CES
CENTRE FOR EUROPEAN STUDIES

October 2011

The EU at a Crossroads:

An Action Plan

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Policy Brief

What is at Stake?

In 2007 the US housing crisis infected the US economy and, subsequently, the European banking sector. This meltdown within the financial sector quickly became an economic crisis which in 2008 led to further disruptions in the global economy. The public deficits and debts of all EU Member States increased, as a result of which doubt was cast over the solvency of not only European banks, but also some European Member States. At present there is deep concern about the Union's ability to deal with the sovereign debt crises currently being faced by certain Member States.

We believe that it is time to use the crisis as an opportunity to take some bold decisions. This policy brief explains the benefits of the euro as a common currency and provides an action plan for overcoming the current crisis.

In the first section of this policy brief we describe the advantages of adopting a single currency and analyse the origins of the current crisis. We conclude that the advantages of the euro outweigh the costs, but that more economic and fiscal integration is necessary to ensure a positive outcome. In the following sections we present our action plan. We first propose important steps towards real economic governance for the eurozone and those Member States willing to participate. We then develop our proposal for a European Debt Agency (EDA). We are convinced that growth is an important factor in overcoming the current crisis; our views on this issue are described in the last section of this policy brief.

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[2] We are grateful for the research assistance provided by Rodrigo Castro Nacarino and to Emanuela Farris, Roland Freudenstein, Christian Kremer and Siegfried Muresan for comments and suggestions.

The Economic Advantages of a Single Currency and its Current Systemic flaws

Historically local currencies have tended to become regional currencies before evolving into national currencies at the end of a gradual process. The American dollar is an example of this. Especially smaller economies, which import and export a lot relative to their economic size, have tried to stabilise prices and facilitate trade by linking their currencies to the currency of their major trading partner(s). The EU includes many small, open economies which are closely integrated. The search for stable exchange rates in the EU has therefore been a lengthy one. This search resulted in the report by Pierre Werner which was adopted in 1969 at the Summit of The Hague.[3] In his report Werner proposed not only a common currency and a common central bank (both realised in 1999), but also a fully fledged European economic government. The *Rapport Werner* was, however, too ambitious for politicians at that time and was shelved. Following the report, the EU went through a long procession of currency systems leading to the adoption of the euro by 11 EU Member States in 1999.

In the midst of the current turmoil we think it would be useful to highlight the advantages of a common currency. In the second part of this section we will analyse the preconditions necessary to make the euro a sustainable success.

The Benefits of participating in a Common Currency Area

The benefits we describe can only be fully reaped if the currency is replaced by a common currency; a fixed exchange rate does not generate all of these benefits. The benefits include the following:

1. The transaction costs related to the exchange of currencies disappear. There is no longer any need to provide for the profit margins of foreign exchange traders; clients save the time previously spent looking for the best rate. This time can be better used for other, more productive activities ('time is money').
2. Prices in the economy are no longer distorted by transaction costs related to the exchange of currencies. Price comparisons become more transparent. This allows the economy to function better and enables consumers to purchase at lower prices.
3. Exchange rate uncertainty is eliminated, resulting in more extensive trade and more capital and labour mobility, which in turn generate benefits due to specialisation.

These three advantages promote competition and the deepening of the Single Market, which in turn lead to more international trade and increased flows of capital and labour. This all helps to improve the welfare of producers and consumers. There are two other advantages to be derived from a common currency.

[3] Pierre Werner, *Rapport au Conseil et à la Commission concernant la réalisation par étapes de l'Union économique et monétaire* (October 1970), accessed at http://www.cvce.eu/ on 19 September 2011.

4. With a common currency the risk of exposure to speculative attacks from financial markets, as was the case under the ERM system, decreases significantly.
5. The common currency assumes a greater role at the global level. The euro is the currency of the second largest economic block in the world; investing in the euro therefore becomes more attractive, compared to investing in 17 small currencies. Among other advantages this results in the possibility of a reduction in real interest rates, in the possibility that the prices of energy and raw materials will be expressed in euros as opposed to USD (reducing price volatility for importers within the eurozone) and in the benefits of seignorage[4].

Additionally, a common currency needs a common central bank. The European Central Bank (ECB) has always strongly defended price stability and consistently achieved this outcome. Eurozone countries experiencing high inflation before the euro was adopted now benefit from stable price evolutions, which is a precondition for sustainable economic growth and prosperity.

Recent empirical analyses of the 'euro effect' suggest that the single currency has increased trade by 5 to 15% in the eurozone as compared to trade between non-euro countries.[5]

An evaluation conducted by the European Commission of the euro after ten years (EMU@10) also came to positive conclusions: the euro has contributed to more growth and jobs, to greater price stability, higher labour productivity, more convergence within the EU, and more financial integration, among many other benefits.

These benefits increase with the level of economic interaction between the Member States of the currency zone. That is one of the reasons that smaller open economies—the Benelux countries for instance—have always strongly defended the euro. The following table shows that the larger Member States also trade intensively with other eurozone countries.

Table 1. Percentage of total exports remaining within the eurozone

Country	Percentage
Germany	43.1%
Spain	56.9%
France	48.9%
Italy	44.0%

Source: Eurostat; the present authors' own calculations

From this we conclude that the common currency within the European Union has generated enormous benefits for its citizens and is hence worth defending.

[4] Seignorage refers to the profit a central bank makes by printing money while charging the official interest rate to commercial banks borrowing money from the ECB. This profit largely benefits the Member States via the shareholders of the ECB, the national central banks. To the extent that the euro is an international (reserve) currency, seignorage increases as more euros are held outside the eurozone and therefore the benefits for eurozone citizens increase.

[5] Richard Baldwin, *In or Out: Does it Matter? An Evidence-Based Analysis of the Euro's Trade Effects* (London: Centre for Economic Policy Research, 2006).

Flaws in the Current Eurozone Arrangement

Being part of a common currency area, however, does not come without consequences, two of which we propose to describe: one has to do with the conditions necessary to achieve the properties of an Optimal Currency Area (OCA), the other is related to control over the central bank and the possibility of monetising sovereign debt, a disadvantage recently described by De Grauwe.[6] Our point will be similar to that of other authors who have examined this issue: if the appropriate instruments and policies for dealing with these consequences are not put in place, the currency union will fail and all of the benefits will be lost (with the possibility of even worse effects).

The theory of the Optimal Currency Area. In the early 1960s, long before the euro came into existence, the theoretical foundations for currency zones were laid out by Robert Mundell, Robert McKinnon and Peter Kenen. Still other commentators have also referred to earlier work by Abba Lerner. All of these authors point to the conditions required for a common currency area to function optimally.

A country that gives up its own currency can no longer change the value of its currency. This policy instrument can be useful if, for instance, a given country has lost competitiveness due to declining export activity itself stemming from a situation where wages have increased too quickly or labour productivity has increased too slowly. In such circumstances, depreciation or a devaluation of the currency can restore competitiveness and help stimulate economic growth (and vice-versa).

The cost of losing this policy instrument can, however, be mitigated. Each of the following points refers to increasing the capability to deal with the loss of the exchange rate as an instrument of control. For some of the points we provide examples relevant to the current European economic situation.

- Members of the currency zone have similar business cycles. When Germany, for instance, experiences a boom, the Benelux countries also benefit because their exports to Germany (their main trading partner) increase, bringing enhanced economic growth. The common central bank can then increase interest rates or let the common currency appreciate in order to cool the economy. Since 2010, Italy, Spain, Greece and Portugal have experienced lower economic growth than the eurozone as a whole and could benefit from a cheaper euro or lower interest rates; however, the common euro and the single interest rate of the ECB prevent this from happening.

- The economic structure of each Member State is diversified. The risk that Member States experience different business cycles (asymmetric shocks) decreases when the relevant economic structures are diversified. According to some theories the very act of adopting a common currency helps diversify the economic structure because the market is expanded. According to others a common currency and increased capital mobility generate more specialisation, thereby making the country more sensitive to asymmetric shocks.

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[6] Paul De Grauwe, *The Governance of a Fragile Eurozone*. University of Leuven and the Centre for European Policy Studies, April 2011.

- Labour and capital mobility across the Member States is high. Therefore, market forces can quickly allocate economic resources (capital and labour) where they are needed most. If citizens are able to move easily between Member States they can look for jobs in expanding regions of the eurozone, thereby solving the unemployment problem in regions facing recession. In the EU capital mobility is guaranteed by the Single Market Act and also the free movement of labour. But labour mobility remains low compared to, for example, the US, due to cultural, language and other barriers.

- There is price and wage flexibility. A problem in the EU is the lack of wage flexibility; nominal wages (wages in current prices) can increase, but it takes a very long time for them to decrease. At the moment Greece is suffering from the effects of more than a decade of rising unit labour costs (labour costs in Greece increased too fast and labour productivity too slowly) which has led to much higher levels of imports than exports. The resulting trade imbalance requires financing in the form of loans which in turn results in unsustainable debt (public as well as private debt). Greece should reduce its wage costs significantly, but the country's inflexible labour market prevents this, resulting in increased unemployment and, ultimately, an economic crisis.

- There are sufficient fiscal transfers to redistribute income to regions or countries in order to soften the impact of asymmetric shocks. Such distribution mechanisms exist at the national level (via the social security system, for instance), but they are very limited at the EU level. The EU budget amounts to 1% of GDP, only about half of which can be considered as fiscal transfers from richer to poorer Member States. Moreover, the EU Treaty includes two 'no bailout' clauses, meaning that fiscal transfers are limited to the EU budget, although the European rescue funds, like the European Financial Stability Facility allow for transfers from outside the EU budget.

- There are similar national inflation levels within the monetary union. When inflation is high in one region of the currency area as compared to another, monetary policy would suggest a devaluation of the currency in the former region. This is not possible, however, as there is only one interest rate and one exchange rate for the whole region.

Control over the currency in which the debt is issued is lost. Recently, De Grauwe[7] described another disadvantage of adopting a common currency, a disadvantage not previously included in OCA theory. It is related to the fact that a member of a currency union loses control of its central bank and, therefore, access to the central bank's function as lender of last resort; the member thus loses the possibility of monetising sovereign debt as an ultimate solution. Markets anticipate this and are encouraged to speculate against sovereign debt. This explains, for instance, why American sovereign debt or that of the UK is not attacked—despite weaker economic fundamentals—while the sovereign debt of several eurozone Member States has come under pressure.

[7] Ibid.

We believe that the consequences of a country losing its own currency can be eliminated or at least significantly reduced. In such a constellation, the benefits of a common currency far outweigh the costs. We distinguish three areas where action is necessary:

- The conditions necessary to achieve an optimal currency area have to be met. This means, in essence, ensuring economic convergence. No single currency area fully meets all the conditions of an optimal currency area. The 50 states of the US, for instance, partially fail to meet some of the criteria, although empirical research points out that they are better met in the US than in the 17 eurozone Member States.

- We also believe that even if they do not find their theoretical foundation in OCA theory, the Maastricht fiscal criteria can be defended in terms of the need to have a sustainable debt/GDP ratio to prevent the insolvency of a Member State. The risk of an insolvent eurozone Member State poses with it the risk of contagion to other Member States via the banking sector. The loss of access to central bank liquidity[8] is another major reason to prevent unsustainable sovereign debt.

- We advocate the creation of a European Debt Agency as previously proposed by Hans Geeroms[9] and Yves Leterme[10]. We will elaborate on this point in section 4.

In the next section we formulate proposals to further strengthen the EU's economic governance. Together they are intended to ensure that the eurozone develops further towards fulfilling the requirements of an optimal currency area and that the Maastricht criteria are respected. In section 4 we formulate our proposal for the creation of a European Debt Agency.

Economic Governance in the Future: Steps to make the 'E' as Important as the 'M' in EMU

From the inception of the eurozone until May 2010, when the Greek crisis erupted, the Stability and Growth Pact (SGP) was the only binding legal framework in place to facilitate macroeconomic governance. Since then the terms of the 'Six Pack' and the European Semester have been finalised. These include a strengthening of the SGP and the introduction of a macroeconomic surveillance procedure, with sanctions for eurozone Member States. Member States have also committed themselves to the terms

[8] Ibid.
[9] Hans Geeroms, 'The Idea of a European Debt Agency', European Economics and Finance Society, Sofia, May 2007.
[10] Yves Leterme, 'Pour une agence européenne de la dette', *Le Monde*, 5 March 2010.

of the euro+Pact. All of the actions of a Member State are listed within its National Reform Programme.

We believe that stricter economic governance mechanisms are necessary to ensure convergence. We also believe that these new mechanisms should be developed via the Community method as opposed to the intergovernmental method.
We envision the implementation of the following steps as a means of achieving better economic coordination. Many of these steps may be decided within the framework of the current TFEU.

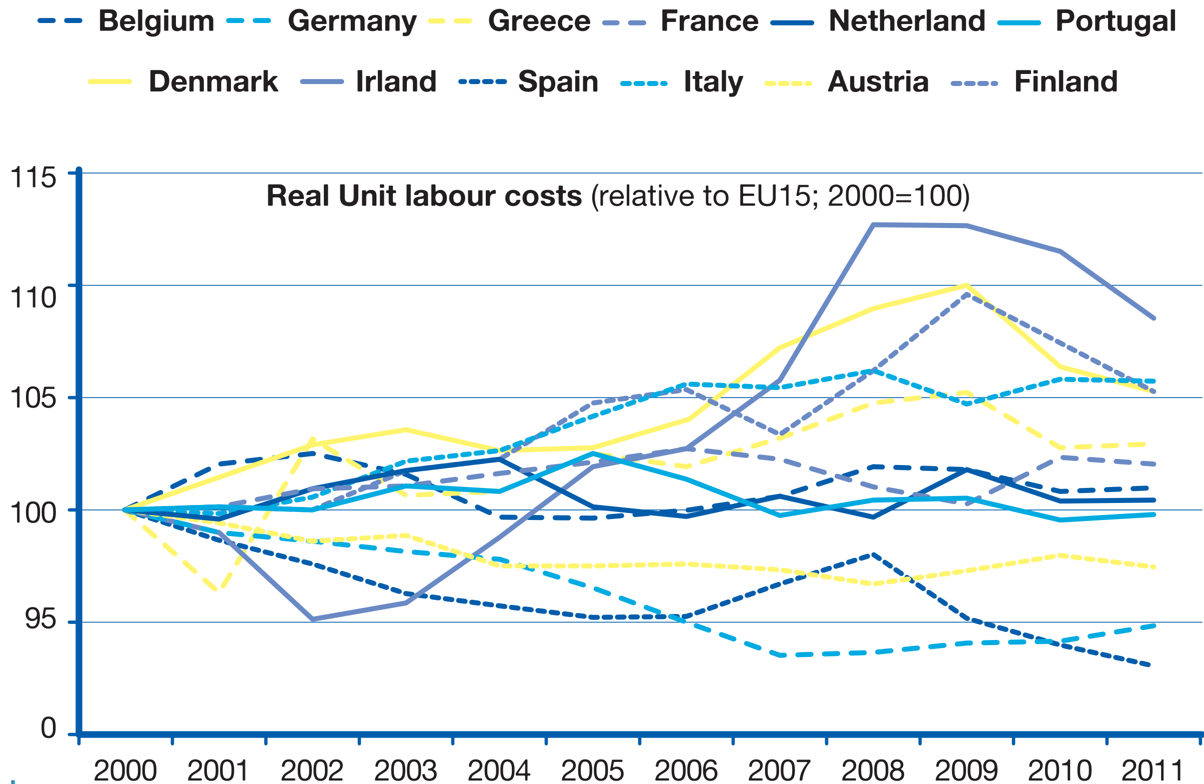
A first proposal is to *strengthen the recently agreed macroeconomic surveillance procedure and to ensure its symmetry*: The 'Six Pack', ratified by the European Parliament in October 2011, includes detailed and enforceable rules concerning fiscal and macroeconomic policy; the latter is very important with potentially far-reaching consequences. It could become even more relevant, however, if the macroeconomic imbalances procedure was to become as strict and enforceable as possible. As of the writing of this Policy Brief, the European Commission is still working on establishing the relevant indicators and benchmarks, the so called scoreboard. We think that the thresholds of the parameters should be strict. Moreover, the indicators related to the external position (current account balance and external assets) should be symmetric. As illustrated in section 2 of this Policy Brief, trade by Member States is to a large extent among themselves. This means that the current account surplus of one Member State mirrors to a large extent the current account deficit of another. Indeed, we cannot all have surpluses.[11] Member States with surpluses have the choice of helping deficit countries by stimulating demand, if possible; otherwise, they will be required to finance the increasing external debt of the deficit countries.

A second proposal is the elaboration of *a European Unit Labour Cost norm*. In the past, Greece, Ireland and Portugal have experienced unsustainable labour costs, leading to external deficits and debt problems. But this divergence in national labour costs is relative and is also due to the fact that other Member States (Germany and Austria) have reduced their labour costs compared to the EU average, and even in absolute terms. Closer convergence of the Unit Labour Costs across the Union should help in achieving smaller external imbalances and would contribute to improving the competitiveness of all Member States while also helping to prevent a potential 'wage dumping' war among Member States. We propose that the EU (Commission, Council and ECB), after consulting with social partners, define an optimal path for the evolution of Unit Labour Costs (ULC) for the eurozone as a whole. This benchmark for the evolution of unit labour costs would need to take into account the ECB's inflation target, the employment targets set out in EU2020 and other elements. The centrally recommended Unit Labour Cost evolution for the eurozone could then serve as a guide during wage negotiations within Member States according to national practices. The ULC of each Member State would evolve within a certain bandwidth around this central eurozone ULC. The system for Unit Labour Costs would function in a manner similar to the ERM for currencies. It would also prevent competitive wage deflation among the Member States of the eurozone. We

[11] Unless such a surplus were maintained vis-à-vis non-eurozone states, which would entail a huge surplus for the eurozone, as a whole. It would be difficult to defend such a policy towards the US, given that the EU and the US commonly criticize China for its exchange rate policy and its huge positive external balance.

agree that such a European Unit Labour Cost norm would not be needed if labour markets were sufficiently flexible; we are concerned, however, that liberalising labour markets to the extent necessary will take a very long time in Europe.

Figure 1 Illustration of the Divergence in Unit Labour Costs among Eurozone States



Source: AMECO Database, European Commission

A third, more fundamental change, would be to strengthen the presidency of the Eurogroup and to merge its function with the European Commissioner for Economic and Monetary Affairs. We therefore support the proposal to *create a 'Mr or Mrs Euro'*. The President would wear 'two hats' (chairing the Eurogroup and serving as a member of the European Commission) and become head of the 'Admonitory Budgetary Compliance Committee' (ABC+) established within the ECOFIN council. We propose a three-step approach for the functioning of the ABC+:

- In the first stage the SGP would be applied. This means that the ABC+ would establish a norm pertaining to the general government's deficit and debt of each member of the eurozone.

- In the second stage, should a Member State not respect the norm, not only would the Excessive Deficit Procedure apply, but detailed guidelines for revenues and expenditure would also be agreed upon. We propose returning to the original proposal

of the Task Force Van Rompuy whereby decisions are ratified according to a reversed Qualified Majority. We favour changing Article 126 of the TFEU for that purpose.

- In the third and final stage the Member State would accept full professional control of its budgetary policy. That is, the ABC+ could propose measures to national parliaments related to the sustainability of their sovereign debt. These measures could be as far reaching as interventions in, for instance, pension reform and income policy. This would most likely require a Treaty change, as Article 136 would not provide sufficient legal basis for this. If national parliaments were not to adopt the measures proposed, this could cause an increase in the rate of interest to be paid on their European Debt Certificates (see next section).

Towards a European Debt Agency

Policymakers, bankers and the general public are concerned about a possible debt default in some periphery countries of the eurozone. It is remarkable that new euphemisms are coined such as 'debt restructuring', 'debt re-profiling' or even 'rationalisation of entitlements'. All of these alternatives refer to an orderly default without, but eventually with, a 'haircut', which means that not all of the principal will be reimbursed. The worst of all possible eventualities would be a messy default, which would seriously damage the whole banking system. Effective efforts should thus be made to avoid such an unfortunate outcome. That is why it is incumbent upon us to look for new constructive and consistent proposals. As a corollary to the previous section we propose in this section a European Debt Agency.

Some politicians and economists strongly defend the emission of common debt which, combined with stricter economic governance, is viewed as the necessary instrument in the creation of a sustainable common currency area. Critics argue that this boils down to nothing less than a straight bailout for profligate peripheral countries. They also point out that this proposal is not consistent with the intent of the European treaties. Quite often it is implicitly assumed that each member in fiscal distress can autonomously issue bonds on the international capital markets. Payment of the coupon interest and reimbursement of the principal would be guaranteed by the other eurozone members. Not surprisingly the more solid eurozone members are unwilling to engage in such a generous scheme.

The European Debt Certificates (EDCs) that we have in mind differ substantially from measures such as this and are based on proposals put forward by De Grauwe and Moesen.[12] The fundamental difference is the distinction between an external and a (differentiated) internal interest rate.

[12] P. De Grauwe and W. Moesen, 'Gains for All: A Proposal for a Common Eurobond'. *Intereconomics* (May/June 2009), 132–5.

Let us elaborate on this feature of the (new) emission vehicle. For ease of exposition we will label it a European Debt Agency (EDA), although it would probably be an offspring of the EFSF.

The EDA would be entitled to issue European Debt Certificates on the international capital market. It is expected that the external interest rate would converge independently on the weighted average of the interest rates of the eurozone members at the time of the emission. As for the joint and several guarantees, the allocation formula itself would be similar to the quota of the European Central Bank (ECB) and the European Financial Stability Facility (EFSF).

As a second step the proceeds from this borrowing would be lent to the member countries at an internal interest rate which would be differentiated. For the distressed countries the internal interest rate would include a premium above the external rate to capture differences in the sustainability of their public finances (level and evolution of debt and deficit) and their willingness to apply the recommendations of the economic governance (the ABC+), as described in the previous section.

As an additional feature Member States could only borrow from the EDA to finance their gross deficit up to the level agreed upon within the Admonitory Budgetary Compliance Committee. For any additional financing requirements the Member State would itself be required to go to the capital markets, where it would be confronted with a higher interest rate. This in itself would be an important market incentive to respect the SGP'.

We thus propose a differentiation in the internal interest rate and access to the certificates as a means of mitigating the problem of moral hazard.

Note that in this configuration Germany, for instance, would also be able to borrow from the EDA at an interest rate which would be well below the external rate. Strong nations are not sanctioned, whereas the weaker members are granted access to a 'window' with an interest rate well below what they would pay on their own sovereign emissions. In fact a major drawback of the sovereign debt crisis is that the 'animal spirits' in the markets make it almost impossible for some distressed countries to borrow at any price. Furthermore, according to this scheme, the interest payments to the EDA would at least be equal to the external borrowing costs of the EDA.

One can imagine additional outlets for the money raised by the European Debt Certificates. Economic diligence and regulatory prescriptions on capital adequacy would require new capital injections in the banking sector. This funding would probably come from the individual governments, as the market for mergers and acquisitions by financial competitors shows little activity. We propose assigning this responsibility to the EDA as far as European cross-border banks are concerned.

A third use is related to the ECB. As it stands now governments disagree whether and to what extent the ECB should buy sovereign debt in the secondary market. Only the ECB has the professional machinery and gunpowder to contravene short term movements. At regular intervals the EDA could buy the portfolio of sovereign debt holdings from the ECB. European Debt Certificates would supply the funding for these

transactions. As such the ECB could always retain reserves of dry gunpowder without expanding the volume of base money.

An increase in the available amounts in the existing support funds and a broadening of their instruments could serve as a first step towards establishing the EDA. We could consider deleting Article 34 of the current ESM (European Stability Mechanism) framework. Thus ESM, EFSF and EFSM lending would not be consolidated and the ESM would be able to deploy the full 500 billion euro.

As an important remark we want to emphasise that international investors from Asia and the oil producing countries are looking for an adequate alternative to US sovereign debt. Within the context of a strategy of prudent portfolio diversification, European Debt Certificates could fill this gap. To the extent that these certificates gain credibility, the market size would be enlarged and liquidity bolstered. European Debt Certificates could then become an attractive alternative to US Treasury bills and bonds and could easily outsize the market for German *Bunds*. One could even argue that the external interest rate would diminish below the level of the weighted average interest rate because of increased liquidity and reduced risks. This would lead to gains for all.

Beyond Austerity: Welfare and Job creating Growth

The financial markets have doubts about the sustainability of certain Member States' debt because they have doubts about the Member States' growth potential. This is a simple deduction from the assumption that public debt becomes more sustainable when the market value of all final goods and services produced in the respective indebted country increases.

Much has already been said about revamping Europe's growth, and the European Institutions have agreed to the commitments of the EU2020 and the euro+Pact. We will not elaborate on those proposals here. However, we believe that, in addition to those initiatives and the proposals mentioned in the other sections of this Policy Brief, European governments should look beyond austerity. European policymakers should take the next step by undertaking concrete action to increase Europe's prosperity and job creating growth. We believe that this is necessary in order to solve the current economic crisis and to sustain Europe's welfare states, including their viable pensions and social security systems.

For these reasons we have called this section 'Beyond austerity: welfare and job creating growth'. Indeed, the ultimate measure of success is not whether bond markets go up, but whether a society can provide decent jobs for its inhabitants.

We believe that this growth potential cannot be separated from the long term socio-economic challenges faced within the European Union, which include the ageing of the population and the corresponding increase in public spending; globalisation, which significantly increases competition; Europe's growing dependence on energy from non-EU countries and; finally, the high levels of youth and long-term unemployment that risk creating 'lost generations'. Without sustainable policies to cope with these challenges, doubts will persist.

In emulation of the example set by Konrad Adenauer, who led his country out of the ruins of World War II and positioned it to become a powerful and prosperous nation, we think the European Union needs a 'Konrad plan'. And of course particular attention and additional European funding should be given to those Member States with lower growth potential. However, solidarity does not come without responsibility. It is each Member State's obligation to implement the agreed actions. These actions should be decided within the European Council and become part of the National Reform Programmes (NRP+); there would thus be no new 'EU2020 plan', 'euro+Pact' or institution, only more commitments. In addition we are convinced that these NRP+ measures should be voted on in national and regional parliaments in order to increase ownership of the agreed initiatives.

We think additional, concrete action in the following domains is necessary: education, labour and capital markets, the single market and R&D. The following three sections provide an indication of the action we feel needs to be taken.

Improve People's skills and stimulate Full Employment

We believe that *more investment in (higher) education is necessary*. Total investment in higher education amounts to 1.31% of GDP, on average, in the EU27, compared to 2.68% in the US and 1.49% in Japan. We also understand that for political reasons it is very difficult to secure increases in public investment in this area, especially in times of austerity. In illustration of this we note that public expenditure on old-age and survivors' benefits as a percent of GDP is at least 5.9% (UK, 2007) in the EU27. For this reason it is hard to see how the necessary increases in investment in higher education are to be borne by public authorities alone. More private investment in higher education seems necessary (amounting to 1.68% GDP in USA, compared to 0.39% for the EU27).[13]

In order to increase employment and growth, the academic literature[14] suggests *shifting taxes away from labour*. The highest (at least in the short run, and this is what we are looking for) beneficial effect on employment would be obtained by a cut in employers' social security contributions. Moreover, keeping in mind the current stress on public budgets, we favour a revenue neutral, growth-oriented tax reform that would shift part of the revenue base from income taxes to less distortive taxes. We propose the following shift:

[13] Pensions at a Glance 2011: Retirement-Income Systems in OECD and G20 Countries accessed at www.oecd.org/els/social/pensions/PAG on 19 September 2011 and Education at a Glance 2009: OECD Indicators accessed at www.oecd.org/edu/eag2009 on 19 September 2011.
[14] An overview of the relevant academic literature may be found in European Commission, *Macroeconomic Effects of a Shift from Direct to Indirect Taxation: A Simulation for 15 EU Member States*, 2006, 29. See also OECD, *Growth-oriented Tax Policy Reform Recommendations*, 2010, 19.

- Currently the EU-budget, which is about 1.0% of the total EU GDP (in payments), is financed in small part by its own resources (import duties and agricultural levies). The lion's share comes from GNI contributions by the Member States. We favour an increase in the EU's own resources (via a financial transaction tax, an air aviation tax or another EU levy). In return, the GNI contribution of each Member State would be equivalently diminished as if it were a hydraulic system. This relief, potentially amounting to up to 0.75% of GDP, could be assigned to a growth enhancing decrease in the taxes on labour.

- As a second additional resource, we would suggest increasing value added taxes (VAT). We believe that indirect taxes, and certainly those on activities generating negative external effects, are superior to personal income tax (PIT). We are aware that there are several problems associated with using an increase in the VAT to compensate for decreasing labour taxation. An increase in VAT tends to reduce the tax burden on higher incomes while increasing it on poor and middle incomes. In addition, increasing the VAT causes a one-time increase in the price level which has an impact on consumer behaviour. We suggest that the VAT system be made more progressive, with a higher VAT for luxury and/or environmentally harmful goods.

To increase growth and equity we support two additional labour market reforms: lifting the increasing dualism on our labour markets and increasing working time.

A recent OECD study[15] highlights the *high number of workers hired on temporary contracts*. OECD statistics[16] show that for the age group 25-54, 20 EU Member States out of 27 saw an increase over the last 10 years. In the age group 15-24, the percentage of workers in temporary contracts often reaches 40%, with significant increases in the last two years. We think a 'grand bargain' is necessary to alleviate this gridlock and to stimulate employment: a certain relaxation of employment protection legislation in return for increased use of permanent working contracts.

Germany's workers work, on average, 80% of their annual working hours in full employment as compared to workers in the United States[17]. We think that there is room to adjust regulatory burdens to offer more choice to employers and workers who prefer to *increase the number of hours worked* in return for a wage increase. This is particularly the case for the high number of women in part-time work (31.9% as compared to 8.7% for men, Eurostat 2010, EU27).

[15] OECD, 'Advancing Pension and Labour Market Reforms', in *Making Reform Happen* (2010), 69–100.
[16] OECD StatExtracts, 'Incidence of Temporary Employment', http://stats.oecd.org/Index.aspx, data extracted on 25 September 2011.
[17] OECD StatExtracts, 'Average Annual Hours Actually Worked Per Worker', http://stats.oecd.org/Index.aspx, data extracted on 25 September 2011.

Spur Capital

Recent IMF working[18] papers confirm what intuitively seems straightforward: negative shocks may trigger sharp contractions in the lending appetite of banks. Moreover, there is evidence that recessions associated with credit crunches and busts in housing prices tend to be deeper and longer than other recessions.

For these reasons, and because innovative start ups and SMEs are keys to growth, we believe that the EU needs to develop other ways of providing capital. Although there has been a decrease in private equity investments in the United States in recent years, the private equity market in the US remains much more important than in Europe. We believe that Europe will also have its Groupons, Facebooks, Twitters, Amazons, etc. when its private equity market increases its size.

Private equity investments as a percent of GDP in 2010 amount to 0.326%.[19] To compensate for the credit crunch in the banking sector, we suggest that Member States put in place a policy to *increase private equity funding*. We therefore welcome the Commission's initiatives in recent years in this field (the *Single Market Act* and others).

Furthermore we want to highlight the existence of the *European Investment Bank (EIB).* The EIB issues a wide range of debt products (some of them called Eurobonds) to finance projects both within Europe and abroad. In 2010 the EIB financed projects amounting to 72.8 billion in the EU27 and 10.4 billion in partner countries.

Open up for Trade and Technological Revolution

A proposed action plan for prosperity and growth through job creation remains incomplete without emphasising that the European Union's single market is far from truly integrated. Liberalisation has increased productivity through more efficiency and more innovation, for example in the telecommunications sector. We would like to emphasise three areas where a *more integrated single market is urgently needed*: the energy sector, the labour market and the digital single market.

The electricity markets of 12 of the 27 Member States show a high or very high degree of concentration, according to European Commission data.[20] The EU single energy market has the potential to deliver benefits in terms of growth, development and energy security. For this to happen, however, market integration is essential.

[18] Fabian Valenci, *Banks' Precautionary Capital and Credit Crunches*, IMF Working Paper, 2008, 37 and S. Claessens, M. Ayhan Kose and M.E. Terrones, *What Happens During Recessions, Crunches and Busts?*, IMF Working Paper, 2008, 77.
[19] UK 1.122%, DE 0.187%. Source: National Venture Capital Association. Yearbook. 2011. Accessed at http://www.nvca.org/ on 22 September 2011.
[20] European Commission, '2009-2010 Report on Progress in Creating the Internal Gas and Electricity Market: Technical Annex' Commission Staff Working Paper, 9 June 2011; and '2009-2010 Report on Progress in Creating the Internal Gas and Electricity Market: Technical Annex', Commission Staff Working Paper, 9 June 2011; both accessed at http://ec.europa.eu/energy/gas_electricity/legislation/legislation_en.htm. At the retail level the situation remains almost unchanged relative to 2009 and 2010. Only five countries registered a change in the number of companies with a market share over 5% in the retail market, and in only seven countries did the concentration rate show a small decrease.

Despite a significant decrease in anti-competitive product market regulation over the past ten years, the OECD's product market regulation indicator[21] confirms that Europe still has work to do in this respect. A recent OECD working paper makes the case for future reform in the professional services sector (the engineering, legal, accounting and architectural professions) where relatively restrictive regulation reflects the stringent access requirements and constraints placed on business conduct in professional services.

In 2010, 12.4% of internet users ordered services or bought goods online from sellers in another EU country, whilst mobile broadband penetration reached 7.2% of all active users that year.[22] We know that IT services are an important driver of growth in Europe and we believe more can be done. In a recent McKinsey Global Institute study, some useful suggestions were made.[23] The development of e-government services and of infrastructure (or the reallocation of the digital dividend) as well as the development and attraction of talent, and the creation of a pro-entrepreneur environment are all listed as areas where policy makers could make a difference.

If we want to lead in future technological revolutions, we have to be ready to *invest more in research and development*:

- In 2008, the gross domestic expenditure on R&D in the EU27 averaged 1.92% of GDP, compared to 2.77% in the United States and 3.44% in Japan (Eurostat, public and private investment combined).

- We agree that research output is important. The Innovation Union Scorecard of the European Commission informs us that the gap with the United States and Japan is increasing (license and patent revenues).

- The European Union has 8 out of 20 countries (regions) in the top-20 best performers in science for 15-year olds.[24] Within the top-5, three countries and regions are situated in Asia. These numbers reinforce our earlier statement that the European Union needs to invest more in education.

For all these reasons, we want to stress the importance of initiatives like Innovation Union and others aimed at increasing our R&D performance.

[21] OECD StatExtracts, 'Product Market Regulation', data accessed at http://stats.oecd.org/Index.aspx. The indicators cover formal regulations in the following areas: state control of business enterprises; legal and administrative barriers to entrepreneurship; and barriers to international trade and investment.
[22] European Commission, DG Information Society, *Digital Agenda Scoreboard 2011*, accessed at http://ec.europa.eu/information_society/digital-agenda/scoreboard/index_en.htm on 19 September 2011.
[23] *Beyond Austerity: A Path to Economic Growth and Renewal in Europe*, October 2010, 71.
[24] OECD, PISA Database 2009, accessed at http://stats.oecd.org/index.aspx on 19 September 2011.

Conclusion

The eurozone is experiencing the negative effects of the sovereign debt crisis being faced by certain member states. This Policy Brief has tried to shed light on possible formulas to deal with the present crisis while preventing other crises from happening. The leitmotif of this paper is that only further economic and fiscal integration will help us in this respect.

We first described the main advantages of belonging to a common currency area while also highlighting the systemic flaws in the current eurozone arrangement. Based on both theoretical and pragmatic arguments, we have highlighted the importance of strengthening economic governance at the European level through the implementation of several concrete measures. The same reasoning led us to present the most ambitious proposal of this study: the creation of a European Debt Agency (EDA), whose working dynamics were also described. In the last section we presented the need to look beyond austerity and emphasised the necessity of implementing ambitious measures to boost Europe's welfare and job creating growth.

Appendix

Timing	Needed	Done	To be done
Short run	Money	1) Direct loans for Greece + EFSM + EFSF + IMF (830 bn euro) 2) ECB actions (SMP, liquidity to banks)	1) more effective EFSF and ESM
Medium term	1) Closer economic coordination 2) Prevent macrofinancial disequilibria 3) Strengthen financial system	1) Task Force Van Rompuy; Six Pack-Europlus pact 2) European Systemic Risk Board 3) ESA's, package Barnier, stress test EU 2020, Euro+pact	1) Stronger Six Pack 2) Authority for cross border banks/EU bank rescue fund
Medium/long run	1) European economic goverment 2) Emmission of common debt 3) Increase economic growth		1) Admonitory Budgetary Compliance/Committee 2) European Debt Agency and European Debt Certificates 3) Do much better than Lisbon process + Additional actions

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CREDITS

Centre for European Studies
Design: RARO S.L.
Printed in Brussels by Drukkerij Jo Vandenbulcke
Brussels
Centre for European Studies
Rue du Commerce 20
Brussels, BE – 1000

The Centre for European Studies (CES) is the official think-tank of the European People's Party (EPP) dedicated to the promotion of Christian democrat, conservative and like-minded political values.
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This publication receives funding from the European Parliament.
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