**In search of sustainable paths for the Eurozone in the troubled post-2008 world**

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Abstract :

The diversity in the Eurozone has costs and advantages respectively for countries whether they are confronted with an overvalued or undervalued euro. Rough estimations of these costs and benefits help to assess the adjustments that could lead to a sustainable Eurozone. A purely financial type of federalism, set up under the pressure of financial markets, risks falling short of the objective. A budgetary federalism, if it is based on long-term investment programs with an enlarged political support, is more likely to meet the objective. A scheme of multispeed Europe could constitute a fallback solution if the political support for a budgetary federalism is not attained.

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Europe, and more specifically the Eurozone,[[3]](#footnote-3) seems to have had a really hard time trying to to survive in the rough waters of the world emerging from the 2008 financial crisis. Indeed, the Eurozone construction has been astoundingly optimistic regarding how it was supposed to maintain some basic cohesion among a set of quite different countries. These countries opted for a common currency on the basis of a certain exchange rate structure. Since then they evolved in various ways reacting to changes, be they internal or external. These imbalances may challenge the sustainability of the zone when faced with major changes in its environment, especially financial. Current accounts can increasingly diverge between surplus and deficit countries. Similar divergences can occur with public accounts. The financing of all these deficits may become more and more difficult if no help is provided. The optimists still assume that capital flows between countries of the zone will help when needed, providing that deficits and surplus countries would alternate after a while. Realists claim that some solidarity mechanisms within the zone should help to see to the reduction of the competitiveness gaps. Ultimately, confronted with the lack of solidarity mechanism in the zone, deficit countries try to reduce their exposure by pushing down wages and prices. Austerity plans are targeting such “competitive internal devaluation”. The efficiency of these various adjustment mechanisms varies with the external and internal contexts. Moreover, their costs are both very different according to countries and very uncertain as they have to be seen in a long term perspective. The present paper aims to assess all the structural elements that should frame the ongoing debates on the policies required to set the euro on a sustainable path. We start in section 1 with a preliminary assessment of the potential costs and benefits attached to the respective misalignments of the underlying real exchange rates that the changes in internal prices and wages imply for each member country. We then look at the experiences of internal devaluation led by severe austerity plans to see the highly specific conditions under which they did not lead to cumulative recessions (section 2). On this basis we can try to assess the potentials and limits of diverse schemes of adjustments that could contribute to the overall stability of the Eurozone (section 3, 4 and 5).

**1 Intra-European imbalances**

The monetary union is based on a fundamentally unbalanced model. Without changes in exchange rate parity, no adjustment mechanism was retained to correct divergent economic performances of member countries. Considerable heterogeneity could occur; no federal budget or guarantee system was put in place. In effect there was no political majority to support such policies.

The idea that closer financial integration would provide sufficient stabilisation mechanisms through internal capital transfers was promoted by the ECB and the Commission in the 2000s (Trichet 2007, European Commission 2007, Asdrubali and Kim 2004). Intra-zone credits and capital gains were supposed to ensure a sufficient stabilising role. But this assumption proved to be wrong and closer financial integration did not bring the reduction in current accounts and public deficits that stability required. The 2008 crisis showed on the contrary that financial integration increased the problems (Duwicquet and Mazier 2010).

The only type of adjustment that remained available in the Eurozone was eventually by means of relative price changes. Countries with recurrent deficits could only reduce prices and wages. But such austerity plans are at best only effective in reducing imbalances in the long run. They have unequal effects on different countries and result in low growth and increased unemployment. Countries applying such policies thus run the risk of opening a cumulative process of deterioration. Austerity policies are all the more ineffective that they are implemented in a group of interdependent countries. They may be more effective if they are applied in a set of small countries.

Such a policy of austerity was implemented in France in the second half of the 1980s under the banner of competitive disinflation. The outcome in France's case was mediocre: lower inflation with slow growth and mass unemployment. There was no long-term effect and in 2010 France still exhibited the same structural problems of weak competitiveness. Reductions in prices and wages were also implemented in Germany in the 1990s to deal with problems arising from the German reunification. Such policy of “internal devaluation” is now imposed in Greece and in other countries of South Europe. The results are unsurprising: reduced output, cost-cutting and increased unemployment with at best a slow and difficult reduction in budget deficits as revenues diminish.

The Eurozone as a whole has a more-or-less balanced current account and EU government deficits are somehow lower than in other OECD countries. The euro, considered globally, is thus rather near its equilibrium parity. Devaluation of the euro might facilitate recovery in Europe but only at the expense of other world regions. It would be a unilateral policy without any objective rationale and one which would aggravate global imbalances. Yet internal imbalances within Europe are considerable if one looks at the misalignments between the euro and what the real exchange rates of equilibrium of each country would be. Estimations of exchange rate misalignments (ERM) from 1994 till 2009 have been done by Jeong, Mazier and Sadaoui (2010) , using the Fundamental Equilibrium Exchange Rates (FEER).This approach is based on a simple multinational model for the main countries (USA, Euro zone, United Kingdom, China, Japan and the rest of the world) linked with usual trade model for smaller countries. Equilibrium exchange rates ensure full employment and respect a current account target. . Table 1 where the above estimations have been extrapolated up to 2011 shows that the euro is strongly over-valued from the perspective of countries in South Europe (including France) and under-valued for countries in North Europe, in particular Germany (see table 1). The degree of misalignment within the Eurozone may be debated[[4]](#footnote-4), but there can be no doubt that in the theoretical event of a breakup, the German euro would appreciate substantially while the Spanish, Portuguese and Greek euros would depreciate strongly. Estimates of the degree of misalignment are substantial: in 2010 the Spanish and Greek euros were overvalued by between 20 and 40%, the Portuguese euro by 20 to 30% and the French euro by 15% while the euro mark was undervalued by 20%.

Table 1: Undervaluation (rc > 0) or overvaluation (rc < 0) for each “national euro” in real effective terms (in %)

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **rc** | **EU** | **AUT** | **FIN** | **FRA** | **GER** | **IRL** | **ITA** | **NLD** | **PRT** | **SPA** | **GRC** |
| **1994** | -3.4 | -5.9 | -4.6 | 0.3 | -13.4 | 0.9 | 6.3 | -2.1 | 6.7 | 3.8 | 16.8 |
| **1995** | 1.2 | -5.8 | 9.7 | 3.9 | -6.9 | 6.3 | 13.7 | 3.3 | 17.1 | 13.4 | 9.0 |
| **1996** | 4.2 | -3.6 | 14.9 | 9.5 | 0.9 | 6.4 | 15.0 | 6.1 | 0.8 | 7.1 | 0.5 |
| **1997** | 3.5 | -6.5 | 19.2 | 17.4 | -1.0 | 2.8 | 10.5 | 4.0 | -13.8 | 5.5 | -5.0 |
| **1998** | 0.6 | -3.0 | 18.0 | 15.9 | -4.7 | -0.2 | 5.6 | -1.6 | -19.7 | 0.5 | -2.3 |
| **1999** | 2.0 | 0.3 | 20.7 | 22.7 | -4.9 | 3.6 | 5.0 | 2.5 | -25.0 | -4.7 | -8.6 |
| **2000** | 0.1 | 6.7 | 27.1 | 13.0 | -2.8 | 3.4 | 5.0 | 1.9 | -29.9 | -7.4 | -11.7 |
| **2001** | 6.9 | 8.6 | 34.3 | 19.6 | 8.6 | 6.6 | 10.9 | 5.6 | -28.6 | -4.6 | -5.7 |
| **2002** | 6.6 | 19.9 | 33.1 | 12.4 | 13.5 | 3.9 | 5.9 | 1.9 | -20.7 | -5.1 | -6.1 |
| **2003** | 2.2 | 8.8 | 17.9 | 2.9 | 8.1 | -0.9 | -1.0 | 3.0 | -14.5 | -9.8 | -8.1 |
| **2004** | 6.6 | 9.7 | 21.4 | 1.6 | 17.8 | 1.3 | 6.8 | 7.8 | -22.7 | -16.1 | 3.5 |
| **2005** | 1.8 | 9.2 | 11.2 | -7.0 | 17.3 | -1.8 | 4.6 | 7.4 | -36.1 | -30.3 | -5.1 |
| **2006** | 0.3 | 10.6 | 12.2 | -7.4 | 19.3 | -2.5 | 2.1 | 9.0 | -37.3 | -40.0 | -20.9 |
| **2007** | 0.1 | 15.4 | 16.7 | -9.0 | 23.6 | -6.2 | 4.9 | 8.4 | -31.5 | -48.3 | -31.4 |
| **2008** | -2.6 | 20.3 | 12.0 | -13.9 | 22.2 | -7.6 | 1.9 | 7.8 | -41.9 | -48.8 | -33.4 |
| **2009** | 0.6 | 12.2 | 4.4 | -9.6 | 21.4 | 0.3 | 2.9 | 6.3 | -30.8 | -17.1 | -20.7 |
| **2010** | 1.6 | 10.9 | 4.8 | -11.8 | 21.8 | 7.6 | -1.2 | 9.1 | -25.1 | -15.2 | -18.5 |
| **2011** | 3.3 | 14.4 | 1.5 | -13.0 | 23.1 | 7.0 | 3.1 | 11.5 | -7.9 | -5.5 | -21.8 |

Note: Forecasts for 2011 based on IMF WEO April 2012; See Jeong *et al.* (2010) for a complete description of the model of world trade and the methodology used to compute ERMs. Source: authors’ calculations.

These exchange rate misalignments reflect structural heterogeneity between the North (Germany, Netherlands, Belgium, Austria, Finland) and the South (France, Italy, Spain, Portugal, Greece) of Europe, be it the degree of openness, the share of manufacturing or the capacity of innovation, all indicators featuring how economies can be responsive to changes in external competition. Degree of openness gives in particular an idea of the importance of sheltered activities in the economy.

These misalignments have an important impact. They slow down growth and increase public and current deficits in the South while growth is boosted in the North by exports to the rest of the Eurozone, facilitating the reduction of public deficits. These misalignments are equivalent, at the end, to implicit transfers from the South to the North representing considerable amounts. Considering that overall the eurozone has no misalignment (which the May 2012 estimations of Fundamental Equilibrium Exchanges Rates by W.R. Cline and J. Williamson confirm) , the problems are really internal. Table 2 gives estimates of the implicit transfers corresponding to a misalignment of 10% depending on the degree of openness by keeping two extreme assumptions: one where exports only are in competition, the other where national producers are also in competition with the imports (for sake of simplification it is assumed that only half of the imports are in competition with local producers, the other part of imports corresponding to goods which are not locally produced). An overvaluation (e) with a degree of openness ((pxX + 0.5pmM)/pY) gives an ex ante additional cost (i.e. a negative transfer), evaluated in % of GDP, equal to T ((pxX + 0.5pmM)/pY), where T is the increase of unit cost due to the overvaluation ( with 1+T= 1/1+e). As an illustration, an overvaluation of 10% with a degree of openness of 30% gives an ex ante additional cost equal to (1/9)\*0.30= 0.033 (3.3% in % GDP).

To estimate the ex post effect of intra-European misalignments a multinational European model with a distinction between intra and extra-trade would have to be used to take into account the volume effect (overvaluation reduces exports and increases imports with an impact on GDP growth) and the price effect (imports are cheaper and exports price higher). It can be simply recalled that an appreciation of the euro of 10% leads to a slowdown of 1.2% in large EU countries and of 2% in smaller ones but this estimation does not take into account the intra-European appreciation effect (Mazier and Saglio, 208).

In this context, we can estimate that 10% of overvaluation equates to a tax of about 2.5 up to 4% of the GDP in the country of the South of Europe. On the contrary an undervaluation as in the Northern European countries represents a subsidy from the South to the North of about 5% of GDP. Combined with the estimations of monetary disadjustments, this means that Spain, Portugal and Greece have been penalised by negative transfers which equaled -5% up to -10% of GDP per year, France by transfers of -6% while Germany has benefited of a subsidy representing 8% of its GDP. Graph 1 represents the implicit transfers in percentage of GDP of each zone between the Northern and the Southern part of the Eurozone during the 2000s. It shows that the phenomenon has been lasting and important. These considerable implicit transfers should be brought into public debates on the stability of the Eurozone. They could for instance help to justify transfers between excess and deficit countries.

Table 2: Implicit transfer for a misalignment of 10%

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Goods and services | Degree of openness MIN | Degree of openness MAX | Implicit transfers MIN | Implicit transfers MAX |
|
| North | **Netherlands** | 71.3 | 103.3 | 6.5 | 9.4 |
| **Austria** | 52.7 | 76.9 | 4.8 | 7.0 |
| **Finland** | 42.1 | 60.5 | 3.8 | 5.5 |
| **Germany** | 41.6 | 60.0 | 3.8 | 5.5 |
| South | **Greece** | 22.3 | 38.9 | -2.5 | -4.3 |
| **Italy** | 26.7 | 40.2 | -3.0 | -4.5 |
| **France** | 26.7 | 40.3 | -3.0 | -4.5 |
| **Spain** | 26.7 | 41.9 | -3.0 | -4.7 |
| **Portugal** | 29.8 | 48.9 | -3.3 | -5.4 |
| **Ireland** | 90.0 | 127.7 | -10.0 | -14.2 |

Notes: Openness ratios are averaged over the period 2000-2011. *Degree of openness MIN = X/Y*; *Degree of openness MAX = (X+0.5M)/Y.*

Figure 1: Implicit transfers in percent of GDP for Southern and Northern euro area countries

**2 Lessons to be drawn from internal devaluations.**

Before considering the transfer schemes that exchange rate misalignments could legitimate, it is important to assess the specific conditions under which internal devaluation can help to finally reduce imbalances.

 Baltic countries which have either entered the Eurozone in January of 2011, such as Estonia, or are in currency board with the euro, are often praised for their exemplary adjustment. Facing important current deficits and, to a lesser extent, public deficits, Baltic countries have made massive internal devaluations. The production has fallen in volume between -10% and -20%, wages and prices have dropped, unemployment has risen dramatically but the current balance has been put right, the budgetary deficit has been reduced thanks to budgetary cuts and the lowering of nominal wages of civil servants. In 2011, growth has strongly picked up driven by exports. Several specificities of the Baltic countries can explain this adjustment, the labour market which is much more flexible than in the old countries of the South of Europe, but above all the small size of these countries which are very open to the rest of the world (47% versus 26% for Portugal) and thus forced to give a bigger response to changes in external competition and, in counterpart, the small weight of the domestic market which makes price adjustments more efficient and less expensive. Besides, the public debt inherited from the transition period has been much less important, which has considerably diminished the debt burden. To a lesser extent this chain of events has also been observed in Slovakia (67% of openness to the rest of the world).

It is thus this model that European leaders try to impose on Southern European countries. But Greece, Portugal, Ireland and especially Spain are less open to the rest of the world and have larger domestic markets. These economies, characterised by more complex economic and social structures, have a lesser adaptation capacity. Their banking sectors are more fragile, their public debt heavier. The generalisation of austerity policies slows down growth in the whole zone and limits the possibilities of recovery through exports. This is all the more true that beyond Spain, the two other big countries of the South of Europe, Italy and France, are also impacted or threatened. The strategy of internal devaluation, combined with budgetary austerity, has a strong negative impact in terms of growth and employment and is only efficient in the long run, especially when it is implemented in large countries.

Germany, however, highlights its past experience for two reasons. The German reunification has been a very costly process for the German economy during the 1990s. It has resulted in a significant escalation of prices and costs which has challenged the German competitiveness, yet believed to be not very sensitive to cost effects. Between 1991 and 2001 the current balance had even been sustainably in deficit. During this period, instead of making a current surplus of 5% of GDP, as during the 1980s, West Germany transferred every year to East Germany the equivalent of 5% of the West German GDP (and almost 30% of the East German GDP) to restructure and re-establish the East German economy. The latter, already in trouble before the reunification, had seen its industry literally collapse with the unrealistic conversion rate of one East mark into one West mark, chosen for essentially political reasons and against the opinion of the Bundesbank. Germany has thus used for itself on a large scale transfer and aid policies to compensate an internal overvalued exchange rate (largely indeed in the East German case). The outcome is seen as mitigated. Twenty years after the reunification, infrastructures have been constructed but the Eastern Länder are still characterised by higher unemployment rates and lower productivity levels.

During the 1990s, with the effects of the reunification, and until the launching of the euro in 1999, the mark has been overvalued, which has handicapped the German economy traditionally focused on exports. It is in this context that in 2002 a set of liberal reforms has been launched (the 2010 Agenda) during the second mandate of the chancellor Schröder to restore the basis of the German model. These measures even included a disguised mini-devaluation, with an increase of the VAT of 2 points to finance the lowering of social charges. The German labour market has been made more flexible with a stagnation of wages and an increase in insecure jobs. The social protection has been lowered. This austerity treatment has blocked the German growth and has contributed to the poor performance of Europe during the 2000s. But the German costs of production have been reduced and the cost-competitiveness, even if not essential in the German export model, has been re-established. The latter, combined with important industrial restructuring and relocations in Eastern Europe, restored the basis of the German competitiveness. It allowed Germany to face more easily the rise in the price of energy that strongly affected the current accounts of its partners as Germany benefitted significantly from the rise in income of its oil producing customers. . Germany was, in effect, much more able than its EU partners to compensate part of the supply side shock by a significant feedback demand effect stemming from the countries which increased their revenue with the oil shock. Figure 1 shows how it placed the south of Europe in a fragile position of strong misalignments within 4 years (2004-2008). The general loss of confidence brought by the 2008 financial crisis and the ensuing pressure on the financing of public deficits worsened the situation for the group of South Europe. Meanwhile, after having been very affected by the 2008-2009 world crisis, the German restored export-led economy benefited as a supplier of capital goods from the continued expansion of the emerging countries, an advantage bound to be reduced with the relative slowdown of emerging countries and their growing capacities to produce their own equipment goods. One should also keep in mind that Germany is already in chronic deficit with China, Brazil and Japan. Most of its surpluses actually come from Southern European countries, Spain, Italy, France and the USA, making profit of the undervaluation of the German euro which is allowed by the functioning of the Eurozone.

Moreover, to take the full dimension of the German experience, one should add that part of the huge costs of the reunification was not accounted for as part of the public deficit but registered in a fund specifically created to finance the reunification.

By and large the “success” of the adjustment of the German economy is significantly tied with both the historical background that the reunification constituted and the imbalance that had developed between between, let us say, North and South of the Eurozone. To conclude that internal devaluation across the board of the countries in the Southern part of Europe could be a recipe for a sustainable Eurozone is therefore misleading for the two reasons we have just given.

Other aspects of this harsh medicine should not be forgotten: the length of the adjustment process, about a decade in a big country, shorter in the countries which are more open to the rest of the world (but this is not the case of Greece or Portugal, even if they are small countries); the social cost in terms of loss of purchasing power, of reduction in employment rate and rise in unemployment. Let us recall that all these problems are amplified if the recipe is applied simultaneously to a set of interdependent countries, as it is the case for the countries of the South Eurozone.

**3 Taking the Eurozone out of its present deadlock: the limits of financial federalism**

The European construction, and particularly the Eurozone, is at a deadlock.

The strategy of European governments is articulated around two axes:

1. the generalisation of austerity policies based on internal devaluations,i.e. wages, jobs and price compression and reduction of public expenditures;
2. the implementation through successive steps and constraints, of new institutions and rules to provide the funding required by countries in big financial difficulties.

The way ahead is narrow and the process of institutional reform incomplete. Every condition contributes to limit growth, particularly in South Europe, making management of public debt problematic although it is precisely this which commands the most attention.

Even the European elite, taking advantage of any further implementation of liberal policies, reducing social expenditure, which increases inequality and obliges households to rely more on private insurance, start to doubt the sustainability of such a strategy since Summer 2011. First because of the development of the American debt crisis and the fragility of the American recovery, then because of the degradation of the economic situation in Europe linked with the generalisation of austerity plans, with the assaults against the Spanish and Italian debts, to which European banks are very exposed.

It explains that measures have been adopted since the last trimester of 2011 allowing to temporarily calm down the assaults of financial markets but new tensions reappeared in the spring of 2012. To face this recurring financial pressure on the weakest euro countries some consider that Europe should move towards some kind of financial federalism which could take various shapes.

The ECB has first tried another policy by offering 3 year loans at a 1% rate to European banks on two occasions in December 2011 and in February 2012 for the considerable amount of 1000 billion euros. This policy aimed at bringing back confidence in the European banking sector weakened by the return of the debt crisis during the second semester, creating a more favorable environment to the revival of credit leading to a reduction of lending rates on public securities. It gained some time but confidence remained weak, even if it allowed Spanish and Italian securities to be sold at reasonable rates.

The mutualisation of European debts through the emission of “Eurobonds” is often put forward with different variants. An integral mutualisation would be hardly conceivable. Its amount would be considerable. It would suppose the implementation of a European debt Agency with a strict control of national budgetary policies. A mutualisation for the debts inferior to 60% of GDP would have a lesser scope, with quite similar consequences in terms of control on national policies. The debts over the 60% level would suffer from very high rates with evident risks of speculative assaults, a real drawback. Reversely a last proposition would limit the mutualisation to the fraction of debts exceeding the 60% threshold. The amount would be less important. Such a mechanism would greatly help Italy, but less Spain. In a perspective of reduction of public debt on the long run, such “Eurobonds” would be meant to disappear. To conclude, “Eurobonds” are not a miraculous solution. They would help to finance structural imbalances without solving them. Growth would remain higher in the North than in the South of Europe. Anyway, facing the opposition of Germany, the project has been abandoned in July 2012, but the idea could be used differently, as we will see below.

The European Stability Mechanism (ESM) will be implemented more rapidly. It will supply loans to countries facing difficulties at a reasonable rate of interest with, in counterpart, a strict control of the fiscal policy. The main limit is the small amount of available funds (400 billions of euros) compared with the potential risks.

A Banking Union has been proposed in July 2012 in spite of German reluctance. It includes a supervision of the whole banks by the ECB in order to break the vicious circle between sovereign debt crisis and bank crisis. The project is large covering the monitoring, the deposits warrant and the mode of intervention during crisis period. It conditions the possibility of direct aids from the ESM to banks in difficulty without passing through the public budget.

The buying back of securities of countries facing difficulties by the ECB without limit is the last and the more global response (“the nuclear weapon”). However the experience of large scale “quantitative easing” of the American Federal Reserve has shown its limits in a low growth context with an inflation of the FED’s assets which increasingly affects its balance sheet. Besides, if the ECB promises to buy back securities without limitations, the counterpart could only be a reinforced control of budgetary policies which raises multiple problems of sovereignty. In spite of the opposition of the Bundesbank, it has been adopted in September 2012, but in a rather restrictive manner as it is reserved to countries having concluded agreement inside the EMS.

On the whole, the underlying idea that financial initiatives (Eurobonds and mutualisation of public debt, European Stability Mechanism, unrestricted ECB purchases, sovereign default of the worst-affected countries) are sufficient to overcome the Eurozone crisis is unconvincing. The present crisis arises from structural disequilibria linked to heterogeneity of member countries and permanently asymmetric patterns of development. It has proved difficult or impossible to maintain countries as different as Greece, Portugal and Germany in the same currency area in the absence of adequate structural measures to reduce these divergences.

Financial federalism is an insufficient response. Even if such measures are useful, and even sometimes necessary, they do not provide a long-term answer to problems arising from heterogeneity of the Eurozone. To overcome this gap current negotiations try to add a growth component in the stability Treaty: enlargement of the role of the European Investment Bank, emission of “project bonds” to finance investment programs in infrastructures, sustainable energies and the ecological transition.But such a reflation by means of investment raises two issues. The delays of implementation are relatively long whereas the blocking factors are very strong in the short term. Without a programming, or even a planning, on a large scale, the macro-economic impact of such a program to support growth could be quite limited. Still such programming of long-term investment is far from getting a political consensus.

**4 The progressive rise of a budgetary federalism**

Some propositions directly target a political objective, calling for a "European economic government" or for an explicit growth strategy, mobilising the growth potential in countries that have undervalued currency and a small public debt, with Germany in first place, in particular through increases of wages in the short term and a slightly higher inflation rate in order to avoid that internal devaluation in Southern European countries bear alone the whole burden of the adjustment.

It seems that a consensus could be reached around investment programs in fields such as education, research, infrastructure for sustainable development and revitalisation of the suburbs. Such investment schemes would require the cooperation of public and private actors. It could be financed partly by emissions at the European level (Eurobonds) and partly by credits from a European Investment Bank EIB, allowed to be refinanced by the ECB.

Still such programs cannot depend on a coordination of member states policies which has failed for decades to be effective. Indeed institutional complexity makes such coordination difficult. "European economic government" in the proper sense implies organised expansion and can only be implemented effectively through explicit federal institutions. This implies in the first place the creation of a relevant European budget.

A “budgetary federalism” is a development of the EU worth considering even if presently there is no political majority to support it. The relevance of such development stems from the legitimacy of budgetary transfers to counterbalance the effects of the exchange rate misalignments (see tables 1 and 2). Some federal compensation would be justified between countries, as they exist in Germany between “länder” or between French Regions and “Départements”.

A modest, but realistic, rise of the European budget from the existing 1% up to 5% of GDP could be progressively achieved by 2017. This European budget would be sufficient to finance new stabilisation and redistribution instruments at a European level through an mployment stabilisation fund, a European social fund to improve the harmonisation of social protection and an enlarged structural fund to act at regional level. Associated with this European budget, increased lending facilities through Eurobonds, the enlargement of the role of the EIB or of the EBRD, as well as new refinancing rules by the ECB would boost investment.

Regarding the progressive increase of the European budget in order to reach 5% of GDP by 2017, one could think of new specific resources, avoiding the delicate issue of transferring national fiscal resources to the federal level, such as taxes on financial transactions to improve financial stability and on CO2 emissions to preserve environment.

Let us now consider successively the three types of federal funds listed above.

**Employment Stabilisation Fund as permanent mechanism of budgetary transfer.**

The EC has already fancied in the 1990s a project of Stabilisation Funds based on employment performance (Italianer et Pisani-Ferry, 1992). In the case of higher than average growth of unemployment in a country, the latter receives a transfer (automatic or negotiated) coming from the European Budget. This transfer is calculated as follows

Ti = 0.01( dUi –dUiEU)\*GDPi si 0<dUi – dUiEU < 2

Ti = 0.02 GDPi si dUi – dUiEU > 2

dUi = Ui(t) – Ui(t-12)

U= unemployment rate as a %

It has been estimated that, with transfers limited to 2% of GDP, the average cost for the European Budget would be modest (around 0.23% of GDP).

The calculations have been done again with 1996-2011 data. They give relatively close results: an average cost of 0.21% of GDP with transfers limited to 2% of GDP, 0.26% of GDP without limitation for the Member-countries of the Eurozone; 0.26% and 0.28% of GDP (with or without limit) when the mechanism concerns all the countries of the UE, including the UK. Table 3 gives the calculations for the 27-member EU without limitation[[5]](#footnote-5). The transfers are generally more important in Southern European countries (Greece 0.75%, Portugal 0.71%, Spain 1.05%, Ireland 0.87%), except for France and Italy, as well as for Baltic countries. Germany is also a gainer (0.27% on average, especially at the beginnings of the 2000s). For some years, unlimited transfers can lead to significant amounts of about 4 up to 5% of GDP.

Table 3: Estimation of transfers in the case of an insurance mechanism against over average unemployment rate (without limitation) (as a % of GDP)



This scheme has never been fully agreed for two reasons.

First, it is accused to encourage bad practices because the cost of continuously rising unemployment is passed on to the Union.

Second, and more importantly, such insurance can permanently play in favour of the same countries. It then becomes a permanent transfer mechanism and no longer a budgetary insurance. This issue in the context of the crisis of the Eurozone seems to apply to Southern countries. But the costs incurred by the overvaluation of their national euro and the ensuing loss of competitiveness could justify the proposed transfers. Thus the transfers would reach up to 3 to 5% of GDP in Greece, Spain and Ireland at the end of the 2000s which is in line with the estimated costs of the overvaluation of their euro[[6]](#footnote-6). Such scheme would preserve the growth potential of the Eurozone and facilitate the resolution of public debt issues. These transfers are preferable to intra-zone credits (the only current type of aid within the Eurozone, except the partial debt write-off of Greece) which only postpone the problems.

Still previous experiences (the German reunification of the 1990s, the transfers to the South of Italy or in favor of less advanced regions in France) show net gains for the beneficiaries but little resolution of the structural problems. Transfers have to be completed by structural policies in the fields of research and innovation, industry, infrastructure and regional policies, as exemplified afterwards.

**A European Social Fund to improve social protection minima**

The “European social model” combines similar features of still disparate national models, helping to differentiate them from the American or the Japanese models. The coexistence of such diversity of European social models has been challenged by the liberalisation trend at work in the EU since the 1990s.

In order to strengthen the attractiveness of the EU citizenship and to reduce inequality between EU citizens it would be good to improve the general conditions of access to social services or public services (health, family aids) and to set goals in each major field (minimum wage, social protection, pension schemes). The minimum wage system is to be extended to every Member-State, taking into account the existing productivity gaps. More constraining procedures are considered to force the respect of minimal norms, for instance regarding the amount of pensions as a percentage of the revenue per capita. Their levels would be negotiated periodically.

An amount varying between 0.5% and 1% of the GDP of the EU would be allocated to such a European Social Fund.

Conversely some coordination of wages evolutions would be desirable. It could take into account productivity differentials as well as sectoral considerations. Such agreements are hard to implement. They could follow the practices of European social-democrat countries. The wage negotiation would thus appear as a component of an enlarged policy mix which would not be limited to the budgetary policy – monetary policy couple.

**A rehabilitation of structural European policies**

If the EU was to give a new priority to industrial policy over competition policy it could be articulated around the three following points: a more active research and innovation policy, the rehabilitation of large public programs and upscaled regional policies.

Research policies could be improved through a better articulation with national policies and greater support to new instruments. The additional effort would account for about 0.4% of the GDP of the EU. The resources of the Framework programme of R&D would thus be considerably increased. Cooperative scientific programs would be launched. European technological agencies responsible for the coordination of the actions in the fields of information technologies and biotechnologies would be created. Public European research organisations would be created in the same spirit matching with the propositions of the Sapir report (2003).

Regarding industrial policies, the large public programs would be rehabilitated. Technology-oriented public programs in the fields of energy, ecological transition, telecommunication or aerospace (sometimes military) would spur innovation in private firms. The development of a European programming would allow to reduce duplications at national level and to take better advantage of synergies.

Large infrastructure programs are a driving force for growth through the externalities they create. Europe would design guiding schemes in the fields of railway transports, electricity, gas, ecological transition, telecommunication or post office. The funding of these investment programs would imply an important increase of public funds available, either in the frame of the European Budget with the possibility of using European debt, or in the frame of new instruments created by the EIB whose role would be enlarged. The concrete management of the implementation of the projects would be in the hand of a unique manager.

Technological programs and large infrastructure programs would account, in total, for about 1% of UE’s GDP per year.

Regarding European regional policy, experiences have been diverse. In some cases, the endowment has been underutilised due to problems of definition and coordination between the different participants. In other cases, the utility of projects can be discussed. But the Eastern enlargement of the EU has brought new challenges. An increase of the European budget would allow the enhancement of the eligibility threshold to Structural Funds up to 90% of the European GDP per capita so that more regions which are less developed could benefit from it. If the transfers are limited to 4% of GDP in the Eastern countries, for absorption capacity reasons, the total cost for the European budget is estimated between 0.18% and 0.38% of the GDP of the EU, whether the evaluations are done in current prices or in PPP.

Finally, the additional 4% of GDP of the European Budget would be distributed as follows (table 4)

Table 4: Distribution of the additional European Budget (as a % of GDP)

|  |  |
| --- | --- |
| Employment Stabilisation Fund | 1 |
| European Social Fund | 0.9 |
| Debt service  | 0.3 |
| Research | 0.4 |
| Regional Policy  | 0.4 |
| Investment programs | 1 |
| Total | 4 |

**5 Multispeed Europe as an alternative**

If the reluctance of old European States to install a budgetary federalism could not be overcome a fall-back scenario could be one of a multispeed Europe with the following characteristics:

* Implementation of a new monetary regime in Europe where a single external euro coexists with national euros with fixed intra-European parities, which can be adjusted according to the structural evolution of each national economy or regional block (South Europe, West Europe, East Europe, North Europe);
* A federal budget maintained at its current level to guarantee the continuation of certain European policies in the fields of agriculture and research; European budgetary transfers have no reason to exist as adjustments can be done through the modification of intra-European parities; there are no Eurobonds, nor European debt agency.
* The modification of parities made at the implementation of the new monetary regime (devaluation of the South and East euros, revaluation of the West and North euros) allow the re-establishment of the competitiveness in the South and in the East and to boost growth by avoiding austerity policies and allowing investment to start again.
* National structural policies, mostly industrial policies and regional policies, regain some favour in a context of weaker European competition policy; national policies have the ability to value more the specificities of each national space; public aids are less controlled by the EC and take different forms depending on the country (more at a central level in France, more at a regional level in Germany or in Italy for instance); more generally industrial policies are organised differently in each country (national investment bank, national champions, industrialisation funds).
* “A la carte” co-operations between some Member-States are developed depending on their specific advantages and their specialisation (European agencies regrouping only some States; “à la carte” common investment programs around large projects such as clean cars, nanotechnologies, photovoltaic cells).
* The diversity of social models is reinforced without any institutional convergence (no European minimum wage, diversity of pension schemes, unequal eight of labour unions and collective negotiations); but a partial convergence is allowed by the economic adjustment and a stronger growth.

**Monetary regime in a multispeed scenario**

The national euros are not convertible at an international level. For external exchanges and capital movements the national euros have to be converted into external euros but this convertibility is not free. External convertibility holds, but there is no internal convertibility[[7]](#footnote-7).

For the country I the national euro is a fraction αi of the external euro (1 euroi = αi euro). This external euro floats freely on international capital markets (1 dollar= xr euro) but this external euro is not independent from national euros. Without an explicit dependence taking the form of a currency basket, a relation of the type (1 euro= Σ βi euroi) exists, βi being the weight of the country I in terms of GDP or in terms of share of trade of the Eurozone.

There is thus a relation 1 euro= Σβi αi euro, thus Σβi αi = 1, which implies that the αi, i.e. the intra-European parities, cannot be determined independently one from another, the coefficient βi being observed data.

With free capital mobility, the system would be instable. In order to limit speculation on intra-European parities, several functioning modes are conceivable with an unequal “financial repression”.

In a first configuration only banks and non-banking financial organisations have external euro accounts. National banks have deposits and make loans in national euros. They hold bonds in national euros, but also bonds of other European countries issued in external euros and bonds in dollars. Banks’ accounts in national euros are freely convertible. To avoid speculation risks, reserve requirement in the Central Bank are imposed on deposits and assets in external euro.

National Central banks make advances to the national banks and hold reserves in euros at the ECB. The ECB plays a role of clearing union as in the current case, but until a certain threshold of reserves. Beyond this threshold, intra-European parities must be adjusted.

Non-financial agents (households and firms) only have accounts in national euro. However, for their foreign trade and financial operations firms can use account in euro of the banking system, with a threshold calculated with the average observed amounts of external trade volume and financial needs.

In a more liberalized regime, banks and firms also have accounts in external euros freely convertible at defined fixed rates. Households have only national euro accounts and remain entirely constrained. To limit the speculation, as previously, the cost of holding external euros by non-financial residents is increased through important reserve requirement imposed on banking deposits.

Last, a more flexible monetary regime can be considered with a system of floating national euros around a reference parity (which can be adjusted) in relation to the external euro. National euros are now convertible at the international level with a large band of fluctuation. The greater flexibility has as a counterpart a risk of increased instability, which implies some instruments to reduce the capital mobility or increase its cost (tax on financial transactions, reserve requirements).

**The transition period to a multispeed scenario and the structure of external debt**

The difficulties of the transition toward such a system should not be underestimated. The implied end of the financial liberalisation is the first issue.

The second is that of the external debt in euros. The repayment of this debt implies either a loss for foreign creditors in case of repayment in national euros convertible into external euros with a loss for countries having devaluated their national euro, or an additional cost for debtors having devaluated if they repay their debt in external euro. An international negotiation, in fact largely intra-European, should allow stakeholders to find a balance between these two extremes.

Table 5 below gives some information on the repartition of the debt of Southern European countries for which there is no (easily available) information on public debt only. The share of securities (except stocks) held by the rest of the world ranges between 40 and 65% for the securities of Southern European countries (except for Ireland with more than 80%). Amongst these securities, public securities represent a very variable share (11% in Ireland, 91% in Greece to take the two extremes). Amongst foreign creditors, the Eurozone and, more largely the EU, accounts for a dominant share, except in France. The negotiation on the restructuring of the debt in the case of the devaluation of the euros of Southern European countries would mostly concern other countries of the Eurozone, France being somehow caught in a vice-like grip, as shown in the table on the main creditor countries.

Table 5: Debt structure of Southern European countries (2010)

|  |
| --- |
| Share of public securities among the total of securities (except stocks) issued : in % |
|  |  |
| Ireland | 11 |
| Greece | 91 |
| Spain | 35 |
| France | 37 |
| Italy | 55 |
| Portugal | 45 |

Source : Eurostat

|  |
| --- |
| Share of securities (except stocks) held by the rest of the world (whole economy) |
|  |  |
| Ireland | 82 |
| Greece | 65 |
| Spain | 46 |
| France | 57 |
| Italy | 42 |
| Portugal | 52 |

Source : Eurostat

|  |
| --- |
| Distribution of debt (except stocks) by zone |
|  | Zone euro | UE | Extra UE |
| Ireland | 62 | 79 | 21 |
| Greece | 91 | 96 | 4 |
| Spain | 77 | 86 | 14 |
| France | 48 | 57 | 43 |
| Italy | 75 | 87 | 13 |
| Portugal | 89 | 93 | 7 |

Source : IMF, CPIS

Distribution by creditor country (TOP 5, in % of the total)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Ireland | Greece | Spain | Italy | France |
| Germa | 19 | France | 24 | France | 27 | France | 24 | Inter org | 22 |
| France | 14 | Germa | 22 | Germa | 20 | Germa | 16 | Germa | 12 |
| UK | 14 | Cyprus | 11 | Lux | 7 | Lux | 11 | Lux | 10 |
| Japan | 7 | Spain | 6 | Inter org | 6 | UK | 9 | Nether | 8 |
| Port | 6 | Belg | 5 | Nether | 6 | Ireland | 8 | UK | 7 |

Source : IMF, CPIS

In the future, after the phase of restructuring of the debt of countries having devaluated, the external debt will be hard to finance and countries which have been in deficit will have to rebalance their current account. The intra-European monetary adjustments and the new parity system will make this rebalancing of current account easier but a restrictive policy will be necessary during the transition period before the return of growth thanks to the re-establishment of competitiveness.

**A Clearing Union project**

To overcome these difficulties, some authors (Amato and Fantacci, 2011) propose the implementation of a Clearing Union system at a European level inspired by the ideas of Keynes. A Clearing Union is a monetary institution which finances the temporary imbalances of current accounts of a group of countries. Each Member-State has an account at the Clearing Union in a specific unit of account different from national currencies (called Bnancor by Keynes). Countries in deficit have a negative account, countries in surplus have a positive account. The Clearing Union is responsible for the centralisation of every account, the compensation is done multilaterally. Three rules define its functioning:

- The functioning is symmetric; countries in deficit pay interests as expected but countries in surplus also pay interests on their surplus; this mechanism favours balanced current accounts.

- There is a ceiling for surpluses and deficits which prevents the indefinite accumulation of net debt or surplus.

- Monetary adjustments between national currencies are possible to contribute to the reduction of excessive current imbalances, devaluation for countries in deficit, revaluation for countries in surplus.

This system, initially imagined by Keynes at an international level, can be transposed at a European level. It also implies radical changes in relation to the current situation. The European Central Bank certainly plays the role of a Clearing Union, but with a complete asymmetry between countries in deficit and countries in surplus, without any ceiling for surpluses or deficits and without any possibility of intra-European parity readjustments.

This Clearing Union project at a European level is compatible with the propositions presented above. The external single euro would be used as a common currency to finance surpluses and deficits. But it would not be a simple unit of account because it would be freely convertible on international capital markets. The possibility of parity readjustment in case of important structural deficits is one of the core elements of the system which is proposed. These readjustments are a priority before the implementation of the new regime. The same problems regarding the end of the financial liberalisation and the management of external debt for countries devaluating their currencies are faced.

Two additional points remain; the definition of the limit of current surpluses and deficits and the definition of the symmetric functioning, as the countries in surplus must also pay charges depending on the amount of their current surplus. The beneficiaries of these interests should probably be specified (the ECB in principle) and what will be done with these interests.

**6 Conclusions**

Given the costs of the structural diversity of the Eurozone in terms of overvaluation of the euro for a large sample of countries the financial federalism that seems to emerge from the ongoing negotiations under the continuing speculative attacks of financial markets may well be inoperative. Two solutions appear as sustainable paths for the euro. One is some kind of budgetary federalism but it is conditioned by a significant rise in political support for a committing federalism. The other, which accommodates a multispeed Europe, is less demanding politically, but faces a difficult transition period and requires some restriction in the capital mobility to preserve financial stability.

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1. CEPN University of Paris13 [↑](#footnote-ref-1)
2. CNRS and CEPN University of Paris 13 [↑](#footnote-ref-2)
3. In 2011 17 countries out of 27 EU members had joined the Eurozone, namely Belgium Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, The Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland.. Non-participants : Bulgaria, Czech Republic, Denmark, Latvia, Lithuania, Hungary, Poland, Romania, Sweden and the United Kingdom [↑](#footnote-ref-3)
4. Each method to measure exchange rate misalignments has its uncertainties, especially regarding the current account target in fundamental equilibrium in the case of the FEER method, but alternative method like the Behavioral equilibrium exchange rate BEER is less suited to study structural problems of current account in the euro area as it makes the implicit hypothesis that effective real exchange rates are at the equilibrium over the whole observed period (Lopez, Mazier and Saadaoui, 2012). [↑](#footnote-ref-4)
5. The other calculations are available without limitation and for the Eurozone only [↑](#footnote-ref-5)
6. Except France and Portugal, particularly penalised by the overvaluation of their euros but which do not benefit a lot from the Employment Stabilisation Fund because of an evolution of their unemployment rate closer to average, which raises the question of the type of indicator to be used. [↑](#footnote-ref-6)
7. It is a variant of what China wants to implement in the mid term for the convertibility of the Yuan, external convertibility without internal convertibility. [↑](#footnote-ref-7)