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SOME CHALLENGES AHEAD FOR THE EU*

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* This Policy brief is an excerpt from one of the three chapters constitutive of the 2019 iASES report (independent Annual Sustainable Economy Survey, formerly iAGS) that will be published in January 2019. G. Allegre, C. Blot, B. Ducoudré, J. Creel, M. Dauvin, A. Gueret, L. Kaaks, P. Malliet, H. Perivier R. Sampognaro, A. Saussay, X. Timbeau as well as IMK (Berlin), ECLM (Copenhagen) & AKW (Vienna) have also contributed to this report

In the euro area growth is holding up but the general outlook is less bright than in recent years. The anticipated slowdown largely results from the gradual attenuation of the post-Great Recession recovery momentum and the convergence of growth rates towards a lower potential growth path. It also coincides with a revival of political turmoil, consequently emphasizing the urgency to deal with external downsize risk by strengthening internal sources of growth—investment and private consumption. The sun has been shining but the opportunity for structural repair has not been taken. Hence, imbalances within the euro area need to be addressed in order to achieve sustainable development.

The increase of public debt is one of the main legacies of the crisis. While it is currently declining, long-run simulations suggest that without further consolidation, the public debt-to-GDP ratio will not reach the arbitrary 60% target by 2035 in a number of countries. To top it off, countries that are concerned are those whose unemployment rate remains above its pre-crisis level, yet the implementation of a new fiscal consolidation would result in higher employment. It thus raises the question of this rule's sustainability. The euro area as a whole has a large trade surplus, which favors pressures for the appreciation of the euro, which can reduce growth prospects. Unlike the period before the crisis, the imbalance is clearly concentrated in surplus countries.

Finally, the aforementioned imbalances make governance reforms more urgent than ever. Until now, progress in this area has proved rather timid.

This work led us to three key policy insights. First, the structural adjustment needed to bring back public debt to its target would weigh on the reduction of unemployment. Euro area countries can pursue an additional fiscal consolidation provided output gap is closed, and countries with fiscal leeway should use it to sustain growth in the euro area as a whole.

Secondly, the ongoing debate on the reform of the economic governance of the euro area must pay more attention to the evolution of nominal prices and wages, in order to reduce the sources of divergence. In the same time, the need to strengthen wage bargaining systems by giving the social partners a greater role is important. Finally yet importantly, the need for a greater automatic stabilization, including of a cross-border nature, in monetary union is undisputed. The proposals under discussion do go to some extent in this direction and deserve support.

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After the double dip of 2008-2009 and 2011-2013, the economic outlook in the euro area (EA hereafter) experienced an upturn, which resulted in a healthy 2.5% GDP growth rate in 2017, against 1.9% the previous year. This recovery has helped to reduce the imbalances resulting from the crisis. The unemployment rate fell by almost 4 points between 2013 and 2017. Budget deficits decreased from 6.2% in 2010 to 1% in 2017, which initiated a decrease in aggregate government debt. Current account imbalances have also apparently been rolled back.

However, challenges still loom. There have been signs of an economic slowdown since the start of 2018, and new tensions have emerged that might threaten the recovery. Recent statistical information is a harbinger of a slowdown of growth coinciding with a revival of political and financial turmoil. The hard bargaining over *Brexit* and its still uncertain outcome, the trade war launched by the United States as well as the turbulence in some emerging countries and the high volatility of oil prices and exchange rates darken the economic outlook and highlight a set of downside risks. In *iASES 2019*, we forecast a slowdown of GDP growth in the European Union as well as in the EA between 2018 and 2020 (see Table 1). Partly the slackening is expected, resulting from a gradual loss of momentum in the post-Great Recession recovery and the convergence of growth rates towards a lower potential pathway. In *iASES 2019* we extend our forecasts to cover poverty rates and changes in $C0_2$ emissions alongside GDP and unemployment forecasts[1]. In most countries, the poverty rate will decline while CO_2 emissions will rise in 2019-2020 on average in the EU[2].

iASES (2019): "The imperative of sustainability—economic, social, environmental", *iASES (formely iAGS) 2019*—independent Annual Sustainable Economy Survey, 7th Report..

In 2017, there are still more than 16 million people unemployed in the EU. Despite the recent improvement, the social stigma of the crisis remains significant. Thus, the expected slowdown in activity will occur in a context where the unemployment rate for the euro area as a whole is still markedly above its pre-crisis level. Underemployment is particularly severe in Greece, Spain and Italy, countries suffering from the fragility of their public finances and their banking system.

iASES 2019 also produces updated medium-term public debt projections. Although aggregate public debt is decreasing in the EA, heterogeneity is persisting, as some countries face a high and only stabilising or slowly decreasing debt level. The current fiscal rules are still stringent and may compel these countries to implement a harder than economically warrented consolidation. This would accelerate the economic slowdown, a point discussed in Part 1. We then turn to the internal imbalances in the EA: the current account imbalances have receded, but they have not faded away, and nominal adjustment is still needed (Part 2). This is yet again raising the issue of wage adjustments and wage policy in the EA. Such further adjustments are likely to be pushed onto the same countries most weakened by the crisis, pointing out the need to improve European governance (Part 3). In this sense, the EU does not seem to be prepared for the next downturn, as huge challenges remain.

1. This constitutes an important step towards forecasting Sustainable Development Goal indicators (SDGs).

2. The methodologies used to compute forecasts for the poverty rate and CO_2 emissions are detailed and discussed in Chapter 2 and 3 of the iASES 2019 report, respectively.

Table 1. **Unemployment rate, poverty and CO_2 emissions forecasts for the European Union**

	Unemployment rate (In % of labour force)				Poverty rate (% of households)				Change in CO_2 Emissions (%)			
	2017	2018	2019	2020	2017	2018	2019	2020	2017	2018	2019	2020
EUZ*	9.1	8.2	7.8	7.5	17.1	17	16.9	16.9	0.6	0.3	0.0	0.8
EU-28*	7.6	6.9	6.5	6.3	16.5	16.4	16.3	16.3	-0.6	0.9	0.1	0.9

* For the poverty rate and the change in Co2 emissions, we compute aggregates on a smaller set of countries (those available), which consist of a population-weighted average and an emission-weighted average, respectively.
Note: The poverty rate is defined as the proportion of individuals in poor households, which are those whose equivalised disposable income is below 60% of the median disposable income.
Sources: Eurostat, National Accounting, iAGS forecast November 2018.

1. The perilous road to reach the DEBT target of 60%

fiscal consolidation helped stabilizing the debt …

Fiscal rules and targets have been driving the fiscal policies of the EA since its very start. The fiscal consolidation implemented between 2010 and 2015 has contributed to the stabilization of public debt in most of the EA countries, although often at heavy cost in terms of lost output. However, public debt ratios are still high in some countries, raising questions about their ability to bring the debt-to-GDP ratio back to 60% as required by existing fiscal rules. Besides, the recent debt turmoil in Italy has been highlighting the importance of political decisions that put additional upward pressures on sovereign risk (as illustrated by the Italian case), thus on the level of public debt.

Discussions on the need for additional fiscal consolidation will not stop as long as the debt-to-GDP ratio is above 60% and has not converged to it: even if there is no economic rationale for this figure. Therefore, we simulate the path of public debt-to-GDP ratios until 2035, which is the horizon of the 1/20th debt rule incorporated in the Stability and Growth Pact and in the Fiscal Compact (Box 1).

Box 1. **Fiscal rules in the euro area**

In principle, each EA country should comply with the following fiscal rules:

- the country-specific structural deficit targets, the so-called medium-term objectives (MTOs);
- convergence of public debt towards 60% of GDP. The reduction of debt should reach 1/20th of the difference between the current level of debt and the 60% target on average within three years.
- an expenditure rule, which limits public expenditure growth (depending on potential growth).

At present, the Commission and Council focus in their evaluation of fiscal policies as well as their policy recommendations on the first rule, as it is the most restrictive one and it is at the center of the TSCG, the so-called Fiscal Compact. However, political attention can change quickly, notably when all EA countries comply with the 3% rule for the public deficit, as should be the case in 2018.

The model used represents the main countries of the EA: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Portugal and Spain.[3] We make three main assumptions in the baseline scenario: 1) all fiscal impulses are null beyond 2020, 2) interest rates converge (no risk premium) and inflation expectations are anchored to the 2% target at the 2035 horizon, and 3) the fiscal multiplier depends on the economy's position in the cycle.[4] In a first exercise, we compute the debt dynamics, structural balance, inflation and the GDP growth rate from 2018 to 2035. The results are depicted in Table 2.

In a scenario where there is no change in fiscal policy beyond 2020, France, Italy, Spain, and Belgium would be the countries—amongst the EA members— which fail to reach the 60% debt-to-GDP ratio by 2035. Consequently, these countries would have to implement additional fiscal efforts to be able to comply with the debt rule. With a public debt-to-GDP ratio of 74%, convergence would be significant in Belgium, while it would be rather sluggish for France and Spain. Public debt in Italy would increase until

3. Details of the model are available here https://www.iags-project.org/documents/iags_appendix2013.pdf.

4. The fiscal multiplier equals 0.5 when the output gap is closed and ends up being null in the long run.

Table 2. **Public finance and output performances**

	Public debt (% of GDP)		Structural balance (% of GDP)		Cumulative fiscal impulse	GDP growth rate (%)		Average output gap	Inflation rate (%)	
	(1) 2020	(2) 2035	(3) 2020	(4) 2035	(5) 2018-2035*	(6) 2018-2020	(7) 2021-2035	(8) 2018-2035	(9) 2018-2020	(10) 2021-2035
DEU	56	40	-0.2	-0.6	0.9	1.8	1.7	-0.1	1.8	2.1
FRA	94	89	-1.8	-2.7	-0.5	1.7	1.3	-0.2	1.9	2.1
ITA	131	143	-2.9	-4.1	1.1	1.0	0.2	-0.2	1.1	2.0
ESP	96	91	-1.9	-2.7	0.5	2.4	1.3	-0.5	1.5	2.0
NLD	48	21	0.3	0.6	0.0	2.4	2.0	0.0	1.8	2.2
BEL	99	74	-1.6	-1.2	0.7	1.7	1.2	0.3	1.6	2.2
PRT	120	45	0.1	2.9	0.7	2.0	1.4	0.7	1.0	2.0
IRL	59	52	-3.1	-2.5	-0.5	4.7	3.1	1.4	1.5	2.1
GRC	171	60	3.0	4.7	1.6	1.9	0.9	-1.2	1.0	2.2
FIN	60	54	-1.6	-1.6	0.0	2.0	1.1	0.5	1.4	2.1
AUT	66	41	-1.1	-0.2	0.8	2.3	1.3	0.8	2.8	2.1
EA	84	70	-1.2	-1.5	0.4	1.9	1.4	-0.1	1.7	2.1

In the baseline scenario, fiscal impulses are equal to 0 from 2021 to2035.
Source: iASES (formerly iAGS) 2019 model.

2035, up to 143% of GDP because of the higher debt burden, i.e. fiscal efforts would have to be substantial to meet the 60% criterion. The decomposition of changes in debt between the fiscal surplus, the "snow-ball" effect and stock-flow adjustments can be found in Box 2. On the other hand, countries experiencing a decrease in the public debt below the 60% threshold would benefit from fiscal space.

Looking at the structural balance also gives information on the situation of the public finances. It would deteriorate for Italy, and to a lesser extent in France and Spain, due to a slightly decreasing public debt for these countries (Ireland also, however its ratio is below 60%). The Netherlands and Portugal would benefit from a surplus, increasing the room for manoeuvre to implement a more expansionary fiscal policy in the future.

… But let's not sacrifice more growth

We then assess whether countries are able to meet the 60% ceiling by 2035. Although almost all EA countries would meet the 60% criteria in 2035, this would imply a reduction in growth for countries implementing additional fiscal consolidation. Growth would then be lower in the EA as a whole, and the heterogeneity in growth performance would widen. Growth would also deteriorate in countries that have already suffered from the double dip recession. The countries with fiscal space are already those in which the unemployment rate has recovered to or is close to pre-crisis levels. This clearly questions the social sustainability of such a policy. As illustrated in previous reports, a trade-off obviously arises between the debt objective and the growth objective.

These simulations suggest that there is still a risk of a new wave of fiscal consolidation in the future, unless the fiscal rules are changed or at least not applied strictly. This may still entail output costs, and add deflationary pressures for the EA, and notably in countries where the output gap is negative and the unemployment rate high (Greece, Portugal, Spain, Italy and France).

Applying the country-specific structural targets, in other words the MTO rule, countries that need to do some fiscal consolidation to reach the 60% debt-to-GDP ratio would require less adjustment. In this optic, applying the preventive arm of the SGP starting from 2021 would be a way to spread the adjustment and to avoid dampening the current recovery.[5] By 2035, France would reach a 65% debt-to-GDP ratio, Spain 68% and Italy 108%.

The conclusions that may be drawn are twofold. First, EA countries should not engage in additional fiscal consolidation unless the output gaps are closed. Second, countries with fiscal room for manoeuver should use it to sustain growth in the EA. This would sustain economic activity in those countries, but with positive spillovers to the others, and it would maintain the fall in the unemployment rate without putting at risk debt sustainability (the 60% debt-to-GDP ratio could still be achieved in 2035).

5. For Greece, we assume that starting from 2020, the country implements fiscal expansion until its primary surplus is 3.5%, as defined in the Memorandum.

Box 2. Decomposition of public debt

Debt variation depends on three things:

- the primary surplus: a higher primary surplus slows debt progression;
- stock-flow adjustments: this includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects;
- a "snow ball" effect: this captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio.

We present a decomposition of public debt evolutions between 2018 and 2035 for 11 EA countries under the baseline scenario (no risk premium, no fiscal impulse beyond 2020, time-varying fiscal multiplier, hysteresis effects) in the next table (Table 3).

The public debt is decreasing in almost all countries. This is due to a favorable snow-ball effect, which turns out to be unfavorable solely for Italy since the latter faces a very low potential GDP growth of 0.3% each year in our projection. Apart from Ireland, the primary surplus has a negative or null effect on debt variation. Stock-flows have a near-zero impact on average on public debt variation, except for Greece, where the annual macro-economic database of the European Commission's Directorate General for Economic and Financial Affairs (AMECO) reports an important stock-flow adjustment for 2018-2020.

Table 3. **Decomposition of average annual public debt ratio variations**

Country	Average annual Public debt variation (in %)	Average annual contribution to debt ratio variation between 2018 and 2035 (in percentage points)		
	2018-2035	Snow-ball effect	Primary surplus	Stock-flow
DEU	-1.3	-0.5	-0.9	0.0
FRA	-0.5	-0.5	0.0	0.0
ITA	0.6	1.3	-0.7	0.0
ESP	-0.4	-0.4	-0.2	0.1
NLD	-2.0	-0.6	-1.4	0.0
BEL	-1.6	-0.3	-1.5	0.1
PRT	-4.5	-0.2	-4.4	0.1
IRL	-0.9	-1.3	0.3	0.1
GRC	-6.6	-1.2	-6.0	0.5
FIN	-0.4	-0.2	-0.3	0.1
AUT	-2.1	-0.6	-1.4	-0.1

Source: iASES (formerly iAGS) 2019 model.

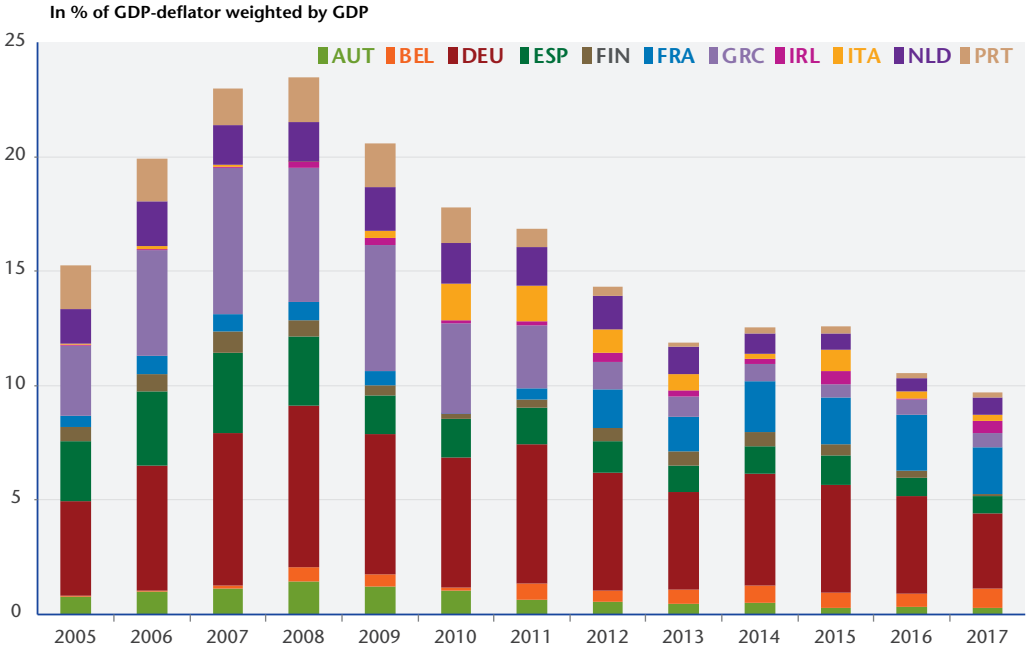
2. Correcting current account imbalances requires wages policies in the euro area

Assessment of internal imbalances in the euro area

Current account imbalances have been at the heart of the EA crisis. The overall situation has improved since the crisis hit, but significant imbalances remain. In order to assess the evolution of current account imbalances within the EA, *iASES 2019* delivers an aggregate indicator of the nominal adjustment needs (see Figure 1), which is the average (weighted by GDP) of the absolute value of misalignments in the euro area.[6] We also report the contribution of each country to this indicator. This gives a measure of the heterogeneity among EA countries, while at the same time pointing to the countries that contribute the most to this heterogeneity.

6. In iASES 2019, we compute the adjustment of the general price level in every euro area economy that would be compatible with both an internal equilibrium and an external equilibrium.

Figure 1. **Indicator of intra-EA nominal misalignments, with per-country contributions**



Source: iASES (formerly iAGS) 2019 calculations.

The picture that emerges from these calculations is that nominal misalignments within the EA reached a peak in 2008, at the time the crisis broke out, then substantially diminished until 2013, and slightly decreased since 2015. The adjustment effort of the Southern countries (Portugal, Spain, Italy, Ireland and Greece) is very clear, since they contributed only 25% to the indicator in 2017 against more than 50% between 2001 and 2007. This adjustment was not due simply to the contraction in demand, since the indicator calculated here corrects for relative output gaps. It was mainly induced by the contraction of wages. The indicator is however sensitive to the output gaps used. Conversely, Germany, Austria and the Netherlands reduced their nominal undervaluation, but at the same time Germany is now the main contributor to the heterogeneity, reflecting the asymmetric nature of the adjustment that took place. Italy remains in a rather well-balanced position.

Even though the situation has improved quite substantially since 2008, it appears that there are still significant underlying current account imbalances within the EA, especially between France and Germany, where—all other things being equal—a

relative nominal price adjustment of 20% is needed. Another way to look at the current situation is to compute projections for long-term net international investment positions (NIIP, or net foreign assets) if trade balances remained the same as today, i.e. if there were no nominal readjustment (and assuming constant asset prices and no other adjustments); the result of this exercise is given by Table 4.

Table 4. **Long-term projections for net international investment positions in the absence of nominal adjustments (% of GDP, 20-year horizon)**

AUT	BEL	DEU	ESP	FIN	FRA	GRC	IRL	ITA	NLD	PRT
39	15	183	9	15	-19	-72	186	57	224	-32

Source: calculs iASES (précédemment iAGS), 2019.

These results show that the situation for deficit countries is rather good, since all of them except Greece would arrive at an NIIP over the macroeconomic imbalance procedure (MIP) threshold of -35% (and even Greece would improve its position relatively to today). The imbalance clearly comes from Germany, the Netherlands and Ireland, which would accumulate a huge amount of foreign assets, close to 200% of their respective GDPs. Again, this shows the asymmetric nature of the adjustment made so far. However, one should not forget that today the EA on aggregate has a large trade surplus, which may not last forever, since it creates pressures to appreciate the euro. If these pressures were to materialize, substantial external deficits could reappear in Southern countries, possibly even leading to a new balance of payments crisis.

Current account adjustments therefore remain an important issue that should be addressed by appropriate policies, starting with surplus countries. The goal should be a still higher inflation in surplus countries to avoid pushing deficit countries into deflation, which points to the need to focus on the evolution of wages. The following analysis of wage developments in the EA gives some insights into ways to boost inflation.

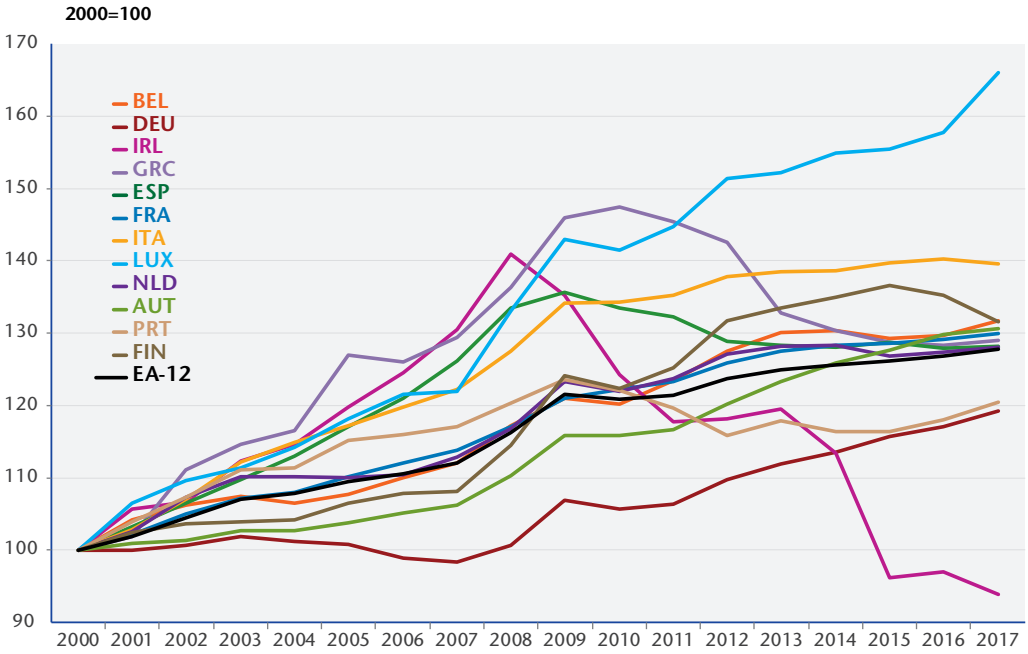
Wage developments and policy in the euro area

iASES 2019 examines wage developments in Europe, with a focus on the twelve first members of the EA. Looking at nominal wage trends, the most striking feature is the wide divergence in nominal wage trajectories up to the crisis, followed by a marked, but not complete and asymmetric, convergence since 2008. Very rapid nominal wage growth in Greece, Ireland and Spain was followed by a massive correction in the former country, and more limited adjustment in the latter two. The downward adjustment has also been very pronounced in Portugal, and less so in Italy, following less substantial above-average growth pre-crisis. The well-known undershooting in Germany (although working time plays a role here) and to a lesser extent Austria is startling; only very belatedly and gradually has an upward correction been forthcoming in these two countries.

A closer look at the data indicates two important features: first, a failure of real wages to keep pace with productivity, and thus a falling EA wage share; second, a failure to anchor inflation close to the ECB target. Evidently, wage-bargainers have factored below-target inflation into their pay settlements, in spite of the improving labour market situation in almost all countries. "Lowflation" is getting hard-wired into the economic system. Amongst other things, this makes the resolution of public debt issues more difficult and, more generally, it is a factor behind still-anaemic demand. In addition, it reflects the failure to correct the competitive imbalances that had built up in a symmetrical fashion; adjustment pressure was applied almost exclusively to the former deficit countries.

Divergence in nominal wages need not have implications for external competitiveness, namely to the extent that they reflect productivity rather than nominal price-wage dynamics. However, a look at nominal unit labour costs shows that this has largely not been the case, as has been pointed out in previous iAGS reports (Figure 2).

Figure 2. **Trend in nominal unit labour costs in the euro area**



Source: AMECO.

Even allowing for productivity, nominal wage trends in Greece, Ireland, Italy and Spain (also Luxembourg) overshot considerably up to the crisis, while Germany and Austria undershot. This went hand in hand with current account imbalances that built up until a sudden correction in the crisis. Important explanations include the failure to keep demand trends in line with domestic potential as well as issues such as housing-price booms that were not addressed by policymakers. These led simultaneously to faster wage-price spirals and widening deficits in countries such as Greece and Spain and stagflation and growing surpluses in, notably, Germany. Since the crisis, a substantial, but one-sided adjustment has occurred. Most countries are now, in terms of the overall trajectory, grouped quite tightly, slightly above the euro area average.[7] Italy and Germany are notable for having made only a very limited downward and upward correction respectively since the crisis. Reflecting this one-sided adjustment, the current account balance of the euro area as a whole has moved very substantially and persistently into surplus. This is unsustainable, however, as is shown by recent debates and disputes at the global level regarding trade policy. This makes it all the more important that domestic demand is underpinned from the wage side.

It does not follow, however, that "wage policy"—the various wage-determination mechanisms operating in member states—bears sole responsibility for ensuring appropriate wage and price trends. Rather this is the responsibility of the macroeconomic policy mix in each country. Wage policy will only be able to play a role in conjunction with fiscal (and possibly macroprudential) policies that work symmetrically to keep demand close to potential output, avoiding persistent stagnations and curtailing booms (Koll and Watt, 2018).

7. Luxembourg and Ireland (where GDP numbers especially in recent years make interpretation difficult) are upper and lower outliers.

Koll, W. and A. Watt (2018): "Convergence and stability in the Euro Area through effective macroeconomic policy coordination", *IMK Study* 61e, Düsseldorf.

Two main policy conclusions can be drawn from this analysis and from previous work done in earlier iAGS reports. One is that the ongoing reform debate on EA economic governance needs to pay greater attention to achieving mutually compatible nominal wage and price developments in all member states. The second is the need to strengthen national wage-bargaining systems.

In order to ensure the former, the EA's economic governance needs appropriate reforms. At a minimum, the Macroeconomic Imbalance Procedure needs to be adapted so as to make it symmetrical in operation, and its influence on national policy needs to be increased vis-à-vis the narrow fiscal rules. These should be changed to improve the focus on achieving inflation rates close to the central bank target, rather than on (arbitrary) debt ratios. A great role should be given in economic policy-making to the social partners, so that wage and price developments are given more weight in economic policy deliberations.

Regarding wages, possible tools include the coordination of national wage policies over the long-term, a generalization of minimum wages in all countries, a better regulation of posted workers to avoid unfair competition, mandatory periodic wage negotiations at the branch level (which would include nominal re-adjustments) and so forth. Regarding fiscal policy and the governance of the EA, possible tools include the coordination of fiscal devaluations (i.e. tax shifting from social security contributions to VAT), the substitution of energy imports particularly in the South by boosting investment in renewable energy, and in particular fiscal re-evaluations in some countries (Germany, Netherlands, Ireland).

3. Economic governance in the euro area: where do we stand?

In light of the remaining imbalances in the euro area, the need to reform governance has not diminished, and many proposals have emerged. Yet, the measures under consideration – some of which we analyse below – are rather weak and there has been much foot-dragging.

On banking and financial matters, while some substantial steps have been taken, such as EU-level supervision of the largest banks, the Banking Union (BU) is remains work in progress. First, a few countries are still reluctant to adopt the European Deposit Insurance Scheme (EDIS) out of fear that well-funded deposit guarantee schemes (DGS) could be tapped to compensate for underfunded ones. The incomplete adoption of the BU also highlights the lack of the political will needed to ensure the homogenous regulation and supervision of banks across the EU. Second, the incomplete adoption of a BU poses a threat to the discretionary character of ECB monetary policy. Indeed, without a fully operational Single Resolution Fund (SRF), the BU may be insufficient to ensure banking stability. The ECB could need to come to the rescue with extended unconventional policies. At a time of tapering measures by the ECB, and yet in a low interest rate environment, the risks of financial instability are likely to intensify: the search for higher yields may feed an excessive appetite for risk. Consequently, macroprudential policies are sorely needed to limit risk. In the Statement of the Euro Summit of 14 December 2018, the Eurogroup announced a reform of the European Stability Mechanism (ESM), endorsing a Common Backstop to the SRF that will help resolve bank crises. However, other important measures like a non-performing loan (NPL) Prudential Backstop remain to be discussed and leave the BU incomplete.

One year and a half after Macron's speech at La Sorbonne and following the German election, envisaged euro area policy reforms have not moved forward much: migration and defence issues, and also Brexit, have taken priority over substantial reform proposals to fix macroeconomic problems like real divergence and the economic slowdown. During the Euro Summit of last December, a budgetary instrument aimed at "convergence and competitiveness for the euro area", possibly extended to Exchange Rate Mechanism II member states, has been planned. Beyond the question of the size of this new budget, which will be decisive for understanding the effectiveness of the new system, its structural focus can prove very useful to boost macroeconomic activity via an impetus to public investment. According to Gechert and Rannenberg's meta-analysis (2018), the fiscal policy most likely to produce a large multiplier effect (a large GDP effect) is public investment. This instrument can therefore promote real convergence between the member states, especially if it is allocated primarily to regions and States whose development is lagging behind, in accordance with the criteria that already apply to the economic, social and territorial cohesion policy of the EU budget.

That said, the stabilization property of the budget, which was part of Macron's speech at La Sorbonne and part of the Franco-German Meseberg Declaration (June 2018), is missing in the Statement of the Euro Summit. That leaves the question of automatic stabilisation measures working across borders (not to mentioned discretionary policies) within the EMU unanswered. The rationale for a euro area smoothing mechanism is clear. Without it, recent history has made it clear that member states encountering a negative shock can quickly come under pressure from the markets or due to the fiscal rules (which rely on unobservable potential output and output gaps, and thus do not in practice reliably distinguish between structural and cyclical budget positions). This puts undue pressure on governments during downswings, as they are forced into pro-cyclical spending cuts or tax hikes. Cross-border stabilisers would then support demand during downswings, and they would also dampen demand in booming economies, constraining governments to run tighter policies in "good times". Overall such stabilisers would help reduce the cyclical divergence that proved so damaging in the run-up to the crisis.

This approach should not be seen as being in opposition to, or a substitute for, a policy of strengthening national automatic stabilisers. This former approach increases the stability of the currency area as a whole; each member state has an interest in other members having strong stabilisers, suggesting a need for coordination to bring about an upward convergence in this regard (Watt, 2011). The fiscal rules—at least the medium-term objective and the expenditure rule—would in principle take account of the greater amplitude of the swings in the government balance. Still, provisions would need to be in place to prevent automatically rising deficits in a downswing leading to market pressures on sovereign bond markets.

The need for greater automatic stabilisation, including of a cross-border nature, in a monetary union is undisputed. Yet, no step has been made in this direction in the euro area. This will leave the burden of a future economic crisis on the ECB and on national governments, provided they recover margins for manoeuvre before it happens ■

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