Redemption?

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Abstract

The economic crisis which started in 2008 led to a strong rise in public debts. The sovereign debt crisis in euro area southern countries breached the unity of the euro area and weakened the 'single currency' concept. The paper shows that this situation is not due to a lack of fiscal discipline in Europe, but to drifts in financial capitalism and to an inappropriately designed euro area economic policy framework. Public debts homogeneity needs to be resettled in Europe. European public debts should become safe assets again, and should not be subject to financial markets' assessment. European Member States should not be requested to pay for past sins through austerity measures, and should not strengthen fiscal discipline through rules lacking economic rationale. The paper deals with recent proposals which have been made to improve euro area governance (redemption fund, Eurobonds, public debt guarantee by the ECB). The paper advocates for a full guarantee of government bonds for the Member States who commit to an economic policy coordination process, which should target GDP growth and coordinated reduction of imbalances.

Keywords: EU fiscal policy, EU governance.

Résumé

La crise économique qui a débuté en 2008 a entraîné une forte hausse du montant des dettes publiques. La crise des dettes publiques des pays du Sud de la zone euro a brisé l'unité de la zone et a affaibli la notion de « monnaie unique ». L'article montre que cette situation ne provient pas d'un manque de discipline budgétaire en Europe, mais de la dérive du capitalisme financier et de défauts de conception de la zone euro. Il est indispensable de rétablir l'unité des dettes publiques en Europe, celles-ci doivent redevenir des actifs sans risque, non soumis à l'appréciation des marchés financiers. Il ne faut ni viser à faire payer les Etats membres de leurs péchés passés par une cure d'austérité ; ni renforcer la discipline budgétaire par des règles sans fondement économique. L'article discute des différents projets qui ont été proposés pour améliorer la gouvernance budgétaire de la zone (fonds de rédemption, trésor européen, euro-obligations, garantie de la BCE). Il se prononce pour une garantie totale des dettes publiques des pays qui se soumettent à un processus de coordination des politiques économiques, coordination dont les objectifs doivent être la croissance et la résorption coordonnée des déséquilibres.

Mots-clés**:** politique budgétaire européenne, gouvernance européenne.

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1. Introduction

The 2008 crisis led public debts to rise strongly, by around 28 percentage points of GDP in terms of the Maastricht debt for the euro area, 40 percentage points for the UK, 45 for the US, 66 for Japan. Net debts to GDP ratios rose by 22.5 percentage points of GDP in the euro area, 42 in the US, 50 in the UK, and 64 in Japan. At the end of 2013, almost all euro area countries will run higher than 60% of GDP public debts. This is also the case for the UK, Japan, and the US.

There is no specificity in the euro area as a whole. However, debts rose very strongly in some countries: Ireland (by 78 percentage points in terms of the Maastricht debt-to-GDP ratio, 85 percentage points in terms of net debt), Greece (by respectively 60 and 77 percentage points), but not Portugal (55/38) and Italy (24/13).

During the crisis, monetary policies have become strongly expansionary, with central banks' interest rates having been cut down to almost 0. In view of the depth of the recession, markets expect that interest rates will remain durably low, and hence long-term interest rates have fallen. Thus, the 10-year government bond rate decreased from 4.6% in 2007 to 1.8% in 2012 in the US, from 5% to 1.9% in the UK, from 1.7% to 0.8% in Japan, despite the rise in public deficits and debts. In the euro area, interest rates fell also in Germany (from 4.2% to 1.5%), in France (from 4.3% to 2.6%), but financial markets fearing or betting against a sovereign debt default in Southern economies requested exorbitant interest rates, i.e. on average in 2012: 5.5% for Italy, 5.9% for Spain, 6.3% for Ireland, 11% for Portugal, 22.9% for Greece. Markets request unjustified interest rates weighing on public finances and national income in these countries; markets are self-fulfilling, and in addition to that the requested interest rates break the unity of the euro area, and destroy the 'single currency' notion. A Spanish company cannot borrow at the same rate as a French company. The interest rates that countries have to pay are conditional to fears or speculation on financial markets.

Should we pay back our sins by a redemption period? How to re-establish the homogeneity of public debts in the euro area? Should we aim to bring debts back to their pre-crisis levels? How to halt the rise in public debts? The answers to these questions depend on the diagnosis made on the roots of the crisis: is the crisis due to a general lack of fiscal discipline, to drifts in financial capitalism or to a euro area inappropriate framework. Section 2 addresses these issues. Section 3 deals with the drawbacks of the euro area framework. Section 4 discusses the reforms introduced since the beginning of the crisis: Fiscal Pact, European Semester, ESM, MTO, Consolidation strategy. Section 5 deals with the different recent proposals made with a view to bring the debt crisis in euro area countries to an end: more federalism, the European redemption fund, European Treasury, euro-bonds, public debt guarantees by the ECB. It is difficult, not to say impossible, to have simultaneously solidarity and autonomy.

2. A lack of fiscal discipline?

In order to assess public finance management before the crisis, one must go back to 2007. According to the OECD assessment released in the June 2008 *Economic Outlook*, the euro

area output gap was nil in 2007; most euro area countries were close to potential output. Euro area inflation was stable at 2.1% per annum; the euro area unemployment rate had come down to 7.4%. In autumn 2012, the OECD revised its assessment: the euro area was now considered to have been running at over full capacity in 2007 with a positive output gap of 3.3%. But in 2007, there was no element on which to base such an assessment; there was no sign of such imbalances.

Table 1 shows that in 2007, most Member States (MS) were running a primary government surplus, i.e. a 1.9% of GDP surplus for the area as a whole. France and Portugal were the only countries running a primary balance slightly below the level requested to stabilise the debt-to-GDP ratio. The euro area primary balance was 1.8 percentage point above this level. In fact, some countries like Spain, Ireland, and even more Greece benefited from very low interest rates as compared to their robust GDP growth. Their public debts were stable, but this was fragile (especially as concerns Greece), because it was relying on the gap between interest rates and GDP growth. The crisis led to a strong and rapid deterioration in government balances, but this deterioration results from the output fall. Current public deficits do not reflect pre-crisis structural imbalances.

Table 1. Public debt stability in 2007

	Government balance, % of GDP	Primary government balance, % of GDP	Net debt, % of GDP	Real interest rate less GDP growth, Percentage point	Stability gap*, Percentage point
Germany	0.2	2.7	42.5	2.0	1.8
France	-2.7	-0.2	35.7	0.3	-0.3
Italy	-1.6	3.1	87.1	0.9	2.3
Spain	1.9	3.0	17.7	-2.5	3.4
Netherlands	0.2	1.8	27.8	0.2	1.7
Belgium	-0.1	3.6	73.1	0.0	3.6
Austria	-1.0	1.0	31.4	0.1	1.0
Greece	-6.8	-2.3	82.4	-2.8	0.0
Portugal	-3.2	-0.6	49.7	0.5	-0.9
Finland	5.3	4.7	-72.6	0.1	4.8
Ireland	0.1	0.7	-0.3	-4.0	0.7
Euro area	*-0.7*	*1.9*	*40.1*	*0.3*	*1.8*
UK	-2.8	-0.8	28.3	-0.3	-0.7
US	-2.9	-1.0	48.0	-0.6	-0.7
Japan	-2.1	-2.1	80.5	0.9	-2.2

Explanatory note: the sustnability gap is measured as the difference between the primary government balance and the balance required to stabilise debt (net debt*long-term interest rate corrected from trend growth).
Source: OECD *Economic Outlook*, 2008/1 and 2012/2, authors' calculations.

A single monetary policy for countries where GDP growth rates and inflation rates structurally differ inevitably generates imbalances. Before the crisis, disparities had been

growing in the euro area between two groups of countries implementing unsustainable macroeconomic strategies: Northern countries (Germany, Austria, the Netherlands) implemented neo-mercantilist strategies which allowed them to accumulate competitiveness gains and large current surpluses, while Southern economies were accumulating large current account deficits due to robust growth strategies boosted by real negative interest rates (Deroose *et al.*, 2004; Mathieu and Sterdyniak, 2007). The economic policy framework of the Maastricht Treaty was unable to prevent the rise in imbalances which became unsustainable when the crisis burst.

In 2007, several euro area countries were running large current account surpluses (table 2): The Netherlands (8.1% of GDP), Germany (7.9%), Finland (4.9), Belgium (3.5) and Austria (3.3), while other countries were running large deficits: Portugal (8.5% of GDP), Spain (9.6%), and Greece (12.5%). The 230 billion euros surplus in Northern economies was initiating and financing the 180 billion deficit in Mediterranean countries. The financial crisis put an end to the debt accumulation process.

Table 2. Current account balances in 2007

	Billion euros	% of GDP
Luxembourg	3.8	10.1
Netherlands	48.6	8.1
Germany	192.1	7.9
Finland	7.3	4.9
Belgium	12.8	3.5
Austria	9.1	3.3
Denmark	1.6	0.7
Italy	-27.7	-1.7
France	-43.0	-2.2
Slovenia	-1.6	-4.6
Slovakia	-2.8	-4.7
Ireland	-10.1	-5.3
Portugal	-16.0	-8.5
Spain	-105.1	-9.6
Greece	-33.4	-12.5
Total	39.4	0.4

Source: IMF.

In 2012, the depth of the recession makes it very difficult to estimate potential growth, if this concept makes any sense, and hence to assess structural government balance levels. According to the latest EC estimates, euro area potential output growth would stand at 0.5% only per year in 2012-13 and the euro area output gap would be -2.3%. All countries except Germany still have to make budgetary efforts to meet the objective of structural balanced budgets. According to us, under the assumption that the financial crisis did not affect potential growth, the output gap is around -11 percentage points of GDP; the objective should be to run

a primary structural budget in balance, which will be sufficient to stabilise the debt-to-GDP ratio, if the interest rate equals (or is lower than) the GDP growth rate. From that perspective, no MS currently needs to make budgetary efforts. The priority is to recover the output lost since the beginning of the crisis. Euro area countries are in a better situation than the US and Japan. The euro area does not suffer from past insufficient fiscal discipline. The roots of the crisis lie in the drift in the wage/profit shares in value added and in the rise in inequalities which have led some MS to increase government deficits to support output. Deficits have risen since 2008 because of the magnitude of the crisis and of the inappropriate euro area economic policy framework.

Table 3. Primary government balances in 2012

% of GDP

	Gov. balance	Structural balance (EC)	Primary balance	Structural primary balance*
Germany	-0.2	0.0	1.6	3.6
France	-4.5	-3.3	-2.0	2.5
Italy	-2.9	-1.3	2.0	8.4
Spain	-8.0	-6.0	-5.6	1.9
Netherlands	-3.7	-2.2	-2.3	2.9
Belgium	-3.0	-2.3	0.2	4,1
Austria	-3.2	-2.9	-1.0	2.4
Portugal	-5.0	-3.1	-0.5	6.3
Finland	-1.8	-0.6	-2.0	5.3
Ireland	-8.4	-7.7	-4.3	3.3
Greece	-6.8	-1.2	-1.4	12.9
Euro area	*-3.3*	*-2.2*	*-0.6*	*4.9*
United Kingdom	-6.2		-3.3	3.3
United States	-8.5		-6.7	-3.0
Japan	-8.3		-7.4	-3.5

*Authors' estimates. Source: European Commission, *Winter Forecasts, European Economy*, February 2013;

3. The euro area drawbacks

The single currency suffers from six original sins, which are difficult to correct:

- According to economic theory, there cannot be a single currency between countries with different economic situations and who wish to keep independent economic policies. The single currency entails introducing economic policy coordination or solidarity mechanisms. Otherwise how to prevent the emergence and persistence of imbalances between some countries running large external deficits and some others running large surpluses? How to handle these situations?

- These mechanisms cannot consist in rigid numerical rules enshrined in a Treaty (such as: public deficits should not exceed 3% of GDP, public debts should not exceed 60% of GDP, structural government budget in balance in the medium term). These mechanisms must be both soft (the objectives should be agreed between countries accounting for the current economic context) and binding (everyone must comply with decisions agreed in common).

But how may governments with necessarily different interests and analyses reach agreement on economic policy strategies? How to convince a country to change its economic policy in order to meet common rules?

- The rules of the game should have been set by clearly considering all possibilities of symmetric or specific shocks, accounting for different objectives. What should be done if a country wishes to build current account surpluses? What should be done after a common or specific shock? How to define the nature of the shock? But no such rules were settled. For instance, no one could imagine in 1997 a situation where monetary policy would not be able to cut nominal interest rates, where public debts would have risen due to banks' rescue packages, etc…

- On the one hand, there cannot be unconditional solidarity between countries with different social and economic systems. For example, Northern countries may refuse to support Southern countries, blaming them for not having undertaken the necessary reforms, for having let imbalances grow and for being unable to meet their commitments. On the other hand, such solidarity is a prerequisite for the single currency to be guaranteed.

- According to the EU Constitution, the ECB is not entitled to finance directly governments (Article 123, TFEU); financial solidarity between MS is forbidden (Article 125, TFEU). Thus, each MS has to borrow on financial markets without any guaranteed support from a central bank acting as a "lender of last resort". This raises the risk that some MS may not be able to fulfil their commitments and may default. MS public debt is no longer a safe asset. Financial markets started to realise this from mid-2009. Today, after the experience of the Greek default, they request unsustainable interest rates to countries in difficulty, which increases further the difficulties of the latter.

- Euro area MS are now under financial markets' judgement and they do not control anymore their interest rates unlike Anglo-Saxon countries or Japan. But financial markets have no macroeconomic expertise, they are – and know that they are – self-fulfilling. However, Northern countries refuse a collective guarantee of MS public debts. They consider that the discipline imposed by financial markets is necessary. But disparity among interest rates is arbitrary and costly. In the long term, for instance, a country like Italy, with a 2.4 percentage points interest rates spread with France, should pay financial markets a premium of around 3% of GDP as a guarantee to an alleged default risk.

- The 2007-2012 crisis is a deep crisis of financial capitalism, which would have requested a strong policy response from governments to reduce the weight of finance and the reliance on public and private debts, to implement a macroeconomic strategy aiming at full employment. But European authorities have denied any questioning of the pre-crisis strategy. This strategy is based on three postulates: the power of national governments should be reduced and handed over to European authorities; fiscal policies should be paralysed; growth should be sought through liberal structural reforms. This strategy did not deliver until now: the euro area remains in depression.

4. Reforms: the EC strategy

The EC strategy has consisted so far in four pillars:

a) Strengthening fiscal discipline

The Commission persists in saying that the functioning of single currency requires structurally budgetary positions in balance. On 29 September 2010, the Commission released a set of Six directives (the six-pack) aiming at "strengthening economic governance", in other words the SGP fulfilment, without questioning the relevance of the latter. The Six-Pack contents were involved in the Fiscal Pact, ratified on 2 March 2012. This Pact is a new step forward from liberal views against Keynesian economic policies and from EU authorities against domestic fiscal policies.

Article 3.1 states that: "The budgetary position of the general government shall be balanced or in surplus. This rule shall be deemed to be respected if the annual structural balance of the general government is lower than 0.5% of GDP. The MS shall ensure rapid convergence towards their respective medium-term objective. The time frame for such convergence will be proposed by the Commission […]. The MS may temporarily deviate from their medium-term objective or the adjustment path towards it only in exceptional circumstances. A correction mechanism shall be triggered automatically in the event of substantial deviations from the adjustment path. The mechanism shall include the obligation to implement measures to correct the deviations over a defined period of time".

Thus, running budgetary positions close to balance is enshrined in the Pact although it has no economic rationale. The true 'golden rule of public finances' justifies on the contrary that public investment is financed through borrowing, since investment expenditure will be used over many years. Besides, households, insurance companies, financial institutions wish to own public debt. If the desired public debt stands at around 60% of GDP and if nominal GDP grows by around 4% per annum (i.e. by 2% in volume and 2% in prices), it is justified to run a public deficit of around 2.4% of GDP. Besides, a public deficit is necessary when it allows reaching a satisfactory demand level leading to the highest output level not accelerating inflation, at a real interest rate close to GDP growth. There is no guarantee that running a government budget in balance is optimal. Since countries do not control anymore interest rates and exchange rates, they need degrees of freedom in the conduct of their fiscal policy.

The Pact requests MS to converge rapidly towards this objective, at a pace defined by the Commission, without accounting for the cyclical context. A temporary deviation would be allowed in case of exceptional circumstances, if 'the deviation from the reference value results from a negative growth rate or from a cumulated fall in output over a prolonged weak period of growth as compared to the potential growth rate' but corrective measures should be taken rapidly. The Commission refuses to recognise that most euro area countries have been in such a situation since 2009, and persists to require the implementation of policies to cut rapidly deficits.

The Pact is based on the structural deficit notion, i.e.: 'deficit corrected from the cyclical component, excluding one-off and temporary measures'. But measuring such a deficit is problematic, especially in the event of strong macroeconomic shocks. In practice the estimates and methods of the Commission will have to be used. But they have two drawbacks. First, these estimates are always close to observed output, since the methods used consider as structural the fall in capital resulting from the investment fall during the crisis: this underestimates the cyclical deficit and will impose pro-cyclical policies. This will oblige MS to undertake pro-cyclical policies, as we could see since 2010.

Second, the estimates vary strongly over time. Hence, potential output estimates for 2006 were revised substantially downwards in 2008. In spring 2007, the Commission estimated that there was a negative output gap of 1% in France in 2006, i.e. the French economy was operating at below its potential. France had not yet reached back its potential output level since the 2002-2005 slowdown. Estimated potential growth for 2008 was 2.3%. In autumn 2011, the Commission considered that France had in 2006 a significantly positive output gap of 2.3% and that potential growth in 2008 was 1.6%. The French economy was therefore at a peak of activity. The potential output level estimate for 2006 was revised downwards by 3.3%. For 2012, what is the French output gap? The Commission (Spring 2013) estimates it at -2.8%, implying that, due to the crisis, the French potential growth rate decreased from 2% to 1.2%. The OECD estimate is -3.4%. If we assume that the crisis did not affect potential growth, then the output gap is -8%. With the Commission's estimates, the French structural government deficit is 3.1% of GDP in 2012 and therefore France should to pursue at least four years of budgetary efforts in the order of 0.75% of GDP per annum. These efforts will weigh on GDP growth and the 1.2% potential growth estimate will probably be validated. With an estimate of a -8% output gap, the structural deficit is only 0.5% of GDP, below the 2.4% of the true golden rule; clearly, the objective today should be to support output so that it reaches its potential level.

According to paragraph 3d, the structural deficit target can be lowered to 1% if debt stands below 60% of GDP. Let us consider a country with GDP growing by 2% per year and annual inflation growing by 2%. If this country runs permanently a 1% of GDP deficit, its debt will come down to 25% of GDP. But nothing guarantees that the macroeconomic equilibrium may be ensured with *a priori* set values: government debt = 25% of GDP; deficit = 1% of GDP.

According to article 3.2, MS should introduce in their constitution the balanced budget rule and an automatic correction mechanism if the public balance deviates from its target, or if this cannot be done, a binding and permanent correction mechanism. The correction mechanism must be based on principles proposed by the Commission. Thus, unenforceable, vague and lacking economic rationale rules would have to be enshrined in the Constitution.

MS will have to set up independent institutions in charge of verifying that the balanced budget rule and the adjustment trajectory path are met. This is one more step towards full technocratic management of fiscal policy. Will these independent institutions be entitled to

question the rule or the adjustment path if the latter does not match the cyclical needs of the economy?

Article 4 repeats the rule according to which public debts should come down below 60% of GDP. This rule was already part of the SGP, but the Commission could not impose it. Thus, a country running a higher than 60% of GDP debt ratio will have to reduce this ratio by at least one twentieth of the gap with 60% each year. This rule assumes that a 60% of GDP ratio is optimal for and can be reached by all countries. But in Europe, countries like Italy or Belgium have run for a long time public debts of 100% of GDP (without mentioning Japan where it has reached 200% of GDP), without imbalances because these debts correspond to high domestic households savings.

However, for a country with a debt-to-GDP ratio of 90% and a nominal growth of 3% this implies that the public deficit is less than 1.115% of GDP. Therefore, this does not introduce additional constraints in the medium term, as compared to a balanced budget target.

According to article 5, a country under an EDP will have to submit its budget and its structural reform programmes for approval to the Commission and the Council who will also exert surveillance on their implementation. This article is a new weapon to impose liberal reforms to MS populations. A country under an EDP has to follow the expected adjustment path for its nominal deficit. Therefore it has to implement all the more restrictive policies than domestic growth is low.

According to article 7, the Commission's proposals will be automatically adopted unless there is a qualified majority against them, the country concerned not voting. Thus, in practice, the Commission will always have the last word.

The Treaty does not introduce an effective economic policies coordination, i.e. an economic strategy using monetary, tax, fiscal and wage policies to reduce economic imbalances in the MS and to come closer to full employment.

The Pact obliges MS to run quasi-automatic fiscal policies, prohibiting any discretionary fiscal policy. But the latter are needed to reach full stabilisation. Let us assume that the tax rate is 50% and that the propensity to spend is 1; then the multiplier equals 2. If private spending falls by 10 e*x ante,* GDP will fall by 20 and the public deficit will rise by 10. without active fiscal policy response. An active expansionary policy, which increases public spending by 10 leads to the same public deficit, but avoids the output to fall. This is prohibited by the Pact, which is based on an implicit but wrong theory: automatic stabilisers must play, but discretionary fiscal policies to support growth should be prohibited.

According to the Pact, each country should run restrictive measures without accounting for the domestic economic situation and policies in the other MS. The Pact assumes implicitly that the Keynesian multiplier is zero, that restrictive policies have no impact on GDP. If we consider the situation in early 2013, this implies that all countries should run austerity policies even if their public deficits are due to insufficient output levels following the burst of the

financial bubble. Also, the Pact may impose a long period of austerity policies in Europe, which will breach euro area growth and will increase imbalances in the most vulnerable MS.

The Commission has been pursuing its efforts to control domestic polices, and has been trying since November 2011 to have two new directives adopted (the two Pack). According to the first one, the Commission would be entitled to criticise euro area MS budgets before they are passed by the Parliament, and could publicly ask for budget amendments. Fiscal policies' supervision will be permanent for MS under an EDP. Countries could be requested to introduce Independent Budget Committees; budgets should be based on independent macroeconomic forecasts.

According to the second directive, the Commission will be entitled to put a MS under strengthened surveillance and the Council could impose it to request financial support.

Some economists and even ministers in Germany or the Netherlands requested that a country not fulfilling the SGP may be condemned by the European Court of Justice. Fiscal policy would be submitted to the judiciary power. Other voices requested that the country concerned may be deprived of structural funds or voting right. The ECB president had suggested that a EU Commissioner be responsible of public finances in the euro area and may control MS budgets.

We can observe a strengthening of binding and absurd fiscal rules, inconsistent with macroeconomic governance needs. This is a failure of today's EU construction: better economic policies coordination is necessary, but a strict numerical constraint on public deficit levels is not economic policy coordination and goes in the wrong direction.

Box 1: A Keynesian perspective

From a Keynesian perspective, a certain level of debt and deficit are necessary to ensure that demand equals potential output.

If $y = g + d + cy - \sigma r + kh$, with h, public debt, stabilisation implies that in the short-run: $g = -d + \sigma r$

If this policy is implemented and if stabilisation is perfect, there is no link *ex post* between the deficit and the output gap. Let us note also that, in this case, g, government borrowing, is considered as structural according to the OECD or the EC methods, which makes no sense.

In the long run, g = 0 and $h = -(d - \sigma r) / k$

The long-term public debt level is not arbitrary, but depends on private agents' wishes: debt must equal desired debt at the optimal interest rate, i.e. the rate equal to the growth rate.

This simple model shows that a fiscal rule like: $g = g_{\circ} - \lambda y - \mu(h - \overline{h})$ cannot be proposed, since it would not allow for full stabilisation and since the government cannot set a debt target regardless of private agents' saving behaviour.

b) Improving economic policy coordination

In 2011 a first 'European semester' was introduced, during which MS present their fiscal plans and structural programmes to the Commission and the European Council, who both give

their opinion before the vote in the National Parliament in the second semester of the year. Such a process could be useful if the objective was to define an agreed economic strategy, but the risk is that this semester increases the pressure on each MS to implement austerity measures and liberal reforms. No agreed plans to reduce imbalances between MS or to support growth have been implemented in 2012 or 2013.

The Six-Pack allows the Commission to exert surveillance on the excessive macroeconomic imbalances in each country by following a scoreboard of relevant variables (competitiveness, external current account, public and private debts). A Macroeconomic Imbalance Procedure has been introduced. Recommendations will be sent out to countries running imbalances. Fines may be decided. So far the Commission does not recommend coordinated strategies to reduce imbalances. Here also, countries are criticised for running excessive public or external deficits, but not for running surpluses.

In June 2012, the employment and growth pact could be seen as re-orientation of the European Strategy, but it was not included in the EU major policies. A euros 120 billion amount is mentioned, i.e. 1% of euro area GDP, but these measures apply to an undefined period of time, while fiscal consolidation policies amount to 2% of GDP per year. The European Council decision in January 2013 to cut the EU budget (in percentage of GDP) brought the hope of fiscal expansionary measures to an end.

c) Implementing some degree of financial solidarity

Financial solidarity has increased progressively since the beginning of the crisis, despite the reluctance of Northern economies, especially of Germany. However, solidarity remains conditional and limited. At the beginning of 2013, three mechanisms are in place.

The European Stability mechanism (ESM) launched in October 2012 introduces some degree of financial solidarity between the MS, but this solidarity is limited and has a very high price. The ESM can lend up to 500 billion euros. It may lend to governments or buy public debt on primary and secondary markets. Countries may benefit from the ESM if they have adopted the Fiscal pact and have fulfilled it. The ESM support will be conditional: a country needs to commit to fulfil a drastic fiscal adjustment programme imposed by the Troika, and will therefore lose all domestic fiscal autonomy and have to accept a long austerity period. The Greek example shows that this type of plan is not the way out of the crisis. The solidarity which is being implemented does not consist in donations but in loans.

The ESM debt will be considered prior to private ones. Public bond issuance should involve a collective action clause, i.e. in case of default, stated by the Commission and the IMF, the country will be entitled to agree with creditors on a change in payment conditions, the agreement applying to all creditors if a majority agrees. Euro area government debts will become speculative as was the case for developing economies, and will not be considered anymore as a safe asset by financial institutions. The interest rate on public debt will rise, be more volatile and less easy to control. Why build a euro area to reach such a situation?

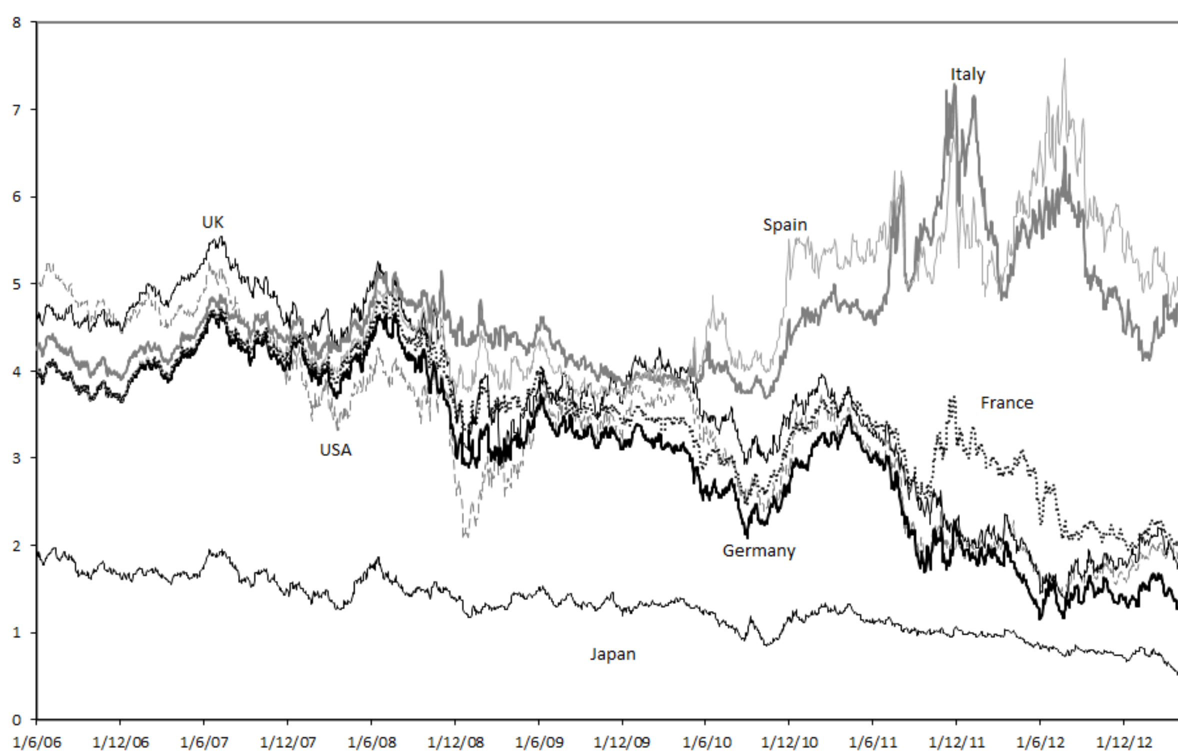
On 29 June 2012, it was agreed in the case of Spain that the ESM will be allowed to intervene to recapitalise banks, to abandon its status of preferred creditor and to help a country which makes the necessary efforts, but is still under financial markets' attack, by a simple agreement 'memorandum'.
On 6 September 2012, the ECB announced a purchasing bonds programme on the secondary markets, for short-term bonds (1-3 years), **the so-called MTO.** No quantitative ceiling has been set. The ECB does not set a target in terms of acceptable interest rate spreads. The ECB announces that it will not be a preferred creditor in order to show that it takes the same risks as private creditors. But the ECB interventions will be subject to strict conditionality. Countries will have to agree on an adjustment programme with the Commission and the European Stability mechanism, the programme being coordinated by the IMF. The ESM will support the country through buying bonds on the primary market. Supported countries will have to make commitments in terms of fiscal consolidation and structural reforms. Since the bonds concerned have short-term maturities, the ECB will be able to stop buying them if the countries concerned do not fulfil their commitments.
Financial markets' fear was self-fulfilling: markets were afraid that Spain would default. Thus, they were refusing to lend to Spain or were requesting high interest rates, which was reinforcing default risks. Since these rates were also applying to companies, this was contributing to deepen the recession in these countries. In putting no ceiling to its interventions, the ECB reassured markets on default risks in the concerned countries, on the risks of a euro area break-up. The ECB broke the spiral of self-fulfilling expectations, so that finally it did not have to intervene. Lower interest rates can help to boost activity. Conversely, countries will have to pursue severe austerity policies. The ECB imposes its views on the economic strategy to be implemented. It requests labour market and goods structural reforms; the full commitment to government balance targets despite the recession; the rapid implementation of the Fiscal Pact. There is a risk that austerity implemented simultaneously in the euro area leads the area to remain durably in crisis.
Although the MTO has not effectively been used, the simple fact that it exists has been sufficient to reduce substantially interest rates spreads to (considering the Dutch rate as a benchmark) 3.35 percentage points for Spain and 2.65% for Italy. But these lower risk premia remain fragile. The euro area remains in permanence under the threat of financial markets' renewed defiance after election results or the release of a fiscal imbalance.
Moreover some German economists (see Doluca *et al*, 2012) consider that the ECB has over-passed its mission in committing itself to support public debt in some countries, that this is not an incentive for countries to implement the necessary reforms, that the ECB should focus strictly on price stability.

Table 4: 10-year government interest rates

	February 2012	February 2013
Greece	40.8	11.1
Portugal	12.3	6.9
Spain	5.05	5.15
Italy	5.5	4.45
Ireland	7.8	3.1
Belgium	3.65	2.3
France	2.95	2.2
UK	2.1	2.1
Sweden	1.8	2.0
US	2.0	1.95
Austria	2.85	1.9
Netherlands	2.2	1.8
Finland	2.3	1.8
Germany	1.9	1.6
Japan	1.0	0.7

Chart 1. 10 year government interest rates

In percent



Source: Financial markets

Transfers between banks in the euro area translate in practice in the **Target 2 system balances**. If a country runs a current account deficit which is not financed by capital inflows, or if it suffers from capital flights, its banks will have a disequilibrium which they will be able to finance through borrowing from the ESCB. Conversely, countries running surpluses become lenders to the ESCB. However, this system does not work directly for public debts, since governments have the obligation to issue debt on markets, and at markets' conditions. On the one hand, this mechanism guarantees automatic financing of national banking systems; questioning it more or less significantly would make the euro fragile, either through introducing a debt ceiling by country or higher refinancing interest rates for banks in some countries. This mechanism allows to compensate money transfers between banks of different countries inside the area. On the other hand, this mechanism leads countries running surpluses to use their surpluses for not very productive purposes, while Northern countries could use their surpluses to finance FDI (foreign direct investment), or to lend to Southern area countries or countries outside the euro area. It is their choice not to do so.

Table 5. Net position in the Target 2 system

In billion euros

	October 2012	December 2012
Germany	719	656
Netherlands	118	121
Luxembourg	109	106
Finland	61	61
Slovenia	-4	-4
Cyprus	-10	-7
Belgium	-39	-38
Austria	-40	-38
Portugal	-70	-66
France	-46	-74
Ireland	-92	-82
Greece	-108	-98
Italy	-267	-255
Spain	-380	-337

d) Fiscal austerity in the euro area

In 2012, the output gap remained significantly negative in all euro area countries. At the euro area level, the estimates vary currently from -2.2% according to the Commission, to -3.7% for the OECD and -11% for OFCE. At the beginning of 2013, the Commission estimates euro area potential GDP to have grown by around 0.5% per year since 2009 (see EC Winter 2013 forecast). Such estimates suggest that Europe has no other choice but accept weak growth and high unemployment. But there is no explanation as to how supply factors would have induced

such a reduction in potential growth. If the only explanation is: “potential growth was affected by effective growth”, then a growth revival would lead to higher potential growth. Hence the concept of potential growth is meaningless and not useful for the conduct of economic policy.

In 2012, the euro area public deficit stood at 3.3% of GDP, well below the level in the UK (6.6%), Japan (9%), and the US (8.5%). Almost all euro area countries, except Germany, Finland, Estonia, and Luxemburg breached the 3% of GDP reference value of the Maastricht Treaty.

Notwithstanding economic developments since the beginning of the 2007 crisis, the Commission pursues its strategy: requesting MS to maintain restrictive fiscal policies, independently of the economic situation, and to impulse growth by structural reforms. Although this strategy failed to deliver, the Commission refuses to change its orientations, although partly due to them, growth has fallen. Euro area GDP was forecast to grow by 1.8% in 2012 according to the Spring 2011 EC forecasts but turned out to fall by 0.6%; for 2013, GDP was forecast to grow by 1.3% in the Spring 2012 EC forecast, versus -0.3 in the Winter 2013 forecast (see Table 6). It may also be noted that the EC has revised downwards once more potential output estimates in the recent period, for instance for 2012: from 1.1% according to the Spring 2011 forecast, to 0.8% one year ago and 0.4% in the Winter 2013 forecast. No explanations are given for these revisions, which are very surprising as many MS undertook the required structural reforms supposed to increase their potential growth.

Table 6. Euro area GDP growth forecasts, according to DG ECFIN Forecasts

	2010	2011	2012	2013	2014
Spring 2011	1.8	1.6	1.8		
Autumn 2011	1.9	1.5	0.5	1.3	
Spring 2012	1.9	1.5	-0.3	1.0	
Autumn 2012	2.0	1.4	-0.4	-0.1	1.4
Winter 2013	2.0	1.4	-0.6	-0.3	1.4

Source: European Economic Forecasts.

Under the pressure of financial markets, of the European Commission (and of the Troika as concerns Greece, Ireland, and Portugal), all euro area MS have implemented fiscal consolidation policies starting either from 2010 or 2011. According to our estimates based on pre-crisis trend output and on the latest EC Forecast, these policies amount on average to around 1.8% of GDP in 2011, 2.4% in 2012 and 1.5% in 2013 (see Table 7). From 2010 to 2014, the cumulated negative fiscal impulse will reach more than 26% of GDP in Greece, 16% of GDP in Portugal, 14.5 % in Ireland, 12% in Spain. Fiscal tightening weighs mainly on the expenditure side: 80% at the euro area level, with two exceptions, Belgium and France, where tax increases are more substantial (see Table 8).

Table 7. Fiscal impulses

In % of GDP

	2010	2011	2012	2013	2014	Total
Germany	1.3	-1.2	-1.2	-0.2	0.0	-1.3
France	-0.4	-2.2	-1.6	-1.9	-0.8	-6.9
Italy	-1.0	-1.3	-3.0	-2.0	-0.2	-7.5
Spain	-2.5	-1.7	-4.2	-2.6	-1.0	-12.0
Netherlands	-0.4	-1.4	-1.9	-1.8	-0.5	-6.0
Belgium	-1.3	-0.1	-1.8	-0.9	0.0	-4.1
Austria	0.5	-1.7	-0.1	-1.0	-0.7	-3.0
Portugal	0.5	-6.2	-5.4	-2.1	-2.9	-16.1
Finland	0.1	-1.8	-0.5	-1.4	-0.8	-4.4
Ireland	-3.8	-2.2	-2.8	-2.6	-3.1	-14.5
Greece	-8.9	-5.0	-7.0	-3.7	-1.8	-26.4
Euro area	-0.9	-1.8	-2.4	-1.5	-0.6	-7.2
UK	-2.8	-2.6	-1.6	-1.1	-1.8	-9.9
US	-0.7	-1.7	-1.8	-1.5	-0.7	-6.4
Japan	0.8	-1.9	0.0	2.3	-3.7	-4.9

Source: Authors' estimates. Fiscal impulses are calculated as changes in structural primary balances, based on pre-crisis trend GDP growth.

Table 8. Fiscal consolidation programmes, breakdown, 2010-2014

In % of GDP

	Primary expenditures	Receipts	Total
Germany	-1.1	0.2	-1.3
France	-3.0	3.9	-6.9
Italy	-6.4	1.1	-7.5
Spain	-12.0	0.0	-12.0
Netherlands	-4.3	1.7	-6.0
Belgium	-1.4	2.7	-4.1
Austria	-3.0	0.0	-3.0
Portugal	-12.8	3.3	-16.1
Finland	-3.4	1.0	-4.4
Ireland	-14.3	0.2	-14.5
Greece	-21.2	5.2	-26.4
Euro area	-5.6	1.6	-7.2
U K	-9.6	0.3	-9.9
United States	-3.6	2.8	-6.4
Japan	-1.6	3.3	-4.9

Source: Authors' estimates.

Table 9 shows the impacts of currently planned fiscal tightening, using a small model built at OFCE. The model embeds the fiscal plans as shown in table 7. It then accounts for the 'direct impact' of these policies, on the basis of domestic multipliers (slightly above 1 for the larger economies). It also accounts for the impact through external demand of fiscal plans

announced in the euro area countries, the UK, the US and Japan. The multiplier is 1.4 for the whole EU. It assumes that interest rates will not be affected as these restrictive policies will not strongly improve the debt ratios.

Table 9. Fiscal impulse impacts on GDP, public deficit, and public debt 2011-2013

In % of GDP

	GDP						Public balance	Public debt
	2010	2011	2012	2013	2014	Total	2014	2014
Germany	1.0	-1.9	-1.9	-0.7	-0.3	-3.8	-0.6	+5.4
France	-0.7	-2.5	-2.5	-2.5	-1.1	-9.3	+2.3	+2.0
Italy	-1.4	-1.6	-4.3	-2.8	-0.5	-10.6	+2.2	+5.4
Spain	-4.0	-3.5	-7.3	-4.6	-1.9	-19.5	+3.2	+8.1
Netherlands	-0.4	-1.5	-2.0	-1.7	-0.6	-6.2	+2.9	-3.6
Belgium	-1.1	-0.6	-1.8	-1.0	-0.3	-4.8	+1.7	-1.6
Austria	0.5	-2.2	-0.8	-1.3	-0.8	-4.6	+0.4	+2.1
Portugal	0.0	-7.7	-7.3	-3.1	-3.6	-20.1	+7.0	+8.3
Finland	0.0	-2.1	-0.9	-1.6	-0.9	-5.5	+1.4	-0.2
Ireland	-3.7	-2.6	-3.0	-2.8	-3.1	-14.2	+7.8	-7.3
Greece	-11.2	-6.8	-9.5	-5.1	-2.5	-30.7	+13.9	+12.0
Euro area	*-1.0*	*-2.4*	*-3.4*	*-2.2*	*-0.9*	*-9.9*	*+2.7*	*+1.4*

Source: Authors' calculations. Explanatory note: The fiscal impulses, as shown in Table 2, reduce euro area GDP growth by 1.0% en 2010, 0.9% in 2014. In 2014, the cumulated impact on euro area GDP is -9.9 %; the public balance is improved by 2.7 percentage points of GDP, but the debt/ratio increases by 1.4 percentage point.

The cumulated negative GDP impact would reach 9.9 percentage points for the euro area, but 19 percentage points in Spain, 20 percentage points in Portugal, 31 percentage points in Greece. The *ex ante* favourable impact of restrictive fiscal policies on public balances would be strongly reduced by this depressive effect. The public debt-to-GDP ratio would decrease in many countries, due to the strong fall in output.

Countries having to implement restrictive fiscal policies suffer from large output fall and high unemployment. In such circumstances, government deficit targets are not met, which will justify additional restrictive measures, etc. Each quarter, governments are required to introduce additional austerity measures, mainly cuts in social and public expenditures, which depress consumption and activity.

Before the crisis, the development of neo-classical or DSGE models at the expense of old Keynesian models, in particular in International Institutions (IMF, ECB, EC) spread out the idea that the fiscal multiplier is very low, even in a rather closed economy, in the order of 0.5 in the short-term and nil after 2-3 years. In many of these models, restrictive policies do not have any detrimental impact on output, thanks to two assumptions. Households anticipate that a permanent decline in public expenditure will reduce their taxes in the future and therefore they immediately increase their consumption, which offsets the decline in public expenditure (Barro-Ricardian effect). Sometimes, the expected decline in taxes induces them to anticipate that labour supply (and then GDP) will increase: the rise in consumption is higher than the cut in public spending, which induces a negative multiplier. The economy is always operating at

full capacity, or very close to it, thanks to price flexibility and monetary policy: a decline in output would induce a strong fall in inflation, and then a strong decline in interest rate which sustain activity.

The crisis has shown that the output level depends on the demand level, that a strong decrease in demand, like in 2008 is not offset by automatic mechanisms. Economists (and International Institutions) have re-discovered that the Keynesian multiplier is high, in the order of 1 to 1.5; that the multiplier is larger in a situation of large underemployment than when capacity is fully used (but who would undertake fiscal stimulus in a full employment situation?); that the multiplier is higher for public consumption or investment, for social transfers than for tax cuts[1].

In the historical expansionary-fiscal consolidation episodes, described by some economists, restrictive fiscal policies where accompanied by elements which are not available today for euro area MS, like exchange rate depreciation, interest rates cuts, increase in private borrowing thanks to financial deregulation, or a strong rise in private demand due to economic shocks (such as joining the EU).

In a depressed situation, restrictive fiscal measures have not impact on inflation and on interest rates. Barro-Ricardian effects are unlikely in this context as austerity measures reduce households' incomes, as liquidity constraints are heavy on firms and households, as banks will not lend massively to private sectors in a low-growth/high uncertainty situation, and as austerity strategies imply that governments consider that potential output growth will be durably lower, which contributes to depress investment. There is no certainty that risk premia will decrease since public debt ratios will not decrease substantially and since fiscal policies implemented in the euro area make the euro area fragile and worries markets. In a depressed situation, high unemployment puts downwards pressure on wages, which lowers households' incomes and thus households' consumption. Weak wages do not strongly increase profits because the fall in demand induces overstaffing. Higher profits do not induce firms to invest, given the weakness of production perspectives. No country benefits from competitiveness gains if the depression hits the whole area.

In his 13 February 2013 letter[2], Olli Rehn, the vice-president of the European Commission refuses to recognise that fiscal multipliers are stronger than the Commission considered. He pretends that the euro area depression results more from the high interest rates imposed by financial markets than from the restrictive fiscal policy imposed by the EC. It is difficult to see how this can apply to the French case, or outside Europe to the US for instance. In any case, the EU authorities have not taken the strong measures needed to restore the unity of MS debts. Olli Rehn refuses to recognise that consolidation policies should be stopped in times of economic recession, even if he accepts that they can be slowed down. He does not see that the increase in public debt may be necessary if the private sector wants to reduce its debt. Austerity policies failed to reassure financial markets. Structural reforms have not offset the impact of consolidation policies. Olli Rehn claims that current restrictive policies will

[1] [1] See *repentance* papers: Coenen C. *et al.* (2012) ; Holland D. and J. Portes (2012) ; *World Economic Outlook*, October ; Blanchard O. and Leigh D. (2013).

[2] See http://ec.europa.eu/commission_2010-2014/rehn/documents/cab20130213_en.pdf

enhance medium-term growth, but the risk is that the euro area never ends with the current depression and never reaches this medium term.

Towards a real and deep economic and monetary union?

The proposals made by the Council's President or by the EC in November 2012 suggest big steps towards federalism:

- 'All major economic and fiscal measures made by a MS will have to be subject to a coordination, approval and surveillance process at the EU level'. The option of different economic or social strategies is forgotten.
- The need to strengthen fiscal discipline is reasserted. At the same time, the need for *ex ante* fiscal coordination is asserted. But, after the fiscal pact, what remains to be coordinated since all fiscal policies have to be run in autopilot mode?
- The EMU could have a fiscal power to absorb asymmetric shocks (with is rather ironic once governments have been deprived of their ability to implement specific fiscal policies)
- The EMU could be entitled to support structural reforms, i.e. to have a tool for convergence and competitiveness, within the pseudo 'golden rule' framework, i.e. balanced budgets. A country could sign an agreement with the EU, according to which it would implement structural reforms and would therefore get a financial reward from the other MS. But can we imagine that a country get subsidies to abolish its minimum wage, or its public pensions system? Can we imagine that France has to pay to subsidize these measures in Spain or in Italy?

- The Commission considers the possibility for the EMU to have own resources and to issue bonds.

- Short-term debts could be mutualised under a European Treasury.
- A common fund could be introduced to amortise public debts, with strict conditionality.
- The role of the vice-president of the Commission in charge of economic and social affairs in the euro area could be strengthened; a Euro Commission could be settled in the European Parliament, the Euro-Group could be strengthened.
- The proposal to issue euro-bonds guaranteed by all MS or by the ECB has not been considered. Germany refuses to make unlimited and unconditional commitments to support the other MS. But how to strengthen the euro area without such commitments?

Three questions remain:

- Should EU powers as the EU works currently be strengthened? As long as there is no certainty than a more democratic functioning can be implemented? As long as the EU does not implement a growth strategy? As long as it remains focused on liberal structural reforms, on public expenditure cuts and on absurd public finance criteria? Should not EU institutions show first that they can implement an efficient strategy before peoples and MS agree to enlarge their power?

- Can we imagine all major economic and social decisions be made at the EU level, by the Commission or the Council without accounting for national votes and debates? Such a denial of democracy would rapidly be sanctioned by citizens through votes in favour of anti-European parties.
- Can we image a federal power able to account for domestic specificities in a Europe made of heterogeneous countries? Can we imagine a single policy implemented in different countries? Or different policies implemented through a central process? These are probably two impossible ways.

Can the Euro be achieved? A recent proposal in France

The French 'Economic Analysis Council' (*Conseil d'analyse économique*, CAE, 2013) has recently made proposals. The CAE recognizes the institutional weaknesses of the euro area, but believes that they can addressed by increasing technocratic, federalist and liberal features.

Hence, the CAE proposes to set up an independent European Fiscal Committee. The latter would coordinate national committees, would set limits to MS public government deficits, and so would be a new technocratic institution which would reduce further MS autonomy. The CAE does not find useful to specify the objective of the Committee: a growth strategy or the arbitrary norm of the Fiscal Treaty? This Committee should alert the European Court of Justice (should fiscal policy be set by the judiciary power?); his proposals should be validated by a euro area European Parliament.

The CAE recognises that fiscal consolidation policies have strong recessive effects before suggesting to look for growth through structural reforms, albeit recognising that such measures are "politically costly". This is the European strategy which has failed to deliver over the last 12 years. Labour market rigidity is of course responsible for the weakness of growth. The CAE 'naively' proposes that each worker in each country can "freely" choose a European employment contract, more flexible than the domestic one, in exchange of a European unemployment insurance, which would come on top of the national unemployment insurance. This proposal lacks realism. The CAE proposes to introduce a transfer system between countries, built on the gap between the unemployment rate of each country and their structural rate of unemployment. But how will the structural rate of unemployment be assessed?

The CAE proposes to offset the balanced budget requirement by setting up a euro area budget, which could be allowed to have cyclical imbalances. But how will it work in the case of specific shocks? The lessons of the 2007-2009 crisis are not drawn: MS should be able to let automatic stabilisers play and to make discretionary decisions, without having a constraint based on a structural balance impossible to measure, without having to wait for European financial support.

4. Redemption?

Public debts in advanced economies have strongly risen during the crisis (table 10). This results from the depth of the crisis itself and not from over-expansionary fiscal policies which would have been implemented before or during the crisis, except probably in the case of Greece. There is no reason to exert redemption for implemented policies. The rise in public debts was implicitly desired (by households who wish to own safe assets, who do not want to bear financial markets risks while companies wish to deleverage), it is useless to try and reimburse debt as long as the factors which have caused the debt to rise remain. Given the interest rates levels on public debt for major countries, it cannot be said that the public debt level induces any rise in interest rates.

Table 10. Public debts in 2007 and 2013, as % of GDP

	2007*	2013*	2013**
Germany	65	81	50
France	79	93	69
Italy	103	128	101
Spain	36	96	65
Netherlands	45	74	45
Belgium	84	101	83
Austria	**60**	**75**	**49**
Greece	**107**	**176**	**159**
Portugal	68	124	88
Finland	35	55	-49
Ireland	25	122	86
Euro area	*66*	*95*	*65*
UK	44	95	78
US	67	111	90
Japan	183	251	144

*Maastricht definition. ** Net debt.

The rise in public debt increases the risk that public finances will be under the supervision of financial markets in the years to come. But this supervision is not satisfactory: financial markets have no macroeconomic perspective, they are pro-cyclical (they will impose efforts in bad times), their opinions are self-fulfilling and they know this, and do not try to incorporate the relevant piece of information, but the piece of information which are ‘in the mood of time’; they are schizophrenic, they request consolidation and growth policies at the same time. They have their own judgement on the needed appropriate economic policy, but is this necessarily the relevant one? There is a big risk that MS set the objective of trying to escape financial markets’ surveillance in cutting too rapidly and too massively government borrowing which would postpone the economic recovery indefinitely. Their ability to run active fiscal policies will be reduced. What would have happened if countries had refused to help banks in 2009, in order to avoid to have to borrow on financial markets? Can financial

markets be given the responsibility to assess public debt sustainability and the usefulness of public deficits?

Two strategies can be implemented today. We advocate for a first strategy: the possibility to run fiscal stabilisation policies needed to support output should be maintained (or rather to re-established), monetary policy should remain expansionary, public debt guarantee by the ECB should allow to bring interest rates down to 2% in all euro area countries; wages should be increased in countries where the wage share in value added has substantially decreased; implementation of specific measures designed to support both public and private investment, as part of the environmental transition. The debt-to-GDP ratio will fall thanks to growth recovery.

The second strategy consists in setting a binding agenda in terms of debt ratios with a view to to bring the GDP ratio back to its pre-crisis level (see IMF, 2010). This raises three issues: it requests a substantial negative fiscal shock, which will be significant in the first years in order to be in line with the requested strategy, but such a shock leads GDP to fall which leads debt to rise (see box 2). The debt reduction path is inconsistent with short term fiscal stabilisation needs, and may lead the commitment impossible to meet, or at a very high cost. There is no guarantee that the final debt ratio target, set *a priori*, is consistent with macroeconomic equilibrium.

Box 2: The public debt norm in the short run

Let us consider an economy in a Keynesian situation. Output is determined by demand as: $y = g + c(1-t)y$. Debt varies as: $h = h_0 + g - ty$. If g falls by 1 this will lead y to fall by 1/1-c(1-t). The debt ratio rises after a restrictive policy if: $h_0 / y_0 > (1-c)(1-t)$.

For instance if c=0.5 et t=0.5, $h_0 = y_0 = 100$, a fall by 1 in the public deficit will lead output to fall by 1.33 (from 100 down to 98.67), *ex post* the deficit will fall by 0.33. Debt will fall down to 99.67. The debt-to-GDP ratio will rise from 100% to 101%. In the short term the debt-to-GDP ratio cannot be cut through a restrictive policy.

The German Council of economic experts (2012) suggested the introduction of **a European Redemption Pact**, i.e. to set a fund in order to guarantee the repayment of the share of the debt above 60% of GDP. Countries where debt exceeds 60% of GDP (Germany, Austria, Belgium, Cyprus, Spain, France, Malta and the Netherlands), at the exception of countries under an adjustment programme (Greece, Ireland, and the Netherlands), would place in the fund the share of their debt over 60% of GDP and, in counterpart, would transfer tax revenues allowing for a debt repayment over 25 years. France, for instance, would thus be able to transfer a debt share amounting to 27% of GDP, transferring revenues of 1.3% of GDP. Countries would transfer guarantees to the Fund, like some part of their gold resources. Moreover, they would implement structural reforms programmes. This would reassure markets, who would agree to own this debt at an interest rate lower than current market rates (the authors consider a 4% interest rate, which is pessimistic since France borrows in February 2013 at 2.3% for 10-year government interest rates). Besides, countries should commit to the Fiscal Pact, i.e. bring rapidly their primary deficit to 0.5% of GDP. Thus the debt ratio would rapidly fall: in 2035, it would stand at 58.5% in Belgium (against 97%

today), 53.5% in France (against 88%), 50% in Germany (against 82%), 60% in Italy (against 120%).

However, countries would commit to strongly restrictive policies in 2012-2015, amounting to, according to the authors' calculations, 6.3% of GDP for Spain, 4.2% for France, 4% for the Netherlands. The paper assumes that the Pact will allow interest rates to fall, as compared to a catastrophe basis scenario, where countries would implement similar austerity measures, while markets would continue to request high interest rates. Thus, it can be claimed that it would have expansionary effects as compared to the catastrophe basis scenario. But it does not draw any lesson from past austerity policies on activity, assuming implicitly that the fiscal multiplier is nil. It does not consider the possibility that Europe go through economic slowdown episodes in the next 25 years, which may require to soften restrictive policies and to abandon the Fiscal pact. What would then happen with the redemption pact? Also, the Pact does not question the factors which led the public debts to rise. Are these sins that MS have to pay for? Or where these increases necessary because of the economic crisis?

We do not see what a redemption pact would add to the fiscal pact, since the fiscal pact already implies public deficits to be cut to 0.5% of GDP as long as debt is higher than 60% of GDP, 1% if debt falls below 60% of GDP, which, assuming a potential nominal growth rate of 3% per year would already lead the debt to GDP ratio to converge towards 33%.

On 12 march 2013 the EU parliament agreed to vote the 'two pack' in exchange of a commitment of the European Commission to settle a high level experts group to assess the feasibility of such a European Redemption Pact. There is a high risk that *a priori* constraints on fiscal policies are thus added.

The euro-bonds and debt agency proposals

The euro area needs to choose between two frameworks: relying on markets to implement fiscal discipline or introduce measures to reestablish the unicity of public debts. The first option has several drawbacks: maintaining interest rates spreads in Europe for an undefined time period, undermining the impact of fiscal policies and letting financial markets play an excessive role. On the one hand, Europe would declare that: the Greek case was an exception, from now on no euro area country will default. On the other hand it would rely on markets to judge how serious this commitment is. The second option can be implemented in two ways: either through an ECB guarantee of always refinancing public debts or by issuing euro-bonds. It requires an issue to be settled first: according to which criteria, and up to which level can public debt be guaranteed by its partners. Several projects have not entirely made a choice between the two frameworks.

The simplest solution consists in introducing a European debt Agency (EDA) which would be in charge of issuing a common debt for all euro area countries. This debt would be guaranteed by all euro area countries; it would be considered as a safe asset by financial markets; its market would be wide; it would be very liquid, hence it could be issued at low interest rates.

The difficult point is that the EDA council would supervise domestic fiscal policies and would be entitled to deny financing *too lax* countries, which would then have to issue bonds on markets. The EDA would raise the same problems as the SGP. What would be its assessment criteria? What would be the democratic and economic legitimacy of its Council? How would he decide that a deficit is excessive for a country, which estimates that such a deficit is necessary to support activity (like in Germany and France in 2002-2005) or to rescue banks? Would it implement strict rules (a country would be entitled to loans from the EDA up to 60% of its GDP) or softer rules? The EDA would benefit neither virtuous countries (who have no difficulty to get financing) nor countries in difficulty, which the EDA would refuse to finance and who would have to issue domestic bonds, without any European guarantee, without any potential financing from the ECB, which would mean this would be risky assets, bearing a high interest rate. The EDA makes sense only if it accepts to consider all public debts, but then what to do against lax countries?

Delpla and von Weisäcker (2010) have suggested to introduce a 'blue debt, collectively issued and guaranteed, with a ceiling at 60% of GDP'. Each year, national governments will have to vote on new public debt issuance (which means that the German government would have to agree on the French deficit for instance and vice versa). Each MS would also be allowed to issue a red debt under its own responsibility. Since such a red debt would bear a high interest rate, this would be a strong disincentive to issue public debt above 60% of GDP. This proposal is almost similar to the EDA one and does not account for economic stabilisation needs. By the way, in 2013, the 60% level raises the same problems. It would induce permanent tensions between euro area MS if every country was expected to make judgements on their neighbour's deficits. The 60% level is arbitrary and breached by 10 over the original euro area MS (except Luxembourg and Finland). The gap between blue and red debt would allow financial markets to speculate in permanence.

Palley (2011) suggests creating a European public finance authority, which would issue euro-bonds and lend to governments. Thus, a limited part of the debt would be mutualised. The ECB would be able to buy such bonds in order to influence the interest rate level. The euro area council of finance ministers would decide on debt issuance. What would be the assessment criteria? Besides, countries would still issue national bonds, which would be subject to financial markets' moods.

Schulmeister (2013) suggests introducing a European Monetary fund (EMF) which would finance member states though issuing euro-bonds guaranteed by the MS and the ECB. The EMF would maintain long-term interest rates slightly below GDP growth. Each MS financing would not be subject to a numerical constraint, but would be decided within the EMF by the MS Finance ministers. The same questions may be raised again. This project hands over to finance ministers the responsibility of agreeing on public deficit targets for each country, which is problematic (what should be done in case of macroeconomic strategies divergences between countries?), not democratic (each finance minister would impose to its national

Parliament the fulfilment of the target set at the European level), difficult to implement (what to do in case of a specific or global shocks?).

The Single currency's contradictions

For developed countries, the system which worked until 1999 lied on unity between the government, the central bank and commercial banks. The central bank is the lender of last resort for the government and banks. The government can issue unlimited public debt. This debt is considered as safe and benefits from as low as possible market interest rates. Of course this unity was to some extent undermined by the independence of the central bank, which generated conflicts between the government (caring about supporting output or specific spending) and the central bank (caring about maintaining low inflation). These conflicts could have led public finances to become unsustainable. But such situations did not deteriorate before 2007. They did never question government solvency.

The introduction of the euro area led to a particularly difficult situation. On the one hand, countries need to run more active fiscal policies because they have lost control over their interest rates and exchange rates. It can also be added that, since 1973, the macroeconomic equilibrium has been requiring a certain level of public deficit and debt. Each country needs to run some equilibrium government deficits. The 2007 crisis strengthened this need. On the other hand, due to the single currency, current imbalances in one country affect the other countries of the area. Therefore excessive deficits (or surpluses) should be avoided. What is acceptable in the national framework where some 'instinctive' solidarity prevails is no more acceptable at the EU level, where citizens from Northern countries have spontaneously no solidarity with unemployed people in Southern economies, where most EU citizens have no solidarity with Spanish, Irish or UK banks. Last, financial markets' functioning makes it necessary for public debts to become safe assets again, while at the same time Northern countries deny to give unlimited guarantee to their partners.

In practice, Europe is paralysed by the decision of the German Constitutional court which forbids any guarantee not expressively agreed by the German Parliament.

The solution adopted so far by Europe, i.e. the Fiscal pact consists in ensuring in the long term solidarity to countries agreeing to implement an absurd fiscal rule: keeping structural deficits below 0.5% of GDP. The problem is that there is neither the guarantee that such a target can be reached, nor that it is optimal.

Euro area countries must become again countries able to issue safe sovereign debt, at an interest rate controlled by the ECB. They must be able to run a public deficit in line with their macroeconomic stabilisation needs.

Public debt mutual guarantee by the ECB or by euro bonds must be entire for countries accepting to submit their economic policies to a coordination process. Therefore the procedures implemented since 2010 should be reviewed and their aims should be modified.

Economic policy coordination cannot consist in fulfilling automatic rules (like the SGP rules); bargaining processes need to be done between countries. Coordination should target GDP

growth and full employment; it should account for all economic variables; countries should have an economic policy strategy allowing to meet the inflation objective (at least to remain in a target of around 2%), to meet an objective in terms of wage developments (in the medium run real wages should grow in line with labour productivity), in the short-term adjustment processes should be implemented by countries where wages have increased too rapidly, or not sufficiently; rises or cuts in social contributions may be used to facilitate the adjustment process; countries should announce and negotiate their current account balance targets; countries with high external surpluses targets should agree to lower them or to finance explicitly industrial projects in Southern economies. The process should always reach a unanimous agreement on a coordinated but differentiated strategy. As shown in box 3, it is not easy to define such a strategy. In that framework, public deficits resulting from this process should be financed through debt issuance guaranteed by all euro area countries and by the ECB. The Treaty needs to maintain an effective process in the case where no agreement is reached. In that case, the new debt issued by countries outside the agreement would not be guaranteed; but this case should never occur.

Box 3: Fiscal policy in a closed or in an open economy.

1) Let us consider first a closed economy. The IS equation is: $y = g + d - \sigma r$, with y, the output gap, r, the interest rate (in difference with the rate of growth), d, private demand, g, public demand. The optimal fiscal policy is therefore to maintain: $g = -d$ and r = 0. The government balance should offset private demand shocks. If households are Ricardian and offset any increase in the public deficit by lowering their consumption, then the economy cannot be stabilised:

$$y = g + d - \sigma r \quad with \quad d = d_0 - \lambda g \quad et \ \lambda = 1$$

The same applies if markets request excessive risk premia:

$$y = g + d - \sigma r \quad with \quad r = r_0 + \mu g \quad and \ \mu > 1/\sigma$$

Households' or markets' expectations on the inefficiency of fiscal policies are then self-fulfilling.

2) Let us consider now an open economy. The equilibrium in the goods market is written as:

$$y = g + d - \sigma r + b \qquad b = n(y^* - y) - n\delta(w - s - w^*) + b_0 .$$

The country should have a trade balance target. A small country in the world does not have to worry about its partners' balance. It should therefore implement: $g = -d - b_I$ $\quad w - s = w^* + (b_0 - b_I)/n\delta$

If the country wishes to run a budget in surplus, it must cut public spending and the level of its wages, either through exchange rate depreciation or through a period of high unemployment.

3) Let us now consider a monetary Union with two countries. The model is written as:

$$y_1 = g_1 + d_1 - \sigma r + b$$

$$y_2 = g_2 + d_2 - \sigma r - b$$

$$b = n(y_2 - y_1) + n\delta(w_2 - w_1)$$

In the event of a domestic demand shock, each country must be able to stabilise its production using fiscal policy. If the interest rate is at its optimal level, fiscal stabilisation is better strategy than monetary policy, as the shock is specific. If demand is excessive in Spain, Spain should implement a restrictive fiscal policy rather than having the ECB raising its rate, implying that Germany needs to run an expansionary fiscal policy.

The problem is the compatibility between the current account targets of both countries. If country 1 targets a trade surplus, while country 2 aims at maintaining full employment, this leads to the pre-2007 crisis situation: Germany cut domestic wages and demand in order to reach a certain level of external surplus, which meant that Spain had to raise its domestic demand. $d_1 = -b_I$; $d_2 = b_I$; $w_2 - w_1 = b_I / n\delta$ No equilibrium can be reached if Spain wants to run a current account in balance.

Conversely, a country can choose to run a trade deficit, imposing his partner to run a surplus which needs to be offset by a restrictive fiscal policy.

4) Let us now consider a monetary Union consisting of two countries in the world. The model is written:

$$y_1 = g_1 + d_1 - \sigma r + b_1 \quad b_1 = n(y_2 - y_1) + m(y^* - y_1) + n\delta(w_2 - w_1) + m\delta(w^* - s - w_1)$$
$$y_2 = g_2 + d_2 - \sigma r + b_2 \quad b_1 = n(y_1 - y_2) + m(y^* - y_2) + n\delta(w_1 - w_2) + m\delta(w^* - s - w_2)$$

Let us assume that country 1 wants to run some trade surplus. It will therefore cut domestic wages. Its trade surplus will be achieved on the rest of the world and on country 2. Country 2 will therefore have to choose between running permanently a certain deficit or to lowering its domestic wages.

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