Budgeting for Uncertainty

Time for Eurozone fiscal risk sharing.

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Eurozone fiscal policy: time for a rethinking

Why we need active fiscal policy

Over the past five years, the Eurozone has been going through a continued recovery. Lately, however, the external environment has changed. Europe faces the uncertainty induced by a Brexit process longer than expected. Recent developments in UK domestic politics increase the risk that the resolution to the impasse will be through a hard exit. Financial integration and the close alignment of the UK and Eurozone financial cycles make the Eurozone prone to negative spillovers from this scenario. External geopolitical tensions have also heightened. Europe finds itself in the crosshair of a US-China trade war which is already exacting a toll on one third of EU companies operating in China[1], while EU exports risk becoming the next direct target of US protectionism.

The sympthoms of a slowdown are especially visible in Germany. In June 2019, the IFO business climate indicator for the German economy dropped to the lowest reading since 2014. The German PMI has been depressed, especially in the manufacturing sector. Production and new orders have been on a downward path for a year, driven by the weakness in key export markets and subdued dynamics in the auto sector. But Germany is not the only one at risk: the so-called Euro 'Periphery' has undergone a massive external adjustment, and now it runs external surpluses too. This makes the Eurozone as a whole more exposed to a negative trade shock.

As highlighted by ECB President Draghi in a recent speech[2], the trade tensions, the downturn in global manufacturing and a turn in the tech cycle expose growth to the risk of faltering. The latest IMF report on Euro Area Policies[3] identifies the same downside risks, together with the persistence of strong sovereign-bank linkages in some high-debt countries – most notably Italy. In this more challenging environment, fiscal policy needs to be ready to play an active role in stimulating aggregate demand. Until now, the burden has fallen on the ECB, which has deployed a massive effort – bringing the main rate at zero, the deposit rate into negative territory, and its balance sheet close to 50% of Eurozone pre-crisis GDP (Figure 1). Yet, inflation keeps eluding its target. The headline rate was 1.7% in April 2019 but core inflation was still 1.3%, with inflation still below 1% for about 44% of the items in the HICP basket (Figure 1).

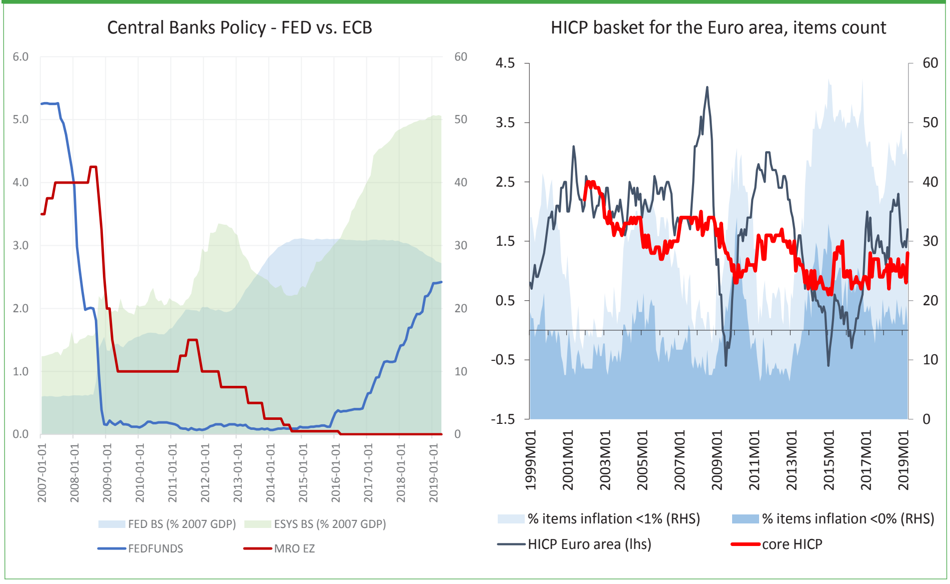
1 See: https://www.dw.com/en/one-third-of-eu-firms-hit-hard-by-us-china-trade-war/a-48800905

2 See Draghi (2019)

3 See (IMF 2019)

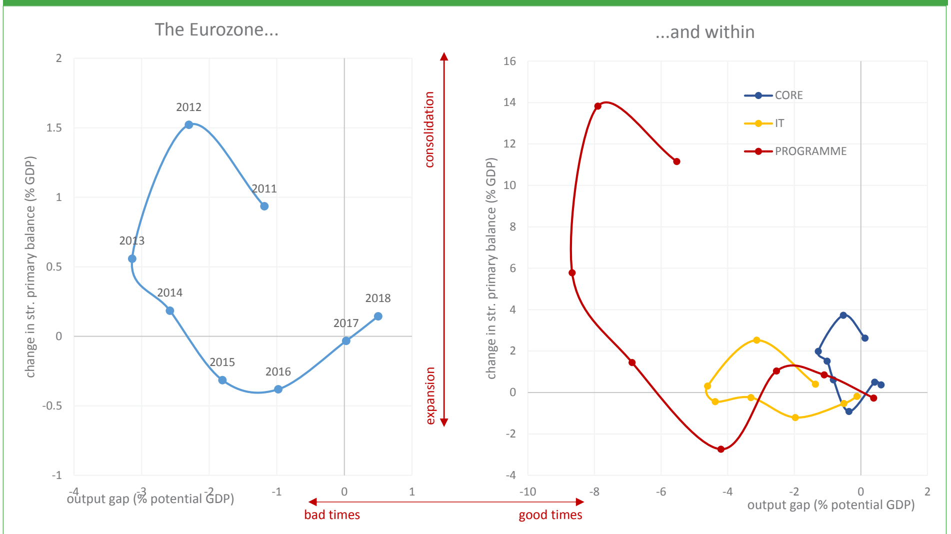
"Over-reliance on monetary policy to stimulate growth raises the risk of politicisation"

Figure 1 · **Monetary Policy and Inflation in the Eurozone**



▶ Source: Authors' calculations based on ECB, FRED, Eurostat data

Figure 2 · **Fiscal stance in the Eurozone**



▶ Source: Authors' calculations based on data from AMECO. PROGRAMME = ES; GR; IE; PT CORE = AT, BE, DE, FI, FR, NL

Despite Draghi's effort to signal that more easing would be feasible if needed, 'unconventional' monetary policies may run out of steam by the time the next shock hits. In its latest annual report, the Bank for International Settlements (BIS)[4] also sees the global economy losing momentum and warns that monetary policy alone cannot save the day. Exceptionally low interest rates may also have a negative impact on financial intermediation and credit supply by lowering interest margins, profits, and banks' ability

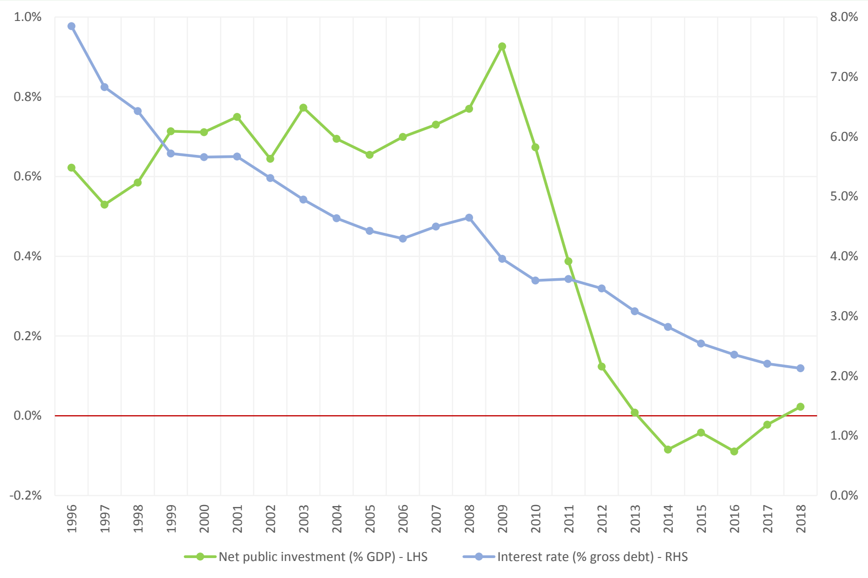
4 See: BIS (2019)

to build up capital. Persistently low rates may lead to misallocation of resources towards lower productivity sectors, but over-reliance on monetary policy to stimulate growth raises concerns that go beyond the economic sphere. In particular, such prominent central bank action lends itself to politicisation. Former German Finance Minister Schäuble exemplified this risk when openly suggesting in 2016 that the rise of right-wing populist party Alternative für Deutschland (AfD) was directly related to the ECB's expansionary monetary policy[5].

Europe has been recalcitrant in acknowledging the merits of active fiscal policy as a counter-cyclical tool. In the first phase of the crisis, fiscal and monetary policy eased together, but after 2010 their stance decoupled, and the Euro aggregate fiscal impulse turned contractionary (Figure 2). Despite steadily declining and low interest rates, net public investment in the Eurozone has been negative or zero since 2013, and the Juncker Plan seems to have played no magic role (Figure 3).

"Fiscal policy has been under-exploited. Despite low and declining rates, net public investment has been zero or negative since 2013"

FIGURE 3 · **Investment and interest rates in the Eurozone**



▸ SOURCE: Authors' calculations based on data from AMECO.

The hesitance to make an active use of fiscal policy is grounded on the intellectual view that underpins the Stability and Growth Pact (SGP) and that suggests business cycle fluctuations should be managed by monetary policy, while fiscal policy should only focus on debt sustainability[6].

5 "I said to Mario Draghi [...] be very proud: you can attribute 50 per cent of the results of a party that seems to be new and successful in Germany to the design of this policy" reported in: https://www.ft.com/content/bc0175c4-ff2b-11e5-9cc4-27926f2b110c

6 See e.g. Ubide (2016) for a discussion

Today, this view is less tenable than it was when output gaps were small, inflation was positive and not far from target, nominal interest rates were above inflation. Most of those conditions are no longer present. Growth today is below potential, even though the (debatable) methodology that international institutions use to estimate potential output does not always point to negative output gaps[7]. Monetary policy is becoming less effective than usual. And, as discussed recently among others by former IMF Chief Economist Olivier Blanchard, very low rates reduce the sustainability concerns typically associated with an active use of fiscal policy, at least for countries whose debt is considered safe by investors[8].

Why we need common fiscal policy

"Fiscal policy within a monetary union produces externalities. Coordination in such an environment has serious limitations"

Within a monetary union, fiscal policy needs to be coordinated in a meaningful way. Because of the close financial integration domestic fiscal policy may have significant cross-border spillovers. We saw them in action during the euro crisis. In a Eurozone where a competitive, moderately leveraged 'Core', and an over-indebted 'Periphery' share a fixed nominal exchange rate, the change in real exchange rates can only be achieved through the so-called 'internal devaluation'. This process ultimately depends on the differential fiscal stance of the two groups. In other words, there is no escape from *relative* austerity and the competitiveness adjustment of one region becomes more difficult if the other region is pursuing fiscal consolidation at the same time[9].

This is what happened during the euro crisis. The *aggregate* fiscal stance was strongly pro-cyclical between 2010 and 2014 (Figure 2, left), driven by sizeable consolidation in the Programme countries, which used fiscal policy as a signalling device to boost their credibility in the eyes of fleeing international investors. But the aggregate stance of Core countries was also tightening, in spite of negative output gaps and abundant fiscal space (Figure 2, right). The result of this lack of coordination has been perverse: the Eurozone as a whole did not start off with a narrower fiscal space than the US in 2008, but it did not use what it had in the best way. The task of fiscal stabilization was left to individual countries, some of which lacked the space and some of which lacked the will to expand. The overall result was an un-coordinated pro-cyclical fiscal tightening.

7 See e.g. Basile & Brooks (2019) for a discussion

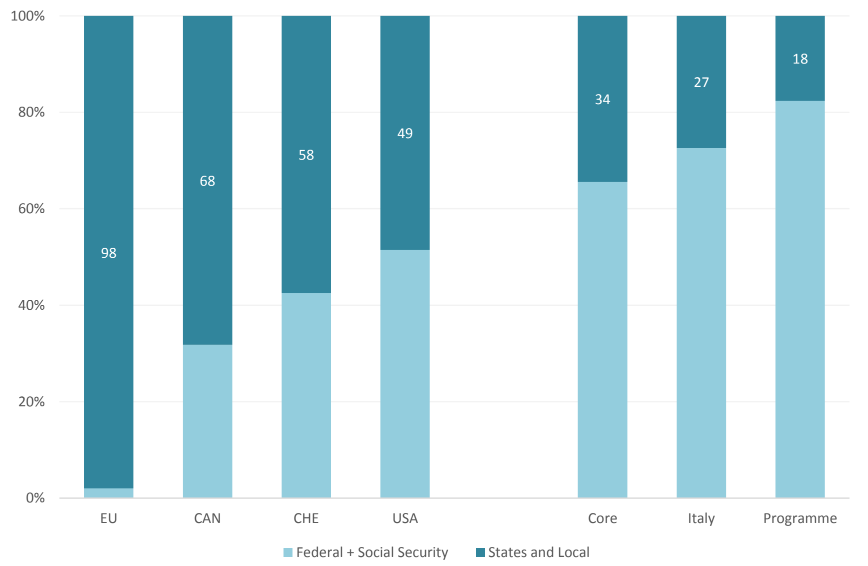
8 See Blanchard (2019)

9 See Merler & Pisani-Ferry (2012) for a more detailed discussion of this

"The fiscal impulse for 2019 is sub-optimally distributed, coming mostly from high-debt countries with limited fiscal space"

Today, we may be facing a similar scenario. The fiscal impulse for the Eurozone as a whole is estimated at 0.3% of potential GDP in 2019, with Germany expected to ease by around 0.6% and the Netherlands by 0.4% (IMF 2019). As stressed by both the IMF and the European Fiscal Board[10], the fiscal impulse in 2019/20 is again sub-optimally distributed. High-debt countries with limited fiscal space account for a large share of the forecasted fiscal expansion, whereas seven countries will over-achieve their Medium Term Objectives in 2019 (Germany and the Netherlands by more than 1% of GDP). For Germany, the IMF identifies a risk that the fiscal outturn will be even less expansionary than forecast, as the country has strongly over-performed its fiscal projections in recent years, especially on the revenue side. Moreover, both Germany and Netherlands are currently expected to shift towards neutral stances in 2020.

Figure 4· **Public Spending by Level of Government**



▸ Source: Authors' calculations based on OECD data.
PROGRAMME = ES; GR; IE; PT
CORE = AT, BE, DE, FI, FR, NL

Could this problem be solved by simply enhancing *coordination* among national fiscal policies, without the need for any *centralisation*? We think there are are two reasons why this not the case.

First, coordination has serious limitations when the policy to be coordinated generates externalities. The story of how Europe came to create a Banking Union illustrates this point very well. The first phase of the European response to the financial crisis featured a move towards harmonised rules and coordination. The Eurozone crisis then showed that coordination was not enough to prevent risk propagation, because national authorities would have no interest in internalising cross-country spillovers from their

10 See: EFB (2019)

actions and they would choose policies that – while protective of the national interest – would be detrimental to financial stability in the Eurozone as a whole. The liquidity and capital ring-fencing implemented independently by national supervisors during the crisis is a clear example of the limits of coordination. This is why the quest to preserve financial stability eventually turned to a *centralisation* approach. Fiscal policy is no different: in a downturn, those with fiscal space should be ready to implement a stimulus – but can they be trusted to do so?

"All federations rely on central stabilisation. The EZ is unique in not having a centralised budget"

Second, there are shocks that coordination would not be able to counteract. The lack of a central fiscal capacity makes the current framework ill-equipped to mitigate the impact of a *severe* downturn. For sure, fiscal policy is not the *only* avenue through which stabilisation of negative economic shocks can occur. Looking at risk-sharing among US states, Asdrubali et al. (1996) show that about 39% of shocks to US states' income is smoothed through the capital market and 23% through credit markets. Furceri and Zdzienicka (2013) replicate this exercise for the Eurozone, finding that the effectiveness of risk sharing mechanisms is lower than in existing federations and it falls in severe downturns, when it would be needed most. The move towards Capital Market Union (CMU), expected to increase shock-absorption capacity in the future, has been slow.

This is why all federations (and standalone countries) do perform some internal stabilisation through various versions of federal or centralised budgets. In the US, the federal budget is responsible for 13% of the shock-absorption capacity identified in Asdrubali et al. (1996). In Germany, Furceri and Zdzienicka (2013) find that the federal budget smooths at least 10% of shocks. The Eurozone is peculiar in its not having any central budget. Even the EU budget is limited to 2% of EU GDP (Figure 4) – significantly smaller than any other federation. About a third of that is allocated to EU Cohesion Policy, which ended up playing an important (but indirect) stabilisation role during the crisis, despite not having any explicit countercyclical mandate[11].

This is not optimal: stabilisation should not happen through the backdoor, but be an explicit aim of a Eurozone budget. Furceri and Zdzienicka (2013) show that a supranational fiscal stabilisation mechanism of 1.5-2.5 percent of GNP could provide significant stabilisation on a par with the fiscal risk sharing observed in Germany and other federally organised countries. In addition, a gross (net) contribution, equivalent to 4.5 (1.5) percent of countries' GNP, would allow to fully insure Eurozone countries even against very severe, persistent and unanticipated downturns.

11 See: http://bruegel.org/wp-content/uploads/2016/10/WP-06-16-1.pdf

The EZ Budget fiasco

Achieving centralised stabilisation was one of the stated objectives of the proponents of a Eurozone budget. French President Emmanuel Macron – acting leader of the ***risk-sharing*** camp – has been calling for a "Europe turned towards growth"[12]. This would feature a common finance ministry in the EU Council and a separate Eurozone budget of about 1-2% of the area's GDP, "establishing a minimum level of solidarity to eventually be able to raise money in common, invest, and absorb economic shocks that could hit Europe again"[13]. The official position of Spain[14] also calls for the creation of a central budget "to promote competitiveness, convergence and stabilisation, starting in 2021, with full democratic accountability".

Positions are markedly different in the North. Having seen their economic models unchallenged by the crisis, Northern countries favour a reform of Eurozone economic governance focused on *risk reduction* (Figure 5). Germany seems to prefer money in exchange for structural reforms[15], very much in line with the view that Merkel's former Finance Minister Schäuble proposed in a 2017 paper[16]. Schäuble was very explicit in saying that "a macroeconomic stabilisation function e.g. through a new fiscal capacity or unemployment insurance is economically not necessary for a stable monetary union" and that rather "we have to much better use the national automatic stabilisers to absorb shocks". A 2018 report published by the German Council of Economic Experts (Sachverständigenrat) similarly rejects the idea of a central fiscal capacity, arguing that: "any insurance function performed by a fiscal capacity can, in practice, hardly be distinguished from quasi-permanent transfers"[17]. Other Northern Eurozone countries appear even less willing to engage in fiscal risk sharing. The Dutch position is that the single currency should "bring us all more prosperity and not a redistribution of existing prosperity"[18]. The self-named 'New Hanseatic League' argues that a stronger EMU "starts with implementing structural reforms and respecting the Stability and Growth Pact, thereby building up fiscal buffers in national budgets to allow room for national fiscal policies [...] to smoothen economic downturns"[19].

"While started with good intentions, the EZ budget debate has stalled onto a meaningless compromise"

12 See Destais (2018)

13 See https://euobserver.com/economic/138841

14 See Moncloa (2018)

15 See: https://www.euractiv.com/section/economy-jobs/news/commission-hails-similarities-with-merkels-eurozone-proposals/

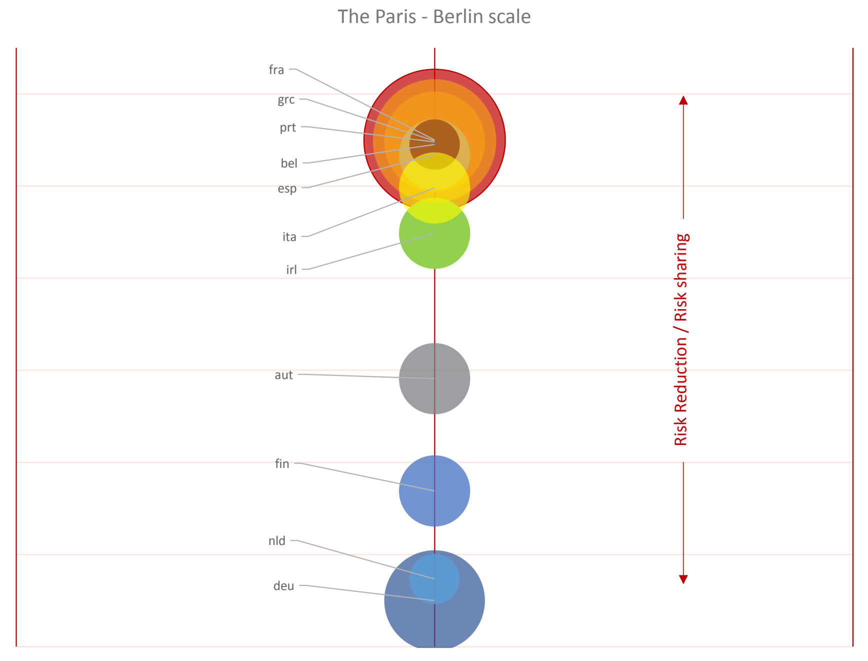
16 See: http://media2.corriere.it/corriere/pdf/2017/non-paper.pdf

17 Page 210 in https://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/gutachten/jg201819/Chapter_4.pdf

18 Rutte (2018)

19 See: Hansa (2018) :

Figure 5 · **Risk Sharing versus Risk Reduction**



▸ Source: Authors' calculations based on the original dataset by Wasserfallen and Lehner (2018). We select 40 of the issues which we believe directly relate to countries' views on risk sharing vs. risk reduction. Applying a basic factor analysis (with 1 factor) we achieve a one-dimensional ranking of countries.

The Franco-German *Meseberg Declaration*[20] of June 2018 was supposed to strike a compromise view. It proposed the creation of a Eurozone budget, but limited in scope to "competitiveness and convergence", with the controversial *stabilisation* function to be addressed separately.

The statement released after the Euro Summit in December 2018 did not mention the word *stabilisation* anywhere[21]. As time went by, even the ambitious French stance weakened. In his appeal to European voters – published across the EU in March 2019 – Macron dropped any reference to the controversial issue of Eurozone governance reform[22]. A joint Franco-German paper on a "Eurozone Budgetary Instrument", released in early 2019[23], conceives the budget mostly as a helping tool for the pursuit of structural reforms. It fails to acknowledge, even in theoretical terms, the need for a Eurozone stabilisation function. In June 2019, the Eurogroup published a term sheet[24] on the "budgetary instrument for convergence and competitiveness" (BICC) that follows the same logic. It clarifies that access to the funds will "depend on […] respect of applicable macroeconomic conditionality", which is the opposite of what should happen for the BICC to be able to play any role in economic stabilisation.

20 https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806
21 See: https://www.consilium.europa.eu/media/37563/20181214-euro-summit-statement.pdf
22 See https://www.theguardian.com/commentisfree/2019/mar/04/europe-brexit-uk
23 See the text at: https://sven-giegold.de/wp-content/uploads/2019/02/French-German-Contribution-on-a-Eurozone-Budgetary-Instrument.pdf
24 See: https://www.consilium.europa.eu/en/press/press-releases/2019/06/14/term-sheet-on-the-budgetary-instrument-for-convergence-and-competitiveness/

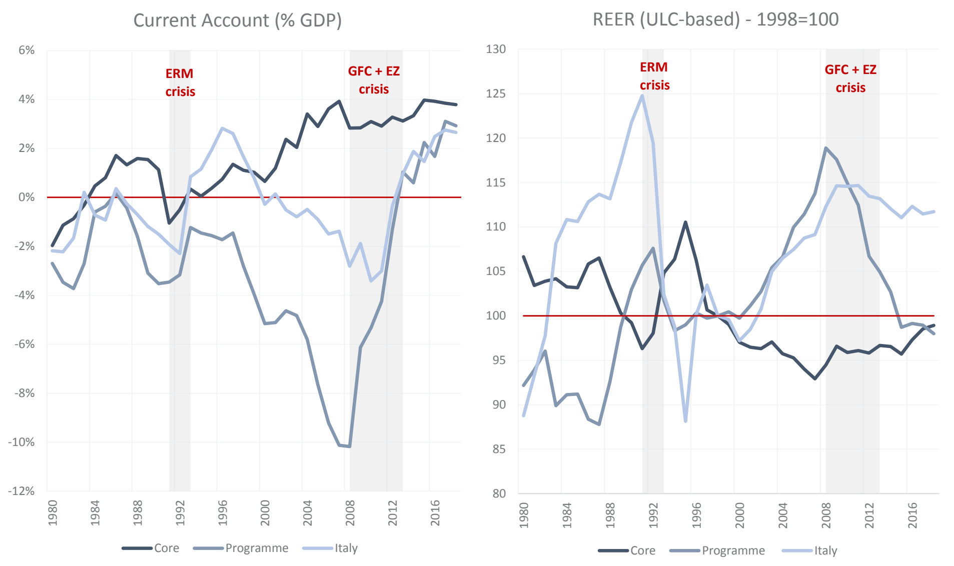
The Great Convergence

Intellectually, the BICC is rooted onto the idea that the Eurozone budget should focus on promoting convergence, and that convergence *itself* would deliver stabilisation. Hardly a novel view, it feels like a revival of the debate that pitted 'economists' against 'monetarists' at the time of the Werner report. The 'economists' view – advocated by Germany at the time – posited precisely that real convergence to a similar economic model ought to be a pre-requisite for monetary unification, to ensure asymmetric shocks would not be destabilising. **Absent convergence, it was feared that any attempt at fiscal union would lead to moral hazard and permanent transfers. How justified are those worries today?**

"Opponents of a EZ budget seem to fear that countries are 'too different' for stabilization not to lead to permanent transfers"

The first decade since currency unification has indeed been one of great macroeconomic divergence, within the Eurozone. This legacy reaches far into today's debate, in a rhetoric that pits Northern 'saints' against Southern 'sinners'. The 2015 'Five Presidents Report' acknowledged this tension and pointed out that while Eurozone members "need to be able to share the impact of shocks through risk-sharing within the EMU", this would require "significant and sustained *convergence towards similarly resilient economies*" to avoid permanent transfers and weakened incentives for sound policymaking.

FIGURE 6 · **External Adjustment**



▸ SOURCE: Authors' calculations based on AMECO data.

"Since 2010, we have seen significant external, internal, and structural convergence of the Periphery towards the Core economic model"

Since 2010, however, convergence has taken place to an impressive degree. The external adjustment after the crisis has been massive. Greece, Ireland, Portugal and Spain used to run an aggregate current account deficit of about 10% of their total GDP in 2008. Today, they are running an aggregate current account *surplus* of about 3% of GDP, not far from the aggregate figure for Core countries (Figure 6, left). Italy – which we look at separately, because while coming under market pressure it did not go through an EU/IMF adjustment programme – is also posting a surplus. Overall, the adjustment in the periphery has turned the Eurozone as a whole into an export-led economy. Compared to the magnitude of the current account adjustment performed by the Programme countries during the Eurozone crisis, even the adjustment that took place after the Exchange Rate Mechanism (ERM) crisis of the early Nineties pales (although conditions back then were obviously very different).

The counterpart to the current account adjustment has been a sizeable correction in the periphery's external competitiveness, through cost compression. This is immediately visible in the stark convergence of the real effective exchange rate (REER) based on unit labour costs (Figure 6, right). Today, core countries and programme countries are almost indistinguishable in terms of their external competitiveness. Importantly, this is not true for Italy, which seems to stand out as a case of missed or delayed adjustment on the external competitiveness front[25].

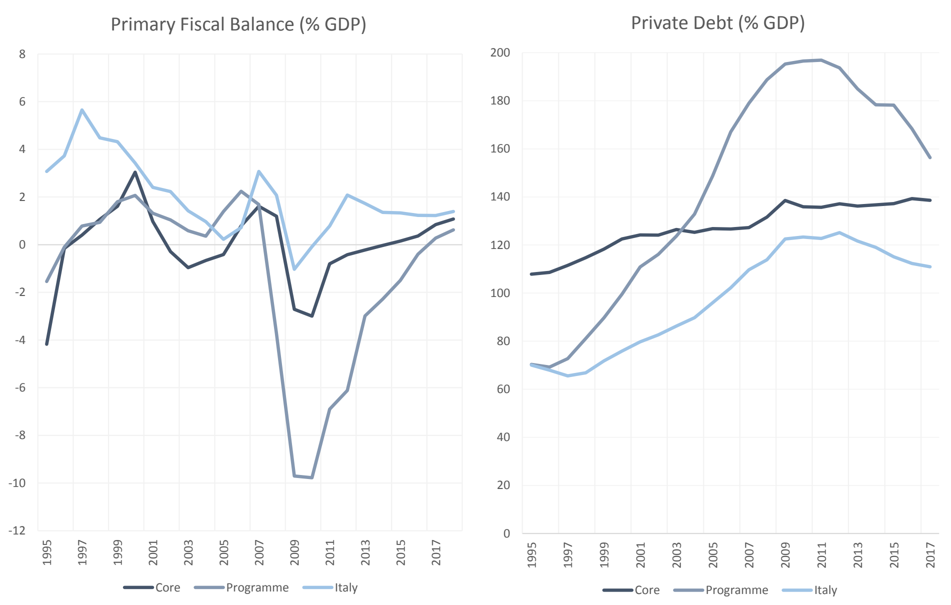
The internal adjustment has been no less impressive. While more prudent in their fiscal policy conduct before the crisis, in 2008 the Programme countries were running an average primary deficit of about 10% of GDP. Today, they have reverted to an aggregate fiscal surplus, again very close to their Northern peers (Figure 7, left). After accumulating a burden of private debt twice the size of their total GDP, Programme countries have embarked on a steady process of deleveraging (and 'risk reduction') since 2011. Today, their aggregate private debt stands below 160% of GDP. While still sizable, it is not too far from the aggregate 140% figure posted by the group of core countries as a whole, while Italy is below average.

"As a result, the synchronisation of business and financial cycles has increased within the EZ, since 2016"

Convergence is visible also on the structural front (Figure 8). Looking at the OECD indexes of Product Market Regulation (PMR) and Employment Protection Legislation (EPL) – which measure the rigidity of product and labour markets respectively – it is possible to see a significant improvement in the Programme countries' labour and product market flexibility between 2008 and the post-crisis period. In Italy, the adjustment is slower, but the latest EPL data available is from 2013, so it does not take into account the labour market reforms undertaken thereafter.

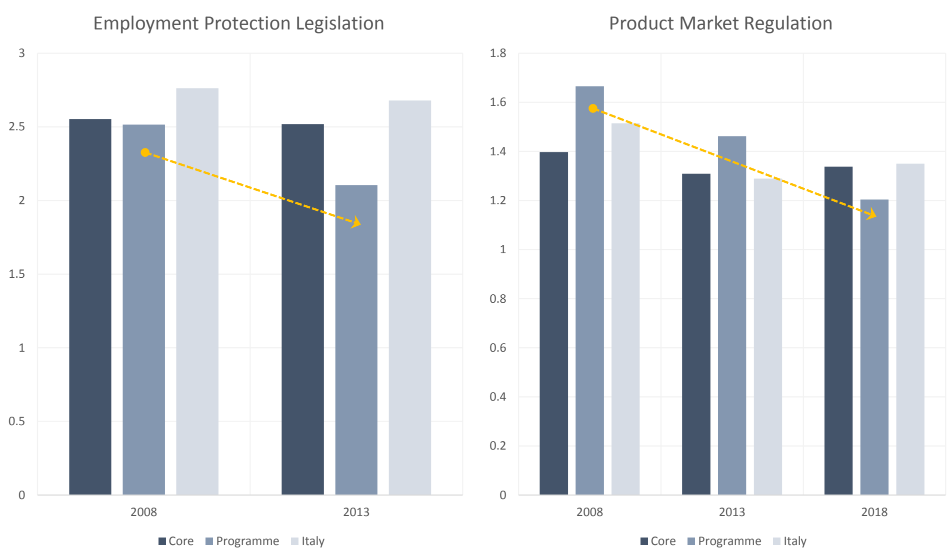
25 See Merler (2019)

Figure 7 · **Internal Adjustment**



▶ Source: Authors' calculations based on AMECO data

Figure 8 · **Structural Adjustment**



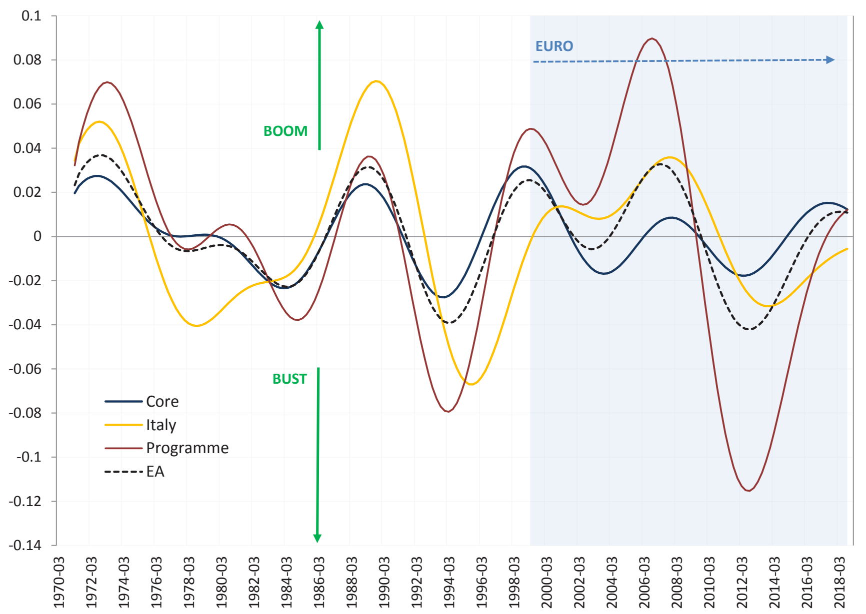
▶ Source: calculations based on OECD data

As a result of these changes, synchronisation of business cycles has increased among Eurozone countries since 2016. This is also evident in the fact that a substantial share of the variation in GDP growth across members is now explained by a common factor[26] .

26 See https://www.ecb.europa.eu/pub/economic-bulletin/focus/2018/html/ecb.ebbox201805_03.en.html

The credit cycles – which in the pre-crisis period had been a source of divergence – have become much more aligned (Figure 9), pointing to the fact that financial integration no longer drives sizable economic asymmetry. These developments are in line with the predictions of the endogenous optimal currency area (OCA) hypothesis, which suggests the degree of business cycle synchronisation should increase over time as a result of deepening financial and trade integration. Italy is again a special case, as the cycle seems to be stuck in a prolonged slump.

FIGURE 9 · **Cycles in real bank credit to non-financial private sector**



▸ SOURCE: AUTHORS' calculations based on BIS and AMECO data

"In economic terms, 'core' and 'periphery' are today more similar than ever in the past. Convergence has been one-sided."

The significant process of convergence observed since 2010 means that individual Eurozone countries today are much less exposed to idiosyncratic shocks than they used to be before the crisis. This will facilitate the job of the single monetary policy going forward. At the same time, it strongly challenges the argument that a Eurozone budget would lead to permanent transfers to countries whose economies are structurally different from those of the 'best performers'. On many economic dimensions, 'core' and 'periphery' are today more similar than they have ever been in the past. Convergence has been one-sided: it is the 'periphery' that has become a lot more like the 'core'. In purely economic terms, there has never been a better time for introducing a common fiscal capacity and a Eurozone budget to deal with temporary stabilisation in case of negative economic shocks. If not now, when?

A ‘Battle of Ideas’?

“Is the north worried that different conceptions of appropriate fiscal policy-making will derail convergence?”

The preoccupation with a risk of permanent transfers appears unsubstantiated, based on the economic performance of North and South since the crisis. But maybe the Northern scepticism about fiscal risk-sharing reflects fears that, once left on their own, Southern neighbours will run foolish fiscal policies nullifying the programme-led convergence achieved so far?

In their 2016 book, Brunnermeier et al.(2016) argue that differences in the German and French conception of the appropriate economic policy were at the heart of the difficulty in finding a response to Europe’s financial crisis. Do ‘North’ and ‘South’ have such radically different conceptions of what appropriate fiscal policymaking is, to suggest that moral hazard and permanent redistribution is somehow unavoidable? Is there an ideological “Rhine-divide” about the conduct of fiscal policy that may justify the Northern hesitance to engage in fiscal risk sharing?

Using data from an original survey of experts[27], we identify two interesting facts. **First, against a view of national economic philosophies as ‘monolithic’, significant differences exist within groups. Second, against the view of a “Rhine-divide” as a major ideological rift, differences across groups are smaller than one might have expected**.[28]

When asked about how fiscal policy should be run in general (Figure 10, top), the risk reduction camp is split almost equally among those saying that fiscal deficit should only be allowed in ‘bad times’ (50%) and those conceding that fiscal deficit could occur in ‘good times’ too, to finance capital investment (40%). It is true that Northern experts are relatively more conservative in their views on the cyclical role of fiscal policy, but not overwhelmingly so. Positions are reversed for the risk sharing camp, where 50% states that fiscal deficit for the purpose of capital investment should also be allowed in good times, while 40% favour more conservative fiscal policymaking.

The differences in positions across groups are even smaller when looking at how fiscal policy should be run *specifically* in Eurozone countries with a high debt burden. Northern and Southern experts are remarkably similar in their views about this: 50% in both groups think that fiscal policy

27 Merler and Nicoli (2018) run an anonymous survey among experts of EU integration and Eurozone economic policy. The 1st wave (used here) contains 58 responses from experts that were contacted directly by the researchers. North and South are defined following the scale identified in Figure 5. North includes Austria, Finland, Germany, and the Netherlands (20 obs); the South includes Belgium, France, Greece, Portugal and Spain (17 obs). We look at Italy separately, because the Italian sample is large (19 obs) and including it as part of the South would bias the results.

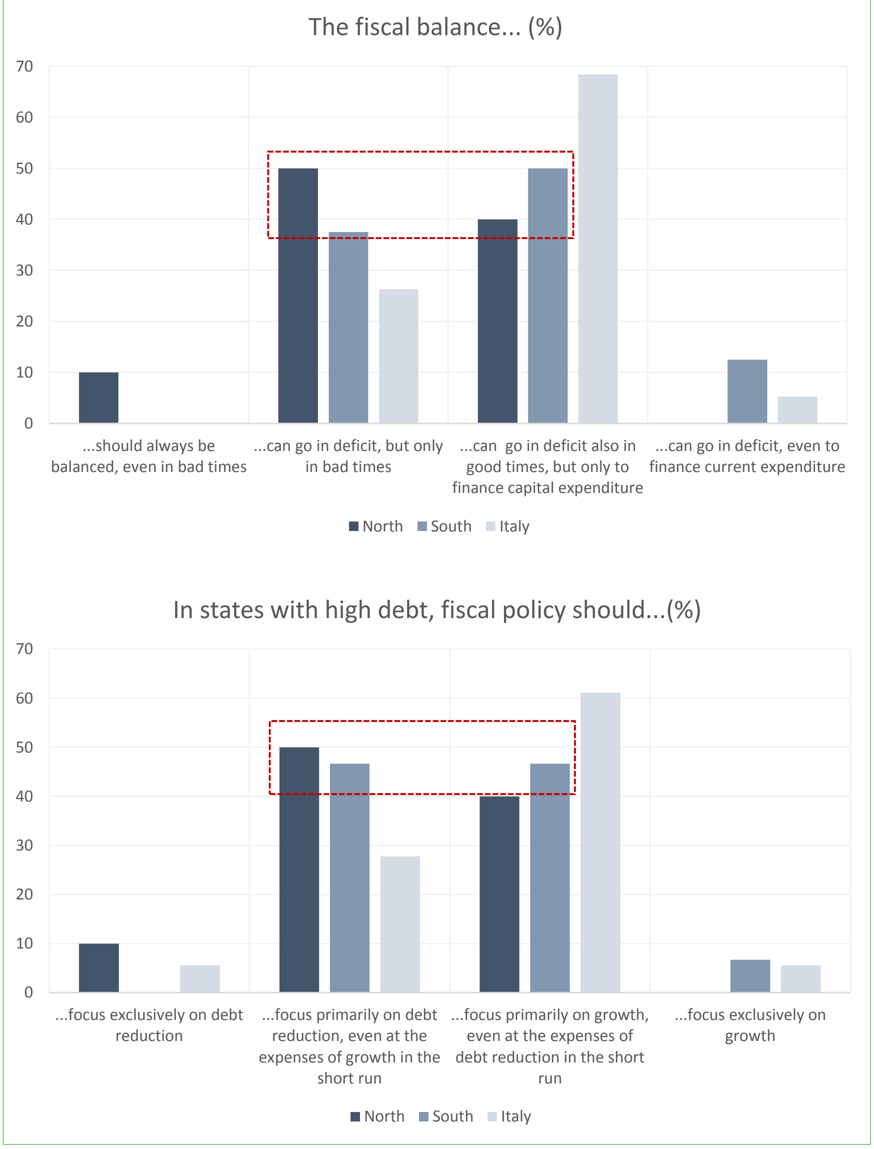
28 North and South in Figure 10 below are defined following the grouping that we identified in Figure 5 - so North represents the risk reduction camp and South represents the risk-sharing camp.

“Economic philosophies are not monolithic, and the ‘Rhine divide’ is not very deep.”

“DiversIty within groups is more present, and diversity between groups is less present than one may think.”

should focus primarily on debt reduction, even at the expenses of growth in the short run. A slightly smaller constituency in both groups thinks that fiscal policy should instead focus primarily on growth, even at the expenses of debt reduction in the short run.

FIGURE 10 · **Fiscal Policymaking views**



▸ SOURCE: Authors’ calculations based onMerler and Nicoli (2018) data

Although limited in scope, this survey confirms the existence of a North/South gap in fiscal policy preferences, but it also challenges some of the ‘hold truths’ about this ideological split.

First, diversity *within* each group is more significant than one might think. Northern and Southern views are split almost equally on the subject of fiscal policy.

Second, views are not very polarised: there is a gap *between* groups in conceptions of what the appropriate fiscal policy is, but it does not appear to be unbridgeable.

A third interesting fact is that none of this seems to be true for Italy. Views of Italian experts are much more internally polarised, and also more extreme in a cross-country perspective. Almost 70% of them favours running fiscal deficits in good time, for the purpose of capital investment. On fiscal policy in high-debt Eurozone countries, 60% of Italian respondents thinks the focus should be primarily on growth, even at the expenses of debt reduction. On this idelological standpoint - probably more than on any economic measure - Italy is today a clear outlier within the Eurozone.

Policy Implications

One year ago, we published a report[29] looking at the strengths and fragilities of the Eurozone. We argued that while being a positive-sum game, gains from monetary integration had not been equally distributed among members. We stressed that for the long-term, fixing the Eurozone required more focus on growth, robustness and equality. Today, the need for reform has heightened significantly on all those three counts.

The Eurozone has been going through a continued recovery, but risks are on the downside. The external environment has changed completely, due to heightened risk of hard Brexit, spillovers from a US-China trade war, and risk that Europe becomes the next target of US protectionism. If winter is coming, the Eurozone is walking towards it without a coat. The internal macroeconomic adjustment has turned the Eurozone as a whole into an export-led-growth economy, which makes the area more exposed to external trade shocks. Northern countries in particular would no longer be able to rely on the Southern periphery to absorb their exports and to cushion the hit. We think action is needed on three fronts:

1. **EDIS.** The EDIS file is a legacy from the previous Commision cycle, but without it, Banking Union remains incomplete. A European Deposit Insurance is necessary to give depositors and investors enough confidence to break the link between banking crises and sovereign crises – a stated objective of Banking Union. Absent that, the risk of negative feedback loops from bank failures remains, and it could weigh on resilience at a time when risks are on the rise.

29 APRF Issue 1 – "The Eurozone: a positive but unequal game". Available at: https://media.algebris.com/algebris_policy_research_forum/Issue-1_The-Eurozone.-A-Positive-but-Unequal-Game.pdf

2. **Active fiscal policy (for the future).** In this challenging environment, the Eurozone needs a more active fiscal policy,. A good place to start a fiscal stimulus, is by envisioning a sizeable plan of investment in what will be the most important challenge that we will face in the near future: climate change. The Stability and Growth Pact (SGP) already features an "investment flexibility clause", but today this can only be used by Member States in bad economic times. The clause could be changed to include more explicitely reference to investment in greening the economy, which should be allowed to benefit from flexibility beyond bad economic times. At the same time, if we are serious about the climate transition, we need to recognise that this will have major social consequences at the local level, on those communities that will need to switch to a completely different model of economic growth. Investment in greening the economy therefore needs to go hand in hand with a rethinking of our social safety nets to ensure that domestic welfare state can cope with this challenge. On top of that, a rethining of Cohesion Policy in a way that allocates funds forward-lookingly to those areas that are expected to be hit harder by theenergy transition would also be warranted.

3. **A more agile fiscal framework.** The intellectual view underpinning the conservative understanding of fiscal policymaking in the Eurozone is becoming less tenable in today's world. Growth is below potential, interest rates are low and below growth rates, concerns with fiscal sustainability are lower. We need a fiscal policy framework that can support monetary policy in the next downturn . Simplifying the currently over-cumbersome fiscal rules - possibly by introducing a simpler expenditure rule, as recommended by many independent studies on the subject - is be a good place to start.

4. **Explicit countercyclical stabilisation.** At the same time, we also need a centralised countercyclical stabilisation function. There is a danger of replicating the sub-optimal uncoordinated fiscal management that we saw during the Eurozone crisis. Most of the fiscal expansion for 2019/2020 is already due to come from high debt countries, whereas fiscal space in Northern countries (Germany in particular) is under-exploited. Fiscal policy within a monetary union has major spillover effects, making coordination hardly reliable when it comes to providing insurance to members in case of asymmetric shocks. The compromise emerged from the Eurogroup (the BICC) is not what the Eurozone needs. It is a hybrid between a duplication of existing tools (the structural funds) and a mild version of a macroeconomic adjustment programme (through the conditionality entailed). The Eurozone budget now being discussed should be endowed with an explicit and clear macroeconomic stabilisation function. There is no lack of proposals as to how this could be achieved.

We believe a serious discussion on a bolder alternative is possible, because today the economic and ideological arguments usually employed against fiscal risk sharing are weakened:

- **From an economic standpoint**, opponents of both active fiscal policy and a Eurozone budget fear it would lead to moral hazard and transfers to countries whose economies are structurally different from the 'best performers'. Today, this fear is misplaced. Economically, 'core' and 'periphery' are closer than ever. Convergence has been unilateral, it has entailed significant risk reduction in the Southern periphery. Business and financial cycles have become more synchronised.

- **From an ideological standpoint**, opponents of active fiscal policy and of a Eurozone budget seem to fear that programme-led convergence will be endangered in the future, by radically different and fundamentally unsound conceptions of fiscal policymaking. Even very simple survey data however suggest that significant differences of views exist within both the Northern and the Southern camps. The "Rhine-divide" is narrower than the current political stalemate would suggest.

- One exception that needs mentioning is Italy, where economic adjustment has been slower (absent, in some areas) and where economic policy views are more internally polarised and more extreme in a cross-country perspective. If Italy wishes not to be isolated in the discussion on the future macroeconomic governance of the Eurozone, this idiosyncrasy will need to be acknowledged and dealt with in a way that reassures both the Northern countries worried of permanent transfers, and the Southern countries that went through a much deeper economic adjustment.

All federations (and standalone countries) perform stabilisation through centralised budgets. The Eurozone does not, and it is therefore overly exposed to large adverse economic shocks. This flaw is even more relevant today, because the very process of internal adjustment has turned the Eurozone into an export-led economy - thus magnifying the risk posed by the recently heightened geoeconomic threats. There has hardly been a more *urgent* time to be discussing a Eurozone fiscal rethinking. Unlike what many may think, however, there has also hardly ever been a *better* time to do so.

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