

## THIS MONTH'S TOPIC

# Europe at an economic policy crossroads

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### The essential

**The new European leadership** (at the head of the European Commission and the ECB), combined with **historically low real interest rates**, provides a unique **opportunity to rethink** priorities in order to meet the challenges at hand (economic, financial, environmental and security challenges). **In economic terms, strengthening Europe and improving its competitiveness means tackling all these challenges simultaneously.**

**At the level of economic policy, the link between monetary and fiscal policy must inevitably be rethought. But that's not enough. The expansionary policy mix must be accompanied by an improvement in the financial architecture.**

**We identify two pillars on which the European authorities should be able to act significantly in 2020-21: the Capital Market Union and budgetary rules. This is a prerequisite for dealing with the inevitable macro-financial shocks that the future holds.** Against this backdrop, the voices of Christine Lagarde and Ursula von Der Leyen (Presidents of the ECB and the Commission respectively) are eagerly awaited.

**On an international scale, Europe is struggling to establish itself, in particular against the two giants, the United States and China. The European Union (EU) must therefore be strengthened at all levels:** political/diplomatic, security/defence, financial architecture, development of high technologies, financing of the energy transition, etc.

**The new European leadership** (at the head of the European Commission and the ECB), combined with **historically low real interest rates**, provides a unique **opportunity to rethink** priorities in order to meet the challenges at hand:

- **An economic challenge:** the combination of low potential growth and high public and private debt is clouding the medium- and long-term outlook. Of course, this is not just a European issue. But structural reforms are still needed. In addition, one of the priorities will be to channel the (very abundant) savings to investment projects with a promising future.
- **A financial challenge:** the Europe of capital is still too fragmented; on the one hand, Europe relies too much on its banking system and, on the other hand, cross-border investment in the region is clearly insufficient (savings circulate poorly between north and south), which limits the resilience of the Eurozone (EZ) in the event of an asymmetric shock. Moreover, banks are still too exposed to their own sovereign securities held on their balance sheet (the "doom loop").
- **An environmental challenge:** the "social demand" in this area is very high, as shown by the breakthrough of the Greens in the last European elections. There is a sense of urgency that needs to be addressed. The Commission is ready to commit itself. The ECB says it is ready to help. All levers must be mobilised to meet this challenge (investment, taxation, regulation).
- **A security challenge:** there are many areas of tension. There is nothing new except that this situation will continue, *especially* if Donald Trump is re-elected as president in November 2020. Europe will have to acquire a credible defence structure – which will require increased investment in technology and security – and uncertainty will rise due to the tensions between the two blocs.

**In economic terms, strengthening Europe and improving its competitiveness mean tackling all of these challenges at the same time.** As Kennedy already noticed nearly 60 years ago, it is indeed when the weather is nice that the roof has to be repaired<sup>1</sup>. But the clouds are gathering. Uncertainty about Europe's future is weighing on confidence. Restoring confidence is a sine qua non for investment. The "European house" will be able to cope

<sup>1</sup> "The time to repair the roof is when the sun is shining" (J-F. Kennedy, State of the Union Address, 11 January 1962).

with a little rain (i.e. a moderate recession), but its financial architecture is still too weak (excessive economic, financial and regulatory fragmentation, uncoordinated fiscal policies, monetary policy that is reaching its limits) to weather a storm (big recession and/or severe financial crisis). Not to mention that it is still powerless in military terms (especially in comparison with the United States and China), but this is another debate.

At the level of economic policy, the link between monetary and fiscal policy must inevitably be rethought. But that's not enough.

**The burden of macroeconomic stabilisation cannot rest with the central bank alone.** Negative interest rates and the ECB's QE are ultimately weakening the macrofinancial system, while the economic impact is increasingly questionable.

**Fiscal policy can help stimulate investment** because the debt constraint is naturally eased by lower interest rates, which increases the room for manoeuvre. **But public debt is already too high in many countries.** It is therefore right to focus attention on those states in the EZ that have the means to act (primarily Germany). **However, fiscal policy is not the alpha and omega of Europe's stabilisation capacity.** And it is certainly not through fiscal policy alone that the authorities will be able to improve European competitiveness.

**It is not just a question of increasing external competitiveness.** The main aim is to improve investment attractiveness. **The EZ is penalised by its financial architecture, which is too fragile in the eyes of many foreign investors.** The result is a form of political risk premium on European assets (which are more affected by mistrust as soon as global conditions deteriorate).

**The expansionary policy mix must be accompanied by an improvement in the financial architecture.** The need for a federal budget is often mentioned, and this goes hand-in-hand with the need to create a European *safe haven*. This progress is essential for the long-term stability of a monetary union. Having said that, we must be realistic, the European states are not yet ready to take this step; it can only be the culmination of a process of further financial integration.

**The EZ benefits from an excess of savings and a shortfall of investment.** Improving the circulation of savings within the zone is a priority. **Households' asset allocation no longer corresponds to the new financial situation.** Their savings are over-invested in debt securities. To remedy this, savers' financial education should be improved and they should be encouraged to diversify their savings into risky assets, including European cross-border investments.

**The EZ is still too dependent on its banking system:** access to the capital market for SMEs must be facilitated. All the more so as the banks, for their part, are weakened by low interest rates and by their ownership of their own sovereign debt.

**In the meantime, all reforms aimed at improving the EZ resilience will improve its attractiveness and competitiveness. Europe's needs and challenges are clearly identified. There is an awareness among the authorities of the need to act, but there is still a lack of agreement on the means to be implemented, particularly between Northern and Southern Europe. Close consultation is needed to find a compromise.** Europe must also find voices that embody Europe and its place on the international stage. The voices of Christine Lagarde and Ursula von Der Leyen (Presidents of the ECB and the Commission respectively) are eagerly awaited.

**We identify two pillars on which the European authorities should be able to act significantly in 2020-21: the Capital Markets Union and budgetary rules.**

### Capital markets union (CMU) is a prerequisite

Empirical work shows that *risk* sharing - much more than fiscal and budgetary integration - is what allows the US economy to absorb shocks, especially when they are asymmetric. In particular, we note that the resilience of the US economy stems from the fact that companies rely more on market financing, which makes the US economy less sensitive to a banking shock.

- A more integrated financial system increases the system's resilience to shocks. **The more geographically distributed the risks, the greater the stability of the Union.** The idea is quite simple:
  - If a country enters a recession, but households and businesses in that country receive dividends and interest income from other countries that are not in recession, that income will help stabilise the country in recession.
  - The same applies when a country's banking sector is affected by a crisis and has to limit the distribution of credit to the private sector. Access to finance will be much easier if households and businesses have access to banks and investors in non-crisis countries.
- Risk sharing is not currently provided through the capital markets. It can be achieved by encouraging cross-holding of assets from other countries in the EZ.
- Tax rules are still too complex for cross-border transactions and national insolvency procedures are too different.

The benefits of the CMU are still very poorly understood by the general public and there is therefore little public support for action in this area. But that should not stop the authorities from taking action.

### Rethinking budgetary rules

This is a very sensitive issue for the new European Commission. In fact, the European states have never observed the rules of the Stability and Growth Pact. The core EZ countries were even the first to set a bad example. More than twenty years after the launch of the euro, there is now a near consensus on the need for new and more credible rules, for the following reasons:

1. The rules have become too complex, which has undermined their effectiveness;
2. The framework has become more opaque over time: many indicators at the heart of the approach are not directly observable (output gap, structural budget balance) and are thus the subject of endless debate among economists.
3. The division of roles between the Commission (initially responsible for legal and economic analysis) and the Council (political body) has become less clear-cut over time. The Commission now plays a key role in imposing penalties, which is probably not desirable.
4. The penalties have not worked. A budgetary framework without any correction mechanism is not credible.

The current framework is the result of a stack of reforms that have made the rules more complex over the years. It is striking that the rules have become more pro-cyclical. The first elements of flexibility and cyclical corrections were introduced before the Great Financial Crisis, when the Eurozone economy was in good health, but the framework was strengthened during the crisis. New elements of flexibility have been added since the sovereign debt crisis, leading to an easing of fiscal targets. This results from the underlying pro-cyclicality of fiscal policies in the EZ and underlines the difficulty of applying a supranational fiscal framework. The Stability and Growth Pact is the result of a political compromise between the Member States. **In the new macrofinancial context, it will be up to the Commission to work on a new compromise that improves the governance of the monetary union without calling into question the existence of rules.** Democratic adherence to these rules will come from their stabilising nature in the event of a crisis.

### Conclusion

**All in all, Europe, and more particularly the Eurozone, seems to us to be ready to face a "small" recession, through a combination of accommodative monetary and fiscal policies.** However, in order to avoid lasting fiscal slippage, it is essential to anchor the credibility of fiscal actions with clear counter-cyclical rules. This means that in periods of expansion, spending will have to be more constrained. **On the other hand, to counter a "great crisis" or a very severe recession, the financial architecture of the Eurozone is still insufficiently consolidated.** This is the task that the European authorities must now tackle; not so much because a crisis is looming, but because a region's resilience is the foundation of confidence.

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