20%.

The CAP is proposed to be cut by 4%, which corresponds to a reduction of 15% in real terms when we consider a 2% inflation rate in the future. Among the two main components of CAP, there is realignment towards the so-called pillar 1, the European Agricultural Guarantee Fund (EAGF – which mostly proves direct transfers to farmers) from the pillar 2 European Agricultural Fund for Regional Development (EAFRD).

The 6% nominal increase and 7% constant price decline of total cohesion spending should be seen in the light of economic convergence of European regions and countries, which reduces the need for such spending. The distribution of two of the three funds, namely the ERDF and ESF, is primarily based on regional GDP per capita: regions with GDP per capita below 75% of EU average are considered as 'less developed', regions between 75% and 90% of EU average are considered as 'transition', while regions with GDP per capita above 90% of EU average are considered as 'developed' (all measured at purchasing power standards).

The distribution of the third fund, the Cohesion Fund, is available for countries (ie. not regions) with GNI per capita below 90% of EU average (that's why, for example, the UK did not benefit from the Cohesion Fund in 2014-2020, while some UK regions benefitted from the other two funds – see Table 1, comparing column 2 and column 1).

Table 1. Agricultural and cohesion commitments in the current and the proposed next MFF

	2014-2020 MFF	2014-2020 MFF excl. UK	2021-2027 MFF	Change %	2014-2020 MFF	2014-2020 MFF excl. UK	2021-2027 MFF	Change %
	Current prices				2018 prices**			
CAP	408	379	365	-4	413	384	324	-15
EAGF	313	289	286	-1	316	292	254	-13
EAFRD	96	91	79	-13	97	91	70	-23
Cohesion	366	354	374	6	369	358	332	-7
ERDF	196	189	226	20	198	190	201	5
ESF+	95	91	101	11	96	92	90	-3
CF	75	75	47	-37	75	75	41	-45

CAP: Common Agricultural Policy; EAGF: European Agricultural Guarantee Fund; EAFRD: European Agricultural Fund for Rural Development; ERDF: European Regional Development Fund; ESF+: European Social Fund +; CF: Cohesion Fund. For 2021-2027, ESF+ merges the former ESF, the Youth Employment Initiative, the Fund for European Aid to the Most Deprived, the Employment and Social Innovation programme and the Health programme. For consistency, we therefore merge these instruments for 2014-2020 as well.

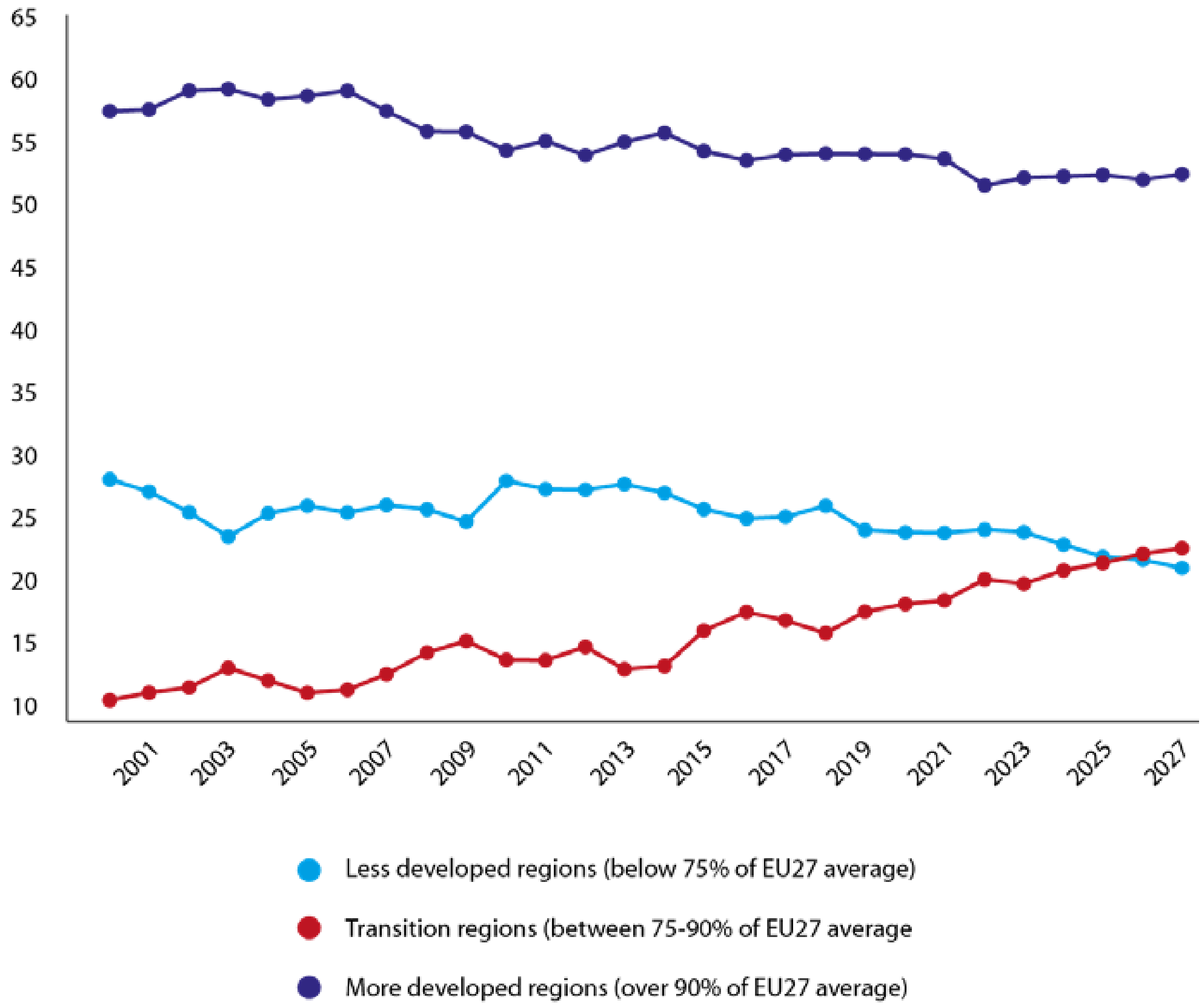
** We compute these numbers by substracting the UK share of preallocations per programme (computed from http://ec.europa.eu/budget/mff/preallocations/index_en.cfm). For Health and ESI programmes, we approximate UK share with the UK share of Total Cohesion Policy.*

*** For col. 5 and 6, we convert each year's current prices into 2018 prices using the GDP deflator for EU excl. UK from DG ECFIN's Ameco database (May 2018). For col. 7, we deflate the annual current prices proposed values by the IMF inflation forecast (which is essentially 2%).*

Sources: European Commission, Bruegel

For EAGF and EAFRD, current prices figures for 2014-2020 MFF from. For ERDF, ESF+ and CF, current prices figures for 2014-2020 MFF are from table 6. For 2021-2027 MFF, current prices and 2018 prices from European Commission 2 May 2018 proposal for the MFF (pp. 29-30), from.

Figure 2. Distribution of EU27 population according to regional GDP per capita at purchasing power standards, 2000-2027



Source: Bruegel based on data from Eurostat (actual regional data up to 2016), May 2018 European Commission forecast on country-wide data up to 2019 and April 2018 IMF forecasts for country-wide data up to 2023.
Note: regional data is available up to 2016. From 2017 onwards, we assume that population and GDP at the regional level change at the same rate as the country-level change. For 2024-27 annual changes we use the 2023 IMF forecasts. Regional data for Belgium is missing for 2000-2002: we use the 2003 values.

Figure 2 shows that the share of EU27 citizens living in the least-developed regions is gradually falling; a temporary increase around 2010 was primarily the result of the major economic downturn of southern European countries, and in particular Greece. If forecasts are right and thereby convergence will continue, the share of EU citizens living in regions with GDP per capita below 75% of the EU27 average will decline from 29% in 2014 to 22% in 2027, increasing the share of transition regions. The share of transition regions is also somewhat increased by the downward movement of developed regions. This is a long-horizon projection, while the actual allocations for 2021-27 will likely be based on pre-2021 data and, depending on the selected year, the share of less-developed regions might not be reduced that much.

The clear implication is that, with continued convergence, the need for cohesion policy is gradually reduced. To get an impression of the reduced need for cohesion funding, in Table 2 we quantify the total allocation of cohesion funds to these three categories of regions as a share of their combined regional GDP (considering only ERDF and ESF, not CF). Less developed regions receive 1.6% of their GDP, while transition regions receive much less – 0.3% of GDP – and more developed regions even less at 0.07% of GDP.

Certainly, allocations reported in Table 2 refer to the current MFF of 2014-2020 and it is up to the negotiations as to how to allocate funding across the three regions in the next MFF. Furthermore, new indicators beyond GDP per capita could be also considered, as the Commission communication (see pages 9-10) suggests: *"The relative per capita gross domestic product will remain the predominant criterion for the allocation of funds – as the main objective of Cohesion Policy is and will remain to help member states and regions lagging economically or structurally behind to catch up with the rest of the EU – while other factors such as unemployment (notably youth unemployment), climate change and the reception/integration of migrants will also be taken into account."*

Table 2. Structural funds as percentage of combined GDP across region types over 2014-2020

	Share
Less developed regions	1.60%
Transition regions	0.30%
More developed regions	0.07%

Source: Bruegel, Table 1 of DG budget (2016) and Eurostat for regional GDP. To classify regions, we use the list provided in Annexes I, II and III of the Commission Implementing Decision 2014/99/EU.
Note: Structural funds include European Regional Development Fund and the European Social Fund, but do not include the Cohesion Fund.

In this post we clarified the agricultural and cohesion spending numbers of the proposed next MFF. In subsequent related posts, Grégory Claeys will assess the part of the proposal concerning the euro area budget, and in another post we will offer our overall evaluation of the whole package. ■

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The troubling transformation of the EU

Hans Kundnani writes that the EU has already undergone a substantial transformation, but that a rigid focus on 'competitiveness' should give cause for concern

'Pro-Europeans' in Brussels and elsewhere tend to think about European integration in a somewhat linear way. They intuitively see integration as good and 'disintegration' as bad. Thus, the European Commission proposal to deepen integration of the eurozone by creating a eurozone finance minister and budget and turning the European Stability Mechanism (ESM) into a European Monetary Fund – which is currently being discussed by European leaders – is generally seen by 'pro-Europeans' as a step forward. Indeed, much of the debate how 'pro-European' the new German government would be has focused on whether it would be open to these ideas, which were originally put forward by French President Emmanuel Macron.

However, there are two quite different ways of thinking about the Commission's proposals. For Macron, they were part of a vision for a 'Europe qui protégé' in which there would be greater 'solidarity' between citizens and member states. In the context of this vision, the new European Monetary Fund would be a kind of embryonic treasury for the eurozone. But many in Germany, including Wolfgang Schäuble, seem to support the same idea for entirely different reasons. They see it as a way to increase control over EU member states' budgets and more strictly enforce the eurozone's fiscal rules and thus increase European 'competitiveness'. If that vision were to prevail, 'more Europe' would mean 'more Germany' – as many of the steps that have been taken in the last seven years since the euro crisis began have.

These different visions illustrate the way that deepening European integration is not automatically or inherently a good thing. In fact, steps such as turning the ESM into a European Monetary Fund may form part of a troubling transformation of the EU that goes back to the beginning of the euro crisis. Although integration has continued since then – and indeed EU member states have agreed to pool sovereignty in ways that would have been almost unthinkable otherwise – there are some reasons to think that this integration is qualitatively different from previous phases of the European project. It may be that, in the name of 'more Europe', a quite different EU is emerging in reality than the idealised project of the 'pro-European' imagination.

The remaking of the EU in the image of the IMF

Central to the transformation of the EU that seems to be taking place is the use of conditionality. Conditionality was originally used in the context of the accession process – 'external conditionality'. EU member states that wanted to join the euro were also subject to conditionality through the terms of the Maastricht Treaty and the Stability and Growth Pact.

After the euro crisis began, 'internal conditionality' on eurozone countries was tightened under 'Maastricht III'. However, it still seemed softer than 'external conditionality' because threats against EU member states lacked

The figure, who, more than anyone else, embodies this transformation of the EU – and has done more than anyone else to make the case for it – is Angela Merkel credibility. But that changed with the threat to eject Greece from the euro in July 2015 – which was revived during the German election campaign by Free Democrat leader Christian Lindner.

This increased use of 'internal conditionality' has transformed the meaning of 'solidarity' within the EU. Since the beginning of the euro crisis, there has been much discussion of the concept of 'solidarity' in the EU. During the euro crisis, debtor countries demanded 'solidarity' and felt they did not receive it because of the resistance by creditor countries to further debt mutualisation.

Meanwhile, creditor countries felt they had shown 'solidarity' by agreeing to bailouts. The truth is somewhere in the middle: there has been a kind of 'solidarity' in the eurozone since the crisis began, but it is the kind of 'solidarity' that the International Monetary Fund (IMF) shows – that is, loans in exchange for structural reform (or 'structural adjustment' in IMF terms). This is not how 'solidarity' was previously understood in the EU.

It is as if the EU is in the process of being remade in the image of the IMF. It increasingly seems to be a vehicle for imposing market discipline on member states – something quite different from the project that the founding fathers had in mind and also quite different from how most 'pro-Europeans' continue to imagine the EU. Indeed, it is striking that, in discussions about debt relief for crisis countries, the European Commission has often been even more unyielding than the IMF. As Luigi Zingales put it in July 2015: *"If Europe is nothing but a bad version of the IMF, what is left of the European integration project?"* The transformation of the ESM into a European Monetary Fund may be the final, logical step in this process of remaking the EU in the image of the IMF.

A 'competitive Europe'

The figure, who, more than anyone else, embodies this transformation of the EU – and has done more than anyone else to make the case for it – is Angela Merkel. She has spoken endlessly of making Europe 'competitive' – that is, able to compete economically, and perhaps also geopolitically, with other regions in the world. But in the process of becoming more 'competitive', another subtle transformation is taking place. 'Pro-Europeans' once thought of the EU as a kind of model for the rest of the world. Led by Merkel, they are now abandoning this idea and increasingly thinking of the EU as a competitor. Supporters of this approach will say that in order to be a model, the EU needs to be 'competitive'. But in order to become 'competitive', the EU may be hollowing out the model for which it once stood.

In particular, Merkel clearly believes that, in order to be 'competitive', Europe needs to cut back on the generous welfare state for which it is known. She likes to say that Europe has 7 percent of the world's population, 25 percent of its GDP and 50 percent of its social spending in order to suggest that *"it cannot continue to be so generous."* This logic is behind the imposition of austerity on 'crisis countries'.

For example, former Greek Finance Minister Yannis Varoufakis says that, in their first meeting, Schäuble told him that *"the 'overgenerous' European social model was no longer sustainable and had to be ditched"* in order to make Europe *"competitive"*. This 'competitive' Europe bears little resemblance to the one of the 'pro-European' imagination with its emphasis on the 'social market economy'.

Perhaps the most striking – and disturbing – image for the new EU that seems to be emerging comes from Mark Leonard's book, *Why Europe Will Run the 21st Century*. In it, he evoked the Panopticon – the circular prison designed by Jeremy Bentham – as a metaphor for the EU. In *Surveiller et Punir* (translated into English as *Discipline and Punish*) Michel Foucault saw the Panopticon as emblematic of a modern form of discipline that aimed to create 'docile bodies'. Leonard intended to apply Foucault's analysis to the EU in a positive sense – the idea was to illustrate how the EU used power in such an efficient way that rules ultimately become internalised. But the idea of the EU as

Panopticon may turn out to have been prescient in a somewhat darker sense. What seems now to be emerging is not so much a 'Europe qui protégé' as a 'Europe qui surveille et punit'. ■

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Explaining Germany's exceptional recovery
Dalia Marin introduces a new VoxEU eBook that explores how Germany transformed itself from the 'sick man of Europe' to 'economic superstar'

In the late 1990s Germany was called 'the sick man of Europe' (Bertram 1997). Today, Germany is an 'economic superstar'. Unemployment declined from 13% in 2005 to 6.1% in 2016. Germany is one of the world champions in exporting, accounting for almost 8% of world exports. A new eBook explains how Germany's extraordinary recovery came about (Marin 2018).

The contributors to the eBook find that changes in the labour market institutions and in firms' business models as a result of trade liberalistion with Eastern Europe after the fall of communism explain Germany's exceptional export performance. They also explain why Germany absorbed the 'China shock' more easily than other countries and why globalisation did not contribute to the rise in voting for the far right in Germany.

The astonishing transformation of Germany's economy happened at the same time as international trade with Eastern Europe was liberalised after the fall of communism. This event profoundly changed the way firms and workers operated. Trade liberalisation with the formerly planned economies after the fall of communism led to decentralised wage bargaining lowering wages; to a decentralised, less hierarchical management style in firms improving the quality of German exports; and to the expansion of production networks to Eastern Europe lowering costs; and finally it allowed Germany to absorb the 'China shock' more easily than in other countries, in particular the US.

The institution of labour relations

One leading explanation for Germany's recovery is the astonishing transformation of Germany's industrial relations from a rigid system of national wage negotiations to a decentralised flexible system of wage bargaining at the firm level as Dustmann *et al*. and Baccaro argue in Chapters 1 and 2 of the eBook. This led to a dramatic decline in unit labour costs and to an increase in competitiveness. The decentralisation of wage bargaining was triggered by the new opportunities to move production to the emerging market economies of Eastern Europe. This changed the power equilibrium between trade unions and employer federations and forced unions and work councils to accept deviations from industry-wide agreements. Dustmann *et al*. emphasise that the 'Hartz reforms' – commonly viewed in Germany as the critical turn around for the economy – played no essential role in this process, which had started a decade before (see also Dustmann *et al*. 2014). Baccaro points out that the old, rigid, high-cost system of wage bargaining may have had its advantages by acting as a 'beneficial constraint' which forced firms to upgrade the quality of their products to stay competitive in world markets (see also Streeck 1997).

One leading explanation for Germany's recovery is the astonishing transformation of Germany's industrial relations from a rigid system of national wage negotiations to a decentralised flexible system of wage bargaining at the firm level

Globalisation and technology

Marin argues in Chapter 3 of the eBook that wage moderation cannot explain Germany's more recent success in exporting. After the financial crisis exports in Germany rebounded more quickly in spite of more rapid increases in wages compared to other European countries. Trade liberalisation with Eastern Europe had a profound effect on Germany's way of doing business (see also Marin and Verdier 2014). Firms reorganised to a more decentralised, less hierarchical style of management which provided workers with incentives for product quality. Workers at lower levels of the firm hierarchy are better informed about market demands. Giving these workers more autonomy in decision making encourages firms to introduce products that customers appreciate. Marin finds that decentralised management contributed to large gains in export market shares (see also Marin *et al*. 2015). This way, the high-cost industrial labour regime before the 1990s may have had a lasting effect on a business culture of quality ('Made in Germany') that persisted even when the disciplining role of high wages and a strong Deutsche Mark vanished.

The opening-up of Eastern Europe after the fall of communism also affected German business in another way: German firms expanded production networks to Eastern Europe. Eastern Europe was rich in skilled labour and this offered not only new market opportunities for German firms, but also a pool of skilled and inexpensive workers. This helped Germany to cope with a skill shortage which became particularly acute in the 1990s. Offshoring to Eastern Europe lowered costs and helped to win market shares globally (Marin 2010).

Trade liberalisation with Eastern Europe was also a driving force behind Germany absorbing the China shock so much better than the US, as Suedekum emphasises in Chapter 4. The job losses from import penetration from China following its accession to the WTO were more than offset by additional jobs which were created from rising export opportunities to Eastern Europe. China's rise has a different effect on Germany than the rise of Eastern Europe, because these two trade shocks are quite distinct. Trade with China is of the inter-industry type (trade across sectors, eg. cars versus textiles), while trade with Eastern Europe takes place within the same sector (intra-industry trade, eg. BMW versus Skoda) and within the same multinational firms (intra-firm trade, eg. car parts versus cars) (Dauth *et al.* 2014).

Moreover, Suedekum finds that robots had a milder effect on Germany's labour market compared to the US. The reason is Germany's particular way of coping with technical change of retaining and retraining incumbents. This way, the robots did not raise the displacement risks for incumbent workers but have replaced potential jobs for young labour market entrants.

The more favourable labour market conditions in Germany may explain why, in Chapter 10 of the eBook, Cantoni *et al*. do not find that globalisation and increasing job insecurity have contributed to the rise of the vote for the far-right. Somewhat worryingly, they identify a stunning historical persistence in voting behaviour: municipalities with high vote shares for the Nazi party in the 1920s-30s also had higher vote shares for the AfD in the 2016/17 state elections.

Cantoni *et al*. identify this correlation after 2015 – the time when the conservative, anti-immigrant members took over the leadership of the party – and not before. They rule out other explanations of the vote for the far-right such as the inflow of refugees to Germany in 2015. They see the success of the AfD as the result of a political supply shock rather than a backlash against economic policies.

Harhoff and Schnitzer point out in Chapter 5 that the loss of human capital and talent after WWII did not create the initial conditions for long-term growth in Germany. Only after 2005 did R&D spending start to rise substantially and the government start an initiative to rejuvenate German universities. They also identify a lack of entrepreneurial dynamism in the German economy.

The current account surplus

With almost 8% of GDP in 2017 Germany has the largest current account surplus in the world. There are two possible sources for the large surplus: large exports or low imports. Chapters 1 to 3 of the book show that Germany is indeed a very successful exporter because of low wages (via decentralised wage bargaining), excellent product quality (via decentralised management in firms), and low production costs (via offshoring to Eastern Europe).

In Chapter 6 Wolff focuses on the import side of the current account. From a national accounts perspective, a country will face a current account surplus if its savings are large and its investments are low. Many of the investment goods are imported. Therefore, little investment leads to low imports. He finds that the German current account surplus is mainly driven by low corporate investments, which are lower than in Italy and France. He suggests that the government should increase public investment (to address the low intangible capital stock that he documents) and should encourage private investment.

In the mid-2000s Germany introduced a mix of taxes which may have shifted relative prices and the external balance in Germany's favour, as Ghironi and Benjamin Weigert explore in Chapter 7. Germany combined an increase in the value-added tax with a decrease in the payroll tax. This menu of taxes corresponds to a fiscal devaluation which is equivalent to a depreciation of a country's currency, as has been shown recently (Farhi *et al*. 2014).

Absent the ability to devalue the currency in a monetary union, countries may introduce this mix of taxes to depreciate their currency. Ghironi and Weigert then ask whether Germany did in fact pursue a fiscal devaluation to improve its external competitiveness. Their answer is no, because policymakers did not intend to use the policy mix to change Germany's external competitiveness, but rather to address domestic problems such as the reduction of distortions in the economy and the need to preserve tax revenue.

The role of history

Chapters 8 and 9 of the eBook turn to a different topic – why Germany's way of operating often leads to tensions in the euro area. Wyplosz argues that with the Maastricht Treaty Germany became the de facto leader of the euro area. The treaty delivered central bank independence and low inflation compared to previous years. This worked until the financial crisis. The unwillingness to act as a lender of last resort transformed the banking crisis into a public debt crisis. The Stability and Growth Pact to control public indebtedness was designed after the German system of federalism, which was a source of tension because the majority of the Europeans do not see themselves as a member of a common state.

James explores in Chapter 9 why the French and the Germans do not communicate effectively. The two countries have a different understanding of the role of the state. The German vision is of rules and consistency, while the French emphasise flexibility and adaptability. From a historical perspective, the beliefs in both countries have been reversed. He thinks that a crisis can be a productive moment for a profound rethinking of the old ways of organising European affairs.

What can be learned?

Is the German success story transferable to other countries? Dustmann *et al*. suggest that existing institutions in other countries restrict the decentralisation of wage bargaining, which they consider as a key factor in Germany's transformation from sick man of Europe to economic superstar. Many of the regulations which are determined by labour contracts in Germany are either legally enforced or nationally implemented and therefore require consent at a much higher level in order to be changed.

Dustmann *et al*. also do not believe that copying the Hartz reforms in other countries, as some economist and policymakers have suggested, would be sufficient. They argue that in addition, decentralisation of wage bargaining is essential to improve competitiveness. Macron's reforms, fostering labour market flexibility at the firm level while strengthening worker's representation, can be seen as a promising way forward for France.

Marin also doubts that a decentralised management style could be easily copied in any other country. The reason is that more autonomy in decision making not only frees up managers to respond to market demands, it also allows them to put their own career interests above the wellbeing of the firm. France is a case in point. She finds that French exporters decentralise their organisation much less frequently, and when they do decentralise they do not win in export markets. Germany is a high-trust society, according to the World Value Survey, in which citizens have confidence in one another's behaviour. Countries which can rely less on trust may have to introduce stronger economic incentives. ■

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Download the Vox eBook Explaining Germany's Exceptional Recovery here.

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The myth of Franco-German friendship

Ashoka Mody considers the friendship between France and Germany and finds that their national interests have diverged, and that their friendship will not plug the gaps in the euro area architecture

Since Emmanuel Macron's election as French president in May 2017, hope has lingered that a mythical friendship between France and Germany will help complete the gaps in the euro area architecture. As this column discusses, however, history provides no basis for such an expectation. National interests, always central to the decision calculus, have diverged even further. French leaders have a pressing task at hand: they need to rejuvenate their own economy and build domestic social cohesion. This may take a generation or more.

The last time the French successfully led a European unity initiative was in May 1950. WWII still cast a heavy shadow over Europe, and France's foreign minister Robert Schuman invited Germany's chancellor Konrad Adenauer to join in creating a European Coal and Steel Community. Adenauer exclaimed to his aides, *"Das ist unser Durchbruch"* (*"This is our breakthrough"*), and readily agreed (Judt 2006). For Germany, Europe was a way to regain international legitimacy.

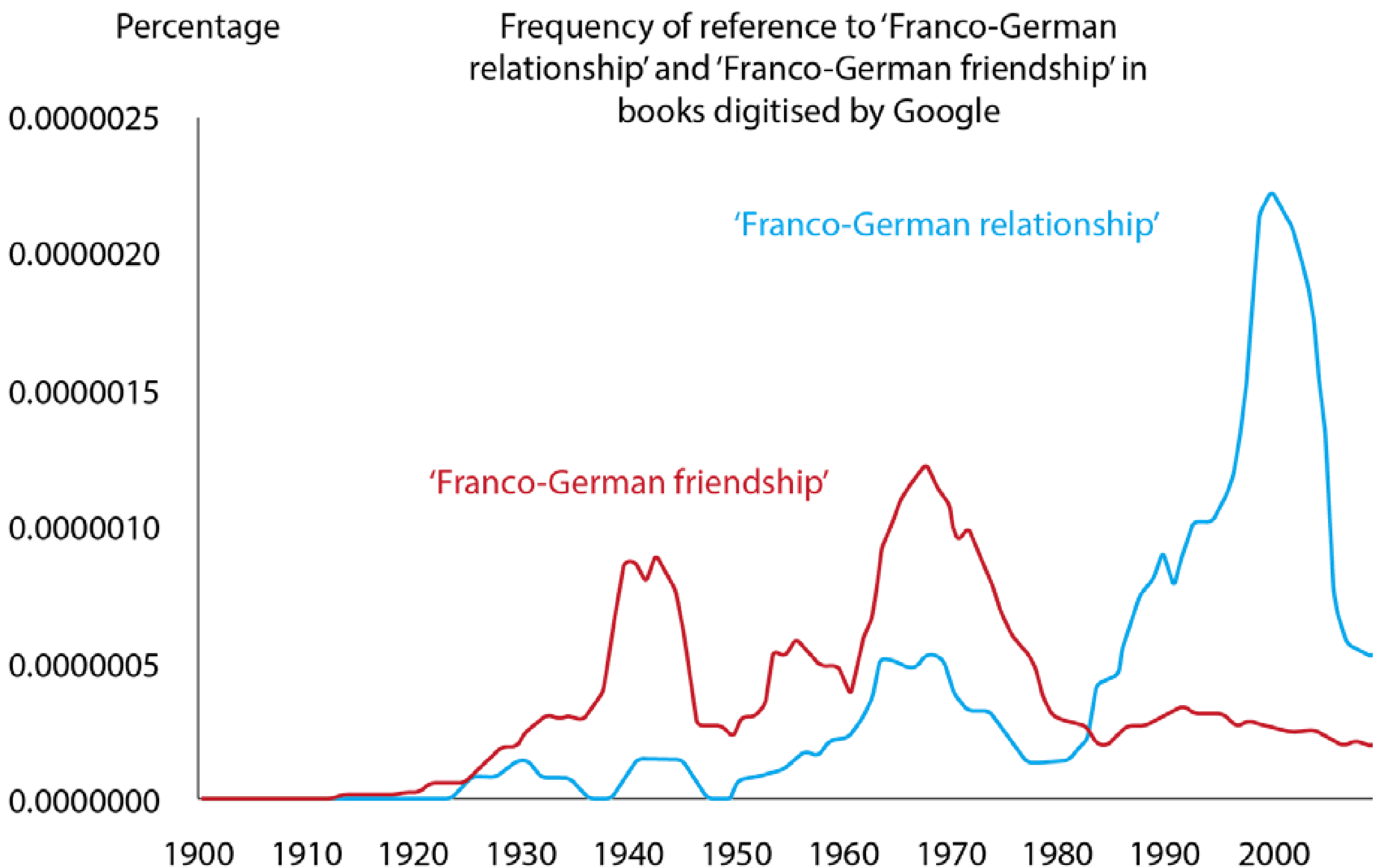
Later the same year, when the Americans insisted on allowing Germany to rearm, the French reluctantly proposed a European Defence Community (EDC), which would merge national armies into a European army supported by a European budget. The EDC Treaty, signed in May 1952, remains to this date Europe's farthest-reaching attempt at political union. Adenauer reluctantly agreed to the arrangement, which would have placed German soldiers in clearly inferior ranks in the European army. But, in August 1954, the French National Assembly backed out of the agreement. The unity drive had run out of steam. French Prime Minister Pierre Mendès-France complained, *"In the EDC there was too much integration"* (Judt 2006).

The Netherlands and Belgium led the next phase of European integration, culminating in 1957 in the Treaty of Rome, Europe's greatest postwar achievement, which opened national borders to trade within Europe. German authorities were unhappy because they believed that borders should be opened to all countries, not just European nations. French leaders opposed the Treaty of Rome because they believed that borders should not be opened at all, even to European nations. As the price for agreeing, the French installed the egregious Common Agricultural Policy (CAP), a system of subsidies for European farmers that helped undercut farmers in developing countries and even today remains a financial drag on the meagre EU budget.

A narrative of Franco-German friendship first emerged in the lead-up to the Franco-German Treaty of Friendship, the Élysée Treaty, signed in January 1963 (Figure 1). French President Charles de Gaulle viewed the Élysée Treaty as a way of creating a united European front against the US's economic and political might. But Adenauer needed the reassurance of the US's political and military support; and US President John F Kennedy was anxious to retain

A new vision for the future of Europe – even if stirred rhetorically by a mythical Franco-German friendship – cannot be based on a redesign of the euro area

Figure 1. The narrative of Franco-German friendship ebbs and flows



Note: The figure was created using the Google Books Ngram Viewer (https://books.google.com/ngrams/info). It reports the frequency with which the phrases 'Franco-German relationship' and 'Franco-German friendship' are mentioned in English-language books scanned by Google.

Germany as an important political ally. Thus, in May 1963, the German Bundestag, while ratifying the Élysée Treaty, introduced in the Treaty's preamble language that recognised Germany's special relationship with the US. Upon hearing of the Bundestag's changes, de Gaulle famously moaned, *"Treaties, you see, are like girls and roses. They last while they last"* (*Deutsche Welle* 2012). Kennedy, on the other hand, travelled to Germany in June and won the hearts of adoring West Berliners when twice in a short improvised speech he declared, *"Ich bin ein Berliner"*.

Although the impetus from the Élysée Treaty faded, a narrative evolved that, if not friendship, at least a constructive transactional 'relationship' existed between the two European nations. The phrase 'Franco-German friendship', although relegated to secondary status, remained alive and was periodically recharged to temporarily mask differences in the two nations' interests.

The narrative of Franco-German cooperation grew to a crescendo in the run-up to Europe's single currency, the euro. In fact, however, relations between France and Germany were fraught during these years. Starting with President George Pompidou in 1969, successive French presidents – Valéry Giscard d'Estaing and François Mitterrand – pushed for a single European currency, believing that by eliminating the humiliation of regular French franc devaluations, France would gain greater equality with Germany (Mody 2018b: Chapters 1 and 2). German chancellors pushed back. Starting with Willy Brandt and continuing with Helmut Schmidt and then Helmut Kohl in his first two terms, German chancellors emphasised that a single currency was ill-suited for divergent economies. When Schmidt briefly seemed to concede ground to Giscard d'Estaing, the Bundesbank held him back.

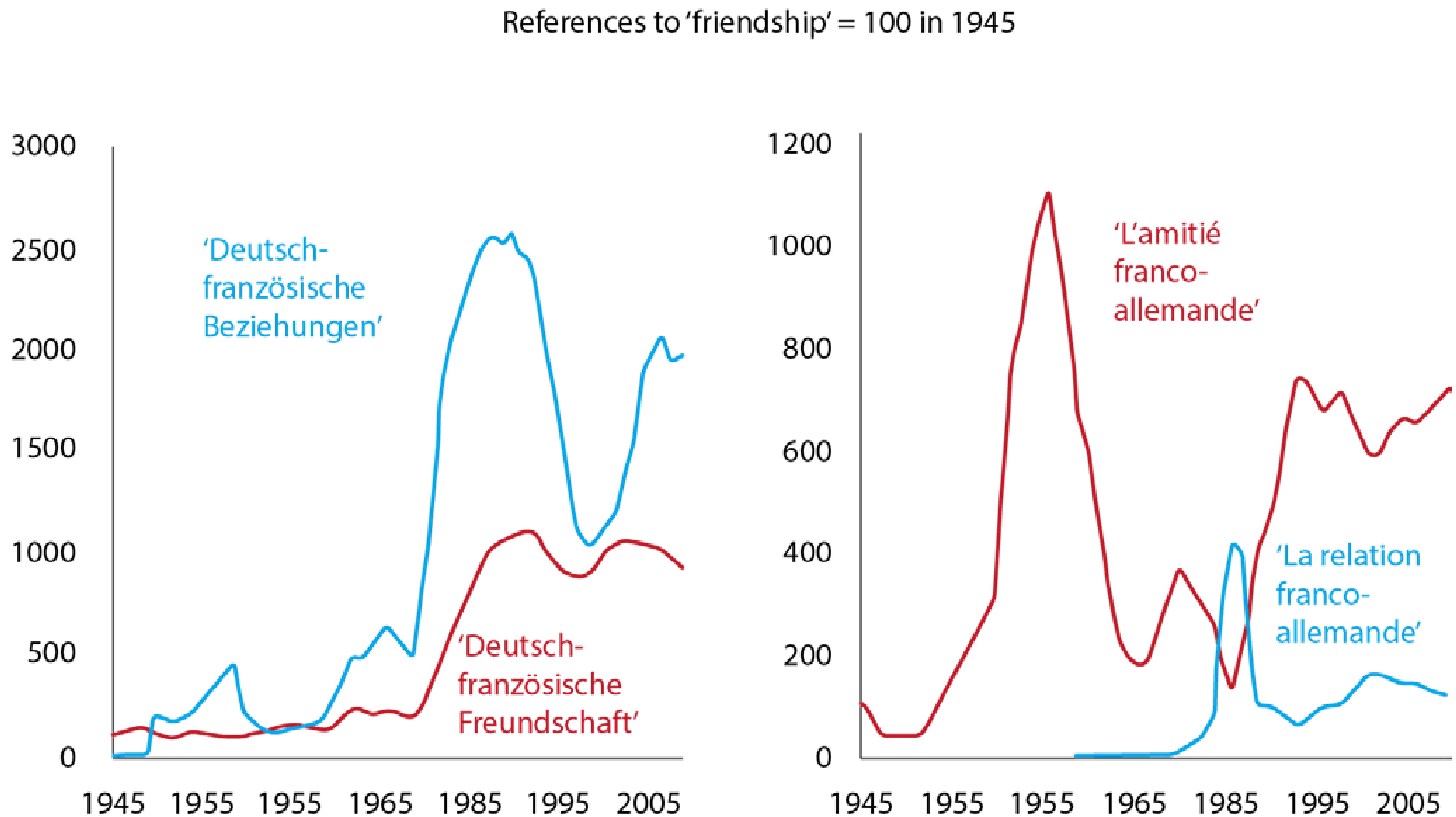
Many have speculated that after the fall of the Berlin Wall in November 1989, Kohl agreed to satisfy Mitterrand's obsession with a single European currency in return for France's green light to unify East and West Germany. There is no evidence to support this speculation. Kohl was backed US President George HW Bush, who viewed German unity as a central objective of US foreign policy. Kohl bought the acquiescence of Soviet leader Mikhail Gorbachev with a generous financial contribution to prop up the teetering Soviet Union (Mody 2018b: 78). Elisabeth Guigou, one of Mitterrand's closest advisors, says that she was present at every meeting between Mitterrand and Kohl, and the idea of a quid pro quo never came up (Schabert 2009: 248).

Kohl did change his position. From 1991 on, he pushed the single currency with boundless vigour for the rest of the decade. Why he did so we will probably never know, because he operated with great autonomy, relying on a close circle of advisors. Superficially, Kohl gave the French the euro, but he did so on German terms. The French wanted a European central bank under political supervision; Kohl, following the Bundesbank model, insisted on a hyper-independent central bank. The French wanted a European fiscal framework that allowed national policy discretion; Kohl insisted on a rigid framework centred on a budget deficit limit of 3% of GDP.

At the Amsterdam summit in June 1997, French leaders pleaded to have the fiscal framework also reflect the goal of fostering economic growth. Kohl agreed only to a name change – the system of fiscal rules would be called the Stability and Growth Pact, rather than the Stability Pact. Philip Stephens of the *Financial Times* commented: *"We are accustomed to Eurofudge, but rarely has it been so richly sweetened with cynicism"* (Stephens 1997). A year later, Kohl made another fateful decision. Despite fierce opposition from his advisors, he insisted that Italy join the euro area with the first batch of members (Mody 2018b: 120).

After the euro's introduction on 1 January 1999, German Chancellor Gerhard Schröder and French President Jacques Chirac continued a tense relationship, sparring at the Nice summit in December 2000 over the allocation of voting rights in the EU's governance. The narrative of Franco-German friendship nevertheless continued, reaching a new fervour in German and French scholarship, curiously enough, around 2002–2003 (see Figure 2). Those were indeed years of rare coincidence in German and French national interests. Both countries were struggling to bring their fiscal deficits below the 3% of GDP limit. Hard pressed by the intrepid European Commission President

Figure 2. The Germans believe in a relationship with France; the French seek friendship



Note: Three-year moving average. 'Deutsch-französische Freundschaft' and 'L'amitié franco-allemande' in 1945 equals 100. The figure was created using the Google Books Ngram Viewer (https://books.google.com/ngrams/info). It reports the frequency with which the phrases 'Deutsch-französische Freundschaft,' 'Deutsch-französische Beziehungen,' 'L'amitié franco-allemande,' and 'La relation franco-allemande' are mentioned in German- and French-language books scanned by Google.

Romano Prodi, Schröder and Chirac pushed back against any imposition of penalties specified under the rules. Prodi recognised that the rules were 'stupid,' but he felt compelled as European Commission president to implement them. German and French leaders, rather than making an effort to undo the rules, merely waved them aside.

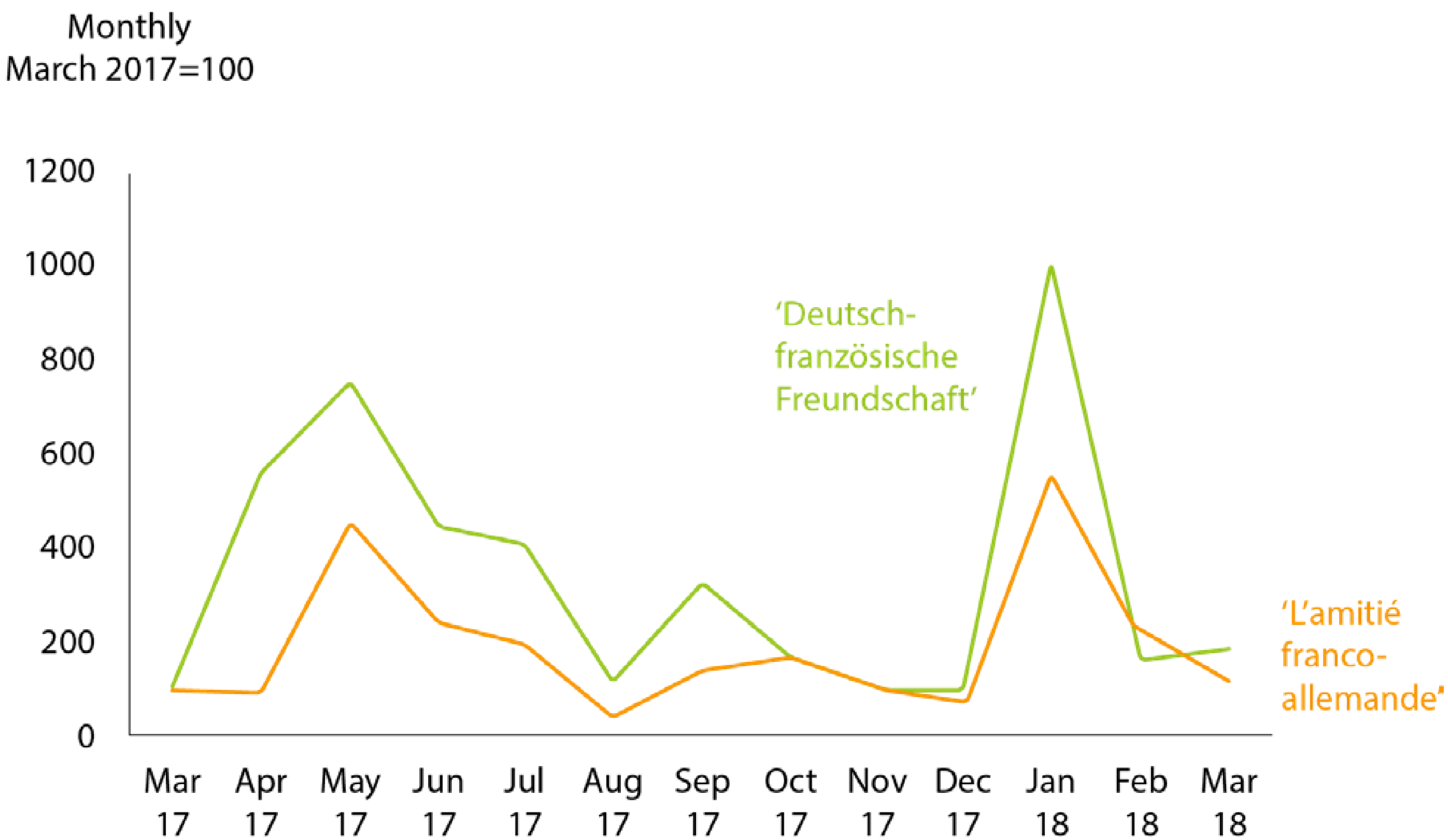
When the Global Crisis reached its most fearsome phase after the fall of Lehman Brothers in September 2008, US authorities established a $700 billion financial rescue fund, the Troubled Assets Relief Program (TARP). Under pressure to take an equivalent initiative, French President Nicolas Sarkozy proposed a similar European fund. German Chancellor Angela Merkel and her finance minister Peer Steinbrück peremptorily dismissed the idea. In December 2012, at the height of the euro area crisis, Herman Van Rompuy, president of the European Council (the gathering of European heads of government), proposed a euro area budget to assist countries in trouble.

At the Brussels summit later that month, an annoyed Merkel asked: *"Where is the money supposed to come from?"* When French President François Hollande helpfully suggested that the intention was to create a *"solidarity mechanism,"* Merkel nixed the idea, repeating: *"And where is the money supposed to come from?"* (Mody 2018b: 324).

Through the global and euro area crises, Merkel ensured that the German taxpayer was called on only to do the bare minimum to prevent the euro area from imploding. She firmly squashed fanciful ideas such as euro area budgets and eurobonds (bonds that would carry the joint guarantee of repayment by euro area governments).

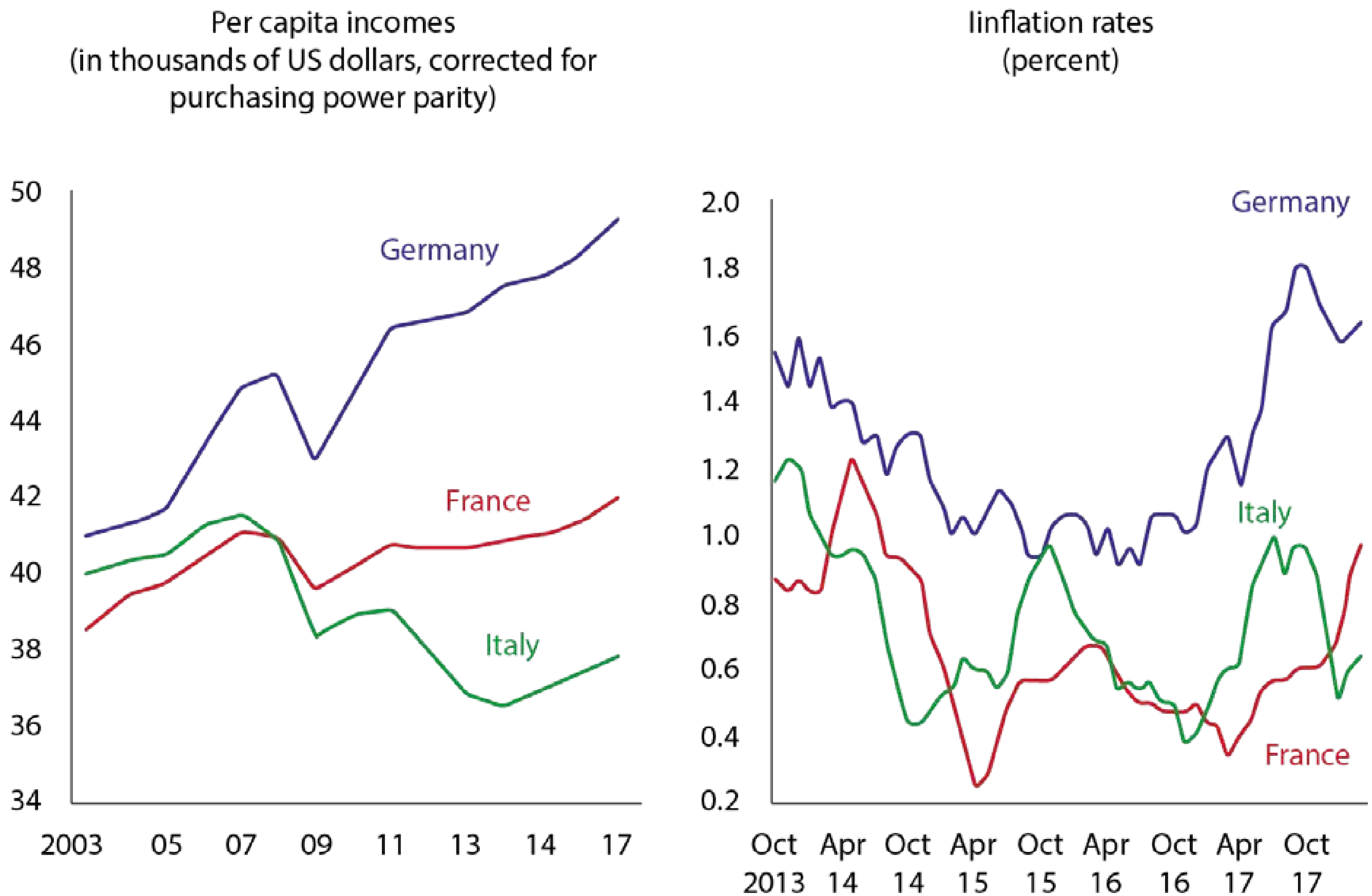
In May 2017, Emmanuel Macron became French president with a promise that he would persuade a reluctant Germany to agree to a euro area budget. A new hope was kindled. The media quickly revived the narrative of Franco-German friendship (see Figure 3). Macron gave stirring speeches in Athens and at the Sorbonne in Paris (Macron 2017a: 2017b). He invoked warm but fuzzy themes, especially a call for European sovereignty. The narrative of Franco-German friendship quickly began to fade, but it was reinvigorated in January 2018, the 55th anniversary

Figure 3. Macron's election revives the Franco-German friendship narrative



Source: Factiva. This figure reports the frequency with which the phrases 'Deutsch-französische Freundschaft' and 'L'amitié franco-allemande' are mentioned in Factiva's global news database.

Figure 4. The great divergence in euro area incomes and inflation



Sources: Conference Board, "Total Economy Database (Adjusted Version)"; Eurostat.
Note: Core inflation is the annual percentage change in the Harmonized Index of Consumer Prices excluding unprocessed food and energy.

of the Élysée Treaty. A romantic view of that treaty bolstered the sense that Germany's substantial economic lead over France and the differences in the two countries' national interests could be overcome by a common desire to promote European unity.

The prospects don't look good. However daring and appealing Macron's European vision may be, France has fallen so far behind Germany that any partnership between the two countries is unrealistic. While the German economy recovered quickly from the Global Crisis, the French economy stalled and the country's inflation rate fell into near deflationary territory (see Figure 4). France's economic woes during the crisis years reflect deep-rooted economic weaknesses.

France is one of the few advanced countries with an expanding 'informal' or 'shadow' economy. The shadow economy's expansion reflects a weak governance system, with France substantially below Germany in the World Bank's governance metrics. Weakness in such metrics is associated with low long-term growth rates, as a ECB study shows (Masuch *et al*. 2017). As further evidence of the French economy's weakness, the innovative energy of French firms is dissipating (Mody 2018b: 393).

The German economy has its own troubles, as Marcel Fratzscher (2018) highlights. But set against Germany's, France's challenges are staggering. The French government's extraordinarily high expenditures have been stuck above 55% of GDP. Soon after Macron was elected, the inimitable European Commission President Jean-Claude Juncker said, *"We have a real problem with France. The French spend too much money and spend it on the wrong things"* (Saeed 2017). Because of its high expenditures, the French government struggles to rein in its budget deficit below 3% of GDP. Its debt-to-GDP ratio remains stubbornly close to 100% of GDP. In contrast, the German government spends about 45% of GDP, now runs a budget surplus, and its debt-to-GDP ratio at 65% of GDP is quickly falling.

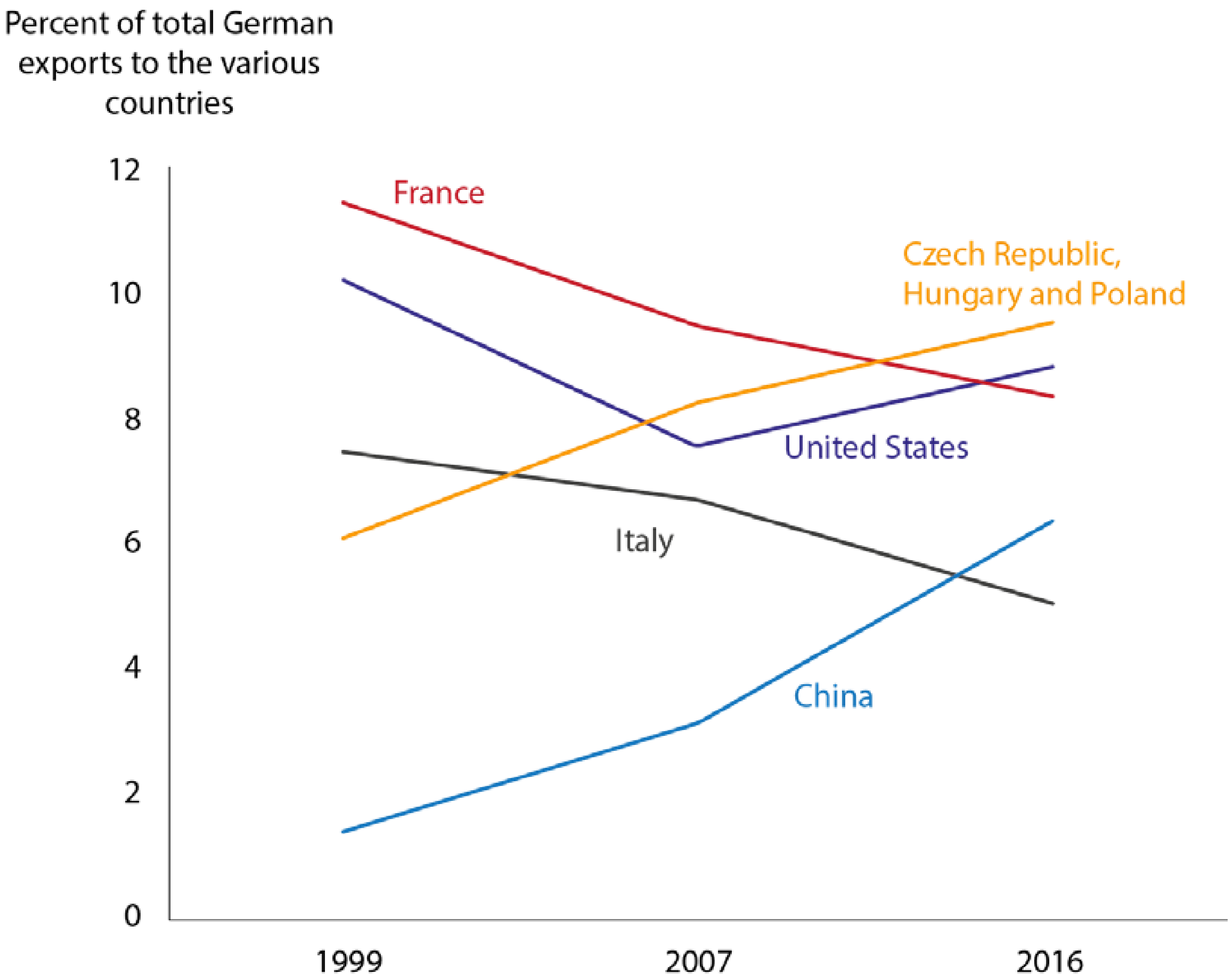
Even more worrisome for France are its long-standing social problems. The traditionally high youth unemployment rate rose during the crisis. And for a country that boasts such a large government expenditure outlay, France has amongst the lowest rates of upward intergenerational mobility in Western democracies. Annie Genevard, who served on the French Parliament's committee for cultural affairs and education, said in December 2016, *"France retains its sad title as champion of social inequalities at school"* (France 24 2016). Such social divisions ultimately are a drag on long-term growth prospects.

The widening economic gap between France and Germany is starkly evident in international trade flows. Two decades ago, France was the prime destination for German exporters (see Figure 5). Since then, the share of exports to France has fallen sharply, while exports to three non-euro area European economies – the Czech Republic, Hungary, and Poland – have steadily increased. With German exporters looking increasingly to China, Franco-German trade ties are set to weaken further.

Although Macron seems to recognise France's handicaps, the measures he has taken so far barely make a dent in addressing the country's enduring problems. Indeed, to the extent that his labour market reforms create more temporary and precarious jobs, the level of social anxiety will remain high. His promise to create greater social insurance is restricted by the realities of French budgetary stresses. And education reforms have so far remained caught in bureaucratic tangles.

A new vision for the future of Europe – even if stirred rhetorically by a mythical Franco-German friendship – cannot be based on a redesign of the euro area. The single monetary policy under the euro will always favour either Germany or France, and, hence, will continue to divide rather than unify (Mody 2018a). For Europe to move forward, the primary tasks are at home: to rebuild economies in long-term decline, especially when measured against the most dynamic countries in the world. At the same time, governments need to sensitively address social stresses.

Figure 5. German exporters shift their sights away from the euro area



Source: IMF data.

German leaders have their own homework to do; for France's leaders, their task at home is the monumental challenge for the next generation. ■

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A proposed EU directive on whistleblower protection

Theo Nyreröd and Giancarlo Spagnolo compare the whistleblower protection policies in the EU and the US and argue that reward programmes are particularly appropriate for specific regulatory areas where wrongdoing can cause substantial harm

The European Commission has recently proposed a directive that provides horizontal protection for whistleblowers in the EU. This could put the EU on a par with the US with respect to protection, but recent episodes of retaliation suggest that it may not be enough.

On 17 April 2018, the European Commission proposed a directive that provides increased protection for whistleblowers in the EU[1]. This is important given that global organised crime is becoming increasingly sophisticated making traditional enforcement methods less and less effective (Radu 2016).

Meanwhile, whistleblowers and journalists are being hunted in the EU by governments and criminal organisations. Examples abound. On 26 February, Ján Kuciak, a Slovakian journalist, was murdered in his home for investigating political connections to organised crime in the heart of Europe (*Washington Post* 2018). In October 2017, Daphne Caruana Galizia was killed by a car bomb after writing about corruption in Malta in connection with the Panama papers (*Financial Times* 2017). Maria Efimova, an employee at a private bank who claimed that her employer had moved illegal funds for Maltese politicians, is under an arrest warrant from Malta and Cyprus on seemingly unrelated charges (*The Guardian* 2018).

Hervé Falciani, who blew the whistle on the bank he was working for in Switzerland that helped clients evade billions of dollars in taxes, was arrested in April in Spain after an arrest warrant issued by Switzerland on 19 March, though he has now been released on bail (*Financial Times* 2018). The last two examples, in particular, suggest that improving whistleblower protection should have a high priority in Europe.

The EU directive and why protection may prove insufficient

The proposed directive should in principle offer increased protection to whistleblowers. It bears some resemblance to the US Sarbanes-Oxley Act (2002) but applies more extensively. It includes the mandatory establishment of confidential internal reporting channels for all firms with more than 50 employees and a large range of public administrations that also allow for anonymous reporting (Article 5). It prohibits a wide range of retaliatory actions (Article 14), places the burden of proof on the employer in cases of alleged retaliation (Article 15), and defines 'whistleblower' broadly to encompass sub-contractors, trainees, and any other person associated with a wrongdoing firm in a 'work-related context' (Article 2).

EU whistleblower protection is likely to be incomplete and insufficient, and the available evidence indicates that reward programmes hold the promise of acting like a scalpel for specific regulatory areas where wrongdoing can cause substantial harm

The directive is a move in the right direction, as European protection for whistleblowers is low and uneven among member states, with some of them offering little to no protection. In 2013, Transparency International rated only four European countries as having an acceptable level of whistleblower protection. In a report by Wolfe *et al*. (2014) several European countries, including Germany, France and Italy, were judged to have inadequate laws with respect to whistleblower protection[2].

If competently implemented, the proposed directive may finally put the EU on a par with the US which still offers the strongest protection for whistleblowers. However, the US has gone above and beyond protection by also granting whistleblowers financial incentives in key regulatory areas. For federal procurement, whistleblowers have been eligible for rewards under the False Claims Act since 1863. In the tax enforcement area, whistleblowers have been eligible to receive rewards from the Internal Revenue Service for a long time, and the system was considerably strengthened in 2006.

In 2010, as a response to the financial crisis, the Dodd-Frank Act was enacted introducing reward schemes for financial whistleblowers managed by the Securities and Exchange Commission and the US Commodity Futures Trading Commission. The reason why the US introduced financial incentives in key areas is that in their experience protection is insufficient and always incomplete.

Even in the UK, the country recognised to have some of the best protection in the EU (Wolfe 2014, Transparency International 2013), whistleblowers are still experiencing significant pushback. The recent case of Jes Staley, Barclays Bank's CEO, is enlightening. He ordered his security team to unveil the identity of an uncomfortable whistleblower, going so far as to request video footage of the person who bought the postage for the letter. Yet, the Financial Conduct Authority and the Prudential Regulation Authority decided to fine him only £642,000 – a small fraction of his pay package that year (Reuters 2018).

Cases like this suggest that the US Congress was right in pushing for rewards. The mild sanctions established by the UK regulators sent a loud and clear message to prospective whistleblowers. Even in the UK, where protection was judged as high in the above-mentioned reports, a CEO that violates the law trying to uncover the identity of someone reporting his potential mismanagement (probably not to give him a premium), will just have to pay a mild fine, if he is caught, of course!

The EU directive does not even mention financial incentives. This is rather unfortunate, given the substantial amount of empirical evidence on the US experience suggesting that these can be very effective, if competently designed and administered (see Nyreröd and Spagnolo 2017 for a recent overview).

Objections to reward programmes

Despite the evidence on the performance of these programmes in the US, European authorities have been critical of them. The Bank of England's Prudential Regulation Authority and the Financial Conduct Authority, for example, came out strongly against financial incentives for whistleblowers in 2014, with a seven-page note[3] arguing, among other things, that financial incentives will encourage malicious or fraudulent claims and produce high administrative costs[4].

The experience of the US, however, suggests that the risk of eliciting malicious or fraudulent claims, an issue sometimes raised also in reference to protection (Mechtenberg *et al*. 2017a, 2017b), can be controlled, as it has not emerged as a major problem for US programs (Nyreröd and Spagnolo 2017). This is probably the case because claims are submitted under penalty of perjury, and fraudulent claimants would be liable for defamation suits (Buccirossi et al 2017a, 2017b).

As for administrative costs, they must be weighed against the benefits of these programmes. Although there is a legitimate concern that rewards generate unmeritorious claims that lead to higher administrative costs, US agencies suggest that these costs can be contained, and that their benefits in terms of improved evidence largely outweigh these costs (Nyreröd and Spagnolo 2017). If one disregards benefits and considers only costs, the most efficient means of law enforcement would be not to enforce the law at all.

Conclusions

EU whistleblower protection is likely to be incomplete and insufficient, and the available evidence indicates that reward programmes hold the promise of acting like a scalpel for specific regulatory areas where wrongdoing can cause substantial harm. Of course, if these programmes are negligently designed or implemented by incapable or captured regulatory agencies, the promise will not be kept. But this is the case also for protection, as the case of Barclays's CEO demonstrates. ■

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Endnotes

1. See http://ec.europa.eu/newsroom/just/item-detail.cfm?item_id=620400

2. Since then France and Italy have introduced new and extensive whistleblower protection laws, while Germany has worked hard to make its protection even worse. No wonder nobody spoke up on Volkswagen's emission fraud or Siemens' global corruption system.

3. See https://www.fca.org.uk/publication/financial-incentives-for-whistleblowers.pdf

4. They also falsely claim that "There is as yet no empirical evidence of incentives leading to an increase in the number or quality of disclosures received by the regulators", even though Dyck et al. (2010) is a famous research paper presenting such evidence was published in the most distinguished finance journal and widely circulated for years before There was more evidence in contrast to that statement published before the note, including Bigoni et al. (2012) and Engstrom (2012, 2014). Other papers falsifying that statement were published later, but were already publicly available as working papers at the time (see Nyreröd and Spagnolo (2018) for an overview).

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Italian populism calls for hard choices

The economic agenda of Italian populists is likely to exacerbate Italy's long-standing problems. Alessio Terzi suggests that if the defenders of the European project want to regain popularity, they will need to present a clear alternative to setting the house on fire

Prompted by an unfolding political crisis and financial-market sell-offs, several international observers have only just tuned in to Italy's current situation. Often, they have been shocked by the strength of support in an EU founder-country for parties embracing such inflammatory, populist and illiberal rhetoric.

In the best case, many have jumped to simplistic explanations, the most frequent of which argues that The League voters just seek lower taxes, while Five-Star Movement supporters – largely located in the poorer south – want easy money through a universal basic income. In the worst cases there have been arrogant explanations posited, along the lines of: *"People don't understand, they are irrational, or daft."*

Looking at the economics of Italian populism, most of the proposals appear to be superficial, unbacked by evidence or careful reasoning, and likely to augment rather than alleviate Italy's long-standing problems – including poor competitiveness, shaky public finances, high spending on retirees and low spending on youth, and rising inequality. However, some of their premises are far from far-fetched. In particular, they are rightfully calling out national and European ruling classes, who have prevaricated over long-known problems and inconsistencies, because they required hard choices.

Though the list could be longer, two cases in point particularly apply to Italy. The first relates to public debt[1].
As is widely known, Italy has the fourth-highest debt-to-GDP ratio in the world, roughly 135%, and by now the government spends more annually on interest payments than on public investment[2]. Reinhart *et al* (2015) have shown how the debt levels we observe nowadays are unprecedented in advanced economies in non-war periods. They go on to show that the menu of solutions to reduce it can be divided between 'orthodox' (fostering growth, privatisation, primary surpluses) and 'unorthodox' (eg. financial repression, inflation, restructuring, etc).

In the Italian case, the orthodox toolkit does not hold bright hopes. The 1980s and 1990s were characterised by large-scale privatisations, which might have had a positive one-off impact but hardly set debt on a downward trajectory. Running large primary surpluses is the official approach enshrined in the EU's Fiscal Compact. However, Italy has run a primary surplus in nearly every year since the early 1990s. While some will claim that these should have been larger, Eichengreen and Panizza (2014) showed how the primary surpluses required to reduce debt significantly are rare birds in recent economic history and as such are unlikely to do the job for Italy[3].

In the Italian case, the orthodox toolkit does not hold bright hopes. The 1980s and 1990s were characterised by large-scale privatisations, which might have had a positive one-off impact but hardly set debt on a downward trajectory

The most favoured option is fostering growth, which usually comes as a recommendation to implement wide-reaching structural reforms. While this is a safe call[4], we know that reform waves have a heterogeneous impact and only occasionally yield the significant positive boost of the kind that Italy would need to break out of the current low-growth-high-debt equilibrium (Marrazzo and Terzi 2017; Peruzzi and Terzi 2018). In advanced economies, this has generally happened in post-military-conflict periods (Reinhart *et al*. 2015).

Unorthodox measures – though more frequently used in the past than we are often led to believe, even in advanced economies – are, however, generally against current EU treaties, or they cross red lines of other member states.

Stuck between a rock and a hard place, the approach at national and European level has been to focus on the short term, employing a combination of the orthodox options, keeping fiscal accounts broadly under control, trying to reduce debt at the margin in good times, and hoping for a supportive external environment.

The second case in point relates to the eurozone architecture more broadly. By now, it is widely accepted that economic and monetary union (EMU) as it stands is incomplete and dysfunctional, leading for example to harsher drops in GDP during bust cycles (Martin and Philippon 2017). While individual solutions to this problem differ, most economists agree that without a political union the whole euro construct cannot hold together long-term[5]. Having concluded that this is politically unfeasible, the approach has been to focus on short-term patches and hope that a crisis as large as 2008 will not hit any time soon.

This piecemeal, small-step approach might be tolerable for euro area member states under normal economic conditions. However, in a country that underwent 20 years of real GDP stagnation, and with no clear path to exiting this negative equilibrium in the near term, radical changes are more likely to be sought rather than small tweaks around the status quo.

As Harvard economist Dani Rodrik recently remarked, at least Italian populists are clear about how to solve his famous trilemma, which in a euro setting states that it is impossible to simultaneously have a functioning EMU, national sovereignty, and democratic politics. National and European ruling classes are yet to provide a clear answer.

If defenders of the European project want to regain popularity, they can no longer hope to brush problems under the carpet and will need to present a clear functioning alternative to setting the house on fire. The current populist agenda might well lead to a poorer Italy; however, simply highlighting the sharp costs of dismantling the status quo will soon no longer suffice. ■

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Endnotes

1. A useful reference for this is "A New Start for the Eurozone: Dealing with Debt" by Corsetti et al (2015)

2. See "Clouds are forming over Italy's elections" by Terzi (2018)

3. In their words, "The point estimates do not provide much encouragement for the view that a country like Italy will be able to run a primary budget surplus as large and persistent as officially projected".

4. On this point, it is worth remembering a quote of the World Bank chief economist: "Structural reform is safe advice. No one knows what it means. If economy grows: I told you. If it stalls: You didn't do structural reform."

5. See "Does Europe Really Need Fiscal and Political Union?" by Rodrik (2017)

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Addressing Europe's failure to clean up the transport sector

Simone Tagliapietra and Georg Zachmann write that Europe would benefit from greater EU action on road transport to cut greenhouse gas emissions and ensure European decarbonisation targets

The issue

Under the Paris Agreement the European Union has committed to cut its greenhouse gas emissions to 40 percent below 1990 levels by 2030. Between 1990 and 2015, emissions decreased significantly in all sectors with the exception of transport, which has seen a 20 percent increase. Transport is thus becoming a key obstacle to EU decarbonisation and more aggressive policies are needed to decarbonise this sector. A particular focus should be decarbonisation of road transport because it is responsible for more than 70 percent of overall transport emissions. Decarbonising road transport would also improve air quality in cities, which remains a fundamental challenge for better public health in Europe.

Policy challenge

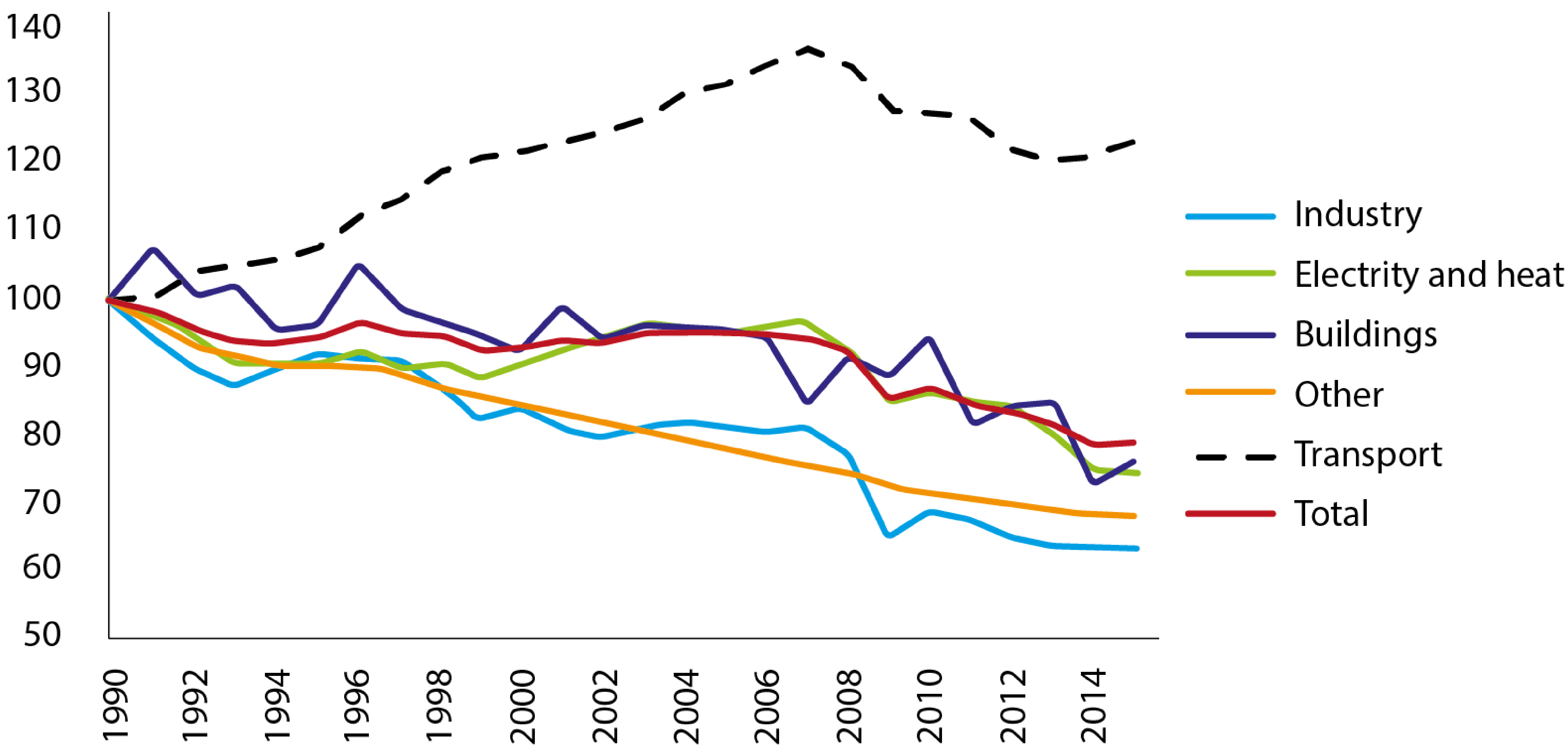
So far, national and EU policies have failed to foster road transport decarbonisation. However, this trend can be reversed by adopting a new EU post-2020 strategy with three main components. First, the EU should foster political momentum and encourage countries and cities to adopt plans to ban all diesel and petrol vehicles by 2030-2040. This would be a strong signal to the automotive industry to invest more strongly in clean vehicles, and to citizens to adopt more sustainable transport modes.

The EU should provide support to countries and cities that take this route though a new EU Clean Transport Fund. Second, the EU should promote a Europe-wide discussion about the future of transport taxation. Third, the EU should focus its transport-related research and innovation funding on supporting new clean technologies that are not yet viable, but are potentially key to ensure deep decarbonisation of road transport in the longer term.

Transport: a major obstacle to European decarbonisation

The European Union has the long-term vision to reduce its greenhouse gas emissions by 80-95 percent by 2050 compared to 1990 (European Commission, 2011a). In this framework, it adopted in 2014 a binding 40 percent

Transport: the only sector in which Europe's CO_2 emissions are on the rise



Source: Bruegel based on EEA (2017). Note: 1990 = 100.

emissions reduction target to be achieved by 2030 compared to 1990 – a target that also represents the EU's international commitment to the Paris Agreement. Meeting these targets requires a profound transformation in all the EU's key greenhouse gas emitting sectors: electricity and heat generation (currently responsible for 27 percent of EU emissions), transport (26 percent), industry (19 percent) and buildings (12 percent)[1].

Between 1990 and 2015, greenhouse gas emissions from the main emitting sector – electricity and heat – decreased by 26 percent, partly as a result of the sector's transformation underpinned by rapid advances in renewable energy technologies and by decarbonisation policies. In the same period, greenhouse gas emissions from industry decreased by 36 percent, from agriculture and waste by 32 percent and from buildings by 24 percent.

The EU has the potential to encourage innovation in low-carbon transport technologies and promote a reduction in road-kilometres. But to do so, it needs to reshape its transport policies

The only sector with rising emissions has been transport, with a 23 percent increase over the period. Transport is therefore set to become the main obstacle to the achievement of the EU's decarbonisation goals, especially as transport activities are expected to grow in Europe, by 42 percent between 2010 and 2050 for passenger transport and by 60 percent over the same period for freight transport (European Commission, 2017a). To meet the current 2050 target of reducing transport emissions by 60 percent compared to 1990 (European Commission, 2011b), stronger policies are already required.

However, to achieve net-zero emissions by mid-century – as implied by the Paris Agreement – transport would actually have to be completely decarbonised shortly after 2050. This obligation cannot be met without much stronger policies. Under current policies, emissions from the transport sector are projected to exceed 1990 levels by 15 percent in 2050 (EEA, 2016).

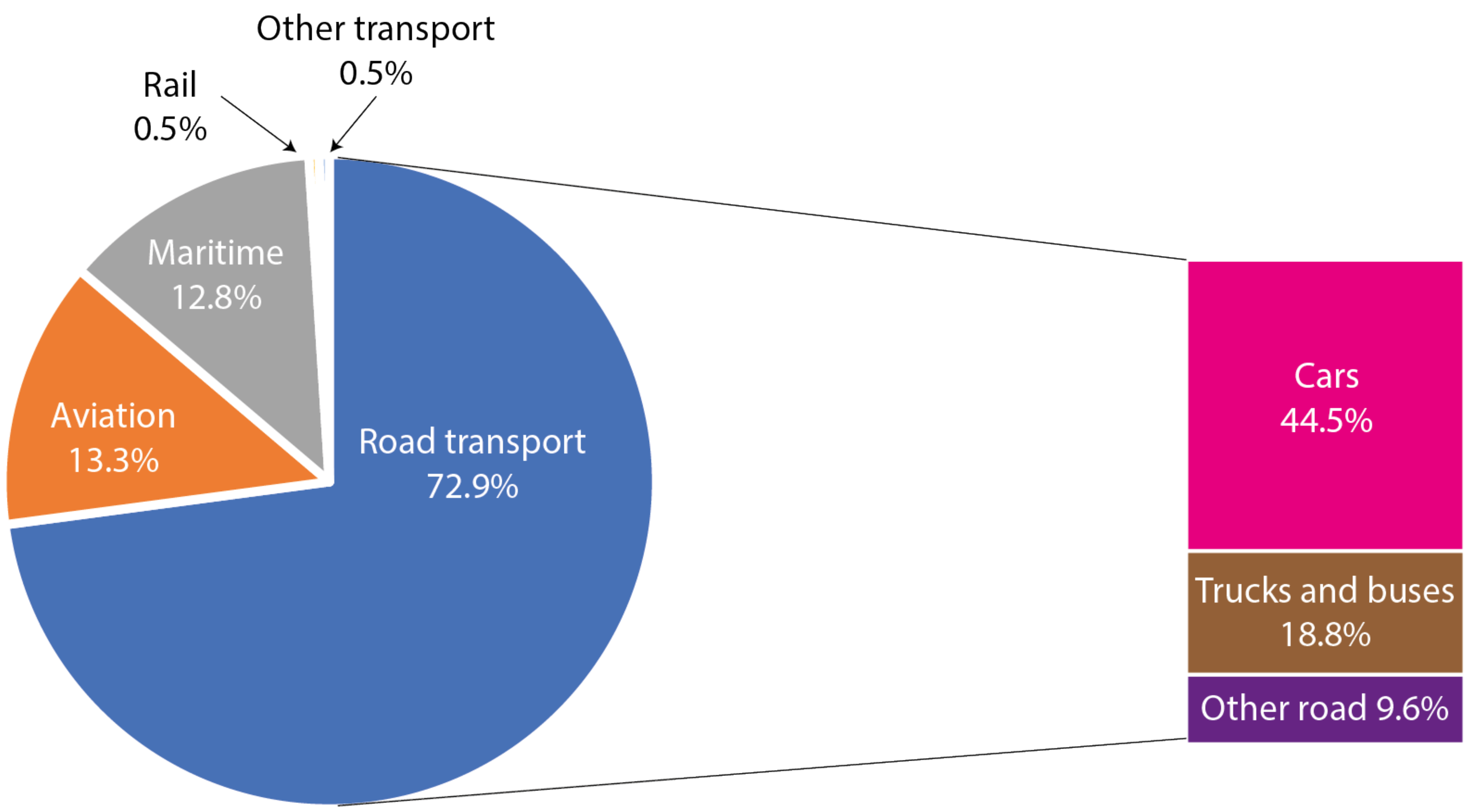
Policy should primarily focus on road transport, which is responsible for 73 percent of the EU transport sector's emissions (Figure 1). Decarbonising road transport is also decisive to improve air quality in cities, which remains a fundamental challenge for public health in Europe. Air pollution is responsible for more than 400,000 premature deaths each year in Europe (EEA, 2016). Pollution from road transport, including sulphur dioxide, nitrogen dioxide and particulate matter, is a key contributor to this problem, notably in urban areas with high traffic volume[2].

Though necessary, decarbonising road transport is difficult. The two toughest challenges are fostering technological innovation and deployment of clean vehicles, and promoting a modal shift.

Fostering technological innovation and deployment of clean vehicles

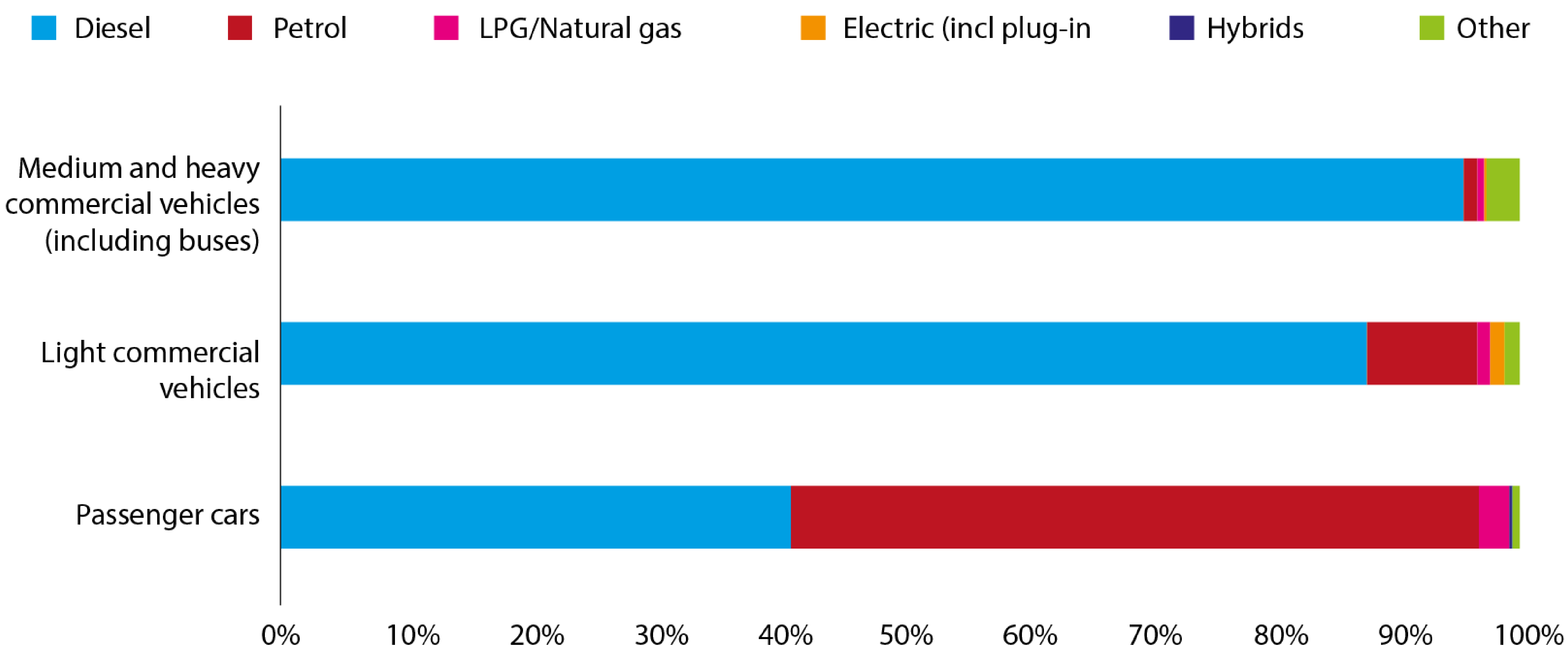
Technological development in principle can enable a switch from fossil-fuelled vehicles to clean vehicles. Electric vehicles (EVs) combined with renewable electricity generation are seen as a promising approach to decarbonise a

Figure 1. EU transport greenhouse gas emissions by mode, 2015



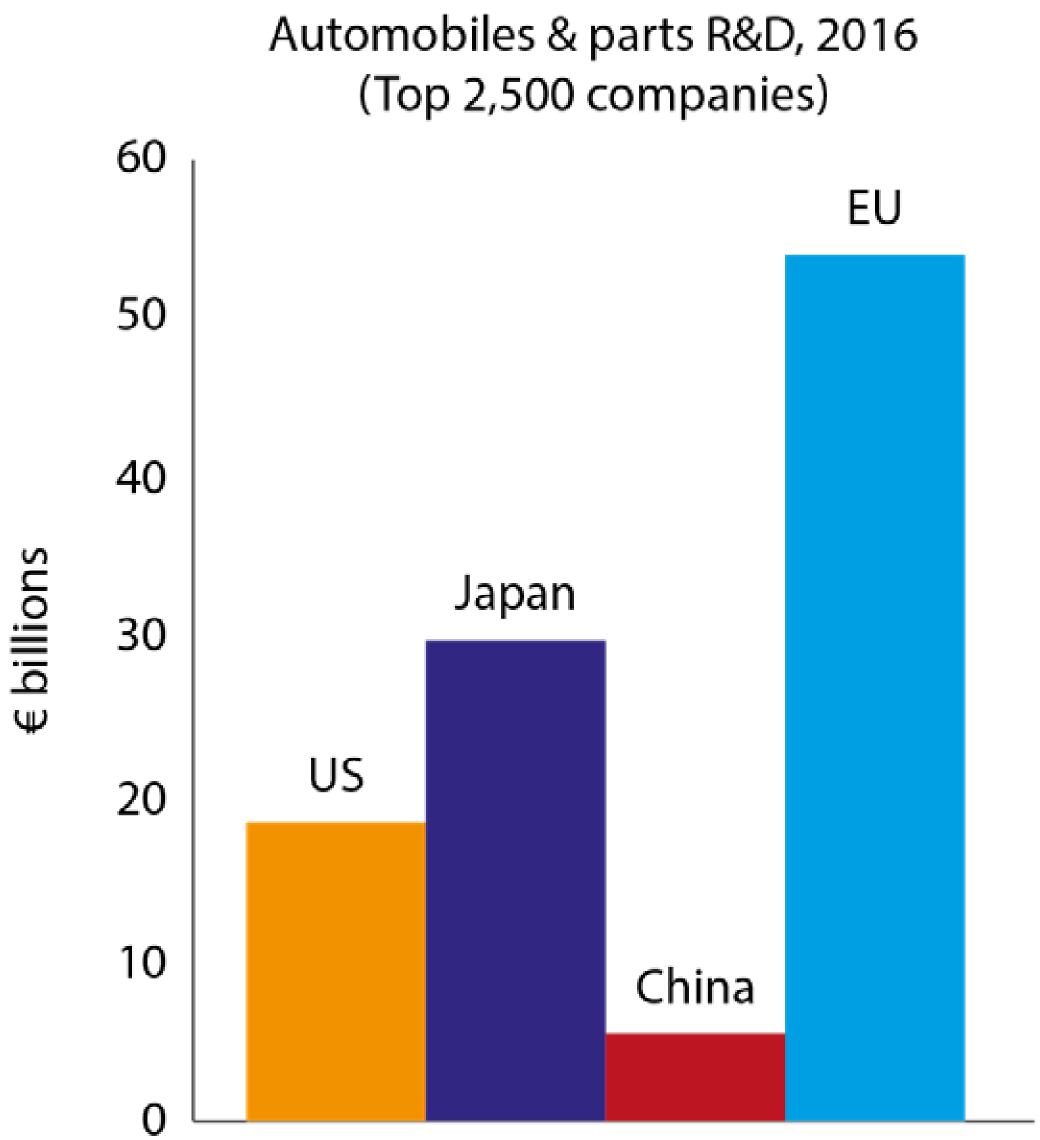
Source: Bruegel based on EEA (2017).

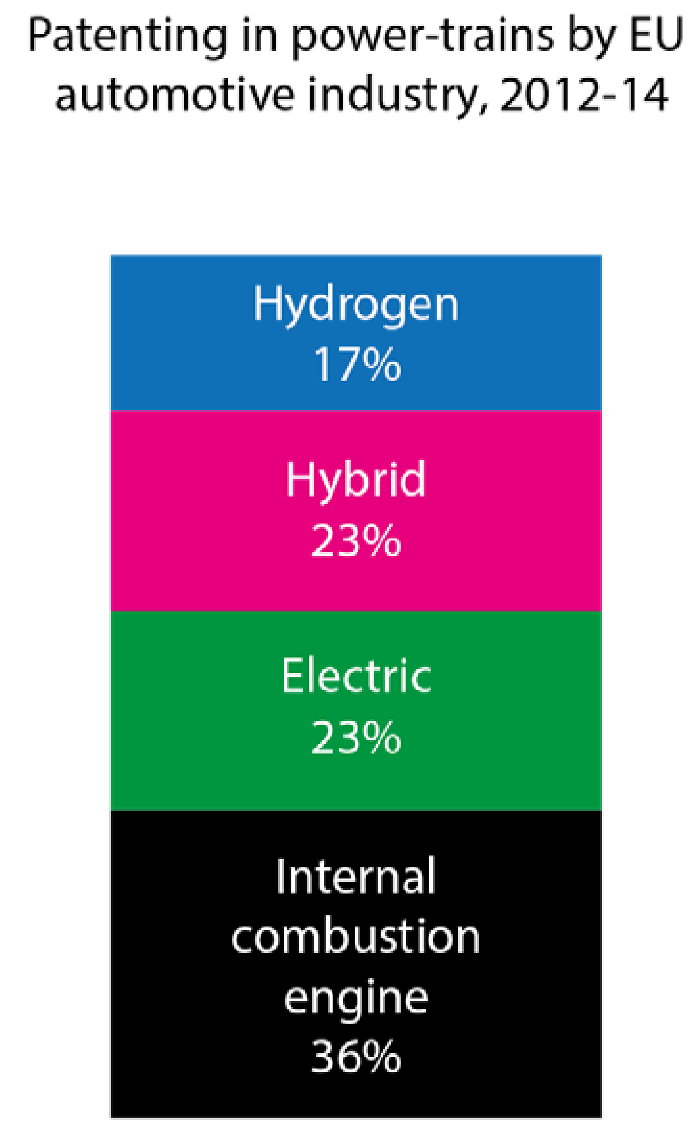
Figure 2. EU vehicle fleet by technology, 2015



Source: Bruegel based on ACEA (2017a).

Figure 3. EU automotive industry, R&D investment and patenting activity





Source: Bruegel based on European Commission (2017b) and OECD (2017).

substantial fraction of road transportation. However, further technological breakthroughs to reduce the cost and increase the range of EVs might be needed if EVs are to replace a significant proportion of fossil-fuelled vehicles. EVs represent only 0.2 percent of the EU's total vehicle fleet (Figure 2). If EVs continue to penetrate the market at the current growth rate, it will take around 60 years for them to reach 50 percent of the current passenger car total fleet[3].

In addition to EVs, other clean technologies might emerge in the future. This will only happen based on major research and development investment in clean vehicles by the automotive industry.

The good news for Europe is that it is by far the world's largest investor in automotive R&D, with €54 billion spent in 2016 compared to €30 billion in Japan, €18 billion in the US and €5 billion in China (Figure 3). However, in terms of the patenting activity resulting from this investment the European automotive industry still appears to be primarily focused on further developing internal combustion engines rather than on advancing hybrid, electric or hydrogen technologies (Figure 3). This represents a risk not only to road transport decarbonisation in Europe, but also to the longer-term competitiveness of the European automotive industry.

Promoting a modal shift

A more structural approach to decarbonise road transport would be to replace the kilometres travelled by road vehicles. This entails promoting public transport, alternative transport modes such as walking and cycling, and more integrated modes of mobility. New mobility such as 'mobility-as-a-service' can be enabled by ongoing developments in digital technologies (Transport & Environment, 2018).

For instance, smartphone apps can allow information about transportation services from public and private providers to be better combined through a single gateway that creates and manages the trip, for which users can pay via a single account. New approaches could help overcome a major comparative disadvantage of public transport – the longer door-to-door travel times – which mainly arise from the first and the last mile in the transport chain. The environmental impact of freight transport could be reduced by promoting a switch from road to rail and maritime, and including the environmental cost of transport in the final purchase price of goods.

But all this is challenging, as reducing demand for transport means changing people's daily habits and taking an integrated policy approach. The governance issue is particularly relevant, considering that road transport is governed by a complex series of policy frameworks developed separately at different levels – cities, national and EU (Table 1). And national and local policies on taxation, infrastructure choices and other matters seem to determine road transport demand. For example, Belgians used 741 kilogrammes of oil equivalent of diesel and gasoline in 2016, which was 30 percent more than the EU average, while Germans used 623kg and French drivers only used 581kg.

Cities are responsible for a wide range of transport policies, such as public transport, enabling car-sharing, congestion charges, parking management and cycling and walking zones. EU countries have different transport taxes and charges, and different policies in relation to the development of transport infrastructure and the creation of alternatives to road transport for freight and in urban areas. On top of this, the EU has developed a wide range of policies aimed at making European transport systems more connected, competitive and sustainable. Such fragmented governance risks impeding the decarbonisation of transport because policy measures implemented at the various levels without coordination can neutralise or even hinder each other.

A notable example of the variety of approaches that could be adopted by countries and cities in decarbonising transport is the introduction of bans on diesel and petrol cars. In 2017, France and the United Kingdom announced plans to ban the sales of diesel and petrol cars and vans by 2040 (Petroff, 2017).

Table 1. The governance of road transport: who regulates what?

	City level	Country level	EU level
Ban on diesel and petrol vehicles			
Emissions standards			
Alternative fuels infrastructure			
Car-sharing			
Car-pooling			
Ride-sharing			
Walking and biking			
Public transport			
Public procurement			
Parking fee			
Congestion areas			
Speed limits			
Energy taxation			
Road charging			
Spatial planning			
Rail activity			
Maritime activity			

Source: Bruegel. Note: red for direct competence, orange for indirect competence.

These plans are mainly driven by a political commitment to reduce air pollution, and are based on the expectation that the already underway shift to clean vehicles will continue to gather pace over the coming years. These plans are also meant to provide a strong signal to the EU automotive industry, encouraging it to innovate and become a global player in clean vehicles.

Cities are also starting to move in this direction, notably to fight air pollution. Paris is developing a plan to completely phase out diesel cars by 2024 and petrol cars by 2030 (Paris, 2018). Copenhagen is discussing a proposal to ban diesel cars by 2019 (Embury-Dennis, 2017), while Madrid and Athens are considering similar proposals to be applied by 2025 (Brunsden, 2017).

Reversing Europe's failure in decarbonising transport

The EU has the potential to encourage innovation in low-carbon transport technologies and promote a reduction in road-kilometres. But to do so, it needs to reshape its transport policies. The EU has mainly tried to promote road transport decarbonisation by introducing mandatory emissions standards for new cars and light commercial vehicles, and by introducing a 10 percent renewable energy target for transport fuel by 2020 (Table 2).

However, emissions reductions have been much less than intended and tighter vehicle fuel economy standards have not delivered. In terms of renewable fuels, the use of food-based biofuels might even have led to a net increase in CO_2 emissions if indirect emissions (ie. emissions generated from indirect land-use change) are taken into account (Valin *et al*, 2016).

In November 2017, the European Commission (2017c) proposed the 'Clean Mobility Package', a new set of policies to decarbonise transport, including new CO_2 emission standards, new rules for public procurement of clean vehicles, new rules to promote the combined use of different modes for freight transport and measures on

Table 2. EU transport targets and emissions standards, year of adoption and enforcement

Emission standards		
130g CO_2/km target by 2015	2009	Non-compliant manufacturers can be fined
95g CO_2/km target by 2021	2014	
175g CO_2/km target by 2017 147g CO_2/km target by 2020	2011	
Targets		
60% greenhouse gas emissions reduction for transport in 2050 compared to 1990	2011	Not binding
20% greenhouse gas emissions reduction for transport in 2030 compared to 2008	2011	
10% of transport fuel to come from renewable sources by 2020	2009	

Source: Bruegel based on European Union (2009a, 2009b, 2011, 2014), European Commission (2011a, 2011b). Note: gCO_2/km = grams of carbon dioxide per kilometre.

batteries. These measures, which are at time of writing under discussion in the European Parliament and Council of the EU, represent a positive attempt to make EU policies more effective.

The measures should be promptly approved and implemented. However, this set of rules might still not be sufficient to ensure road transport decarbonisation. In the past, the Council has resisted stricter car emission standards because of resistance from some countries, such as Germany (Carrington, 2013). Europe needs to overcome this political barrier, allowing some member states to move ahead in decarbonising road transport – and allowing cities in all EU countries to also move ahead, and to take advantage of incentives put in place by the EU. The EU therefore needs to develop a new post-2020 road transport strategy. This strategy should have three pillars:

1. Encourage EU countries and cities to adopt plans to ban diesel and petrol vehicles

More EU countries should follow the example of France and the United Kingdom, and adopt plans to ban diesel and petrol vehicles by 2040 or, even better, by 2030.

The more EU countries that make these commitments, the stronger the signal will be to the European automotive industry that it should invest more in the development of clean vehicles.

That is, these commitments should also be seen as a simple but effective tool to provide investment certainty to the European automotive industry, and to foster its focus on clean vehicles. Clear planning of these commitments would leave the automotive industry a window of 10-20 years to fully switch from the traditional internal combustion engine business model to the new clean vehicles and clean mobility business models.

Cities should also be encouraged to adopt plans to ban the circulation of diesel and petrol cars, which could be a major factor in inducing behavioural change on behalf of citizens and promoting modal shift.

For example, an EU Clean Transport Fund could be established to provide dedicated financial support to countries and cities committed to the phase-out of diesel and petrol vehicles. This fund should allow cities to bid for EU money to support measures such as the deployment of alternative fuels infrastructure, zero-carbon public buses, sharing and pooling solutions allowing a reduction in car ownership or the promotion of more sustainable modes of transport such as cycling[4].

Such a fund could be created by making better use of existing financial resources, such as from the Connecting Europe Facility for Transport (CEF-T) or from the Structural and Cohesion Funds. For the period 2014-20, CEF-T has a budget of €24 billion (European Commission, 2018a), while the Cohesion Fund and the European Regional Development Fund have a budget for transport and energy network infrastructure of €71 billion[5].

2. Stimulate an EU-wide reflection on the future of transport taxation

Taxation is a key policy tool to foster road transport decarbonisation. Different taxes apply throughout the transport system, from the initial purchase of a vehicle, to ownership taxes (eg. annual registration tax, company car taxation) and usage taxes (eg. taxes on fuel, tolls, roadspace, parking, commuter tax deductions) (Green Fiscal Commission, 2010).

These taxes can be used to influence user decisions, and possibly also to influence the automotive industry's strategies. For instance, to promote the deployment of clean vehicles, taxes can be differentiated on the basis of vehicles' carbon emissions, or simply allow for deductions or other special provisions (eg. subsidies, grants, tax credits, tax exemptions).

European countries still have very different transport taxation regimes. For example, only ten countries take into account CO_2 emissions in the composition of their vehicle registration taxes (ACEA, 2017b). Fuel cost savings –

which largely arise from the different taxation of gasoline and electricity – provide EVs with an important cost advantage. Savings are significant in Norway where running an electric vehicle can cost 64 percent less than running a diesel or petrol vehicle. In Germany, by contrast, the difference is only 25 percent (Lévay *et al*, 2017).

Given the importance of this policy tool in delivering decarbonisation, the EU should promote a new discussion among EU countries on the future of transport taxation, as is being done in the field of digital taxation (European Council, 2017).

3. More focused and impactful research and innovation funding for transport

After 2020, the EU should improve its transport research and innovation funding. In particular, it should carefully allocate this money, targeting areas in which it can truly have leverage. EU transport research and innovation funding should become mission-oriented, or directed at solving specific problems, as more generally suggested by Mazzucato (2018).

The introduction of bans on diesel and petrol vehicles by countries and cities could lead to a quick take-up of already commercially-viable clean vehicles, such as EVs. Though necessary to foster road transport decarbonisation in the short-to-medium term, this should not prevent currently less-mature technologies from developing and demonstrating their longer-term potential to contribute to road transport decarbonisation.

To avoid this risk, the EU should focus its post-2020 transport-related research and innovation funding on early-phase technologies, such as hydrogen, solid-state batteries or electrofuels (liquid fuels produced from CO_2, water and electricity). This would be the most sensible way to invest the limited available resources (equivalent to 0.2 percent of the European automotive industry's total investment in research and innovation) in areas that otherwise might not find adequate private funding.

Conclusions

Cleaning up road transport is a fundamental prerequisite if the European economy is to be decarbonised, if air quality is to be improved and if – indirectly – the European automotive industry is to have a sustainable future. Given the still-limited level of ambition at national level, Europe would greatly benefit from stronger EU action on road transport. For this reason, the EU should foster political momentum and promote the collective adoption of bans on diesel and petrol vehicles by 2030-40 by European countries and cities.

This will provide a strong signal to the European automotive industry that it should invest more in clean vehicles, thus contributing to the industry's long-term competitiveness and sustainability. This will also provide a signal to citizens to adopt more sustainable transport modes.

The EU can provide support to countries and cities in deploying already viable clean transport options by making better use of its transport- related funding through a new EU Clean Transport Fund. Through the launch of an EU-wide reflection on the future of transport taxation and its central role in decarbonisation, the EU can promote more ambitious and coordinated actions by member states. Through better use of its transport-related research and innovation funding, the EU can also support the development of new clean technologies that might otherwise never be explored. ■

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Endnotes

1. Other sources account for 16 percent of the EU's greenhouse gas emissions.

2. "The annual EU limit value for nitrogen dioxide, one of the main air quality pollutants of concern and typically associated with vehicle emissions, was widely exceeded across Europe in 2014, with 94 percent of all exceedances occurring at road-side monitoring locations. Also, in 2014, about 16 percent of the EU urban population was exposed to PM10 [fine particles] above the EU daily limit value" (EEA, 2016).
3. Between 2015 and 2016, new registrations of electric passenger cars grew by 11 percent (EEA, 2018).
4. The EU LIFE programme already provides some support to urban mobility projects, mainly aimed at reducing transport impacts in order to improve air quality.
5. These funds have mainly targeted Poland (€28 billion), Romania (€8 billion), the Czech Republic (€7 billion), Slovakia (€4 billion) and Hungary (€4 billion). See European Commission (2018b).

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Trade war: how tensions have risen between China, the EU and the US

The multilateral trading system has been challenged by unilateralist measures and subsequent threats of retaliation. Francesco Chiacchio discusses possible scenarios for the EU

The multilateral trading system has been challenged by unilateralist measures and subsequent threats of retaliation. We collect the main events that have shaped the current situation and show which trade flows have been and will potentially be affected by the various measures. We end by discussing possible scenarios moving forward for the EU.

Since the beginning of the year, the multilateral trading system has been challenged with a number of decisions and announcements on tariffs. The trade conflict between the United States and China may be escalating, while the European Union finds itself in a precarious position in responding to the US' challenges.

So what has and what has not yet happened this year? We focus on the measures taken and announcements made by China, the EU and the US in terms of trade policy. Here is the timeline:

- January 11: US secretary of commerce reports results of an investigation into the effect of imports of steel mill articles on national security.
- January 19: US secretary of commerce reports results of an investigation into the effect of imports of aluminium on national security.
- January 22: President Trump approves recommendations to impose safeguard tariffs on imported large residential washing machines and solar cells and modules.
- February 28: President Trump's policy agenda and annual report *"for free, fair, and reciprocal trade"* are released.
- March 6: the European Commission (EC) extends anti-dumping measures on Chinese steel products.
- March 7: the EC outlines EU plan to counter US trade restrictions on steel and aluminium.
- March 8: proclamation of US' tariffs on imported steel (25%) and aluminium (10%), effective from March 23, without prejudice to (temporarily) exempted countries.

- March 16: the EC launches a public consultation on the US' tariffs and possible EU retaliatory measures (EU list of products), considering the US tariffs as de facto safeguard measures.
- March 21: Commissioner Malmström met US Secretary of Commerce Ross, *"with a view to identifying mutually acceptable outcomes as rapidly as possible".*
- March 22: following the Office of the US Trade Representative (USTR) investigation on "*China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation*", President Trump announces his decision to take actions on China.

In the event of a full-fledged China-US trade war, trade diversion constitutes a risk to the EU, as the redirection of flows towards the EU may cause an impairment of the position of local industries

- March 22: the Chinese Ministry of Commerce (MOFCOM) decides to launch anti-dumping measures for imports of photographic paper from the EU, US, and Japan, from March 23 and for 5 years.
- March 23: USTR launches a WTO challenge to address China's technology licensing requirements.
- March 23: MOFCOM issues a list of discontinuation concessions against the US' steel and aluminium tariffs, involving approximately US$3 billion worth of trade, and solicited public comments on tariffs to be imposed on certain products imported from the US.
- March 26: the EC launches a safeguard investigation on imports of steel products to prevent trade diversion into the EU, in response to the US' steel and aluminium tariffs.
- March 27: MOFCOM launches an anti-dumping investigation against phenol products imported from the US, the EU, the Republic of Korea, Japan, and Thailand.
- April 3: USTR publishes a proposed list of products imported from China that could be subject to 25% tariffs. A public hearing will be held on May 15.
- April 5: MOFCOM publishes a list of US' products potentially affected by 25% import tariffs of its own, in response to recent US' announcements. On the same date, it files a request for consultation at the WTO, claiming that US' steel and aluminium tariffs are actually safeguards.
- April 17: MOFCOM decides to launch provisional anti-dumping measures for grain sorghum originating in the US, starting from April 19.
- April 20: MOFCOM launches provisional anti-dumping measures against the imported halogenated butyl rubber originating in the US, the EU, and Singapore.
- April 24-27: President Macron (April 24) and Chancellor Merkel (April 27) meet President Trump, holding talks that included trade relations.
- April 27: USTR releases 2018 Special 301 report on intellectual property rights, identifying 36 countries on the Priority Watch List or Watch List (Greece and Romania are the only EU member states included, in the Watch List; China is in the Priority Watch List).

- May 1: extension until 1 June of the EU's exemption from US tariffs on steel and aluminium imports.
- May 3-4: US' trade delegation meets Chinese officials on the US-China economic relationship, providing a 'draft framework' in advance. A second round of trade talks is scheduled to start on May 15th.
- May 8: President Trump and President Xi discuss bilateral trade over phone call.

The result of those is the looming prospect of continuous trade restrictions and retaliation measures involving a variety of products. Apart from steel and aluminium, the US targeted over 1,300 imported Chinese products worth around $50 billion, possibly aiming at China's high-tech and industrial sectors.

China announced discontinuation tariff concessions for 128 products and a longer list of its own (also worth approximately $50 billion), focusing more on lower-end products, while the EU has a two-part list of products imported from the US that it could target if the US moves forward with steel and aluminium tariffs (worth approximately $7.5 billion, of which $3.2 billion from Part A, and $4.3 billion from Part B), targeting very 'American' goods from specific regions.

Below is a table on which trade flows are mainly affected. The affected numbers are in red.

The four charts below depict the network of international trade flows between China, the EU, and the US for different categories of goods (steel and aluminium targeted by US tariffs, the US list of products, China's long list of products, and the EU's total list of products). The thickness of the bilateral linkages is proportional to trade value, and highlighted are those (potentially) affected by the announced/implemented tariff schemes.

The charts show how much is being exported of each of the goods that would be affected by tariffs. Imagine for a moment that a good is perfectly substitutable.

Table 1. Trade value of main products possibly affected by announced/implemented tariff schemes (billion USD)

	Destination	Steel	Aluminium	US list	CN's long list	EU's list A	EU's list B	Total EU's list
China	EU28	3.8	2.0	80.6	1.0	8.2	18.2	26.4
China	USA	1.0	1.8	46.2	6.2	-	-	36.5
EU28	China	2.6	0.5	113.4	1.0	1.8	2.4	4.1
EU28	USA	6.0	1.2	206.4	62.7	6.2	7.3	13.4
USA	China	0.4	0.3	26.2	49.2	-	-	1.4
USA	EU28	1.0	0.6	77.2	23.3	3.2	4.3	7.5

Source: USITC, Eurostat, Comtrade.
Note: Product categories selected up to the 8-digit code where possible, otherwise the 6-digit aggregate is used. Product lists retrieved from the Office of the US Trade Representative (USTR), China's Ministry of Commerce (MOFCOM), and DG Trade. Data for 2017, except for US exports to China of products affected by China's proposed retaliation list (2016 data).

For example, the goods exported from China to the US that would be affected by the US list amount to $46 billion. China exports $81 billion-worth of the same kind of goods to the EU. Chinese producers could compensate for a 10% reduction in Chinese exports to the US, due to the tariff, if they were able to increase their exports to the EU by only some 5%. In turn, the EU could compensate for the newly arriving supply from China by increasing its exports to the US by only 2%.

In the event of a full-fledged China-US trade war, trade diversion constitutes a risk to the EU, as the redirection of flows towards the EU may cause an impairment of the position of local industries. Furthermore, greater

Figure 1. Network of bilateral trade flows – China's list

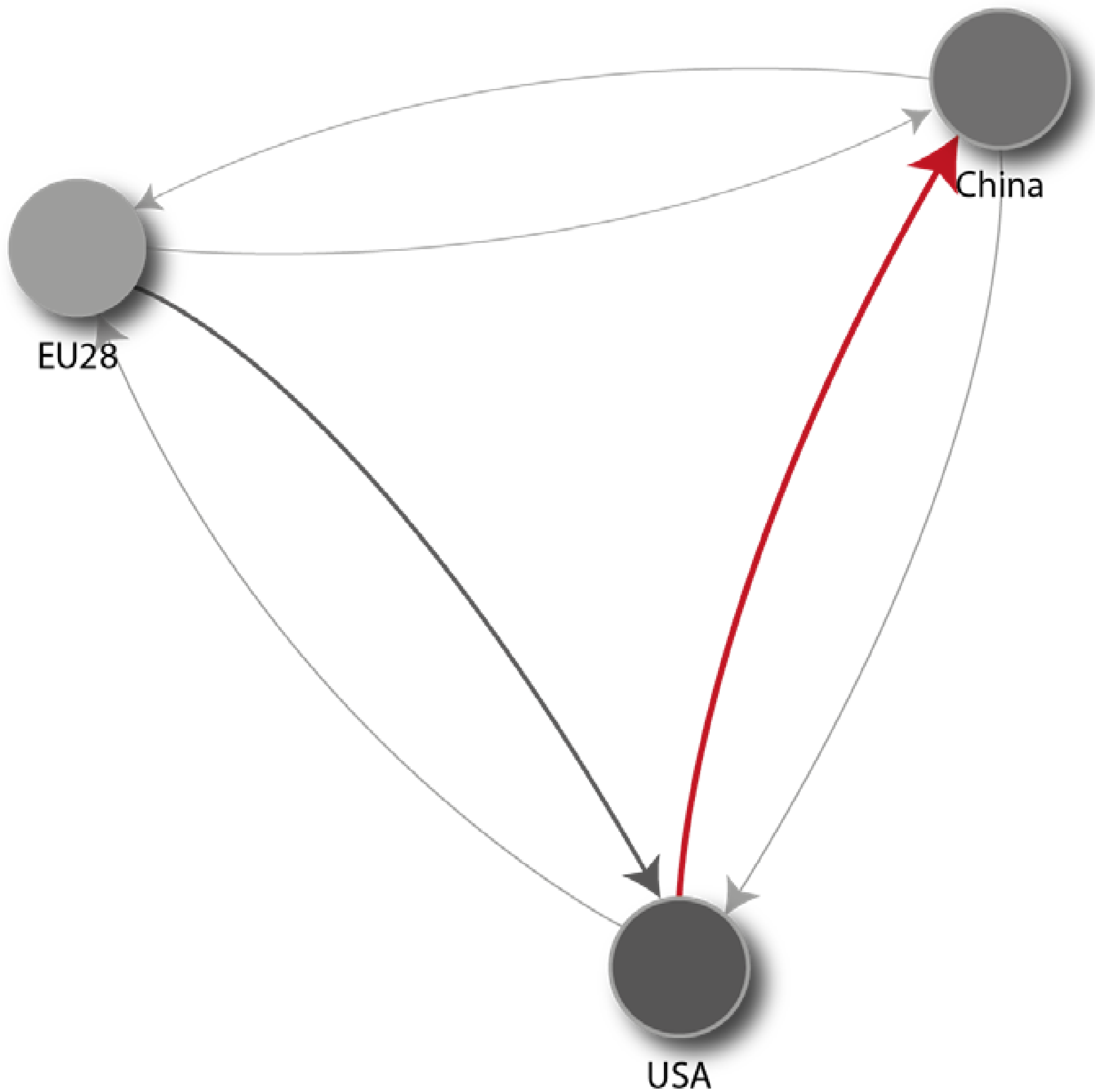


Figure 2. Network of bilateral trade flows – steel and aluminium

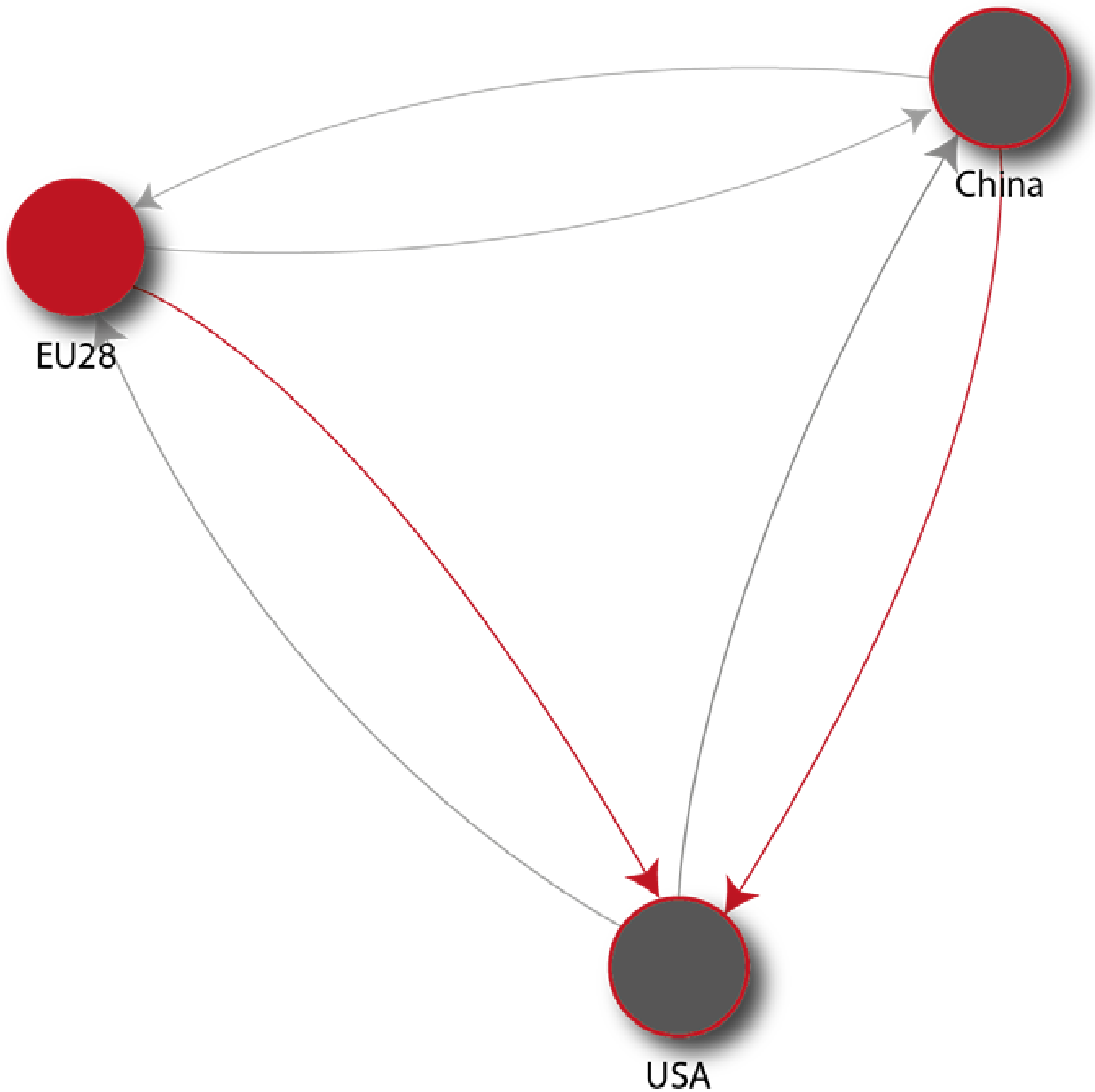


Figure 3. Network of bilateral trade flows – US' list

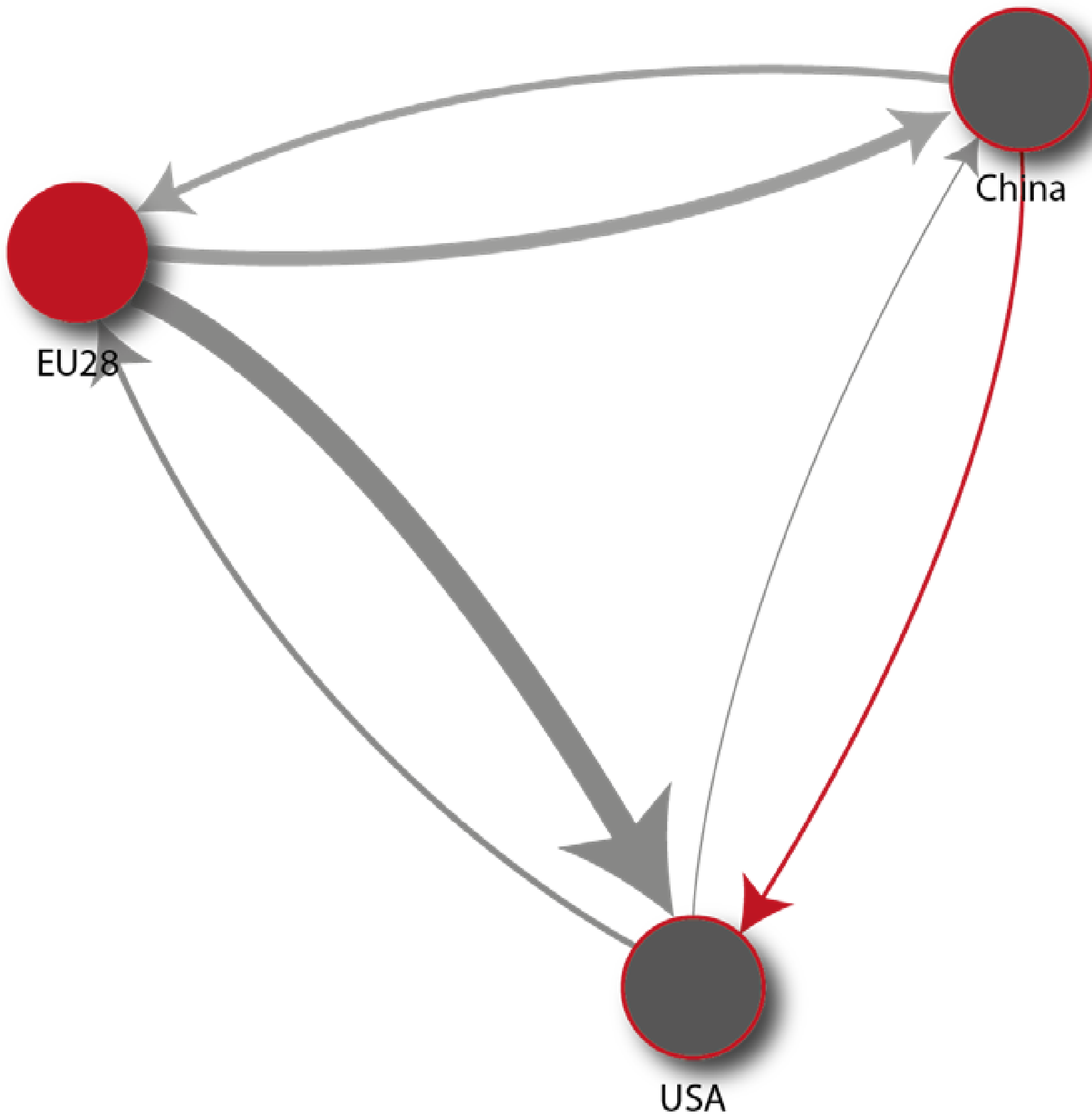
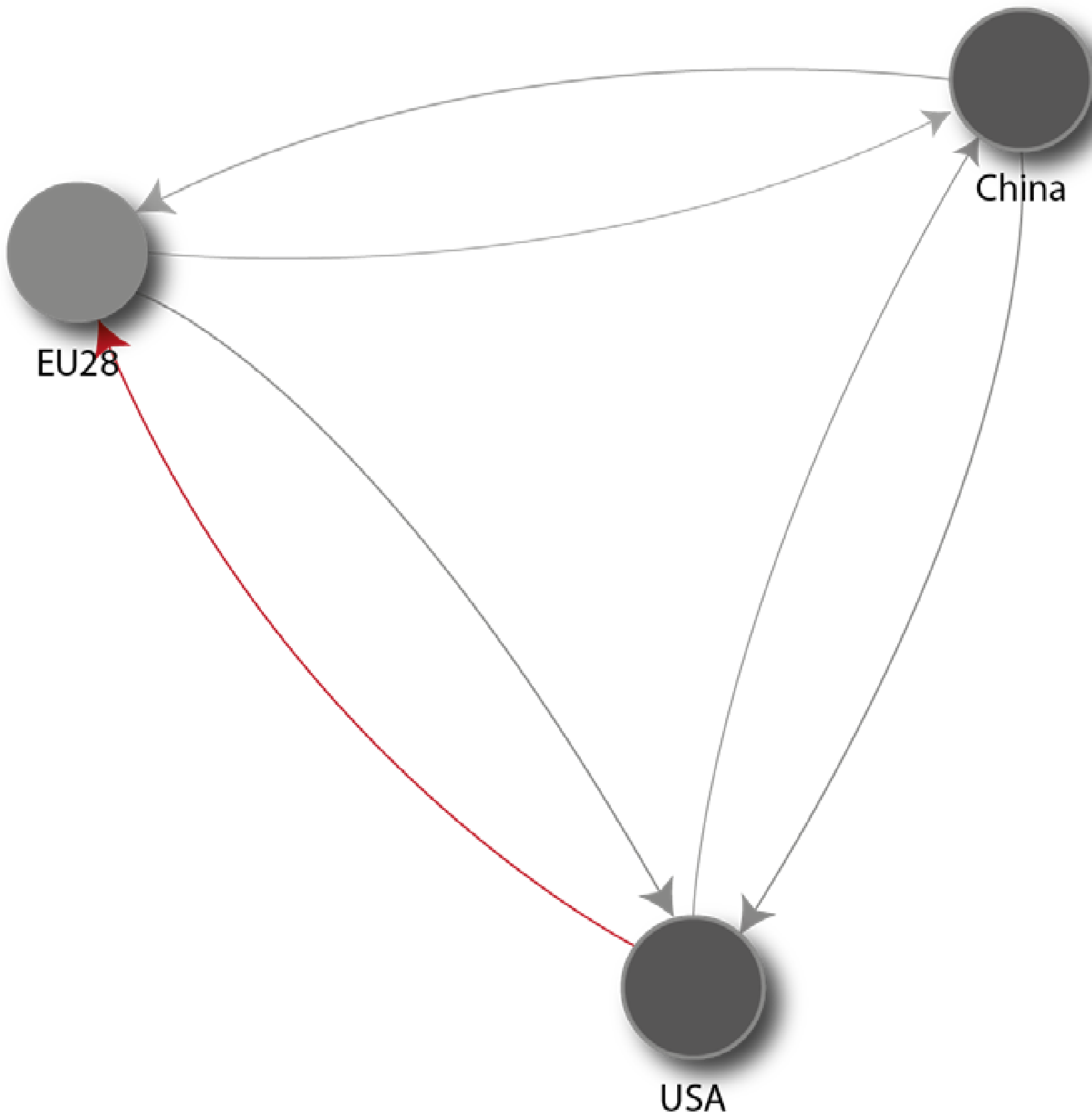


Figure 4. Network of bilateral trade flows – EU's list



protectionism may also induce higher production costs and a slowdown of Global Value Chain participation (through the channel of intermediate goods), possibly affecting technology diffusion and productivity growth.

However, such a crisis might also bring opportunities for EU industries if there is production and innovation capacity to cover the void left by tariff schemes. Thus, one of the key questions is to what extent the goods affected by bilateral tariffs are substitutable and can somehow be shifted around to other destinations.

In practice, the raising of bilateral tariffs will likely create substantial distortions for the global economy that would also affect the EU, bringing some opportunities but also creating costs for industries. However, a deal between the US and the EU could also have negative consequences for the EU as new trade could be created and the EU would potentially lose access, at least in relative terms. It is time for the EU to reflect on its options in global trade, and to reduce the vulnerability of its industries to the global challenge that Trump and China pose. ■

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The Eurasian Landbridge: linking regional value chains

Richard Pomfret looks at the catalyst for the Eurasian Landbridge rail services and its impact on trade costs

A dramatic development in the 2010s has been establishment of overland rail freight services between the EU and East Asia. This column, the first in a two-part series, look at the catalyst for the Eurasian Landbridge rail services and its impact on trade costs. While traffic on the Landbridge is still small compared to China-EU maritime trade, there is potential for further service improvement with implications for global value chains across Eurasia.

A dramatic development in the 2010s has been establishment of overland rail freight services between the EU and East Asia. Coverage of the phenomenon has tended to focus on 'firsts' (the first train from China to Spain, to France, to England), and academic debate has placed the Landbridge in the context of China's One Belt, One Road initiative as an instrument to increase Chinese influence. This emphasis ignores the underlying economic forces, and the significance of the Landbridge for understanding the nature of global value chains (GVCs) and the role of service providers.

A common finding is that most GVCs are regional, with three centres in North America, Europe, and East Asia (Baldwin 2016). The catalyst behind the Eurasian Landbridge was demand from global firms seeking to link their European and Asian value chains. National rail companies and other service providers responded by reducing the costs of connecting the chains by rail, which is faster with more precise delivery times than maritime transport. Little investment in physical capital was required because the track was already in existence before the 21st century.

Once the Landbridge had been created,growth was driven by freight forwarders, courier firms and other companies providing services that made the rail route attractive to a larger number of potential users. The dynamic scale effects created a virtuous circle of reduced costs, more frequent service and increased route choice generating additional customers and making further service innovations profitable.

China-Europe rail links before and after 2011

Overland trade between China and Europe dates back more than two millennia, until discovery of sea routes from Europe to Asia around 1500 destroyed overland trade. After China's 'open door' reforms of 1978/9, transport of exports from eastern China travelled by sea and, to a much lesser extent, air freight. By 2015 the largest ships could carry over 20,000 twenty-foot-equivalent (TEU) containers through the Suez Canal.

Several rail links were constructed in the 20th century, but none was a significant carrier of China-Europe freight before 2011. Occasional block trains of flat trucks carrying containers were run along the Trans-Siberian Railway on an ad hocbasis for German car companies seeking to ship components to their joint-venture assembly factories

... the rail Landbridge appears to be firmly established, with potential for further service improvement and implications for GVCs across Eurasia

in northeast China (VW/Audi in Changchun and BMW in Shenyang). Similar block trains carried Korean car components from Lianyungang to the Uz-Daewoo joint-venture factory in Uzbekistan (now GM Uzbekistan). Such journeys to and through China showed that long-distance international rail services to serve GVCs were feasible, but they were commissioned by firms as bespoke services for their own use and were not availed by other potential users.

The catalyst behind new rail services was China's Go West policy launched in 2001 to provide incentives for firms to produce in China's inland provinces. The policy's impact was minor, until a bonded train link between Shenzhen and Chongqing was opened in 2010. The bonded train brought imported components from Southeast Asia and elsewhere to the factory gate in Chongqing without border-crossing problems, highlighting the nature of the assembly facilities which Foxconn, Hewlett-Packard and others built in Chongqing as the final stage of Apple laptop or HP printer GVCs.

The new investors may have planned to export via the Yangtze River to Shanghai, but increased shipping along the Yangtze led to congestion. HP encouraged the railway companies of Germany, Poland, Belarus, Russia, Kazakhstan and China to provide a solution in the form of a Chongqing-Duisburg block train. Deutsche Bahn and China Railway Corporation provided overall quotes to clients and organised loading and unloading at the termini, while the Polish, Belarus and Kazakh rail companies collected transit fees and organised the change of gauge at the China-Kazakhstan and Belarus-Poland borders. Policy coordination among the six countries' governments was necessary to ensure smooth passage, essentially a simple transit agreement to respect seals on bonded containers. The containers returned with components for German car factories in China.

The Chongqing-Duisburg block train was a commercial response by service providers to demands from two of the leading GVC sectors: cars and electronics. It was successful because, although rail was more expensive than sea,

Figure 1. The route of the Chongqing-Xinjiang-Europe International Railway

Sources: Ministry of Commerce, General Administration of Customs, YuXinOu Rail Logistics Company, Feng Xuxia/China Daily it took less than half the time (16 days between Chongqing and Duisburg, compared to a minimum 36 days and typically over 40 days by sea from Shanghai to Rotterdam) and promised reliable delivery times, both of which are important considerations for GVC participants.

The success of the Chongqing-Duisburg train led to a classic tournament. Between 2011 and 2015, at least nine different routes were trialled (Table 1). Some of these routes used the Trans-Siberian Railway (eg. Harbin-Hamburg or Suzhou Warsaw), but most took the route across Kazakhstan, as in Figure 1. The trial-and-error process was a market discovery exercise to find routes on which customers were willing to pay for rail service between China and Europe. The initiative on the European side came from Deutsche Bahn (and its logistics subsidiary, DB Shenker, and the Trans Eurasian Logistics joint venture between DB and the Russian rail company), and from freight forwarders such as Vienna-based Far Eastern Landbridge and Swiss-based Interrail Group. On the Chinese side, local governments took the initiative either directly or by pushing a local company such as Yiwu Timex to establish services.

The trial process continued after 2015 and regular services were established on successful routes. In April 2016 the first China-France train went from Wuhan to Lyon in 15 days. In January 2017 the first China-UK train went from Yiwu to London. By the end of 2017, the Landbridge had connected 35 Chinese cities and 34 European cities by rail. Some connections were one-off trials, while other routes flourished. By 2018 the Duisburg-Chongqing-Duisburg route ran on a daily schedule.

The role of service providers

The original drivers (car and electronics GVCs) remain important as they wish to transform what have largely been regional value chains in Asia or in Europe into Eurasian value chains. They also benefit from increased scale

Table 1. Railway routes from China to the EU, to end of 2015

Route	Start	Length (km)	Duration (days)
Chongqing-Duisburg (DE)	July 2011	11,179	16
Wuhan-Mělník (CZ)	October 2012	10,863	16
Suzhou-Warsaw (Poland)	November 2012	11,200	18
Chengdu-Łódź (PL)	April 2013	9,826	10.5
Zhengzhou-Hamburg (DE)	July 2013	10,124	19-20
Yiwu-Madrid (ES)	November 2014	13,052	21
Hefei-Kazakhstan: Hefei-Hamburg (DE)	June 2014	c. 11,000	15
Changsah-Duisburg/Moscow/Tashkent	October 2014	11,808	18
Harbin-Hamburg (DE)	June 2015	9,820	15

Source: Li et al. (2016: 8).

and reduced costs, as schedules become more frequent and competing routes have incentives to become more efficient in reducing transit times and increasing the range of services.

A major reason behind the wider success of the post-2011 routes has been the early and increasing involvement of intermediaries. Freight forwarders and courier companies arranged multimodal connections, consolidated part-container loads and offered additional services such as refrigerated containers. Through such service provision, hubs such as Duisburg, Łódź, and Yiwu have become popular termini. Over 300 freight forwarders and other facilitators have offices at the Duisburg hub, which provides access to rail, river, road and air transport and is within short distance of tens of millions of people in Germany, France, Belgium, Luxembourg, and the Netherlands. Poland is a centre for ecommerce fulfilment, and Łódź has become an eastern Europe hub. Yiwu in Zhejiang Province, famous as the world's largest market for small goods, has become a rail hub for the Yangtze Delta.

Multimodal hubs with a greater range of specialised service-providers are convenient places of origin or destinations for many customers. The added services appeal to GVCs, such as agribusiness, where goods may be perishable and require refrigeration, or to non-GVC traffic with part-container loads.

The role of governments

Emergence of the Landbridge after 2011 reflected a conjuncture of demand, service-provider response, and governments willing to facilitate transit trade. Time cost and predictability of border crossings are crucial, and all countries along a route must agree to simple transit procedures. Against that backdrop, the Landbridge has largely been driven by commercially motivated state-owned and private companies[1].

A striking feature of the story so far is the absence of major investment. The Landbridge runs on 20th century rail-track. The main infrastructure investment has been in facilities where change of gauge is necessary between China and Kazakhstan and between Belarus and Poland. The container transfers at the change-of-gauge border are simple procedures: the incoming train and the outgoing train are lined up side by side, and a crane moves the containers from one to the other. At Khorgos, on the Kazakhstan-China border, the transfer for a 40+ container train can be done in 47 minutes. This investment has contributed to shaving the time (eg. Chongqing-Duisburg took 16 days in 2011 and 12 days in 2017), but most of the time-saving is associated with better logistics and prioritising the profitable service.

Reduced transport costs have net benefits, but as with most economic changes there are potential losers as well as gainers. Reduced trade costs make exporters more competitive in foreign markets but subject import-competing firms to greater competition. If Eurasian value chains displace regional value chains in East Asia and Europe, then successful GVC participants in Europe and Asia may find new opportunities in the larger Eurasian GVCs while coming up against more competitors for GVC tasks.

Conclusions

As the GVC phenomenon has flourished, value chains are becoming longer and more complex. Following from sub-regional zones such as Sijori or the Pearl River Delta in the 1980s and 1990s to 'Factory Asia' in the 2000s (Pomfret 2011), the next step is to link the regional value chains of East Asia and Europe. This requires low trade costs (in time, money and uncertainty) across Eurasia.

The catalyst for the Landbridge rail services was car and electronics firms seeking to reduce their trade costs between German component suppliers and VW, Audi and BMW assembly plants in China and between Apple, HP and Acer assemblers in China and distribution centres for consumers of their electronics products in the EU. Production along these GVCs relies on minimising the need for inventories by securing just-in-time delivery of components to the next-stage producer and prompt delivery of the final product to distribution centres and final retailers.

At current transport costs, auto components and laptops/printers fit into an intermediate category of goods for which a rail link between China and Europe offers a useful niche; the goods are too bulky for air transport, but the firms want faster and more reliable delivery than intercontinental maritime transport can provide and are prepared to pay for the time-saving that rail transport offers over maritime transport. As an added social benefit, per tonne of freight, rail is much more environmentally friendly than road or air.

Service providers have responded by reducing trade costs. Since 2011 the number of trips along the Landbridge has mushroomed to 6,235 by December 2017, and over half of those were in 2017. The freight has diversified, including two-way trade in[2]. To keep perspective, traffic on the rail Landbridge is still small compared to China-EU maritime trade. In 2016, 42,000 containers passed through Kazakhstan, a big increase over the 2,000 in 2011, but they would fit on four container freighters that can pass through the Suez Canal. Nevertheless, the rail Landbridge appears to be firmly established, with potential for further service improvement and implications for GVCs across Eurasia. ■

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Endnotes

1. The financial returns to the rail companies are commercially sensitive. However, Kazakhstan's rail company is reported to have earned over a billion dollars in transit fees in 2015; see Asian Development Bank (2015: 43).

2. Car producers now use the Landbridge for two-way trade in high-end cars with a single assembly point. Volvos assembled in China are shipped to an EU distribution centre in Belgium and Range Rovers assembled in the EU are shipped for sale in China.

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The Eurasian Landbridge and China's Belt and Road Initiative

Richard Pomfret argues that the BRI could be a major step towards Eurasian integration and greatly improve rail's competitiveness relative to air for time-sensitive shipments

China's Belt and Road Initiative has the potential to extend the Eurasian Landbridge to include both the current China-Poland mainline to western Europe and a China-Istanbul mainline with spurs to the Middle East and North Africa. This column, the second in a two-part series, outlines the history of the initiative and argues that future construction on the network could be a major step towards Eurasian integration and greatly improve rail's competitiveness relative to air for time-sensitive shipments.

In September 2013 President Xi Jinping on a Central Asian tour announced the One Belt One Road initiative and pledged over $50 billion in Chinese funding for infrastructure projects. The Asian Infrastructure Investment Bank (AIIB), mooted shortly after and officially opened in 2016, stood ready to provide funding. In May 2017, rebadged as the Belt and Road Initiative (BRI), the initiative was officially launched at the Belt and Road Forum for International Cooperation in Beijing, attended by representatives from more than 130 countries and 70 international organisations. At China's 19th National Congress in October 2017, the BRI was incorporated into the Chinese constitution, institutionalising its position as a foremost foreign policy goal of President Xi.

China's Belt and Road Initiative

The high profile given by China to the BRI and AIIB helped to publicise the option of overland rail service across Eurasia. However, the BRI did not create the China-Europe railway Landbridge; much was already happening and had been market-driven in both Europe and China. The most popular line, between Chongqing and Duisburg, has been in operation since 2011 and offers a daily service in 2018. On the Yiwu-Madrid route that is now a weekly service, the first train departed in 2014, but Yiwu business leaders were exploring Landbridge options in January 2013, before President Xi's announcement. By the time of the May 2017 Belt and Road Forum, China Railway Express, which coordinated all China Railways Corp's European services, showed connections from 27 Chinese cities to eleven European countries on its route map (Figure 1).

What can the BRI add to rail connections west from China across Eurasia? The BRI holds promise for extending the Eurasian Landbridge to include both the current China-Poland mainline to western Europe and a China-Istanbul mainline with spurs to the Middle East and North Africa. Indeed, Chinese maps published since President Xi's 2013 announcement highlight a route to Europe south of the Caspian Sea through Iran and Turkey (Figure 2).

As with the north of the Caspian Landbridge, the track for a south of the Caspian rail route already exists, including a recently opened rail tunnel under the Bosporus. China's interest in the southern route was highlighted after the easing of UN sanctions on Iran in January 2016. One week later, President Xi visited Tehran. On 28 January the

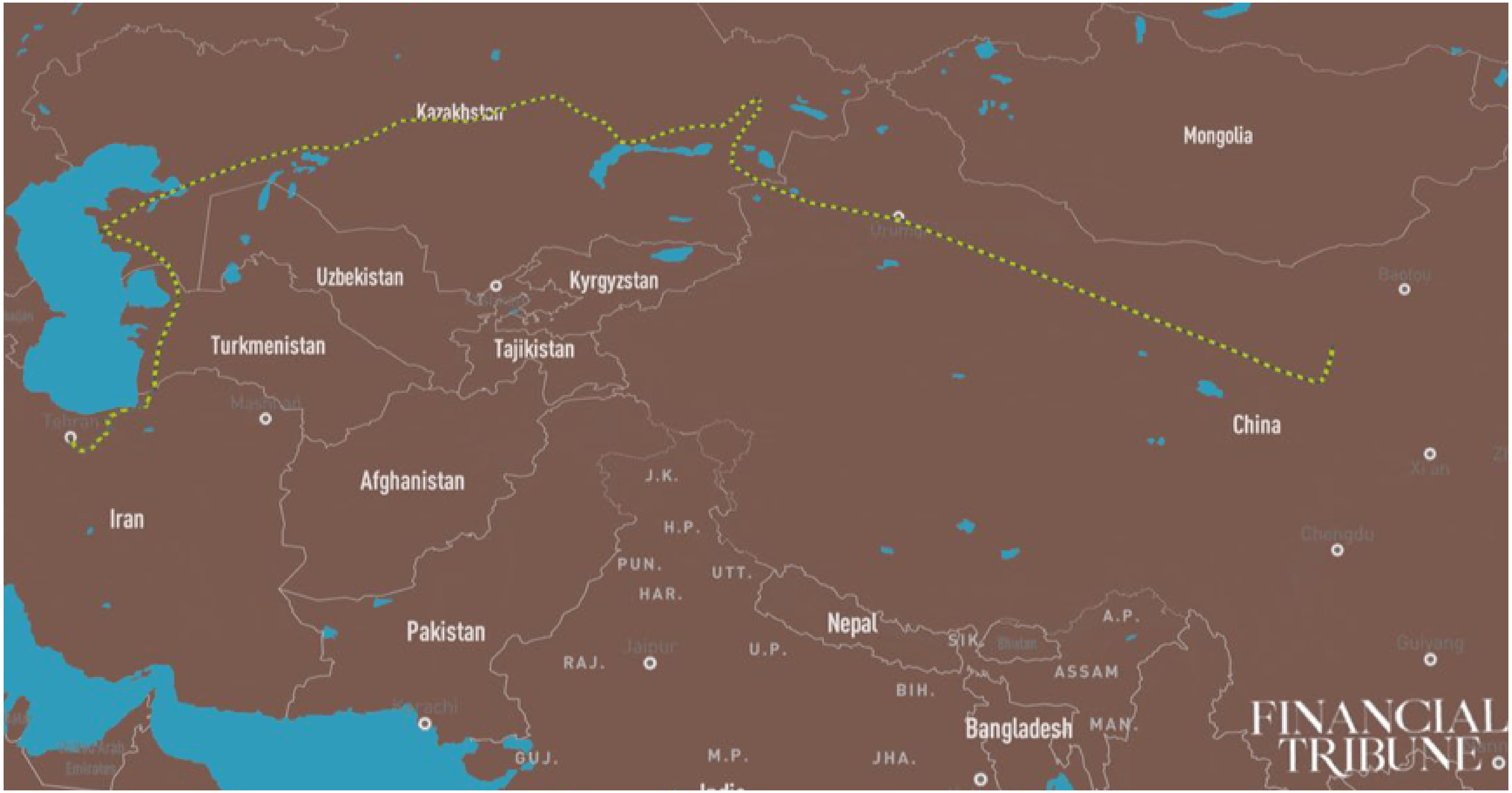
The high profile given by China to the BRI and AIIB helped to publicise the option of overland rail service across Eurasia

Figure 1. China Railway Express route map, May 2017

Figure 2. The New Silk Road railway

Source: Xinhua News Agency, May 2014

Figure 3. The first China-Iran train route, January-February 2016



Source: *FinancialTribune.com*

first train left Yiwu for Tehran with 32 containers. It took fourteen days due to a slightly circuitous route (Figure 3). In September 2017 the first train to Tehran departed from Yinchuan, capital of Ningxia Autonomous Region, and a twice-weekly schedule for 2018 was announced. The departure point in a Muslim area of China signalled the significance of the trans-Iranian route, not just as an alternative passage to Europe, but also as a potential gateway to the Middle East and North Africa.

Why did the first China-Iran train take a circuitous route via the Kazakhstan-Turkmenistan line along the Caspian coast, which had been opened in December 2014, rather than transiting Uzbekistan and Turkmenistan on a more direct line through Meshed in northern Iran? One consideration was that Uzbekistan under long-time President Karimov had a poor reputation as a transit country, imposing substantial delays both for border checks and along the way.

In September 2016 President Karimov died. His successor, President Mirziyoyev, immediately signalled greater openness to the world, including easing border-crossing restrictions. In 2017-18 negotiations advanced between China and the Kyrgyz Republic for construction of a railway line between Kashgar and Uzbekistan, the only dotted line on Figure 1 where the track does not yet exist.

The proposal is popular with China and Uzbekistan but controversial in the Kyrgyz Republic, which sees little benefit beyond limited transit fees and potential costs if the country has to take on debt to build the line. An independent report by Hurley *et al*. (2018) highlighted the potential for debt dependence in small countries along BRI routes, and listed the Kyrgyz Republic as one of the eight countries most at risk[1]. These episodes illustrate the importance of a country's commitment to trade facilitation if it wants to be on a Landbridge route, and China's search for alternative routes, even in the face of strong opposition.

Why does the BRI involve multiple belts?

China's desire for multiple routes could come from two, not mutually exclusive, motives. Multiple routes are important because they enhance the range of transport options and reduce hold-up possibilities, which are always a danger along a single route passing through several countries. On the other hand, if the eventual intention is to cut transport times by constructing a high-speed rail line, China may be trialling the two options to determine the better security/cost trade-off.

Public investment can create alternative routes and could provide a high-speed option. Future prospects will be enhanced by investment in new or upgraded track, better rolling stock and other facilities. These are ways in which the BRI, backed by the AIIB's financial clout, could make a difference.

Investment plans such as the track connecting Kashgar to Andijan have a dual purpose for China. The connecting line will make a south of the Caspian route shorter, and also reduce the potential of Kazakhstan to demand higher transit fees. The BRI also envisages improved rail connectivity with Southeast Asia and with Pakistan. In sum, the BRI envisages a network with multiple, potentially competing (or substituting) routes.

If the intention is to cut transport times by constructing a high-speed China-Europe rail line, the cost is likely to make the two routes – north and south of the Caspian Sea – mutually exclusive as lines between China and Europe. In this scenario, China may be trialling the two options to determine the better security/cost trade-off. Although construction costs would be high, a two-day rail service between China and the EU would be a major step towards Eurasian integration and greatly improve rail's competitiveness relative to air for time-sensitive shipments.

Conclusions

The catalyst for the Landbridge rail services was car and electronics firms seeking to reduce their trade costs, evaluated in money, time and certainty, between German component suppliers and car assembly plants in China, and between Apple, HP and Acer assemblers in China and consumers of their electronics products in the EU. Since 2011 the number of trips along the Landbridge has grown rapidly, with over 3,000 in 2017. These development predated China's BRI, although the two are related and often conflated.

China's BRI is not just piggybacking on the Landbridge. The vision of the overland segment of the BRI has developed as a network of competing and complementary rail lines. The importance for China is reflected in embracement of the Landbridge plus exploration of alternative westward routes through Iran which may be reinforced by substantial investment in a shorter line from China to Uzbekistan. With a longer time-horizon, the Eurasian rail network could link Central Asia to the China-Pakistan Corridor and connect Southeast Asia to the Eurasian rail network. Commentators are right to see China's BRI as a long-term vision. That vision should not be confused with the existing Landbridge, which has been a bottom-up commercial story rather than a top-down political project. ■

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Endnotes

1. IMF Managing Director Christine Lagarde cited the study in a widely quoted speech in Beijing (featured, for example, on the front page of the Financial Times, 13 April 2018). Construction costs of the line will be high due to the mountainous terrain and will depend on the route; a commonly cited figure of $6 billion is almost as large as the Kyrgyz Republic's annual GDP.

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Resolving the conflict between privacy and digital trade

Exports of data-based services by developing countries is threatened by the EU's privacy regulation. Aaditya Mattoo and Joshua Meltzer argue that the way forward is to reflect the EU-US Privacy Shield bargain

The EU's privacy regulation threatens developing country exports of data-based services by making data transfers more difficult. Traditional trade rules and regulatory cooperation cannot resolve this conflict. The column argues that the way forward would be to design trade rules that reflect the bargain struck in the EU-US Privacy Shield. Data destination countries would promise to protect the privacy of foreign citizens in return for source countries promising not to restrict data flows.

On 25 May 2018, the EU's new General Data Protection Regulation (GDPR) takes effect (European Union 2018). It has wider scope and stronger enforcement than the Data Protection Directive, which it replaces.

The current news focus on data leaks associated with Facebook, or on transatlantic data flows, have obscured the impact of GDPR on developing countries. Many developing countries export digitally delivered data-processing and business services, which require international flows of data. These services, ranging from financial accounts and tax returns to health transcriptions and diagnostics, contributed to more than $50 billion worth of developing country exports to the EU in 2015 – of which one-fifth came from Africa. Strengthened regulation makes data transfers more difficult, and so threatens some of these exports (Bauer *et al*. 2013).

Strengthened regulation

To ensure that the personal data of EU citizens is not abused, data can be transferred out of the EU only under certain conditions. One is that the country meets the GDPR 'national adequacy' requirement by enacting a national privacy law essentially equivalent to that of the EU. When GDPR comes into effect only Andorra, Argentina, Canada (for commercial organisations), Faroe Islands, Guernsey, Israel, Isle of Man, Jersey, New Zealand, Switzerland, Uruguay, and the US (using Privacy Shield) will have been recognised as adequate (European Commission 2018).

A national law imposes the same standard on all firms in the country, whether they handle EU data or not. This could adversely affect poorer countries. Prematurely stringent privacy laws could hurt the development of markets by inhibiting the flow of information. For example, the reporting of personal credit histories is critical to consumer credit, and privacy laws could create significant asymmetries of information and affect the efficiency of markets (Kitchenman 1999).

Traditional trade rules and regulatory cooperation cannot resolve this conflict... the way forward would be to design trade rules that reflect the bargain struck in the EU-US Privacy Shield. Data destination countries would promise to protect the privacy of foreign citizens in return for source countries promising not to restrict data flows

Enacting national privacy legislation would also increase the economy-wide cost of doing business. A recent survey suggested that, on average, members of the Fortune 500 would need to spend $16 million each on average to avoid falling foul of the new EU regulation (Financial Times 2017). The increased costs would hurt access to services at home and competitiveness in foreign markets where privacy is less of a concern. When the Philippines drafted national privacy legislation to ensure continued access to the EU data processing market, US firms based in that country suspended investment plans because operating costs would increase, leading the government of the Philippines to reassess its approach.

If a country's national law fails the EU adequacy test, as happened in the case of India, firms are required to use either Binding Corporate Rules (BCRs), designed for multinational companies to move data globally, or Standard Contractual Clauses (SCCs) for each business deal. Both instruments require levels of protection, oversight, and access for individuals that would be offered in the EU. Both also require a data controller or processor, who can be held liable for breach, to be established in an EU member state.

Both routes are costly and time-consuming. The requirement of a presence in the EU increases costs and limits the benefits of seamless cross-border digital trade, especially for smaller firms. A survey in India of the impact of the earlier, less-stringent EU Data Protection Directive revealed that the BCR process took more than six months, and 90% of the respondents used SCCs. These also involved a complex process and took on average more than three months (NASSCOM-DSCI 2013). Two-thirds of the surveyed services exporters claimed a significant loss of business opportunities because of the requirements.

Alternative routes to compliance

Is it possible to satisfy the EU's legitimate needs without obliging other countries to use EU standards in their privacy laws, or to incur the substantial compliance costs associated with SCCs and BCRs?

The tension between international data flows and divergent national privacy standards has provoked two types of international response: negotiation of trade rules, and cooperation between regulators.

- **Negotiation**. The WTO's General Agreement on Trade in Services (GATS) provides an exception for measures necessary to secure compliance with laws that are otherwise consistent with the GATS relating to *"the protection of the privacy of individuals in relation to the processing and dissemination of personal data"* (GATS, Article XIV(c)). The chapeau to Article XIV limits the exception to measures that do not lead to *"unnecessary and unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services".* While the WTO panels and appellate body have made judgements in other cases on whether a measure was necessary to achieve a specific objective, it is probably unrealistic to expect an already strained WTO dispute settlement system to adjudicate the politically sensitive issue of privacy protection.

- **Regulatory cooperation**. Traditionally this implies harmonisation and mutual recognition. This is unlikely in this case and would not be sufficient to ensure international data flows. Harmonisation and mutual recognition of national regulations help firms create economies of scale, because they do not need to fragment operations to conform to differing regulations. But identical or mutually acceptable regulations do not, by themselves, address the central problem of international data flows. To protect the interests of their citizens, regulators in each country need to influence the behaviour of data-handling entities located outside their jurisdictions. The regulators in other jurisdictions who have control over these entities are not mandated to look out for the interests of citizens from other countries.

Instead of these traditional routes, it may be possible to build on a recent model of international cooperation.

- **Privacy shield**. When the EU first enacted privacy rules, it considered US laws inadequate, and transatlantic data flows were threatened. In response, the EU and the US negotiated a Safe Harbor Agreement. This was updated after the Snowden revelations as the Privacy Shield Agreement (Privacy Shield Framework 2018). At the heart of this deal is a promise by US firms such as Microsoft and Google to protect the privacy of European citizens to European standards, in return for unrestricted data flows. This commitment is monitored and enforced by US institutions, notably the Federal Trade Commission and the Department of Commerce.

Since the EU has recognised US conformity assessment mechanisms under the Privacy Shield, WTO services law requires it to also grant other countries an opportunity to negotiate a similar arrangement. Developing countries can take advantage of the opportunity while strengthening their case for recognition by creating credible assessment institutions.

A recognition agreement with the EU would have big advantages over existing options. First, unlike in the case of BCRS and SSCs, firms would not be required to establish a costly presence in the EU because any assessment of conformity with EU standards would be done by domestic regulators. Second, unlike in the case of national adequacy, firms would not be obliged to adopt more stringent and more costly standards for data, involving transactions at home or with countries less demanding than the EU. Countries would be free to tailor domestic standards to domestic needs, and export standards to foreign needs.

First steps

We expect countries to proceed step-by-step in small groups, self-selecting into specific arrangements and gradually deepening them. As a first step, data source countries may still specify conditions and determine conformity unilaterally, but lend additional transparency and predictability to their requirements by listing them, for example as Additional Commitments under Article XVIII of the GATS.

A further step could be for data source countries to recognise conformity assessment in specific data destination countries when there is trust in enforcement,even though norms diverge. In parallel, groups of countries could also make collective additional commitments when they converge in regulatory requirements – say, in a WTO Reference Paper on Privacy – building on OECD and APEC principles (OECD 2013, APEC 2017).

These steps could pave the way ultimately for mutually binding obligations on source and destination countries, which is one of the most innovative elements of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). In this agreement, data source countries agreed not to restrict the flow of data, in return for legal obligations on data destination countries to protect the privacy of foreign citizens.

Apart from a bilateral or plurilateral approach, there may also be scope for multilateral discussions, for example as part of the recent initiative on electronic commerce. Such discussions could help forge a broader consensus on both data protection standards and mechanisms to ensure compliance. ■

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Past and future of the ECB monetary policy

Having developed its monetary policy through four key phases, the ECB is a modern and effective central bank, says Vítor Constâncio. He adds that it is equipped to continue to deliver on the priority of price stability for euro area citizens

I would like to take this opportunity to adopt a historical perspective and offer some reflections on monetary policy in the euro area over the past two decades. I will start with a review of the ECB journey from 1999 to date, to highlight the evolution of the practice of monetary policy in the euro area over this period. I will then draw some lessons from this experience, both for economic thinking and monetary policy making.

The ECB journey

The Treaty on the European Union defines the contours of monetary policy in the euro area. According to Article 127 of the Treaty, price stability is the primary objective of monetary policy in the euro area. It is only without prejudice to the objective of price stability that monetary policy can support the general economic policies in the Union. This high-level mandate enshrined in the Treaty is the cornerstone of all ECB decisions and has remained unchanged over its two decades of existence.

Within the boundaries of the Treaty, however, the practice of monetary policy in the euro area has undergone a process of transformation over time. While the transformation has often been gradual, four key phases can be clearly identified.

First Phase: monetary policy beginning and adjustment (1999-2003)

The first phase starts with the launch of the single currency and lasts until the revision of the monetary policy strategy in May 2003, when the weight of the monetary pillar and the 'dominant role of money' were demoted and the framework got closer to the flexible inflation targeting regime adopted by many other central banks around the world.

In the preparation for monetary union, a document published in 1997 by the ECB predecessor, the European Monetary Institute, explained why both a monetary aggregates targeting strategy and an inflation targeting regime were not considered fully appropriate for the euro area[1]. The first regime, which was followed by the Bundesbank, in a tradition that understandably exerted a crucial influence on the initial ECB decisions, was refused for the practical reason that money demand functions at the European level would not be stable enough to allow for a reliable calibration of a M3 target. The refusal of pure inflation targeting was justified by the theoretical reason that it did not allow a role for money.

From now on, the ECB will have no excuse not to fulfil its mandate, either in fighting against deflation or in addressing the impairment of the single monetary policy transmission by intervening in the sovereign bond market

One of the first decisions of the Governing Council, already in 1998, was to announce the adoption of a 'stability-oriented monetary policy strategy' to attain the goals set out in the Treaty. The strategy was a sort of hybrid based on the two main strategies previously examined and characterised by the following key elements, as described in the ECB's *Monthly Bulletin* of January 1999: *"The strategy consists of three main elements: (i) a quantitative definition of the primary objective of the single monetary policy, namely price stability; and the 'two pillars' of the strategy used to achieve this objective: (ii) a prominent role for money, as signaled by the announcement of a reference value for the growth of a broad monetary aggregate; and (iii) a broadly based assessment of the outlook for future price developments and the risks to price stability in the euro area as a whole."*

There was clearly a dominant first pillar with a reference value initially set at 4.5% growth rate for M3. The text further explained: *"To signal the prominent role it has assigned to money, the Governing Council has announced a quantitative reference value for monetary growth as one pillar of the overall stability oriented strategy"*. So, some trace of technical monetarism[2] was implicitly present.

In 2006, explaining the origin of the 'two pillars', Otmar Issing quoted former President Wim Duisenberg's reply to a question by a journalist in 1999: *"it is not a coincidence that I have used the words that money will play a prominent role. So, if you call it the two pillars, one pillar is thicker than the other is or stronger than the other, but how much I couldn't tell you"*[3].

The reference value for the monetary aggregate M3 was considered a relevant variable for inflation assessment and was related to the theoretical approach of technical monetarism in that money predicts inflation and differs from credit or other aggregates. The reference value for M3 annual growth was calculated to be 4.5% and was used to produce a monetary overhang: the difference between actual M3 growth and the reference value, with higher numbers representing higher risks for medium term inflation.

The monetary policy framework announcement sparked a lively debate in the academic community, regarding the differences between the ECB approach and the inflation targeting regime[4]. There were criticisms about the ambiguity of having two seemingly different approaches, one close to monetary targeting (the reference value) and another related to a public commitment of a quantified inflation target (less than 2%), an element of utmost importance in an inflation targeting regime.

The sobering experience of the following few years with the framework, determined the need for clarifications and ultimately for a revision of the strategy. Since 2001 the growth of M3 started to accelerate to values well above the 4.5%, registering 10.9% in December 2001 and in December 6.6% in 2002[5]. It thus suggested significant risks for inflation that the behavior of prices did not show, even when considering meaningful lags.

In fact, the money demand function became clearly unstable since 2001 and did not justify the use of a concept like the reference value referring to the medium-term of up to two years which is the operational horizon for monetary policy decisions[6]. The continuous need to try to explain away the growing monetary overhang without corresponding inflation in the horizon, was turning into an embarrassing exercise.

Consequently, in May 2003, the ECB published a review of the monetary policy framework including the following elements. First, the medium-term target for inflation was redefined to a value below but close to 2%; second, the presentation of the monetary policy decisions would start with the economic analysis to identify short- to medium-term risks to price stability; third, the monetary analysis would mainly serve as a means of cross-checking, from a medium- to long-term perspective, the indications coming from the economic analysis; fourth, the review of the reference value on an annual basis was dropped. While still at 4.5%, the reference value has, in fact, not been mentioned or used since then. The monetary pillar became thinner.

Finally, in June 2004 the ECB started publishing its staff macroeconomic projections for the euro area. In my assessment, the decisions taken in 2003 and 2004 were important steps towards a higher degree of transparency and accountability and made the ECB strategy even more aligned with inflation targeting. I therefore believe that the ECB's monetary policy strategy can be seen as consistent with the broad features of flexible inflation targeting as described in Svensson (2008).

It includes: first, an announced numerical inflation target; second, monetary policy decisions that make the inflation forecast published by the central bank, converge to this numerical target, and third, a high degree of transparency and accountability[7]. Naturally, this does not mean that all central banks do not look at what is happening with monetary aggregates, especially credit, as they have information content. In the same way, central banks also follow general financial conditions. In both cases, however, central banks cannot extract quantitatively precise calibration on what will happen to inflation from those monetary and financial variables.

Second Phase: monetary policy until the financial crisis (2003-2007)

The period spanning from the revision of the monetary strategy to the beginning of the crisis in 2007 coincided with the build-up of macroeconomic imbalances in several member countries. With hindsight, the ECB has been criticised for not helping prevent that development. I do not agree with such criticism as it ignores that a single monetary policy cannot cater for heterogeneity across member states.

Rates were increased in December 2005 as there was evidence that strong growth was contributing to a rise in inflation above 2%, with a rate of 2.5% in the third quarter of that year. Curiously, the interest rate decision was criticised at the time by a number of commentators[8] and even by some policy institutions. However, the IMF's economic outlook of April 2005 considered that monetary policy in the euro area *"should remain firmly on hold"*[9]. A similar recommendation was issued by the OECD in November 2005[10]. With the benefit of hindsight, most observers now agree that the tightening decision in December 2005 was appropriate.

Let me emphasise however, that this conclusion does not imply that monetary policy interest rates are the best tool to respond to financial imbalances with what is called 'leaning against the wind' policy. I do not believe that monetary policy should be normally used to prevent the build-up of financial imbalances. The main reason is that, due to the imperfect synchronisation of financial and business cycles, leaning against the wind would pose an intertemporal trade-off in achieving price stability[11].

More precisely, 'leaning against the wind' requires intentionally producing deviations from price stability over the short- to medium-term, as a precautionary move against the risk of a future financial crisis. Its benefit would be to help prevent potentially larger deviations from price stability over the medium- to long-term, once the financial crisis occurs. The risks of this approach are to increase the amplitude of business cycle fluctuations and hinder the credibility of the central bank regarding its inflation objective, while only marginally reducing the probability of financial crises.

My conclusion is that the costs of 'leaning against the wind' are likely to exceed benefits as I illustrated in a recent intervention applying the methodology developed by Lars Svensson to the euro area[12].

Macroprudential policy should be the main policy tool to respond to the build-up of financial imbalances. In this respect, the fact that monetary policy 'gets in all the cracks' of the financial system was seen as an advantage by Jeremy Stein. However, it can easily become a significant inconvenience if it creates an unnecessary recessionary episode or when in a monetary union, a financial instability episode is not generalised across all countries[13].

Indeed, some influential authors have pointed out that a tightening of monetary policy could, in some cases, even boost the bubbly component of stock prices, or increase house price imbalances through debt deflation effects[14]. This requires strong macroprudential policies to complement monetary policy in order to achieve both price and financial stability.

The Third Phase: global financial crisis and Great Recession (2008-2013)

The third phase marks an abrupt change in euro area monetary policy. It can be identified as a result of the financial crisis of 2007, and especially its intensification after the bankruptcy of Lehman Brothers in September 2008. However, in July 2008, overreacting to a reading of 4% in headline inflation related to oil price developments we took the controversial decision to increase the policy rate to 4.25%. Following the dramatic effects of the Lehman bankruptcy, rates were subsequently cut three times to a level of 2.5% in December 2008. A broad policy of liquidity provision to the banking sector replacing auctions by the fixed rate full allotment regime was introduced in October and kept until this day.

The operational approach was to calibrate each measure to address the specific market impairment prevailing at that point. For example, liquidity was provided at much longer maturities than usual to help alleviate tensions exacerbating the maturity mismatch on the banking sector's balance sheet. The list of eligible collateral was also expanded to ease the shortages that emerged during the crisis.

A direct implication of the activity of eased liquidity provision to the market was the increase in the size of the ECB balance sheet. The increase in financial institutions' demand for ECB liquidity led to a progressive, and sizable, increase in bank reserves. This was accentuated by the effects of the SMP programme under which the ECB boldly intervened since 2010 with purchases of government bonds of countries where monetary policy transmission had been severely impaired as a result of excessive market pressures. Between 2007 and mid-2012, the size of the ECB's balance sheet more than doubled. Clearly, the larger balance sheet was then not the objective of our non-standard measures, but rather the result of the lender of last resort function to the market. Indeed, as the funding situation in the banking sector started improving in mid-2012, the ECB balance sheet slowly began to contract without any adverse effects.

Some commentators were nevertheless concerned by the increasing size of the ECB balance sheet. Based on the high long-run correlation between inflation and money growth, they interpreted the huge growth in the ECB monetary base as a signal of future high inflation risks. These fears obviously disregarded three things: first, no theory of inflation is directly related with the central bank's balance sheet; second, the relationship between the monetary base and the broad monetary aggregates is unstable and, in fact, during that period monetary aggregates did not increase in response to the expansion of central bank liquidity; third, that the crisis implied a shock to money demand that totally disrupted any potential relationship between monetary aggregates and inflation. This assessment has been vindicated by subsequent developments. Almost ten years after the initial increase in size of the ECB balance sheet, the problem in the euro area remains one of too low, rather than too high, inflation.

In the opposite direction, concerns were also voiced about the reduction in the ECB's balance sheet size beginning in 2012 and a possible link to the recession and low inflation period that followed. This view is compounded by the criticism of the two policy rate increases in April and July of 2011, taking it from 1% to 1.5%. This episode and the double dip in growth deserve therefore further comment.

Those rate increases came on the wake of developments in the first half 2011, showing economic growth slightly above 2% and with inflation attaining 2.75 % in the second quarter. We were also overly influenced by growth forecasts which turned out to be excessively optimistic. Blanchard and Leigh, who also point out that many other forecasting institutions made recurring errors on euro area growth during this period, make an independent validation of this hypothesis in their 2013 paper[15]. The authors argue that this is due to an underestimation of fiscal multipliers, which in turn led to an underestimation of the contractionary effects of the fiscal consolidation plans announced in early 2010.

With hindsight, it is now clear that increasing interest rates during this phase was premature. The economy weakened markedly after the summer, on the wake of the acute market pressures on the sovereign debt of Spain and Italy that led to a second round of interventions in the sovereign bond markets under the Securities Market Programme (SMP). The two consecutive rate hikes were quickly reversed in November and December of that same year.

In view of the long lags of monetary policy effects, it is obvious that the quick succession of increases and reductions of policy rates cannot be responsible for the recessionary episode of that period. What really was responsible for the recession of 2012/2013 was the coordinated fiscal consolidation in which all member states engaged. A working paper published by the European Commission estimated that collective fiscal consolidation led to cumulative deviations from the baseline growth in 2011-2013 from 8% in Germany to 18% in Greece[16]. Another paper finds a loss deviation from baseline between 14% to 20%, for the euro area GDP during the same period[17].

Monetary policy continued to help the situation when, at the end of 2011, the ECB introduced two three-year longer-term refinancing operations implemented in December 2011 and February 2012 amounting to EUR 1 trillion. This measure and the correction of the two rate hikes contributed to attenuate the severity of the 2012 recession[18]. The announcement of the Outright Monetary Transactions (OMT) programme in 2012 further contributed to preventing an even worse deterioration of economic conditions by removing redenomination risk, which had become an important source of macroeconomic uncertainty. The programme facilitated an ease of tension in all financial markets, which was accompanied by a slow, but progressive return of spreads towards normal levels. Altogether, with the second round of sovereign bond purchases in 2011, the liquidity supplied at end-2011 and the OMT announcement, the ECB put an end to the euro area acute existential crisis.

The Fourth Phase: ultra-low inflation and QE (2014-today)

This brings me to the fourth and current phase of monetary policy in the euro area. In 2013, the euro area recovery had not yet gained traction. In spite of the ultra-low level of interest rates, renewed deflationary risks emerged with a progressive fall of inflation towards levels significantly below 2 percent. In contrast with the previous five years, financial disruptions could no longer be responsible for the economic slowdown. The coincident reduction of output and inflation suggested that the renewed economic weakness was driven by a negative aggregate demand shock. In turn, the negative demand shock could be the delayed result of the fiscal policy tightening since 2010, or possibly the consequence of weakened economic sentiment after two recessions[19].

Maintaining price stability in the face of insufficient aggregate demand and downward inflationary pressures required a more expansionary monetary policy stance. In response to these developments, a new phase in non-standard measures was launched, including increasing the balance sheet with asset purchases. The new non-standard policies were not merely expected to undo any remaining financial market impairments, but to further ease the monetary policy stance at a point where policy rates had reached their lower bound.

In July 2013, in response to the contagion of increased bond yields resulting from the 'taper tantrum' in the US, the ECB had already introduced the non-standard policy of forward guidance, indicating its intention to keep interest rates at prevailing or lower levels 'for an extended period of time'. As inflation continued to decelerate from October 2013, falling under 1%, a comprehensive package of expansionary measures[20] was announced in June 2014 including: a cut in policy rates and a negative deposit facility rate; two asset purchase programmes for asset backed securities (ABS) and covered bonds (CBPP), and a facility to provide longer-term funding to banks for new loans, contingent on bank credit supply behaviour, which we refer to as targeted longer-term refinancing operations (TLTRO). In January 2015, the large-scale asset purchase programme (APP) was extended to include purchases of sovereign bonds.

A growing number of studies about the impact of APP suggest that the programme was effective in lowering spreads on long-maturity assets and thereby boosting inflation and growth[21]. These studies also highlight that the APP announcement contributed to a re-anchoring of inflation expectations by reversing their previously observed decline. From a simpler perspective, we can state today that three years of large-scale asset purchases have eliminated the risk of prolonged deflation. This fact is incontrovertible and should be admitted by both the early APP critics and those who claimed it was unnecessary[22].

Nevertheless, we should remain aware that the precise channels of transmission of Quantitative Easing (QE) are still imperfectly understood and they do not relate to technical monetarism. I think that making progress in our theoretical understanding of QE remains an important research priority for central banks, especially in view of the possibility that nominal interest rate will be more persistently low in the future, and thus that the effective lower bound constraint will be hit more frequently.

A particular aspect of QE programmes that needs to be investigated further regards its distributional effects. As an instrument of monetary policy accommodation, the APP led to an increase in economic activity, which was especially beneficial for those individuals who, as a result, found a job after being unemployed. At the same time, the APP increased the value of financial assets and thus led to capital gains for the holders of those assets. Improving our understanding of the relative strength of these distributional effects is also an important priority for central banks.

Ongoing work at the ECB suggests that the decline in unemployment that followed the introduction of the APP had a disproportionately positive impact on low-income households[23]. The net overall impact of APP has therefore reduced income inequality. Furthermore, as a result of housing price increases associated with the economic recovery, the same positive outcome took place with respect to wealth distribution.

Implications for the future

The ECB journey that I have recalled here can give rise to two obvious questions. The first one relates to economic analysis: were the mainstream macroeconomic models used before the crisis appropriate to help guide policy decisions, or should these be changed? The second question relates to the monetary policy strategy: should lessons learnt in the journey be reflected in a change of central banks' monetary policy strategies?

Implications for macroeconomics and monetary theory

Let me start with the first question. The shortcoming of mainstream macroeconomics and of the type of Dynamic Stochastic General Equilibrium (DSGE) models that prevailed before the crisis, are by now quite well known[24].

Besides extending DSGE models to include macro-financial linkages, the ECB decided to develop a new Multi-Country model starting from the premise that, in the words of Olivier Blanchard, 'policy models' cannot be expected to have the same tight structure as 'theory models'[25]. A semi-structural approach along the lines of the Federal Reserve's FRB/US model has been adopted[26]. We can therefore put more emphasis on the model's ability to provide sound quantitative predictions. When introducing financial frictions, we have relied on a reduced form representation that is consistent with different theoretical micro-foundations. This more flexible, semi-structural approach allows us to model a wide range of banking and financial variables, going from bank lending spreads to term premia, without taking a stance on the theoretical fundamental debate about how they are linked to the macroeconomy[27].

A crucial theoretical aspect which requires improvement is related to the Phillips curve, the most commonly used empirical model of inflation that faces several estimation problems as it uses several unobservable variables[28]. It started as a relationship between wage growth and unemployment and later, prices or inflation substituted wages. In 1967-8, Phelps and Friedman introduced expectations as a variable that shifted the previously considered stable relationship. Jointly with this change, Friedman added the concept of a fixed Natural Rate of Unemployment (NARU), determined only by supply factors, to which the economy would tend in the long-term.

The difference between actual unemployment and this long-term unemployment rate became the variable used as proxy for demand pressure in the market of goods and services, seen as the main theoretical cause of inflation. Inflation was an excess demand phenomenon and demand could be controlled by monetary policy — via monetary aggregates for Friedman or with interest rates, as believed today. In practice, estimates of a Non-Accelerating Inflation Rate (NAIRU) are what is obtained instead of the unobservable long-term NARU, which are doubtfully deemed to be the same.

In the late 1970s, two different research approaches emerged, thus characterised by Robert Gordon[29]: *"The left fork in the road,… is the resurrection of Keynesian economics in the form of a …. Phillips Curve (PC) model that incorporates long-run neutrality and an explicit role of supply shocks in shifting the Phillips Curve up or down, together with an interpretation of the influence of past inflation as reflecting generalized inertia rather than expected inflation. The right fork in the road of the post-1975 evolution, features an approach developed by Kydland, Prescott and Sargent, and more recently by Galì and Gertler and others. Inflation depends on forward-looking expectations, and expectations respond rationally to actual and expected changes in monetary and fiscal policy. This two-way game has no room for supply shocks or inertia".*

This second approach produces what is called the New Keynesian Phillips Curve (NKPC) that basically focuses on the output gap and expectations and is a crucial part of the DSGE models, where the interest rate is all-powerful to control demand and therefore inflation.

Gordon and others forged ahead with the first approach, adding variables representing supply shocks (as prices depend on demand and supply factors), inertia represented by long lags of inflation and a time-varying NAIRU determined by a simple stochastic process. To this day, using this so-called 'triangle approach', Gordon continues to obtain very good results in predicting inflation out-of-sample[30]. In 2013, Gordon shows that his model *"can estimate coefficients up to 1996 and then in a 16-year-long dynamic simulation, with no information on the actual values of lagged inflation, predict the 2013 value of inflation to within 0.5 percentage point. The slope of the PC relationship between inflation and the unemployment gap does not decline by half or more as in the recent literature, but instead is stable."*

This last aspect is particularly important as it highlights one of the puzzles found in the second approach of the NKPC, since Roberts[31] obtained the result of a 50% decline in the slope coefficient for the US in 2006. As is to be expected, the value of that coefficient depends on the entire specification of the regression. When it does not use supply-side variables, assumes inflation lags with coefficients that add to 1, and a constant NAIRU, as in the NKPC specified by Roberts, it is natural that the low inflation environment of the period shows up in a declining slope coefficient.

The problem is that the NKPC did not perform empirically well from the start. Many ad-hoc remedies have been tried in order to make it work, even when they did not conform to the pure theoretical paradigm of the model. First, lags of inflation were introduced by Galì and Gertler (1999) to create the so-called hybrid NKPC[32]. This hybrid model has faced many difficulties in predicting inflation with acceptable accuracy, even when embedded in DSGE models.

As I mentioned in another intervention[33]: *"As King and Watson (2012)[34] highlight when using the labour income share or unit labour costs the models do not capture that the last 15 years do not show a co-movement of inflation with the significant decline of those ULCs".* Gürkaynak, Kisacikoglu and Rossi (2013)[35] also illustrate the subpar performance of DSGE models to forecast inflation. In their encompassing survey, Mavroeidis, Plagborg-Møller and J Stock (2014)[36], also conclude that, *"we are unable to pin down the role of expectations in the inflation process sufficiently accurately for the results to be useful for policy analysis".*

Many other transformations have been attempted to make variants of the hybrid model perform better. One way is to focus on core inflation on which the missing supply factors may be less important. Another approach is to take expectations from consumer surveys or professional forecasters, which of course are not microfounded[37]. In some estimates, the price of oil or the full price of imports is introduced as an ad-hoc element within the paradigm. Time-varying coefficients and NAIRUs are also used. So, pragmatically adjusted, hybrid NKPCs can be made to work, especially for core inflation. This specification is quite distant from the initial pretensions of the NKPC and from rationale of DSGE models where everything is microfounded and subject to rational expectations. The two strands of the literature identified by Robert Gordon seem to have undertaken some convergence.

An important source of the Phillips curve's poor performance can be the mis-measurement of the output gap and the NAIRU. An important part of the under-prediction of inflation in recent years may be the result of an underestimation of the slack in the economy. This is illustrated by the fact that we better predictions of inflation can be obtained when the broad concept of unemployment is used (eg. U6, which is at 16% for euro area) instead of the usual measure of unemployment (standing at 8%). Usual measures of slack can vary substantially across methods and chosen variables, although they tend to agree on the timing of peaks and troughs.

The fact that economic activity is multidimensional suggests that there might be advantages in using large dynamic models to estimate it. For instance, ECB staff used a dynamic factor model that performs a trend/cycle decomposition of real activity variables and core inflation[38]. Using different sets of variables and trend assumptions, they get different measures of the output gap. One way to discriminate among different estimates of the output gap is to check their ability to forecast inflation. It turns out that the variants associated with a continuation of a positive growth trend, implying a wider output gap, are the ones that produce better inflation forecasts.

The best variant from this perspective implies that the output gap was as large as -6% in 2014 and 2015, on average, an estimate which is considerably more negative than most official estimates, hovering between -2 and -3% for those years[39]. Results for 2017 still continue to show a quite meaningful negative output gap, instead of one already close to zero as reported by several international institutions. This points to the great uncertainty behind the estimation of the output gap, the same being true about the concept of an unemployment gap more directly involving the NAIRU.

In any case, what matters is that it is possible to find specifications that can be used as fairly good inflation forecasting tools. Either NKPC or Traditional Keynesian Phillips Curves (TKPC) can achieve that. For instance, in their estimations of the Non-Accelerating Wage Rate of Unemployment (NAWRU), the European Commission has used the NKPC for 21 countries and the TKPC for 7 countries[40].

In recent ECB work about understanding the low inflation environment, a variant of the hybrid NKPC for core inflation was used but with the inclusion of import prices, lagged inflation and expectations taken from surveys[41]. Using that pragmatic specification, acceptable forecasting results are obtained and we find that the slope has been increasing in recent years. This is a source of confidence that our policy, having contributed to the recovery, will in the end contribute to achieve our inflation goal.

Another question related to the PC, beyond the forecast of inflation, refers to the interpretation and use of the NAIRU that can be extracted from it. It is common to see it as equivalent to the Friedman's NARU, a long-term structural rate of unemployment totally dependent on supply-side factors like demography, technology, institutions that shape market rules, etc. This view then endorses the use of estimated NAIRUs for several policy decisions: for instance, using that particular value as a measure of structural unemployment that enters into the calculation of potential output and the structural budget deficit with all its implication for fiscal policy. Trusting just one number to conduct policy can be dangerous.

In their seminal paper, Staiger, Stock and Watson (1997) estimated standard deviations for the NAIRU and concluded that these were very large[42]. The standard deviations are not usually calculated and/or disclosed in estimates of NAIRU but we can rely that they are normally quite large. This recommends caution in using NAIRU estimates for strict policy decisions.

A second aspect to underline is that it is difficult to accept that estimated NAIRUs are long-term constants determined exclusively by supply-side factors. This would correspond to the natural rate hypothesis (NRH) put forward by Friedman. This view of separating trend from cycle or supply from demand shocks has repeatedly been challenged, for example in the hysteresis hypothesis proposed by Blanchard and Summers[43].

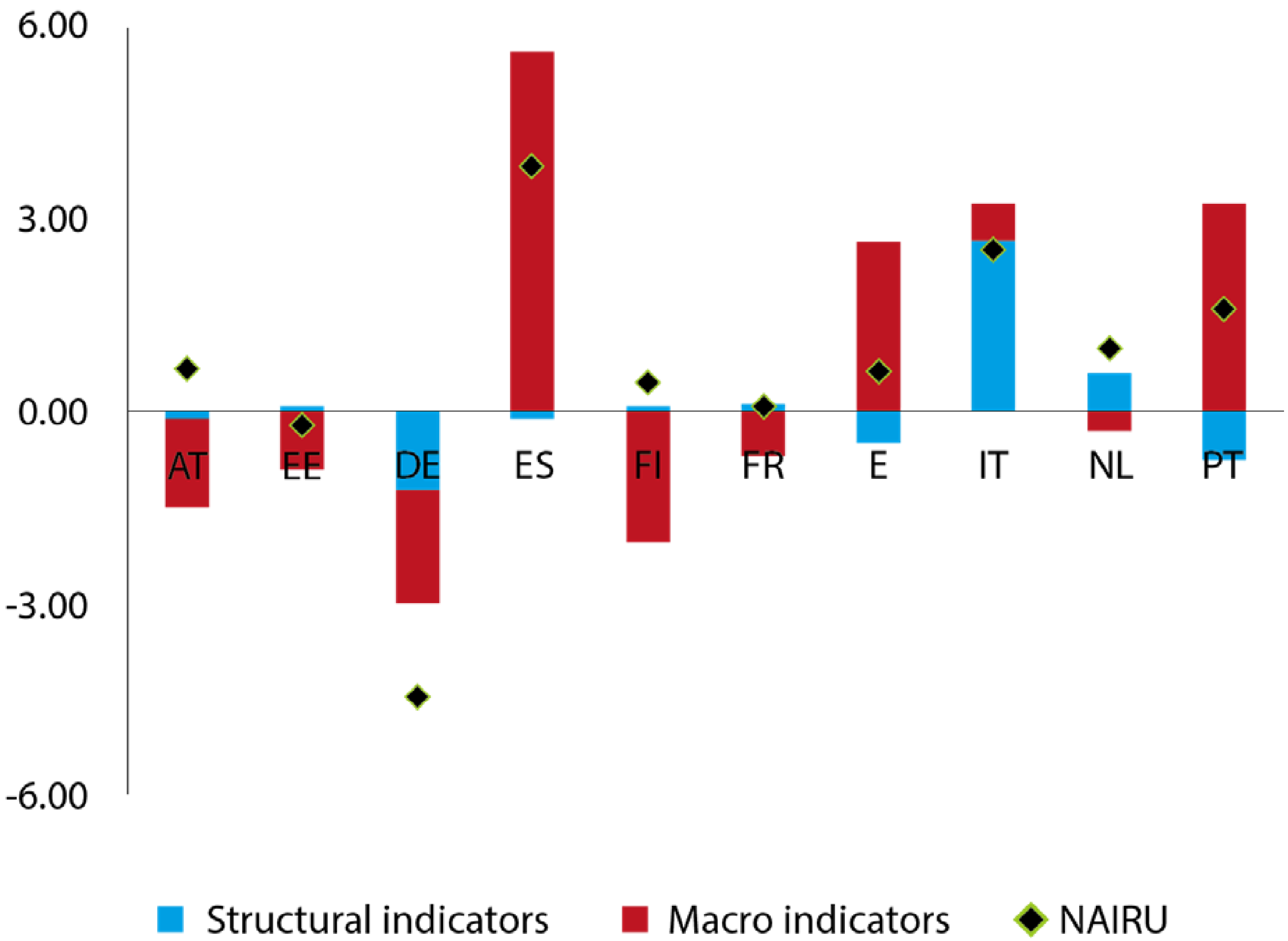
Recently, Blanchard even questioned whether the NRH should be rejected which in the end he refrains from doing while instilling a high degree of doubt and caution in its use. The main argument behind hysteresis is that there are various transmission channels that may induce a long-lasting impact of economic fluctuations due to aggregate demand. Unfortunately, it is very difficult to detect this hypothesis on empirical grounds from an aggregate economic viewpoint. However, some micro-evidence appears to support it, such as the decreased employability of long-term unemployed, as they lose skill and morale, or the decline in R&D activities and investment of firms during recessions.

One change in the NARU long-term assumption is to accept that it changes over time, albeit slowly and indeed much more sluggish than what is normally used in estimates of NAIRU that even show yearly changes. About these time-varying NARUs and NAIRUs, Farmer refuses the whole concept[44]: *"Defenders of the Natural Rate Hypothesis might choose to respond to these empirical findings by arguing that the natural rate of unemployment is time varying. But I am unaware of any theory which provides us, in advance, with an explanation of how the natural rate of unemployment varies over time. In the absence of such a theory the NRH has no predictive content. A theory like this, which cannot be falsified by any set of observations, is closer to religion than science."* In the same vein, Solow once quipped *"a natural rate that wanders permanently is not natural, is epiphenomenal"*.

The major point behind the previous discussion is that estimated NAIRUs are not good proxies of structural unemployment. Already in 1998, Estrella and Mishkin[45] showed that the NAIRU use in monetary policy *"… depends critically on redefining NAIRU as a short-term concept and distinguishing it from a long-term concept like the natural rate of unemployment…something that is not typically done in the literature. Furthermore, …the view that the NAIRU concept implies that the monetary authorities should try to move the economy towards the NAIRU, thus to some treating it as a target, is both incorrect and misguided"*.

Indeed, the casual identification of the NAIRU with the level of long-term structural unemployment has pernicious consequences, either in using to calculate potential output or the structural budget deficit. Being a short-term concept, the NAIRU estimates since 2007, for instance, seem, to a large extent, to be driven by macro-economic developments rather than by shifts in structural labour market characteristics. ECB staff have recently replicated and updated an earlier study of the European Commission (EC) to illustrate this point. The study relates the European

Figure 1. Changes in NAIRU and contributions 2007-2016



Commission' s NAIRU estimates to four structural labour market indicators (unemployment benefits, replacement rates, labour tax wedges, union density, and active labour market policies) and three macro-economic indicators (total factor productivity growth, the share of construction in GDP and the real interest rate)[46]. As shown in the chart, the structural indicators explain only a small fraction of the changes in NAIRU, whereas the macro-economic indicators appear to explain the bulk of its variation. Another paper, reaching the same conclusion and using a broader set of variables is Heimberger *et al*.

Overall, this evidence suggests that the shifts in unemployment rates observed since 2007 were mostly triggered by the macro-economic cycle and not by an increase of structural unemployment as allegedly indicated by very high NAIRU levels. This means that the estimated NAIRU from Phillips curves is not a good representation of structural unemployment.

Confirming this, an Economic Paper published by the European Commission uses a concept of Structural Unemployment Rate (SUR) to substitute the NAWRU[47] in the calculation of the structural budget deficit. A subsequent Discussion Paper integrated the concept of SUR as a sort of anchor in the estimation of NAWRUs, that are therefore less pro- cyclical and less sensitive to data corrections[48]. These analyses produce meaningful changes on fiscal policy stance indicators when compared with the previous straight estimates of NAWRUs.

In view of all the uncertainty, policy-makers should seriously consider the possibility of dropping the NRH as a long-term stable concept that can be estimated from Phillips curves and used in policy decisions. This does not imply abandoning the idea behind the Phillips curve as a pure forecasting device with a positive slope coefficient indicating that strong growth of aggregate demand, given time, will increase inflation. What should be refused is the idea that there is a unique identifiable level of unemployment, corresponding to a level of stable structural unemployment, above which expansionary macro policy exclusively accelerates inflation.

Monetary policy strategy in the future

While our quest for better analytical tools continues, a broader question concerns whether there is a need to also change central banks' monetary policy strategies. Many commentators have started discussing whether these should undergo a more complete overhaul, rather than eventually returning to the pre-crisis status quo[49].

I think that the position to take in this debate hinges on the assessment of the recent experience with non-standard monetary policy measures. If non-standard measures were considered to be ineffective, then interest rates would really be the only available tool to achieve price stability. In other words, we would conclude that, once interest rates reach their effective lower bound, central banks are, de facto, powerless. The inconvenient truth behind that view is that it would crucially require reducing to literally zero the likelihood of hitting the effective lower bound ever again in the future.

A substantial overhaul of current strategies would in the end be necessary. Options that have been proposed in this context include the abolition of cash, to eliminate the arbitrage opportunity which prevents policy rates from going negative, and a higher inflation target to reduce the likelihood of hitting the lower bound even after large, adverse shocks[50]. In my view, on the issue of the abolishment of cash, *"a prudent policy-maker would advise to be very cautious before proceeding with this radical proposal, even if digitalisation may gain ground and finally prevail – as we start to observe in some countries"*[51].

Regarding proposals to increase inflation targets, I think they are in general problematic, in view of the difficulties of managing the transition without losing credibility. Notwithstanding this, I would have no theoretical objections to a mild correction as proposed by many economists. My reaction is similar to what Janet Yellen replied in June 2017 to a question about the letter to the Federal Reserve signed by 22 prominent American economists[52] in favour of increasing the inflation target: *"…this is one of our most critical decisions and one we are attentive to evidence and* *outside thinking. It's one that we will be reconsidering at some future time. … It needs to be a balanced assessment. But I would say that this is one of the most important questions facing monetary policy around the world in the future. And we very much look forward to seeing research by economists that will help inform our future decisions on this."*

An interesting alternative proposal has recently been made by Bernanke, the former chairman of the Federal Reserve[53]. In a nutshell, the idea is to switch to a temporary price level target during episodes in which the interest rates effective lower bound is binding. Under a price level target, the central bank aims to stabilise the price level, rather than inflation, and it therefore ensures that any low-inflation episode is compensated by a period of relatively high inflation[54]. Outside the zero lower bound, the central bank would continue to target a standard inflation objective.

The main advantage of this proposal is that it clearly communicates the horizon over which a period of inflation below trend would have to be compensated. Relative to other proposals, the fact that for most of the time, the central bank would continue to target the inflation rate also facilitates communication with the public. Nevertheless, I am not sure whether the practical difficulties of implementing the policy would prevent markets and the public from fully understanding it, which may make the proposal an unrealistic option to be adopted by a central bank in the future.

I have a positive assessment of the experience with non-standard measures, from large scale open market operations of asset purchases to negative rates, and I am glad that they now permanently belong to the ECB's toolkit of instruments to address particular stressful situations. Even outside those special conditions, it is somewhat doubtful that monetary policy can remain effective just by going back to the traditional approach of very small central bank balance sheets and the targeting of overnight money market rates, for a number of reasons.

First, the importance of banks in funding non-financial firms has declined everywhere, including in the euro area. There has been a dramatic change, as non-bank financing sources have become much more important since the onset of the financial crisis. Total assets of investment funds in percentage of total bank assets increased from 16% in 2007 to 44% last year. The percentage of bank loans in the total stock of firms' external financing in 2017 was just above 12% (or 15%, if intra-company loans and trade credit are excluded from total external financing). For the same year, if only the stock of debt instruments is considered (excluding equity sources), bank loans represented only 28% of total debt financing (or 45%, if net of intra-sectoral financing). Before the crisis, back in 2007, bank loans represented 37% of total debt financing (or 60%, if net of intra-sectoral financing)[55].

Second, other structural changes in the financial system are also important in this context: the increased role of secured money market transactions; the importance of a broad set of market rates beyond the overnight rate, in view of imperfections in arbitrage; the growing relevance of market-based finance; and finally, the scarcity of safe assets that affects the functioning of markets and the management of collateral.

These developments are behind proposals to keep central bank's balance sheet with significant size to allow the use of a programme like the Fed's reverse repo programme (RRP) where its stock of government securities is available for repo operations against cash[56]. The programme would be used to involve more counterparties and affect several interest rates, thereby contributing to a better transmission of monetary policy, in view of the limits to arbitrage hampering the pass-through from short- to long-term interest rates. Recent internal work at the ECB also detects similar pass-through imperfections in European markets. Furthermore, by keeping a significant balance sheet, albeit much smaller than the present levels creates short-term safe assets. This would foster financial stability: the unsuccessful attempts by the financial system to engineer 'safer' private assets, as we saw before the crisis would be unnecessary.

Both arguments deserve careful consideration for the design of future monetary policy after the present normalisation phase. Maintaining a much smaller but still significant balance sheet may be necessary to allow targeting a broader set of interest rates. Another related dimension refers to central bank counterparties. Central banks have traditionally granted access to monetary policy operations exclusively to credit institutions. Nevertheless, non-banks are beginning to play a greater role in the European financial landscape, and are likely to take an even greater role as the capital markets union deepens and broadens financial markets in Europe.

Such a consideration is not neutral for market rates in the euro area. Secured money market rates, when backed by high quality collateral, have traded several times below the ECB deposit facility rate, which normally sets a floor for short-term money market rates. In part, this discount is explained by non-banks' activities that – not having access to central bank facilities – are accepting interest rates below the deposit facility rate in their repo activity. The discount is, of course, also attributed to the APP which has reduced the availability of high quality collateral at the same time as market demand for that collateral has increased. Nonetheless, understanding these drivers is crucial for the central bank when making decisions about future counterparty eligibility and the choice of money market rates to target to ensure an effective monetary policy transmission.

These are, however, questions for the long-term future of monetary policy. At present, we have started a very cautious withdrawal of monetary accommodation. The caution is justified by the subdued inflation dynamics since the second half of 2017 and the recent levels of headline inflation: 1.4 % in March, following 1.1% in February, with underlying inflation at just 1%. The ongoing robust recovery that the euro zone is experiencing is a source of optimism for the immediate future. The euro area is much more resilient to possible external financial shocks[57].

Yet, a great deal still remains to be achieved. The euro area is a highly integrated economic and financial area which needs to be managed through common decisions. However, it lacks powerful instruments in domains other than monetary policy, ranging from private risk sharing in a true capital markets union with a European safe asset, to a strong centralised fiscal stabilisation function to deal with asymmetric and symmetric shocks.

The creation of such instruments would also ensure that the fiscal policy mistakes made in 2011-12 would not be repeated so that we do not suffer from avoidable double dip recessions. Over the business cycle, we also need co-ordinated fiscal policies to ensure that the overall fiscal policy stance is sufficiently countercyclical, thereby contributing to economic stabilisation. Until now, the burden of countercyclical stabilisation has been mainly left to monetary policy.

This situation is not sustainable, particularly in the context of a recessionary episode that should come at some point. Monetary policy will certainly require the help of strong fiscal policy that will then need to be in place. Governments need to act now and take advantage of the ongoing recovery to make the necessary institutional adjustments.

Conclusion

In my remarks, I have reviewed the different phases of monetary policy since the introduction of the euro and have described how the financial crisis has affected the conduct of monetary policy. Like in other jurisdictions, the deployment of large scale asset purchase programmes is the most relevant change observed since the financial crisis. These new unconventional instruments, along with forward guidance, negative rates and reverse repos belong now to the monetary policy toolkit to be used whenever necessary.

From now on, the ECB will have no excuse not to fulfil its mandate, either in fighting against deflation or in addressing the impairment of the single monetary policy transmission by intervening in the sovereign bond market. The ECB made the journey from a central bank still under the partial influence of the simple monetary aggregates approach, to join the community of central banks of other major jurisdictions using flexible inflation targeting regimes and asset purchases as non-standard measures. It is therefore prepared to continue to deliver on the priority of price stability for euro area citizens, while contributing to favourable growth conditions and financial stability in a world in which market-based finance is ever more complex and dominant. In sum, the ECB is now a modern, effective and prepared central bank to serve the goals of monetary union. ■

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Endnotes

1. See EMI (1997) "The single monetary policy in stage three: elements of the monetary policy strategy".

2. I use the expression "technical monetarism" to designate the operational approach relying on a target for a monetary aggregate precisely calibrated to achieve the desired level of inflation. The word Monetarism has been used in a more general doctrinal way, referring to a set of beliefs about a particular vision of the way market economies work.

3. See Issing, O. (2006), "The ECB's Monetary Policy Strategy: Why did we choose a two Pillar Approach?", contribution to the 4th ECB Central Banking Conference, Frankfurt, November.

4. See ECB (2011), "The monetary policy of the ECB", third edition, May. For a detailed review of the theoretical features of inflation targeting, see Svensson, LEO, (2010), "Inflation Targeting," in: Benjamin M Friedman and Michael Woodford (ed.), Handbook of Monetary Economics, Edition 1, Volume 3, Chapter 22, pp 1237-1302.

5. December year-on-year percentages.

6. Already in 2000, Gerlach and Svensson had concluded that "the prominent "first pillar" in its (ECB) monetary strategy, contains little information about future inflation". See, Gerlach, S and LEO Svensson (2000), "Money and Inflation in the Euro Area: A Case for Monetary Indicators?", NBER Working Paper No. 8025, published later in the Journal of Monetary

Economics 50 (2003) 1649-1672. See also, Alves, N and CR Marques (2004), "Money in the ECB's monetary policy strategy: a reassessment", Banco de Portugal, mimeo, December 2004, later developed into a Working Paper No. 20, 2007 "Is the euro area M3 abandoning us?".

7. Svensson, LEO (2008), "Inflation targeting", in The New Palgrave Dictionary of Economics, Second Edition, 2008.

8. See for instance De Grauwe, P (2005), "Monetarists cry wolf on eurozone inflation", Opinion, Financial Times.

9. IMF World Economic Outlook, April 2005.

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Are SBBS really the safe asset the euro area is looking for?

Grégory Claeys argues that sound policies at the national level, combined with an ambitious reform of the eurozone architecture, would render unnecessary the provision of safe assets in the euro area via potentially hazardous SBBSs

The European Commission is pushing to create a synthetic euro area-wide safe asset in the form of sovereign bond-backed securities (SBBS). However, SBBS do not fully fulfil their original promises. If introduced on a massive scale, they might increase the supply of safe assets in good times and loosen the link between sovereigns and banks. But they will not give governments a means to maintain market access during crises, they might change incentives for governments to default, and they could pose a problem to individual bonds not included in SBBS if, in the end, they are put at a regulatory advantage vis-à-vis individual bonds.

A safe asset is a liquid asset that credibly stores value at all times, in particular during adverse systemic crises (Caballero *et al*. 2017). There is high demand for this type of asset: from savers in need of a vehicle to store their wealth for the future; from domestic financial institutions to satisfy capital requirements, liquidity ratios and more generally to post collateral in many financial operations; and from abroad, from emerging market economies looking for a means to invest their foreign exchange reserves.

Several assets can play such a role: cash, central bank reserves, bank deposits, etc. Sovereign debt securities also play this role, in advanced countries in particular, thanks to their high liquidity and simplicity – as long as public finances are considered sound by the markets.

From the establishment of the monetary union through to the crisis, most of the bonds from euro area countries enjoyed this status – but several of them lost it during the euro crisis, and spreads with German bonds increased rapidly. The loss of the safe-asset status resulted in two main problems:

1) these countries lost the possibility to put in place countercyclical fiscal policies at low cost during the recession, and

2) the fall in sovereign bond prices put an additional strain on European banks holding a significant amount of these bonds, having been drained already by the global financial crisis and the burst of housing bubbles in several countries.

Given the inability of some euro area sovereign bonds to play the role of safe assets during the crisis, ideas on how to create synthetic euro area-wide safe assets have emerged (see Leandro and Zettelmeyer, 2018, for a good

The SBBS idea remains untested and politically controversial. Policymakers and public debt management agencies in many euro area countries are afraid of the unintended consequences that such a drastic change could entail for the sovereign bond markets of the eurozone overview of the main proposals). The SBBS proposal – originating from the European Safe Bonds ('ESBies') proposed by Brunnermeier *et al*. (2011, 2017) – has recently gained some traction in the policy sphere. As a result, it has been developed in more detail by the European Systemic Risk Board High-Level Task Force on Safe Assets (ESRB, 2018a and 2018b) and is supported by the European Commission (2017a, 2017b and 2018), which sees it as a way to strengthen the euro architecture.

What are SBBS and why would we need them?

The main idea behind ESBies/SBBS is to pool sovereign bonds from all euro-area countries (in proportion to the ECB's capital keys, i.e. more or less the size of each economy in the euro area) to use them as collateral and to provide cash flows for securities issued in several tranches, with different seniorities: senior 'safe' assets, and mezzanine/junior 'risky' assets. This has the additional (political) advantage over other proposals – such as Eurobonds or blue bonds/red bonds (Delpla and von Weizsäcker, 2010) – that it would create safe assets without resorting to any mutualisation of debt between countries.

Originally, the ESBies proposal had three main objectives:

1) To ensure a large supply of euro area safe assets. As some countries of the eurozone lost their safe-asset status during the crisis, this reduced significantly the quantity of European safe assets in circulation. SBBS, thanks to pooling and tranching, could increase the supply again by offering a euro area wide safe asset in the form of senior SBBS.

2) To help break the link between euro area sovereigns and their domestic banks, which resulted in doom loops during the crisis. Introducing SBBS could help reduce the domestic bias in sovereign bond holdings of banks by providing them with an easy way to diversify their portfolios, thus making them more immune to

the default risk of their sovereign. An additional advantage is that it would also make bank deposits (another type of safe asset available to ordinary savers) safer by making the banks, issuers of these deposits, safer.

3) To avoid intra-euro area flights to safety during crises, which reduce the fiscal space of some countries at the worst moment. SBBS could help countries from the monetary union maintain market access in times of crisis in order to be able to put in place countercyclical fiscal policies, which are needed as euro area countries cannot rely on their own independent monetary policy, exchange rate or on a federal budget to respond to asymmetric shocks.

Would SBSS really help achieve these three objectives?

In practice, it is possible that SBBS would help increase the stock of supply for safe assets and break the link between banks and sovereigns, but it is hard to imagine how they would provide a way for euro area governments to maintain market access in times of crisis.

However, even for the first two objectives to be met, SBBS would need to be introduced on a massive scale. This would require significant regulatory changes so that SBBS could be treated as a risk-free asset, while the holding of individual sovereign bonds would be penalised (just aligning the regulatory treatment of SBBS with that of sovereign bonds as proposed by the Commission might not be sufficient to push investors to switch from simple sovereign bonds to more complex SBBS).

A change in the ECB's refinancing operations and haircut valuation to give a preferential treatment to SBBS would also be crucial to encourage financial institutions to use them as collateral. Such a drastic regulatory advantage for SBBS over individual bonds would give an incentive to the euro area's banks to switch, at least partly, from the latter to the former.

This would result in some diversification of their portfolios and thus reduce the probability of a doom loop. However, the extent to which this probability would be reduced would depend on the development of SBBS. This would need to be very high to have a significant impact on banks' balance sheets.

The issuance of SBBS would be constrained by lower debt levels prevailing in some countries. Putting aside countries like Luxembourg or Estonia, which have very low debt-to-GDP ratios (and which would force SBBS to deviate from the official ECB capita keys very quickly), the maximum issuance of SBBS would be constrained at some point by German and Dutch levels of debt. This means that there would be a significant share of Italian, Spanish, Belgian, French, Portuguese, Austrian and other bonds from the EMU that would not be included in SBBS. As the regulatory treatment would have changed, putting them at a disadvantage against SBBS, funding for these bonds could actually become more problematic.

Turning to the third objective of SBBS – to offer a flow of 'safe liabilities' (as put by Coeuré, 2017) for governments to rely on in bad times – this is clearly a false promise, for two reasons. First, the ESRB insists that sovereign bonds of countries losing market access will not be included in the pooling. Second, for other countries, finding buyers for junior SBBS in bad times would become crucial as this would limit the possibility of issuing any SBBS at all during stress periods.

Proponents of SBBS argue that there would be investors interested in buying both senior and junior tranches, given the low level of complexity and transparency of these assets. It is true that SBBS would be less complex and risky than some of the collateralised debt obligations (CDOs) produced before the global financial crisis. But this is not an assurance that the market in SBBS will function correctly in stress periods. These episodes are often characterised by flights to safety but also to flights to simplicity. As the financial panic of 2007 showed, runs on asset-backed securities (ABS) were indiscriminate, and depended neither on their complexity nor on their intrinsic performance (Covitz *et al*. 2009).

This general panic about ABS made new issuances impossible even for simple products, while secondary markets froze completely. The same could happen to SBBS. In addition, the idea to exclude some countries from the pool (whether because they are losing market access or, on the contrary, because their debt is too low) would make matters worse by creating a variety of SBBS with different compositions, resulting in the lack of a homogenous market, lower liquidity, and less transparency.

This is an issue because, in a financial crisis, even a bit of complexity can make these assets vulnerable. To play the role of safe assets, securities need to be information-insensitive – ie. they need to be *"simple in complex times"*, as Caballero *et al*. (2017) put it, which would not be the case with SBBS. That's why the ESRB concludes that *"SBBS do not entail any built-in promise to offer a stable source of finance for governments during a crisis"*.

In addition to not fulfilling one of its main objectives, there could be other unintended consequences of introducing SBBS. As highlighted by De Grauwe and Ji (2018) – but also by the recent increase in spreads in Spain and Portugal, following the announcement of the coalition agreement in Italy between The League and the Five Star Movement – correlations between sovereign bond prices of the euro area have had a tendency to increase quickly in stress times.

Coupled with the low diversification of SBBS – almost 80% of SBBS portfolios being invested in the four biggest countries of the euro area (Germany, France, Italy and Spain), thanks to the use of ECB capital keys weights – and with modified incentives related to the introduction of SBBS, the risk of default on European debts could end up increasing. That is why the use of historical data in SBBS simulations is generally hard to justify.

Indeed, the incentives of governments to default could be completely altered by the introduction of SBBS and regulatory changes. For instance, if domestic banks only hold senior SBBS and, if the junior SBBS were only held abroad by non-systemic institutions, a default would not impact the domestic banking sector (which is one of the goals intended) and countries might have an incentive to default more often. Although the ESRB insists that SBBS are not *"build to fail"* or a *"precursor to debt restructuring"*, incentives to default might be affected by their introduction.

Overall, SBBS could lead to an increase in the stock of European safe assets, available in particular for banks during good times – which could appear to be a good thing, as it would help them diversify away from their domestic sovereigns. However, SBBS do not seem to provide a greater possibility for governments to finance themselves in crisis times, nor do they increase the flow of new safe assets to which investors could turn to in bad times (as SBBS could be vulnerable to panics due to their (even limited) complexity, markets could freeze and SBBS could quickly become illiquid assets).

Of course, even if other objectives are not fulfilled, the diversification of euro area banks' portfolios is desirable *per se* in order to share risk between countries, to avoid doom loop situations, and to be able complete the banking union from a political perspective (because some countries will be reluctant to accept a European Deposit Insurance Scheme as long as banks are biased in their exposures towards their own sovereigns). However, SBBS are not indispensable for this task; concentration charges, as proposed by Véron (2017), should be able to play that role by themselves.

It is true that SBBS, in addition to diversification, also result in some de-risking for banks if they only hold senior tranches of SBBS, but the same would be true if they would hedge themselves against sovereign default by buying sovereign credit default swaps (CDS) for instance (as long as the counterparty risk of the CDS is low).

The proposal from the Commission to pursue SBBS could be seen as a way to convince countries reluctant to introduce concentration charges on their banks' portfolios that they could rely on this new instrument to be able to sell their bonds to investors at all times. However, as discussed above, SBBS (at least in the version proposed by the ESRB) might not have this property.

Conclusions

The key to be considered a safe asset is, of course, sound fiscal and structural policy. A pool of euro area bonds can contribute to diversify risks but faces numerous drawbacks. The SBBS idea remains untested and politically controversial. Policymakers and public debt management agencies in many euro area countries are afraid of the unintended consequences that such a drastic change could entail for the sovereign bond markets of the eurozone.

Moreover, as argued in another post, the most compelling argument against SBBS is that they represent a distraction in the current debate. Instead, making all euro area sovereign bonds safe again – and for good – remains the most desirable way to increase the supply of safe assets and avoid intra-euro area flights to safety during bad times. This can be achieved through sound policies at the national level, combined with an ambitious reform of the eurozone architecture. This would render unnecessary the provision of safe assets in the euro area via potentially hazardous SBBSs. ■

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A ‘what if’ approach to assessing proposals for euro area reform

The policy discussion on euro area reform has entered a critical phase. George Papaconstantinou attempts a ‘what if’ experiment based on the proposals in the recent CEPR Policy Insight

The policy discussion on euro area reform has entered a critical phase. This column, part of the VoxEU debate on euro area reform, attempts a 'what if' experiment based on the proposals in the recent CEPR Policy Insight. Focusing on the Greek case, it looks at the counterfactual case of such proposals having already been implemented at the outset of the crisis and examines their potential role in preventing the outbreak of the crisis or mitigating it once it was underway.

The policy discussion on euro area reform has entered a critical phase, and analytical contributions informing that discussion have become particularly important. Among these, the recent CEPR Policy Insight (Bénassy-Quére *et al*. 2018) stands out. It is an important contribution to the discussion which the European Commission kicked off institutionally with its own 'roadmap' proposals. Reacting to the Policy Insight, together with a number of other economists with diverse academic and policy backgrounds, I co-signed an opinion piece on a *Blueprint for a democratic renewal of the Eurozone* (Andor *et al*. 2018).

These two contributions share a number of common views on the state of affairs and the way forward. The starting point to both is the built-in institutional weaknesses of the euro area and the recognition that these have been only partly addressed to date. And both believe not only that the status quo is not tenable but also that it would be a mistake to settle for marginal changes. Where they differ is in their scope and intent. Bénassy-Quére *et al*. explicitly attempt to influence the ongoing Franco-German debate on euro area reform by presenting what could constitute an acceptable compromise. Andor *et al*. (2018) instead sketch out a bolder and broader direction that in the current political climate would seem to be beyond reach.

As a contribution to the debate engendered by Bénassy-Quére *et al*., I would like to offer some thoughts in the context of a 'what if' counterfactual. This consists of exploring ex post the impact of having Bénassy-Quére *et al*.'s reform proposals already implemented before the euro area crisis on preventing the crisis outbreak or mitigating it once it was underway. I will take the Greek case as my starting point and as main focus, in full knowledge that the characteristics of the Greek crisis are not representative or fully replicated in the other euro area countries which had to rely on emergency loans[1]. Nevertheless, it is by examining the outlier Greek case that one can best draw conclusions on the adequacy of preventive and stabilisation mechanisms in place.

Turning to the final issue of contagion, many of the proposals in Bénassy-Quére et al. would have helped avoid the Greek crisis spreading and becoming systemic in nature

Counterfactuals are by nature difficult to sketch out and especially difficult to interpret in order to draw conclusions. In addition to the influence of the inevitable hindsight, one difficulty is in separating the counterfactual set up from actual historical events which would arguably not have happened in a policy environment vastly different as a result of having implemented certain policy proposals.

Nevertheless, I will offer some reflections on the 'what of' question by looking at the potential impact of the different proposed reforms in Bénassy-Quére *et al*. (2018) on the factors which (i) triggered the crisis; (ii) made it worse than it could have been; and (iii) allowed contagion to other euro area countries.

Starting with the initial trigger, at the root of the Greek economic and financial crisis was a triple deficit: a fiscal deficit, an external deficit, and one of confidence. In 2009, the country was running a public deficit in excess of 15% of GDP and a double-digit deficit in the external account. At the same time, the realisation that the deficit figures were severely underreported made markets wary of corrective policy pronouncements by the new Greek government.

The situation was further exacerbated by the long delay of EU countries and institutions in the early months of 2010 in understanding that in the case of Greece, markets were effectively looking for a guarantee of no default. Market financing became gradually more expensive, leading to the *in extremis* creation of the bailout arrangements.

Would the crisis prevention proposals in Bénassy-Quére *et al*. (2018) have helped Greece avoid this outcome? A definitive answer to this question is obviously impossible. But following a simple expenditure rule guided by a long-term debt reduction target could have avoided the sharp increase in expenditures of the 2005-8 period, which the rules of the preventive arm of the Stability and Growth Pact (SGP) failed to properly monitor. This assumes effective monitoring, with the proposed independent national fiscal watchdog, supervised by an independent euro area-level institution, providing the early-warning signs which eluded Commission services in practice.

In such a situation, the huge discrepancy between reported and actual deficit data which contributed to the loss of market financing could have been avoided. Separating the role of an independent fiscal watchdog at EU level from that of the political decision maker would also have added to the credibility of EU institutions vis-à-vis the markets when assessing the Greek situation.

Similarly, in a country which routinely used its domestic banking system in its public debt-financing exercise, the introduction of sovereign concentration charges for banks would have acted to effectively introduce a tighter market test when issuing debt and thereby reduced the large exposure of Greek banks to the sovereign, which undermined their position during the crisis. Simultaneously, a common deposit insurance would have at least tempered the continuous 'bank jog' of early 2010 which precipitated the need for financing from Greece's EU partners and the IMF.

In an unpublished companion note to Bénassy-Quére *et al*. (2018), Jeromin Zettelmeyer attempts such a 'counterfactual' for Greece, assuming all recommendations had been in place by 2001: the expenditure rule, banking union, sovereign concentration charges, the regime for debt restructuring, easy access to ESM liquidity, the rainy day fund. He runs simulations and concludes that if the government had followed the expenditure rule, Greece's fiscal balance in 2009 would have been positive, as opposed to a 15% deficit; hence the crisis would have been averted.

If, however, the government had ignored the expenditure rule but had still issued junior bonds, he believes one would have observed an earlier and less severe debt crisis, triggering an ESM programme with higher chances of success. Finally, if the Greek government had disregarded both the expenditure rule and the junior bond issue, there would likely have been a bailout in 2010, but on condition of debt reprofiling, followed by debt restructuring in 2012, again with higher chances of success.

These conclusions are reasonable; they point however to the inherent difficulty of such counterfactuals, especially in terms of how much of the initial environment they assume to be altered by 'full implementation' of the proposals. And should then one not also compare such a 'what if' with the alternative of full implementation of the existing institutional framework at the time?

This would be relevant in judging the effectiveness of the expenditure rule versus simply following the SGP rules in the decade leading to the crisis. Had the government simply followed the SGP rules, with the EU institutions using the monitoring tools in place at the time more effectively, it is not unreasonable to suggest that the same crisis-aversion result could also have been the outcome in Greece.

Passing from prevention to mitigation, it is clear that once in the assistance programme, Greece suffered an enormous economic and social cost. The drastic fiscal consolidation, together with the internal devaluation to balance the external account, would under any circumstances cause a steep recession; however, the almost 30% cumulative drop in real GDP during this period is far in excess of what should have been necessary, even taking into account the adverse initial conditions.

At the same time, the two additional programmes after the initial 2010 bailout are testimony to a series of failures, both external and internal. The former stretch from an initial programme design which was more a child of political realities amongst euro area countries than the result of robust economic design, to the delay in taking action on debt restructuring[2]. The latter includes an important implementation deficit, the result of the inability or unwillingness of successive Greek governments and of the entire Greek political system to take ownership of the necessary reforms.

The proposals in Bénassy-Quére *et al*. (2018) do not address issues of programme design, or equally importantly the required political economy discussion which should have accompanied the bailout arrangements to ensure that the economic downturn is not converted into an economic and social collapse, with the associated political fallout and rise in populism.

The second of the two contributions referred to in the beginning of this piece (Andor *et al*. 2018) comes closer to recognising the importance of these aspects. Proposals for a stronger macro stabilisation in the event of extreme shocks, such as a euro area-level unemployment insurance scheme, are important in this respect.

Equally important are proposals for a new form of cohesion and convergence policy for countries with competitiveness and institutional challenges. Greece is a perfect example where investments in education, legal systems and infrastructure could have made a difference.

Of the proposals in Bénassy-Quére *et al*. (2018), however, one has a high relevance to mitigating some of the adjustment costs. It is the framework involving sovereign-debt restructuring when solvency cannot be restored through conditional crisis lending.

Reducing banks' exposure to an individual sovereign (not only Greek banks in the case of government-guaranteed bonds, but also German and French ones), together with better stabilisation tools and a euro area safe asset, had they been in place at the time, would have helped euro area countries arrive faster at decisions on the inevitable debt restructuring of Greek official debt.

The two-year delay in executing the private sector involvement – what Bénassy-Quére *et al*. call a *"gamble of redemption"*, but one driven by creditors rather than Greece – weighed on the adjustment effort by making market re-entry impossible and rendering the 2012 assistance programme unavoidable.

Turning to the final issue of contagion, many of the proposals in Bénassy-Quére *et al*. (2018) would have helped avoid the Greek crisis spreading and becoming systemic in nature. A euro area fund assisting countries to absorb large economic disruptions, or a euro area safe asset offering investors an alternative to national sovereign bonds, had they been in place during the crisis, would have contributed to financial stability.

Conversely, it is harder to state definitively the impact of the sovereign-debt restructuring proposals. 'Fully implemented', they would have indeed in principle rendered unnecessary the decisions taken at the October 2010 Deauville 'walk on the beach', which effectively precipitated Ireland and Portugal into assistance programmes[3].

Full implementation, however, is not necessarily the right yardstick; we are always in a partial implementation environment, vulnerable to the political and market pressures of the moment. Even without Deauville, debt sustainability would in such crisis situations very much be 'in the eye of the beholder'. The mere existence of the mechanism could instead well have led markets to assume that Greece was simply the first of many to fall. It is difficult to gauge whether rather than acting as a stabilisation mechanism, the existence of the mechanism would in fact force its broader than intended use.

In conclusion, the proposals in Bénassy-Quére *et al*. (2018) are a welcome contribution to that delicate dance between politics and economics which has always characterised attempts to reform the euro area. Had they been in place when the Greek woes triggered the broader euro area crisis, they would undoubtedly have made for a more robust system.

It is unclear, however, whether by themselves they could have avoided the outbreak of the crisis or seriously mitigated its impact. The policy tools in place at any given moment are obviously critical; but for the eventual outcome, the defining difference may lie in the political economy of the situation. ■

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Endnotes

1. For an insider's account of the Greek crisis, see Papaconstantinou (2016).

2. While this is broadly recognised by academics and policy-makers alike, the IMF is one of the rare institutions that has attempted to provide an ex post analysis; see Independent Evaluation Office (2016).

3. The "Deauville decision" preannounced that in future, sovereign bailouts would require that losses be imposed on private creditors, and as a result drove spreads higher, arguably forcing the hand of Portugal and Ireland in requesting assistance programmes. For a more skeptical view on this, see Mody (2014).

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Euro area reform cannot ignore the monetary realm

Jérémie Cohen-Setton and Shahin Vallee write that the recent CEPR Policy Insight missed an opportunity to provide a balanced reform package

The authors of the recent CEPR Policy Insight argue that the euro area needs an alternative to the current system of fiscal rules and financial penalties to discipline fiscally wayward members. This column, part of the VoxEU debate on euro area reform, argues that by not complementing their proposals with recommendations in the monetary realm, the authors have missed an opportunity to provide a balanced reform package that would not only increase fiscal discipline and risk sharing, but also enhance liquidity provision.

The authors of CEPR Policy Insight 91 (Bénassy-Quéré *et al*. 2018) are right to argue that the euro area needs an alternative anchor than the current system of fiscal rules and financial penalties to discipline fiscally wayward members. But by refusing to complement their proposals with recommendations in the monetary realm, they miss an opportunity to provide a balanced reform package that would not only increase fiscal discipline and risk sharing, but also enhance liquidity provision. The responsibilities and operating procedures of the Eurosystem cannot stay outside of debates about the future architecture of EMU.

The view that the proposals in Bénassy-Quéré *et al*. (2018) would increase rather than decrease *"redenomination risks connected to acute liquidity and credibility crises"* (Buti *et al*. 2018) results in part from the authors' silence on the role of the ECB and national central banks in the provision of liquidity when needed. That 14 economists would have different views on the appropriate stance of monetary policy and their preferred choice of instruments is not surprising (Farhi and Martin 2018). But there should be broad agreement on some basic principles about ways to improve the lender of last resort function in a reformed EMU.

Principles for improving the Eurosystem

In our view, the following four principles should guide such rethinking:

The central bank of a monetary union should be able to backstop financial markets in sovereign bonds if it considers that panicked investors are threatening the integrity of the single currency (Eichengreen 2016). Being an unconditional lender of last resort for solvent governments (Mody 2014) – instead of making the activation of Outright Monetary Transactions (OMT) conditional on a European Stability Mechanism (ESM) programme – necessarily requires drawing a difficult line between liquidity and solvency.

If this judgement is completely left to governments, it creates a risk of fiscal dominance. If it is completely left to the ECB, it creates a risk of monetary dominance. If it is shared between several institutions, it creates risks of indecision, delays and uncertainty. Claeys and Goncalves Raposo (2018) recently proposed relying on a debt sustainability analysis, which would be done by the ESM, to determine eligibility of government bonds in refinancing operations.

There can be no such thing as the completion of the monetary union without profound reforms in the conduct of monetary operations and its interactions with fiscal and political authorities

Under the current intergovernmental structure of the ESM with unanimity, this approach seems unsuitable for OMT. But options along these lines should be explored to improve predictability of the sovereign backstop and to remove the ECB from a position where its actions can be interpreted as attempts to discipline governments[1].

Monetary policy and liquidity operations should be fully centralised and mutualised. That *"remnant[s] of national sovereignty in monetary policy"* (Draghi, 2018) still exist in the risk-sharing arrangements of the Eurosystem governing the provision of emergency liquidity (Emergency Liquidity Assistance), some aspects of its collateral framework (Additional Credit Claims), and its most important asset purchases programme (the Public-Sector Purchase Program) is troubling and should be removed. The renationalisation of these policies has limited their effectiveness and increased redenomination risks by suggesting that there could be *"conditions […] in which one [national central bank] would be reluctant to build up claims indefinitely on some other national central bank"* (Kenen 1999).

Balance sheet considerations should not constrain a central bank's ability to perform its monetary and lender of last resort functions. The current ECB doctrine on financial independence should be revised and replaced by a Fiscal Carveout,as suggested by Tucker (2018), which would specify how losses would be covered by the fiscal authority.

Alternatively, it could be replaced by a more blanket statement of support from European governments for ECB actions and the potential risks associated with them. This would make clear that recapitalisation arrangements matter not because the notion of central bank solvency makes sense, but because they reveal the sovereign's political support of the monetary authority.

The operational framework should not reinforce doom loops. Since 2005, the ECB has relied on ratings made by private credit-rating agencies to determine eligibility and haircuts. This reliance has led to abrupt swings in haircuts that have been destabilising (Claeys and Goncalves Raposo 2018). To counter some of the built-in procyclicality of its collateral framework, the ECB has often relaxed these constraints ex post by introducing waivers, lowering haircuts, and expanding the collateral pool (Cohen-Setton *et al*. 2013, Wolff 2014).

A more robust, predictable and countercyclical framework could, however, be designed to deal with these problems ex ante rather than ex post. It would also help avoid the risk of the ECB appearing politicised in its eligibility decisions.

How the Great Depression changed the Federal Reserve System

As we argue in a recent paper (Cohen-Setton and Vallée 2018), these principles draw on important lessons from the history of the US Federal Reserve System, whose initial design was also problematic and was only corrected after its failures became obvious during the Great Depression.

Because the Federal Reserve Act of 1913 created a decentralised system of 12 regional Federal Reserve Banks (FRBs) owned by commercial banks in their respective districts, risk-sharing of profits and losses linked to monetary operations did not occur automatically. In fact, what was still a decentralised system of regional central banks with 12 individual balance sheets only became de facto unified when the federal government eventually clarified in 1933 that FRBs – if faced with important losses – would *not* have to be recapitalised by the member banks of their respective districts but by the US Treasury.

In the words of President Franklin D Roosevelt, *“it [was] inevitable that some losses may be made by the FRBs in loans to their member banks […] [but] there is definitely an obligation on the Federal Government to reimburse the 12 regional*

FRBs for losses which they may make on loans made under these emergency powers. I do not hesitate to assure you that I shall ask the Congress to indemnify any of the 12 FRBs for such losses" (Silber 2009).

In fact, the preceding weeks had illustrated the extent to which autonomous regional FRBs could behave in uncooperative manners to protect their own reserves leading (Eichengreen 1992). In early 1933, a speculative attack against the New York Fed's gold reserves had led to a reduction of its gold ratio towards the statutory limit. In refusing the New York Fed's request to rediscount government securities, the Chicago Fed precipitated a cascade of state bank holidays that culminated with the National Banking Holiday (Wigmore 1987).

Only when regional monetary autonomy was eliminated[2], and when the compact between the central bank and its sovereign was clarified, did regional considerations eventually became subordinated to national ones. Together with these institutional changes, technical improvements in its operational framework were also critical in transforming the Federal Reserve into a fully-fledged lender of last resort.

Recognising, for example, the procyclical bias of a collateral framework that *"require[ed] substantial amounts of excess collateral"* (McKinney 1960) against the deterioration of economic activity, the Federal Reserve Board adopted a new regulation specifying that credit be instead extended liberally *"at times when the value of assets held by banks may be decreasing because of a downward turn in the nation's business and a decrease in the national income"* (Board of Governors of the Federal Reserve System 1937).

The initial design of the Eurosystem is stronger than that of the initial Federal Reserve System. The ECB has also clearly moved some distance to complement its framework and enhance its lender-of-last-resort function and to provide some level of backstop to the sovereign bond market.

Yet this remains incomplete and the renationalisation of some aspects of its operational framework have generated new institutional risks that need to be addressed in the context of reforms of the architecture of the euro area. There can be no such thing as the completion of the monetary union without profound reforms in the conduct of monetary operations and its interactions with fiscal and political authorities. ■

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Endnotes

1. For this same reason, we think that the ECB should no longer participate in troika programmes.

2. Between 1913 and the New Deal reforms of the Fed regional Feds enjoyed autonomy in setting discount rates, in participating in open market operations and in their lender of last resort policies.

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Europe needs a broader discussion of its future

When thinking about what will determine the prosperity and well-being of citizens living in the euro area, five issues are central. Guntram Wolff considers the CEPR Policy Insight and argues that it leaves aside some of the most crucial ones

When thinking about what will determine the prosperity and well-being of citizens living in the euro area, five issues are central. The Franco-German paper (Bénassy-Quéré *et al*. 2018) makes an important contribution to two of them but I find it overall unbalanced. Let me take the five issues in turn.

1. Providing adequate public goods

The well-being of citizens will depend on whether European institutions, together with national institutions, will provide European public goods. Yet the debate on these issues is often superficial. How to provide border protection, fund immigration, how to divide national and European competences or how to advance the Single Market are topics often lacking thought leadership.

One may argue that such public goods are not directly connected to the euro. Yet, political cohesiveness crucially depends on them. And without political cohesiveness, the foundations of the euro will be more fragile than ever. Moreover, public goods often play a role in macroeconomic stabilisation as Bénassy-Quéré *et al*. acknowledge but unfortunately don't pursue. To my mind, the political debate rightly puts a strong focus on these issues at this stage[1].

2. Ensuring that the fiscal stance of the euro zone is appropriate when monetary policy is at the zero lower bound

One of the key reasons for the dissatisfactory macroeconomic performance of the euro area has been its inability to run a sensible fiscal policy for the euro area as a whole. It is well established in standard macroeconomic models that when monetary policy hits the zero lower bound, the role of fiscal policy becomes more important in ensuring a proper macroeconomic stabilisation. Without proper macroeconomic policy, recessions will be deeper than necessary, unemployment will be higher and hysteresis effects in labour markets can lower growth potential for many years to come.

The EU's institutional set-up ignores this issue and there is no mechanism to ensure that the sum of national fiscal deficits makes sense for the euro area as a whole. International institutions such as the IMF have repeatedly asked stronger countries to contribute more to fiscal stabilisation in the recession years.

Attempts to address this institutional weakness have gone nowhere. Unfortunately, Bénassy-Quéré *et al*. put the topic aside and do not confront the significant political resistance on the issue – a missed opportunity to shape the debate. For example, one could propose to amend the expenditure rule and increase expenditure in countries with fiscal space when monetary policy is at the zero lower bound (Claeys *et al*. 2016).

Europe needs to discuss the broader horizons of its future. The starting point needs to be an understanding that a shared currency comes with many spill-overs and therefore shared responsibilities

3. Ensuring that macroeconomic imbalances and structural weaknesses are addressed

One of the key fragilities of the euro area is the fact that prices and wages have diverged so substantially across different countries. The past divergence in the smaller countries of the euro area has been addressed as they have adjusted to the euro area's core. But the divergences between Germany, France, and Italy remain a major liability.

Adjustment is ongoing, but at a low inflation rate and slowly. The low inflation rate of the euro area has made relative price adjustment more painful, forcing some countries to be close to deflation. As real rates rise as a consequence, the debt burden increases, weighing further on economic performance. Debt-deleveraging in a low-inflation environment is difficult and painful.

Addressing these significant divergences more quickly and with a lesser economic cost requires bold structural and macroeconomic policies at the national level. It requires an acceptance in the national political debates, including in Germany, that national structural and macroeconomic policies matter not only for the domestic economy but also for the euro area as a whole.

It remains a key priority that Germany addresses its low investment, France its overly high and inefficient government expenditure, and Italy its low productivity growth and the weakness of its institutions. Failing to address any of these issues will mean a structurally weak euro area that remains fragile and susceptible to further crises, no matter what is achieved as a compromise on how to deal with sovereign debt. These issues deserve academic debate, which I had hoped my 14 colleagues would bring.

4. Completing banking union and advancing capital markets union

The most convincing section is that on banking union. The idea of sovereign concentration charges (Veron 2017) is well thought through and would reduce the link between banks and sovereigns without creating major financial instability. The introduction of a European deposit insurance scheme – once exposure to sovereign debt is reduced and legacy problems with non-performing loans are addressed – is also sensible. Differentiating the fee structure for the insurance according to country characteristics would sensibly acknowledge that we remain a union in which country policies matter for banks despite being in a banking union.

Yet, one should not claim that introducing such insurance is a major concession by stronger to weaker countries. Introducing insurance after legacy issues are addressed and allowing for differentiated fees depending on risk is just simple, good-sense economics.

Unfortunately, it also means that banks in countries with weaker institutions will continue to face higher costs of deposit financing (Wolff 2016). This would cement funding-cost differences for banks across countries, but it would usefully preserve incentives to improve country institutions. It may also be the necessary political condition to get insurance introduced. Overall, it should not be considered a substantial concession to the weaker countries as many strings have been attached.

In terms of political economy, the spreading of sovereign debt across euro area countries may make debt restructuring more difficult though. The financial system may be more easily able to cope with the restructuring when the debt is widely spread in the system, but influential owners of debt in many countries would be affected and will make their political influence heart.

Still, completing banking union with such deposit insurance and fiscal backstop to the resolution fund would increase the financial stability of the euro area and should therefore be pursued. Banking union should be complemented with strong steps that would make capital markets union a reality (Sapir *et al*. 2018).

5. Dealing with sovereign debt

The core of the paper is about how to reconcile risk sharing with market discipline and here the paper makes an important contribution. It takes up a strand of work that was perhaps first advanced by the Glienecke Gruppe. My main concern is that the paper is not sufficiently courageous in arguing the case for significant integration steps needed to manage the consequences of major debt restructuring. In particular, banking union would not be sufficient to ensure that the economic and political fall-out of a major debt restructuring would be manageable and the other parts of the proposals appear too half-hearted and weak to manage such fall-out.

I have two main worries in this section. The first is that the paper is explicit about debt restructuring with clear criteria that would remove current constructive ambiguity on when such restructuring would happen. This would mean that market participants can more easily calculate when and how to speculate against a country. Earlier market panic is a likely result.

It is notable that the Outright Monetary Transactions (OMT) programme is not explicitly mentioned. Willingly or not, this creates an imbalance where debt restructuring is explicit while OMT is at best implicit. Yet, a euro area without OMT or a true safe asset would be susceptible to bad equilibria problems. (A small rainy-day fund is hardly worth mentioning in this context). Removing constructive ambiguity and not mentioning OMT and the conditions under which it is used could render the euro area more fragile.

Second, I missed a more comprehensive discussion of the implications of debt restructuring in a major country. The authors somehow lightly discuss debt restructuring but do not seem to reflect much on its major consequences. Cruces and Trebesch (2013) find that restructurings involving higher haircuts are associated with significantly higher yield spreads and longer periods of capital market exclusion. Trebesch and Zabel (2016) find that hard defaults are associated with steep output costs.

The authors suggest that the ESM could ensure the funding for the basic provisioning of public services and the support needed to reduce the impact on the economy. Yet, the ability of the ESM to fund a major country for several years after a restructuring may be more limited than the authors assume, at least in the absence of the ECB's OMT and in the absence of the IMF. Contagion effects to other countries may further erode the capacity of the ESM. The proposals to experiment with a synthetic safe asset would also not help in providing funding to a country in difficulties. The ESRB report on ESBies (ESRB 2018) even acknowledges that countries losing market access would be excluded from ESBies.

All of this does not mean that debt restructuring cannot and should not be a measure of last resort. In fact, the ESM treaty does foresee it and bond spreads currently do price risk. But it is a measure of very last resort and constructive ambiguity currently prevents unwarranted market speculation. If it had to happen in a major country, major political decisions would be needed to preserve stability.

Europe needs to discuss the broader horizons of its future. The starting point needs to be an understanding that a shared currency comes with many spill-overs and therefore shared responsibilities. It is about keeping one's own house in order but also about taking into account effects on neighbours of one's own policies. ■

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Endnotes

1. See for example Emmanuel Macron's speech at the Sorbonne or Mark Rutte's speech in Berlin.

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Analysis of the proposal: 'A constructive approach to euro area reform'

There is currently both an economic and a political window of opportunity for reform in the euro area. Andrew Watt discusses the strengths and weaknesses of recent proposals and makes recommendations for extensions and alternatives

A group of 14 prominent economists, seven each from France and from Germany, has issued a detailed and rather comprehensive proposal for reform of the euro area (Bénassy-Queré *et al*. 2018). This is a welcome initiative. There is currently both an economic and a political window of opportunity for reform in the euro area. Following the structure of the paper itself, I discuss strengths and weaknesses of the proposals and make recommendations for extensions and alternatives.

Underlying philosophy and problem analysis

The basic philosophy underlying the report is to strike a balance between risk sharing or collective insurance (identified as the 'French view') and rules and market discipline that ensure 'sound' domestic policies that make crises impossible (identified as the 'German view'). The authors argue that, provided they are carefully designed, risk-sharing measures can minimise moral hazard issues and may actually be necessary to enable the imposition of rules because they reduce contagion from one country to others, and thus prevent a country from holding its partners to ransom.

The report identifies the so-called doom loop between national banking systems and sovereigns and a lack of stabilisation capacity as the main weaknesses of the euro area. While valid, this does not get to the heart of the two fundamental problems. At the euro area level, first, there is an insufficient capacity in times of crisis to keep aggregate demand in line with potential. The mechanisms to set and enforce an appropriate aggregate fiscal stance are, at best, weak. And, as the crisis showed, the ECB, facing a multitude of fiscal actors, has more difficulty than other central banks in taking the required measures.

Second, the mechanisms to avoid and correct competitive and macroeconomic (current account) imbalances between the member states are too weak given the powerful mechanism of procyclical differences in real interest rates resulting from differences in inflation rates.

In short, a lack of effective cooperation between central monetary and the multiple actors responsible for fiscal and other national policies, including wage setting, make it very difficult to stabilise national economies and rapidly and effectively combat crises.

The financial proposals

In line with the importance given to the doom loop between banks and sovereigns, financial-sector reforms – including bail-ins of bank bondholders, de-privileging government bonds, and a common deposit insurance scheme with country-specific experience rating – occupy a prominent position in the proposals.

The team of French and German economists is to be congratulated for the attempt to put together a package of measures that is effective in stabilising the euro area, internally coherent, and politically feasible

Achieving an adequately backstopped (ie. through the ESM) common deposit insurance and a harmonised resolution regime would be important steps in stabilising the euro area financial system. The bail-in principle has risks, though: if retail investors suffer severe losses, the real-economic impact can be very counterproductive for restoring economic growth (which is a condition for stabilising the banking sector).The authors do not sufficiently appear to take account of the fact that, rather than improper regulation or an excessively close bank-sovereign link, banking sector problems in some countries are a direct consequence of prolonged contraction or stagnation of the real economy; the source not the symptom of this problem needs to be addressed.

The recommendation to differentiate premiums to the deposit insurance scheme to reflect perceived country risk seeks to address moral hazard (and political obstacles), but it also imposes longer-term costs on already – as a legacy of the crisis – weaker countries. At a minimum, some collective efforts to resolve the legacy non-performing loan issues are required to enable countries to start with a clean slate.

The measures to increase geographical diversification of banking assets and to develop Capital Markets Union reflect a belief that international portfolio diversification and private capital flows have substantial stabilising properties. There is good reason to be sceptical, however (Dullien 2017). Indeed, the securitisation schemes at the heart of the Capital Markets Union (CMU) may pose detabilisation risks (Theobald *et al.* 2017).

The fiscal proposals

The most important reform proposals are to be found in the area of public finances and the governance of fiscal policy. The starting point is that the fiscal rules are badly designed, complex, and virtually unenforceable.

While this is correct, the authors retain the basic philosophy of limiting public deficits and reducing debts in the medium run. What is needed is to achieve an appropriate fiscal stance in aggregate, but also in each member state. For the latter, the output gap and the competitive position are decisive and these must be analysed in a symmetrical way. Deficits can be too low (or surpluses too high).

The proposed shift from a focus on (cyclically adjusted) deficits to an expenditure rule is welcome. No fiscal rule is perfect. At least non-cyclical expenditure can be readily measured, and is under government control. However, the focus on convergence to an arbitrary debt-to-GDP target should be downplayed in favour of nationally specific targets that emphasise counter-cyclicality and symmetry; current-account-surplus, low-inflation countries must be constrained to expand aggregate demand and allow upward adjustment of nominal wages and prices.

Care must be taken using nominal GDP so as to avoid procyclicality. A higher inflation rate implies higher nominal GDP growth, implying more space for government spending. Yet an important lesson of the crisis is that higher-inflation countries need to run tighter fiscal policy. It should also be considered to enrich the expenditure rule by differentiating spending categories so as to privilege productive investment, ie. combining it with some version of a golden rule (Truger 2016).

The ex post punishment regime has indeed failed. Far-reaching policy federalisation or at least rules providing for a progressive takeover of national policymaking competences in the case of repeated flouting of agreements (as in federal states), while they would be effective, are almost certainly a political non-starter at the current juncture. As such, the differentiated stick and carrot approach set out in the report has, in principle, much to recommend it. Imposing 'market discipline' on government bonds without a backstop has potentially massively destabilising impacts, however (Lindner 2018, Watt 2017).

If it is applied only to new government spending that is in contravention of agreed (and broadly sensible) principles – as with the junior bonds proposed in the paper – it could serve as an effective control mechanism. If risk sharing is extended, there certainly has to be some reliable way to constrain national fiscal policy. Any drawbacks of the partial introduction of market discipline need to be weighed against those of possible alternatives.

However, such an approach should only be considered if the existing stock of sovereign debt, and also new bonds issued within the agreed limits, are not subject to restructuring; they should continue to have zero weighting and the ECB should be able to purchase them on secondary markets so as to keep spreads within tight limits. The paper is ambiguous on this point. The section on financial markets implies increased use of collective action clauses and thus greater possibilities for restructuring. That would be highly destabilising.

It seems that the only protection for outstanding and new bonds will be to the extent that they are securitised into ESBies. It is by no means clear that such untested collateralised financial products would really guard against 'skittish' market forces destabilising countries. There is no discussion of the size of the ESB market – specifically how to get a senior tranche that is both safe and large, given a small number of mutually correlated securities – nor of a possible stabilising role for the ECB and whether ESBies would be a tool for quantitative easing or other monetary policy measures in the future. At the very least it seems that a disproportionate degree of faith is placed in this measure, the practicalities of which are barely discussed.

The authors accept the need for a euro area fiscal capacity. This is welcome. The version proposed is unnecessarily restrictive, however. Differentiated contribution rates will (here too) penalise the countries who have suffered most in the recent crisis. There is no obvious reason why such a fund should be pre-financed; collectively, the member states are not like households or firms. An ESM credit line with appropriate conditionality would suffice, if the ESM can freely issue bonds (which can be purchased by the ECB to the extent that its inflation mandate allows). Again, the exaggerated concern with moral hazard leads to a serious risk that countries getting into difficulties will at some point transgress against the expenditure rule, will lose access to the various support measures, and will be faced with debt restructuring. Knowledge of this fact will induce anticipative speculation. Such a currency union is fundamentally unstable.

Overall assessment and proposals

The team of French and German economists is to be congratulated for the attempt to put together a package of measures that is effective in stabilising the euro area, internally coherent, and politically feasible. That is a tall order and any critic must recognise the scale of the challenge. To conclude, I focus on suggestions as to where the package needs to be extended or adapted.

Much of the underlying problem analysis is correct, although in some areas it is limited. The downplaying of the inherent tendency to competitive and current account imbalances ('rotating slumps') is a serious shortcoming. The proposed policy package attempts to overcome the 'discipline through punishment' approach, which has manifestly not worked, without far-reaching federalisation, which seems politically infeasible.

At the same time, it fails to adequately address some important issues and the proposals are skewed – notwithstanding the claim to be a marriage of the risk-sharing and disciplinarian approaches – in favour of the latter. The excessive concern with 'moral hazard' issues in a number of areas prevents a clear line being drawn under the crisis.

Under the various strictures imposed on them (such as higher interest rates and fund contributions), those countries hit hardest by the crisis will struggle to develop, while those that have emerged from the crisis comparatively unscathed will not be so encumbered. Countries facing higher costs will constantly be confronted with the question of whether they are not better off regaining their own monetary autonomy. Thus the future of the common currency will continually be in doubt (Watt 2017).

If the proposals are to be taken as a point of departure, important changes and extensions would be needed, including notably:

- Solutions need to be found to legacy issues in vulnerable national banking sectors with a collective element.
- The European fiscal capacity should not take the form of a rainy-day fund but a lending capacity by the ESM.
- Any creation of junior bonds must go hand in hand with effective measures to ensure that existing government bonds and new issues under the spending rule are risk-free and thus removed from the threat of destabilising speculation.
- National fiscal stances must be set with much greater regard to safeguarding public investment and to ensuring symmetrical counter-cyclical stances at national level and thus their coherence at the aggregate level.
- To this end it is vital to reform the Macroeconomic Imbalance Procedure to ensure it is symmetrical vis-à-vis deficit and surplus countries and its application to the entire macroeconomic policy mix. Koll and Watt (2017) and Horn and Watt (2017) propose developing the new national productivity boards into a platform for macroeconomic expertise and extending the existing Macroeconomic Dialogue (MED) at the EU level also to the euro area and national levels. Alongside fiscal policy, the MED brings in the social partners and the national central banks. Fiscal, incomes and macroprudential policies can be thus be better aligned towards growth and stability-oriented and mutually consistent stances. Ownership of agreed targets is increased. This approach emphasises the preventive rather than corrective approach, and would reduce the need for disciplinary measures inspired by a fear of moral hazard. ■

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A plan to save the euro

For the euro area to be stable and move forward productively substantial improvements in its operation are required, argues Jeffry Frieden

The mismanagement of the euro area debt crisis has been the gravest failure in the history of European integration. Inaction, misguided action, contradictory policies, and political conflict turned a manageable debt problem into a decade of economic stagnation, social upheaval, and political protest.

The economic and social impact of this bungled crisis has contributed mightily to the rise of populist movements that challenge the euro, and European integration more generally (see Algan *et al*. 2017 for one among many surveys).

For the euro area to be stable and move forward productively requires substantial improvements in its operation. It is unlikely that the euro could survive another crisis like the one from which it is just (barely) emerging.

This makes it particularly important to evaluate the proposal from 14 leading French and German economists to reform the euro area in a way that they say combines risk-sharing and market discipline (Bénassy-Quéré *et al*. 2018). It also makes it particularly important to understand the political need for reform, and the political conditions any meaningful reform has to address in order to be successful.

There are several points worth making if we want to understand the current political economy of euro area reform.

1. Most residents of the euro area remain positive about the monetary union.
Even in the most heavily affected debtor nations, support for monetary union never fell below 50% of the population, and was typically closer to 70%. However, Europeans have little faith in the willingness or ability of existing political leaders to manage it fairly and efficiently: debtor-country citizens' confidence in the institutions of the EU dropped from over 70% before the crisis to barely 20% during it (eg. Foster and Frieden 2017, Frieden 2016).

2. The central failure of crisis management was the inability to arrive at a reasonable distribution of the adjustment burden.

As in all debt crises, a major axis of conflict has been between debtor and creditor countries over how to distribute the pain. Creditors wanted debtors to make the sacrifices necessary for prompt and full debt service payments; debtors wanted creditors to play their part in helping reduce the political and social costs of austerity. And in this crisis, like most other debt crises, there was also a domestic axis of conflict. Citizens of debtor countries battled over

... the proposals in the recent CEPR Policy Insight are necessary if the euro area is to avoid another catastrophic crisis and that they would go a long way towards addressing the legitimate concerns of citizens in both the core and periphery of the euro area

who would make the most sacrifices to satisfy creditors; and within creditor countries, the dispute was over whether taxpayers, financial institutions, or others would pay whatever price there might be for a settlement. As it turned out, in this debt crisis the vast majority of the adjustment was done by the debtors, and there was no serious debt restructuring (Greece was an exception, given the clear impossibility of servicing its debt as contracted).

Citizens of the debtor nations, quite reasonably, resent bearing the lion's share of the burden of adjustment, despite the fact that lenders were at least as responsible for the accumulation of bad debts. Citizens of creditor nations, quite reasonably, having been largely misled by their governments about the true nature of the crisis, resent the use of taxpayer money for purposes never made clear to them.

And the sad fact is that much of this suffering, and much of this bitterness, was avoidable. Prompt debt restructuring, with creditor financial institutions sharing the sacrifice with debtor nations, might well have reduced the likelihood of the ten years of stagnation that ensued, of the vicious political standoffs that continue to hamper progress in the euro area, and – not incidentally – of the rise of dangerous strains of populism throughout the region.

3. The principal culprits in the mismanagement of the crisis have been national governments, not European institutions.

Certainly, the construction of the euro area left many important issues unresolved, and the euro's inadequacies deepened the impact of the crisis. However, when the crisis hit it, was not primarily the institutional inadequacies of the euro area that failed its people. It is true that the principal euro area institution, the ECB, could have played a more positive role at the outset of the crisis; but eventually, after 2012, it performed reasonably well.

However, it was first and foremost the member states that came close to destroying the euro. At almost every turn, member states attempted to shift the burden of adjustment onto others, missing opportunity after opportunity for a less costly resolution of the crisis. Almost from the moment the crisis broke, the governments of the principal nation states stubbornly resisted attempts to find cooperative strategies to address the debt problem. The tragedy is that the more these conflicts delayed constructive policies, the more the costs of the crisis rose. A quicker resolution of the crisis with more burden-sharing would almost certainly have been in the interests of all member states.

For the euro area to move forward, its member states have to overcome the existing stalemate. The gridlock hampers both the resolution of the remaining debt overhang – which continues to exert a drag on the region's recovery – and the reform of euro area institutions. This reform needs to address some of the principal gaps in the monetary union's construction; and, perhaps more important, it needs to provide assurances to the citizens of the euro area that it will be managed more responsibly in the future.

What are the principal, legitimate, concerns of the euro area's citizens? Those in the peripheral, debtor countries see the euro area as a mechanism to impose austerity on them. They believe that the creditor countries have used their massive bargaining power to force onto the borrowers virtually all of the burden of dealing with the fallout from a decade of irresponsible lending. For their part, citizens of the core, creditor nations see the euro area as a mechanism to force them to send their money to dissolute southern Europeans, to turn the euro area into a transfer union. There is some truth in both sets of beliefs; but, of course, both are misguided.

What, then, are the economic policy and political tasks faced by the member states?

Any serious reform needs to prove to citizens of the indebted, crisis-ridden periphery that the institutions of the euro area – and, most important, the other member states – will take seriously their legitimate concerns. This means ensuring that the creditor nations take on at least some of the sacrifice necessary to wind up the ongoing crisis – and that future crises will be resolved in a more timely and equitable manner.

By the same token, any serious reform needs to prove to citizens of the core, creditor nations that the institutions of the euro area – and, most important, the other member states – will undertake serious reform measures to avoid a recurrence of the current disaster. This means ensuring that the peripheral nations undertake a credible commitment not to abuse the common pool components of a monetary union in order to engage in uncontrolled and unjustified borrowing and spending.

Would the measures suggested by the current reform document accomplish these tasks? To a large extent, they would. The proposals for a meaningful mechanism to restructure troubled debts, along with a common deposit insurance scheme, would help guarantee that the risks inherent in lending among euro area members would be more equitably shared. A strengthening of the banking union, of common regulation, and of mechanisms to bail in creditors of failing banks, would all go in this direction as well.

On the other hand, sovereign concentration charges would limit opportunistic behaviour by debtor sovereigns and banks; and a more reasonable – hence credible – system of fiscal and debt oversight would limit excessive sovereign borrowing. This would complement a reform of relevant euro area institutions, first and foremost of the ESM, to play a more consequential part in monitoring the operation of the monetary union.

So the reform proposals are eminently reasonable. They are, more to the point, necessary if the euro area is to move forward without risking another catastrophic crisis. And they would go a long way towards addressing the legitimate concerns of citizens of the euro area, core and periphery. This in turn would help limit the ability of anti-European populists to point to the disastrous mismanagement of the crisis as evidence for their rejection of European integration.

Whether these reform proposals are politically feasible is another matter. Perhaps growth will soften hearts on all sides of the bargaining table. Perhaps, also, the continuing and escalating economic policy threats from the Trump administration will lead to a greater sense of solidarity among the EU's member states.

Progress in this direction is certainly to be desired. Failure to move forward with a reform of the euro area now may lead to its collapse in the future. ■

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Blind spots of the 14 economists' Policy Insight

Sebastian Dullien argues that the recently published CEPR Policy Insight leaves too many questions open and fails to address a number of central problems of EMU architecture

After months of tedious negotiations between its mainstream parties, Germany has finally managed to get a new working government. With a delay of almost half a year, the debate on the reform of the euro area is thus to start in earnest.

For this debate, the recently published CEPR Policy Insight (Bénassy-Quéré *et al*. 2018) will certainly be a major point of reference. The authors, a group of 14 well-known and well-connected German and French economists, present their package of reform proposals as compromise paper taking into accounts concerns of both the 'French position' as well as the 'German view' and, politically, from economists from the left as well as from those from the right.

The authors make the basic point that the euro area needs both risk sharing and risk reduction (or crisis mitigation and crisis prevention), and that reforms need to make progress on both fronts in order to be acceptable to both Germany and France.

In short, they propose the following measures:

- Completion of the Banking Union: cleanup of banks' balance sheets; streamlining and strengthening the framework for bank supervision and bank resolution; establishment of a common deposit insurance with the ESM as a backstop; removal of obstacles for cross-border bank mergers; strengthening of the bail-in requirements in cases of bank restructuring.
- Completion of the Capital Union
- Reform of the treatment of sovereign bonds in banks' balance sheets: regulations to limit banks' exposures to government bonds; creation of European Safe Bonds (ESBies), structured credit products based on a portfolio of sovereign bonds
- Reform of fiscal rules: nominal expenditure rules instead of deficit rules; spending overshoots will have to be

covered by junior sovereign bonds which will be restructured first in times of payment difficulties

- Facilitating sovereign debt restructuring: changes in voting rules to make holdouts less likely; automatic extensions of junior bonds' maturities when a country receives an ESM loan
- Reform of ESM governance
- Fiscal capacity for the euro area: a fiscal stabilisation scheme (or unemployment reinsurance) offering one-off transfers to national budgets in case of deep recessions

Many of the package's elements make sense. No one can really oppose the cleaning up of banking sectors still burdened by large amounts of non-performing loans, nor turning the ESM into a fiscal backstop for a common deposit insurance. Also, streamlining the decision procedures and strengthening the competencies of the ESM is a no-brainer.

... the package contains a lot of good ideas, it will hopefully not be taken at face value by politicians

Nevertheless, as a whole, the package is not convincing. In the end, too many questions remain open, and the package fails to address a number of central problems of EMU architecture.

The three most important problems are that the package:

- does not address the issue of boom-and-bust cycles in the euro area;
- puts an excessive trust in the ability of financial markets to stabilise national economies and to discipline governments in a sensible and desirable way; and
- proposes fiscal rules and rules for sovereign debt restructuring which run the risk of reducing governments' policy space.

Let us start with the problem of boom-and-bust-cycles. The package does not address the argument that EMU might have led to longer and deeper national business cycles. In a monetary union, all participating countries have to live with the same nominal central bank interest rate. If cycles are not completely synchronised, this interest rate will always be too low for some countries and too high for others.

If a country is in a boom, inflation in this country will pick up and the common nominal interest rate will translate into a lower real interest rate, further fuelling the boom. If a country is in a recession, inflation will fall. This will increase the real interest rate and prevent a quick recovery. Overall, this leads to longer and deeper business cycles, with overheating booms and long recessions or at least periods of stagnation.

This logic is important as in all countries affected by the euro crisis (maybe with the exception of Greece), boom-and-bust-cycles played a central role. Both Spain and Ireland experienced a real estate boom prior to the crisis. The construction sector of these countries expanded strongly, and wages and consumption increased. The good labour market situation attracted immigrants, the demand of which further increased real estate prices. As the ECB could not react to the overheating of these economies (but had to set its interest rate with regard to the whole euro area), the boom ran much longer than it otherwise might have. While the construction sector grew far beyond its normal (or appropriate) size, export competitiveness deteriorated.

Problems in the Irish and the Spanish economies emerged when the boom came to an end and the real estate bubble deflated. Suddenly, banks were faced with large amounts of non-performing loans and, as a consequence, they cut back lending. Consumption, employment and tax revenues imploded. And as national governments were seen as responsible for bailing out banks, the banking crisis turned into a sovereign debt crisis.

The paper by the 14 economists addresses this problem only by asking for the completion of the Banking Union. The implicit hope here seems to be that under better supervision, in the future banks will not fuel real estate bubbles again. Moreover, in the future, European institutions will provide funds so that even severe national banking crises can be solved by resolution and recapitalisation without pushing national governments to the brink of default.

Yet, it is highly questionable whether all this is sufficient to prevent deep boom-and-bust cycles at the national level in the future. Historically, in major economies, even after reforms, banking regulation and oversight has not been able to permanently prevent real estate bubbles. Moreover, it is unlikely that a resolution of banks in Ireland and Spain according to the new rules would have prevented the deep downturn these countries have experienced.

It is even questionable if under a completed banking union, Spain would have dodged the confidence crisis in its sovereign bond market. From 2007 to 2016, Spanish public debt increased by €723 billion. The fiscal cost of bank restructuring in Spain has last been estimated to have been slightly more than €40 billion. It is plausible that markets would have turned against Spain even without this extra €40 billion of additional public debt.

The authors of the Policy Insight might claim that their proposed fiscal stabilisation scheme could have helped. According to their proposal, countries in which unemployment rises in a single year by more than a certain number of percentage points (they propose a threshold of two percentage points) would receive a one-off transfer.

However, upon closer inspection, it quickly becomes clear that the proposed scheme is much too small to be able to have a significant impact. First, pay-outs are supposed to be capped above a certain amount, and second, if a number of countries go into a recession simultaneously and reserves are not sufficient, pay-outs are scaled down to prevent the fund having to go into debt.

A simple rule-of-thumb calculation with the parameters proposed by the 14 economists yields that this scheme would not have made much difference in the case of Spain and Ireland. Over the whole crisis period, in an ideal case, Spain would have received a total of about 1.3% of GDP (roughly €14 billion), and Ireland of less than 1% of GDP.

If one puts these numbers into comparison with the drop in tax revenues (Spain's annual tax revenues after 2007 dropped by about €70 billion, or 7% of GDP), one quickly sees the inadequacy of this proposed scheme. Again, the transfers would hardly have made any difference in terms of debt sustainability.

One gets the impression that the 14 economists here have thrown out the baby with the bathtub. Being afraid of moral hazard in a transfer system, they have shrunk it to a level at which it does not yield any real benefits anymore.

Some economists might claim that the proposed completion of capital market union would do the trick. The hope here is that more cross-border financing outside the banking system might help to bolster growth in times when domestic investors and banks cut back lending. Yet, while the hypothesis of cross-border financial market integration as a stabilisation tool is very popular, it is empirically questionable (see Dullien 2017). Instead, most empirical evidence points to cross-border capital flows being extremely pro-cyclical. In the run-up to the euro crisis, foreign capital propped up real estate bubbles. When the crisis hit, these flows quickly dried up.

This links to the second major criticism. In many aspects, the 14 economists count on financial markets to stabilise economies and correctly discipline governments. The central idea of forcing governments to finance overshooting expenditure with junior bonds is that markets will allow such borrowing if the funds are put to good use and prohibit this borrowing if funds are wasted. Yet, as we have seen prior to the euro crisis, in good times, financial markets tend to lend to governments irrespective of imbalances (as they did to Greece), while in bad times, they might cut off financing indiscriminately.

The third problematic point is the facilitation of debt restructuring and the automatic maturity extension which could actually make sovereign debt crisis more likely, not less likely, relative to the status quo with ESM and OMT in place.

The underlying idea of the 14 economists is that public expenditure (except cyclical costs for unemployment and interest rate) above a certain nominal public expenditure path has to be financed by junior bonds which can easily be restructured and the maturity of which is extended automatically if the country gets an ESM loan. The expenditure path is to be set taking into account potential growth rates, and would be lower for countries with large debt-to-GDP ratios.

In principle, the public expenditure rule has the advantage over the current rules that fiscal policy most likely would be less pro-cyclical. However, the automatism of maturity extension carries the risk that it actually creates new incentives for speculation. According to standard procedure, rating agencies would count a maturity extension as 'default'. Hence, if fears of an ESM programme grow among market participants, they will have an incentive to dump these bonds, pushing up the interest rate and potentially cutting countries off from market access. This might then make the ESM programme necessary, and turn the fear of debt restructuring into a self-fulfilling prophecy.

As a result, one could expect more frequent, smaller-scale sovereign debt restructurings in the euro area which actually make the expenditure path a hard boundary. Hence, over time, the 60% debt-to-GDP threshold of the Maastricht Treaty would finally be enforced.

However, whether this leads to better economic policy in the euro area is questionable. The 60% threshold always has been arbitrary. Pushing highly indebted countries today quickly towards this threshold by limiting public expenditure growth would mean years of constrained public expenditure, and because of political economy considerations, it is likely that this will first be seen in further cuts to public investment. (The 14 economists might argue that countries could still increase taxes to finance more public investment, but empirical evidence with expenditure rules like the PAYGO system in the US in place during the 1990s shows that these rules carry an inherent bias to cut public investment). Given that public investment in the euro area is already at a record low, and given the fact that demand for government bonds overall remains strong, it is questionable whether such a strong push for a quick return to a debt-to-GDP level of 60% is sensible.

So, in conclusion, while the package contains a lot of good ideas, it will hopefully not be taken at face value by politicians. A compromise between the archetypical German and French position might have the virtue that it has better chances of being implemented. However, if the compromise is struck at the expense of adding some elements to the euro area architecture which will weaken the already wobbly structure, it might not be worth implementing it. ■

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Beyond risk sharing and risk reduction

Rafael Doménech, Miguel Otero Iglesias and Federico Steinberg argue that this risk can only be tackled with common instruments and policies at the European level, whose mere existence will reduce not only its magnitude but also its asymmetric consequences

The euro remains a vulnerable construction. Despite the enormous progress in improving its governance achieved in the last years, its present architecture cannot ensure its long-term survival (Matthijs and Blyth 2015). Much more needs to be done, and the June summit is an opportunity that we cannot afford to miss to advance towards a more genuine monetary, fiscal, economic, and political integration.

The European Commission's reflection paper for deepening EMU (European Commission 2017) and the recent proposal by 14 French and German economists (Bénassy-Quére *et al*. 2018) on how to reconcile risk sharing with market discipline have revitalised an intense debate on euro area reform. A recent manifesto, signed by more than 20 Spanish experts (Almunia *et al*. 2018), contributes to this debate, emphasising the need of deeper integration beyond the narrow view in some quarters of just completing the banking union and using the ESM as a bank backstop, both necessary in the short run but not enough in the long term.

As the manifesto points out, in the long run *"there needs to be further fiscal coordination and discipline and a joint facility for macro stabilisation within the currency area, an unconditional lender of last resort and an effective mechanism to break the link between banks and sovereigns, ensuring financial stability, more effective macroeconomic surveillance and coordination, and greater legitimacy in the overall governance structures"*.

However, this cannot be achieved overnight. European construction only moves forward in small, gradual steps. That is why, from the political point of view, it would be a great achievement if all EMU countries could agree that the above-mentioned list constitutes indispensable long-term goals, and then build a strategy to achieve them gradually with consistent steps in the short run. In this vein, Buti *et al*. (2018) have stressed the need for a *"coherent and well-sequenced package, avoiding unsafe steps in the dark"*. A shared and clear vision on the euro's end goals would make the long journey towards deeper economic and political integration easier and help re-establish trust between the member states. In other words, the principle of 'ever closer union' of the first architects of EMU cannot be lost (Dyson and Maes 2016).

We share with the French and German economists' proposal the view that risk sharing and risk reduction need to proceed simultaneously. In fact, the interconnection between the euro area countries' economies is so intense

Deepening of EMU cannot wait until all countries have carried out all their domestic reforms, both risk sharing and risk reduction need to proceed simultaneously. In fact, all euro area countries are exposed to the risk of an incomplete monetary and economic union but with very asymmetric costs that they already share many risks, but they do not yet share the costs. Many of these risks (geopolitics, terrorism, globalisation, protectionism, digital revolution, demography, immigration or climate change, among others) may have significant economic, social, and political consequences. They require a proper response by the EU and EMU in particular, and the improvement of their institutions and governance.

In the case of EMU, as the sovereign debt crisis highlighted, most of the challenges and structural problems can only be tackled with common instruments at the European level, whose mere existence would reduce the risks and their effects. As Lane (2012) and many others (eg. Doménech and González-Páramo 2017, Martin and Philippon 2017) have noted, the differences in the response to the financial crisis between the US and EMU appeared after 2010, when the euro area experienced sudden stops, financial fragmentation, and sovereign debt crises coupled with the redenomination risks of national currencies and the potential breakup of the currency union.

Despite all the important advances in recent years, the redenomination risk is likely to remain a major problem if EMU institutions, rules and governance are not improved (Bini Smaghi 2018). This is a risk that Benassy-Quéré *et al*. (2018) tend to underestimate.

The need for a central fiscal authority

In the long run, the euro area needs a central fiscal authority (CFA) with its own sources of revenue and the ability to issue joint debt. We understand that this institution will not fit easily in the currently existing governance structure. That is why we suggest that its president be proposed by the Eurogroup to become the Commissioner for the euro and that a newly created Committee for EMU affairs in the European Parliament specifically ratify his/her appointment to ensure democratic legitimacy.

Input legitimacy at the European level is important because the CFA's president, who would be in fact the euro finance minister heading an embryonic euro area treasury, would be responsible for enforcing fiscal and macroeconomic rules. These rules, which should be simplified, as suggested by Bénassy-Quéré *et al*., have to be more credible, and should be monitored at a technical and independent level by a reformed Fiscal European Stability Board (FSB) that would absorb the current ESM and integrate it into EU law.

Despite significant progress in fiscal and macroeconomic governance, countries still have incentives to delay fiscal consolidation as much as possible. There is still a widespread view in Europe that the main problem is the lack of willingness or inability of countries to comply with the rules. Nevertheless, experience shows that even strict adherence to fiscal rules (which is clearly necessary) is insufficient to guarantee a well-functioning and stable monetary union.

Going beyond the existing intergovernmental structures of the Eurogroup and the ESM within EMU would facilitate both decision making and legitimacy. We need a common European approach, not that of 19 European countries. The FSB would, therefore, be in charge of the technical analysis of macroeconomic and fiscal stability, while the CFA would take the ultimate political decisions on these matters under the following incentive and governance structures – countries that abide by the rules receive counter-cyclical fiscal support in downturns, but countries that break the rules do not. The president of the CFA would set the overall fiscal stance for the euro area as a whole, with a view to ensuring an adequate stimulus in recessions and consolidation in expansionary periods.

Given its broad mandate, decisions by the CFA should be taken by qualified majority of the euro area member states. Moreover, crucial ones such those related to debt limits, sums destined to pan-European projects or countercyclical support measures should be approved by the Committee for EMU affairs of the European Parliament.

Banking union and the role of the ECB

We also agree with other proposals in the need to complete the Banking Union with a common deposit guarantee mechanism, further convergence in bankruptcy laws, deepening the capital market union, and a credible fiscal backstop, ultimately provided by the CFA mentioned above. As Schnabeland Veron (2018) have argued, in the short run, a limited package aimed at breaking the doom loop between banks and sovereigns would be a great success.

We agree with Bénassy-Quéré *et al*. that debt restructuring should be possible as a last-resort option. However, this should not raise expectations that some of the present debts of high-debt countries will inevitably be restructured. Moreover, we disagree with their proposal of transparent and consistent across countries ESM criteria for debt restructuring based on a data-driven method that can be reproduced and checked by the public, because that would contribute to create the conditions for financial instability.

As Wolff (2018) points out, constructive ambiguity currently prevents unwarranted market speculation. ESM rules may be useful to assess the potential risks of debt sustainability. However, it should also be clear that these rules would not trigger insolvency automatically. There is a need for some discretionality since, at the end of the day, the commitment of a country to honour its public debt depends on political and social factors and uncertainties that are difficult to measure and to impose systematically upon all countries. All these factors make quantifying how close different countries are to their fiscal limits very challenging (Leeper and Walker 2011).

We think that, as long as there is no large euro area treasury with a sizable budget capable to deal with asymmetric shocks, all euro area sovereign bonds should continue to be considered risk-free assets, implicitly backed by the ECB, leaving the possibility of public debt restructuring as a very last-resort option and preserving the current constructive ambiguity. Questioning the risk-free nature of public debt carries the risk of instability in the bond markets, worsening the current financial fragmentation and threatening to create another episode of market turmoil.

We therefore think that the ECB needs to be able to act as the lender of last resort for illiquid but solvent member states stressed by financial markets but not under a CFA programme of debt restructuring, as it does for the banking sector. Building on its current Public Sector Purchase Programme (PSPP), the ECB has to be the ultimate provider of unconditional liquidity, through the secondary sovereign debt markets, for circumstantially illiquid countries that might suffer market panics or speculative attacks. As Constancio (2018) has recently emphasised, after the experience of the sovereign debt crisis, the ECB has no excuse not to fulfil its mandate by intervening in the sovereign bond market.

However, in the event of an official insolvency of a member state, the CFA would take control of its public finances and negotiate a memorandum of understanding with the country under stress, which would lose part of its sovereignty. The CFA, drawing on the independent technical work of the FSB, would then be in charge of monitoring and implementing the adjustment programme under the parliamentary scrutiny of the Committee for EMU affairs of the European Parliament.

Economic convergence and structural reforms

Finally, there is a need to promote more economic convergence between different euro area countries. Therefore, positive incentives need to be put in place for countries to undertake unpopular structural reforms on an ongoing basis so that their economies are sufficiently flexible, innovative, and socially inclusive to live within a single monetary area.

The CFA, with its capacity to issue joint debt and raise its own fiscal resources (under the supranational democratic control explained above), could provide finance for pan-European public goods, such as security, border protection, the digital transformation, and country-specific reforms that are essential for the area as a whole. The work of the European Semester and its country-specific recommendations could be useful, but they need to be enforceable by designing an intelligent incentive structure.

The euro area experience has shown that countries joining the currency union have insufficient incentives to implement the structural reforms needed to make their economies more flexible and convergent, and that external pressure only works in exceptional circumstances. In order to provide the adequate incentives and avoid the problem of moral hazard, only countries that commit to reforms should be able to receive financial support from the CFA to help stabilise their economies cyclically. This conditional mechanism would facilitate politically difficult structural reforms and reduce the risk of deflation.

Of course, this unavoidable level of deeper integration will require a greater degree of political union to provide democratic legitimacy and accountability. We are fully aware that our proposals imply a significant transfer of sovereignty from member states to European institutions, some of which will require a treaty change. However, we believe they are necessary for the euro's long-term sustainability. This is the consensus in Spain, both among the elites and the public at large. Ultimately, the euro area needs to create its own sovereignty, for only a European sovereign can make EMU last for centuries, as in the case of the US.

Such reforms require in the long run the support of the people, expressed in the approval of the treaty change in each of the member countries. Euro area citizens need to be given a real choice between continued fragmentation (which leaves the euro exposed to structural weaknesses and recurrent crises) and greater integration (which pools more sovereignty at the same time as it strengthens EMU governance). In a world subject to ceaseless technological transformation and revived geopolitical tensions, with increased rivalry among the great powers, kicking the proverbial can much longer down the road is no longer an option. ■

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Make euro area sovereign bonds safe again

A recent CEPR Policy Insight suggests introducing sovereign bond-backed securities to play the role of safe asset in the euro area. Grégory Claeys argues that an improved euro area architecture would make all euro area sovereign bonds safer

The proposal for how to complete the monetary union's architecture, made by a group of 14 economists from France and Germany (Bénassy-Quéré *et al*. 2018), constitutes a timely attempt to build a consensus position between economists from the two largest euro area countries and from a broad political spectrum.

Overall, most of the measures advocated in the paper are sensible and form a coherent package in which the various pieces complement each other. Actually, the main proposals of the paper are broadly similar to the ones I made in a paper published last year (Claeys 2017).

Basically, to make the monetary union more resilient, it is necessary to complete the Banking Union, develop a Capital Markets Union to increase private risk sharing, reform the European fiscal framework, build a euro area stabilisation tool to deal with large asymmetric shocks, and reform the European Stability Mechanism (ESM).

However, one problematic element of the 'Franco-German' package is the implicit view on what should be considered as a safe asset in the euro area. This position is exemplified in the group's inclination to introduce sovereign bond-backed securities (SBBS) to play the role of safe asset in the euro area.

What is a safe asset?

A safe asset is a liquid asset that credibly stores value at all times, and in particular during adverse systemic crises. There is a high demand for this type of asset: from savers in need of a vehicle to store their wealth for the future, from domestic financial institutions to satisfy regulations and to post collateral in financial operations, as well as from emerging market economies looking for means to invest foreign exchange reserves.

Thanks to their high liquidity and simplicity, sovereign debt securities can play that role as long as two conditions are fulfilled: 1) the country's fiscal policy is sustainable; and 2) its central bank stands ready to play a backstop role in the sovereign debt market in case of a self-fulfilling crisis, while having an impeccable record in maintaining the value of the currency (ie. low inflation and stable foreign exchange rate).

However, in the euro area, these two conditions have not always been fulfilled: 1) Greece clearly did not have sound public finances before the crisis; and 2) a strict interpretation of the prohibition of monetary financing, coupled with the difficulty of disentangling liquidity and solvency issues, prevented the ECB from offering a backstop to solvent sovereigns at a crucial moment (from 2010 to 2012).

... an improved euro area architecture would, in the long run, make all euro area sovereign bonds safer, and thus make the provision of safe assets through untested and potentially disruptive sovereign bond-backed securities unnecessary

While the prohibition of monetary financing is justified to avoid unsustainable fiscal policies in the monetary union, this left the door open to self-fulfilling sovereign debt crises in some countries – at least until Draghi's *"whatever it takes"* promise in the summer of 2012 and its formalisation as the Outright Monetary Transactions (OMT) programme. This put some euro area countries at a disadvantage to issue safe assets and extract the main benefit from doing so, ie. the possibility to put in place countercyclical fiscal policies at low cost during recessions.

Which asset should play that role in the euro area?

Given the inability of some euro area sovereign bonds to play the role of safe assets during the crisis, ideas on how to create synthetic euro area-wide safe assets emerged. In particular, proponents of SBBS suggested pooling sovereign bonds from all euro area countries and using them to provide cash flows for securities issued in several tranches of different seniorities, in order to supply safe assets (senior SBBS) in large quantities to economic agents needing them.

However, the idea remains untested and politically controversial. Despite the support of the European Systemic Risk Board (ESRB) and the Commission, policymakers and public debt management agencies in many euro area countries are afraid of the unintended consequences that such a drastic change could entail for the sovereign bond markets of the euro area.

But in my view, the main argument against SBBS is that they are unnecessary and represent a distraction in the current debate. Instead, making all euro area sovereign bonds safe again, and for good, is the most desirable way to increase the supply of safe assets and avoid intra-euro area flights to safety during bad times.

What would it take for all euro area bonds to be considered safe again? As mentioned earlier, sovereigns need to fulfil two conditions, they must have 1) sustainable fiscal policies; and 2) a credible (inflation-targeting) central bank ready to play a backstop role in a liquidity crisis.

For public finances in the euro area to be sustainable, respecting fiscal rules is necessary. But current rules need to be drastically improved to play their role – ditching the flawed structural deficit rule and replacing it with a reformed expenditure rule would be a step in the right direction. However, good fiscal rules are not sufficient. To ensure sound public finances in the long run in the Economic and Monetary Union (EMU) it is also essential to have:

- effective macroprudential policies to avoid bubbles that end up weighing heavily on public finances when they burst;
- a completed Banking Union to make European sovereigns immune to domestic banking crises (thanks to the European Deposit Insurance Scheme and a credible Single Resolution Fund);
- and a euro area stabilisation instrument to deal with large asymmetric shocks.

This corresponds to some of the proposals in Bénassy-Quéré *et al*. (2018). However, the authors do not offer a convincing solution to fulfil the second condition. Even though it was never activated, the creation of the OMT programme was crucial to end the self-fulfilling crises taking place in several countries in 2012. However, its setup remains fragile and could limit the possibility for some euro area sovereign bonds to qualify as safe assets in a crisis. It is thus essential to reform the ESM/OMT framework to make sovereign debt markets genuinely liquidity-crisis-proof in the EMU.

The necessary reform of the ESM

The problem of the OMT programme is that it is difficult to distinguish liquidity from solvency issues. If the ECB were using the OMT in all cases in which yields increase significantly, without being confident that they are related to a self-fulfilling issue and not linked to fundamentals, this could lead to moral hazard. A strong presumption ex ante that debt is sustainable is thus necessary to justify an OMT programme. To solve that problem, the ECB decided that the implementation of an OMT programme would be conditional on participation in an ESM programme.

This implies that the Commission, in liaison with the ECB, would have to assess first whether the public debt of the country requesting help is sustainable, before the ESM programme can be approved. More importantly, given that the ESM board – composed of the finance ministers of the member states – needs to approve the programme, this means that there must be not only a technical assessment but also a political agreement that debt is sustainable. The ESM thus plays a fundamental role in the current setup, not primarily because of its capacity to lend to countries (which is relatively small) but because it provides the political validation of the debt sustainability necessary for the ECB to act.

However, the current options available at the ESM are not appropriate to solve a liquidity crisis, which would be highly problematic if the OMT ever needs to be used. Thus, the role of the ESM must be clarified and its functions should be differentiated depending on whether countries face liquidity or solvency crises. As I proposed in Claeys (2017), there should be three distinct ESM tracks:

1. A track for 'pure' liquidity crises, in which the ESM would just be used as a political validation device for the ECB's OMT programme, without any conditions attached or any debt restructuring.

Conditionality would not be needed because there would no ESM loans involved and therefore no need to ensure the country's capacity to repay its European partners. On the contrary, the current situation is problematic because a country might be forced to implement policies to access an OMT programme solely because of a problem of multiple equilibria for which it might bear little responsibility. In principle, today, to be eligible for the OMT, countries could apply to an ESM precautionary credit line instead of a full programme, but credit lines are still conditional on the signature of a Memorandum of Understanding.

Moreover, the criteria for accessing credit lines is overly restrictive as it requires *"market access on reasonable terms"*, which might not be the case in a liquidity crisis. In practice, the criteria could be interpreted loosely and conditionality could be very light. But, for the sake of clarity, it is better to create a new track reserved for pure liquidity crises to 'authorise' OMT programmes by the ECB (the central bank would retain its independence as the Governing Council would be the one ultimately activating the asset purchases once debt sustainability is technically and politically validated). In the absence of such a track, countries facing a self-fulfilling crisis and in need of an OMT programme might be reluctant to apply to the ESM for fear of losing economic sovereignty. Adding a liquidity track to the ESM toolkit would increase the credibility of the OMT and reduce the likelihood of it ever being used.

2. A track for situations in which countries could be 'at risk of insolvency' in the future.
The ESM would offer a precautionary credit line under relatively light conditions, which would also make the country eligible for OMT once there is no doubt remaining on the sustainability of the country's new debt trajectory. This track will be particularly useful in the cases in which liquidity and solvency issues are difficult to disentangle. This type of programme could be activated at an earlier stage with light conditionality, and no debt restructuring, to avoid full-blown crises and last-minute decisions.

3. A track for clear solvency crises, in which the ESM would provide funding conditional on a full macroeconomic/fiscal/financial adjustment programme and on the restructuring of the sovereign debt held by private institutions, which would also enhance market discipline ex ante. In that case, the ESM would provide a loan to help the country smooth the shock of losing market access.
Bénassy-Quéré *et al*. make some suggestions to reform the ESM in a direction that would lead to a set-up with two tracks broadly similar to track 2 with a flexible ESM facility (for countries with good policies ex ante and with light policy conditionality ex post), and to track 3 with a basic ESM programme conditional on sovereign debt restructuring. Unfortunately, they do not go as far as introducing an option similar to track 1, ie. without ESM loans and without any conditionality, neither ex post nor ex ante. This track is, in my view, essential if financial markets

were to call the ECB's bluff one day and the OMT actually needs to be used to solve a liquidity crisis. The absence of such a track in their proposal to reform the ESM is problematic because it makes debt restructuring and/or policy conditionality compulsory to access the ESM and thus the OMT.

More generally, making debt restructurings the norm in the euro area could have dangerous implications. First, frequent debt restructuring would make it impossible for countries to borrow in bad times to run countercyclical fiscal policies (while ESM loans would not be sizeable enough to compensate for market access loss). Second, it is difficult to believe that public debt restructuring can be painless (even if banks are more protected thanks to concentration charges), given the crucial roles played by member states as a benchmark in domestic financial markets and in the real economy through the provision of safety nets and essential public goods (health, education, defence, etc.).

Conclusions

Overall, an improved euro area architecture – with a completed Banking Union, effective macroprudential policies, improved fiscal rules, a euro area stabilisation instrument, and a reformed ESM/OMT framework – would, in the long run, make all euro area sovereign bonds safer and thus limit drastically the intra-EMU flight for safety observed during the crisis. This would make the provision of safe assets through untested and potentially disruptive SBBS unnecessary. ■

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No deal is better than a bad deal

The recent proposals for euro area reform have initiated an intensive debate. Peter Bofinger argues that the specific insolvency risk of euro area membership is the main risk that should be covered by joint risk sharing

A team of prominent French and German economists have presented a paper which they regard as *"a game changer for the euro area"* (Benassy-Quéré *et al*. 2018). Their proposals have initiated an intensive debate (Bini Smaghi 2018, Micossi 2018, Buti *et al*. 2018, Pisani-Ferry and Zettelmeyer 2018).

While several shortcomings of *CEPR Policy Insight 91* have already been discussed, in this column I argue that the specific insolvency risk of euro area membership is the main risk that should be covered by a joint risk sharing. The authors' modest proposals for a public and private risk sharing are insufficient in this regard. With a strengthening of market discipline, this risk could even be increased.

So far, there is little evidence that financial markets could play a stabilising role in the euro area. The proposal for an expenditure rule has its merits as it focuses on a target which governments can control effectively. But it requires a sensible debt-to-GDP target, for which the completely arbitrary 60% value of the Maastricht Treaty should not be slavishly adopted. For a productive compromise between France and Germany, the German side has to take the first step by allowing at least some debt financing of public investments within the fiscal framework of the euro area.

The specific insolvency risk of euro area membership

Given the focus on 'risk sharing', it is surprising that the authors do not explicitly explain what specific risks they want to be shared. Their proposals focus on the risk of idiosyncratic demand shocks and the risk of a national banking crisis. But this neglects **the unique and existential risk of euro area membership**. Monetary union exposes its member states to an **insolvency risk** which is absent for similar countries which have a national currency. When a country adopts the euro, its debt is redenominated from the national currency into the euro. Thus, member states are in a similar situation as emerging market economies which can only lend in a foreign currency ('original sin'). In a crisis they can no longer rely on the support of their national central bank.

This specific risk is aggravated by an **easy exit option** that the single currency provides for investors. If, for example, a Japanese pension fund is no longer willing to hold Japanese government bonds and decides to hold US treasuries instead, it is confronted with a currency risk. For institutional investors that are required to hold safe assets, this **'currency wall'** is difficult to surmount. Within the euro area this wall has been removed so that investors can exchange domestic bonds into bonds of other member states without an exchange rate risk.

Above all, Germany must have a strong interest in the integrity of the euro area. The euro has protected German manufacturing against exchange rate shocks vis-à-vis the other member states

The combination of the insolvency risk with the easy exit option leads to a denomination risk (Bini Smaghi 2018) which has manifested itself in the euro crisis. Only with Mario Draghi's commitment to save the euro *"whatever it takes"*, which was regarded as an implicit insurance against this risk, could the stability of the euro area be maintained. It is important to note that this risk is not due to *"a poorly designed fiscal and financial architecture"*, as Benassy-Quéré *et al*. see it. It is due to the fact that the monetary union is a building which is not yet finished. It would require more political integration to become a stable building.

Above all, Germany must have a strong interest in the integrity of the euro area. The euro has protected German manufacturing against exchange rate shocks vis-à-vis the other member states. One can also assume that the Deutsche Mark would have been a stronger currency than the euro, so that the protection has also been effective vis-à-vis other countries. Thus, one should expect that a proposal by German and French economists for 'risk sharing' would address this risk. But as the Policy Insight not even mention it, proposals for such risk sharing (Delpla and von Weizsäcker 2010, German Council of Economic Experts 2011) are also not discussed.

Two not very effective proposals for political risk sharing

The proposal for a European Deposit Insurance Scheme (EDIS) envisages insurance premiums which are pricing country-specific risks. It also requires that first losses should be borne by the relevant national compartment. Common funds should be provided only *"in large, systemic crises which overburden one or several national compartments".*

But in such a situation, the risk sharing provided by the EDIS (with a target size of 0.8% of covered deposits of participating banking systems) would soon reach its limits. An insurance scheme is effective only if risks are uncorrelated. In 'large, systemic crises' risks are correlated, and the scheme breaks down. Thus, only the ECB as lender of last resort would be able to stabilise the system effectively.

The second proposal envisages a **European fiscal capacity** for *"large downturns affecting one or several member states"*. The authors compare it to a *"catastrophic loss insurance"*. With total annual contributions of 0.1% of euro area GDP, the size of the fund is limited as a borrowing possibility is explicitly excluded. As a result, even in a severe recession a country would receive rather limited transfers. For an increase of the national unemployment rate by 4 percentage points, a one-time transfer of only 0.5% of national GDP is envisaged. But this makes a country only better off if it is hit by the shock within the first five years of the existence of the fund

In addition, due to the limited size of the fund the shock must not affect too many member states simultaneously. As a specific hurdle, access to the fund requires that a member state complies not only with the fiscal rules but also with the country-specific recommendations. In a situation with a very large shock, this is very unlikely. And for such an ideal country it should be possible to finance a temporary cyclical deficit on the capital market without major problems.

Both forms of risk sharing resemble the idea of establishing a fire brigade which can only be activated in the case of huge fires. But at the same it is designed with such limited capacities that it will never be able to deal with such fires.

The limits of market risk sharing

Benassy-Quéré *et al*. propose **market risk sharing** as another stabilising factor. One element is the **completion of the Banking and Capital Market Union**: *"Euro area citizens and corporations should be able to hold their savings in instruments whose returns are independent of unemployment and output declines in their home country."* But this is already possible under current institutional arrangements. As already mentioned, the single currency has removed the 'currency wall' for portfolio investors. And it was an **excessive cross-border bank lending**, above all by German and French banks in in the years 2000-2007, which contributed to the crisis. More generally, it is not clear how bond and equity markets can provide significant risk sharing given the very asymmetric distribution of wealth in the member states. For households with very little or no financial wealth at all, Capital Market Union cannot provide an effective insurance for the risk of unemployment.

The second element of market risk sharing is the creation of euro area safe assets (ESBies). The authors believe that a *"safe asset in the euro area would create a source of demand for euro area sovereign debt that is not 'skittish' in the face of changes in market sentiment."* But they also admit that this is only the case *"so long as sovereigns do not lose market access since this triggers exclusion from the collateral pool of new issues."* And they see the risk that *"it may be difficult to find buyers for the junior tranches in time of crisis"*. In other words, their scheme for market risk sharing would fail exactly in the situation when the fundamental insolvency risk of the area becomes manifest.

Market discipline: governments under the control of markets?

The authors regard risk sharing and market discipline as complementary pillars for the euro area architecture. But this raises the question of whether 'market discipline' can be regarded as a stabiliser at all. For Benassy-Quéré *et al.* this seems out of question. But almost 20 years ago the *Delors Report* came to the following assessment:

> *" [...] experience suggests that market perceptions do not necessarily provide strong and compelling signals and that access to a large capital market may for some time even facilitate the financing of economic imbalances. Rather than leading to a gradual adaptation of borrowing costs, market views about the creditworthiness of official borrowers tend to change abruptly and result in the closure of access to market financing. The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive."*

The developments since the start of the euro have confirmed this prediction. The market reaction to the chronic lack of fiscal discipline in Greece came much delayed in the year 2010, and then the reaction was so sudden and disruptive that the system could only be saved by Mario Draghi's intervention. More generally, it is surprising that the economists' trust in market discipline could survive the financial crisis almost unscathed.

In addition, one must ask whether 'market discipline' is an adequate concept for the organisation of the euro area. In the context of the banking sector it may have its merits, but in the context of the monetary union it implies that markets are assigned a disciplining role over states. This turns the traditional **relationship between state and markets** on its head. In the past there was a consensus among economists that markets must be under the control of the governments. Market discipline calls for governments that are under the control of markets. This concept is especially questionable as financial markets are dominated by mighty players like Goldman Sachs or Blackrock.

In sum, the whole concept of stabilising the euro area by combining enhanced market discipline with homeopathic elements risk sharing is not convincing. While the elements of risk sharing do not address the euro area's most fundamental risk of insolvency, the strengthening of market discipline has the potential to even increase this risk. The authors are aware of this problem, but they regard it as a transition problem only: *"The main lesson is that the* ***'transition problem'*** *– getting to a state of more effective market discipline and higher stability, without triggering a crisis on the way – needs to be firmly recognised and addressed in proposals to raise market discipline".*

But how should the transition be managed? The authors propose that the new regime should be introduced *"at a time when the debts of all euro area countries that depend on market access – particularly those of high debt countries – are widely expected to be sustainable with high probability […]"*. As such a situation is very unlikely for the foreseeable future, this looks much like an escape clause for the French economists.

An expenditure rule set by wise men and women

A third element of the report is a new framework for fiscal policy. The proposal is based on the assessment that the fiscal rules *"have not worked well"*. While this is true for Greece, which published incorrect statistics, for the large member states this not so obvious. Comparing the fiscal balances of Germany, France, and Italy on the one hand and of Japan, the UK, and the US on the other, the much lower deficits of member states speak for a pronounced fiscal discipline.

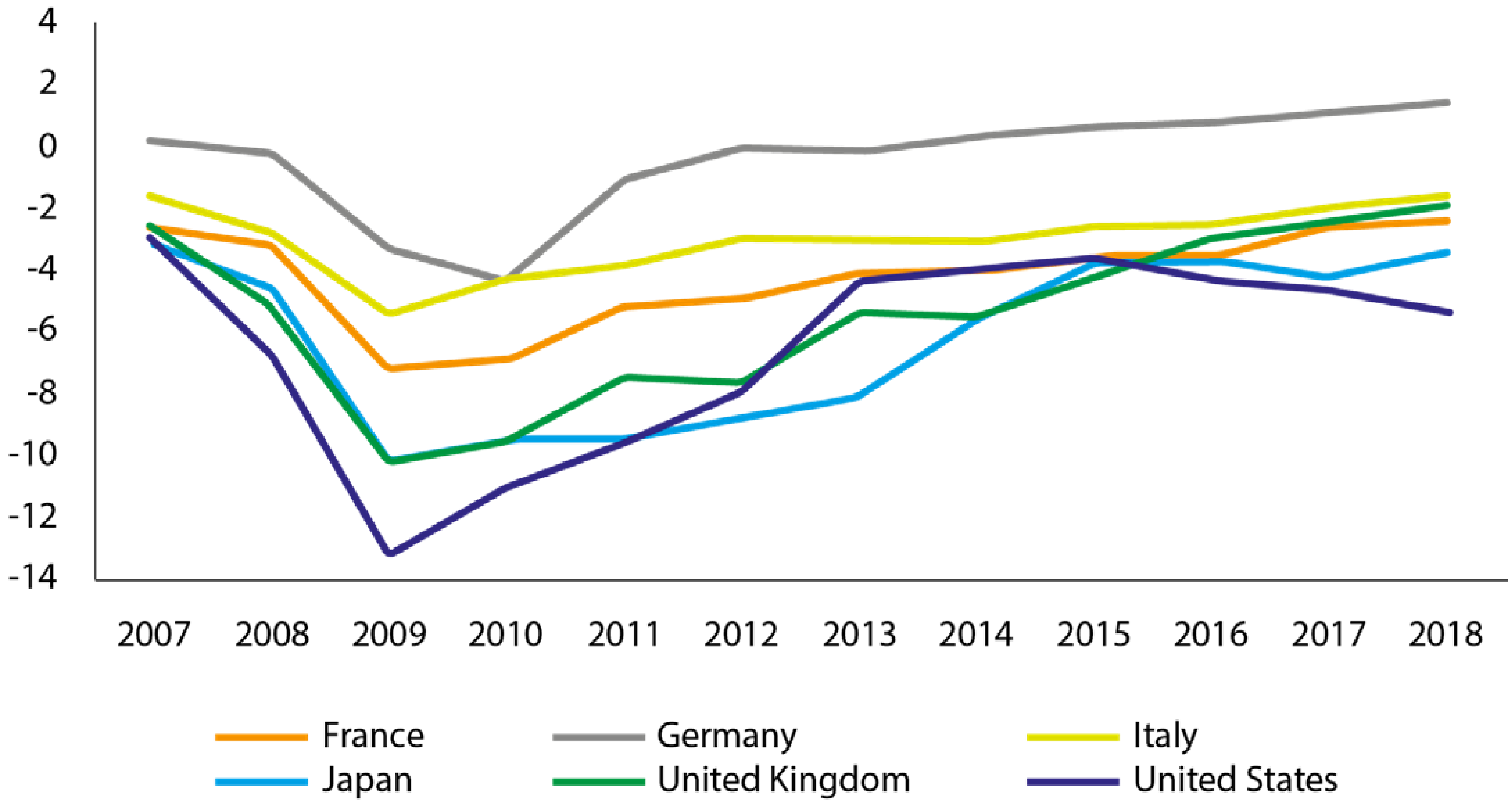
The authors propose a two-pillar approach with a long-term debt target *"such as 60 % of GDP, or a more bespoke objective"* and an expenditure-based operational rule to reach this target. For this purpose, **an independent, national-level fiscal council** shall be established. It shall propose a rolling medium-term debt reduction target, chart a consistent medium-term expenditure path, and use this to set a nominal expenditure ceiling for the coming year. If a country exceeds the target path all excessive spending must be financed by junior sovereign bonds.

There is no doubt that expenditure rules have their merits as they are easier to follow than deficit rules. But it is not clear why the rule should be set by an expert council and not by an elected government or parliament. Economists have **ideological biases** which influence the judgements that must be made given the limitations of the science of economics. Thus, the nomination of specific experts for the council has a strong influence on the outcome of the debt target and the corresponding expenditure path.

In addition, it is far from obvious that the 60% target for the debt level is a sensible medium-term target for the fiscal policy. For the Maastricht Treaty it was derived as the average debt level of the member states at that time. The attempt by Reinhart and Rogoff (2010) to derive a target scientifically failed. Renowned economists have made the case for **evidence-based economics**. David Eddy (1990), who coined the term 'evidence-based medicine', puts it as follows:

> *"[E]xplicitly describing the available evidence that pertains to a policy and tying the policy to evidence. Consciously anchoring a policy, not to current practices or the beliefs of experts, but to experimental evidence. The policy must*

Figure 1. Fiscal balances of large member states compared with Japan, the UK and the US (% of GDP)



Source: IMF World Economic Outlook.

be consistent with and supported by evidence. The pertinent evidence must be identified, described, and analysed. The policymakers must determine whether the policy is justified by the evidence."

The Maastricht 60% target is obviously based on current practices and beliefs of experts and it lacks any pertinent evidence (for example, in the UK the long-term historical average from 1700 to 2016 is 99.5%; Figure 2). Thus, any strategy that tries to make the euro area more stable should entail an intensive analysis of an adequate debt target for the member states. Substituting the 60% target by a target which is closer, say, to the debt-to-GDP level of the US could fundamentally change the perception of the financial soundness of the member states.

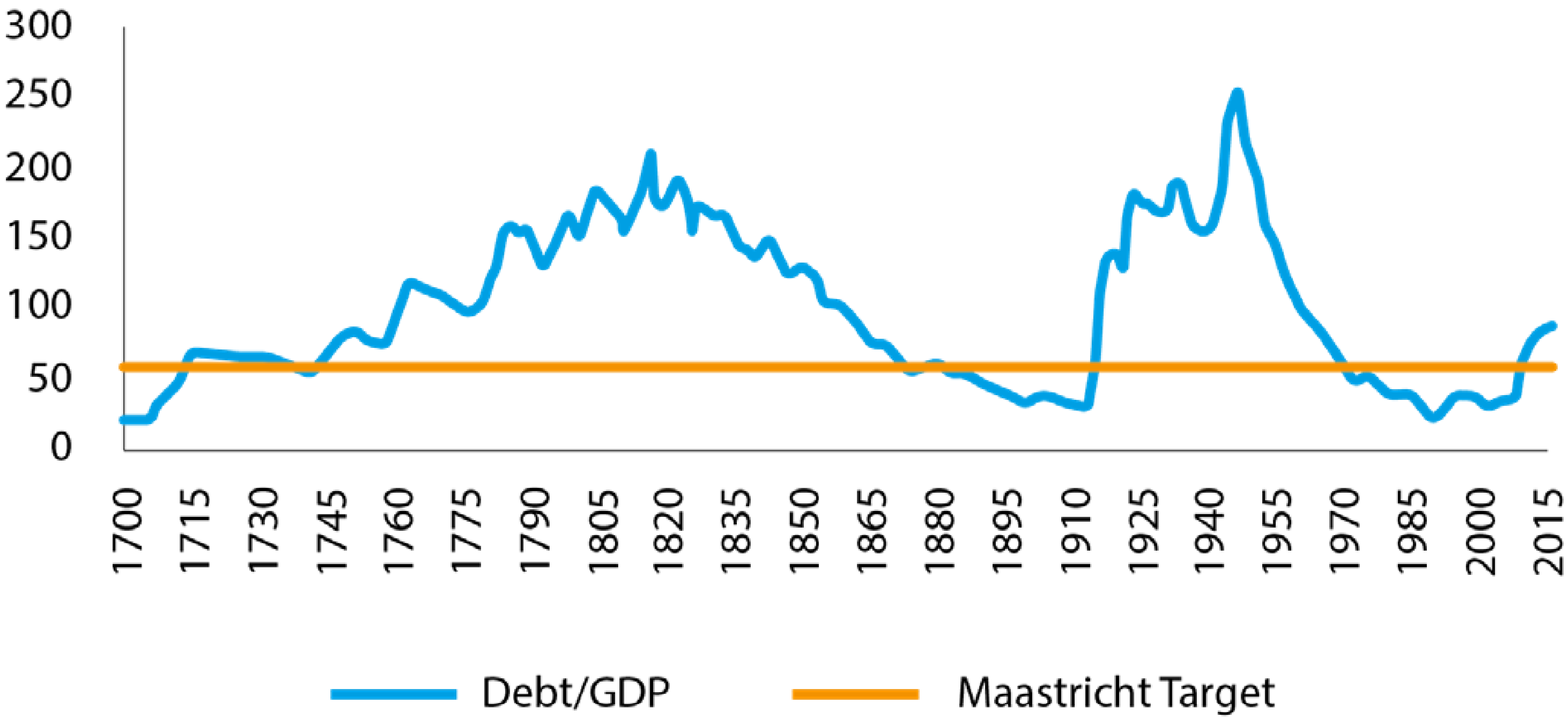
The way forward

The instability of the euro area architecture is not due to a *"poorly designed fiscal and financial architecture"*. It reflects an unfinished building with a supranational monetary policy and 19 independent national fiscal policies. Thus, the only way to make it stable is to go ahead with political integration. This would allow a comprehensive debt mutualisation which would remove the specific insolvency risk of euro area membership.

With the transfer of fiscal policy responsibilities to the supranational level, fiscal discipline of the member states would be enforced by a democratically legitimised euro area finance minister and not by myopic financial investors. In the current situation progress towards a fiscal policy integration is not very likely. But for economists this is not an excuse for not making explicit what is really required to stabilise the architecture of the euro area.

For a productive Franco-German compromise, the German side must make a first step by allowing some flexibility concerning the 'black zero'. This would allow more room for the golden rule in the Stability and Growth Pact so that at least a limited debt financing of public investments would be possible. As another step forward, one could envisage projects with large euro area externalities (infrastructure, defence, research, industrial policy, environment)

Figure 2. UK Debt-to-GDP ratio, 1700-2016



Source: Bank of England, "A millennium of macroeconomic data".

which are financed by bonds with a joint liability. Finally, a thorough and open-minded analysis of the adequate targets for public debt to GDP would be very helpful.

CEPR Policy Insight 91 calls for *"a shift in the euro area's approach to reconcile fiscal prudence with demand policies, and rules with policy discretion"*. But it presents a framework that limits the scope for demand policies by the introduction of fiscal rules and *"sovereign concentration charges"*. And it reduces the scope for national policy discretion not only by the establishment of independent fiscal councils and but also by exposing governments to more 'market discipline'. The proposal could indeed be a 'game changer', but into the wrong direction. ■

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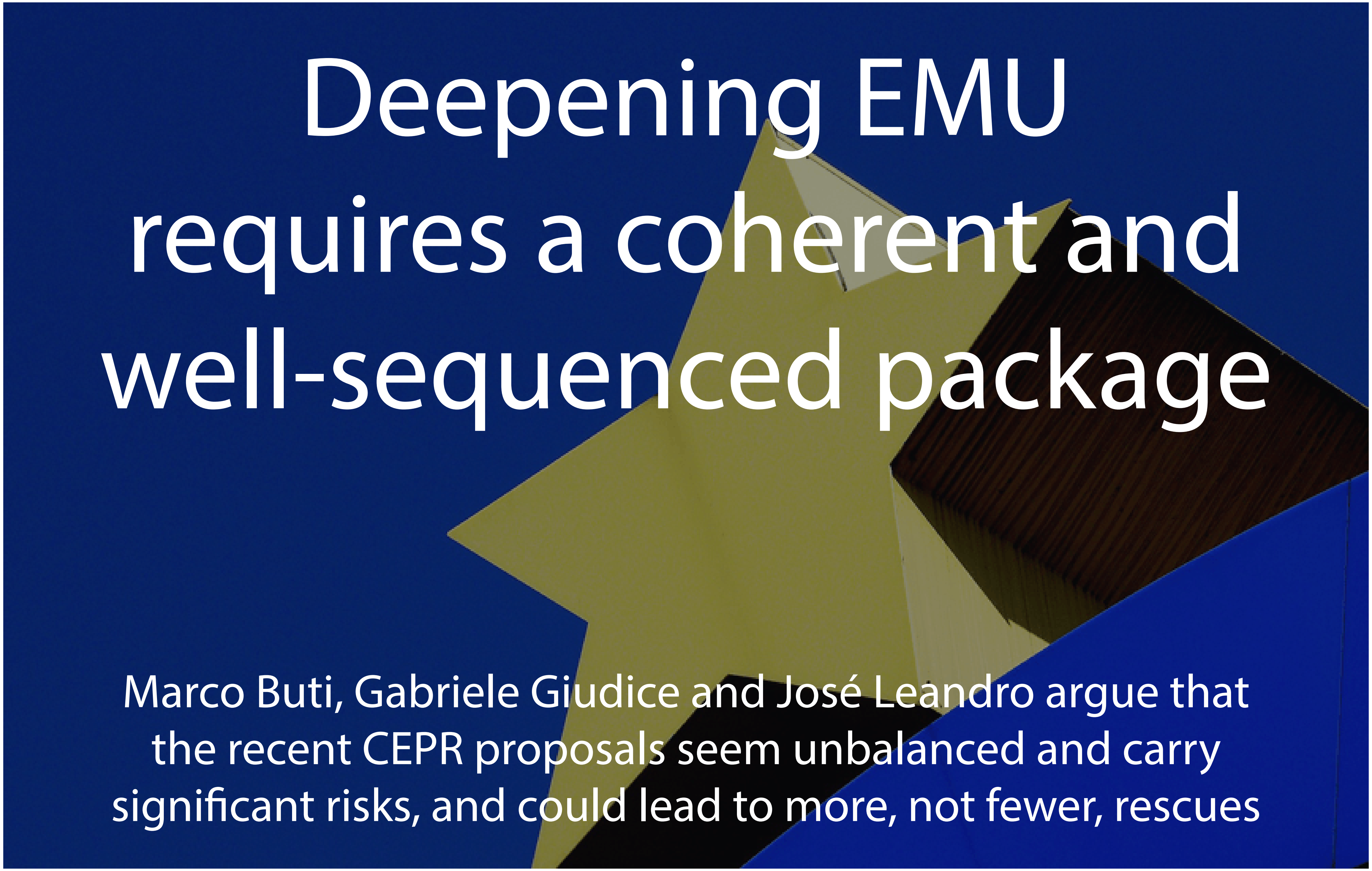


Deepening EMU requires a coherent and well-sequenced package

Marco Buti, Gabriele Giudice and José Leandro argue that the recent CEPR proposals seem unbalanced and carry significant risks, and could lead to more, not fewer, rescues

The debate on deepening EMU is entering a critical stage. This column, contributing to VoxEU's Euro Area Reform debate argues that while the proposals in a recent CEPR Policy Insight are both timely and attractive, the mix seems unbalanced and carries significant risks. The focus of the proposals on reducing fiscal risks could lead to financial distress, ultimately requiring more, not fewer, rescues.

The debate on EMU deepening is entering a critical stage. The contribution of 14 French and German economists (Benassy-Quéré *et al*. 2018) is therefore timely. It suggests ways for reconciling risk-sharing with market discipline – where the biggest divisions lie. Their initiative overlaps in spirit and with much of the substance of the European Commission's May 2017 Reflection Paper on Deepening EMU (European Commission 2017a) which identified indispensable components of a comprehensive reform of EMU (see Buti *et al*. 2017) and underpins the subsequent Commission's initiatives (European Commission 2017b).

Benassy-Quéré *et al*. put forward several attractive ideas on how to reform EMU. At the same time, the mix of proposals seems unbalanced and carries significant risks. The diagnosis of the crisis overlooks crucial issues such as macroeconomic imbalances and adjustments within the euro area and the redenomination risk connected to acute liquidity and credibility crises. As such, the proposals are mainly geared at increasing market pressure on fiscal policies, and are aggregated without appropriate sequencing necessary to contain macroeconomic and financial risks.

Building on the progress made

As a starting point, the progress made in reducing risks in Europe – in parallel with, or ahead of more risk sharing – should be more clearly recognised. Achievements at both the EU and national level are in line with, and sometimes surpass, the ECOFIN Council's June 2016 roadmap for the BU and July 2017 Action plan to tackle non-performing loans (NPLs), as also acknowledged by the Eurogroup in February 2018. Several packages have been tabled and are being implemented to further reinforce banks' prudential management and strengthen market discipline, to improve insolvency frameworks, restructuring and second chances, to define a more gradual path to risk sharing reflecting progress in risk reduction, and to support the ongoing fall in non-performing loans (see Figure 1) and prevent their resurgence[1].

Preserving financial stability is of the utmost importance

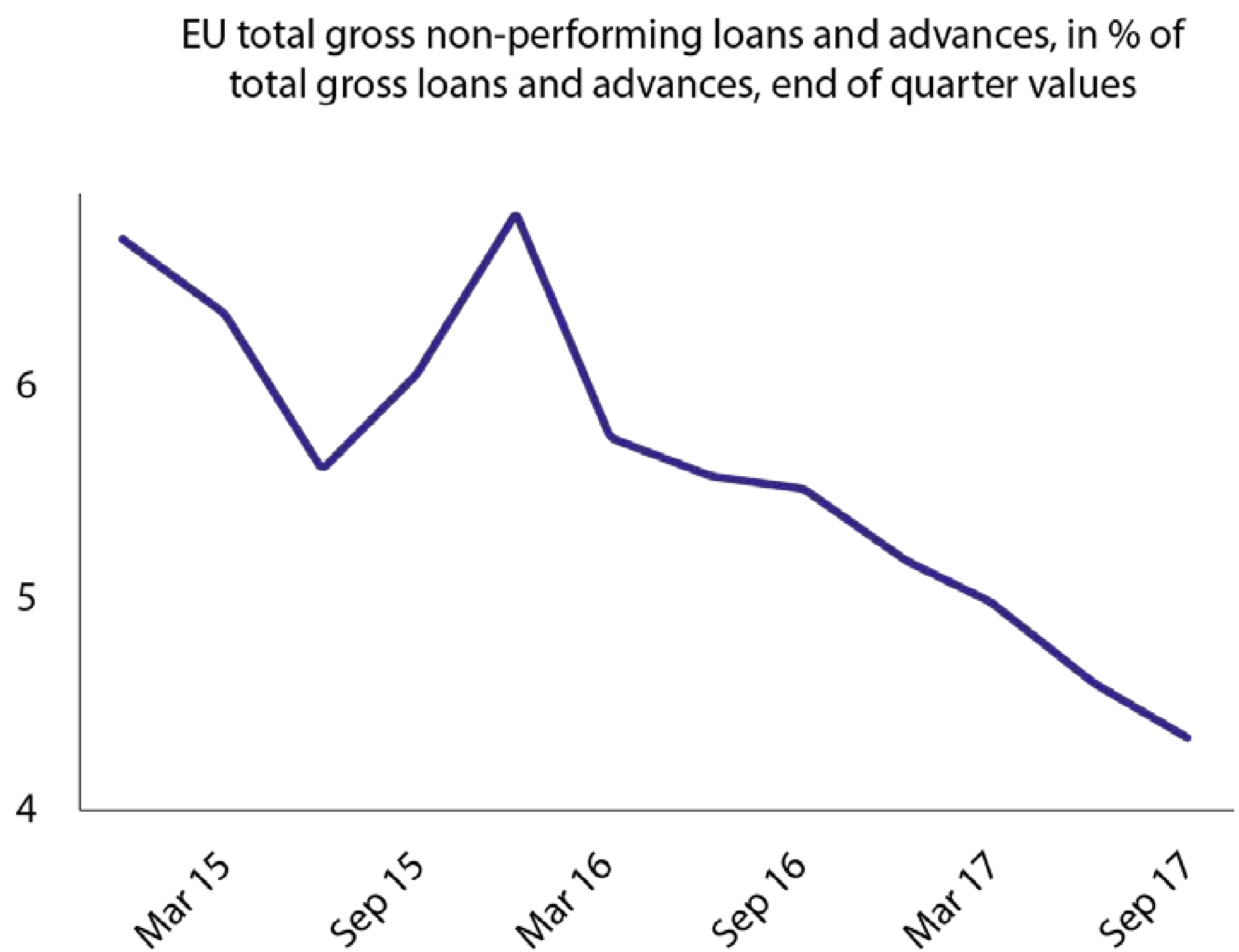
Benassy-Quéré *et al*. aim at making the 'no-bailout' clause (Article 125 TFEU) more credible, which is a desirable objective. A country not respecting its fiscal targets would face heightened market pressure, as ultimately it would

After all the effort to regain financial stability, there is a need to advance without delay, but with a coherent and well-sequenced package, avoiding unsafe steps in the dark

Figure 1. Evolution of non-performing loans in selected countries and the EU

	Non-performing loans in % of total loans in selected countries		
	Q3 2016	Q3 2017	% change
Cyprus	36.8	32.1	-12.7
Spain	5.8	4.7	-19.7
Greece	47.4	46.7	-1.5
Ireland	14.4	11.2	-22.5
Italy	16.1	12.1	-24.9
Portugal	17.7	14.6	-17.3
Slovenia	14.4	10.8	-24.8

Figure 1. Evolution of non-performing loans in selected countries and the EU



Source: European Central Bank

be forced into outright default. They focus therefore on defining 'when' or 'how' default should take place, through the equivalent of a Sovereign Debt Restructuring Mechanism, or SDRM (Corsetti *et al*. 2016): governments missing their expenditure targets would issue junior national debt, which would be automatically restructured should the country require ESM crisis support.

But market forces must be handled with caution. Financial markets tend to operate along horizontal (benign neglect) and vertical (overreaction) lines. The proposals by Benassy-Quéré *et al*. concentrate both liquidity and credit risks on a very narrow tranche of national debt. This would take Europe into uncharted waters and raises significant questions[2].

While in theory the proposals concern only the flow of debt, the crisis showed that markets fail with critical spillovers across assets issued by a country, and across jurisdictions. These proposals could generate self-fulfilling prophecies, with uneven market reactions to changes in perceptions and credibility of governments, destabilising financial markets.

As costless defaults are an illusion, rather than forcing defaults it would make more sense to work to reduce the economic, financial, and political costs in the extreme and unlikely case that a sovereign debt default becomes inevitable in the euro area. This alternative approach would involve: (1) making the financial system more resilient to such a default event (see below); (2) improving the EMU architecture to make defaults even less likely; and (3) clarifying ex ante 'who'would bear the cost of a government default.

Making the financial system more resilient

Sovereign bonds have a particular role in funding public expenditure and as benchmarks for national financial systems, which explains why they enjoy a risk-free status across all advanced economies. If the regulatory treatment of bank sovereign exposures were to be changed in isolation, or with an inappropriate combination or sequencing, the consequences could be material and unpredictable for financial stability.

A regulatory reform to reduce excessive concentration of sovereign bonds in the banks' balance sheets could reduce the impact of government defaults, improve incentives for governments and avoid any possibility of indirect financing, but only if such reform were implemented wisely, gradually, and as part of a well-sequenced package. The right sequencing would depend not just on having a deal on the deposit insurance, as proposed by Benassy-Quéré *et al*, but on key steps to improve the functioning of financial markets: completing Banking Union, progressing towards the Capital Markets Union and reaching an agreement to launch a genuine European safe asset. This should not be seen as a way to delay progress but rather as an argument that all these elements of the package should be considered as soon as possible.

A stone that could hit many birds

A genuine European safe asset would create a large, homogenous, and hence liquid euro area-level bond market; it would avoid 'sudden stops' and reduce the financial fragmentation that blunts the transmission of monetary policy; it would replace sovereign bonds on the banks' balance sheets, hence mitigating the sovereign-bank loop; and it would increase the total supply of European and global safe assets. It would therefore improve debt dynamics across the Euro area. Mutualised solutions such as Eurobonds (De Grauwe and Ji 2018) or Blue-Red bonds (Delpla and von Weizsäcker 2010), while appealing, have limited political traction at this juncture and would require a change to the EU treaties.

Sovereign bond-backed securities (Brunnermeier *et al*. 2016, ESRB 2018), while increasing diversification and the supply of safe assets, are unlikely to fulfil all the objectives of a genuine European safe asset, as many market analysts, academics and sovereign debt managers have highlighted, even if regulatory barriers are removed.

In addition, introducing SBBS alongside Accountability bonds, as proposed by Benassy-Quéré *et al*, would also dangerously fragment bond markets even more.

A recent paper (Leandro and Zettelmeyer 2018) concludes that safe assets could be produced without mutualisation in sufficient quantities to replace the euro area banks' current holdings of sovereign bonds, which would make them more immune to defaults. Among the non-mutualised options, so-called E-Bonds (Monti 2010: 61-65, Juncker and Tremonti 2010) – whereby the whole national debt is subordinated to any funding received from the common issuer, which may well be the ESM or the EIB – could directly exert fiscal discipline (by raising the marginal cost of sovereign debt issuance, without raising the average costs for lower-rated borrowers).

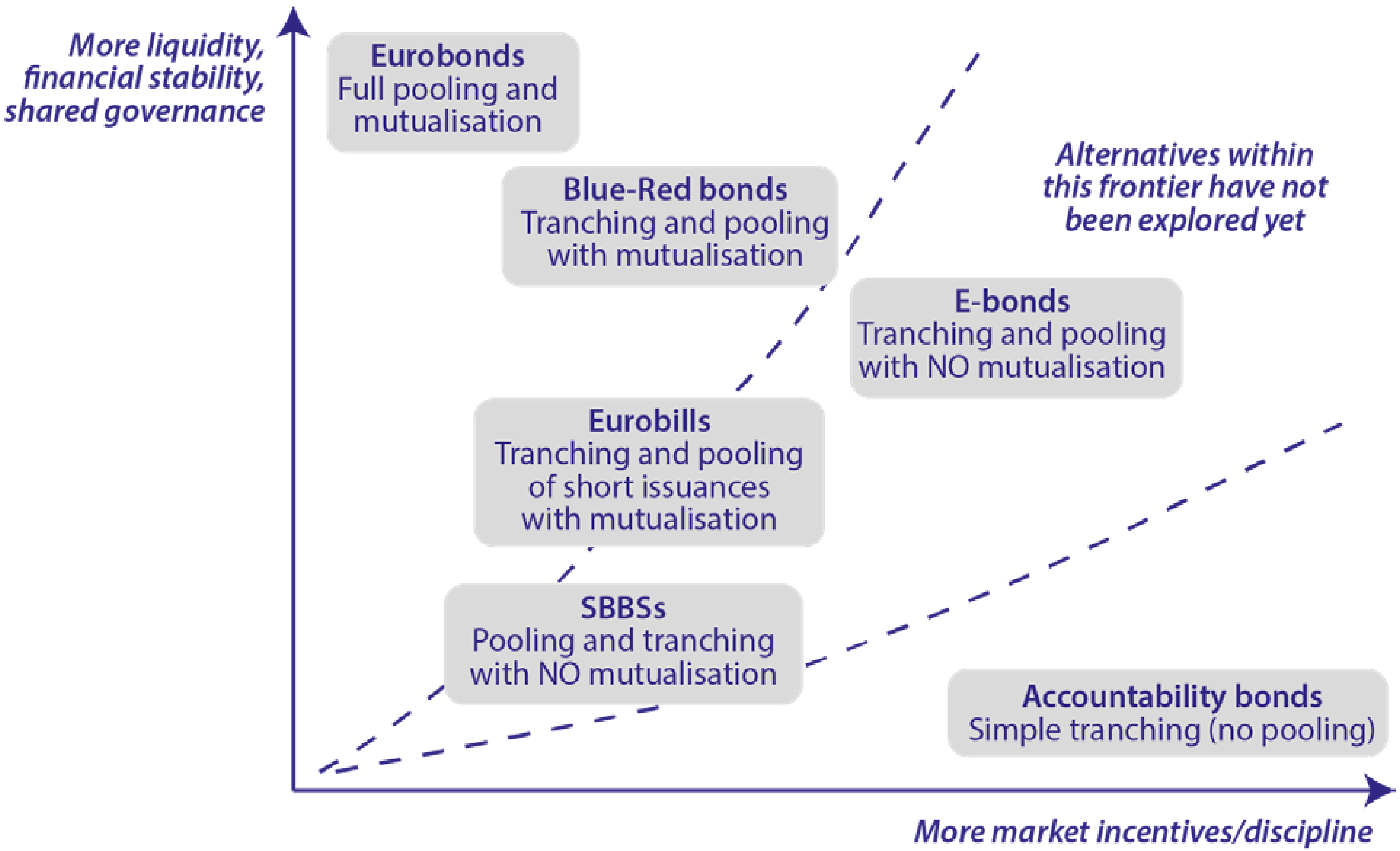
Against the current lack of trust among European countries, an option balancing and indissolubly binding significant common issuance with market discipline could overcome the reciprocal fear among member states that others may backtrack on agreed reforms (see Figure 2). Its introduction would facilitate a progressive implementation of concentration charges, the prospect of which could help a rapid agreement on both the deposit insurance and the backstop, while it may also smoothen the reduction of the ECB's balance sheet.

Conclusion

The proposals in Benassy-Quéré *et al*. (2018) are welcome and the main message should be heard loud and clear: there is a need to strengthen EMU through parallel risk reduction and risk sharing, complementing each other within a package of reforms. Risk reduction has to continue, but one should avoid changing the goalpost before risk sharing takes place.

In the paper the exact sequencing is however unclear, not all necessary elements are covered, and some proposals create risks. The diagnosis overlooks some key aspects of EMU (internal imbalances, liquidity flows, redenomination risks) and the focus of the proposals on reducing fiscal risks could rather lead to financial distress ultimately

Figure 2. Possible forms for a European safe asset



Source: Buti et al. (2017).

requiring more, not fewer, rescues. After all the effort to regain financial stability, there is a need to advance without delay, but with a coherent and well-sequenced package, avoiding unsafe steps in the dark. ■

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Endnotes
1. See European Commission (2016, 2017c, 2018).
2. Such as: What happens if fiscal targets are missed because of forecast errors or surprise elements, rather than wrong policies? If bonds are meant to be issued only rarely (as countries would normally stick to the fiscal targets), how easy will it be to issue them in a very thin market? Who would enforce their issuance? What happens if there is no buyer at any price (something that we also experienced during the last crisis)?

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Authors' note: The authors are writing in their personal capacity and their opinions should not be attributed to the European Commission.

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Risk reduction and risk sharing in EU fiscal policymaking

Roel Beetsma and Martin Larch argue that the policy dilemma around a central fiscal capacity can only be overcome if fiscal risk sharing and risk reduction advance in parallel

The key question in the policy debate on the next steps for the Economic and Monetary Union seems to be whether we can progress with integration in a context where some countries perceive themselves as consistently paying for policy mistakes of others, while others see themselves victims of a moral diktat. This column, adding to VoxEU's Euro Area Reform debate, argues that the policy dilemma around a central fiscal capacity can only be overcome if fiscal risk sharing and risk reduction advance in parallel. Therefore, reform of EU fiscal rules need to receive more attention.

The CEPR Policy Insight by 14 French and German economists (Bénassy-Quéré *et al*. 2018) marks a crucial stage in a long-lasting debate on how to reform the euro area. It offers a convincing synthesis in a discussion which until then had been held hostage by diametrically opposed camps: the advocates of risk reduction led by Germany and the apologists for risk sharing led by France. Bénassy-Quéré *et al*. (2018) convincingly underscore that the debate can be won neither on the battleground of the first best nor on the moral high ground. Progress requires movement on both fronts – risk sharing and risk reduction are complements, not substitutes.

We share this view. In this column we focus on fiscal policy dimensions and argue that finding the appropriate balance between risk sharing and risk reduction will be of crucial importance. We are convinced that fiscal risk reduction must be part and parcel of any viable reform proposal. In essence, establishing new arrangements of fiscal risk sharing such as a central fiscal capacity will only be politically feasible and economically effective if accompanied by a serious effort to strengthen existing elements of fiscal risk reduction.

Completing EMU or defending the status quo?

The euro crisis of 2011-2012 was a particularly drastic reminder of how incomplete the architecture of the single currency area has been. However, the insight of how important a central fiscal capacity (CFC) would be for the smooth functioning of a monetary union pre-dates the euro crisis by quite a bit. In particular, the theory of optimum currency areas and fiscal federalism pre-date the crisis by around 50 years. Yet, these early insights are more relevant than ever before.

Therefore, the underlying question is not whether a CFC is needed to complete the EMU; rather, how much additional integration do citizens and their political representatives really want. In some euro area countries, more integration has become a euphemism for footing more bills of policy mistakes made by others. They are not at

Progress with EMU deepening has been hampered by diametrically opposed views on the need for risk reduction versus risk sharing all convinced that the benefits of further integration outweigh its costs, especially fiscal ones. Other countries in contrast underscore the benefits of more fiscal integration for the overall stability of the EMU and bemoan the moral intransigence of the other camp.

The current impasse can only be overcome if we accept the reservations of both camps and take them into account when putting forward reform proposals. Clearly, this key message of Bénassy-Quéré *et al*. (2018) applies to all policy areas of economic and monetary integration. We would add that it carries particular weight in relation to fiscal integration, because that's where citizens see the most direct impact in the form of taxes and transfers.

Two sides of the same coin

To be clear, we are strongly in favour of a CFC; we believe it is a crucial element of a complete EMU. And indeed, the call for a CFC aimed at dealing with major adverse shocks, is becoming louder: the IMF (Berger *et al*. 2018, Arnold *et al*. 2018) has recently confirmed its strong support for a CFC, a support that is shared by many others, including earlier contributions such as Beblavý *et al*. (2015), Dolls *et al*. (2015), Carnot *et al*. (2017), Abraham *et al*. (2017), and Beetsma *et al*. (2018).

The design of a CFC raises many questions: what should it target – unemployment or investment? How should it be triggered – automatically or with expert judgement? Which shocks should it address – symmetric or asymmetric? How should it be funded – transfers, borrowing, a budget? And how should the moral hazard problem be tackled? The last one features particularly prominently in the policy debate. How can we ensure a CFC does not make governments less attentive towards prudent fiscal policymaking?

There are several ways to address the underlying concern, but one stands out: making access to the CFC conditional on compliance with commonly agreed fiscal rules. Hence, strengthening the EU fiscal framework and setting up a

CFC must be seen as one package. Trying to push ahead with a CFC without improving the common fiscal rules will not work.

The assessment of how the SGP has worked exhibits a clear cyclical pattern. The post-2007 crisis illustrates this nicely. After the crisis had broken out and until recently, the consensus was that the SGP had failed, and valiant attempts were made to amend shortcomings. Right now, after several years of solid economic growth, the assessment by EU institutions has become more sanguine: the SGP is again considered to have worked.

A typical argument to substantiate the rosier appraisal is to say that public finances in other jurisdictions such as the US, Japan, or the UK are in a worse shape. What this view overlooks is that complete economic and monetary unions, which include a central fiscal instrument and one single sovereign bond market, can afford higher deficits and debt.

If we adjust for the cycle in the shifting assessment, the impact of the SGP has not been impressive. It did not push member states to take advantage of economic good times. Whenever a downturn arrived, some countries had not accumulated sufficient buffers to let automatic stabilisers dampen the decline in aggregate demand. Painful and pro-cyclical consolidation measures had to be implemented, giving rise to misgivings.

Initially, the predicament was blamed on the 'stupidity' of the rules, but things did not improve as rules became more 'intelligent'. The outcome is an excessively complex set of rules that few understand and where the many elements of discretion are less used to tackle economic contingencies, but to solve problems that lie outside the realm of fiscal policy making.

There has been a surprising convergence of views on how to overhaul the SGP. Since the complexity of the current system has put off almost everyone simplification is the magic word. Almost all proposals put forward in the recent past, including by the European Fiscal Board (EFB)[1], are organised around the same basic elements: one main objective (reducing government debt), one operational rule (capping expenditure growth, for example), and a parsimonious use of escape clauses (to account for unforeseen contingencies).

Some observers doubt simplification will work; they think simplification is an illusion, because there are too many details and special circumstances (the cycle, one-off measures, and much more) that need to be taken into account in order to produce sensible results and ensure strict cross-country consistency (Bini-Smaghi 2018). The problem with this view is that it is stuck in the fallacious paradigm of the complete contract.

Expert judgement is inevitable in the application of fiscal rules, as it is in all areas of economic policymaking; the key question is who should exercise it. Bénassy-Quéré *et al*. (2018) raise this fundamental question and advance a proposal that is in line with our thinking and the thinking of the EFB (EFB 2017). The proposal is to separate the assessment of fiscal policy developments vis-à-vis commonly agreed rules and the political decision on whether steps are to be taken under the rules. Bénassy-Quéré *et al*. (2018) refer to the role of the 'prosecutor' and the 'judge'. While we share the idea of separating roles, we find the expressions 'prosecutor' and 'judge' misleading. The 'judge' is generally meant to impartially interpret the law in light of the available evidence.

In EU fiscal surveillance the 'judge' is the decision maker endowed with the necessary democratic legitimacy, and its decision will and should follow prevailing political majorities. It is the 'watchdog' rather than the 'prosecutor' who should provide an impartial assessment, and by making the assessment public it enhances the accountability of the decision maker. With further economic and political integration the European executive will inevitably move from its original role of the guardian of the Treaty to a more conventional executive branch that takes political decisions. As a result, an independent assessment will gain in importance[2].

The role of market discipline

Although the disciplining effect of the financial markets on fiscal policymaking has proved erratic, recent commentaries, including Bénassy-Quéré *et al*. (2018), have emphasised the potentially increased role of financial markets. Since institutions have failed, the underlying argument goes, it is time for markets to step in. Bénassy-Quéré *et al*. (2018) put forward a novel idea whereby euro area countries should finance new debt in excess of limits imposed by the SGP's expenditure benchmark with junior debt. The higher yield on junior than on senior debt would encourage fiscal discipline.

Junior debt may indeed fulfil a useful role in this regard. However, we also see risks to its issuance. First, one needs to be able to unambiguously establish that the threshold activating its issuance has been exceeded – assessing compliance with the expenditure benchmark involves judgement. Second, placement of junior debt may be risky if the existing senior debt stock is very high – markets may be disrupted if they are reluctant to accept the junior debt (realise that financial markets do not react in a smooth way). Third, how can one legally enforce the issuance of junior debt?

An alternative to the issuance of junior debt could be a 'budgetary charge' levied at the EU level for non-compliance with commonly agreed rules. The charge would not be imposed by the markets, which have a track record for not being consistent, but by the supranational institution. Different designs are imaginable in practice, but the underlying mechanism could be as follows.

For as long as a member state is found to run afoul of key elements of commonly agreed rules, a given percentage of EU expenditure allocated to that member state would be transferred – subject to a decision of the Council with reversed qualified majority – to a rainy-day fund to be used – again based on a Council decision – the next time the country is in economic bad times.

Conditionality on EU expenditure is not new and has slowly grown over the years. The recent Commission proposal for the 2021-2027 Multiannual Financial Framework even aims at extending it to areas such as the rule of law. For the reasons mentioned above, the budgetary charge would unlikely be effective with the current set of fiscal rules. It would have to be introduced with the overhaul of the fiscal framework.

Concluding remarks

Progress with EMU deepening has been hampered by diametrically opposed views on the need for risk reduction versus risk sharing. There is increasing doubt in the policy debate about whether further steps of integration should actually be taken. The contribution by Bénassy-Quéré *et al*. (2018) contains welcome suggestions for finding common ground to break the deadlock. We agree with this approach and view an exchange of risk reduction and risk sharing as a prerequisite to make progress with the fiscal architecture of EMU.

In fact, as we have argued, political support for a properly designed central fiscal capacity will only emerge if access to the CFC is made conditional on an effective fiscal framework. Consequently, fiscal rules need to receive more attention. ■

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Endnotes

1. The EFB has outlined its proposals for simplification in its first Annual Report 2017. Other prominent proposals, in *addition to those included in CEPR Policy Insight No. 91, include Eyraud and Wu (2015), Claeys et al. (2016) and Eyraud et al. (2018).*

2. Interestingly, not all advocates of a radical simplification of the SGP thematise the separation of roles, which we believe is essential to make a simplification work in practice.

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