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“Re-inventing Europe”

ESTRATTO

Executive summary

President Macron has called for the re-invention of Europe. *“Faced with the great challenges of our times, such as defence and security, great migrations, development, climate change, the digital revolution and regulation of a globalized economy”*, he asked, *“have European countries found means to defend their interests and values, and to guarantee and adapt their democratic and social model that is unique worldwide? Can they address each of these challenges alone? We cannot afford to keep the same policies, the same habits, the same procedures and the same budget. No more can we choose to turn inwards within national borders. The only way to ensure our future, is the rebuilding of a sovereign, united and democratic Europe”* (1).

This year's *Rapporto Europa* will focus on the economic context for re-inventing European model. We give particular attention to the details of a European Fiscal Union. The Maastricht Treaty did not incorporate any form of Fiscal Union, except in the very narrow sense of fiscal discipline: each member state committed to maintain sound finances and the Stability and Growth Pact (SGP) detailed the operationalisation of fiscal discipline. A common European budget exists, but it small and has no specific functions for the Euro Area. The Euro crisis has revealed that this institutional set-up is not optimal.

In June 2015, the so-called *Five Presidents' Report* noted that *“all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone”* (p. 14). It proposed a *“fiscal union”* that would *“improve the cushioning of large macroeconomic shocks and thereby make EMU over all more resilient”* (p.14) (2).

(1) <http://www.elysee.fr/assets/Initiative-for-Europe-a-sovereign-united-democratic-Europe-Emmanuel-Macron.pdf>

(2) Juncker J-C., D. Tusk, J. Dijsselbloem, M. Draghi and M. Schulz (2015): *Completing Europe's Econom-*

Since then, many improvements have happened:

1. By the European Semester of economic policy coordination has been given clearer guidance for the Euro Area as a whole and a stronger focus on social aspects.
2. European Fiscal Boards and National Productivity Boards have been set up.
3. Technical assistance to Member States was boosted with the creation of the Structural Reform Support Service.
4. Important steps towards completing the Banking Union and Capital Markets Union have been taken, notably by advancing in parallel on risk-reduction and risk-sharing measures in the banking sector.

In December 2017, the European Commission has presented new proposals and initiatives that echoed President Macron's discourse and Commission President Juncker's State of the Union speech:

1. A European Monetary Fund (EMF) is to safeguard the financial stability of the Euro Area, as well as the financial stability of the 'participating member states'
2. The so-called Fiscal compact (Treaty on Stability, Coordination and Governance) is to be integrated into the Union legal framework, taking into account the appropriate flexibility.
3. New budgetary instruments for the Euro Area are to be developed within the Union framework.
4. For the period 2018-2020, EU funds will be mobilised in support of national reforms and the Structural Reform Support Programme is to be strengthened.
5. Finally, reflection has started whether the Euro Area needs a European Minister of Economy and Finance.

The interaction between sovereign member states' fiscal policy and the unified monetary policy is not optimal in the European Monetary Union (EMU). Therefore, the European Central Bank is overcharged and the policy mix in the Euro Area has been suboptimal for a long time. We believe that a European Fiscal Union will help to improve the policy mix and, therefore, the long run development of the member states in the Euro Area. We develop the analysis in this year's *Rapporto Europa* starting from an overview of the main developments of the Euro Area economies. We then look at the economic governance of the Euro Area, especially the coordination of fiscal policy between member states and the interaction with monetary policy.

Economic activity is now well above the previous peak attained in 2008: it is 7.5% higher in the Euro Area as a whole. Not only actual, but also potential output growth has improved since the ECB has started its unconventional monetary policy in 2012. While this was a necessary policy response to the crisis, the situation now calls for a cautious normalization of monetary policy and a careful evaluation of fiscal policy.

The closing of the output gaps may explain why potential output is improving again across Europe. Although the impact of closing the output gap on non-TFP growth differentials is small, the indirect effect that output gaps exert on potential output growth through the growth of factors of production is large. However, as the gaps disappear, one must consider that in the long-run economic growth is determined by total factor productivity (TFP). For stagnating countries like Italy, the challenge does not so much consist in stimulating the economy, which could of course contribute to an increase in the use of capital and labour, but more importantly structural reforms are urgently needed to improve the efficiency of resource use and raise TFP. This is also necessary in order to improve competitiveness and raise the purchasing power of wages.

The unique set of policy rules and institutions in the Euro Area makes policy coordination difficult. The interaction between sovereign member states' fiscal policy and the unified monetary policy is not optimal in the EMU. The European Central Bank is therefore over-charged and the policy mix in the Euro Area has been suboptimal for a long time. A European Fiscal Union would help to improve the policy mix and in the long run the development of the member states in the Euro Area.

Between 2011 and 2014, fiscal consolidation made the policy mix excessively tight; after 2014, monetary policy has contributed to a significant softening (real long-term interest rates fell), but fiscal policy remained stuck at an aggregated cyclically adjusted deficit of -1%. This aggregate development is not fully reflected in the levels of individual member states' real long-term interest rates: while in Italy nominal interest rates strongly declined, the deflationary pressures shrank the gap between nominal and real interest rates, but in Germany this gap widened, driving real interest rates into negative territory for several years. The divergence in the real long-term interest rates' dynamic observed in the last years might be attributable to country-specific policy, and in particular to heterogeneous fiscal stance. Before the crisis the relationship between long-term interest rate and the fiscal stance was linear and negative across the countries, but during the crises and even more recently this relationship has become highly non-linear.

We show that the government budget position does not explain the output gap, nor is the volatility in government budgets affected by output gap volatility over the medium run. By contrast, monetary policy is highly significant, confirming the excessive burden for monetary policy in the European policy mix. However, monetary policy affects real long run interest rates in the short-run, although in the medium run their dynamics depends also on government budget positions. This highlights that the effectiveness of monetary policy is highly dependent on the fiscal policy stance in shaping the dynamic of the long-run rate. Since fiscal policies are heterogenous among the countries, the effectiveness of monetary policy in stimulating the economy is highly uneven across countries and most of the relative ineffectiveness of QE is attributable to fiscal policy moral hazard.

Fiscal policies by member states are not neutral in the European monetary union, because the changes of fiscal stances will generate spillover effects in neighbouring member states. Our estimations suggest that signs and dimensions of spillovers are strongly heterogeneous among member countries so that a different form of fiscal policies coordination within the Euro Area, defined by a strategic interaction between member countries on the timing of consolidation, would be preferable to just a common set of rules, which might induce all countries to consolidate at the same moment, making austerity unsustainable. However, since the cross-country heterogeneity of attitude towards a joint consolidation across country is a matter of fact, supranational coordination by means of a European Minister of Finance might mediate this position, increasing the sustainability of fiscal consolidation in Europe.

The budget of the European Union pays for policies carried out at the European level. The total budget amounted to € 136 bln in 2016, which is less than 1% of gross national income (GNI) of the European Union. Of this amount, € 117.9 bln are spend inside the EU but only € 77.2 bln in the Euro Area. There are therefore good reasons for increasing the budget for the monetary union, as President Macron has demanded.

The experience has proven that the voluntary cooperation among the EU member states is no longer sufficient to generate and allocate European public goods efficiently. Instead of intergovernmental cooperation, it may be a better solution to provide certain public goods by a federal agency, which is acting on the basis of competing legislation. With these elements, a re-invented European Union would be able to keep its founding promise: namely to preserve peace, increase welfare and bring people together.