Europe’s fiscal rules – up for debate

By Pierre Aldama and Jérôme Creel

At the euro zone summit in December 2018, the heads of state and government hit the brakes hard on the reform of fiscal governance: among the objectives assigned to the euro zone’s common budget that they are wishing for, the function of economic stabilization has disappeared. This is unfortunate, since this function is the weak point of the fiscal rules being pursued by the Member States.

In a recent article, we assessed how governments use the fiscal tools at their disposal to respond to information about trends in the public debt or the economic cycle that is at their disposal when they make their budgetary decisions. Thus, instead of evaluating the properties of fiscal rules using data that may well be revised retrospectively, we evaluated them “in real time”.[1]

Three main results emerged from our study. On the one hand, European governments ensure that their public debts are sustainable by improving their fiscal balance when the public debt increases. On the other hand, we found a trend towards fiscal consolidation at the bottom of the cycle in the euro area: fiscal policy is then rather destabilizing. Finally, euro area Member states have adopted a behaviour that was not found in the non-European countries in our sample: the euro zone Member states, unlike the others, continued to stabilize their public debts at the bottom of the cycle and during the crisis years. Thus the fiscal policy in the euro zone countries appears rather clearly to be untimely and inappropriate.

The results obtained as a whole for the euro area argue for a

reform of Europe's fiscal rules, but not necessarily in the sense most commonly accepted. The issue of stabilizing the public debt does not seem to be essential in so far as this is already being taken care of by the fiscal policies being implemented. Rather, what is needed is to rebalance these fiscal policies in favour of macroeconomic stabilization, especially if no common mechanism – such as a euro zone budget – has been set up for this purpose. European fiscal policies need to be more flexible and less prescriptive, with a focus on the dynamics of macroeconomic stabilization. Since no progress is envisaged at the European level, national automatic stabilizers need to be reinforced, increasing tax progressivity and the responsiveness of social spending to changes in economic activity in order to deal with the next cyclical downturn, both individually and collectively.

[1] One of if not the first article that focuses on evaluating fiscal policy using "real-time" data is by Golinelli and Momigliano (Journal of Policy Modeling, 2006). This literature is summarized in Cimadomo (Journal of Economic Surveys, 2016).

The euro-isation of Europe

By Guillaume Sacriste, Paris 1-Sorbonne and Antoine Vauchez, CNRS and Paris 1-Sorbonne

In the latest article in *La Revue de l'OFCE (no. 165, 2019), accessible here in French*, the authors analyze the emergence of a new European government, that of the euro, built to a great extent on the margins of the EU's existing framework. In

noting this, the article takes stock of a process of the transformation of Europe (the European Union and Member States), which we call here the "Euro-isation of Europe", in three dimensions: 1) the creation at its core of a powerful pole of Treasuries, central banks and national and European financial bureaucracies; 2) the consolidation of a European system of surveillance of the economic policies of the Member States; 3) the gradual re-hierarchisation of the political priorities and public policies of the European Union and the Member States around the priority given to financial stability, balanced budgets and structural reforms. The article thus makes it possible to redefine the nature of the "constraints" that the management of the single currency is imposing on the economies of the Member States, constraints that are less legal than socio-political, less external and overarching than pervasive and diffuse, and ultimately closely linked to the key position now occupied by the transnational network of financial bureaucracies in defining European issues and policies.

The imperative of sustainability economic, social, environmental

OFCE[1], ECLM[2], IMK[3], AKW[4]

It was during the climax of the so-called Eurozone sovereign debt crisis that we engaged into the independent Annual Growth Survey – the project was first discussed at the end of the year 2011 and the first report was published in November 2011. Our aim, in collaboration with the S&D group at the European Parliament, has been to challenge and question the European Commission contribution to the European Semester, and to push it toward a more realistic macroeconomic policy, that is to say less focused on the short term reduction of public debt and more aware of the social consequences of the crisis and the austerity bias. For 7 years, we argued against a brutal austerity failing to deliver public debt control, we warned against the catastrophic risk of deflation. We also alerted on the social consequences of the deadly combination of economic crisis, increased labor market flexibility and austerity on inequalities, especially at the lower part of the income distribution. We cannot claim to have changed alone the policies of the Union, but we acknowledge some influence, although insufficient and too late to prevent the scars let by the crisis.

Today, there is a need to take this initiative a major step forward. The adoption of the UNSDGs calls for a new approach to economic governance and to economic growth. The measurement of economic performance needs to evolve into the measurement of well-being on all three accounts of sustainable development – economic, social and environmental. A broad range of policies have to be mobilized coherently to this effect, which must move fiscal policy from a dominant to an enabling and supportive role. Moreover, those policies need to be anchored on a consistent and inclusive long-term strategy, and should be monitored closely to check that they deliver sustainability.

So far, the EU has not properly embraced this agenda, and the still prevailing European Semester process is an inadequate process to lead the EU towards achieving the UNSDGs. In the

same way as the iAGS challenged the dominant orthodoxy in the macroeconomic field, the iASES 2019 – independent Annual Sustainable Economy Survey, the new name of the iAGS – is our contribution to support a strategy towards sustainability and show the way.

The iASES 2019 scrutinizes the general outlook of the EU economy. The coming 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. The slowdown of growth coincides with a revival of political turmoil – *Brexit*, Italy's public finances, the trade war and turbulences in some emerging countries. The upturn will come to an end at some point, and the euro area is not yet prepared for that, as imbalances persist and the institutional framework remains incomplete[5]. The euro area has moved into a large trade surplus, which may not be sustainable. Nominal convergence remains an important issue that should be addressed by political willingness to coordinate wage development more actively, beginning with surplus countries. Moreover, the incomplete adoption of a Banking Union may be insufficient to ensure banking stability in case of adverse shocks. The ECB could have to come to the rescue with extended unconventional policies, complemented with automatic stabilisation measures working across borders within EMU.

The social situation has slightly improved in the EU since the worse of the crisis and, on average, the unemployment rates across European countries are back at their pre-crisis levels. However, differences across countries and sections of the population are still huge. Policy makers need to be aware of possible trade-offs and synergies between economic, social and environmental goals in general and the Sustainable Development Goals (SDGs) in particular[6]. In line with the SDGs and intended goals of the European Pillar of Social rights iASES aims at promoting policies – expanding social investments,

pro-active industrial policies, reducing working time, increasing collective bargaining to limit primary formation of inequalities – that address these goals and overcome the direct and indirect negative consequences of unemployment.

Climate change is arguably the most serious challenge that we collectively face. Computing carbon budgets can be useful to warn policy-makers about the effort to be delivered in order to put society on the road to environmental sustainability. The iASES evaluates the "climate debt" which is the amount of money that will have to be invested or paid by countries for them not to exceed their carbon budget, leading to three key policy insights. There are few years left for major European countries before exhausting their carbon budget under the +2°C target. Consequently, the carbon debt should be considered as one of the major issues of the decades to come since in the baseline scenario it represents about 50% of the EU GDP to stay below +2°C[7]. Framing the climate question in the words of debt is deliberate as the concept of excessive deficit applies today totally to the procrastination we demonstrate there.

[1] Directed by Xavier Timbeau with Guillaume Allègre, Christophe Blot, Jérôme Creel, Magali Dauvin, Bruno Ducoudré, Adeline Gueret, Lorenzo Kaaks, Paul Malliet, Hélène Périvier, Raul Sampognaro, Aurélien Saussay, Xavier Timbeau.

[2] Jon Nielsen, Andreas Gorud Christiansen.

[3] Peter Hohlfeld, Andrew Watt.

[4] Michael Ertl, Georg Feigl, Pia Kranawetter, Markus Marterbauer, Sepp Zuckerstätter.

[5] See « Some Challenges Ahead for the EU », *OFCE Policy Brief*, n°49, February 5,2019.

[6] See « Social Sustainability: From SDGs to Policies », *OFCE Policy Brief*, n° 50, February 5, 2019.

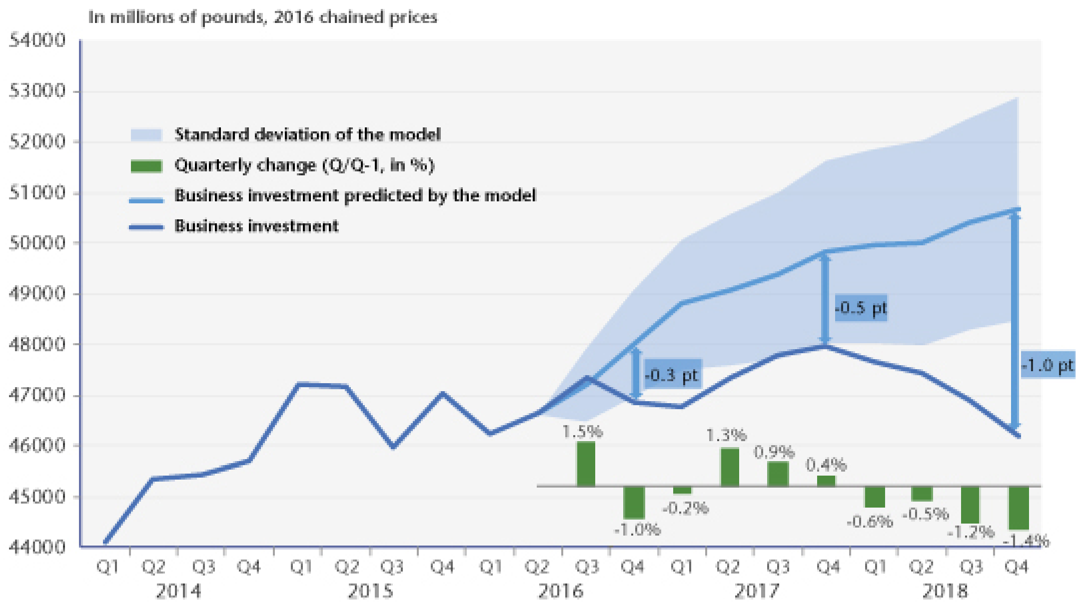
[7] See "An explorative evaluation of climate debt", *OFCE Policy Brief*, n° 45, December 11, 2018.

Business investment hurt by Brexit

By Magali Dauvin

At a time when the outlook for world trade outlook remains glum [1], British domestic demand is struggling to remain dynamic: household consumption has run out of steam at the end of the year, while investment fell by 1.4 points in 2018.
This latest fall can be attributed almost entirely to the investment of non-financial corporations [2] (55% of GFCF in volume), which fell consecutively during the four quarters of the year (Figure 1), for a total fall of -3.7% in 2018.
Investment can be predicted by an error-correction model [3], and the one used for the investment forecasts of non-financial firms in the United Kingdom benefits from an adjustment that can be considered "correct" in terms of its explanatory power (86%) over the pre-referendum period (1987Q2 – 2016Q2). If we simulate the trajectory of investment following the 2016 referendum (in light blue), we can see that it deviates systematically from the investment data reported by the ONS (dark blue) [4].
This result is consistent with the results found in the recent literature, which also show that the models have consistently tended to overestimate the investment rate of UK firms since 2016 [5]. The gap has steadily risen in 2018, from 0.5 percentage point of GDP in 2017, to almost one point of GDP in the last quarter.

Figure. Evolution and simulation of investment by non-financial corporations in the United Kingdom



Source: ONS, OFCE calculations.

What explains the gap? We interpret this deviation as the effect of the uncertainty arising from Brexit, particularly that on the future trade arrangements between the UK and the EU. Nearly half of Britain's foreign trade comes from or goes to the single market. Although the inclusion of an uncertainty indicator (Economic Policy Uncertainty – EPU, see Bloom et al., 2007) in the investment equation failed to identify it clearly, several studies on data from UK firms point in this direction. First, periods of heightened uncertainty moved in line with significantly lower investment after the 2008 crisis (Smietbanka, Bloom and Mizen, 2018). In a scenario without a referendum (no Brexit), the transition to a regime with renegotiated customs tariffs would have had the effect of:

– Reducing the number of companies entering the European market and increasing the number exiting (Crowley, Exton and Han, 2019);

– Weighing on business investment with the prospect of tariffs similar to those prevailing under WTO rules (Gornicka, 2018).

The reduction in investment "cost" 0.3 percentage points of GDP in 2018, and this cost could rise as second-round effects

are taken into account (which is not the case here). If the uncertainties do not rise, the "Brexeternity" – an expression used to characterize the relationship between the United Kingdom and the European Union, that is to say, inextricable – could have a much more depressing effect on Britain's future growth and its citizens' standard of living.

[1] The WTO composite indicator has stayed below (96.3) its long-term trend (100) since mid-2018.

[2] Reported by the Office of National Statistics (ONS) as Business Investment. Non-financial corporations partially or wholly owned by the government are included in this field, but they account for less than 4% of the total. This measure of investment does not include spending on housing, land, existing buildings or the costs related to the transfer of ownership of non-produced assets.

[3] See the article by Ducoudré, Plane and Villemot (2015) in the *Revue de l'OFCE*, for more information on the strategy adopted.

[4] A slight gap can be seen from 2015, when the law on the referendum was adopted.

[5] In particular the work of Gornicka (2018).

Climate justice and the social-ecological transition

By Éloi Laurent

There is something deeply reassuring about seeing the growing scale of climate markets in numerous countries around the

globe. A section of the youth are becoming aware of the injustice they will suffer as a result of choices over which they do not (yet) have a say. But the recognition of this *inter*-generational inequality is running up against the wall of *intra*-generational inequality: it will not be possible to implement a real ecological transition without dealing with the social question here and now, and in particular the imperative to reduce inequality. In other words, the ecological transition will be social-ecological – or it will not be. This is the case in France, where the national ecological strategy, currently 90% ineffective, needs to be thoroughly overhauled, as proposed in the new *OFCE Policy Brief (no. 52, 21 February 2019).*

This is also true in the United States, where a new generation of red-green politicians is taking part in one of the most decisive political struggles in the country's history against the ecological obscurantism of a President who is a natural disaster in his own right. In a concise text, which is remarkable for its precision, analytical clarity and political lucidity, the Democrat Alexandria Ocasio-Cortez has just proposed a "Green New Deal" to her fellow citizens.

The title may seem ill-chosen: the "New Deal" carried out by Franklin Delano Roosevelt from 1933 was aimed at reviving an economy devastated by the Great Depression. But isn't the American economy flourishing today? If we rely on the economic indicators of the twentieth century (growth rate, finance, profit), there's no doubt. But if we go beyond appearances, we can discern the recession in well-being that has been undermining the country for thirty years and which will only get worse with the ecological crisis (life expectancy is now structurally declining in the United States). Hence the first lever of the ecological transition: to break with growth and count on what really matters to improve people's well-being today and tomorrow.

The second lever: coordinating the approach to social

realities and ecological challenges. The New Green Deal identifies as the root cause of America's malaise "systemic inequalities", both social and ecological. Accordingly, it intends to implement a "fair and equitable transition" that will benefit in priority "frontline and vulnerable communities", which one could call "ecological sentinels" (children, elderly people, the energy insecure). These are people who prefigure our common future if we allow the ecological crisis for which we bear responsibility to deteriorate further. It is this coordination between the social and ecological that lies at the heart of the proposal by several thousand economists to introduce "carbon dividends" (an idea originally proposed by James Boyce, one of the world's leading specialists in the political economy of the environment).

Which brings us to the third lever: to gain citizens' interest instead of terrorizing them. In this respect, the detailed report published by the Data for Progress think tank deploys an extremely effective argumentative sequence: the new ecological deal is necessary to preserve humanity's well-being; it will create jobs, it is desired by the community of citizens, and it will reduce social inequalities; and the country has the financial means to implement it. It's concrete, coherent, convincing.

In 1933, Europe and France were half a century ahead of the United States in terms of the "new deal". It was in Europe and France that the institutions of social justice were invented, developed and defended. It is in the United States that the social-ecological transition is being invented today. We should not wait too long to get hold of it.

On French corporate immaterial investment

By Sarah Guillou

A note on the immaterial singularity of business investment in France from 26 October 2018 highlighted the significant scale of investment in intangible assets by companies in France. In comparison with its partners, who are similar in terms of productive specialization, the French economy invests relatively more in Research and Development, software, databases and other types of intellectual property. Looking at gross fixed capital formation (GFCF) excluding construction, the share of intangible investment reached 53% in 2015, compared to 45% in the United Kingdom, 41% in the United States, 32% in Germany and 29% in Italy and Spain.

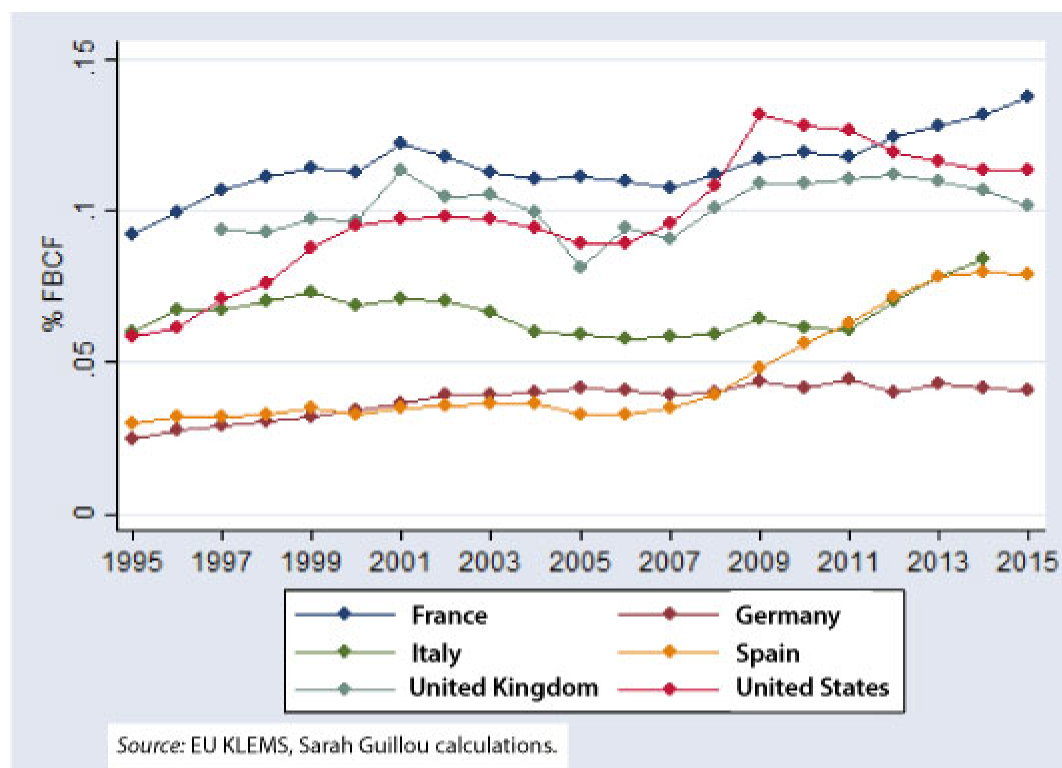
These results are corroborated by statistics that evaluate other dimensions (INTAN basis), outside the national accounts, of intangible investments, such as those in organization, training and marketing. France is not lagging behind its partners in this type of asset either (see Guillou, Lallement and Mini, 2018).

As for the national accounts, these include two main intangible assets: R&D expenditure and expenditure on software and databases. In terms of R&D, French investment performance is consistent with the technological level and structure of its production specialization. If the French economy had a larger manufacturing sector, its spending on R&D would be much larger. What is less coherent is the extent and intensity of investment in software and databases, to such an extent that one cannot help but wonder whether this immaterial dimension of investment is almost unreal.

Figure 1 illustrates that "Software and databases" investment

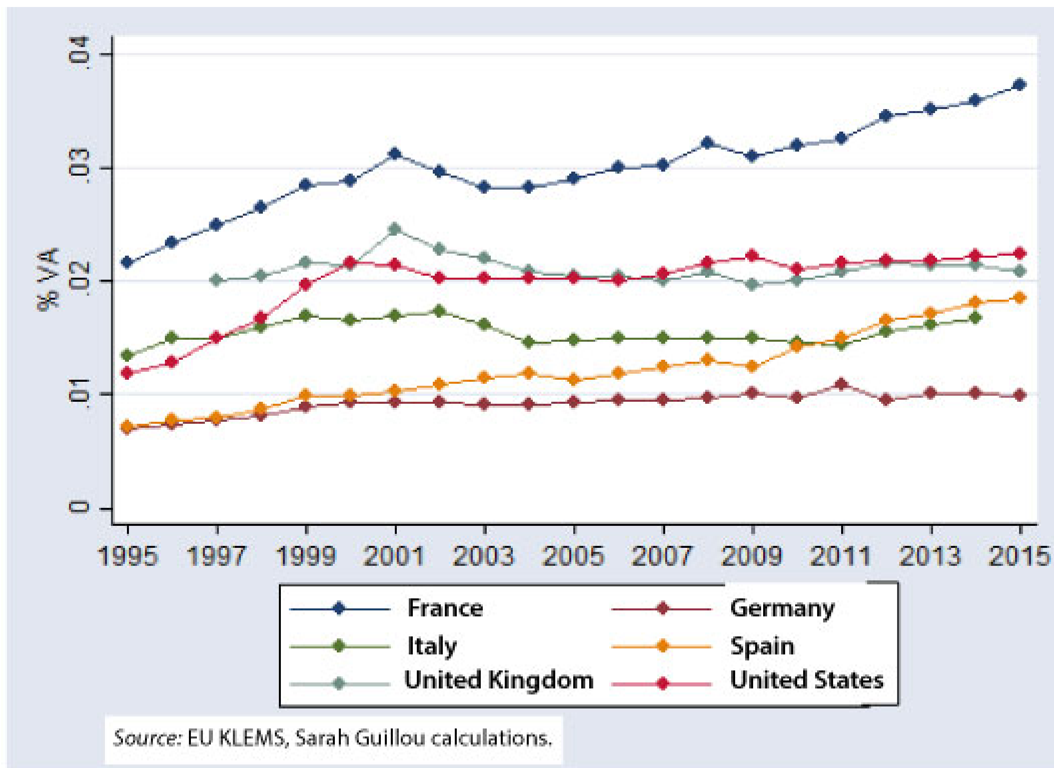
is larger in France than in the rest of the European countries. The share is, however, close to the levels observed in the United Kingdom and the United States. Of course, this share reflects the weakness of other targets for investment such as machinery and equipment specific to the manufacturing sector (see the earlier note on investment).

Figure 1. Share of GFCF in software and databases in total market sector GFCF



In terms of the rate of investment, that is to say, investment expenditure as a ratio of value added of the market economy, the dynamism of the French economy in terms of software and databases is confirmed: France clearly outdistances its partners.

Figure 2. Rate of investment in software and databases in the market sector



This also raises questions because it reveals a gap of 2 percentage points of the VA relative to the United States and 3 points relative to Germany. French companies invested 33 billion euros more in software and database than did German companies in 2015. Note that in 2015 total GFCF excluding construction was 285 billion euros in Germany and 197 billion in France. Moreover, the gap in the investment rate across all types of assets in France was 4 percentage points vis-à-vis Germany (see Guillou, 2018, page 20).

This gap can be explained only under the conditions, 1) that the production function of the French economy uses more software and databases than its partners, or 2) that the GFCF software and databases item is either artificially valued in relation to the current practices of France's partners, which may be the case, or because the value of the software asset is more important in France (companies may choose to put spending on software in current spending), either because the asset value is greater (which is possible because part of this

value, that of software produced in-house, is up to the discretion of the companies).

Understanding this gap is of considerable importance, because it is decisive for making a diagnosis of the state of French corporate investment and the state of its digitization (see Gaglio and Guillou, 2018). The aggregate macroeconomic value of GFCF includes GFCF in software; if this is overestimated, it has implications for the macroeconomic balance and the contribution of GFCF to growth. The measurement of total factor productivity would also be affected, as the overestimation of capital (fuelled by investment) would lead to underestimating residual technical progress. So not only would the investment effort of French companies be overestimated, but the diagnosis of the nature of growth would also be off.

But there are reasons to question how real this gap is. In other words, shouldn't the immateriality of GFCF be viewed as a flaw in reality?

On the one hand, it is not clear that France's productive specialization justifies such overinvestment in software and databases. For example, the comparison with Germany, the United Kingdom, Italy, the United States and Spain shows specialization that is relatively close, with the exception of the manufacturing sector, which has a much greater presence in Germany. The share of the "Information and Communication" sector in which digital services are located correlates well with GFCF in software, but this sector is not significantly more present in France. It represents 6.5% of the value added of the market economy, compared to 6% in Germany and 8% in the United Kingdom (see Guillou, 2018, page 30).

On the other hand, the data from the input-output tables on consumption by branch of goods and services coming from the digital publishing sector (58) – a sector that concentrates the production of software – do not corroborate French

superiority. The following graphs show that, whether considering domestic consumption (Figure 3) or imported (Figure 4), intermediaries’ consumption of digital services in France does not confirm the French domination recorded for GFCF in software and databases. On the contrary, these two graphs show that the French economy’s consumption of inputs from the digital publishing sector is not especially high and even that domestic consumption has fallen.

While the overlap between “software and databases” on the one hand and “digital publishing services” on the other is not perfect, there should not be a contradiction between the trends or the hierarchies between countries – unless software expenditure consists mainly of software produced in-house, in which case it will be recorded as assets rather than as consumption of inputs from other sectors.

Figure 3. Consumption of digital publishing companies of domestic services (per 1000 of value added)

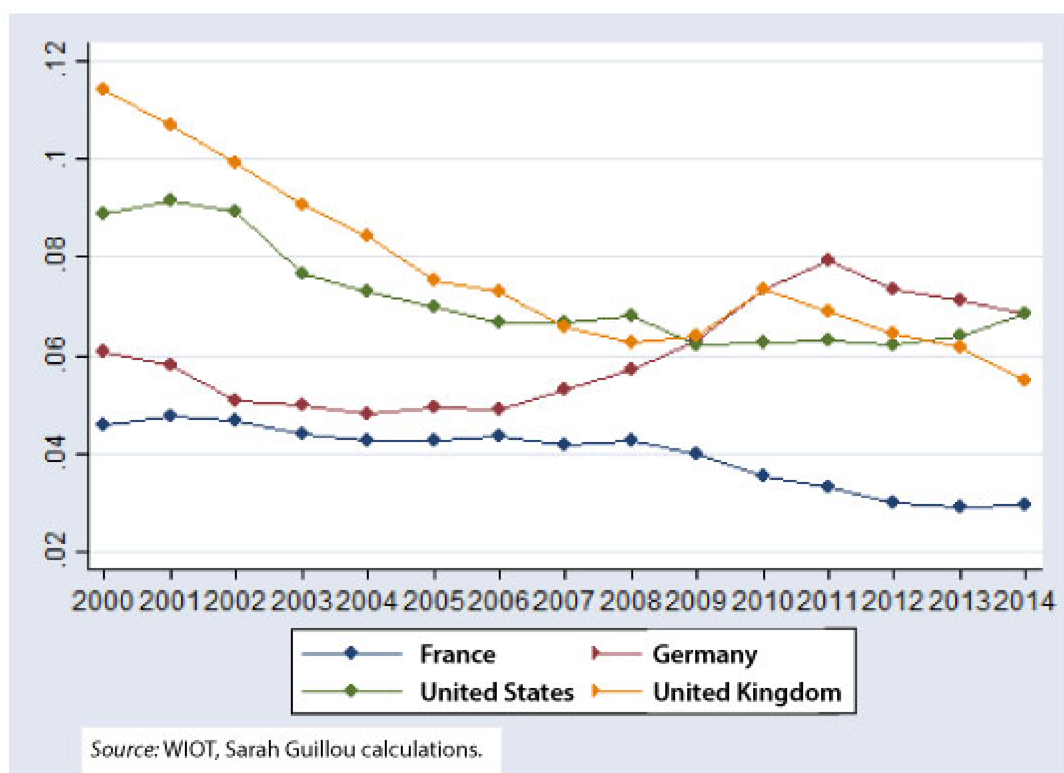
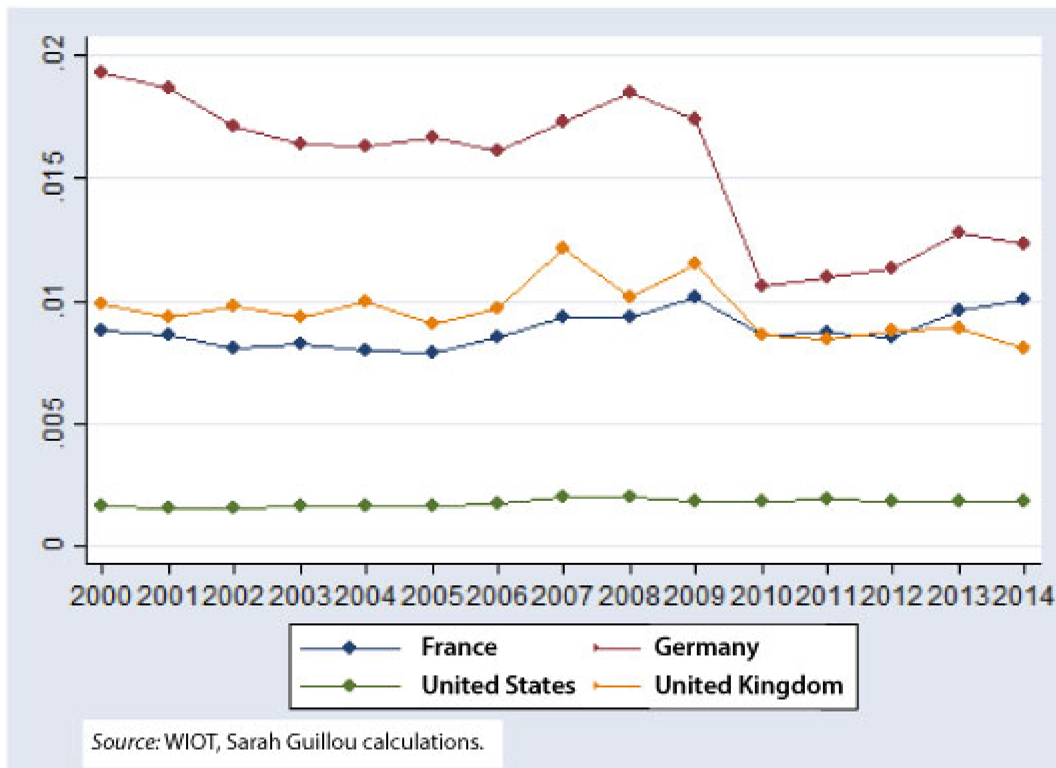


Figure 4. Consumption of digital publishing intermediaries of imported services (per 1000 of value added)



As a result, investment in software and databases would be mainly the result of in-house production, whose capital asset value (recorded as GFCF) is determined by the companies themselves. Should we conclude that GFCF is overvalued? This is a legitimate question. It calls for more specific investigation by investor and consumer sectors in order to assess the extent of overvaluation relative to economies comparable to France.

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German women work less than French women

By Hélène Périvier and Gregory Verdugo

In terms of the employment rate, French women work less than German women: in 2017 the employment rate of women aged 15 to 64 was 67.2% in France against 75.2% in Germany. But this commonly used indicator does not take into account that to arrange their time German women are more likely to be in part-time work than French women. This is because underemployment and labour market regulations differ in the two countries, in particular as Germany has a plentiful supply of part-time mini-jobs that are held by women more than men. Moreover, the differences in terms of policies affecting the family life-work-life balance in the two countries make it possible to deal with early childhood more extensively in France than in Germany and lead German women to take up part-time work.

To compare the employment situation of women in France and Germany, we use indicators that take into account working time, which we calculate by age to illustrate a life cycle perspective [1]. The results confirm that German women are in part-time work more than their French counterparts, and this is particularly marked at the age of maternity. These differences in women's working hours explain why the gender pay gap is higher in Germany than in France.

Employment rate and employment rate in full-time equivalents by age

Comparing employment rates with employment rates in full-time equivalents over the life cycle highlights the significant differences between the two countries in terms of the reduction in women's working hours at the ages when the family constraint is the strongest, between 30 and 40 years old. Figures 1A and 1B show employment rates and full-time equivalent employment rates by age for women in 2010, the moment when European countries were to have reached a female employment rate of 60% according to the Stratégie européenne de l'emploi (EES). Figures 2A and 2B show these same indicators for men.

If we restrict ourselves to employment rates, the models seem similar in the two countries: changes in the employment rates over the life cycle for women are quite similar, as is the case for men (with the exception of the ages of entering and leaving working life, which differ between the two countries for both sexes). In Germany as in France, women's employment rate is high, but the gap with men increases between age 30 and 40 (solid lines).

Once part-time work is taken into account, the gender division of labour turns out to be much more marked in Germany than in France (dashed lines) [2].

At all ages, the full-time equivalent employment rate for women is lower in Germany than in France (whereas for men it is close to the employment rate, for both countries). From the age of 30, the female full-time equivalent employment rate falls below 60% in Germany, while in France it is above 65%. This means that German women are adjusting their working time more as family constraints become stronger. For men, the full-time equivalent employment rates are close to the employment rates at all ages in both countries.

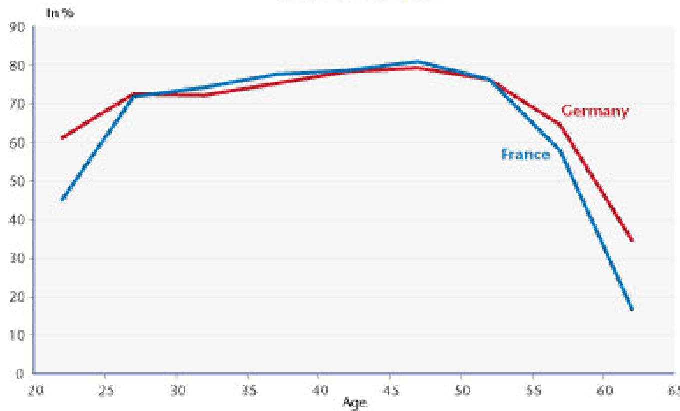

Figure 1a. Women's employment rate by age in Germany and in France, 2010

Lecture: Women's employment rate at age 42 was 78.3% in Germany and 78.7% in France.
Source: Labour force surveys, authors' calculations.

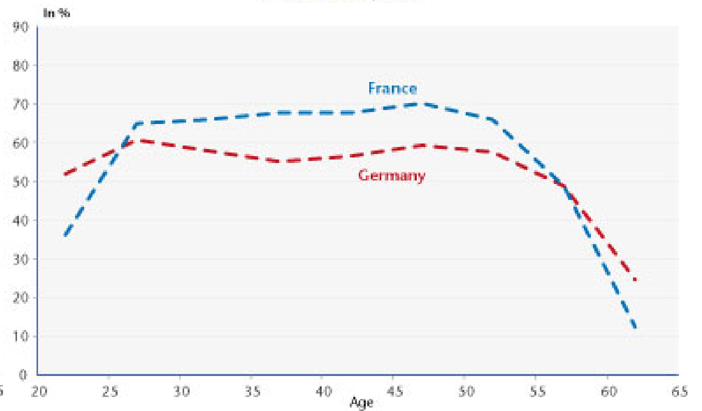

Figure 1b. Women's full-time equivalent employment rate by age in Germany and in France, 2010

Lecture: Women's employment rate at age 42 was 56.6% in Germany and 67.7% in France.
Source: Labour force surveys, authors' calculations.

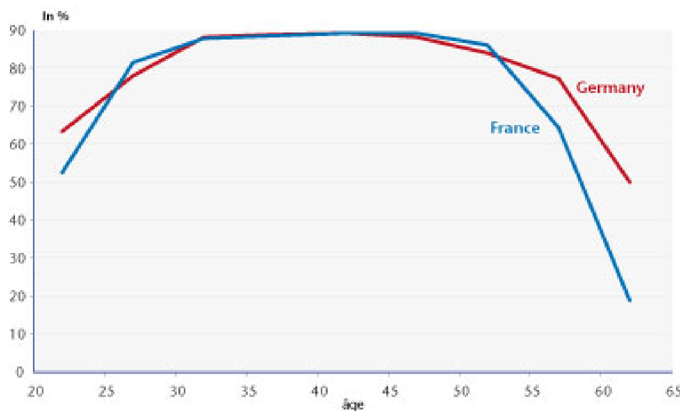

Figure 2a. Men's employment rate by age in Germany and in France, 2010

Lecture: Men's employment rate at age 42 was 89.3% in Germany and 89.3% in France..
Source: Labour force surveys, authors' calculations.

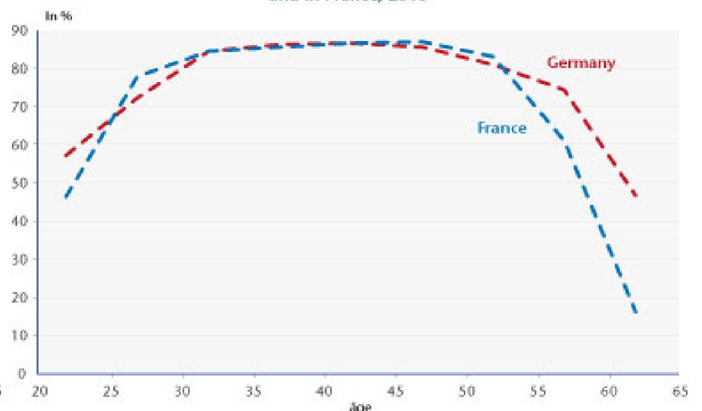

Figure 2b. Men's full-time equivalent employment rate by age in Germany and in France, 2010

Lecture: Men's employment rate at age 42 was 86.6% in Germany and 86.9% in France.
Source: Labour force surveys, authors' calculations.

The overall wage gap: the impact of working time

The massive use of part-time work by women in Germany compared to France explains a large part of the wage differentials, which are higher there. The global wage gap indicator calculated by Eurostat [3] shows that the overall wage gap is very high in Germany (45% compared to 31% in France), and that this is due mainly to differences in working time. On average German women work 122 hours a month against 144 for French women, with the average hourly wage rate being comparable (Table).

Table. Overall wage gap in 2014 in France and in Germany

	Average wage level		Average numberof paid hours per month		Employment rate in % (age 15-64)		Overall wage gap
	Men	Women	Men	Women	Men	Women	
France	18.8	15.9	154.0	140.0	67.3	60.4	31%
Germany	19.9	15.4	154.0	122.0	78.1	69.5	45%

Source : Eurostat, Structures of earnings survey (earn_ses_hourly) (earn_ses_monthly) (lfsa_ergaed) (tegges01).

Thus policies aimed at occupational equality cannot leave aside the issue of working time and the quality of the jobs held by women. It seems that from this point of view France is doing better than Germany, although much remains to be done in this area.

[1] This blog is taken from: « La stratégie de l'Union européenne pour promouvoir l'égalité professionnelle est-elle efficace ? », [Is the European Union's strategy for promoting occupational equality effective?], Périvier H. and G. Verdugo, *Revue de l'OFCE*, no. 158, 2018.

[2] Full-time equivalent employment rates were calculated from the European Labour Force Surveys. Each job is weighted by the number of hours worked. A full-time job is defined as a job where the number of hours worked is greater than or equal to 35. If the number of hours worked is between 25 and 34, we assign a weight of 75% of a full-time job, a weight of 50% if the number of hours is between 15 and 24, and a weight of 25% if the number of hours is less than 14 hours.

[3] The gap calculated by Eurostat corresponds to the average wage differential for the entire population.

The euro is 20 – time to grow up

By Jérôme Creel and Francesco Saraceno [1]

At age twenty, the euro has gone through a difficult adolescence. The success of the euro has not been aided by a series of problems: growing divergences; austerity policies with their real costs; the refusal in the centre to adopt expansionary policies to accompany austerity in the periphery countries, which would have minimized austerity's negative impact, while supporting activity in the euro zone as a whole; and finally, the belated recognition of the need for intervention through a quantitative easing monetary policy that was adopted much later in Europe than in other major countries; and a fiscal stimulus, the Juncker plan, that was too little, too late.

Furthermore, the problems facing the euro zone go beyond managing the crisis. The euro zone has been growing more slowly than the United States since at least 1992, the year the Maastricht Treaty was adopted. This is due in particular to the inertia of economic policy, which has its roots in the euro's institutional framework: a very limited and restrictive mandate for the European Central Bank, along with fiscal rules in the Stability and Growth Pact, and then in the 2012 Fiscal Compact, which leave insufficient room for stimulus policies. In fact, Europe's institutions and the policies adopted before and during the crisis are loaded down with the consensus that emerged in the late 1980s in macroeconomics which, under the assumption of efficient markets, advocated a "by the rules" economic policy that had a necessarily limited role. The management of the crisis, with its fiscal stimulus packages and increased central bank activism, posed a real challenge to this consensus, to such an extent that the economists who were supporting it are now questioning the direction that the

discipline should take. Unfortunately, this questioning has only marginally and belatedly affected Europe's decision-makers.

On the contrary, we continue to hear a discourse that is meant to be reassuring, i.e. while it is true that, following the combination of austerity policies and structural reforms, some countries, such as Greece and Italy, have not even regained their pre-2008 level of GDP, this bitter potion was needed to ensure that they emerge from the crisis more competitive. This discourse is not convincing. Recent literature shows that deep recessions have a negative impact on potential income, with the conclusion that austerity in a period of crisis can have long-term negative effects. A glance at the World Economic Forum competitiveness index, as imperfect as it is, nevertheless shows that none of the countries that enacted austerity and reforms during the crisis saw its ranking improve. The conditional austerity imposed on the countries of the periphery was doubly harmful, in both the long and short terms.

In sum, a look at the policies carried out in the euro zone leads to an irrevocable judgment on the euro and on European integration. Has the time come to concede that the Exiters and populists are right? Should we prepare to manage European disintegration so as to minimize the damage?

There are several reasons why we don't accept this. First, we do not have a counterfactual analysis. While it is true that the policies implemented during the crisis have been calamitous, how certain can we be that Greece or Italy would have done better outside the euro zone? And can we say unhesitatingly that these countries would not have pursued free market policies anyway? Are we sure, in short, that Europe's leaders would have all adopted pragmatic economic policies if the euro had not existed? Second, as the result of two years of Brexit negotiations shows, the process of disintegration is anything but a stroll in the park. A

country’s departure from the euro zone would not be merely a Brexit, with the attendant uncertainties about commercial, financial and fiscal relations between a 27 member zone and a departing country, but rather a major shock to all the European Union members. It is difficult to imagine the exit of one or two euro zone countries without the complete breakup of the zone; we would then witness an intra-European trade war and a race for a competitive devaluation that would leave every country a loser, to the benefit of the rest of the world. The costs of this kind of economic disorganization and the multiplication of uncoordinated policies would also hamper the development of a socially and environmentally sustainable European policy, as the European Union is the only level commensurate with a credible and ambitious policy in this domain.

To say that abandoning the euro would be complicated and/or costly, is not, however, a solid argument in its favour. There is a stronger argument, one based on the rejection of the equation “euro = neoliberal policies”. Admittedly, the policies pursued so far all fall within a neoliberal doctrinal framework. And the institutions for the European Union’s economic governance are also of course designed to be consistent with this doctrinal framework. But the past does not constrain the present, nor the future. Even within the current institutional framework, different policies are possible, as shown by the (belated) activism of the ECB, as well as the exploitation of the flexibility of the Stability and Growth Pact. Moreover, institutions are not immutable. In 2012, six months sufficed to introduce a new fiscal treaty. It headed in the wrong direction, but its approval is proof that reform is possible. We have worked, and we are not alone, on two possible paths for reform, a dual mandate for the ECB, and a golden rule for public finances. But other possibilities could be mentioned, such as a European unemployment insurance, a European budget for managing the business cycle, or modification of the European fiscal rules. On this last point,

the proposals are proliferating, including for a rule on expenditures by fourteen Franco-German economists, or the replacement of the 3% rule by a coordination mechanism between the euro zone members. Reasonable proposals are not lacking. What is lacking is the political will to implement them, as is shown by the slowness and low ambitions (especially about the euro zone budget) of the decisions taken at the euro zone summit on 14 December 2018.

The various reforms that we have just mentioned, and there are others, indicate that a change of course is possible. While some policymakers in Europe have shown stubborn persistence, almost tantamount to bad faith, we remain convinced that neither European integration nor the euro is inevitably linked to the policies pursued so far.

[1] This post is an updated and revised version of the article "Le maintien de l'euro n'est pas synonyme de politiques néolibérales" [Maintaining the euro is not synonymous with neoliberal policy], which appeared in *Le Monde* on 8 April 2017.

Brexit: the November 25th agreement

By Catherine Mathieu and Henri Sterdyniak

The United Kingdom will leave the European Union on 29 March 2019 at midnight, two years after the UK government officially

announced its wish to leave the EU. Negotiations with the EU-27 officially started in April 2017.

On 8 December 2017, the negotiators for the European Commission and the British government signed a joint report on the three points of the withdrawal agreement that the Commission considered to be a priority[1]: the rights of citizens, a financial settlement for the separation, and the absence of a border between Ireland and Northern Ireland. The European Council meeting of 14-15 December had accepted the British request for a transitional period, with the end set for 31 December 2020 (so as to coincide with the end of the programming of the current European budget). Thus, from March 2019 to the end of 2020, the United Kingdom will have to respect all the obligations of the single market (including the four freedoms and the competence of the European Court of Justice – CJEU), while no longer having a voice in Brussels. This agreement opened the second phase of negotiations.

These negotiations culminated on 14 November 2018 in a withdrawal agreement[2] (nearly 600 pages) and a political declaration on future relations between the EU-27 and the United Kingdom, which was finalized on 22 November 22 [3] (36 pages). The two texts were approved on 25 November at a special meeting of the European Council [4] (all 27 attending), which adopted three declarations on that occasion[5]. The withdrawal agreement and the political declaration must now be subject to the agreement of the European Parliament, which should not be a problem and, what is much more difficult, the British Parliament.

The withdrawal agreement corresponds to Article 50 of the Treaty on the Functioning of the European Union (TFEU). It is a precise international agreement, which has legal value; it must be enforced by the UK courts, under the authority of the CJEU as far as EU laws are concerned. It takes up the points already settled by the negotiations in December 2017: the

rights of British citizens in EU countries and the rights of EU citizens in the UK; and the financial settlement. It has three protocols concerning Ireland, Cyprus and Gibraltar. Any disagreements on the interpretation of the agreement will be managed by a joint committee and, if necessary, by an arbitration tribunal. The latter will have to consult the CJEU if this involves a question that one of the parties considers to be relevant to EU law. In July 2020, a decision could be reached to extend the transition period beyond 31 December 2020: this would require a financial contribution from the UK.

A safeguard clause will be applied to avoid the re-establishment of a physical border between Northern Ireland and the Republic of Ireland (the “backstop”): the United Kingdom will remain a member of the Customs Union if no other agreement has been concluded before the end of the transition period, and for an indefinite period, until such an agreement is reached. This agreement must be approved by the joint committee. The Customs Union will cover all goods except fisheries (and aquaculture) products. The United Kingdom will not have the right to apply a trade policy that differs from that of the Union. British products will enter the single market freely, but the UK will align with EU rules on state aid, competition, labour law, social protection, the environment, climate change and taxation. In addition, Northern Ireland will continue to align with single market rules on VAT, excise duties, health rules, etc. Controls could be put in place on products entering Northern Ireland from the rest of the United Kingdom (in particular for agricultural products), but these controls would be carried out by the UK authorities.

Thus, trapped by the issue of the Irish border, the United Kingdom must forgo for an indefinite period any independent trade policy. It will have to align itself with European regulations in many areas, subject to the threat of recourse to the CJEU.

The 22 November Joint Political Declaration outlines the possible future relations between the UK and the EU-27. On the one hand, it clearly corresponds to the goal of the close, specific and balanced relationship that the British have demanded. On the other hand, the UK is making a number of commitments that rule out any possible strategy of being a "tax and regulatory haven".

Article 2, for instance, states that the two parties intend to maintain high standards for the protection of worker and consumer rights and the environment. Article 4 affirms respect for the integrity of the single market and the four freedoms for the EU-27, and for the United Kingdom the right to conduct an independent trade policy and to put an end to the free movement of persons.

In general, the Declaration states that both parties will seek to cooperate, to discuss, and to take concerted action; that the United Kingdom will be able to participate in Union programmes in the fields of culture, education, science, innovation, space, defense, etc., under conditions to be negotiated.

Article 17 announces the establishment of an ambitious, wide-ranging, comprehensive and balanced free trade agreement. Articles 20 to 28 proclaim the desire to create a free trade area for goods, through in-depth cooperation on customs and regulatory matters and provisions that will put all participants on an equal footing for open and fair competition. Customs duties (as well as border checks on rules on origin) will be avoided. The United Kingdom will strive to align with European rules in the relevant areas[6]. This kind of cooperation on technical and health standards will allow British products to enter the single market freely. In this context, the Declaration recalls the intention of the EU-27 and the UK to replace the Irish backstop with another device that ensures the integrity of the single market and the absence of a physical border in Ireland.

In terms of services and investment, the two parties are considering broad and ambitious trade liberalization agreements. Regulatory autonomy will be maintained, but this must be “transparent, efficient, compatible to the extent possible”. Cooperation and mutual recognition agreements will be signed on services, in particular telecommunications, transport, business services and internet commerce. The free movement of capital and payments will be guaranteed. In financial matters, equivalence agreements will be negotiated; cooperation will be established in the domain of regulation and supervision. Intellectual property rights will be protected, in particular as regards protected geographical indications. Agreements will be signed on air, sea, and land transport and on energy and public procurement. The parties pledge to cooperate in the fight against climate change and on sustainable development, financial stability, and the fight against trade protectionism. Travel for tourism or scientific, educational or business motives will not be affected. An agreement on fisheries must be signed before 1 July 2020.

Provisions will have to cover state aid and standards on competition, labour law, social protection, the environment, climate change and taxation in order to ensure open and fair competition on a level playing field.

The text provides for coordination bodies at the technical, ministerial and parliamentary levels. Every six months, a high-level conference will review the agreement.

Negotiations will continue on trade so as to ensure compatibility between the integrity of the single market and the Customs Union and the UK’s development of an independent trade policy.

On the one hand, the text provides for a close and special partnership, as requested by the United Kingdom; on the other hand, the UK pays for this by its commitment to respect European rules; finally, problematic issues still need to be

negotiated, including fishing rights, an independent British trade policy, and avoiding the Irish backstop. On 25 November, the European Council wanted to adopt two declarations. The first emphasizes the importance of reaching an agreement on fisheries before the end of the transitional period and making it possible to maintain the access of EU-27 fishermen to British maritime waters. It also links the extension of the transitional period to compliance by the United Kingdom with its obligations under the Irish protocol. It recalls the conditions that the EU-27 had set on 20 March 2018 for an agreement: "The divergence in external tariffs and internal rules, as well as the absence of common institutions and a common legal system, require checks and balances and controls to safeguard the integrity of the EU single market and the UK market. Unfortunately, this will have negative economic consequences, particularly in the United Kingdom … A free trade agreement cannot offer the same advantages as the status of a Member State." The second Declaration states that Gibraltar will not be included in the future trade agreement negotiated between the UK and the EU-27; a separate agreement will be necessary and subject to Spain's prior approval. These declarations will not make it easy for Theresa May to win the approval of the UK Parliament.

It is necessary to highlight two points that were barely mentioned in the negotiations. This privileged partnership could serve as a model for relations with other countries. The EU has signed many customs union agreements with its neighbors, the countries of the European Economic Area (Norway, Iceland, Lichtenstein), as well as Switzerland, Ukraine, Georgia and Moldova. Five countries are candidates for entry (Albania, Montenegro, Serbia, Kosovo and Northern Macedonia). Perhaps these partnerships could be formalized in a third circle around the EU?

Does not the commitment to fair competition impose some level of tax harmonization in the EU-27, particularly with respect

to the rates and terms of corporation tax? Was the EU-27 right to support the Irish Republic without some quid pro quo? It is unclear how the EU-27 could accuse the UK of practicing unfair competition when it tolerates the practices of Ireland, the Netherlands and Luxembourg. Likewise, the insistence on arrangements that prevent the UK from engaging in unfair tax and social competition contrasts with the EU's laxity both in its relations with third countries and in the control of the internal devaluation policies of certain member countries (e.g. Germany).

On balance, the United Kingdom gets to regain its national sovereignty, to cease being subject to the CJEU, and to no longer need to respect the freedom of establishment of workers from EU countries. In return, it will have no voice in Brussels.

The business community has welcomed the proposal as it avoids the risks of No Deal and announces a free trade agreement between the UK and the EU that would impose few restrictions on trade.

To date, there is no certainty that the UK parliament will approve the deal proposed by Theresa May and the EU-27 negotiators. Theresa May must find a majority for a compromise deal. She will encounter opposition from Conservative hard Brexiteers who are prepared to leave without an agreement so that the United Kingdom can "regain control", engage in trade negotiations with third countries, get out from under European regulations, and begin a policy of deregulation that would make the UK a tax and regulatory haven. But the UK is already one of the countries where the regulation of the goods and labor markets is the most flexible. A sharp cut in taxes would imply further cuts in social spending, contrary to the promises of the Conservative Party. And leaving with no deal would erect barriers to the UK's access to the single market for its products and services. Theresa May will clash with the Irish Unionist Party (DUP), which is opposed to any

differences in the treatment of Northern Ireland, as well as with Scottish nationalists, who want Scotland to remain in the EU. She will also have to confront the Remainers (Conservatives, Labour and Liberal Democrats) who, buoyed by some recent polls, are calling for a new referendum. While Jeremy Corbyn is not calling into question the result of the referendum, many Labour MPs could vote against the text, even if they are supporters of a soft Brexit, as the Treaty organizes. They hope to provoke early elections that could allow them to return to power. They claim they will resume negotiations after that, making every effort to obtain a better deal for the United Kingdom, which would allow it to enjoy "the same advantages as at present as members of the Customs Union and the Single Market" and to control migration. But the EU-27 has clearly refused any resumption of negotiations, and some Labour forces want a new referendum … Theresa May's hope is that fear of a No deal will be strong enough to win approval for her compromise.

If, initially, Brexit seemed to weaken the EU, by showing that it was possible for a country leave, the EU has demonstrated its unity in the negotiations. It became clear quickly that leaving the EU was painful and expensive. The EU is a cage, more or less gilded, which it is difficult, if not impossible, to escape.

[1] See: *Joint report from the negotiators of the EU and the UK government on progress during phase 1 of negotiations under Article 50 on the UK's orderly withdrawal from the EU*, 8 December 2017. See Catherine Mathieu and Henri Sterdyniak, "Brexit: Pulling off a success", *OFCE blog*, 6 December 2017.

[2] https://ec.europa.eu/commission/sites/beta-political/files/draft_withdrawal_agreement_0.pdf

[3]
https://www.consilium.europa.eu/media/37059/20181121-cover-political-declaration.pdf

[4]
https://www.consilium.europa.eu/media/37114/25-special-euco-final-conclusions-fr.pdf et

[5]
https://www.consilium.europa.eu/media/37137/25-special-euco-statement-fr.pdf

[6] The vagueness is in the text: "The United Kingdom will consider aligning with Union rules in relevant areas".

Non-performing loans – A danger for the Banking Union?

By Céline Antonin, Sandrine Levasseur and Vincent Touzé

The establishment of the third pillar of the Banking Union, namely the creation of a European deposit insurance scheme, has been blocked up to now. Some countries – like Germany and the Netherlands – are arguing that the risk of bank default is still too heterogeneous in the euro zone to allow deposit guarantees to be pooled.

Our article, **L'Union bancaire face au défi des prêts non 'performants'** ["The Challenge of Non-performing Loans for the Banking Union"], focuses on how to solve the "problem" of non-performing loans (NPLs) in a way that can break this deadlock and finally complete the Banking Union. This is a crucial step

in order to restore confidence and allow the emergence of an integrated banking market.

Our review of the current situation shows that:

1. The level of NPLs is still worrying in some countries. The situation is alarming in Cyprus and Greece, where unprovisioned NPLs represent more than 20% of GDP, whereas the situation is “merely” worrying for Slovenia, Ireland, Italy and Portugal, where unprovisioned NPLs are between 5% and 8% of GDP;
2. In total, at end 2017, the amount of unprovisioned NPLs for the euro area came to 395 billion euros, which is equivalent to 3.5% of euro area GDP. On this scale, the “problem” of non-provisioned NPLs thus seems more modest.

Looking beyond private solutions such as debt forgiveness, provisioning, securitization and the creation of bad banks, our conclusion is that it is the public authorities at the European level who ultimately have the most effective means of action. They have multiple levers at their disposal, including the definition of the relevant regulatory and institutional framework; supervision by the ECB, which could be extended to more banks; and not least monetary and fiscal policies at the euro zone level, which could be mobilized to buy up doubtful debt or enter the capital of banks experiencing financial distress.