EMU: myth or reality?

Note written by Jacques de Larosière and Didier Cahen

1. The Single Currency area has failed to deliver all the expected benefits because some Member States have not demonstrated the economic discipline imposed by a monetary union

The specificity of the euro currency is that it is not an overwhelming symbol of unity but rather a permanent source of issues to negotiate for the Member States of the Eurozone.

A national and sovereign currency usually constitutes a synthesis of the economy of a given country. It reflects the relation between the given country and the international system and is part of the necessary dialogue between the fiscal and monetary authorities. To put it bluntly, the currency is normally the catalyst of a country's unity.

For sure, the euro has been a success insofar as it has become the second most important currency globally after the American dollar. Indeed, in 1999, the euro became the single currency of a vast economic entity whose market of 350 million inhabitants is one of the largest in the world. Exchange rates have disappeared by design, and the share of the euro across various indicators of international currency holdings continued to average close to 20% in 2022[1] (*see Chart 1*).

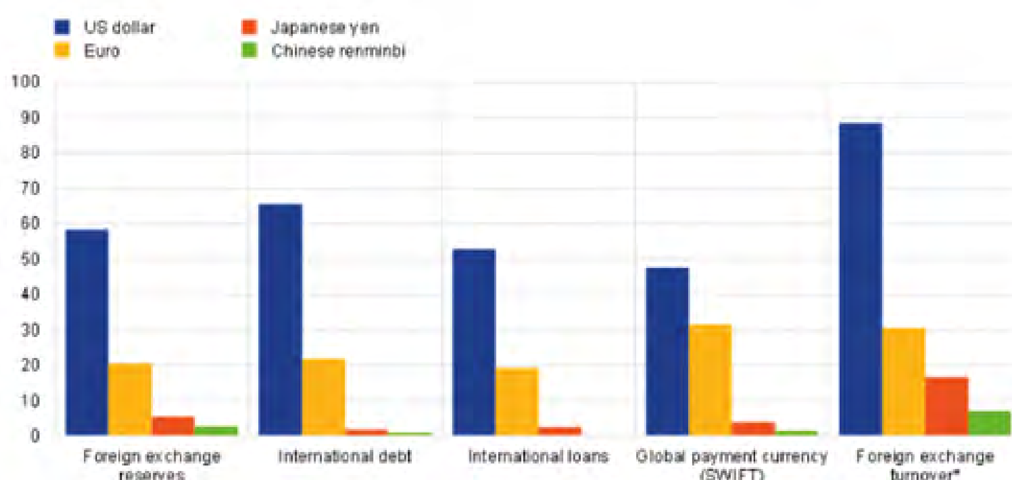
But this success cannot conceal the deep internal divisions within the monetary zone.

If one takes a close look at the euro, one can perceive that, unlike other currencies, it is far from being the reflection of a country's unity. The euro has gone through dramatic turmoil during the euro sovereign debt crisis and is regularly a source and a manifestation of some discord among Member States.

Why is that? There are several reasons:

- The first reason is that there are as many fiscal policies as there are members of the Eurozone,
- The second reason is that there are heterogeneous perceptions of the inflation that must be fought (North countries are less prone to inflation than South countries),
- The third one is that the key interest rate of the euro is the same for all members of the monetary zone. It is an average, which, by definition, is more tolerant for countries with

CHART 1.
Snapshot of the international monetary system



Source : BIS, IMF, Society for Worldwide Interbank Financial Telecommunication (SWIFT) and ECB calculations.
*Notes: The latest data for foreign exchange reserves, international debt and international loans are for the fourth quarter of 2022. SWIFT data are for December 2022. Foreign exchange turnover data are as at April 2022. *Since transactions in foreign exchange markets always involve two currencies, shares add up to 200%.*

1. ECB, The international role of the euro, June 2023.

higher inflation than for those that have a more stable outcome,

- The fourth one is that the Union has moved since the 60s from structural European policies (industrial, agricultural, energy competition...) towards a single market with no community preferences and strong national trends.

In short, the handling of the single currency is a matter of permanent discussions between the members of the boards of the ECB and the Eurogroup.

As Europe is not a single nation but a confederation of national states, we have to accept that the EU seeks compromises that optimize national objectives. But a monetary union can only function if a minimum of fiscal discipline is ensured by all States which has not been the case for 25 years.

It is common knowledge that the Eurozone is not an optimal currency zone[2]. Moreover, if external shocks (Covid-19 pandemic, energy crisis...) hit all the EU Member States, they do not hit all of them with the same intensity.

This conception illustrated by Mundell does not apply to the Eurozone insofar as the fiscal policies (and related national indebtedness) have been disjointedly steered in a certain number of countries. The solution which could have compensated the effects of this absence of convergence, *i.e.* collaboration between Member States, has never happened.

It is sometimes argued that the imported shocks suffered by the EU have become symmetric. There would no longer be shocks affecting South countries as opposed to shocks affecting North countries. Everybody would be on the same boat.

In reality, when one takes a closer look at facts, one notices that, if it is true that there are shocks affecting the Union as a whole (the Covid-19 pandemic, the energy crisis, the environmental crisis...), there are also behind them national shocks of significant importance and variability depending on the country.

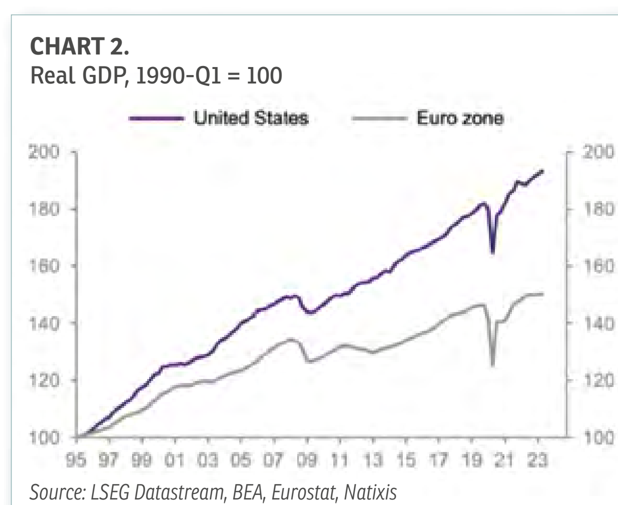
The fact that the "supplement of shocks" suffered by some countries, particularly those with very expensive public spending, have a national origin, whereas the global shocks (*i.e.* those which affect the Union as a whole) have an external origin only adds add to the complexity of the issue.

2. The Eurozone is characterized by growing heterogeneities

All observations point to the same finding: the Eurozone is characterized by these internal economic and fiscal divergences and not by its unity. Here are some examples of the mentioned heterogeneities.

- **In terms of growth, the Eurozone has been lagging behind the US for decades.** Indeed, since 1995, the cumulated level of real GDP has risen by 94% in the US, compared to only 51% in the Eurozone[3] (*see Chart 2*).

CHART 2.
Real GDP, 1990-Q1 = 100



Source: LSEG Datastream, BEA, Eurostat, Natixis

One can also observe on Chart 2 that the growth gap between the US and the Eurozone has been intensifying since the Great Financial Crisis (GFC). This is partly due to productivity growth, which is stronger in the United States.

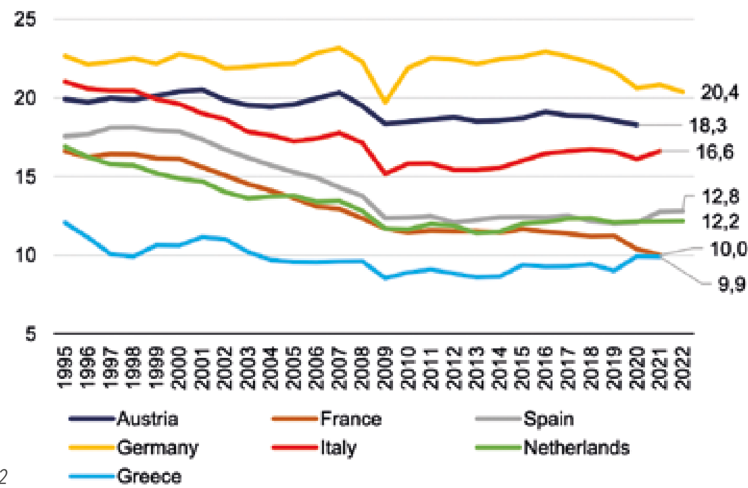
- **The euro has strengthened the more industrialized countries, to the detriment of those experiencing deeper industrial decline.**

The elimination of foreign exchange risks normally encourages productive specialization within a Monetary Union. This turned out to be true only for certain Member States of the Eurozone; the single currency has given an edge to exporting countries that specialized in tradable products for which they exhibit a strong competitiveness such as Germany and Austria over countries that have progressively experienced deindustrialization such as France and Spain.

Indeed, the economies of the best performing countries benefit from the fact that the external value of the euro represents an average for the

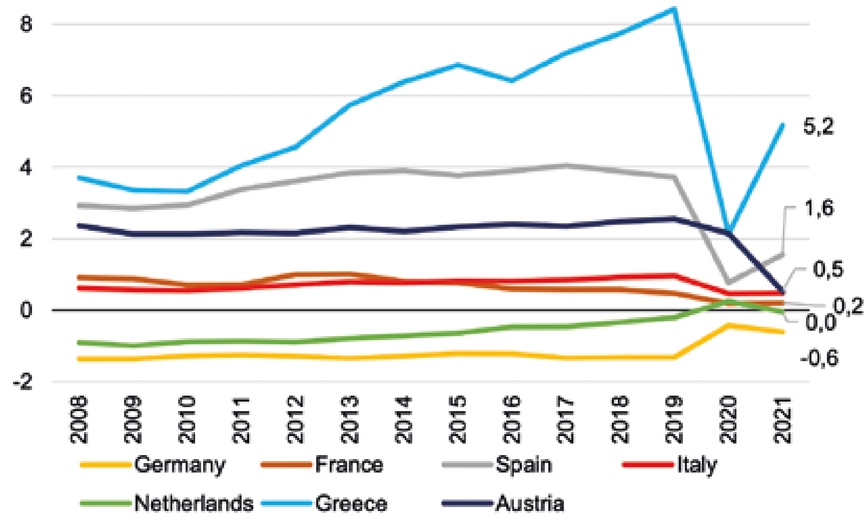
2. In 1961, R. Mundell developed a theory about optimal currency zone. The 4 often cited criteria for a successful union are: labor mobility across the region, openness with capital mobility and price and wage flexibility across the region, a risk sharing system, participant countries have similar business cycles.
3. P. Artus, "The growth gap between the United States and the Eurozone and its consequences", *Natixis Flash Economics*, 20 September 2023.

CHART 3.
Manufacturing,
% of total added value



Source: OECD
Last observation is from 2021, except for Spain, Germany and the Netherlands which dates from 2022

CHART 4.
Balance of payments
in travel, % of GDP



Source: Eurostat

entire economic area and appears undervalued in relation to their own economic performance, resulting in an additional competitive advantage. For example, it is estimated that Germany's exchange rate is 20% undervalued, in terms of real effective exchange rate relative to the Euro area.

Charts 3 and 4 below highlight the divergences between industries in EU member states.

- **The Eurozone macroeconomic divergence is especially conspicuous when looking at the TARGET 2 imbalances (*Chart 5*).** Indeed, the net TARGET 2 liabilities of the Bank of Italy and the Bank of Spain are quite high, standing at respectively €555 bn and €395 bn as of September 2023 (which represents roughly 29% of GDP for the two countries).

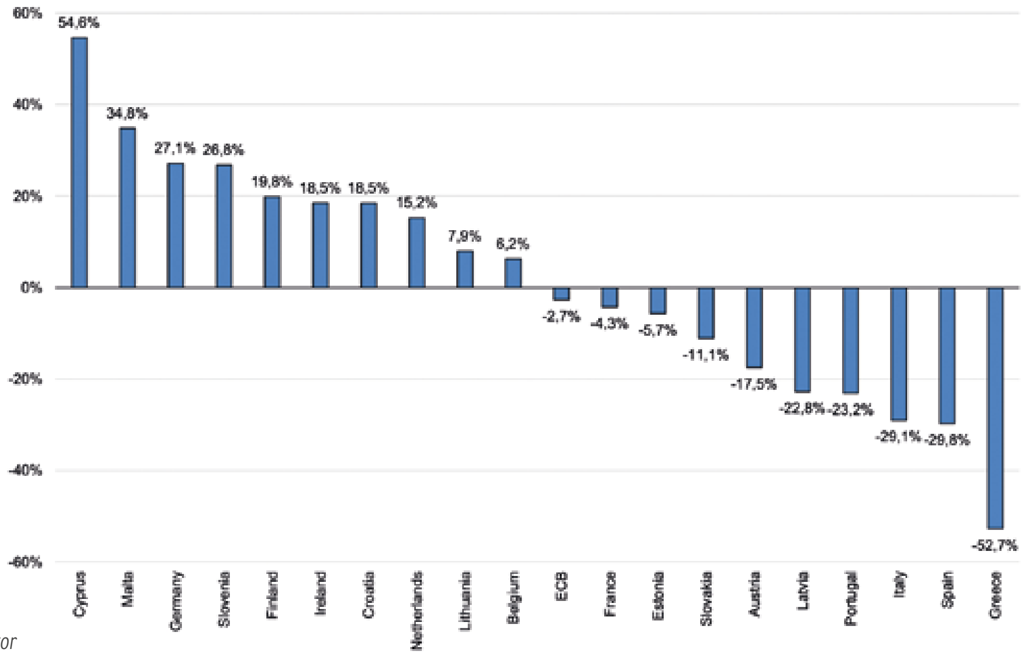
Conversely, the Bundesbank had a net TARGET 2 credit of around €1.048 bn in September 2023 (roughly 27% of Germany's GDP).

It has been forgotten that a monetary union does not erase current account imbalances which remain, by definition, national.

So even though we are in a monetary union and have a single currency, the monetary reality is different: the value of the euro minus inflation is highly volatile depending on the Member State.

- **The divergence in public debt levels across Member States is a major concern (*see Table 1*).** Indeed, the public debt-to-GDP ratio has continued to grow steadily in significant countries of the Eurozone (*e.g.* France, Italy, Belgium, Spain) and is approaching – and even in certain cases exceeding – 120% of their GDP. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt-to-GDP of about 60% or less in the recent years.
- **Disparities are also striking in terms of public deficit (*see Table 1*)**: in 2023, while Germany and the Netherlands have managed to have a public deficit below the 3% threshold (respectively -2.2% and -0.5%), France, Spain and Italy have exceeded the 3% threshold with respectively -4.8%, -4.1% and -5.3%.

CHART 5.
TARGET2 imbalances as of September 2023, % of GDP



Source: Euro Crisis monitor

TABLE 1.
Economic and Fiscal Fundamentals across key EU Member States

	Gross Public Debt, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	59,3	65,7	75,3	59,6	66,1	64,8
France	58,9	68,8	94,9	97,4	111,8	109,6
Italy	109,0	106,2	135,4	134,2	141,7	139,8
Spain	57,8	39,7	105,1	98,2	111,6	107,5
Netherlands	52,2	54,7	67,9	48,6	50,1	47,1
Portugal	54,2	75,7	132,9	116,6	112,4	103,4
Austria	66,1	68,7	84,1	70,6	78,4	76,3
Belgium	109,6	93,2	107,0	97,6	104,4	106,3
Greece	103,6	109,4	180,4	180,6	172,6	160,9

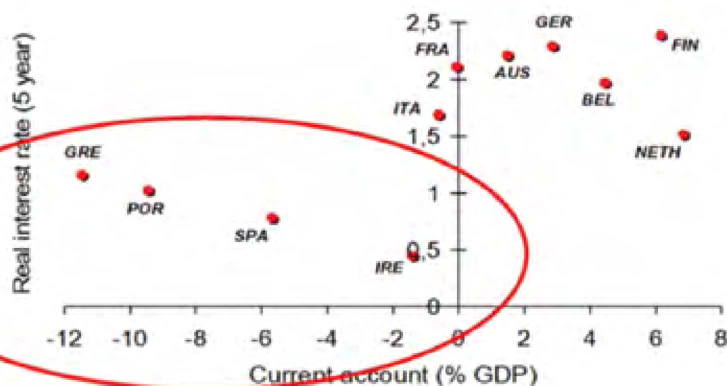
	Total Budget Balance, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	-1,6	-0,1	0,6	1,5	-2,5	-2,2
France	-1,3	-3,3	-3,9	-3,1	-4,8	-4,8
Italy	-2,4	-2,6	-3,0	-1,5	-8,0	-5,3
Spain	-1,2	-4,6	-6,1	-3,1	-4,7	-4,1
Netherlands	1,2	0,1	-2,2	1,8	-0,1	-0,5
Portugal	-3,2	-3,7	-7,3	0,1	-0,3	0,8
Austria	-2,4	-1,5	-2,7	0,6	-3,5	-2,5
Belgium	-0,1	-1,1	-3,1	-2,0	-3,5	-4,9
Greece	-4,1	-10,2	-3,7	0,9	-2,4	-2,3

	Total Government Expenditure, % of GDP					
	2000	2008	2014	2019	2022	2023
Germany	47,8	44,2	44,3	45,0	49,5	48,2
France	51,7	53,3	57,2	55,4	58,3	56,5
Italy	46,5	47,8	50,9	48,5	56,1	53,1
Spain	39,1	41,4	45,3	42,3	47,4	46,8
Netherlands	42,4	43,5	46,1	42,1	43,5	43,2
Portugal	42,7	45,3	51,7	42,4	44,1	42,5
Austria	51,0	49,9	52,4	48,7	53,2	51,4
Belgium	49,4	50,8	55,6	51,9	53,2	54,9
Greece	46,4	50,8	51,2	48,2	52,9	50,5

	Current Account Balance, % of GDP					
	2007	2011	2014	2019	2022	2023
Germany	6,9	6,2	7,2	8,2	4,2	5,9
France	-0,1	-0,9	-1,0	0,5	-2,0	-0,5
Italy	-1,4	-2,8	1,9	3,3	-1,5	0,8
Spain	-9,4	-2,7	1,7	2,1	0,6	1,9
Netherlands	6,9	8,6	8,5	6,9	9,3	9,2
Portugal	-9,6	-6,0	0,2	0,4	-1,2	1,6
Austria	3,8	1,6	2,5	2,4	-0,3	0,7
Belgium	1,9	-1,9	0,8	0,1	-1,0	0,2
Greece	-15,2	-8,8	-0,7	-1,5	-10,3	-6,7

Source : AMECO
Notes : all data are taken from the Autumn Forecast of the EU Commission (November 2023)

CHART 6.
Real interest rates and external balances, 1999-2007 average



Source : Eurostat, BNP Paribas

As M. Luis de Guindos said: "After four years without EU fiscal rules, governments may have got used to a little bit of a 'whatever it takes' approach with respect to fiscal policy,". "But that has to change. Having a tightening of monetary policy and, simultaneously, an expansionary fiscal policy would be a very bad policy mix."[4]

- **Current Account Balances are another indicator of the heterogeneities of the Euro area (*see Table 1*)**: in 2023, Germany and the Netherlands had Current Account Surpluses of respectively 5.9% and 9.2% of GDP whereas France and Greece had important structural deficits of respectively -0.5% and -6.7%.
- **Regarding inflation in Europe, there were two discernable zones during the 2000s (*see Chart 6*)**: one where inflation was rather high (Spain, Italy...) and one where inflation was rather low (Germany, the Netherlands...).

In other words, while the objective of maintaining an inflation rate similar to the one observed before the global financial crisis (*i.e.* close to 2%) was, on average, attained, it remains that the "peripheral" countries who had let their inflation soar, their budgetary deficits derail and their real estate markets explode, had, in a way, "taken advantage" of the low interest rates of the ECB (whose rates were obviously too low for them while they were more in line with the needs of the more stable core-countries of the Eurozone).

Consequently, the current account balance of countries with high inflation have deteriorated during the 2000s. Meanwhile, countries that had contained inflation had positive real interest rates and current account surpluses, encouraging them to be even more virtuous in their fight against inflation. The monetary system has thus pushed countries towards one extreme or the other depending on their economic discipline.

- **The reality of the European Single Market has not favored more economic coherence**

The single market is an essential objective, but it does not improve the homogeneity and economic performance of all member states in itself. It would only have positive results if all Member States advanced at an almost similar pace in terms of structural reforms.

Cross-border capital flows within the Eurozone have been limited since the euro sovereign debt crisis. Additionally, until 2008, European cross-border capital flows mainly fueled unproductive asset bubbles (in Spain, Ireland...).

- The ECB's interest rates have been structurally lower than the FED's ones for 15 years, which leads to capital flight from the Eurozone to finance the rest of the world, especially the United States.
- The accentuated economic divergences between Member States can scare investors away, as they have better remunerated and less risky opportunities elsewhere, especially in the United States.
- The EU banking market remains fragmented notably due to home-host issues and ring-fencing practices from host countries.
- The Capital Market Union (CMU) remains a dream[5].
- The absence of a European safe financial asset due to the absence of a common fiscal policy.

It is therefore important to promote integrated banking and financial markets where excess savings from North countries could finance necessary investments in South countries which would foster not only growth in Europe and the international role of the euro but also the European strategic autonomy in the financial area. But unfortunately, this does not work due to the increasing economic divergences between Member States.

To overcome the inherent contradiction of the heterogeneity of the monetary zone, there should have been at least one element of macro prudential surveillance: in the 2000s, simple, non-monetary regulatory measures such as loan to value, increasing down-payments by borrowers for loans would have been effective in preventing asset bubbles. We missed out on this macroprudential phase.

It is already difficult to manage a single monetary policy with strong economic divergences, and it's even more difficult if we don't use the simple measures known as macroprudential measures, which would have made it possible, in particular, to attenuate the problems of financial instability in the 2000s.

The current intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a current policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharking and weakens the Eurozone. The prerequisite to move towards a federal EU fiscal capacity is to achieve economic convergence in all parts of the Union in order to build sufficient trust amongst EU Member States.

4. Interview with *Financial Times*, 2 October 2023.
5. To achieve a genuine CMU, the EU needs to have adequate financial products – especially pension funds (essential to fund retirement pensions at the national level), sufficient interest rate remuneration, rules that foster equity financing and securitization, and European actors as well as consolidated infrastructures, which requires a harmonized legal framework regarding bankruptcy and securities.

Consequently, it is not easy to achieve global objectives (*e.g.*, green transition, digitalization, defense, social redistribution, migration...) including monetary stability while maintaining fiscal policies so diverging from one another.

3. The ultra-loose monetary policy in the Euro area (2008-2022) has disincentivized Member States to undertake structural reforms and has led to "fiscal dominance"

The delicate arrangement of the European construction, largely illusory, depended very much on the maintenance of a zero-interest rate policy from the ECB to make public deficits easily financeable. Which is what we did for 15 years! (apart from the crisis of 2009-2011) (*see Chart 7*).

Keeping interest rates at 0 during more than 15 years reduced the financial difficulties caused by the emergence of spreads and the public deficits but encouraged general indebtedness as well as the vulnerability of the financial system and have disincentivized Member States to undertake necessary structural reforms (especially in France and Italy).

The fact that the ECB has gone so far on the fiscal issue (the Eurosystem holds more than 30% of the outstanding public debt) sheds a rather dark light on the concept of independence of the central banks.

Monetary policy can erase spread differentials in the Euro area but can neither solve domestic structural problems nor relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita GDP countries (Spain, Italy, Portugal, Greece)[6].

By setting medium and long-term interest rates in an administrative manner, central banks have crossed a crucial boundary: that of intervening in the allocation of resources and the distribution of wealth without letting the market define interest rate equilibria based on the supply and demand of capital. In fact, central banks have systematically favored debtors over creditors. Are we still in the realm of monetary policy or in a market economy?

Now, the debt servicing costs are rising along with the interest rates and are becoming heavy on highly indebted countries' budgets, leaving them with really little room for maneuver. Without efforts to comply with the fiscal discipline required by a monetary union, the sustainability of the debts of certain EU Member States could be questioned.

When the ECB massively buys financial securities, it is, by definition, running a risk, which is that of the intrinsic value (risk of default) and duration (interest-rate risk) of these securities.

If the Central Bank has miscalculated its risk (by underestimating inflation or forcing rates to 0 while financial bubbles are inflating), it is preparing for a crisis. This is exactly what is keeping.

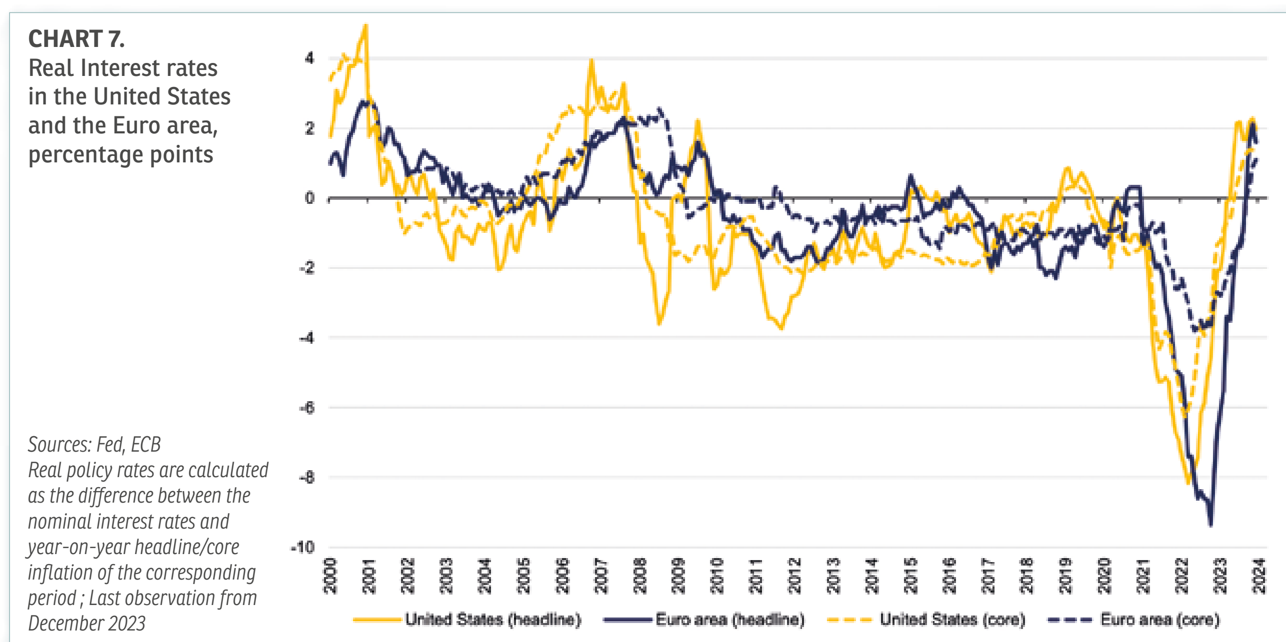


CHART 7.
Real Interest rates in the United States and the Euro area, percentage points

Sources: Fed, ECB
Real policy rates are calculated as the difference between the nominal interest rates and year-on-year headline/core inflation of the corresponding period ; Last observation from December 2023

6. This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the Eurozone countries, the insufficient number of investment projects and the absence of a European industrial policy.

In the ascending phase of QE, governments were happy with the fall in rates and the rise in the value of Treasury securities. But as soon as inflation reappeared and rates had to be raised, governments began to worry: borrowing would cost them more, and they would have to make up the central banks' deficits (through recapitalization) and suffer the consequences of rising interest rates.

- What goes around comes around. A political agenda that encourages fundamental economic divergence is one that turns its back on reality. And when one turns its back on reality, the spreads of interest rates on the markets tend to increase and the spreads for the least competitive countries to jump.

As long as it is not sufficiently understood, especially in highly indebted countries, that over-indebtedness is a source of under-competitiveness and higher spreads, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe.

Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharking and weakens the Eurozone.

4. Necessary improvements are required to face challenges ahead of the EMU

Monetary policy must continue to be normalized to fight inflation

ECB should pursue the normalization of monetary policy to fight inflation which remains persistent and elevated.

TABLE 2.
Evolution of real key rates since inflation started

	Nominal key rates in 2021	Key rates in Dec. 2023 (a)	Underlying inflation, Dec. 2023 (b)	Real rate (a-b)
Fed	0%	5,5%	3,9%	1,6%
BCE	0%	4,5%	3,4%	1,1%

In recent months, real interest rates have turned positive in the Eurozone, which is necessary to keep inflation under control.

However, should the monetary policy consider the possible financial fragmentation that exists in the Eurozone?

The fear of the reappearance of spreads in Europe should not dominate the decision-making process of the monetary policy. Indeed, sooner or later, structural spreads – based on the past accumulation of fiscal and structural deficiencies – in Europe will appear on the markets.

The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But central banks do not have an obligation to systematically erase all traces of interest rate differences in the appreciation of the markets. The elimination of all spreads would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline – place greater emphasis on the objective of monetary stability (believing that the ECB should not monetize public debt).

Monetary policy cannot solve structural issues. Member States are the ones which must adjust their economic and fiscal policies accordingly to address their domestic economic weaknesses.

It would make sense to decisively start a quantitative tightening monetary process in order to undo the excessive liquidity that has accumulated during the years of monetary accommodation.

The review of the Stability and Growth Pact (SGP) is not ambitious enough

Turning to fiscal policy, it is time to tighten belts. Public debt levels are at records and fiscal deficits remain way too large in large EU member States (France, Italy, Spain in particular). The fact that money has been thrown at the problems for years has worked against supply-side policy which are essential to raise potential growth, and which have been the orphans of this EMU story during the 25 past years.

Excessive deficits and debt work against economic growth. In the absence of an competitive production system stimulating demand does not translate into increased domestic production, but leads to a widening of our trade deficit if a country does not have an efficient production system. In this respect, the quality of public spending is becoming an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spendings.

On 21 December 2023 the Ecofin Council achieved an agreement on the reform of fiscal rules which paved the way for negotiations with the EU Parliament on the preventive arm regulation.

The goal of simplification of the rules has regrettably not been achieved. What is even more worrying is that the Commission's proposal demands from the most indebted countries the smallest effort, which should perpetuate the decline of these economies.

The European agreement on the Stability and Growth Pact of December 2023[7] contains some positive elements:

- The case-by-case framework – which is a specific technical dialogue between the EU Commission and each Member State regarding their differentiated multi-year budget trajectory – has been introduced in the reformed Pact. It enables a differentiated approach towards each Member State to take account of the heterogeneity of fiscal positions, public debt and economic challenges across the EU.
- This dialogue will be based on a new indicator, the "net expenditure[8]", which should, in principle, serve as a basis for setting a fiscal path and carrying out annual fiscal surveillance for each Member State. The multi-annual trajectory for this indicator, prepared by each Member State, must also be adopted by the Ecofin Council, which could reinforce the self-discipline of Member States.
- The obligation to reduce the public debt-to-GDP ratio by a minimum average of one percentage point of GDP per year over a period of 4 to 7 years for countries where outstanding public debt exceeds 90% of GDP (preventive aspect of the Pact) has been introduced. This measure is reduced to 0.5% for countries whose debt is between 60% and 90%.

However, there are several areas of concern:

- Countries that are subject to an excessive deficit procedure (total public deficit over 3% of GDP) are exempt from the rule requiring them to reduce their public debt by an average of 1% a year until their deficit falls back below 3%. These countries will only be subject to the procedure once their public deficit has fallen back below the 3%. This is not the best way to encourage the worst performers to reduce their debt to GDP ratio! It's as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.
  The quality of public spending and composition on public finances must be given more importance than its quantity[9]. A review of the composition of public finances must take corrective actions to ensure a path to primary surpluses and reduce unproductive public spending. Illusion over these countries 'capacity to stimulate demand should be ditched out. But if countries that are subject to an excessive deficit procedure are not required to reduce their public debt by an average of 1% a year, they will have no incentive to do so. This is an incentive to remain above a 3% deficit for as long as possible. When the level of public debt is at the limit of what can be tolerated, the trade-off in public spending is generally in favour of the most current and unproductive expenditure in order to cope with the next day, instead of giving priority to research, training and well-chosen public infrastructure investment.
- Adjustment implementation horizons seem very long: 4 to 7 years to reduce the public deficit below 3% and experts deem the Commission unlikely to force a government elected with different priorities in the middle of the seven-year cycle to implement policies agreed by its predecessor[10]. As mentioned by L. Garicano, "the framework is also vulnerable to manipulation through creative accounting and over-optimistic growth assessments".
- For the transitional period in 2025, 2026 and 2027, the Commission may exclude the expected rise in debt servicing costs from the calculation of the adjustment effort, despite the fact that this will be the largest item of budget expenditure in some countries.
  This measure raises questions insofar as it reduces the effectiveness of the mechanism and weakens efforts to consolidate the public finances of over-indebted Member States.
  This measure is all the more questionable given that, between 2014 and 2022, some Member States that benefited from very low interest charges due to zero or even negative interest rates have not begun to rebuild their primary budget surpluses.
- Reference is made to the structural deficit in both the corrective and preventive sections of this revised Pact. Its definition as a "cyclically adjusted deficit" risks weakening the agreement. Why take up this complicated reference, which has failed to reduce excessive deficits in the

7. At the time this note is written, the preventive arm of the proposal still has to be adopted by the European Parliament.
8. "Net expenditure" means "government expenditure net of interest expenditure, discretionary revenue measures, expenditure on programs of the Union fully matched by revenue from Union funds, cyclical elements of unemployment benefit expenditure, and one-offs and other temporary measures" (Chapter 1, article 2).
9. See J. de Larosière and D. Cahen, "Reforming the Stability and Growth Pact", , Eurofi Regulatory Update, April 2023.
10. L. Garicano, "The EU's new fiscal rules are not fit for purpose", *Financial Times*, 8 January 2024.

past, and not keep the simple notions of total public deficit (as a % of GDP) or primary budget surplus, which are essential ratios for putting the public debt trajectories of the most indebted countries back on a sustainable path?

- In any case, primary budget surpluses are necessary to reduce public debt, but not sufficient for a return to growth, as shown by the example of Italy in the years preceding Covid-19. These primary surpluses must be accompanied by the implementation of structural policies to return to growth (*see detailed recommendations related to these reforms issued by the OECD and the IMF – articles IV*).
- The Commission's powers to enforce these "new" rules have not been strengthened, even though it can initiate an excessive deficit procedure based solely on the criterion of public debt in relation to GDP.

What makes these new rules any more likely to be implemented than the previous ones? All the more so as the final discussions in the Council focused on minimum safeguards, which risk becoming maximum rules...

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The postponement of the of budgetary adjustment for countries subject to an excessive deficit procedure and the extremely long periods granted to over-indebted countries to bring their public debt back to below 60% of their GDP (around 50 years for France, 80 years for Italy) are based on two erroneous prejudices:

- The reduction in the public debt ratio is based on the expectation that medium – and long-term interest rates will return to very low levels in the coming years, which is likely to prevent budgetary efforts (*i.e.* cuts in public spending). The peak of the increase in the interest burden on the public debt of hyper-indebted countries is expected to be reached by 2027 and should subsequently fall as a result of the return to permanently low interest rates. This is the "easy money" paradigm: an accommodating monetary policy (permanently low interest rates) avoids budgetary efforts.
- Any budgetary adjustment is "by nature" recessionary because economic growth is based primarily on domestic demand.

These two assumptions should lead European countries with excessive debt to continue their economic decline. There are several explanations:

- Recent monetary history (2014-2021) puts the emphasis on the paradigm of easy money which leads to excessive debt that does not stimulate economic growth. Persistent low (or even negative) interest rates over this period have not led to an increase in productive investment but have on the contrary encouraged savers to keep their financial assets in liquid instruments (see Eurofi Scoreboards) and not to channel them in securities geared to long-term investments[11]. Furthermore, persistent low interest rates encourage indebtedness and the proliferation of asset bubbles, increase wealth inequalities and favor a misallocation of resources (*e.g.* development of zombie firms).
- Excessive deficits and debt jeopardize economic growth. They require an increasing tax pressure, which deteriorates further the competitiveness of companies in these countries. Stimulating demand does not translate into increased production but leads to a widening of trade deficit if a country does not have an efficient production system. On the contrary, what is needed to increase potential growth and achieve a better allocation of resources is:
  - To return to primary surpluses as soon as possible,
  - To rationalize of public spending – qualitative public spending must be an absolute priority – in countries where the public spending-to-GDP ratio exceeds the European average,
  - To steer supply side-oriented reforms that enhance productivity gains.

The Macroeconomic Imbalance Procedure (MIP) needs to be rigorously respected thanks to equal treatment and multilateral surveillance assured by an independent dedicated Commission.
Unfortunately, the review of EU economic governance rules does not address this issue.

The Macroeconomic Imbalance Procedure (2011) must be applied effectively, and evenly among all Member States. This means that the adjustments of the current account balances should not only concern countries running structural deficits, but also countries running structural surpluses.

It is not possible nor honest to expect South countries to be the only ones to indefinitely scale down their revenues to compensate for the growing surpluses of North countries.

11. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.

It is therefore high time to design and implement a **symmetric** adjustment mechanism where surpluses are addressed the same way deficits are. Unfortunately, the revision of the EU economic governance framework did not change the MIP.

The present complex situation where a monetary union is run without a credible mechanism dedicated to economic stability is not sustainable in the long term. Member States must use their fiscal and structural policies to strengthen the cooperation that the Union needs. In the present circumstances, the European Union with 27 members is not willing to force economic convergence on Member States in the name of a discipline that ultra-loose monetary policy discouraged.

To break this contradiction, it is essential that the European executive power, and more precisely the Commission, assume their responsibility regarding the respect of economic discipline.

This requires independence, skills, vision and courage from the leaders in charge of these economic topics within the Commission.

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It has to be acknowledged that institutional progress has been achieved to a certain extent. Such progress can be illustrated by the creation of the European Stability Mechanism (2011) and the design of Next Generation EU (2020).

These are positive decisions as they emphasize the need for structural adjustment. However, it cannot be ignored that the financing on the market of both these initiatives is accompanied by average interest rates that reflect the European economic heterogeneity.

When comparing NGEU (€800 bn) and the American IRA ($369 bn), one thing is striking: the American funds are easily and quickly accessible and work as an incentive to achieve the fixed objectives, whereas national and European bureaucracies make the process of spending NGEU funds cumbersome and relies heavily on prohibitive rules. As a result, only 30% has been spent halfway through the lifetime of the project. Additionally, some European companies have been attracted by the IRA and have thus shifted investment to the US, including Total Energies, MBW and Northvolt.

Several economists think that it is not possible to finance massive investment in the ecological transition if Eurozone fiscal policy brings fiscal deficits below 3% of GDP and if monetary policy keeps inflation below 2%. They propose to accept higher inflation, low interest rates and fiscal deficits in excess of 3%.

These are dangerous ideas for several reasons:

- The negative real interest rates do not favor productive investment as observed for 10 years but encourage liquid assets holdings as well as the proliferation of asset bubbles (*see Eurofi Monetary Scoreboards*) and increase wealth inequalities.
- Inflation reduces the purchase power of households and reduces consumption.
- Economic uncertainty linked to inflation hold productive investment back.
- Public deficits can only be accompanied by an increasing tax pressure, which will deteriorate further the competitiveness of companies.

Contrarily, we must fight persistently high inflation: it is necessary to refrain from administratively fixing long-term interest rates and to accept to let the market remunerate medium and long-term savings according to supply and demand, without which there can be no productive investment or productivity gains.

National budgets must be under control in all part in the Union: the future depends on a consolidation of present weak fiscal positions (primary surpluses) and shift towards qualify of expenditure and investment.

To do that, there is a need for a deep review of all the layers of national public spending – renewed because voted beforehand – and for the reduction of unproductive and socially not obvious spendings.

The idea of labelling a spending as "investment" and to add it on top of the 3% rule makes no sense. Indeed, given the little room for maneuver that countries have in terms of budget, it is paramount to substitute productive investment to spending that does not benefit the general interest. The experience has proven that the 3% rule has been perfectly applicable in countries like Germany, which is among those having the most productive investment and the least non-necessary public spending.

Furthermore, increasing public deficits is not a solution, as market rates would become even tighter, and the borrowing machine would be hindered. Ultimately, if we were to continue, at all costs, to pile up public debt, the risks of a market downturn would become very serious, just when we had exhausted our fiscal margins.

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If fiscal, inflationary and economic drift continues in the Eurozone, the "virtuous" countries will end up paying for it. This would be the definition of an uncooperative game, where most players try to evade their obligations by passing on the cost to those who respect them. We must therefore take the Union's destiny into our own hands and not let it drift. If this is to be the case, the logical outcome could well be a new and inevitable Eurozone crisis.