REBUILDING EUROPE'S COMMON FUTURE

COMBINING GROWTH AND REFORM IN THE EURO AREA

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INTRODUCTION

ADAM S. POSEN AND ÁNGEL UBIDE

Europe can grow and reform at the same time. In fact, it must now do both at once. The ongoing decline in inflation and income growth in the euro area and the resulting rise in public debt are the consequence of two deliberate policy choices: to hold back macroeconomic stabilization in pursuit of a narrow vision of structural reform and to treat risks to financial stability in Northern Europe as more important than risks to social stability in Southern Europe. This approach has been self-defeating. There has been too little progress on structural reform and fiscal consolidation to show for all the damage inflicted on human and physical capital as well as on European solidarity. The misguided and monomaniacal focus in the crisis response on internal devaluation—reducing labor costs aggressively to improve international competitiveness—instead of productivity-enhancing reforms is making long-term prospects worse. In short, the policy mix pursued since the Greek crisis began in early 2010 has failed as predicted in the manner that many (including scholars at the Peterson Institute for International Economics) predicted.[1]

Instead, the euro area has entered true secular stagnation, where persistently low expectations keep investment near zero, thereby foreclosing the future. The subsiding of the acute financial fragility of two years ago therefore does not constitute the end of substantial risk to the euro area's economic or political future. In recent weeks, the European Council, the European Central Bank (ECB), and the new European Commission have awakened to the necessity for change.[2] A shift to increased public investment from all-out austerity, as just proposed by European Commission President Jean-Claude Juncker, encouraged by the G-20, and a commitment to keep inflation positive, as enunciated by the ECB, are welcome, but those plans are insufficient in size, scope, and coordination to stop Europe's downward slide.

In this *Briefing*, six European-focused economists from the Peterson Institute propose a better way to pursue sustainable growth and reform simultaneously in Europe:[3]

- European leaders should acknowledge that many structural reforms, and labor reforms in particular, tend to be contractionary or even deflationary while being implemented

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1. Blanchard and Cottarelli (2010), Blanchard and Leigh (2013), Posen (2011), among others, predicted the failures.
2. See Juncker (2014) and Draghi (2014) for the latest proposals by the European Commission and ECB, respectively.
3. Each author is individually responsible for the views expressed in their own contribution to this *Briefing* and has not necessarily signed on to all or any of the others. That is at least as true for this introductory essay as any other. Nevertheless, all contributors agree on the urgency for new policies, the need to combine greater stimulus with better targeted reform, and the fact that greater integration of the euro area is the way forward economically and politically.

and therefore should coordinate expansionary macroeconomic policy with reforms; reforms also should be better targeted to increase productivity, not just reduce labor costs.

- The ECB should pursue quantitative easing via sovereign debt purchases until the inflation forecast credibly and sustainably averages a newly announced symmetric target of 2 percent (that means the scale of the purchase program should be determined by progress towards the inflation target, not limited ex ante).
- The Council should respect the new Fiscal Compact, including normal limits for budget deficits to 3 percent of GDP, but that respect should also require fiscal expansion from those members with space and those facing a "severe downturn," as defined by a clause in the compact. Fiscal policy can be disciplined while still being conducive to growth if accompanied by public spending reviews and expanding infrastructure maintenance.
- Further labor market reforms should concentrate on reducing duality in labor markets that protects insiders (full-time, permanent workers) and hurts part-time, temporary workers, mostly the youth, and on decentralizing wage bargaining to the firm level.
- The progress made in unifying banking supervision in the euro area should be followed immediately with creation of a capital markets union, deepening the availability of nonbank financing vehicles like securitization.

Knitting these necessary proposed measures together is a commitment to unify economic policy in the euro area, which European leaders must take up. Rather than bemoaning that monetary and political union is incomplete, and stating that each economy must pay for the past before further integration can occur, economic policies should advance an integrated European recovery. Only by so doing can all members recover from, and pay for, past mistakes. Rather than insisting that Northern creditor governments should have a *de facto* veto over economic policy and dictate to other members, European institutions should act in line with the existing *de jure* policymaking process and allow majority or qualified majority rule. So doing will lend democratic legitimacy to economic reform. Policymakers should heed the evidence from present developments and past experience and not insist that cutting some countries' wages and public budgets is the only way to sustainable growth. To grow in the long term, Europe needs structural reform that further integrates its economy, including capital, product, and labor markets, which requires more macroeconomic solidarity and even taxes and transfers.

ECONOMIC POLICY MUST RESPOND TO SOUTHERN PAIN AS MUCH AS TO NORTHERN PRUDENCE

True, the acute stage of the euro area crisis, in which doubts about the solvency of banks and liquidity of sovereigns led to spiraling interest rate spreads amid concerns about default, is over for now. The fears about imminent euro breakup or sovereign debt defaults, which required urgent weekend decisions, have vanished. But euro area stagnation has become chronic in perception and reality. Politicians and policymakers, who no longer see imminent disaster and have largely returned to business as usual, are still putting the European project at risk.

So doing ignores the frustrations of many Southern, younger European citizens, who are losing hope. Political elites in Europe express only limited concern for the protests seen so far, so long as the conditions do not disrupt the ability of Southern governments to pay down their debts. Yet, the surge of anti-establishment, anti-immigrant, and euro-skeptic movements in the recent European parliamentary elections, the advance of far right parties in France and other countries, and the push for independence in Cataluña and elsewhere reflect deep dissatisfaction with the euro area's disappointing crisis response and bleak economic future. That the relatively well-off or insulated countries like France and the United Kingdom are becoming increasingly radicalized should be a cause for concern. If that is how those who are not truly economically desperate feel, then what resentments are building up in countries where protests are muted by seeming necessity?

Europe today is well-designed to prevent a recurrence of the 1930s political breakdown in response to high unemployment, European states today provide welfare benefits to the poor and unemployed (except, notably, Greece postcrisis), European constitutions are designed to prevent splinter parties from paralyzing parliaments, and feelings for the EU ideals of democracy and peace are widely held. The current European stagnation has taken hold after decades of growth, not of war, especially in periphery economies, which have benefitted from catch up growth as EU members. So, of course, no one should have expected immediate violent breakdown of the euro area when the financial crisis was at its height. No one, however, should dismiss the ongoing erosion of faith in unresponsive elected officials and the seemingly unfair system either. That loss of faith can be credibly traced to high-handed economic policies imposed by senior officials on countries not their own—policies that are making the situation palpably worse rather than better.

THE STAGNATION WILL WORSEN ABSENT ACTION

The current chronic stage in Europe's crisis requires decisions more ambitious and politically controversial than those adopted under the immediate pressures in 2009–12. In essence, European leaders must reverse their major policy errors, while making decisions more European in scope and intent. Until now, European policy response to their financial crisis has been premised on faulty economic ideas. European leaders have incorrectly assumed that the collapse of private sector overinvestment was a public debt crisis, and then they made it become one. They have treated moral hazard by Southern borrowers as deadly, while sparing irresponsible Northern lenders from the costs of their perfidy. They have ignored the realities of fiscal policy, producing simultaneous austerity in a trade bloc where reduced growth has predictably left debt to GDP ratios largely undiminished or even rising. They have accepted that deficit countries and small borrowers must undertake all adjustment of current account imbalances, limiting the compensation and stimulus provided by surplus countries and reducing the losses of their larger banks. Probably worst of all, they have insisted that structural reforms be pursued only under pressure from contractionary policy and therefore politicized and inhibited monetary policy in the euro area.

As many predicted, every one of these policies has been largely self-defeating. Both reform and debt reduction have made little progress. Stagnation has become entrenched seven years after the downturn started. This economic agenda is essentially the one that the victorious Allies destructively imposed on Germany following World War I and that John Maynard Keynes famously critiqued in *The Economic Consequences of the Peace*. Now German economic leaders and their political allies are imposing the misguided Versailles Treaty in economic terms on their indebted euro area partners.[4] The reality now, as then, is that debtors cannot pay off huge loans in hard currency if the burden of those payments and the mercantilism of the lenders prevent the debtors from growing. Continuing on this path could take Europe from secular stagnation into debt restructuring and default, because the high level of euro area debt is not sustainable with weak nominal GDP growth. Also, maintaining this situation leaves Europe horribly vulnerable to future external macroeconomic shocks.[5] Policymakers have the responsibility to strengthen the euro area so that it can survive the next economic downturn and so that all members can share in any future upturn that comes.

4. See Eichengreen (2015), Posen (2014), and Ubide (2014), among others.

5. A potential vulnerability identified prior to the current crisis in the ECB's bias against stabilization policy and the euro area's absence of fiscal transfers in Posen (2005) and Pisani-Ferry and Posen (2009)—and presciently in Kenen (1969).

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Harvard economist Alvin Hansen first introduced the concept of secular stagnation in the 1930s to describe a situation of persistently insufficient demand. Former US Treasury Secretary Lawrence H. Summers (2013) has influentially revived and applied the concept to our present problems, and it describes the current euro area situation particularly well. In secular stagnation, the economy cannot reach full employment and production at potential largely because people become risk averse and aggressively save and reduce investment. This state becomes self-reinforcing, rather than self-correcting, generating prolonged weak growth, high unemployment, and low inflation absent credible lasting stimulus. In normal times, monetary policymakers could restore investment by reducing interest rates below the inflation rate (i.e., achieving negative real interest rates).[6] But the problem now is that nominal interest rates are zero, and inflation is excessively low, making it increasingly difficult to generate sufficiently negative real interest rates. In addition, in the euro area, regulatory pressures, an overhang of debt, and fragmentation of financial markets further dampen investment that central banks encourage. Larger and sustained monetary stimulus and fiscal stimulus are therefore required to get out of this trap.

There is a case to be made that secular stagnation has taken hold to some degree in the United States, the United Kingdom, and the developed world in general, not just in the euro area. (Indeed Summers [2013] starts his argument describing this situation in the United States.) But Europe has made that situation worse for itself: Labor market reforms have reduced real wages, while governments have tightened budgets in tandem over several years to comply with the needlessly strict application of European fiscal rules. Credit restrictions, and the lack of clarity about the euro area's priorities, have further diminished investment demand. And real interest rates have remained too high as a result of too low inflation and timid monetary policy. Credit supply has been allowed to remain overly tight in some euro area countries in a way unseen in the United States and elsewhere. Again, these policy choices were based on false analyses and privilege Northern creditors over the euro area as a whole.

More important, in this environment, the combination of internal devaluation and fiscal adjustment were supposed to be the key to restoring investor confidence and thus sustainable growth. Euro area economic policymakers have concentrated on shifting private bank losses onto public balance sheets, supplying liquidity to creditors and major banks, and imposing fiscal austerity. Instead, this program has demonstrably weakened growth and pushed the euro area toward deflation, while eroding human and physical capital. Yet, if growth is slowing down secularly in the United States, China, and elsewhere, it is all the more important that reforms be carried out to raise productivity and domestic investment rather than lower wages to chase after a smaller export market through wage compression. In fact, reforms that raise domestic productivity, supported by accommodative policies, could bring about several years of strong growth for Europe as reforms take hold, irrespective of the secular slowdown.

Thus, the main message of this *Briefing* is that monetary and fiscal policies must work together with productivity-enhancing structural reforms (such as decentralizing wage bargaining and deepening the single market in services like finance, energy, and digital trade). A simultaneous push by both is required to shift the euro area toward a path of higher potential growth and stable prices. Absent such combined efforts, inadequate macroeconomic policies and mistargeted so-called reforms will dig a deeper hole on debt, weaken labor productivity, and threaten political stability. The package of policies recommended here is well within the mainstream of macroeconomic practice and has demonstrated merits. This policy package would replace the politically dominant narrative in Berlin and Brussels of fiscal austerity, internal devaluation, and moral hazard, which has led to the current stagnation.

6. The real interest rate is the nominal interest rate minus the inflation rate and is the key determinant for saving and investment decisions. To achieve a negative real interest rate, nominal interest rates have to be below the rate of inflation. If inflation declines, real interest rates increase, all else being equal.

A FIVE-PART ACTION PLAN FOR THE EURO AREA

Ajai Chopra argues that demand and supply policies should be complements, not substitutes. He points out that the current euro area policy mix—tight fiscal policy, insufficiently loose monetary policy, and reforms targeted mostly towards fostering internal devaluation driving down wages—was based on the misguided assumption that the entire growth slowdown was structural and the decline in inflation transitory. Chopra argues that the near-term impact of labor market reforms is typically contractionary, and therefore aggressive reforms at a time of depressed demand can backfire. He provides numerous examples of this perverse effect, as well as pointing to the evident failure of reforms in the euro area. Furthermore, he makes the case based on global experience that stimulating demand will make structural reforms more successful by offsetting their deflationary impact. He calls for more stimulative monetary and fiscal policies and structural reforms that boost productivity rather than lower wages and prices.[7]

Turning to monetary policy, Ángel Ubide argues that the risk of deflation in the euro area will increase dangerously without decisive action by the ECB. (It is already estimated by the International Monetary Fund in its recent *World Economic Outlook* to be around 30 percent [IMF 2014].) Deflation not only is harmful on its own terms but also is a strong signal that expectations of future growth are low and that there is room to expand policy. Strong political pressure, mostly from the Bundesbank and German politicians, is preventing the ECB from adopting the normal aggressive monetary policy to counteract deflation risks. Instead, the ECB has focused too much on supplying liquidity to banks, hoping for credit to grow, and not enough on directly addressing a dangerous decline in inflation expectations, Ubide says. He proposes two measures for the ECB: (1) a large, open-ended program of asset purchases, including government bonds. Open-ended is a key attribute, so the policy lasts until the ECB can credibly and sustainably forecast 2 percent inflation over the medium term, not limiting the scale of the purchases ahead of time; and (2) redefining the ECB's definition of price stability in practice as a "symmetric" target to average 2 percent headline inflation over forecasts of two to three years, i.e., ensuring that inflation below 2 percent is no less tolerated than inflation of more than 2 percent.[8] These two commitments, and the actions that would necessarily follow, would expand credit and restore price stability by providing credible insurance on the inflation outlook. While Mario Draghi (2014) has just signaled the ECB's unwillingness to let this inflation decline continue, announcing a symmetric inflation target of 2 percent along with purchases of sovereign debt would constitute a regime shift and thereby reduce doubts that the ECB will give up too soon.

Paolo Mauro says that the euro area should respect the revised EU Fiscal Compact and its supporting domestic rules so that euro area governments remain credible to financial markets and the public. Yet, he also denies that such respect compels the extreme fiscal policies of today to maintain that anchor. Mauro proposes that countries with fiscal space should ease fiscal policy by increasing their cyclically adjusted primary balance by at least 0.5 percent of GDP.[9] The "severe economic downturn" clause in the pact should be activated for other countries if growth were to deteriorate further, in order to further ease the fiscal policy stance of the euro area as a whole. In addition, Mauro argues that growth can be meaningfully fostered by improving the composition of taxes and expenditures rather than simply pursuing deficit reduction targets through one-off or inefficient measures or cuts in public investment (often missed anyway). On the tax side, cutting taxes on labor, especially for younger workers, would support labor market reforms (a point echoed by Jacob Kirkegaard in this *Briefing*). Neither sensible cuts in spending nor the important tax aspect of labor reform are yet being pursued. Regarding spending, Mauro favors boosting public investment like many but highlights maintenance of

7. See the precrisis evidence in Hellebrandt, Posen, and Tolle (2012) and the numerous assessments of the aftermath and lags of Hartz IV reforms in Germany until recovery set in.

8. The ECB's current definition of price stability, inflation close to but below 2 percent, is interpreted by many as asymmetric: Inflation below 2 percent is more tolerable than inflation above 2 percent. This implies that, for many, 2 percent is a ceiling, not a midpoint. Recent inaction in the face of repeatedly lowered inflation forecasts has reinforced this belief.

9. In other words, countries that already comply with their medium-term fiscal objectives as defined by European fiscal rules.

the existing capital stock as a good and disciplined starting point. He also recommends more use of spending reviews in euro area countries to make spending cuts more durable, freeing space for further tax cuts. He proposes harmonizing the euro area's value-added tax (VAT) in the medium term, with a view to transforming it into an EU-wide tax that can eventually back the issuance of eurobonds.

Jacob Kirkegaard shows that most of the adjustment in euro area labor markets has been the result of job shedding, rather than changes in hours worked. This adjustment increases the social and fiscal costs, as well as the political tensions, for a given decline in labor demanded. It is hardly evidence of more liberal labor markets. Notably, all the talk and emphasis on labor market reform has resulted in very little action, not just in Portugal and Italy. He argues that further reforms should reduce duality in the labor market by closing the gap in protection between permanent and temporary/part-time contracts, ideally moving towards universal labor contracts within companies or industries.[10] In addition, Kirkegaard proposes that wage bargaining in Europe should be further decentralized. Indeed, firm-level agreements should replace national and sectoral accords, with more use of clauses enabling employers and employees to opt out of these arrangements (this is one of the hidden causes of success in reducing German unemployment). All remaining automatic wage indexation practices should be ended. Again turning to the long term, Kirkegaard believes that a discussion should begin about launching a pan-European unemployment insurance scheme to encourage best practices in labor market institutions.

Nicolas Véron notes the significant progress that Europe has made of late on financial stability, cleaning up bad loans, and bank supervision. The principle guiding this successful reform is the breaking down of national barriers, meaning Europe has been unified in imposing the costs of bad lending on banks. Building on this achievement is necessary, and structural reform cannot be just of labor markets. So now that the asset quality review and stress tests of banks have brought a European banking union closer to fruition, Véron calls for the rapid development of a capital markets union (CMU). Deeper, more integrated euro area capital markets should make the financial systems more resilient to shocks by providing greater diversity of funding sources, more responsive to monetary policy measures, and more able to respond to the financing needs of an innovation-driven economy. More specifically, Véron suggests that the CMU process should help develop new intermediation segments and financing vehicles, with necessary but not excessive controls to avoid systemic risk. The CMU process should encourage development of market segments, such as securitization and private placements, that are currently tiny or moribund; review prudential requirements that discourage investment in unrated corporates; strengthen regulation of auditing activities and supervision of central counterparties; foster international accounting standards; and harmonize insolvency legislation and taxation of financial products.

MAKING IT TO THE LONG TERM

The time to act is now. Our action plan offers a roadmap for policymakers to get Europe out of its dangerously prolonged stagnation and put it on the path to higher sustainable growth. Fortunately, Europe is at the beginning of a new political cycle, with a new European Parliament and a new European Commission opening a fresh five-year period, in which the needed policies can be adopted and implemented. The proposals recently made, however, will not suffice. The just published Franco-German report by Henrik Enderlein and Jean Pisani-Ferry (2014), for example, deserves praise as a start down the path of basing policies on sounder economics. Understandably, as a document from and for German and French officials, however, their agenda is limited. It was bounded from calling for coordinated monetary and fiscal policy, from repudiating internal devaluation for productivity-enhancing reforms, and from talking about how the Southern economies' debts should be better treated in everyone's interest. Furthermore, as inherently a report aimed at the famed Franco-

10. Dual labor markets are structured to treat insiders with seniority who already have jobs differently than new entrants or younger workers, usually as a result of union politics and/or special interest serving wage and pension policies.

German engine of Europe, it only reinforces the perceived illegitimacy of current economic policy leadership by ignoring the voices of smaller and poorer member economies.

Our recommendations collectively underscore the need for change in European policy but of a specific nature. Our action plan is not about stimulation without regard for structural reform, though some will no doubt try to belittle it as naïve Keynesianism. In reality, our plan starts from economically grounded recognition of the current demonstrated failure and the known existence of an alternative policy path. A critical component of our approach is that both fiscal policy and structural reform need to be thoughtfully designed to improve productivity—blind service of generic targets to reduce deficits and wages will be counterproductive, as recent developments in the euro area have shown. Another component is that demand stimulus and structural reform are complementary, not to be conditioned on one another, both for economic and political economy reasons. We also believe that secular stagnation and incomplete European union can combine in a downward spiral, which only greater European integration can arrest.

To stimulate demand in a disciplined manner, euro area leaders should immediately revise the ECB's definition of price stability and properly interpret the rules governing the fiscal framework to make both truly symmetrical with respect to the business cycle. The Fiscal Compact and its secondary legislation were created at a time of stress and doubts about the solvency of the euro area and are clearly asymmetrical: The compact's sole objective is to define a path for each member state to achieve a balanced budget without allowing for discretionary fiscal stimulus. It is a legacy of the precrisis period when fiscal policy was not expected to help stabilize the business cycle. But even before interest rates reached the zero lower bound and monetary policy could largely offset cyclical fluctuations, the absence of fiscal risk-sharing was a vulnerability of the euro area.[11]

If used properly, the Fiscal Compact forces a member country to adopt a more expansionary fiscal policy to compensate for the tightening that other countries may need, which will be better policy for the short and long terms. Similarly, the asymmetry of the ECB's inflation target towards zero has been criticized long before interest rates reached the zero lower bound. Revising the inflation target would add to the effectiveness of quantitative easing today and equip the ECB with an improved policy framework tomorrow.

A fiscal risk-sharing mechanism and a new monetary regime should not be improvised during a crisis. They must be established not over frantic weekend negotiations but following careful preparations and discussions, perhaps including democratically approved changes in the EU treaties. While the ECB is fully capable of shifting the monetary regime, fiscal change requires more institutional capacity. That mechanism could take the form of a system of partial eurobonds, whereby each country's financing needs would be covered by eurobonds up to a maximum of 30 percent of GDP, while the rest would be financed by national bonds to preserve market discipline (Ubide 2013).[12] Eurobonds could be partially backed by a harmonized VAT, as Mauro suggests in this *Briefing*. Such measures would ensure that fiscal policy will not behave sharply procyclically again, worsening a severe recession.[13]

As for structural reforms, euro area leaders must take ownership of their initiatives. They have to stop talking about reforms in the abstract because so doing creates persistent uncertainty about what is being accomplished and about the future, dampening investment and growth. Worse still is the subversion of the concept of structural reform to a codeword for internal devaluation. Structural reform should mean the enhancement of productivity through liberalization and regulatory change as needed in all sectors (not just labor). A better framework, in the spirit of Hausmann, Rodrik, and Velasco (2006), would be for each euro area member to identify its own most important constraint to growth, which of course will differ across countries,

11. Again, see Kenen (1969), Posen (2005), and Pisani-Ferry and Posen (2009).

12. 30 percent of GDP is designed to be enough to deal with a large financial crisis.

13. In other words, deficits will not have to be cut during a recession, and therefore fiscal policy would cushion the downturn, rather than aggravating it.

and commit to a specific reform (or two) every year to alleviate it—including specific legislation and a timetable for implementation. Such a step would show ownership and commit every euro area country to the process, reduce uncertainty, and introduce a peer review procedure to enhance confidence on the reform agenda. It is in this spirit that our authors advocate widespread national public spending reviews, progress towards a common VAT and unemployment benefits, capital markets union, and other European policies with locally nuanced targets.

European leaders must change their approach and continue advancing European economic integration, if they want the euro area to survive secular stagnation, which is politically corrosive and is eroding productivity. The Southern economies have had to endure too much adjustment for too little gain in terms of productivity improvements and debt reduction. Even on its own terms, the Germanic approach has failed to deliver its narrow targets of protecting Northern creditors, reducing Southern public debt, and improving competitiveness. Instead, structural reform and macroeconomic stimulus must go together and must involve adjustment by all euro area members. Our action plan provides practical proven steps in line with those principles and is sufficiently ambitious to arrest Europe's descent. That is the truly responsible path for Europe toward price stability, fiscal sustainability, and sufficient growth, as well as to reviving faith in the democratic parties advancing European ideals.

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STIMULATING DEMAND TO FOSTER STRUCTURAL REFORM IN THE EURO AREA

AJAI CHOPRA

The euro area must act soon to breathe life into its stagnant economy, reverse its falling inflation rates, and put people back to work, or risk social and political instability. Lack of action could once again raise doubts about the sustainability of public debt in some countries, and the resulting uncertainty could further damage confidence and disrupt financial markets, generating a vicious circle. Pursuing more aggressive macroeconomic measures to stimulate euro area aggregate demand is thus essential to turn this situation around and avoid lasting damage to growth prospects. But stimulating demand would serve another important objective. Fiscal and monetary stimulus are needed to counter the negative short-term impact of structural reforms on output and prices, and thus give more room for the longer-term benefits of reforms to be realized.

Since the start of heightened stress in the euro area in 2010, the policies adopted have evolved. The first section of this essay discusses the evolution of the policy mix from an initial misguided approach, which put more emphasis on implementing structural reforms and less on supporting demand, toward a more coherent strategy of addressing the problem of falling or stagnant demand. The second section highlights the adverse consequences of implementing structural reforms when demand is depressed. Drawing on the analysis of these consequences, the final section proposes a policy mix to strengthen the region's recovery and future prospects.

EVOLUTION OF THE POLICY MIX IN THE EURO AREA

Three aspects of the initial approach to address the sovereign debt crisis and revive the euro area economy stand out. First, aggressive budget cuts have been pursued since 2010 to curb the rapid rise in public debt and ease stress in sovereign debt markets. The fiscal austerity drive was similar across euro area countries, for example, with the Netherlands (which has a relatively low public debt ratio) and Italy (which has a high ratio) responding forcefully (Mazzolini and Mody 2014).

Second, at the same time, Europe's leaders emphasized structural reforms to increase productive capacity and improve competitiveness via internal devaluations—i.e., cutting nominal wages and reducing living standards to make a country's products less expensive because the option of a nation devaluing while belonging to a currency union is not available. Because policy makers attributed poor growth to structural rigidities, they believed that reform would rekindle confidence and economic activity.

Third, monetary policy was slow to ramp up needed stimulus because falling inflation was mistakenly viewed as temporary. The European Central Bank (ECB) did try to improve the transmission of its monetary

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policy by announcing its Outright Monetary Transactions (OMT) scheme, which allows it to purchase weaker euro area countries' government bonds. Steps have also been taken to create a banking union for the euro area and the ECB has spurred banks to increase funds set aside to cover loan losses and to raise more capital.

These policies succeeded in preventing the breakup of the euro area, but they have failed to deliver growth and stability, which is the core objective of the euro area's economic policies. Instead, the approach has caused the region's economy to shrink because both the public and private sectors were deleveraging (i.e., reducing their debts) at the same time. In the second quarter of 2014, real GDP was still 1.6 percent below its level at the beginning of 2008, and real domestic demand was 5 percent lower, an outcome significantly worse than the experience of other advanced economies. In addition, the ECB is systematically undershooting its inflation target of 2 percent. As a result, inflation expectations have declined, as financial market indicators show. The ratio of public debt to GDP has increased as GDP declined by more than the size of budget consolidation, suggesting that fiscal austerity has been self-defeating.[1] Public investment has been hit severely, hurting growth prospects (Barbiero and Darvas 2014). Average euro area unemployment was 11½ percent in September 2014, with the proportion of those unemployed for more than a year at about 50 percent. Low inflation also worsens the position of debtors by raising the real value of their debts, which suppresses aggregate demand and increases stress for banks.

Recently, some top euro area policymakers have shifted their approach to the euro area's malaise. ECB president Mario Draghi has pointed out in a series of speeches that the euro area is operating well below capacity and that unemployment resulting from weak demand justifies more stimulative monetary and fiscal policies (2014a, 2014b).[2] Draghi's comments also reflect a concern about potential hysteresis effects—i.e., an erosion of productive capacity because of an extended period of low investment and because workers lose their skills and ability to enter the labor force after being unemployed for a long time. Accordingly, in October 2014, the ECB launched a program to purchase asset-backed securities and covered bonds and indicated its intention to expand the central bank's balance sheet. Little action has been taken to use fiscal policy to support demand. President Draghi, however, supports a more expansionary fiscal policy for the euro area as a whole, but with the caveat that the rules of the Stability and Growth Pact be respected (which among other things limits fiscal deficits to less than 3 percent of GDP).

Draghi also emphasized that the problems the euro area faces are structural as well as cyclical, underscoring the need for structural reforms. He argued further that aggregate demand policies must be accompanied by structural reforms to be effective. Referring to an open letter to President Franklin Roosevelt in 1933 by John Maynard Keynes, who cautioned against the deflationary effect of structural reform, Draghi declared: "We face the opposite concern to that expressed by Keynes. Without reform, there can be no recovery" (Draghi 2014b).

STRUCTURAL REFORM WHEN DEMAND IS DEPRESSED

Keynes was correct to warn Roosevelt that reform can impede recovery and advise that it is through "success in short-range Recovery, that you will have the driving force to accomplish long-range Reform" (Keynes 1933).

Many studies have demonstrated that the benefits of structural reform on output and employment typically take time to materialize.[3] Indeed, structural reforms can contract the economy in the short term because they often create insecurity about income, causing people to save more and consume less. Moreover, structural reforms—for example, removing barriers to entry in various service sectors (like the taxi industry)—may be

1. Using a variety of models, Rannenberg, Schoder, and Strasky (2014) find that fiscal consolidation caused a cumulative GDP loss of between 14 and 20 percent of annual baseline euro area GDP over 2011 to 2013, implying a cumulative multiplier of between 1.5 and 2.2.

2. See also Buti (2014) and Coeuré (2014).

3. Many of those studies have been conducted by the European Commission, the IMF, and the OECD. See, for example, Anderson et al. (2014); Barkbu, Rahman, and Valdés (2012); Bouis et al. (2012); Bouis and Duval (2011); and Varga and Veld (2013).

healthy in the long run but in the short run impose costs on existing businesses and workers. These short-term costs can erode political support and even generate political resistance, impeding needed reforms (Leiner-Killinger et al. 2007, Teulings 2012).

All these adverse effects are exacerbated by weak demand, high unemployment, private and public deleveraging, and tight credit conditions, limiting the potential benefit of reforms. For example, making it easier to fire employees may expand employment in the long run but increase unemployment in the near term. Reducing unemployment insurance in order to encourage people to seek work could lower disposable income if no jobs are available (Anderson et al. 2014, Bouis et al. 2012).[4] As Rodrik (2013) points out, in practice structural reform increases productivity through two complementary channels—first, low-productivity sectors shed labor, and second, high-productivity sectors expand and hire more labor. Both processes are needed to get economywide productivity gains. But when aggregate demand is depressed, as in many southern euro area countries, the second mechanism operates weakly if at all. This is because making it easier to fire workers or start a new business has little effect on hiring when firms have excess capacity and cannot find customers.

Eggertsson, Ferrero, and Raffo (2014) examine the case of structural reforms when monetary policy is constrained at the zero lower bound (ZLB) for the nominal interest rate and unable to accommodate the increase in supply associated with reforms. They argue that structural reforms are counterproductive in such situations. In their model, product or labor market reform lowers prices and wages, which raises the real interest rate for the fixed nominal policy rate at the ZLB. Aggregate demand falls with the higher real interest rates. Reforms then depress rather than stimulate economic activity. Using a small-scale dynamic general equilibrium model to assess the quantitative impact, they find that a permanent 5 percentage point reduction in wage and price markups in the nontradable sector in a group of reforming euro area countries lowers the areawide inflation rate by 2.7 percentage points, increases real interest rates by 1.7 percentage points, and reduces output by an additional 0.6 percentage points compared with the no-reform baseline.[5]

A BETTER POLICY MIX FOR THE EURO AREA

No doubt structural reforms are essential to improve productivity and long-run growth. But the euro area's immediate problem is of poor demand and a potential debt-deflation trap, which structural remedies are ill-suited to address. In such a trap, falling prices and wages increase the value of debt owed by households and businesses, making them curtail consumption and investment to pay off the rising debts, which in turn depresses economic activity. Moreover, just the expectation of lower prices makes people less willing to spend and borrow. Monetary and fiscal stimulus must therefore be applied in tandem to generate a recovery, minimize hysteresis effects, and counter the deflationary impact of structural reforms.

The following general principles should dictate the mix of demand and supply policies.

First, as recommended by Ángel Ubide in this PIIE Briefing, the ECB should launch a quantitative easing program to lift inflation and inflation expectations back to 2 percent and revise its definition of price stability to 2 percent inflation over two to three years.[6] Some have argued that easier monetary policy could weaken

4. Anderson et al. (2014) present an illustrative worst-case impact of real GDP falling by as much as 4 percent in the first year when there is no hiring despite the increase in labor supply from the reforms.

5. Coeuré (2014) notes that reforms can be expansionary in the short term if they raise expectations of permanent income and thus induce firms and households to invest and consume. For reasons already noted, however, when the demand gap is sizable and unemployment is high, this channel is unlikely to be strong enough to offset the short-term contractionary forces associated with reforms.

6. It is noteworthy that Charles Evans (2014), president of the Federal Reserve Bank of Chicago, said, in the context of the United States, that "… a symmetric inflation target means we should be averaging 2 percent inflation over time. We've averaged well under that 2 percent mark for the past six and a half years. With a symmetric inflation target, one could imagine moderately-above-target inflation for a limited period of time as simply the flip side of our recent inflation experience—and hardly an event that would impose great costs on the economy."

the incentive to reform in countries most in need of it. Rebutting that view, Coeuré (2014) notes that price stability must be the anchor of the structural adjustment process and that it is the ECB's duty to deliver on its inflation mandate.

Second, fiscal policy in the euro area as a whole must do more to support demand because monetary policy is constrained by the ZLB. Refusing to allow larger fiscal deficits is not appropriate for the euro area's stagnant economy. Making euro area fiscal policy more expansionary must involve more public spending by Germany, the area's largest economy, which would raise its current inflation rate of just 0.8 percent and thus reduce pressure on southern euro area countries that are trying to close the gap in competitiveness with Germany to have zero or negative inflation. European leaders must also invoke the flexibility clauses of the Stability and Growth Pact to permit bigger deficits at a time of the greatest economic stagnation in Europe in 75 years. Because of previous cuts to public investment, fiscal stimulus should concentrate on infrastructure investment and other goods that enhance productivity.[7]

Third, fiscal policy should support the type of labor market reforms advocated by Jacob Kirkegaard in this PIIE Briefing. In particular, simulations in IMF (2014b) show that because labor market reforms often entail fiscal costs and transitory losses in output—especially if implemented in depressed conditions—fiscal stimulus would help bring forward the positive effects of such reforms by several years. If hysteresis is high, the simulation shows that the output gains from fiscal offsets can be large and persistent.[8]

Finally, as Coeuré (2014) notes, structural reform should emphasize raising productivity instead of deflationary internal devaluation. This emphasis requires a broader and smarter set of reforms. The example of Italy's 20 years of stalled labor productivity is instructive. Pellegrino and Zingales (2014) have attributed this problem not to the introduction of the euro or excessively protective labor legislation but to the failure to harness advances in information and technology of the last 20 years.[9] They also conclude that other European countries suffer from the same "disease"—with the same causes—as Italy. Mody and Riley (2014) have reached similar conclusions about Italy, noting that the problem is compounded because the country's bleak economic prospects weaken incentives to invest in education and innovation.

Structural reform policies that focus on raising productivity should encourage competition, efficient markets, and incentives for firms to innovate and diffuse technology. These reforms should create an environment where resources can be reallocated from failing to growing firms and where entrepreneurs have financial incentives to undertake risky projects. Such policies should be pursued at the national level and also by Europe as a whole—for example, by completing the single market in services and creating a single digital market to speed the diffusion of new technologies. European authorities should also broaden the sources of financial intermediation beyond bank-based channels to deeper and more vibrant bond, equity, and venture capital markets to promote investment and create drivers of growth beyond manufacturing.

In sum, a better policy mix for the euro area would be to apply monetary and fiscal stimulus to increase demand, which would also provide space to undertake structural reforms that improve productivity growth. Increasing demand in the euro area in the short-run will make long-run objectives more achievable.

7. IMF (2014a) presents a persuasive case that increased public investment in infrastructure raises output in both the short and long terms, especially when there is economic slack and borrowing costs are low.

8. See figure 2.9 in IMF (2014b) for the simulation results. The study also presents econometric results showing that cutting the labor tax wedge (i.e., the difference between the labor cost paid by employers and the take-home pay of employees because of income tax and Social Security contributions) by 1 percentage point is, on average, associated with a revenue loss of 0.3 percent of GDP.

9. Pellegrino and Zingales (2014) also find that Italy falls behind because its small firms cannot respond to the challenge posed by global competition.

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THE EUROPEAN CENTRAL BANK MUST ACT AGGRESSIVELY TO RESTORE PRICE STABILITY IN THE EURO AREA

ÁNGEL UBIDE

An air of crisis looms over the euro area once again as growth weakens, inflation declines, and unemployment remains at historical highs. Increased dissatisfaction with the policies of the European Central Bank (ECB) has only aggravated the situation. The recession that started in 2011Q3 has not ended.[1] Economic slack is ample. GDP has not recovered to its precrisis level and is about 20 percent below what it would have been had it continued to grow at the precrisis trend of 2 percent. As a result, annual headline inflation has reached an all-time low[2] at 0.3 percent (0.1 percent under constant tax rates).

The time has come for the ECB to act forcefully.

Even after the recent announcements, the ECB's monetary policy remains too tight. Interest rates are low, but not low enough. The central bank should try to restore inflation to 2 percent, a goal entailing two steps. First, it must launch a large, open-ended quantitative easing (QE) program consisting of monthly asset purchases, including government bonds of duration higher than five years, of at least €80 billion a month. The program should be made explicitly conditional to last until the ECB can credibly and sustainably forecast 2 percent inflation over the medium term. Second, the ECB must revise its definition of price stability to an explicitly symmetric 2 percent over two to three years, as I suggested in Ubide (2014a), in order to arrest the decline of inflation expectations.

Opposition to this policy is misguided. It is based on exaggerated fears that the ECB could suffer losses from its purchases of government bonds under QE, and these losses would have to be covered, in part, by Germany's budget. The fierce political opposition in Germany to ECB policies is a major infringement of the ECB's independence and to its independent mandate established by the Maastricht Treaty to deliver price stability. The ECB has defined price stability as "close, but below 2 percent." This definition is open to interpretation, and opponents of ECB policies have argued that the current inflation outlook is compatible with this definition. But the ECB's own practice has clearly identified price stability with 2 percent inflation (see the discussion in Ubide 2014a and figure 1), which compares today's term structure of inflation swaps with that in 2005–06, when there was unanimous agreement that the ECB was delivering price stability). The price stability mandate is violated as much when the target falls short as when it is exceeded. Second, the strong German opposition to QE via purchases of government bonds has no legal or economic basis. There is no legal impedi-

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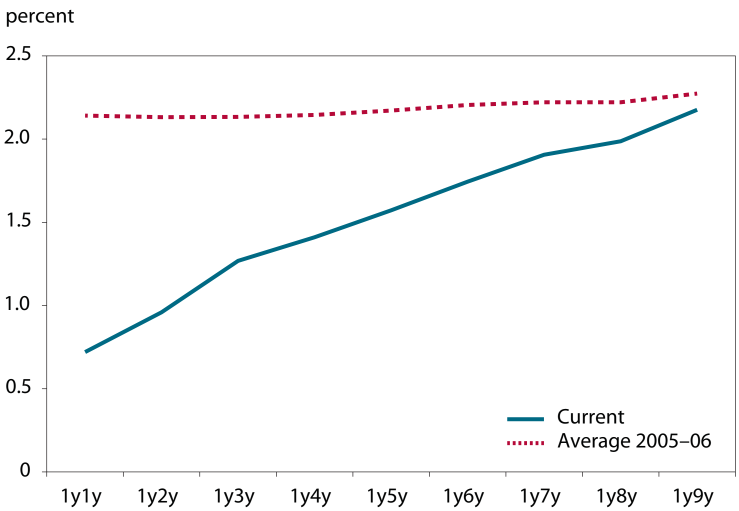
1. As declared by the dating committee of the euro area business cycle of the London-based Center for Economic and Policy Research.
2. Excluding the oil induced swings of 2008–09.

Figure 1 EU inflation term structure



Source: Bloomberg and author's calculations.

ment in the Maastricht Treaty to purchases of government bonds in the secondary market. QE would be very different in nature from the outright monetary transactions (OMT) program, which was brought to the German Constitutional Court, as purchases would be across all countries and without conditionality.

From an economic standpoint, the experience in other countries shows that QE is unambiguously positive if implemented in an effective and decisive manner (see Ubide 2014b), and there is no conclusive evidence that asset purchases diminish the incentives of governments to implement needed policies (it certainly didn't prevent the US Congress from implementing a very aggressive fiscal adjustment).[3] Moreover, there is no evidence that European assets have reached lofty valuations and that further easing could generate financial stability risks—in fact, European assets have underperformed global assets during the recovery. More importantly, the opposite is true: The main risk to financial stability at present is a long period of stagnation and low inflation, which worsens the debt dynamics of euro area countries and the quality of banks' portfolios.

Only the ECB can avoid a secular stagnation in the euro area. It must act.

BACKGROUND

The decline in inflation in the euro area is broad based, with over 50 percent of items in the consumer price index (CPI) basket showing inflation below 1 percent. It should be a matter of concern that long-term inflation expectations measured by the 5-year forward 5-year rate[4] have declined to 1.8 percent, and inflation swaps imply a decade of inflation below 2 percent (figure 1). This inflation pattern is not only incompatible with the ECB's price stability mandate but also a major obstacle to the recovery of the euro area, for three main reasons: First, extremely low inflation precludes the necessary decline in real wages once the growth of nominal wages reaches zero and thus neutralizes the positive impact of labor market reforms; secondly, it worsens the dynamics of debt sustainability in the euro area as a whole, especially in periphery countries, therefore requiring even bigger fiscal deficit cuts to achieve a given reduction in the debt/GDP ratio, which in turn further depress growth[5]; finally, very low inflation makes deficit reduction more difficult, because tax revenues decline with low inflation while nominal cuts to public wages and pensions are very costly politically.

This decline in inflation results from insufficient demand. This becomes clear from the fact that both growth and inflation forecasts have been steadily revised lower during the last two years. In addition, the

3. The actions of the Berlusconi government in the summer of 2011—reneging on its commitment to fiscal adjustment and reforms after the ECB had agreed to intervene in sovereign bond markets to stabilize the spike in yields—are often mentioned as clear evidence of the moral hazard effects of QE. It looks very opportunistic to use that isolated example to oppose a policy that has worked elsewhere, and Italy is now embarking on a serious program of reforms.

4. The 5-year average inflation starting 5 years into the future, as priced in the inflation swaps market.

5. Recall that the future debt/GDP path is determined by the initial debt/GDP level, the difference between real interest rate on the debt and real GDP growth, and the primary balance. This implies that, in an economy with a debt/GDP ratio of 100 percent, a 1 percentage point reduction in inflation that increases real interest rates by the same amount requires an increase of a percentage point of GDP in the fiscal surplus to achieve the same reduction in the debt/GDP.

downward revisions to inflation have been bigger than the downward revisions to growth, suggesting that the output gap is very likely bigger than what was thought to be.

Inflation has also fallen in Germany, despite robust growth and a tight labor market, suggesting something beyond insufficient demand is pushing inflation down. Goldman Sachs (2014) has analyzed the sources of euro area inflation forecast errors using the Smets and Wouters (2007) model. The results show that despite wages having declined less than expected, inflation has also been lower than expected because firms fear that if they hike prices they will lose market share in an environment of weak demand has kept inflation lower than expected. This implies that the focus on boosting German wages as an alternative to further monetary easing is unlikely to lead to higher inflation, as corporate profits are very high as a share of GDP and offer plenty of room to accommodate some wage inflation without passing it to prices. The example of Sweden, where inflation has collapsed to zero despite unit labor costs growing at 2 percent, is a clear clarion call.

The experience of Japan offers an additional source of worry that the decline in inflation could be long lasting. Japan reformed its labor market in the mid-1990s, reducing the rigidity of the system by introducing temporary and part-time employment. This led to a long period of very low wage growth, as temporary and part-time jobs, with lower wages, became more prevalent and led to a reduction of the total wage bill (the so-called composition effect). The onset of deflation, combined with the crises in 1997–98 and 2007–09, created an environment where workers felt they lacked bargaining power, and the labor market settled in a new equilibrium around zero wage growth regardless of the level of unemployment.[6]

Something similar could happen in the euro area. In Spain, the combination of the sharp recession and the labor market reforms has led to a big decline in starting salaries (about 25 percent lower than precrisis) for those leaving the unemployment ranks, and a sharp increase in the number of workers with a job experiencing zero wage growth (the percentage of workers with zero wage growth has increased ten times).[7] In an environment of zero inflation and very high unemployment, aggregate wage growth could remain flat for a very long period.

The euro area is facing a textbook case of second round effects affecting inflation to the downside.[8] Financial markets don't expect 2 percent inflation to be achieved in the next decade (see figure 1). Inflation expectations are likely to continue to decline because they have a strong adaptive component (in other words, inflation expectations depend on both past inflation and the belief on the ECB's commitment to deliver future inflation). Therefore if the current period of low inflation is allowed to persist it will further depress inflation expectations, which, in turn, will continue to put downward pressure on measured inflation.

THE ECB'S ACTIONS SO FAR

In April 2014, ECB president Mario Draghi outlined in a speech[9] the bank's strategy. He argued that (1) pressures on the exchange rate could be addressed with negative interest rates; (2) further impairments in the transmission mechanism of the monetary policy stance, via the bank lending channel,[10] could be addressed via long-term refinancing operations (LTROs) targeted at encouraging bank lending or a purchase program of asset-backed securities (ABS) supported by regulatory changes to revitalize high-quality securitization; and

6. Kuroda (2014) offers a good discussion of these dynamics, and Japan is now trying to return the labor market to a new equilibrium around positive wage growth.

7. See Jansen, Jimenez, and Garcia Perez (2014).

8. Second round effects are a situation where a decline in inflation expectations leads to a decline in current inflation, which then leads to a further decline in inflation expectations. Central bankers are always very alert to this risk when, for example, oil prices spike higher. I alerted of this downside risk early in the year in Ubide (2014a).

9. Mario Draghi, Monetary Policy Communication in Turbulent Times, speech delivered at the conference on "De Nederlandsche Bank 200 years: Central banking in the next two decades," Amsterdam, April 24, 2014, www.ecb.europa.eu/press/key/date/2014/html/sp140424.en.html.

10. This refers to the fact that, in the last few years, private lending rates have remained very high despite the ECB rate cuts, thus blunting the transmission of the ECB's monetary easing to the real economy.

(3) a worsening of the medium-term outlook for inflation would require increasing *meaningfully*[11] the degree of monetary accommodation with a broad-based asset purchase program that would include government bonds. Since then, the ECB has cut deposit rates to –0.2 percent, launched a targeted LTRO, and started a program of ABS and covered bond purchases. These actions are focused on the exchange rate, credit supply, and liquidity.

The deposit rate cuts and the LTROs have kept euro area interest rates low at a time of increasing US rates and have helped lower the exchange rate of the euro. The desire for a weaker euro is understandable, as it should boost growth and increase inflation, but it is unlikely to achieve much by itself. The impact of the currency on growth and inflation in the euro area is not large. Based on the Euro Area Wide Model , a 1 percent permanent depreciation of the trade-weighted euro sustained over five years would lift inflation by 3 basis points the first year and a cumulative 9 basis points the second year, reaching about 21 basis points by the fifth year. However, note that the euro appreciated almost 10 percent during 2012–14, and therefore plenty of downward impact on inflation is still in the pipeline. With inflation unlikely to be above 1 percent over the next two to three years, the euro would have to decline by at least 10 to 15 percent on a permanent basis in order for inflation to approach 2 percent.

The purchases of ABS and covered bonds could help by attracting new buyers to these markets and thus reducing the stigma and the cost of securitization**.** But the impact should be marginal, as credit supply and liquidity are not factors restraining credit growth. In fact, private lending rates have remained high in the euro area periphery, especially at the 5-year maturity, the key maturity for investment. The tightening of macroprudential regulations and the persistence of sovereign spreads will ensure that financial sector fragmentation persists for a long period, creating a permanent wedge between policy rates and private sector rates.

Overall, the announced measures have prevented unwanted tightening and will help expand the range of funding sources for the euro area economy, but they have generated very little additional easing. On the positive side, the ECB has shifted from a policy of reactive easing (providing liquidity on demand via LTROs), which had sharply reduced the size of its balance sheet, to a proactive strategy of asset purchases aimed at expanding its balance sheet. But the asset purchases program just announced is very small and is mostly targeted at credit supply, making it irrelevant from the point of view of boosting demand and stabilizing inflation expectations.

As a result, the markets' belief in the ECB's ability and commitment to deliver 2 percent inflation is deteriorating. The 5-year forward 5-year inflation rate, a key measure of inflation expectations, has continued its downward trend and is now around 1.8 percent. Not only is the level too low but also it has shown a pattern of small increases before and large declines after ECB meetings, suggesting markets are increasingly doubting the effectiveness of the ECB's actions. Survey data show a similar pattern. The price expectations index of the European Commission confidence survey is at the historical low end. The Survey of Professional Forecasters shows that the distribution of inflation forecasts has deteriorated materially, with over 30 percent of the distribution now below 1.4 percent and a weighted average forecast of just 1.75 percent (see table 1). Ominously, the ECB's credibility is lower today than in mid-2011, when the future of the euro was clearly in doubt.

Table 1 5-year ahead inflation forecast

Year	<1.4	1.5 to 1.9	>1.9	Weighted average
2005Q2	20.4	38.8	40.9	2.0
2008Q3	13.3	29.6	57.0	2.1
2011Q2	20.9	29.2	49.7	1.9
2014Q3	30.8	32.7	36.6	1.8
2014Q4	34.1	32.3	33.6	1.7

Source: Survey of Professional Forecasters.

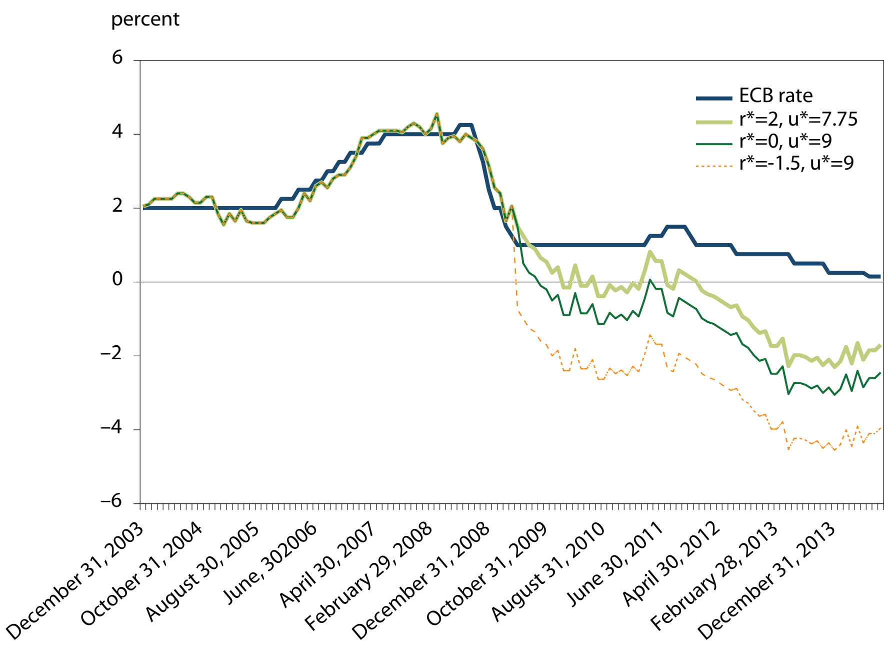
11. Emphasis in italics is mine.

WHAT SHOULD THE ECB DO?

The current policy stance of the ECB, even after the recent measures, remains too tight. Interest rates are low but not low enough, mostly because the euro area neutral interest rate (r^*) has declined as a result of the increase in savings and, especially, the sharp decline in investment. The International Monetary Fund (IMF 2014) shows that euro area investment is about 3 to 6 percentage points of GDP below its normal relationship with economic growth.

The tightness of the ECB's policy becomes evident in figure 2. It shows the path of desired interest rates using a policy rule for the ECB estimated on the precrisis period and simulated since 2010 assuming different values for the neutral interest rate and the NAIRU (the level of the unemployment rate that generates stable inflation, u^*). The assumptions cover different scenarios to explore the range of possible outcomes: ($r^* = 2$ and $u^* = 7.75$) assumes that both the neutral interest rate and the NAIRU have remained at precrisis levels; ($r^* = 0$ and $u^* = 9$) assumes that the neutral interest rate has declined to zero (the level currently implied for the United States by Laubach and Williams 2003) and the NAIRU has increased; and ($r^* = -1.5$ and $u^* = 9$) uses the model of Laubach and Williams (2003) to estimate the neutral interest rate, which yields a result of a negative neutral interest rate in the euro area of –1.5 percent. The simulations in figure 2 suggest that the current policy interest rate should be somewhere between –2.5 and –4 percent. These numbers may look too negative but are not excessive: Estimates of a standard policy rule for the United States generates desired interest rates of as low as –5 percent during 2009–10.

Figure 2 The ECB's policy reaction function



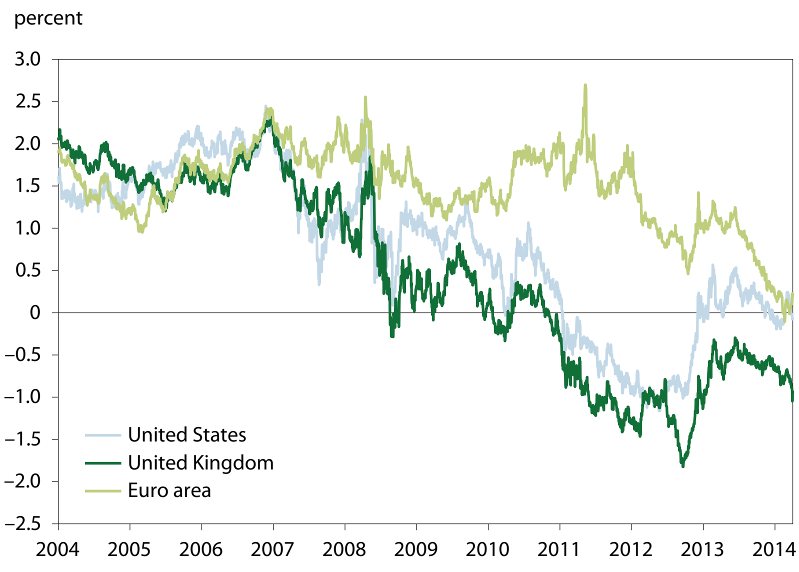
Source: Bloomberg and author's calculations.

To achieve this desired easing of monetary policy, the ECB must do two things. First, launch a large, open-ended, QE program consisting of monthly purchases of a basket of assets, including sovereign bonds from all euro area countries. The weights of each country in the basket of assets could be designed by the capital key (the share of each country's contribution to the ECB's capital) or, preferably, by market share, a more market-neutral approach. Short-term rates are already very low as a result of the cuts to the deposit rate and the LTROs, and therefore the ECB should purchase bonds of duration higher than five years to maximize the impact of the program. The purchases should amount to at least 80 billion euros per month, aiming at a rate cut equivalent to about 200 basis points if maintained over at least two years—the experience of the Fed and Bank of England QE programs suggests that $100 billion of bond purchases reduce 10-year rates by about 2 to 3 basis points, which is equivalent to a reduction in the policy rate of about 10 basis points (see Ubide 2014b). Because the euro area economy is similar in size to the United States but is starting from a lower level of inflation, a program smaller than that of the Fed would not be credible. In President Draghi's own words, such a program would *meaningfully* increase the degree of monetary accommodation.

The communication of the asset purchases program is critical. The program should be open ended and communicate explicitly that it will last until the ECB can credibly and sustainably forecast 2 percent inflation over the medium term. The word "sustainably" is very important. The euro area will experience a very long period of below 2 percent inflation and therefore just touching 2 percent inflation once will not be enough. A period of above 2 percent inflation will be necessary to ensure that inflation expectations return, credibly and sustainably, to 2 percent. Because of the high persistence of the inflation process, the longer it takes for the ECB to start the asset purchases program, the more difficult it will be to restore inflation to 2 percent.

Second, the ECB must revise its definition of price stability to an explicitly symmetric target of 2 percent over two to three years, as I suggested in Ubide (2014a). This revision would eliminate the current doubts about the ECB's stance—some ECB officials seem content with an outlook for 2 percent inflation only in 2022. By reinforcing the commitment to 2 percent inflation, a revision of the price stability definition will likely shorten the duration and extent of the QE program.

Figure 3 Evolution of 10-year real interest rates



Source: Bloomberg and author's calculations.

The main effects of such a program will be to (1) restore inflation expectations to 2 percent and lower long-term real interest rates to negative levels, as QE has achieved in other countries (see figure 3), and thus accommodate the negative neutral real rate; (2) incentivize portfolio rebalancing towards risky assets to lower private financing costs and boost investment; and (3) boost confidence by signaling a long period of rates on hold and a determination to restore price stability. The main channel of transmission is the provision of insurance on the inflation outlook, and thus unanimous communication will be critical to the success of the program (see Ubide 2014b).

Time is of the essence. The longer growth and inflation are allowed to remain weak, the more potential growth will suffer, especially in a situation of very high youth unemployment, which is twice as sensitive to the business cycle and thus amplifies the risk of hysteresis effects (IMF 2014). And the more damage to potential growth, the higher the financial stability risks, as a long period of stagnation with low inflation will worsen the debt dynamics of the euro area and the quality of banks' portfolios.

The ECB has the democratic mandate to achieve price stability and the tools to achieve it. It should use them forcefully.

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ROLE OF FISCAL POLICY TO SPUR GROWTH IN EUROPE

PAOLO MAURO

Europe's highest priority is to increase growth of output and employment, especially for the youth, without sowing the seeds of a macroeconomic crisis. To what extent can fiscal policy help? A little, not much, particularly in the short term. The bulk of the work right now has to be undertaken through structural reforms aimed at removing obstacles to entrepreneurship, investment, and job creation. Extremely loose monetary policy is also necessary to foster credit flows and investment.

This essay outlines how fiscal policy measures can at least modestly contribute to economic growth and job creation. I group my considerations under four distinct umbrellas: (1) the fiscal policy stance (whether upcoming budgets need to favor fiscal stimulus versus long-run sustainability and discipline) as well as the EU-related constraints on such stance; (2) the composition of fiscal policy (the types of revenues and expenditures that policymakers select for a given level of the fiscal deficit); (3) the "vision thing" for continued European integration, a topic that for obvious reasons I mention briefly here; and (4) the reasons why it is proving difficult to make things happen. My contention is that the debate has focused too much on the near-term policy stance (stimulus versus austerity) and too little on the remaining items, which can yield greater gains.

1. FISCAL POLICY STANCE

Most euro area economies are constrained not only by agreements they have signed but also by an even more powerful force—the financial markets. In this context, the EU architecture governing deficit objectives is beneficial to anchor market expectations. For example, all EU economies routinely have to present a somewhat detailed fiscal plan for at least three years. Clarifying fiscal policies countries intend to pursue over the medium term helps to reassure markets. Those who think that EU constraints are a source of excessive austerity in Europe need to bear in mind that markets would likely impose even more forceful, if less predictable, discipline on countries' fiscal policies in the absence of the European Union's monitoring and enforcement framework.

The impact of fluctuating sovereign bond markets varies substantially across European countries, depending on their financing needs. It is highest in Italy—where sovereign bonds equivalent to more than a quarter of annual GDP are rolled over each year—followed by Spain and Portugal.[1] Just as these countries are set to benefit tremendously from the recent decline in nominal interest rates to historical lows, renewed concerns by market participants resulting in higher rates would risk triggering another vicious circle of higher rates and

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1. The International Monetary Fund's biannual *Fiscal Monitor* (chapter 1) routinely provides estimates of gross financing needs for individual countries.

higher debt, as experienced during the fall of 2012. In this light, several euro area countries simply cannot afford to risk another increase in bond spreads.

Other countries in the euro area are in a more enviable position with plenty of credibility—including the largest euro area economy, Germany, which has attained a balanced budget (also in structural terms) and is projected to reduce its debt to 60 percent of GDP by 2019 under current fiscal policy plans. Such credibility is reflected in interest rates on 10-year bonds below 1 percent in nominal terms at the time of writing. These countries are rightly mindful of the need to remain bulwarks of stability for their own public, the eurozone, and the world economy. But on balance the risks would be greater if Germany and other well-positioned countries failed to use the limited fiscal room they have, because prolonged stagnation and deflation currently seem a more likely and costly scenario than a possible increase in interest rates. From this position of strength, Germany and others have an opportunity to help secure a lasting domestic recovery and to continue to benefit from a reasonably healthy eurozone by providing a moderate fiscal stimulus. A loosening of the cyclically adjusted primary balance by ½ percentage point or perhaps more would abide by previously agreed EU constraints as well as domestic fiscal rules.

Is there a case to change the EU rules to make them less stringent? The answer is unambiguously no. A campaign to loosen the rules would do more harm than good and would likely backfire. The optics are as important as the substance here. An overt and loud debate among politicians from different EU countries could easily be portrayed through the prism of facile stereotypes in the international media, which often take a dim view of prospects in the eurozone. Tinkering with the recently approved constitutional amendments that enshrine structural fiscal balance agreements in national law would also be a nonstarter, likely to undermine credibility. Moreover, the architecture of fiscal rules in Europe is already overly complicated: how many among the noninitiated understand the implications of two-packs, four-packs, fiscal compact, and the like? Adding further exceptions and escape clauses would simply make the whole architecture even less transparent. The 3 percent deficit limit in particular should remain sacrosanct, because it is possibly the only part of the rules that the public at large truly understands.

A few technical adaptations—not requiring changes to the EU agreements—could usefully be made. For example, the way that the EU Commission assesses the output gap and thus the structural fiscal deficit gives excessive weight to growth performance in recent years. As a result, using the current technical methods results in estimates of nearly zero potential output for Italy and negative 1 percent potential growth in Greece. Besides being unrealistic, these results have two adverse operational implications. First, if growth were to pick up next year to a very low 1 percent, then Italy and Greece would be asked to cut their deficits more rapidly than would seem appropriate, simply because of growth "above potential." Second, the agreed EU rules require that expenditure growth be maintained well below potential output growth; again, underestimating potential output growth would require curtailing expenditure growth beyond reason. These small technical adaptations are not likely to capture the hearts of the general population nor are they an avenue to permit significant fiscal stimulus. But at least they protect the economy recovery from the harm that would otherwise result from blindly applying technical procedures to a situation for which they were not intended.

Moreover, the unchanged Stability and Growth Pact (SGP) needs to be implemented wisely. The preventive arm of the SGP envisages that countries improve their structural balance by at least 0.5 percent of GDP if they have not reached their medium-term objective of structural balance. For some countries, requiring such rapid adjustment in 2015 would be counterproductive. If necessary, the EU institutions should note the "severe economic downturn in the euro area as a whole." In the 115-page vade mecum on the SGP, a severe downturn is specified as "negative growth *or* an accumulated loss of output during a protracted period of very low growth relative to potential." Real GDP in the euro area in 2015 is projected to be at essentially the same level as in 2007 or 2008; arguably, this situation meets the definition of a severe downturn. Critics might point out that this clause was not activated in recent years and raise the question why it should be activated now. The answer lies in the fact that low growth has now abundantly proven protracted.

In the event that the economic environment deteriorates further, the agreed EU rules provide additional avenues for reducing the pace of fiscal consolidation. These are well defined and therefore less likely to undermine market confidence, compared with generic calls for new flexibility. A thoughtful and balanced review of such possible avenues is provided by Leipold (2014), who, for example, outlines ways of excluding from the fiscal deficit those public infrastructure investments that are cofinanced and thus vetted by the European Union.[2] These would be worth considering should growth slow down further in the euro area or individual countries.

2. COMPOSITION OF FISCAL REVENUES AND EXPENDITURES

Improving the composition of fiscal expenditures and revenues would strengthen economic growth significantly in the medium term. If they are well explained to the public at large, they may also have a beneficial impact in the near term, through improved expectations, higher private investment, and job creation.

In the context of medium-term fiscal adjustment strategies, a first question is whether the adjustment needs to occur through expenditure savings or higher revenues. Traditionally, European fiscal plans have focused (ex ante) on cutting expenditures rather than increasing taxation, though a good portion of the adjustment (ex post) was eventually accomplished through revenue increases.[3] In other words, policymakers in past years must have felt that in most European countries the state has become too bloated and savings can be gained by eliminating duplications and redundant services. This perception probably remains generalized in much of Europe, among not only politicians but also voters, subject to a qualification that I will return to below. Thus, it is likely that medium-term fiscal adjustment plans in most European countries will continue to aim at reducing the size of the state and if sufficient expenditure cuts are feasible, perhaps even permit reductions in taxation. Let me now discuss separately the composition of revenues and expenditures.

The structure of taxation clearly needs to be improved. In most European (as well as many other advanced) economies, the burden of taxation falls too much on labor and too little on property. Both empirical studies and economic logic suggest that when an opportunity arises to reduce taxation, the priority is to reduce taxes on labor, so as to enhance the incentives for job creation.[4] A second priority would be to reduce consumption taxes, and property taxes would come last. In fact, given the acute job crisis, an increase in property taxes to make room for cuts to taxes on labor would make economic sense. Regrettably, in some countries the issue has been turned into a seemingly insurmountable political totem. Nevertheless, the case should be made for improved tax structures. Grandparents who own their homes might be willing to pay higher property taxes if they were convinced that doing so would improve their children's and grandchildren's chances to find a job. To limit revenue losses and maximize job creation, cuts to labor taxation (e.g., social security contributions) should be targeted to the groups with the highest elasticity of employment, such as the youth.[5]

Policy choices regarding the composition of spending go well beyond macroeconomics, as they have major distributional implications that, again, are inherently political. Many studies have also addressed the extent to which some expenditure items (such as health, education, and infrastructure) foster long-run economic

2. Leipold (2014) also highlights the possibility of taking into consideration the costs of structural reforms, an avenue used thus far only for pension reforms whose impact can be precisely quantified. Broadening the use of the structural reform clause would have to be a last resort, because estimating the costs (and benefits) of other types of reforms would be challenging, and would thus risk undermining the credibility of the rules.
3. See evidence in Mauro (2011).
4. Empirical evidence is presented, for example, in Arnold et al. (2011).
5. IMF (2014) summarizes successful experiences in this regard.

growth. Here I offer only a couple of points that relate more strictly to the effectiveness of fiscal adjustment and fiscal stimulus from the perspective of macroeconomic developments in the next few years.

First, evidence from case studies suggests that expenditure cuts tend to be more durable and effective if they reflect strategic choices made through an inclusive "spending review" process rather than proportional cuts. The most telling historical example is provided by Canada, where across-the-board cuts had temporary effects in the 1980s, whereas an adjustment reflecting strategic choice had more pronounced and longer lasting effects in the 1990s.[6] This approach is underway in Italy, where it has attracted much attention, but it is widely applicable in Europe. Indeed, it would be desirable to extend the use of spending reviews to many more countries in the European Union.

Second, several commentators have argued for a major increase in public investment in infrastructure, particularly in view of the decline in long-term interest rates to rock-bottom levels.[7] Public infrastructure capital stocks have declined as a share of output in most advanced economies for many years. Yet, higher infrastructure investment improves potential growth. Moreover, the International Monetary Fund's *World Economic Outlook* (2014) has made a convincing case that the multiplier of infrastructure investment is higher in times of depressed domestic demand, such as now in Europe.[8] Maintenance investment is always a good place to start: It can be put in place relatively quickly; it is also often neglected, as it is less glamorous than building new infrastructure. Particularly for countries experiencing historically low interest rates, the argument "if not now, when?" is compelling, subject to the customary notes of caution: selection and implementation of projects has to ensure they are worthwhile, actually completed, and maintained after they are built.

3. REGAINING THE "VISION" FOR EUROPE

Part of the reason for market participants' pessimism regarding prospects for some eurozone economies is the lack of clarity about the vision for Europe's future. European policymakers have been on the defensive for too long, letting the media and market developments drive the rhetoric and the agenda. Media and market commentary understandably focus on last-minute, piecemeal reforms portrayed as a lowest common denominator to ensure the eurozone's survival. European policymakers need to regain the initiative by outlining a renewed vision for the Union's long run and by spelling out some key integration initiatives aimed at that goal. Here politics and economics become inextricably intertwined. For example, reaffirming the general political commitment to a long-run project such as the United States of Europe by, say, the middle of the century, would yield significant economic benefits earlier, through credibility gains. Initially these benefits would be small but would grow as reforms consistent with the vision are implemented.

Some important reforms toward further European integration—such as the crisis insurance mechanisms and the banking union—are already shaping up, albeit modestly and slowly. In the fiscal sphere, steps would ultimately need to include the establishment of truly European taxes and spending mechanisms. Proposals to issue European bonds would be credible if they were backed by a real authority for the European Union to collect revenues and, correspondingly, to make spending decisions, subject to approval by the democratically elected European Parliament. In the area of taxation, one obvious candidate is a truly EU-wide value-added tax (VAT), including harmonization of the rates and a revenue administration involving extensive EU-wide cooperation. An EU-wide VAT would also bring major efficiency gains of its own, such as preventing fraud and, more important, facilitating the effective working of the free trade zone.[9]

6. The Canadian experience is summarized by Sancak, Liu, and Nakata (2011).
7. Summers (2014) has made this point forcefully for the United States. Similar arguments have been put forward in the European context by many (including Barbiero and Darvas 2014 and Kirkegaard 2014) after the decline in interest rates experienced in 2014.
8. IMF (2014b).
9. These are well known proposals. Cogent analyses of a common VAT for Europe are to be found in Baldwin (2007) and Keen and Smith (1996). Beyond the intrinsic efficiency of an appropriately designed VAT, cross-country compensation mechanisms could be designed to avoid chronic one-way transfers to less advanced member economies and to reduce fiscal procyclicality.

4. MAKING THINGS HAPPEN

Many of the fiscal reforms mentioned above—especially those relating to the composition of fiscal adjustment—have significant distributional implications and thus present challenges in attaining consensus and successful implementation. In this regard, they bear similarities to structural reforms in factor and product markets, such as those involving liberalization. The difficulties Europe is experiencing, both within countries and across countries, are a textbook example of the well-known problems illustrated in Mancur Olson's timeless *The Logic of Collective Action*. When a reform is attempted (cut an expenditure item, eliminate a particular tax deduction, or open up a certain market to greater competition), it is often the case that although the net gains to society as a whole are significant, the per-person losses incurred by a small group are sizable. Members of this group will thus fight tooth and nail to boycott the reforms, whereas the per-person gains of the large but diffuse majority will provide insufficient incentives to lobby in favor of the reforms. In principle, one could try to break the impasse by compensating the losers, but this is difficult when fiscal resources are scarce. To implement reforms, policymakers will need to convince the public that even though the risk of a full-blown crisis appears to have abated, reforms are necessary to avoid its reemergence, and that all groups will bear a fair share of the adjustment at the same time.

Bringing back confidence and investment will require a combination of near- and medium-term policies, under an overarching vision of greater European integration. These policies include implementing the agreed EU fiscal rules, using the existing limited and well-defined flexibility; undertaking moderate fiscal stimulus in countries that can afford it, to secure their own domestic recovery; reducing the burden of taxation on labor, beginning with targeted cuts for the youth; reorienting expenditure toward infrastructure investment; and reaffirming a political commitment to the European project.

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AN AGENDA FOR REFORM OF THE EURO AREA LABOR MARKETS

JACOB FUNK KIRKEGAARD

Persistent economic stagnation continues to afflict the euro area, with financial institutions and government budgets struggling under its weight. But at the core of the region's malaise lies the suffering of the unemployed. The aggregate employment rate is stubbornly low at 63.9 percent and the unemployment rate is stubbornly high at 11.5 percent.[1] More macroeconomic stimulus is one response to these difficulties.

But it would be a tragic mistake to overlook the vital importance of labor market reforms in several member states with acute labor problems, especially among the youth. The adjustments should focus on the myriad labor market regulations that stifle hiring or contribute to low total hours worked per capita. Euro area member states with persistent unemployment and underemployment must adjust their labor market regulations as the strongest national contribution to a coordinated euro area policy response.

The labor market is not like the market for fish (Solow 1990).[2] Labor markets in the most troubled euro area countries are hampered by multidimensional sets of legal rules, institutions, societal conventions, informal traditions, and financial relations. To a surprising degree, these arrangements are connected to a country's productive capacity, poverty, gender and social exclusion, political stability, and even residents' individual self-esteem. Improving flexibility for firms that hire, and ending legal discrimination between classes of workers, can increase the well-being of employers and employees. Companies throughout the region should be encouraged to adopt the best practices of other euro area members, including greater latitude in setting wage and working conditions according to local firm-level circumstances. All workers should have access to employment with comparable legal contractual conditions.

Three market reform priorities should be pursued. First, euro area countries should end the duality in labor market structures, eliminating a system that protects so-called labor market insiders (those enjoying full-time, permanent jobs with strong legal job protection) and outsiders (typically young people and women who are compelled to work only part-time, and on temporary work contracts with little or no legal job protection).

Second, euro area wage negotiations must be decentralized. Legally binding national, cross-sectoral or multiemployer bargaining should be eliminated, allowing nations, regions and sectors to establish their own arrangements according to their own needs. Firms should be able to withdraw from requirements of higher level agreements in times of economic pressure.

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1. Latest available data for the total age group of 15–64 years for 2014Q2 for employment rate and August 2014 for unemployment.
2. I am indebted to my colleague David Blanchflower for pointing me to this wonderful quote.

The third priority should to promote euro area unemployment insurance to help member states in acute crises finance their benefit payment systems, eliminating the distortions that affect workers as different countries struggle to respond to crises within the limits of their own resources.

Some of these steps would temporarily lower wage rates, reduce benefits, and diminish job security protections and severance pay for some in the labor force, leading to a short-term income loss. National collective bargaining agreements are likely to be weakened, generating sporadic protests and maybe strikes by workers.

But these tradeoffs are not valid reasons to put off policy action. Reduced household purchasing power for some today leads to an increase in household income for more in the long term. The adjustments would restore business confidence and encourage new hiring and investment decisions that generate growth.

National macro policy changes should play an important role in reviving the euro area economy, but it would be a mistake to carry them out without legislated labor market reforms.[3] To create the conditions for reform, countries that improve the functioning of their labor market for the long run should be granted additional latitude to run budget deficits and undertake targeted monetary stimulus today.

CURRENT STATUS OF THE EURO AREA LABOR MARKET

Unemployment rates, despite their statistical peculiarities,[4] command the attention of most media and policymakers. A more revealing metric for particular problems in the euro area job market, however, is the employment-to-population rate, broken down by gender. Figure 1 shows the gender specific 20-64-year-old[5] employment rates for Germany, France, Italy, and Spain, the largest states in the 18-member euro area, from the first quarter of 2000 to the present.

The figure shows major differences between men and women in the euro area as a whole and in these four countries, particularly since the most recent crisis began. Male employment has declined substantially (5 percentage points) in the 18 euro area countries since the crisis began, while female employment, which rose strongly before the crisis, was stable after 2008–09 and has since picked up slightly. It is striking that the euro area female employment rate reached a historic high of 62.8 percent in the second quarter of 2014!

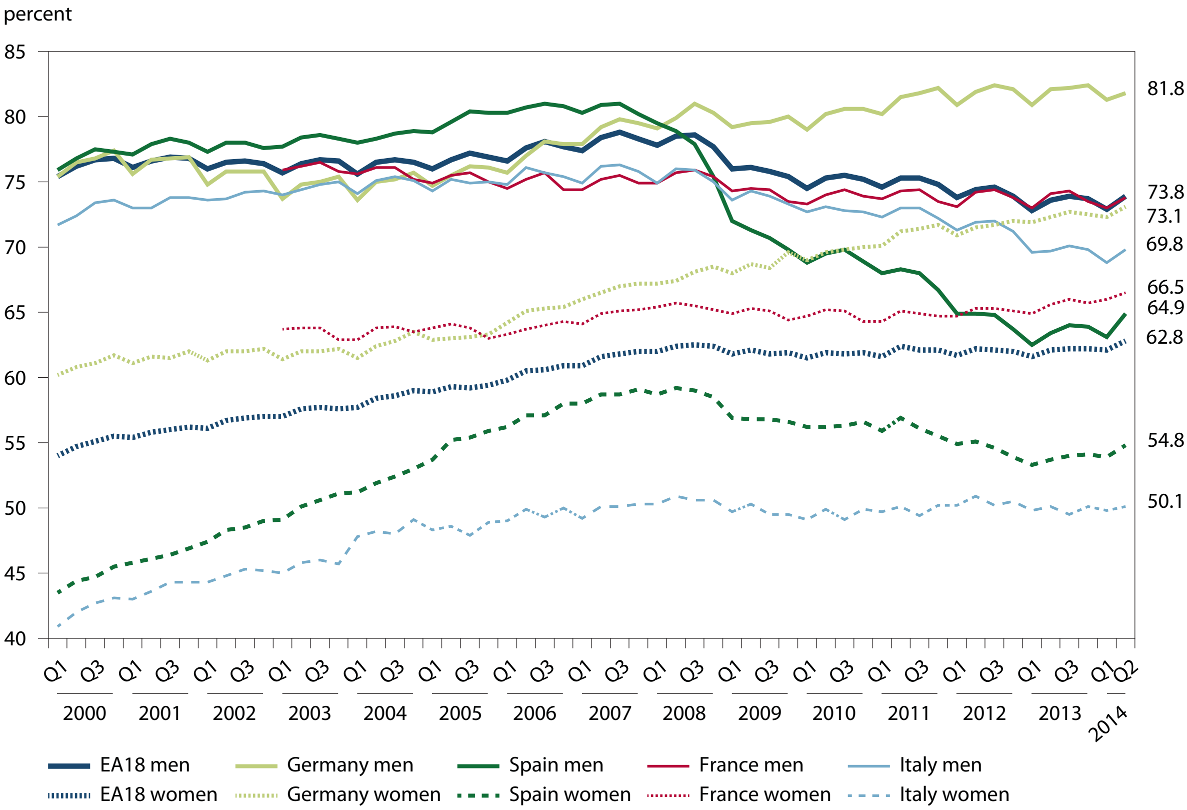
The trends among member states are also varied. German employment has soared in recent years, and especially among German women. French men have not fared noticeably worse after the crisis, merely continuing a slow employment rate decline. Jobs for French women, on the other hand, have never been as plentiful, reaching a 66.5 percent employment rate, as they are today. Italian men meanwhile have suffered substantial employment losses since the crisis, but Italian women managed to keep their employment rate stable at an extraordinarily low level of 50 percent. In Spain, the crisis in the construction sector destroyed many male jobs. Spanish women fared better but continued to hold jobs at rates far below the euro area aggregate.

3. IMF (2014, chapter 2) suggests that carefully targeted fiscal stimulus can help bring forward net output gains from reforms in especially high hysteresis countries—which would include potential euro area reformers.

4. Unemployment rates are, for instance, always estimated as a share of the labor force, which for some age groups—like 15–24-year-olds, where most are in full-time education and hence outside the labor force—can be highly distortive and greatly inflate the unemployment rate. If, for instance, 70 percent of the 15–24-year-olds are in school and not in the labor force, the age specific labor force is only 30 percent of all young people of this age. A reported 50 percent youth unemployment rate would correspond to only 15 percent of all 15–24-year-olds looking for a job.

5. Typically, the total labor force is defined as the 15–64 age category. However, as average full-time schooling time in OECD countries is 17.7 years, the vast majority of people do not enter the workforce until around age 20. I chose the age group of 20–64 years for figure 1 to capture the age group in which governments should actively promote full-time work (at least until retirement ages rise further). Data are from OECD (2014).

Figure 1 Employment rates, 20–64 years, 2000Q1–2014Q2



EA18 = 18 members of the euro area

Source: Eurostat, European Union Labor Force Survey.

The euro area average for the usual hours worked in a full-time job has not adjusted much since the crisis began. The number fell only 0.3 hours from 2008Q3 to 41.3 hours in 2014Q2.[6] The number also varied little across member states: It was 41.7 hours in Spain, 41.6 hours in Germany, and 40.5 hours in France and Italy in 2014Q2. Some countries impose explicit restrictions on the hours worked for full-time jobs—for example, France's 35-hour work week. In other cases, the economic crisis compelled workers to reduce their hours rather than face layoffs, as in the case of Germany's *Kurzarbeit* at the height of the recent crisis in 2009. But these practices seem to have had little impact. Labor adjustments in the euro area have generally come from labor shedding and through differences in the utilization of part-time workers across member states, gender, and age groups.

Members with poorly functioning labor markets should coordinate their policy responses, for example, by adopting regional unemployment insurance. Doing so would stabilize the most troubled countries over the long term, promote intergovernmental solidarity, foster national labor market reforms, and send a powerful message that there is a "European level answer" to joblessness. Three priorities for such cooperation stand out.

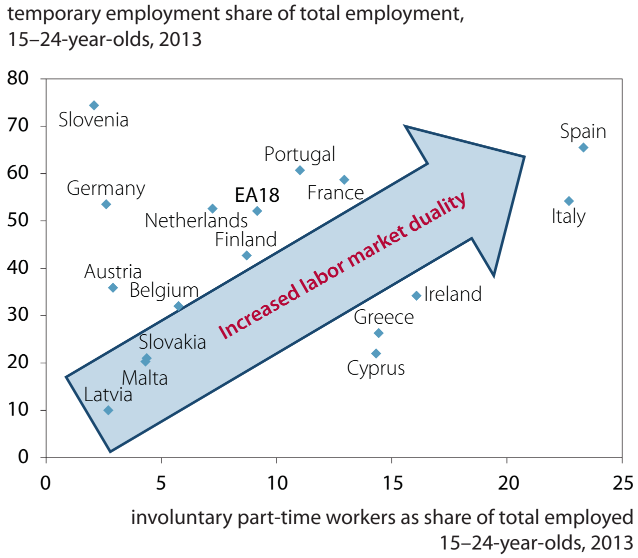
6. The gender difference in hours worked in full-time jobs in the euro area is also limited with men working just over 42 hours per week and women just below 40 hours.

ENDING THE DUALITY IN EURO AREA LABOR MARKETS

Creating jobs is a crucial policy objective for the euro area, but it is no less important for several euro area members to end the legal and regulatory inequalities in the contracts available to different groups of workers. This means eliminating the legislated discrimination between labor market "insiders," who have full-time, permanent jobs with strong legal job protection, and "outsiders," who work part-time, on temporary work contracts that provide little or no legal job protection.[7]

This duality is the legacy of previous labor market reforms in some countries that liberalized labor regulations to encourage employers to hire workers on temporary and part-time contracts. The objective was to overcome employer reluctance to hire permanent workers, who could not easily be dismissed in the event of an economic reversal. Such reforms left the myriad protections on dismissing permanent workers intact. Figure 1 shows that in the precrisis years, the rise in temporary or part-time contracts helped push up especially female employment in the euro area. Since the crisis began, labor market duality, however, has led to highly disproportionate job loss for workers with the least employment protection—inevitably, young people. The result has been the widely publicized soaring youth unemployment rates in many euro area members. Figure 2 shows that young people with jobs in several euro area members are disproportionally "outsiders," who remain vulnerable because of fewer job protections.

Figure 2 Labor market duality for 15-24-year-olds, 2013



EA18 = 18 members of the euro area

Source: Eurostat, European Union Labor Force Survey.

Discrimination against young people is particularly acute in Spain, Italy, France, and Portugal,[8] where these workers continue to suffer from excessive job churning, fewer hours worked, poor earnings, and fewer training and career opportunities.

One sensible reform for these countries (seen in the upper right part of figure 2 signaling high levels of temporary and involuntary part-time young workers) would be to legislate a new single, open-ended employment contract for all new hires outside explicitly educational processes—in apprenticeships, for example. Such a new law would limit the number of temporary contracts to those facing maternity leave, family emergencies, and long-term sickness. A new single contract would end the legal discrimination against some groups of workers and ensure that all workers in the countries in question enjoy a legal level playing field in the labor market. A single

7. The traditional insider-outsider labor market literature from Lindbeck and Snower (1984, 1988) and the hysteresis model of Blanchard and Summers (1986) focuses on how unemployment can persist if working conditions and wages are determined by only the interests of employed "insiders," while ignoring the plight of unemployed "outsiders." Given the current situation in many euro area countries, however, it is appropriate to expand the category of outsiders to include people in precarious employment, as these groups traditionally have not affected the political economy of labor market regulation.

8. The large number of temporary contracts in countries like Germany, the Netherlands, and Slovenia, which have very few involuntary part-time workers, is because of the widespread use of vocational training schemes and apprenticeships. These trainees and apprentices are by definition temporary contractual workers.

contract would enable new employees to negotiate the same job protections with their employers as those currently enjoyed by labor market insiders.[9]

Meanwhile, some countries should consider limiting the many protections on permanent employees. For example, severance payments, which are part of the existing national labor market regulations, should be allowed to increase only slowly and smoothly with seniority. Simpler single employment contracts would also eliminate any need for a specialized labor court system, where employees have many opportunities to sue their employers (especially large firms) for alleged unfair dismissal. Such courts should be gradually phased out.

DECENTRALIZING EURO AREA WAGE NEGOTIATIONS

Euro area countries should all work together to liberalize negotiations on setting wages and working conditions. As outlined in Eurofound (2014), mechanisms for such negotiations in the euro area and especially in crisis countries have been increasingly decentralized, a trend that should be encouraged. Legally binding national, cross-sectoral, or multiemployer bargaining should be replaced by more flexible arrangements at the national, regional, multi/single sector, and/or firm level. Opt-out clauses, under which employers and employees are able to agree to not implement some otherwise binding provisions from higher level agreements during times of economic distress, should be included in all collective bargaining agreements. The principle of extending agreements reached between a small number of firms and workers' representatives to all firms and workers within their field (Erga Omnes) should be ended, and so should the practice of automatic adjustment of wages to changes in the cost of living (i.e., wage indexation), including of legal minimum wages.

Removing the straitjacket of uniform job regulations would enable companies with different wages and working conditions, as well as different productivity levels, to adjust their wage rates accordingly. Companies would be able to adjust wages as economic conditions rise or fall in a more cyclically sensitive manner. Along with regulations to ease the discrimination between permanent and temporary workers, these changes would reduce the opportunities for collusive behavior by both employers and the labor unions. Larger and higher-productivity companies would be barred from using national or sector specific agreement provisions to prevent entry of smaller firms into their markets—for example, by imposing inflexible working conditions that make it impossible for companies with few employees to be profitable. In addition full-time, permanent workers would have fewer options to use unrepresented part-time and temporary workers as buffer to shield their own jobs from economic pressures.

PROMOTING A EURO AREA UNEMPLOYMENT INSURANCE SCHEME

A euro area–wide unemployment insurance system, collectively financed or sponsored by all countries in the euro area, could under some conditions finance benefit payments in member states in acute economic crisis.[10] One way it might work would be to allow a member state that has met certain efficient labor market characteristics to access a central fund when it faces a crisis that crosses a predetermined threshold of severity. Countries should finance the assistance based on the number of hours worked in each of their own economies.

Because of their legacy of historic, cultural, and political differences, euro area labor markets remain highly heterogeneous. Attempts to impose even limited institutional uniformity would reduce healthy policy

9. The single contract has been proposed earlier by Blanchard and Tirole (2003) for France, Boeri and Garibaldi (2008) for Italy, and Andrés et al. (2009) for Spain.

10. Pan–euro area unemployment insurance has previously been suggested by both French (Mayneris 2014) and German (Glienicker Gruppe 2013) scholars and has been a popular topic of analysis at the European Commission. See, for instance, the papers presented at the Economic Shock Absorbers for the Eurozone Conference in Brussels on June 20, 2014, available at http://ec.europa.eu/social/main.jsp?catId=88&langId=en&eventsId=992&moreDocuments=yes&tableName=events&typeId=92.

competition between member states and, given the politics in each country, probably prove futile.[11] Instead, requiring that euro area labor markets agree to certain institutional norms (such as a single labor contract and bargaining for flexible wage/working conditions, discussed earlier) before they are eligible to participate in a regional unemployment insurance scheme would allow for this heterogeneity to continue. At the same time, such a system would provide incentives for member states to eliminate their most destructive labor market distortions.

Such a supplementary insurance system would resemble the US Emergency Unemployment Compensation, which supplements regular state-level unemployment benefits with federal funding. The US system does so only after the state exhausts its benefit funds and only with the approval of the US Congress.[12]

Contingent pan–euro area unemployment insurance would automatically stabilize countries in times of deep crises,[13] while providing the euro area with needed new economic shock absorbers.

11. See Claeys, Darvas, and Wolff (2014) for details on the degree of differences in labor market structures in the euro area.
12. See also Epaulard (2014) for a discussion of contingent unemployment insurance schemes in Europe.
13. See Doll et al. (2014) for a detailed estimate.

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OVERHAUL OF EU FINANCIAL SYSTEM NEEDED TO FOSTER GROWTH

NICOLAS VÉRON

Europe's crisis has been a banking and financial system crisis at least as much as a crisis of unsustainable public finances and sclerotic economies. Banking system dysfunction has crippled the European economy from the start of the crisis in 2007 to mid-2012, when the survival of the euro itself was threatened. Since mid-2012, more energetic policy efforts have been devoted to bank crisis resolution and the creation of a more sustainable architecture for banking policy, known as banking union. A healthy banking union can only be a part of the solution to securing a prosperous future, however. Europe's entire financial system needs to be reformed to strengthen financing, particularly for high-growth businesses, and jumpstart growth. The goal of this ambition is what is currently referred to in Brussels as capital markets union (CMU). Banking union and capital markets union are at different stages of design and execution, necessitating different approaches for each.

Part of the reason why the euro area economy has not bounced back yet is that banks have been constrained in their lending by the sorry state of their balance sheets. The banking union has belatedly triggered a process of balance sheet repair, but this process is still far from complete. Banking union refers to the centralization of supervisory and resolution authority in two European-level bodies: a newly created supervisory arm within the European Central Bank (ECB) and a new Brussels-based agency, the Single Resolution Board (SRB). The ECB's supervisory arm is fully operational and has been the licensing authority for all banks in the euro area since November 4, 2014, just after a year-long comprehensive assessment of the area's 130 largest banking groups was completed. The SRB will gradually start operations in 2015 and become fully operational in early 2016, when it acquires the authority to "bail in" failing banks by imposing losses on their creditors as well as to use its own resources for bank resolution (the Single Resolution Fund or SRF).[1]

By contrast, Europe's capital markets union is not even on the drawing board yet. A senior European financial policymaker describes the CMU as "a concept under construction."[2] On July 15, 2014, Jean-Claude Juncker, on his way to becoming president of the European Commission, announced the establishment of a European CMU to develop the weak and fragmented nonbank segment of Europe's financial system. While the banking union will have the biggest economic benefit in the short run, a well-designed capital markets

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1. The SRF will reach its steady-state dimension in 2024.
2. Speech by Steven Maijoor, chairman of the European Securities and Markets Authority, at the Finance for Growth Conference in Brussels, November 6, 2014, www.esma.europa.eu/content/Capital-Markets-Union-building-competitive-efficient-capital-markets-trusted-investors.

union would have major long-term structural impact by making the European financial system more resilient, efficient, and competitive.

Jonathan Hill, who holds the unwieldy title of European commissioner for financial stability, financial services, and capital markets union, has announced his intention to "develop an action plan by the summer of next year [2015] (...) [as a] roadmap to developing an ambitious Capital Markets Union."[3] The CMU agenda is widely seen as being primarily about new EU legislation. Since the European legislative cycle from initial proposal to entry into force typically takes at least 18 months to two years, the CMU is not likely to have much economic impact before 2017, unless the behavior of market participants changes in anticipation of its creation.

ECONOMIC IMPACT OF BANKING UNION

Four main factors could contribute to the economic impact of banking union.

- First, the unanimous decision of euro area member states in late June 2012 to initiate this union by pooling their sovereignty over banking policy at the supranational level, and to entrust the corresponding supervisory authority to the ECB, signalled their political solidarity and commitment to the integrity of the euro area. This development enabled the ECB to proceed with its outright monetary transactions (OMT) program, announced less than three months later. This step succeeded in calming the euro area's shaky sovereign debt markets.
- Second, the announcement of a banking union has already led to greater market discipline in the European banking system. Before mid-2012, most situations of bank weakness in Europe were met by public bailouts and/or nationalizations, at least in countries not under formal assistance programs by the International Monetary Fund and the European Union. Since then, a belated backlash against overly generous bank bailouts during 2007–12 has imposed the principle that shareholders and subordinated creditors should lose their money before any public assistance is provided, and even stricter discipline is expected to apply from 2016, when new antibailout legislation enters into force.
- Third, EU policymakers hope that the results of the comprehensive assessment will restore trust in the European banking system, even though the demand for credit is likely to remain anaemic in several member states for a long time. A firmer judgment on the success of the comprehensive assessment should be possible in early spring 2015, assuming that no nasty surprises ruin the credibility of the process, as had sadly been the case in earlier stress testing exercises in 2010 and 2011. A successful assessment will likely ease the credit supply problem, which has constricted European growth since 2007.
- Fourth, the ECB's actions as a banking supervisor in the next 12 to 18 months could reverse the euro area financial system's harmful fragmentation along national lines since 2010–11. The ECB should prevent national supervisors from forcing banks to ring-fence their internal capital and liquidity along national lines and should work at reducing the high home bias in their portfolios of euro area sovereign debt. The ECB can also favor the emergence of more integrated pan-European banking groups through more cross-border acquisitions.

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3. "Capital markets union—Finance serving the economy, speech in Brussels, November 6, 2014, http://europa.eu/rapid/press-release_SPEECH-14-1460_en.htm.

Despite these steps, the onset of banking union also coincides with a phase of bank deleveraging, resulting in more scarce credit in parts of Europe and highlighting the insufficient diversity of Europe's financial system, in which banks are the dominant actors. The ECB is trying to stimulate the development of market-based alternatives to bank financing through its consideration of purchases of asset-based securities (ABS) in the next few months. But no miracles should be expected on this front: Many obstacles to cross-border capital market integration in the European Union are deeply embedded in legislative frameworks and entrenched in financial industry structures. Complementing the current bank-dominated system with a "spare tire"[4] of non-bank finance requires legislative and structural changes, which is what the CMU agenda is about.

DEFINING THE CAPITAL MARKETS UNION

In this debate, "capital markets" is shorthand for a variety of equity and credit market segments that are small compared with banks, and thus play a smaller role in the process of channeling savings into investments in Europe. The list includes venture capital, private equity investment, public equity issuance and initial public offerings, corporate bond issuance, corporate debt securitization, direct purchase of loans by insurers and investment funds from banks, and credit intermediation by specialized nonbank financial firms such as leasing companies or consumer finance companies. By developing these and other financial market segments, the CMU agenda aims to make Europe's financial system more efficient and competitive, more resilient thanks to greater diversity, more responsive to monetary policy signals, and more able to respond to the financing needs of a vibrant innovation-driven economy. The European Commission has also made clear that, unlike the banking union, the CMU would cover all EU member states, including the United Kingdom because of its status as host to Europe's largest financial center in London.

CMU policy should not freeze market structures in their currently underdeveloped form. On the contrary, policy should improve the environment for the development of new forms of intermediation—i.e. channeling savings toward productive investment—and new financing contracts, with effective but not excessive controls against systemic risk. In this respect, it is odd that some early blueprints for CMU read like a catalogue of market segments, as if each of these needed specific legislation to fulfill its potential.[5] Rather than this curiously top-down government driven impulse, a more growth-friendly CMU approach should embody the principle of setting the right general framework that is conducive to the development of efficient financial services and contractual arrangements. [6]

An ambitious CMU agenda will face challenges from powerful interests threatened with displacement. Many banks will resist competition from alternative financing channels. Banking advocates will warn against the perils of "shadow banking" and regulatory arbitrage, while ignoring that their own core features of deposit collection and high leverage call for targeted and onerous regulation. A capital market development agenda will run into deep ideological scepticism from those who view markets with suspicion, a view that is influential among politicians and the general public in large parts of continental Europe. This view is abetted by the failure of economists to produce a convincing model for the financial sector around which a market-friendly consensus could coalesce. Finally, as previously mentioned, the agenda may centralize regulatory policy at the EU level to encourage market development, even though this would not be the primary end of the CMU proj-

4. This expression was popularized by the then-chairman of the Federal Reserve Board when he advocated a similar policy of capital market development in Asia following that region's crisis in 1997–98. See Alan Greenspan, speech at the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, www.federalreserve.gov/boarddocs/speeches/1999/19991019.htm.

5. See, for example, Hugo Dixon, "Unlocking Europe's capital markets union," Centre for European Reform (London), October 2014.

6. The phrase *Ordnungspolitik*, "Policy of order" in German, is a familiar reference in European economic debates to government action that focuses on setting the right framework conditions for economic development, as opposed to the *dirigiste* approach of directly promoting or protecting individual economic actors, sectors, or in this case, market segments.

ect, unlike banking union. Such a move is sure to encounter stiff resistance from interests invoking national sovereignty in the United Kingdom and elsewhere.

The UK situation is unique because of the high concentration in London of wholesale market activity, private equity, hedge funds, and other segments. Representatives of the City of London often highlight the benefits to the European Union of having a globally leading financial center on its territory. But they typically fail to acknowledge that the regulatory framework for the City should support the broader European public interest and not only the local interest of the United Kingdom.[7] As Simon Gleeson, a prominent British legal expert on financial services regulation, put it, "We still do not have sufficient European control of the City of London to leave other European Governments happy with the fact that increasingly Europe has only one financial centre, and that is it."[8] This issue must also be considered within the current UK domestic political context, which is marked by uncertainty about government attitudes towards the European Union and even about continuation of EU membership.

AGENDA FOR CAPITAL MARKETS UNION

Six main areas should be considered for inclusion in the CMU agenda, listed by increasing order of potential economic impact and political difficulty.

1. *Regulation of specific market segments*: This area commands the broadest discussion and consensus so far. Possible items include defining simple and transparent securitization products; amending the Transparency Directive to facilitate market access for medium-sized companies; and harmonizing frameworks for private placements. Onerous national rules that require nonbank lenders that do not take deposits to have a banking license could also be dismantled.

2. *Review of prudential frameworks*: Regulators should reconsider capital and liquidity requirements for financial firms that unnecessarily discourage investment in unrated corporate credit and other market segments. In particular, prudential requirements on insurers and pension funds have tended to mimic banking requirements, partly ignoring the fact that these players can legitimately take different risks from those taken by banks because of the longer maturity of their liabilities. The Solvency II Directive (for insurers) and the Occupational Pension Funds Directive should be reviewed accordingly.

3. *Financial transparency, accounting, and auditing*: While banks can use their relationships with borrowers to assess their creditworthiness, capital market investors need reliable public financial data. But public financial information in the European Union is of variable and often poor quality and not easily comparable across member states. A reform agenda could (1) harmonize EU regulation of auditors and create an EU regulator for the largest audit firms (something that recently adopted EU audit legislation signally failed to achieve); (2) establish a European chief accountant with authority over the enforcement of International Financial Reporting Standards (IFRS), either within the European Securities and Markets Authority (ESMA) or as a new EU agency; and (3) require the use of IFRS by all unlisted banks to enable consistent banking supervision.[9]

7. See International Regulatory Strategy Group, "Briefing on the principles that should underpin the development of a Capital Markets Union in Europe," City of London / TheCityUK, 2014.
8. UK House of Lords, transcript of evidence taken before the Select Committee on the European Union, Sub-Committee A on Economic and Financial Affairs, September 9, 2014.
9. On a related theme, it is worth noting that the ECB has taken steps towards the gradual formation of a credit register that would cover the entire banking union area. See the "Decision of the ECB of 24 February 2014 on the organisation of preparatory measures for the collection of granular credit data by the European System of Central Banks," https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2014_104_r_0008_en_txt.pdf.

4. *Supervision of financial infrastructure*: Financial market infrastructure firms that carry potential systemic risk, primarily central counterparties (CCPs, known as clearinghouses in the United States), remain subject to a national framework for their supervision, contingent liquidity support, recovery, and resolution. This framework creates major barriers to cross-border capital market integration. The European Union should support the establishment of a global (treaty-based) supervisor and resolution authority for CCPs, with the establishment of an EU-wide supervisory and resolution agency for CCPs as a second-best alternative.

5. *Insolvency and debt restructuring frameworks*: European insolvency frameworks work too slowly. They result too often in liquidation, and they fail to protect employment and private creditor rights. Furthermore, differences across national insolvency frameworks hamper the emergence of pan-European credit markets, not least for securitizations. Out-of-court restructuring is also underdeveloped in Europe. While full harmonization would be unrealistic, EU framework legislation could help overcome national obstacles. Even partial harmonization might foster cross-border market integration.[10]

6. *Taxation*: Differences between national tax regimes for savings products pose a major obstacle to cross-border capital market integration. Member states should seek more convergence in this area, either by unanimity or through enhanced cooperation, as well as simplification and stabilization of national tax regimes. In addition, the European Union should build on existing studies and national experiences to rebalance the differential tax treatment, which generally favors debt over equity.

The third and fourth areas could transfer some regulatory and supervisory functions from the national to the EU level. It would be a mistake to bar such a transfer a priori. EU-level supervision already exists within ESMA for derivatives trade repositories and credit rating agencies. Other categories of supervised financial firms may be subjected to either ESMA's authority or one or several specialized agencies that are to be created. Simultaneously, ESMA's governance and funding should be reformed to better fit its supervisory role, as suggested in President Juncker's mission letter to Commissioner Hill. A location in London for such new supervisory functions, inside or outside ESMA, could mitigate UK concerns.

The EU debate on CMU over the next few months should determine whether a realistic legislative reform agenda for the next half-decade could include all six of these items, or only some of them. The debate should also shape which reforms are of highest priority, and in what sequence they should be adopted. The European Commission will need to consult widely and will face challenging tradeoffs. But capital markets union can become a major component of the European agenda of structural reform, and the current moment of opportunity should not be missed.

10. Separately, in order to move towards a more complete banking union, a specific European insolvency regime should be created for banks, at least the largest ones.