On public debt in the euro area

Catherine Mathieu, Henri Sterdyniak

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Abstract*:* The 2008 crisis led to a strong rise in public deficits and debts in most developed economies. These debts and deficits are currently Keynesian (i.e. required for macroeconomic stabilisation), as shown by low inflation and interest rates levels. Euro area public debts are not guaranteed by a lender of last resort. The rules enshrined in the Stability Pact and the Fiscal Treaty have no economic basis. The paper discusses federalist proposals such as a European Debt Agency or a European Treasury, and unconventional solutions, such as debt monetisation, buyback by the ECB, and even debt cancellation. It concludes in advocating for a rule-free economic policy coordination.

Keywords: public debt, euro area governance, euro area fiscal policy, debt management.

JEL classification: E42 E62, H63.

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1. Introduction

The 2008 crisis led to a strong rise in public debts, by around 30 percentage points of GDP in terms of Maastricht debt for the euro area, 40 percentage points for the US, 45 for the UK, 65 for Japan (Table 1). At the end of 2014, public debts were above 60% of GDP in almost all euro area countries, but this was not specific to the euro area, and was also the case for the UK, Japan, and the US. Almost all developed countries run high public deficits, reaching, in 2014, 7.7% of GDP in Japan, 5.3% in the UK, 5.0% in the US, but 2.4% only in the euro area at the price of past heavy fiscal austerity.

Table 1. Public debts in 2007 and 2014, as % of GDP

	Gross debt, Maastricht definition		Net debt	
	2007	2014	2007	2014
Germany	64	75	42	46
France	64	96	32	78
Italy	100	132	89	131
Spain	36	99	17	81
Netherlands	42	68	24	44
Belgium	87	107	74	102
Austria	65	84	39	59
Greece	103	179	80	141
Portugal	68	130	55	108
Finland	34	59	-70	-55
Ireland	24	107	-1	82
Euro area	*66*	*95*	*42*	*73*
UK	44	88	30	76
US	64	105	45	86
Japan	183	246	81	129

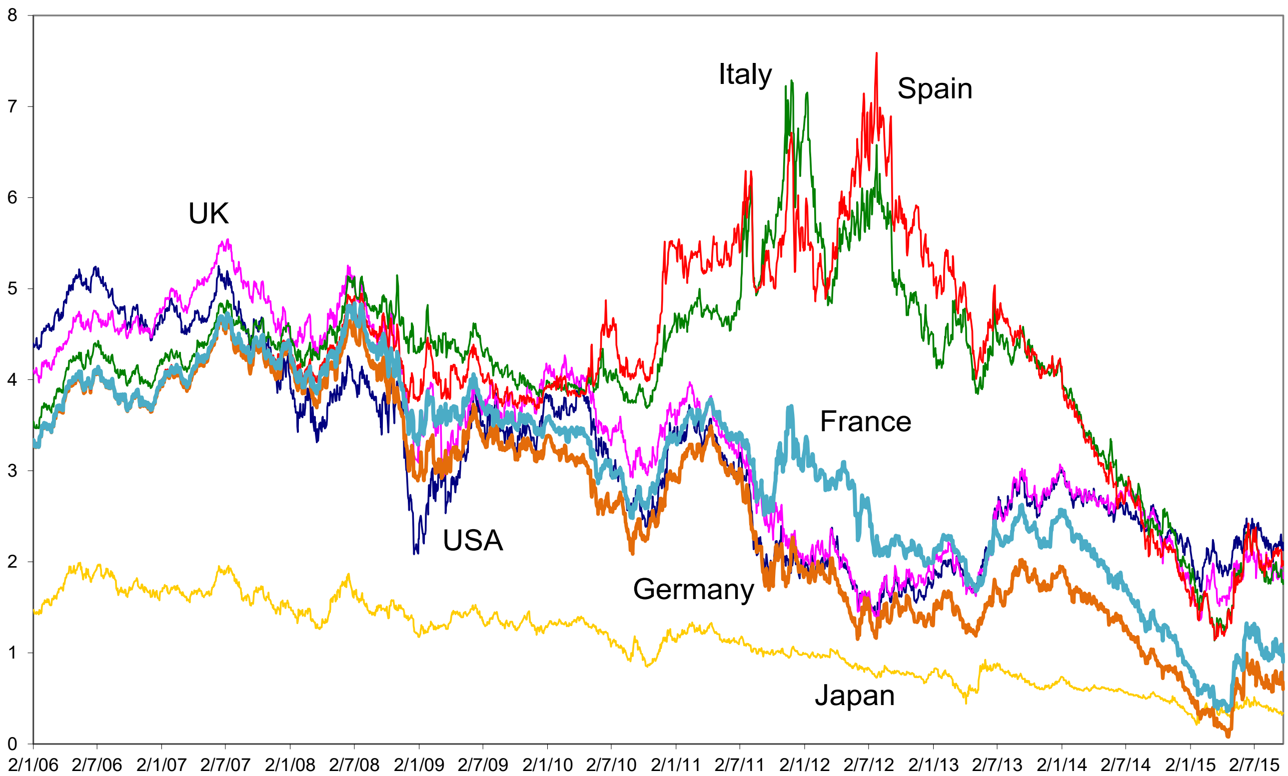
Sources: EC DG-ECFIN, AMECO, November 2015; OECD, *Economic Outlook*, November 2015.

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 interest rates to remain durably low, and hence long-term interest rates have dramatically fallen (Figure 1).

The current situation raises two issues. The first concerns all developed countries: how can this rise of public deficits and debts be explained? Should developed countries aim to bring public debts back to their pre-crisis levels? The second issue concerns euro area Member States (MS): how to re-establish public debt homogeneity within the area? How to deal with public deficits and debts in an area with a single monetary policy and autonomous fiscal policies?

We will discuss the European institutions strategy (the Fiscal Treaty, fiscal austerity and structural reforms, fiscal federalism), mainstream proposals (Redemption Fund, Blue and Red debts, European Debt Agency, European Treasury,) and unconventional ones (public debts monetisation and cancellation, future tax revenue capitalisation). We will conclude by advocating for a rules-free economic policy coordination based on an ecologist/social democrat/Keynesian strategy.

Figure 1. 10-year government interest rates (in %)



Source: Financial markets, Datastream.

2. About the rise in public debts and deficits

Two theories may explain the high level of public deficits and debts. From a liberal point of view, governments are demagogic, myopic, under the influence of lobbies and civil servants interests[1]. Public deficits are therefore an autonomous cause of macroeconomic unbalances. According to the 'crowding-out' effect theory, public deficits generate excessive demand, which induces too high interest rates. They are detrimental to capital accumulation and therefore to future growth. It is necessary to paralyze national fiscal policies by fiscal rules, by independent fiscal committees, or by financial markets surveillance.

However, these mechanisms of higher interest rates and crowding-out effects have hardly been observed in reality. From 2002 to 2005 and since 2008, both short and long-term interest rates have been historically low despite the rise in public debits and deficits in Europe, the US and Japan. It is difficult to pretend that the low levels of current interest rates are detrimental to investment. This theory does not explain why all governments would have suddenly become demagogic and increased too much public expenditure in 2002 or in 2009. In the recent past, the rise in government deficits has been due to fiscal stabilisation rather than to a spontaneous

[1] See, for instance, Alesina and Perotti (1995), Alesina and Tabellini (1990), Drazen (2004), Wyplosz (2011).

rise in expenditure or a spontaneous decrease in tax revenues. It is not obvious that OECD countries were characterized, before and after the 2008 crisis, by fiscal indiscipline (contrary to what Debrun and Kumar (2007) or Wyplosz (2111) pretend).

From a Keynesian perspective, public debt and deficit may be necessary to ensure that demand equals potential output (Box 1). Public debts and deficits result from the need to reduce macroeconomic imbalances and are not at the origin of these imbalances. In times of economic uncertainty or of entrepreneurs' pessimism, private demand cannot maintain a satisfactory level of employment. The optimal policy consists in cutting the interest rate until demand is sufficiently robust. This policy does not increase public debt; it lowers the profit rate requested by firms to invest and stimulates capital accumulation. However, it may lead to excessive companies' or households' debt accumulation. It may generate financial or housing bubbles. Interest rates cuts may be inefficient in times of strong economic depression, when private agents are reluctant to borrow. It may be insufficient because there is a floor to nominal and consequently to real interest rates. It may not be implementable in the euro area where the common interest rate cannot adjust the different business cycle situations in the 19 Member States. So the sharp rise in public debts must be related to lower inflation and growth (which prevents monetary authorities to reduce sufficiently the real interest rate adjusted for growth in depression episodes) and to the introduction of the euro. Furthermore, the public debt level desired by private agents has increased after the crisis as households wish to hold safer financial assets and companies wish to deleverage. Structurally, the ageing of populations induces increasing demand for safe public assets.

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 *y*, GDP, *g* public deficit, *d*, private demand, *r,* real interest rate, *h*, public debt, full stabilisation implies that in the short-run: $g = -d + \sigma r$

If the country can freely manage its real interest rate, fiscal policy is not necessary. If this is not the case, either because the interest rate is set at the European level or because the nominal interest rate is already at zero, then an active fiscal policy is necessary.

If an active fiscal 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.

Such a deficit necessary to support output will not crowd out private spending: it will not raise interest rates, as in this situation they are as low as possible. It does not raise sustainability issues: if the rise in public debt leads private agents to increase their spending, then the government will be able to cut its deficit accordingly. Public debt can be reduced only through higher firms' or households' borrowing or lower savings (owing to reduced uncertainty about the future). When public deficit is of a Keynesian type, it makes no sense to advocate fiscal *consolidation* without explaining how the resulting lack of demand will be offset.

Today's low inflation and interest rates show that public deficits are Keynesian (needed to resorb macroeconomic imbalances) and not classical (autonomous source of imbalances). Therefore the fundamental question remains: why are large public deficits necessary today at the world level in order to support demand? Prior to the crisis, six factors contributed to a lack of world demand:

- Many countries implemented neo-mercantilist strategies targeting current account surpluses accumulation: Asian countries learnt the lesson from the 1997 crisis and wish to be free of financial markets and IMF pressure; China's growth model is export-led; many countries wish to anticipate the costs of ageing populations (Japan, Germany, Austria, the Netherlands, and Nordic countries). Their surpluses add to oil exporting countries' ones.

- Trade globalisation increases the weight of international competitiveness. Each country has an incentive to put downward pressure on their wages. Countries like Germany, the Netherlands and Austria have succeeded in substantially lowering the wage share in value added since 2000. Consequently domestic consumption decreased as a share of GDP.

- Anglo-Saxon economies have chosen a growth strategy based on wage and incomes stagnation for households as a whole and the rise in inequalities. This implies a declining consumption trend, which was offset by higher households' borrowing and by financial and housing bubbles allowed by low real interest rates. When households' borrowing reach a paroxysm and when bubbles burst, public debt has to support demand.

- Population ageing and the rise in pension funds increase the level of available financial capital. These funds wish to own risk-free assets, i.e. public debt.

- Financial globalization induces all investments to compete on financial markets. Productive investments are compared without caution with financial investments associated with an illusory high profitability based on the rise in financial bubbles. Consequently investors request higher profitability while at the same time productive investment stagnates in developed countries due to slow growth, industrial projects' relocation in emerging countries, and decrease in investment goods relative prices.

- With the objective of free labour and capital movements, EU institutions have forbidden countries to implement measures needed to protect their tax policies. Hence EU governments have engaged in tax competition. Tax and contributions cuts have been intensified (on corporate taxation, on higher-income households, on wealth, on employers' contributions, etc.) with no positive impact on growth. These tax policies have therefore increased social inequalities and public deficits. Simultaneously these tax cuts policies were chosen by EU institutions, right-wing governments and leading classes with a view to cut tax revenues, and pretend afterwards that, in view of the resulting public deficit, expenditure need to be cut.

A structural imbalance has widened between savings and investment, which must be filled by low interest rates, by private and public debts, or by financial bubbles. After the 2008 crisis, "private debt/financial bubbles" solutions came to a halt and only the "public debt" solution remained. The crisis led to a strong rise in public debts as governments had to rescue banks, to support aggregate demand and, above all, because of lower tax revenues due to the long-lasting depression. These effects add to the structural drifts induced by financial capitalism.

The crisis was not caused by a high level of public expenditures, debts or deficits, neither in the euro area, nor in other developed countries. For instance, in 2007, the public deficit for the euro area as a whole amounted to 0.6 % of GDP, well below the level ensuring debt stability.

3. The drawbacks of the euro area framework

The drawbacks of the euro area framework have been highlighted by widening divergences and imbalances between euro area Member States from 1999 to 2007 and in the 2007-2014 crises. Prior to, and after the beginning of the crisis, EU institutions and the MS have been able to implement neither a common economic strategy nor satisfactory economic policy coordination. The single currency suffers from eight original sins, which are difficult to correct:

- According to economic theory, there cannot be a single currency between countries with different economic situations and independent economic policies. The single currency requires the implementation of precise, well-defined and binding constraints, solidarity mechanisms or economic policy coordination. How to prevent otherwise the emergence and persistence of imbalances between countries running large external deficits and countries running large surpluses?

- These mechanisms cannot consist in rigid numerical rules enshrined in a Treaty, without economic rationale (such as: public deficits should not exceed 3% of GDP, public debts should not exceed 60% of GDP, and structural public budgets should be in balance in the medium-term). These mechanisms should be both soft (the objectives should account for the current economic context) and binding (each country should comply with decisions agreed in common). But how may governments with different interests and analyses reach agreement on economic policy strategies? How to convince a MS to modify its economic policy in order to meet common objectives?

- The common monetary policy cannot fit each MS situation. A country with stronger growth and inflation has a low real interest rate as compared to its GDP growth rate, which boosts GDP growth; it is the opposite for a country with low growth or inflation. Since 2010, this feature has been strengthened by the rise in interest rates spreads requested by financial markets, since capital flies away from fragile countries with zero or negative growth (which increases their interest rate) and rush to countries with a satisfactory growth such as Germany (which contributes to low interest rates). Northern EMU countries benefit from a relatively weak euro pulled down by Southern countries; Southern countries suffer from a strong euro due to Northern countries' external surpluses.

- On the one hand, there cannot be unconditional solidarity between countries with different social and economic systems. Northern countries may refuse to support Southern countries, blaming them for not having undertaken the necessary structural 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 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. After the experience of the Greek default, they requested unsustainable interest rates to countries in difficulty, which increased 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. This induces disparities among interest rates, which is arbitrary and costly.

- The 2007-2009 crisis is a deep crisis of financial capitalism, which would have requested government strong policy responses to reduce the weight of finance and neo-liberalism domination, to implement a macroeconomic strategy aiming at full employment, social cohesion and ecological transition (see Mathieu and Sterdyniak, 2009). But EU authorities denied any questioning of the pre-crisis strategy.

- Two doctrines differed in Europe about the conduct of economic policy. For Keynesians, economic policy should stabilise demand at a satisfactory level through the common monetary policy and national fiscal policies, through automatic stabilisers but also through discretionary measures. This requires a precise coordination of economic policies. On the contrary, for the liberal, technocratic, and federalist ideology which prevails in EU institutions, growth should be obtained through public deficits cuts (the so-called 'growth-friendly fiscal consolidation') and through structural reforms: supply policy, public expenditure and tax cuts, product, labour and financial markets deregulation. Demand should not be supported, as this would allow MS to delay the necessary reforms. Europe should deprive democratic States (subject to demagogic temptations) of their powers (especially of fiscal autonomy) to concentrate them in EU bodies (ECB, Commission) which will move Europe towards a liberal model. This strategy has not delivered so far: the euro area remains in depression.

Strengthening fiscal discipline

According to the Commission, the crisis is due to fiscal indiscipline. It succeeded to introduce the Fiscal Pact (the Treaty on Stability, Coordination and Governance), ratified by the MS on 2 March 2012. This Pact is a new step forward from liberal views against Keynesian economic policies and from EU authorities against autonomous 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 […]. A correction mechanism shall be triggered automatically in the event of substantial deviations from the adjustment path."

Thus, close-to-balance fiscal positions are 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. Besides, households, insurance companies, financial institutions wish to own public debt. If the desired public debt stands at around 60/80% of GDP and if nominal GDP grows by around 3.5% per annum (i.e. by 1.75% in volume and 1.75% in prices), it is justified to run a public deficit of around 2.1/2.8% of GDP. Besides, a public deficit is necessary when it allows reaching a satisfactory demand level leading to the highest non-accelerating inflation output level, at a real interest rate close to GDP growth. There is no evidence that running a structural public budget in balance is optimal. Since MS do not control interest rates and exchange rates anymore, they need degrees of freedom in the conduct of their fiscal policy.

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 requires evaluating structural output, which is problematic, especially after strong macroeconomic shocks. According to the Pact, the Commission's estimates must be used. But these estimates are not reliable: estimates for the pre-crisis period were revised substantially downwards after the 2008 crisis (Mathieu and Sterdyniak, 2015). The estimated structural output is always close to observed output, since, after a crisis, the methods consider as structural the fall in capital resulting from the fall in investment, the increases in the unemployment rate and often the decrease in the available active population: this underestimates the cyclical deficit and imposes pro-cyclical policies.

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 nominal GDP growing by 3.5% per year. If this country runs permanently a 1% of GDP deficit, its debt will come down to 28.6% of GDP. But nothing guarantees that the macroeconomic equilibrium could be ensured with *a priori* set constraints: public debt below 28.6% of GDP; public deficit below 1% of GDP.

Article 4 repeats the rule according to which public debts should fall below 60% of GDP. This rule was already part of the SGP, but the Commission was not able to 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 assumes that a 60% of GDP ratio is optimal for all MS and may be reached by all of them. But in Europe, countries like Italy or Belgium have run public debts of 100% of GDP for a long time (without mentioning Japan where it has reached 200% of GDP), without imbalances as these debts correspond to high domestic households savings (see also Box 1). Hence this does not introduce additional constraints in the medium-term as compared to the balanced budget target.

The Pact obliges MS to run quasi-automatic fiscal policies, prohibiting any discretionary fiscal policy, which is however needed to reach full stabilisation. According to the Pact, each country should implement restrictive measures without accounting for the economic situation and policy in the other MS. The Pact assumes implicitly that restrictive policies have no impact on GDP. The current crisis makes high public deficits and debts necessary. This is not taken into account by the Pact.

Improving economic policy coordination

Euro area economic governance involves a complicated set of procedures, reports, and dialogues between the EU and national institutions. This does allow neither for democratic or scientific debates, nor for strong economic policy responses. It does not embed real economic policy coordination, i.e. an economic strategy using monetary, fiscal, tax and wage policies to bring together countries towards full employment or to correct imbalances between countries. The "fiscal austerity/structural liberal reforms" ideology prevails without discussion. The whole process works as long as no MS questions this ideology. In June 2012, the new French government quickly accepted to remain in this framework. In 2015, it took six months for Greece to finally surrender. Democratic choices and economic alternatives are therefore strictly constrained.

Implementing some degree of financial solidarity

After the financial crisis, financial markets bet on the default and euro area exit of several MS. EU authorities and MS did not react sufficiently rapidly and strongly. They denied guaranteeing unconditionally public debts. Financial solidarity increased progressively since the beginning of the crisis, despite the reluctance of Northern economies.

The European Stability mechanism (ESM) launched in October 2012 introduces some degree of financial solidarity between MS, but this solidarity is conditional, limited and has a very high price. 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 (the ECB, the IMF and the European Commission), 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 implemented does not consist in donations but in loans. MS public bond issuance should now 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. Government debts will become speculative assets in the euro area as was the case for developing economies, and will not be considered as a safe asset anymore by financial institutions. Interest rates on public debt will rise, will be more volatile and less easy to control. Why build the euro area to reach such a situation?

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 OMT (outright monetary transactions). In putting no ceiling to its interventions, the ECB broke the spiral of financial markets self-fulfilling expectations, so that finally it did not have to intervene. Interest rates spreads decreased substantially (Table 2). But the ECB was able to impose its views on the economic strategy to be implemented: product and labour markets structural reforms; full commitment to government balance targets despite the recession; rapid implementation of the Fiscal Pact. Many German economists (see Doluca *et al*, 2012) consider that the ECB has gone beyond its mandate in committing itself to support public debt, which is an incentive for MS to delay the necessary reforms, and raises moral hazard issues; they claim that the ECB should focus strictly on price stability.

Table 2. 10-year government interest rates

	February 2012	May 2013	January 2014	March 2015	November 2015
Greece	40.8	9.6	7.9	10.8	7.3
Portugal	12.3	5.5	5.1	2.25	2.4
Spain	5.05	4.2	3.7	1.25	1.6
Italy	5.5	3.9	3.8	1.3	1.45
Ireland	7.8	3.45	3.2	0.8	1.0
Belgium	3.65	2.05	2.35	0.5	0.8
France	2.95	1.85	2.2	0.45	0.8
UK	2.1	1.9	2.8	1.55	1.9
Sweden	1.8	1.8	2.4	0.4	0.8
US	2.0	1.85	2.8	1.9	2.2
Austria	2.85	1.7	2.1	0.4	0.8
Netherlands	2.2	1.6	2.05	0.3	0.6
Finland	2.3	1.5	1.95	0.4	0.65
Germany	1.9	1.35	1.75	0.2	0.5
Japan	1.0	0.6	0.7	0.3	0.3

Source: Financial markets.

The ECB is powerless on four issues: it cannot resorb intra-area imbalances; it does not control MS long-term interest rates; it cannot cut nominal rates below 0; it cannot expand credit when demand for credit is at a standstill. The ECB cut its interest rates down to 0, but fiscal policies implemented under the Commission's recommendations and domestic wage policies maintained the euro area in depression, and consequently underlying inflation remained around 1.0% in 2015, well below the ECB's objective of inflation below, but close to 2%. In 2015, the ECB succeeded to lower the euro/dollar exchange rate, which could have the desired inflationary and expansionary effects. But euro area economic policies remain unbalanced: a zone with high unemployment and an external surplus should run an expansionary fiscal policy, rather than depreciate its exchange rate.

Fiscal austerity in the euro area

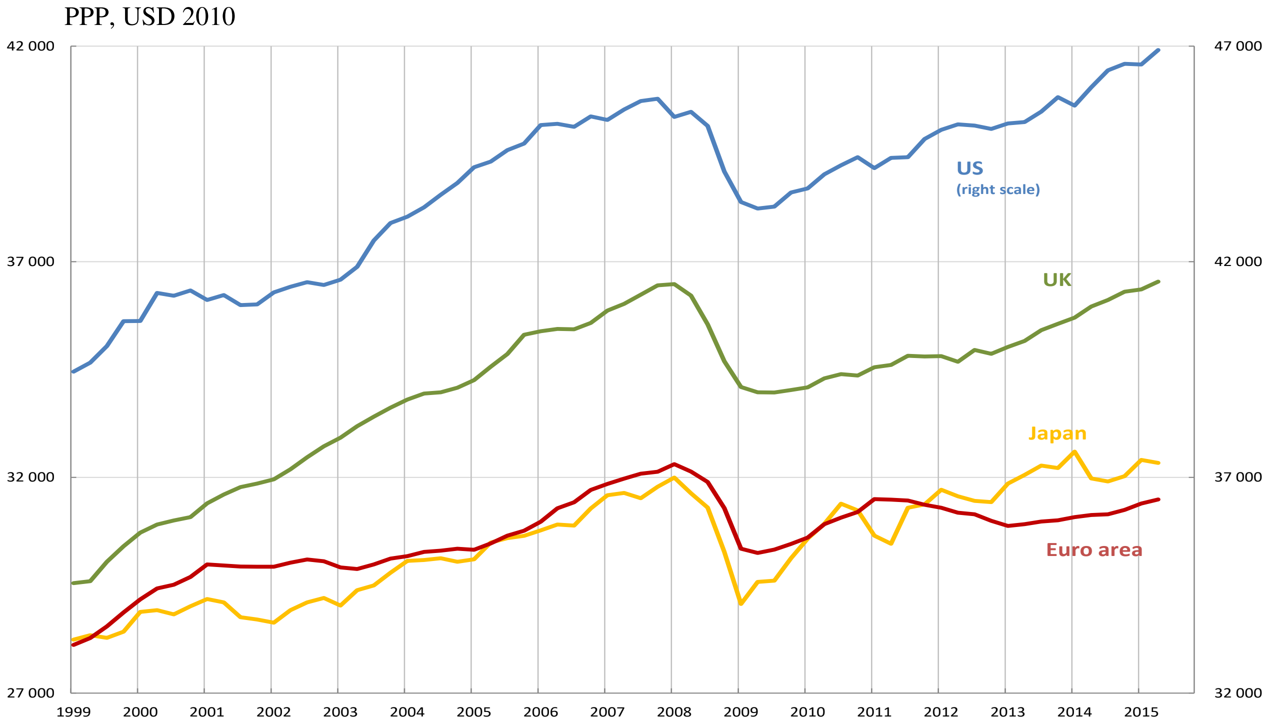
Since 2009, the output gap has remained significantly negative in almost all MS. At the euro area level, the estimates varied for 2012 between from -2.3% according to the Commission and OECD and -10.4% for OFCE. In 2015, the Commission estimates euro area potential GDP to have grown by around 0.6% per year since 2009. Such estimates suggest that Europe has no other choice but accept low growth and high unemployment. But there is no explanation as to how supply factors would have induced such a weakening in potential growth. If the only explanation is: "potential growth was affected by effective growth", then growth recovery would lead to higher potential growth.

Under the pressure of financial markets, of the European Commission (and of the Troïka as concerns Greece, Ireland, and Portugal), all euro area MS have implemented restrictive fiscal consolidation policies since 2011. According to our estimates based on pre-crisis trend output and on the latest EC forecasts, these policies amounted on average to around 1.5% of GDP in 2011, 2.3% in 2012, 1.2% in 2013, 0.7% in 2014, 0,4 in 2015, i.e. 6 % in five years. These policies put to a halt the recovery which had taken place in the euro area in 2009-10 (see Figure

2). The cumulated negative GDP impact could be estimated to be 9.2 percentage points for the euro area (Mathieu and Sterdyniak, 2013). The *ex-ante* favourable impact of restrictive fiscal policies on public balances would be strongly reduced by this depressive effect: the *ex post* deficit reduction could be estimated to be only 1.5 point of GDP. The public debt-to-GDP ratio would increase, by 4 percentage points, due to the strong fall in output.

During this episode, economists (and international institutions) have re-discovered that the Keynesian multiplier is large, in the order of 1 to 1.5; that the multiplier is larger when unemployment is high than when the economy operates at full capacity (but why implement a fiscal stimulus in a full employment situation?); that the multiplier is larger for public consumption, investment and social transfers than for tax cuts.

Figure 2. GDP by head



Source: National Accounts, OECD, IMF.

Unfortunately, the European Commission persists in November 2015 to require strict compliance with arbitrary trajectories of public finances and to blame six MS (France, Spain, Italy, Portugal, Lithuania and Ireland) for not fulfilling the targets, regardless of their macroeconomic context.

Towards a federalist Europe?

The proposals made by the Commission in November 2012 in *A blue print for a deep and genuine monetary and economic and monetary union* and by the four presidents in December 2012: *Towards a Genuine Economic and Monetary Union,* suggested new steps towards a liberal and technocratic federalism:

- 'All major economic and fiscal policy choices by a MS should be subject to deeper coordination, endorsement and surveillance process at the EU level'. The possibility of different economic or social strategies is forgotten.
- The needs for strengthened fiscal discipline and for *ex ante* fiscal coordination are asserted. But, after the fiscal Pact, what remains to be coordinated since all fiscal policies have to be run in autopilot mode?
- The Commission wishes to be entitled to oblige a MS to revise its national budget or to change its budget execution. It wants to be allowed to suspend programmes payments to MS not taking the corrective action required by the Commission.
- The euro area should have a fiscal power to absorb asymmetric shocks (with is rather ironic once national governments have been deprived of the ability to implement specific fiscal policies).
- The Commission considers the possibility for the euro area to have its own resources and to issue bonds.
- Short-term debts (Euro bills) could be mutualised under an EMU Treasury.
- The role of the vice-president of the Commission in charge of economic and social affairs in the euro area should be strengthened; he should be in charge of an EMU Treasury;
- A Euro Committee should be settled in the European Parliament, the Euro-Group should 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?

A new report was proposed by the five presidents on 25 June 2015: *Completing Europe's Economic and Monetary Union*. MS should accept that more and more decisions are taken at the European level, which would allow moving away from today's governance by rules.

The report recommends the establishment of a new network of independent advisers: competitiveness councils. It proposes the introduction of a European fiscal council to coordinate national councils, remaining under the Fiscal Pact rules. Later, a fiscal stabilization mechanism could be put in place at the euro area level, but it should neither allow for permanent transfers, nor reduce incentives to run a sound fiscal policy, nor help countries in crisis.

The project is disappointing in terms of both institutional reforms and policy content. The project is at a standstill with most MS refusing to move towards more federalism, with virtuous States refusing to provide greater solidarity, and with its inability to propose a convincing supply policy to face ecologic and globalization issues.

Towards fiscal federalism?

In theory the Fiscal Pact prevents MS to implement stabilisation fiscal policies. Some economists and the Commission have proposed to implement at the euro area level a system of transfers between MS to ensure that countries in good economic situation support MS in economic depression (see European Commission, 2013). In the spirit of these promoters, this system should avoid permanent transfers; each country should alternatively be paying or receiving transfers. Some (like Enderlein *et al.,* 2013) propose to base these transfers on output gap differentials, since, for a given country, the sum of output gaps is nil, by construction, over a long time period. But these authors forget that potential output is a vague concept, with a questionable and time-varying measurement: should there be refunds whenever the Commission revises its estimates? Should a country in depression wait for EU funds to support its activity and, meanwhile, run a restrictive pro-cyclical policy?

Some propose the unification of unemployment allowance systems, since they are pro-cyclical public expenditure, but national systems are currently very diverse and are often managed by social partners. Unification, under the EU umbrella, is likely to reduce the generosity of national systems. The unemployment concept should be standardised (what about vocational training, disability pensions, or early retirement schemes?). A country having made efforts to reduce its unemployment rate will refuse to pay for high unemployment rates countries, and will blame the latter for not having undertaken the necessary reforms.

Others propose transfers between countries based on differences in unemployment rates levels or on their variations or on the discrepancy between the effective unemployment rate and the structural one (as if the latter would be measurable): this raises the same problems. In order to avoid permanent transfers between countries, these projects are limited to the recent unemployed, for a limited time period (see Dullien, 2014). Transfers are generally small and disappear if the depression lasts and is widespread throughout the area. As these transfers must be balanced for each country in the long-term, they could only have a negligible impact.

Some economists consider that the Commission could manage stabilisation policies tools centrally, but this is an illusion as the Commission minimises the size of negative output gaps and prevents discretionary fiscal policies.

The French CAE (2013) recognizes euro area institutional weaknesses, but believes that the latter can be addressed by strengthening technocratic, federalist and liberal features. It proposes to set up an independent European Fiscal Committee, which would coordinate national committees, 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 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?); their proposals should be validated by a euro area Parliament. 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 euro area functioning cannot be based on transfers between Northern countries (in good economic health and running large trade surpluses) and Southern countries (in a situation of mass unemployment). Northern countries populations would not accept it. Southern countries cannot offset a situation of economic distress by transfers which would submit them to the diktat of Northern countries and EU institutions. Transfers between Member countries can be implemented only in exceptional circumstances or in the framework of productive development policies. Each country should aim at finding a satisfactory economic model, which requires today differentiated strategies. Economic policies coordination should aim at reducing imbalances between MS. According to us, MS do no need fiscal federalism, but they need to regain full freedom to implement stabilisation fiscal policies.

Democratic federalism?

Can we imagine all major economic and social decisions being made at the EU level, by the Commission without accounting for national votes and debates? Some (like Autret *et al.,* 2014) propose a euro area political union where most decisions would be made democratically by a Government and an elected Parliament of the euro area. But can we imagine a federal power able to account for domestic specificities in an area made of heterogeneous countries? Can we imagine a single policy implemented in different countries? Or different policies implemented through a central process? In our opinion, accounting for current disparities in Europe, economic policies should be coordinated between MS and not decided by a central authority.

Europe is not a country; there is no European solidarity, while there is national solidarity; such solidarity cannot be accepted as long as functioning rules differ within MS. In fact, national specificities remain and the peoples are attached to them. They are not prepared to engage in reforms allowing for convergence towards a social or a fiscal Europe. Moreover, there is no consensus on the design of this Europe. So Europe must live in a painful contradiction between the monetary Union and the absence of political Union (which makes the European experience differ from the German, Italian or the US unifications).

We do not think that EU powers should be strengthened as long as the EU works as it currently does, 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 irrelevant public finance criteria. EU institutions should show first that they can implement an efficient strategy before peoples and MS agree to enlarge their power. Europe's survival requires the European project to become popular again, therefore a source of growth, social progress and solidarity. It is only within this framework that institutional progresses could be made.

4. Public debt governance

Public debts in advanced economies have strongly risen during the crisis (Table 1). Except in the Greek case, this results from the depth of the crisis itself and not from the implementation of too expansionary fiscal policies before or during the crisis. Given the current interest rates levels on public debt for major countries, it is clear the public debt level does not induce any rise in interest rates. It is dangerous to try to cut public debt as long as the factors which have caused the debt to rise remain.

The rise in public debt increases the risk that public finances will be under financial markets' supervision in the future. But this supervision is not satisfactory: financial markets have no macroeconomic perspective; they are pro-cyclical (they impose efforts in bad times); their opinions are self-fulfilling which they are aware of; they react strongly to the pieces of information which are 'in the mood of time'; they are schizophrenic: they request fiscal consolidation and growth policies at the same time. They have their specific judgement on the needed appropriate economic policy, but is this necessarily the relevant one? There is a huge risk that MS set the objective of trying to escape financial markets' surveillance by cutting too rapidly and too massively government borrowing which would postpone the recovery indefinitely. MS ability to run active fiscal policies will be reduced. What would have happened if countries had refused to rescue banks in 2009, in order to avoid borrowing on financial markets? Can financial markets be given the responsibility to assess public debt sustainability and public deficits usefulness?

Two strategies can be implemented today. We advocate for the first one: fiscal stabilisation policies should remain allowed (or rather be allowed again), monetary policy should remain expansionary, public debt guarantee by the ECB should allow to maintain interest rates below domestic growth rates in all euro area countries; wages should be increased in countries where the wage share in value added has substantially decreased; specific measures designed to support both public and private investment as part of the ecological transition should be implemented. The debt-to-GDP ratio will fall thanks to growth recovery.

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

The euro area needs also to choose between two frameworks: relying on financial markets to implement fiscal discipline or introducing reforms to re-establish the unity of public debts. In the first option, proposed for instance by the German Council of Economic Experts (GCEE, Doluca *et al*. 2012) any debt mutualisation would be avoided, the no bail-out principle would be reaffirmed. MS public debts should not be guaranteed in order to strengthen financial markets supervision; MS default should be explicitly envisaged in the Treaties. This proposal has several drawbacks: MS public debts would be risky assets; interest rates spreads in Europe would remain for an undefined time period, undermining the impact of fiscal policies. On the one hand, Europe and the ECB 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 financial markets to judge how serious this commitment is. Financial markets surveillance is not precise. A MS debt ratio can increase during a long time period without alarming markets, which can suddenly react with brutality.

The second option can be implemented in two ways: either through an ECB guarantee of always refinancing public debts or by issuing euro-bonds collectively guaranteed. It requires an issue to be settled first: according to which criteria could a MS public debt be guaranteed? Northern MS will refuse an automatic guarantee. Most MS will refuse to pay this guarantee by abandoning fiscal policy autonomy for stricter fiscal rules or for stricter controls from European Institutions. Several projects have not made a choice between these frameworks.

Redemption?

The GCEE (Doluca *et al.,* 2012) suggested the introduction of a European Redemption Pact, in order to guarantee the repayment of the share of public debts above 60% of GDP[2]. 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 Portugal), would place the share of their debt over 60% of GDP in a Redemption Fund (RF) and, in counterpart, would transfer tax revenues allowing for debt repayment over 25 years. Besides, countries should firmly commit to the Fiscal Pact, i.e. to bring rapidly their structural deficit down to 0.5% of GDP. This would be introduced in their Constitution. Countries would transfer guarantees to the fund, such as part of their foreign and gold reserves, for 20% of the transferred debt. Moreover, they would have to implement structural reforms programmes agreed and monitored by the European Institutions. All euro area countries would be jointly and severally liable for the debt guaranteed under the RF, but each MS would keep the responsibility of serving its debt. This would reassure markets, who would agree to own this mutualized debt at an interest rate below current market rates.

Thus the debt ratio would fall rapidly: in 2035, it would reach 58.5% in Belgium (against 97% in 2012), 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 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 catastrophic basis scenario, where countries would implement similar austerity measures, while markets would continue to request high interest rates. Thus, it can be claimed that the RF would have expansionary effects as compared to the basis scenario. But it does not draw any lesson from the effects on past austerity policies on output, assuming implicitly that the fiscal multiplier is nil. What if MS are unable to cut the public deficit by as much as initially requested, due to the impact of these generalized restrictive policies on growth and on tax revenues?

The GCEE' paper does not consider the possibility that Europe goes through slowdown episodes in the next 25 years, which may require to undertake active fiscal policies. What would happen then with the redemption pact? MS would have to negotiate their fiscal policy with the RF, in addition to the Commission and Council monitoring. During the RF existence, the coexistence of national debts with the RF debt will allow speculation on the capacity of individual MS to fulfil their commitments. After the RF existence, domestic fiscal policies would have to strictly follow the Fiscal Pact, which is not questioned by the authors; the "no bail-out" rule would be restored; the RF is a temporary mechanism to correct past MS sins. The project does not question the factors which led public debts to rise. Are these sins that MS have to pay for? Or was the rise in public debts necessary because of the economic crisis?

In December 2012, the Commission Communication (2012) envisaged the introduction of such a fund, although its annex 3 criticized its principle: a temporary fund cannot solve a structural issue: the integration of euro area public bond markets. On 12 March 2013, the EU Parliament however agreed to vote the 'Two-Pack' in exchange of a commitment of the European

[2] See also Parello and Visco (2012) and Tober (2014).

Commission to settle a high level experts group to assess the feasibility of a Debt Redemption Fund and of Euro bills introduction (but not on Eurobonds). The report (Tumpel-Gugerell, 2014) was not conclusive and the project seems abandoned.

Euro-bonds and debt agency proposals

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 MS; it would be considered as a safe asset by financial markets; it would be very liquid, with a wide market, hence it could be issued at low interest rates. But the EDA council would supervise domestic fiscal policies and would be entitled to deny financing *over-lax* countries, which would then have to issue bonds on markets. The EDA would raise the same problems as the SGP with more issues at stake. What would be the democratic and economic legitimacy of its council? What would be its assessment criteria? How would the EDA decide that a country runs an excessive deficit, if the country considers that such a deficit is necessary to support domestic output (like in Germany and France in 2002-2005) or to rescue its domestic banks? Would it implement rigid automatic rules - a country would be entitled to loans from the EDA up to 60% of its GDP- or softer ones - a country would be entitled to loans from the EDA without precise limit, which requires rewriting the SGP and the Fiscal Pact. Would the EDA be allowed to refuse to guarantee a specific debt issue if the MS fiscal policy induces macroeconomic imbalances? The EDA would benefit neither virtuous countries (which have no difficulty to borrow) nor countries in difficulty, which the EDA would refuse to finance and which would have to issue domestic bonds, without any European guarantee, without any potential financing from the ECB, in other words risky assets, bearing a high interest rate. The EDA makes sense only if it accepts to consider all public debts, but Northern countries refuse such a system on moral hazard grounds: 'sinner' MS would have no incentives to reduce their public debts or to introduce structural reforms.

The Tumpel-Gungerell report (2014) only studies the opportunity to issue Euro bills, with short-term maturity (up to one or two years). These Euro bills, collectively guaranteed, would be a safe and liquid asset which could be used for short-term ECB operations or banks' liquid reserves. MS will lose the right to issue short-term bills (which many MS may refuse) but will continue to issue longer maturity bonds. This distinction is arbitrary. The crucial point is to determine the quantity of Euro bills a MS will be allowed to issue. A MS having difficulties to issue national debt would be tempted, or obliged, to issue more Euro bills, which will be refused by virtuous MS and would be a bad signal for financial markets. On the contrary, virtuous MS may prefer to issue national debt, without any risk premium and collective guarantee, which will lower Euro bills quality. The report mentions the possibility that this joint debt issuance possibility is reserved to MS accepting an *ex ante* control of their fiscal policy by the European authorities, who would be entitled to oblige countries to modify their budget. But most MS would refuse this control.

Enderlein *et al*. (2012) suggest that the EDA should be headed by a Ministry of Finance of the euro area. The EDA would issue a collectively guaranteed debt. In normal times, each MS would receive a loan of 10% of its GDP, which could increase to 20% of its GDP in the event of a crisis, if the country fulfils the SGP and the Fiscal Pact. The loan could be larger than that level but at a higher interest rate (200 basis points above the EDA rate) and with increasing conditionality: from 20 to 30% of its GDP, the country should fulfil a Memorandum of Understanding; from 30 to 40%, it should fulfil an adjustment programme dictated by the Troika and the EDA; for a loan above 40% of its GDP, its fiscal sovereignty would be transmitted to the EDA. But this project does not question the SGP and the fiscal Pact; it does not give more leeway to MS; it merely formalizes the existing situation. A country in difficulty could be helped only if it accepts to lose its fiscal sovereignty.

Delpla and von Weisäcker (2010) suggest the introduction of a 'blue debt, collectively issued and guaranteed, with a ceiling at 60% of GDP'. 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 does not account for economic stabilisation needs. The 60% level is arbitrary and is breached in 2015 by 11 of the original euro area MS (all except Luxembourg). The gap between blue and red debts would allow financial markets to speculate in permanence.

De Grauwe (2012) estimates that "the solution of the systematic problem of the Eurozone requires a far-reaching degree of political union" but recognizes that "there is no willingness in Europe today to significantly increase the degree of political union". But he accepts the blue/red suggestion and only adds that each country would have to pay a different interest rate on their blue debt, according to their debt level, as if public debt was always a sin and should be punished, as if public austerity should always be rewarded.

For Aglietta and Brand (2013), the euro cannot be a full currency without a political union. They propose to create a European Fiscal Institute (EFI) which would coordinate fiscal policies "according to a criterion of public debt long-term consolidation"; they write: "fiscal consolidation would require two decades", as if a long-term arbitrary objective can be useful to implement current fiscal policy. At the national level, committees of independent experts would evaluate the sustainability of the government's strategy, with macroeconomic assumptions being provided by the EFI. But sustainability is not easy to assess, as it depends on short-term output gap and long-term structural growth, which are both impossible to determine with certainty. A European Debt Agency would issue Eurobonds with an insurance premium to oblige countries at high risk to pursue a consolidation strategy and to reward low-risk countries from the protection they bring to others. The project is technocratic and has no macroeconomic logic as low-risk countries may be responsible for other MS difficulties.

Gros and Mayer (2010) propose a European Monetary Fund. Each 'sinner' country would have to pay a contribution: 1% of the share of the debt above 60% GDP + 1% of the share of the deficit above 3% GDP. A country in difficulty could borrow, without conditions, an amount corresponding to its past contributions. To obtain more, the country would have to accept an adjustment programme. If it did not fulfil this programme, penalties would apply like abolishing its structural funds, abolishing the acceptance of its debt as collateral by the ECB, abolishing its voting rights; the country could be expelled from the euro area. But the 3% and 60% figures remain arbitrary. It is difficult to impose fees on a country already in a difficult financial situation. Too much conditionality, too high fees will increase market speculation, which may make it impossible for the country concerned to restore its situation. Often, the country concerned is not entirely responsible for its problems. Like most proposals, this one does not deal with countries running too restrictive policies.

Palley (2011) suggests creating a European public finance authority, which would issue euro-bonds and lend to governments. Thus, a limited share 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. But 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 MS though issuing Eurobonds guaranteed by the MS and the ECB. The EMF would maintain long-term interest rates slightly below GDP growth. Individual MS financing would not be subject to a numerical constraint, but would be agreed within the EMF by the MS Finance ministers. 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?), undemocratic (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 CIEPR (2013) proposes to introduce a European Sovereign Debt Restructuring Regime, based on a reform of the ESM and on the introduction of two thresholds. MS with below 60% debt/GDP ratios would have unconditional access to the ESM. For MS with debt ratios at between 60 and 90 percent, access to the ESM would be conditional on fiscal adjustment and structural reforms. For above 90% ratios, the ESM support will only be possible with a debt restructuring programme. As the debt restructuring possibility would be planned, financial markets would be more vigilant, would require high interest rates when debt comes close to 90% of GDP, which would strengthen discipline in lax States. But the new 90% figure for debt-to-GDP is as arbitrary as 60%. MS public debt would become riskier, more subject to financial markets' moods. MS would have difficulty to finance their public debts, which is the aim of this project, but is dangerous if public debt is necessary. At the end of 2014, seven MS ran debts above the 90% limit, although they did no run lax fiscal policies.

Bofinger (2014) considers that Germany will never accept any form of debt mutualisation. So he suggests creating a Basket Eurobond - where each MS will be liable for its share in the bonds (determined according to GDP weights or total public debt weights). We do not see how the proposal would help since investors can already create such a basket of public bonds if they wish (but in fact they do not). The project requires that MS agree on the amount of Eurobonds to be issued and lend to MS (for example up to 10% of GDP), which would be insufficient for the most highly indebted countries. The unity of MS public debts markets will not be entirely restored, as Bofinger suggests differentiating the interest rate according to country debt levels. For instance, a discount on the basket bond interest rate could be made for each percentage point of the national debt-to-GDP ratio below the euro area average. A surcharge would apply to countries with above-average debt levels. But it is arbitrary and counter-productive if the euro area needs more expansionary fiscal policies.

Bibow (2014) proposes to establish a European Treasury who will issue Eurobonds to finance public investment in the euro area. In return, MS should bring their structural current budgets in balance. Thus, a significant part of public debts would progressively be settled at the European level[3]. The project has the advantage of being based on the "true golden rule of public finances": the structural deficit must be equal to public investment; it relaxes the budget constraint relatively to the Fiscal Treaty. Conversely it prohibits discretionary fiscal policies. But it is a sleight of hand, which Germany and the *virtuous* States are unlikely not to see. The MS public debts would be hidden in the European Treasury balance sheets. In fact, according to the Treaties, the European Treasury debt would be allocated among member States and be counted within the envelope of the 60% limit for public debt. This would be automatically the case if the European Treasury lends to Member States rather finance directly investment projects. A direct lending from the European Treasury to specific projects raises institutional issues: most public investments are made by local authorities; another issue concerns large infrastructures; another issue concerns military defence. Can MS accept a European Treasury to decide for them in these fields?

5. Public debt governance: unconventional proposals

A strange proposal: Padre

Pâris and Wyplosz (2014) consider that there is a debt problem in the euro area, but they refuse to understand why (the *ex-ante* macroeconomic imbalances). In their PADRE (Politically Acceptable Debt Restructuring in the Eurozone) project, the ECB will buy a share of MS public debts: half of the global public debts of the area, but for each country in proportion of their share in the ECB's capital (to avoid any transfer between MS). It will keep these debts in its book at perpetuity, without requiring any interest payments from MS. The ECB will issue bonds to finance this purchase; these bonds will be risk-free (as the ECB is always able to create money), so their interest rate could be very low.

The operation induces permanent losses for the ECB, and this will be offset by the cancelation of the ECB's profit transferred to MS and by annual MS transfers. For the future, MS will be strictly constrained to fulfil the Fiscal Compact; the "no-bailout rule" will be restored and enhanced. A new debt ratio ceiling will be set (for each MS, 10 percentage points above the post-restructuring level); if a MS breaches it by 1 percentage point, it will be obliged to reimburse 1 percentage point of GDP to the ECB. So financial markets will impose a higher interest rate on such domestic bonds. This would be a strong incentive to avoid any *slippag*e in public debt.

The project has the advantage of rapidly reducing the interest rate spreads paid on debts by some fragile MS who will be able, for a while, to be financed by the ECB. It makes clear that a country does not have to reimburse its public debt; it only has to pay the interest payments and to convince its creditors that it is not engaged in an unsustainable path.

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[3] In fact, Bibow proposes to enlarge the investment definition so that the European Treasury lends automatically each MS 3% of their GDP each year; the European debt will converge towards 60% of MS global GDP if nominal GDP growth is 5%, but the author does not explain what shall be done if nominal growth is only 3.5%, which means that the European debt/GDP ratio will converge towards 86%.

Nevertheless, fundamentally, this project does not make sense. Public debts will not disappear if they are intermediated by the ECB; MS will always have to pay interest payments on this debt (even if the payment involves the abolition of seigniorage and the introduction of transfers from national governments to the Central bank); a new ceiling for the debt ratio would be arbitrary; what shall be done if a MS breaches the ceiling for good reasons (a strong depression)?

To stabilize their debt ratio, MS do not have to pay the nominal interest rate, but only the interest rate corrected by growth and inflation. If in the future, euro area growth returns to an equilibrium path with interest rates equal to a 3.5% nominal growth, MS will have to pay 1.75% of their GDP to the ECB (if the ECB owns a debt of 50% of its GDP), when 0% would be enough to stabilize the debt ratio. The authors assume implicitly that MS will hold a primary public surplus of 1.75% of GDP in the future allowing paying back the public debt in the long-term, but there is no evidence that this assumption is realistic from a macroeconomic point of view.

In principle, it will work only once; but MS and financial markets can anticipate that this process will be repeated, and so virtuous MS will refuse on moral hazard arguments and financial markets will add for each MS the debt hidden in the ECB's accounts with its explicit national debt and will always require high spreads on the latter.

Seven European Economists Experts published in March 2015: *A New Start for the Euro Zone: Dealing with Debt* (Corsetti *et al.,* 2015). They propose a policy to decrease the legacy sovereign debt in exchange for a credible mechanism that limits the build-up of excess debt, as if the current level of MS public debts resulted from fiscal indiscipline and not from macroeconomic imbalances.

They suggest creating a "stability fund" to bring public debt rapidly down below 95% of GDP (but why 95?). This fund will buy the share of national debt above 95% of GDP and will finance their interest payments and their refund by a commitment of national future revenues streams (seigniorage or VAT or real estate tax) over a long horizon. In fact, this is an accounting trick, without any economic meaning. The interest rates on the debt purchased by the fund would remain to be paid by the MS. Allocating specific tax revenues to the fund is fictitious without a commitment on the entire fiscal balance. If the project is to establish *ex ante* constraints on future public deficits, it does account for macroeconomic equilibrium. If the project obliges to increase taxes, it will have restrictive effects on the economy.

The authors propose to formalise MS classification as "in excess debt" (debt above 60% of GDP), "at risk of stress distress" (debt above 95% of GDP). The latter will have access to ESM and will envisage a debt haircut reduction operation. They expect that markets discipline can discourage over-borrowing, but this is an illusion as markets react only when they fear a default risk, which is not a usual situation and has nothing to do with the issue of an optimal fiscal policy. The authors accept that MS public debts remain risky, that government bonds interest rates will differ between countries and will be incontrollable by monetary policy.

The authors criticize the European banks "home-bias" which, according to us, is necessary to have efficient links between banks and non-financial agents in each country: the real problem is the loss of the “lender of last resort”. The authors propose to create a synthetic risk-free asset as the safer tranche of a bundle of sovereign bonds. Banks would be encouraged to hold it. “The junior tranches would harness market discipline by pricing sovereign default risk.” Hedge funds would be required to hold junior tranches, so speculators would judge fiscal policies. According to us, MS sovereign risks should be eradicated, not priced.

Their proposal intends to give a new start to the euro area, but does not deal with any of the real problems of the area: lack of growth, de-industrialization of many countries, growing inequalities, and financial instability.

About public debt monetisation and cancellation

Grjebine (2015) proposes to reduce public debts through Central bank’s purchases financed by monetisation. This proposal is difficult to understand. Public debt bonds held by the central bank remain public debt. Let us assume that the central bank buys 100 billion of public bonds from banks (Table 3). Bank refinancing by the central bank will decrease by 100 billion. The “Central Bank + State” wealth will not be affected. They will save interest payments on the public debt, but will lose interest payments on bank refinancing. These two components are roughly equal in the absence of sovereign bankruptcy risk.

According to Grjebine, “the monetization of government debt is equivalent to increase currency in circulation.” But this is not true. There is no reason why money supply increases after this financial operation. Money supply increases only if the public deficit increases or if banks distribute more credit, but they have *a priori* no reason to do so as a result of this operation.

In normal times, central bank liabilities are of limited size: the central bank has only one free resource: banknotes in circulation, amounting to 10% of GDP in the euro area in 2015. These 10% have counterparts: external reserves (3% of GDP), refinancing of banks and government bonds. Central bank liabilities include also free banking deposits (beyond reserve requirement), which rose dramatically with the crisis, but are remunerated at a rate close to the money market rate. In ordinary times, the central bank’s ability to hold public debt is therefore limited. Over 7% of GDP, the central bank must borrow from commercial banks and loses its ability to control the money market. Under normal circumstances, government debt cannot be monetized to a large extent. The central bank should simply guarantee it and ensure that the State will always find financing.

The public debt should find owners. This requires national treasuries to offer satisfactory remuneration conditions. They cannot find private agents willing to hold more banknotes to finance the state at zero interest rate.

Moreover, Grjebine advocates that the central bank cancels the public debts it has acquired. But the central bank’s balance sheet would exhibit negative own assets, which according to the author, does not matter because the central bank is issuing money. This proposal is unfortunately false. A bank, even a central bank, must have a positive capital. If not, the State would be required to recapitalize it. We cannot get rid of public debts by replacing them by a deficit in the ECB’s capital.

Let us assume that initially, the central bank holds deposits amounting to 10% of GDP. In normal circumstances, interest rates are 4%. The central bank refinances banks; makes a profit of 0.4% of GDP, which is transferred to the State. Suddenly, the central bank must acquire public debt for 20% of GDP and cancel it. The State therefore saves interest payments of 0.8% of GDP. The central bank must now borrow for 10% of GDP from banks and pay banks interest payments of 0.4% of GDP. As the central bank has no additional resources, the State shall transfer it 0.4% of GDP interest payments. As the State loses also the 0.4% dividend, the operation is neutral for the State. It is a pure accounting artefact. Public debt has not disappeared. It is hidden in the central bank's balance sheet. But will anybody be fooled? Moreover, it would be inconsistent for an independent central bank to become financially dependent of the State.

Similarly, Watt (2015) tries to find a way to get around the SGP and the Fiscal Treaty. The authors proposes, like many others (see, for example FNH, 2011), to finance a large public investment programme of 7.5% of GDP in 5 years through ECB's money creation. In practice, the investment projects would be financed by EIB lending to MS; the EIB would issue bonds, which would be purchased by the ECB on the secondary market. According to Watt, the advantage of such funding is that public debt does not rise and generates no costs in terms of interest payments. Like Tober (2015), we think that this view is *simply* wrong.

Of course, the objective of the proposal is fully relevant: a strong revival of public investment in Europe focused on ecological transition. The funding should have a counterpart, not in the form of banknotes with zero interest rate, but in the form of interest-bearing deposits or bonds. The ECB will have to reduce banks refinancing, which entails lower incomes for the ECB, and for public finances through lower seigniorage incomes. Above all, the ECB is at risk of losing control of the money market. Monetary theory has shown that there is no difference between debt financing and monetary financing, when the central bank sets interest rates (with a Taylor rule or at a zero lower bound). Debt and monetary financings have the same macroeconomic impacts and the same costs in terms of public finances. Their impacts on output and inflation are the same. As non-financial private agents will not hold more central bank banknotes, money supply will not increase. If the central bank holds more bonds issued by the State or by a public bank (such as the EIB), the State (or the EIB) will issue less bonds on financial markets (Table 3). So financial investors will hold more companies' bonds, and companies will need less credit. For the central bank, the increase in government bonds holdings will be offset by lower commercial banks refinancing.

Table 3. The effect of public investment monetary financing relatively to debt financing

Central bank		State or EIB	
Credit to State (or EIB) : +100			CB Credit: + 100
Refinancing:-100			Bonds :-100
Commercial banks		Firms	
Credit:-100	Refinancing =-100		Credit:-100
			Bonds: + 100

Watt (2015, box page 18) assumes that people who own a public debt of 100% of GDP (at a market interest rate) would agree to own instead 100% GDP of central bank money, i.e. banknotes which pay no interest. This does not make sense. In fact, people would ask (public or private) remunerated bonds so that the manoeuvre would not work.

Moreover, EIB loans would be counted in public debt figures, and so that the operation does not allow circumventing the TSCG constraint for public debts. Possibly, the Commission could accept that, for this operation, the EIB loans are removed from public debt in its assessment of MS public finances (but public debt will not be affected, according to Eurostat). Once the EIB has granted the loans it can finance without difficulty by issuing bonds, the purchase of its bonds by the ECB has no macroeconomic impact.

Tober (2015) correctly criticizes the proposals made by Pâris and Wyplosz and by Watt. She raises the issue of the respective roles of fiscal and monetary policy. In fact, both must manage the growth/inflation tradeoff. In the short-term, a given level of output may be achieved with a high public deficit and a high interest rate or with a balanced budget and a low interest rate. Coordination between fiscal and monetary policy is therefore necessary. In the euro area, the rule cannot be today: "public budgets must always be in equilibrium and monetary policy manages the economic situation" as monetary policy is constrained by the nominal interest rate zero limit and as national economic situations differ. Therefore, the only possible rule is: "monetary policy maintains a near-zero interest rate as long as inflation does not converge towards the 2% target, increases the interest rate towards the GDP nominal growth rate in normal time; fiscal policies support economic activity as long as national inflation is not excessive".

Furthermore, the ECB who must guarantee public debts and commercial banks, should not commit to funding any investment programme. The ECB should ensure that banks can finance adequately the economy both in quantity and quality. A point has not been agreed by the banking Union: are MS, individually or collectively, entitled to orient banks financing? Either by developing public, local or cooperative banks, either by encouraging lending to sectors according to a national or European industrial policy or to firms engaged in the ecological transition.

On public debt defaul

Some authors propose that MS cut their public debts in a discretionary manner, by an arbitrary percentage at the expense of their creditors. But this would have no economic or legal justification. This would be done at the expense of agents who trusted European countries and often lent them without risk premium. It would destroy market confidence in euro aera MS, whose public debt would be, for a very long time, considered as risky. It would justify financial markets speculation against MS public debts.

One cannot argue that MS debts are *illegitimate,* because they have been issued by democratically elected governments. Even if some tax cuts and some public expenditure are questionable, creditors cannot be asked to pay for them, as it would justify the right for financial markets to assess national fiscal policies. One cannot argue that public debt is *unsustainable* when EU countries have been able to borrow at 1% interest rates for 10 years, with a higher than 2.5% trend nominal growth, and hence the primary balance required for the debt-to-GDP ratio stability is negative.

However, the concept of *illegal* debt can apply to the share of the public debt resulting from tax evasion; but the fraudsters should be expropriated, not the creditors. In some MS, a share of government debt results from private banks debts' take over. Rich depositors benefited from exorbitant interest rates and took part with banks to the rise in financial and real estate bubbles (as in Iceland, Ireland, Spain, Greece, or Cyprus). Therefore, it is not legitimate that their assets become public debt. It is legitimate that banks' shareholders and important creditors bear losses (this is the example given by Iceland). Moreover, public debts result from partly from the excessive interest rates of the 1980-2005 time period, partly from tax competition and tax evasion, partly from banks debts, partly from the great depression, and so from neo-liberalism functioning. It is socially unfair and it is an economic nonsense to ask austerity efforts to peoples to reduce public debts. The only possible strategies for public debt reduction are on the one hand to increase taxation on wealthy households and large multinational companies, to combat tax evasion and to prevent tax competition, and on the other hand to maintain interest rates below the rate of growth, which should be accompanied by a strong political macro-prudential framework to avoid the rise in financial bubbles.

6. Can the single currency contradictions be overcome?

In developed countries, the system which worked until 1999 lied on unity between government, central bank and commercial banks. The central bank is the lender of last resort for the government and banks. The government guarantees banks; it 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 undermined to some extent by central bank independence, which could have generated conflicts between the government (caring about supporting output) and the central bank (caring about maintaining low inflation). These conflicts could have led public finances to become unsustainable if the central bank had maintained high interest rates to fight inflation when the government had maintained high public deficits to support output; they could have led to a "fiscal dominance" situation if the central bank had been obliged to cut its interest rate to stabilize public debt and to accept a too high inflation level; they could have led to a "monetary dominance" situation if the government had been obliged to reduce the public deficit and to accept a too high unemployment rate to avoid public finances unsustainability. But such situations did not occur before 2007. They never questioned government solvency.

The euro area introduction 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. Since 1973, the macroeconomic equilibrium has been requiring a certain level of public deficit and debt. 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 external deficits (or surpluses) should be avoided. 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 particular, the German constitutional court forbids any guarantee not expressively agreed by the German Parliament.

The solution adopted so far by Europe, i.e. the fiscal pact and the ESM, consists in ensuring solidarity to countries agreeing to implement a fiscal rule lacking economic rationale: keeping structural public deficits below 0.5% of GDP. But such a target is not optimal, there is no certainty that it may be reached; coordination should account for external balances rather than for public balances and should be symmetric.

Euro area countries should be able to issue safe sovereign bonds again, at an interest rate controlled by the ECB. They should be able to run a public deficit in line with their macroeconomic stabilisation needs. So a coordination process needs to be organised between MS. Coordination should target GDP growth and full employment; it should account for all economic variables; countries should follow an economic policy strategy allowing to meet the inflation target (at least to remain within 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-run adjustment processes should be implemented by countries where wages have risen too rapidly, or not sufficiently; increases or cuts in social contributions may be used to facilitate the adjustment process; countries should announce and negotiate their current account balance targets; countries running high external surpluses should agree to reduce them or to finance explicitly industrial projects in Southern economies. The process should always reach unanimous agreement on a coordinated but differentiated strategy.

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 event where no agreement is reached. In that case, the new debt issued by countries outside the agreement would not be guaranteed, but such a case should never occur.

It would be difficult, if not impossible, to reach such an agreement, based on a wise and precise cooperation rather than on rigid rules. It would require negotiations with uncertain outcomes. But this is the only way for a currency area to work properly. If open economic policies cooperation cannot be run within the euro area, the single currency will not survive.

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