Making the Eurozone sustainable

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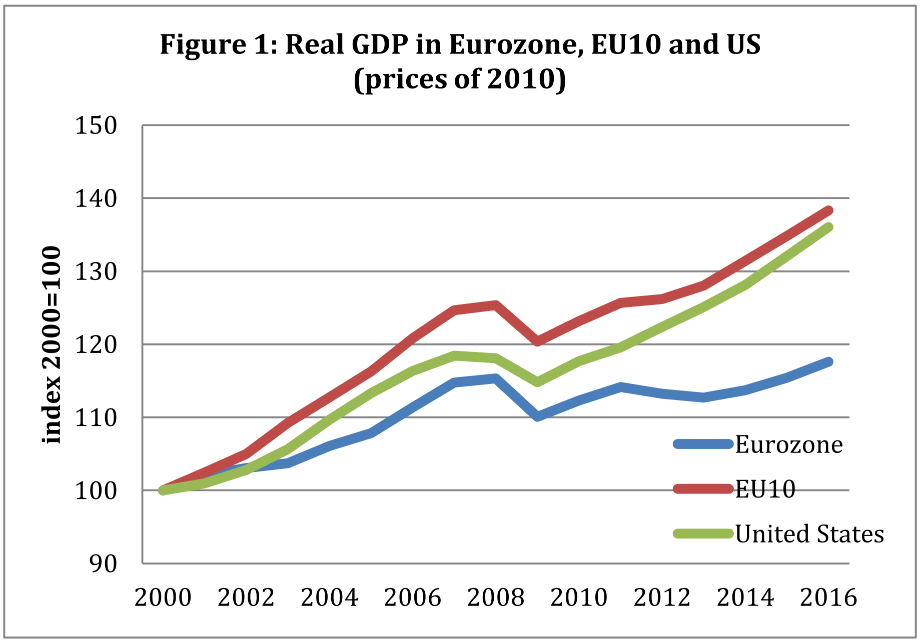
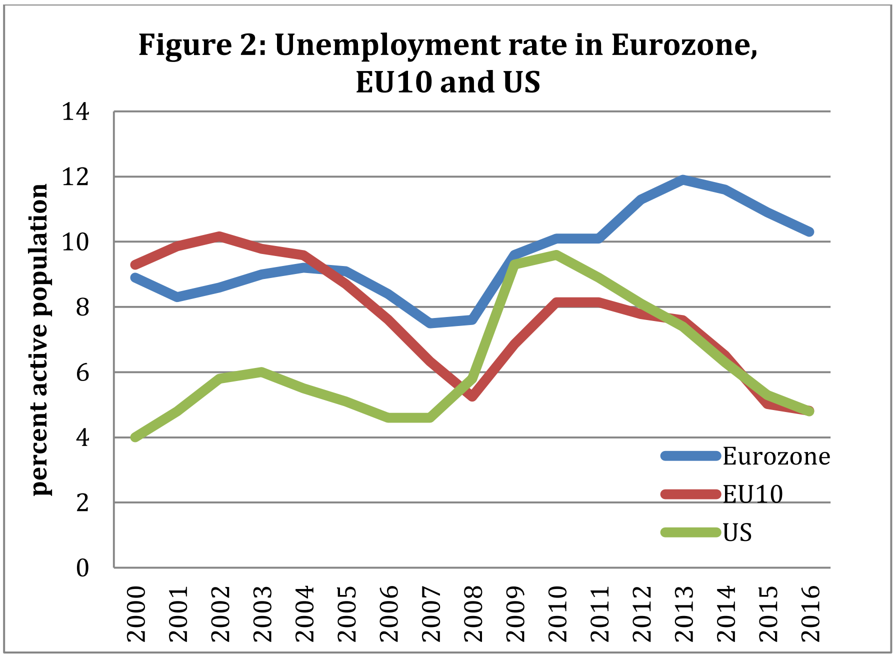
The election of Emmanuel Macron to the French Presidency creates new opportunities for taking initiatives that will ensure, first, that the Eurozone becomes a source of economic growth and second that its long-run survival is guaranteed. At this moment none of these two objectives have been realized. In this article I first analyze how a new growth impetus can be brought in the Eurozone, and second how the long-run sustainability of the Eurozone can be ensured. The first objective can be realized without intrusive institutional changes, the second one will require deeper institutional changes in the Eurozone. Yet small steps can be taken today that do not require Treaty changes.

The failure of the Eurozone as a source of economic growth is illustrated by Figure 1 which compares the evolution of real GDP of the Eurozone with the US and with EU-10 (defined as the group of EU-countries that are not in the Eurozone). The contrast between the EU-10 and the Eurozone is stark. The former group of countries that decided not to be in the Eurozone has managed to recover much better from the recession of 2008-09; the Eurozone has experienced quasi stagnation since 2008. There is some recovery in the Eurozone since 2014 but the gap with EU-10 has not narrowed.

The dismal economic performance of the Eurozone as compared to the EU-10 is also made clear in Figure 2, which shows the evolution of unemployment rates in these two groups of countries (together with the US). It is disturbing to find that while in 2000 the rates of unemployment in the Eurozone and the EU-10 were approximately equal, in 2016 the Eurozone unemployment rate was twice as high as in the EU-10. Again, the recent decline in unemployment in the Eurozone has been insufficient to narrow the gap with the group of EU-countries that remains outside the Eurozone.



Source: European Commission, Ameco



Source: European Commission, Ameco

At the start of the Eurozone, this historically unique monetary experiment was hailed as one that would promote economic growth and welfare for its citizens. It has to be admitted that these promises have not been realized. On the contrary, The Eurozone countries, on average, performed worse than the EU-countries that decided to stay out of the monetary union. Of course, this average hides large differences within the Eurozone. Northern countries like Germany and the Netherlands have performed relatively well. This, however, also implies that many Eurozone countries economic performances have been even more dismal that what appears from the Eurozone average.

The poor economic performance of the Eurozone explains why in a number of member-countries popular discontent with the Euro has been on the rise, feeding populist parties with promises that a euro-exit would help to improve economic performances.

What should be the priorities for Eurozone policy-makers to redress the dismal economic performance and to put the Eurozone on a sustainable path? I concentrate first on the role of public investment in boosting the Eurozone economy and then on new initiatives for improving the governance of the Eurozone.

Boosting the Eurozone economy through public investment

Public investment has been one of the many casualties of the austerity programs that were imposed on the Eurozone countries since the sovereign debt crisis. This is paradoxical since it is public investment that is key to the recovery in the Eurozone.

There are two reasons why public investment is central for promoting economic growth. First, the private sector is still very risk averse and fails to invest enough. This has to do with the lack of confidence in the future. The way to deal with this is for the public authorities to show the way and to kick-start public investments. This will stimulate economic growth and create more confidence in the future, which in turn is likely to stimulate private investment.

Second, public investment is needed to achieve long-term objectives of sustainable growth. The latter requires investment in alternative energy sources, the environment and in public transportation.

Unfortunately, public investment is discouraged by a rule that the members of the Eurozone have imposed on themselves, i.e. that public investment cannot be financed by bond issue. It has to be financed by current tax revenues. This prevents public investment from taking off, from sustaining the recovery and from developing a green economy.

It is often argued that public authorities should not increase their debt; on the contrary that they should reduce it. Some countries of the Eurozone periphery undoubtedly have limited capacities to add to public debt[1]. But other countries, like Germany, France, Belgium, the Netherlands and Finland surely can. The governments of these countries today can borrow at very long maturities almost for free. There are certainly many investment projects that have a rate of return of more than 0%.

A government that issues bonds at close to 0% and channels the money into projects that will have rates of return by far exceeding 0% promotes economic growth and makes the future repayment of the debt easier. This was also stressed by the IMF in its World Economic Outlook of 2014 where it concluded that "debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment" IMF(2014).

Put differently, what matters is not gross debt, but net debt of governments. Debt issue that makes it possible to invest in assets with a much higher rate of return than the cost of borrowing will reduce net debt in the future. Unfortunately, Eurozone countries, pushed by European policymakers, continue to be mesmerized by gross debt numbers and as a result fail to do the obvious.

European authorities have put great emphasis on structural reforms to boost long-term economic growth. Econometric analysis of the relation between long-term growth and structural reforms (see IMF(2015), De Grauwe and Ji(2016)) suggests that these reforms have a weak effect on growth. These same studies, however, reveal that public and private investments are far more important to boost economic growth. Yet, by imposing a balanced budget on its member-countries and thereby outlawing the financing of public investment by the issue of bonds, the European authorities discourage public investment in the Eurozone. They do this even at a time when the financial conditions to borrow have never been so favourable.

It is often said that governments today cannot issue more debt because this will place a burden on our grandchildren. The truth is that our grandchildren will ask us why we did not invest in alternative energy and public transportation, and thereby

[1] Some of these countries may also lack the appropriate governance to ensure that public investments raise productivity (see Gros(2014) and IMF(2015) on this).

made their lives miserable, when we faced historically favorable financial conditions to do so.

The use of a more intelligent rule that will be conducive to economic growth would be easy to implement if the political will exists to do so. This is where President Macro may make the difference. An agreement between the member-states of the Eurozone could be reached that allows to distinguish a current budget and a capital budget. The former would be subject to the structural balanced budget rule of the Fiscal Compact. The latter could show a deficit reflecting the financing of public investment by the issue of bonds. This is sometimes called the "Golden Rule" of fiscal policy. It has been proposed by many economists in the past.

The Juncker investment plan that was launched in 2014 is certainly the right approach, but it is clearly insufficient to lift the Eurozone on a higher growth path. It has to be supplemented by the capacity of national governments to boost public investment.

There are certainly problems with the Golden Rule, one of which is that politicians may manipulate the rule so as to increase current spending by relabeling these as capital spending. There is a role here for Eurostat to set up a monitoring system that aims at preventing the improper use of the Golden Rule.

Boosting the prospect of the Eurozone by improving its governance

One of the main design failures of the Eurozone is that national government bond markets continue to exist while national governments lack the support of a central bank that is capable of supporting its sovereign's bonds in times of crises. This is a problem that is likely to arise with each recession when investors will flee from the bond markets perceived to be less safe and towards bond markets of safe countries. The ensuing capital movements within the Eurozone will be destabilizing and prevent countries from using the automatic stabilizers in the budget. Put differently, the Eurozone has stripped national governments from their capacity to stabilize the business cycle, thereby increasing the hardship of those hit by the recession. If not remedied this is likely to intensify the hostility of millions of people towards a system that fails to provide some protection against booms and busts that capitalism inevitably produces.

The first best solution would be to consolidate national government bonds into a common bond. This would amount to a fiscal union. It is clear that today there is no political appetite for moving into such a union. That does not mean, however, that it should not be maintained as a long run goal aimed at making the monetary union sustainable.

The only viable strategy for reaching this long run goal is a strategy of small steps. This should be designed in such a way that it is clearly seen as a step towards that long-term goal.

My favorite proposal is a common unemployment (re)insurance scheme. There have been many recent proposals (for a survey see Beblavy at al.(2015); see also Four Presidents Reports(2012). The essential features of such a proposal are, first, that it keeps the insurance dimension intact, thereby avoiding that it degenerates into a scheme making permanent transfers from one group of countries to another one. This would lead to a dreaded “Transfer Union” so feared in Germany. A second feature is that it should also be allowed to provide not only inter-country insurance but also inter-temporal smoothing. The reason is that the business cycles in the Eurozone are highly correlated (albeit with different amplitudes). Thus the common unemployment insurance scheme is likely to be underfunded during recessions and overfunded during booms. As a result, it should be allowed to issue bonds (Eurobonds) during recessions and to retire these during booms. Such a scheme would therefore combine inter-country insurance and smoothing over time. By its capacity to issue bonds it would be a precursor of a more ambitious scheme of debt mutualization to be realized in the long run.

Clearly such a common unemployment scheme must start small and therefore will be insufficient to take care of all stabilization needs in the Eurozone. However, its existence will show the direction in which the Eurozone countries wish to go to make the Eurozone sustainable in the long run.

To conclude. The Eurozone is an ambitious project. However, it is also an unfinished project. If left unfinished it will destroy itself. It is therefore of the utmost importance that steps are taken to make the monetary union sustainable. The political configuration after the election of Macron to the French Presidency has created a window of opportunities to take these steps.

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