



A Shared European Policy Strategy for Growth, Jobs, and Stability

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The European project is suffering an unparalleled crisis: the policy reaction to the economic recession and large unemployment is often perceived as insufficient by European citizens, which often struggle to perceive the value added of being part of the Union. National interests are prevailing over the common good. Growing signs of disaffection, fed by the exceptional duration and intensity of the crisis, are boosting consensus for populist proposals; Euroscepticism is on the rise in almost every Member State.

If Europe is to be part of the solution – and not of the problem – we must rebuild trust among our citizens and between member states, and develop an EU-wide strategy to restore sustained growth and boost jobs. We have gone a long way towards more integration, but now Europe is at a crossroads: if we were to keep muddling through an uncertain recovery, progress in growth and job creation would fail to emerge and the Euro area would remain exposed to shocks, undermining its sustainability.

Against this backdrop we believe that the EU is a big opportunity. We must seize it and deliver to our citizens the solutions they expect. The Italian Government presents a far-reaching policy agenda and concrete proposals in order to contribute to the debate on how such an opportunity can become a concrete project.

1. A Fragile Recovery: Challenges and Opportunities

The recovery that has been developing over the past several quarters in Europe is still too modest and fragile. Weaker external demand and uncertainties in the global outlook point to increased downside risks. A protracted period of exceptionally low inflation coupled with sluggish growth is negatively affecting the growth potential and weakening expectations on future economic perspectives. Crucial indicators such as employment, industrial production and investment are still far below the pre-crisis levels in several Member states. Imbalances have further widened, with negative consequences on the overall sustainability and resilience of the euro area.

Signs of disaffection in the EU project, boosting consensus for populist perspectives, are much more widespread than we could have expected even at the peak of the crisis. These have been fed by the exceptional duration of the crisis. They are also fueled by the difficulties in perceiving the added value of being part of the European Union. On the contrary, especially in some countries, the response to the crisis has been perceived as exacerbating divergences and segmentation between core and periphery, despite the policy effort put in place. Overall, the Eurozone policy mix to counter the crisis and support a sustained recovery has proved to be inadequate.

More convergence, acceleration of structural reforms and stronger domestic demand are necessary to avoid that significant and persistent losses of output permanently affect potential growth. Decisive coordinated policy action is needed beyond the current policy mix and the positive contribution by the ECB policy stance. The urgent challenges of restoring sustained growth and anchoring expectations must be addressed. If, instead, Europe were to keep muddling through a hesitant recovery, progress in growth and job creation would fail to materialize and the euro area would remain vulnerable to shocks.

Furthermore, Europe is facing new formidable systemic challenges represented by the influx of migrants and asylum seekers. These challenges call for a coordinated policy response to provide immediate relief and design common initiatives to facilitate integration. Any tightening of internal border controls would be detrimental to free movement of labour and goods with negative consequences of unpredictable impact.

Relevant policy decisions can be taken now, following an integrated approach where the implementation of short term initiatives is part of an ambitious longer term strategy.

2. A Comprehensive Policy Mix

A comprehensive approach for a more sustainable and resilient Economic and Monetary Union should aim at boosting growth potential while enhancing the adjustment capacity and flexibility of markets in all Member states also through better risk sharing. This policy objective can be fully achieved with a mix of short and longer term policy measures. Action must be accelerated on several fronts: structural reforms, investment, employment, the banking sector and the internal market. Actions on the different fronts are complementary and mutually reinforcing.

2.1 Governance to Boost Growth Capacity

The governance framework must provide the right incentives to growth-friendly fiscal policy and to continuous reform effort. However, further steps are urgently needed vis-à-vis protracted historically low levels of investment and employment. The three main pillars outlined by the recent *Annual Growth Surveys* – **re-launching investment, pursuing structural reforms and promoting fiscal responsibility** – should be seen as mutually reinforcing.

The Commission's communication on **flexibility in the Stability and Growth Pact** marked a step forward in improving the policy mix. It creates the appropriate incentives for reforms and investment. It strengthens the coordination between structural and fiscal policies triggering a virtuous circle: structural action and investments boost medium-term growth thus supporting consolidation of public finance.

2.2 Fiscal Policy

In presence of protracted modest growth rate and exceptionally low inflation even the extraordinary measures put in place by the European Central Bank are proving insufficient. **Fiscal space should be fully used to support growth.** At the same time, restoring a sustainable pace of growth and job creation is also the most effective way to keep debt on a sustainable path.

More symmetry is needed in macroeconomic adjustment. Very large current account surpluses have a negative impact on the overall functioning of the Eurozone just as current account deficits. To the extent that they reflect excess savings surpluses should be addressed by policies spurring investment, both private and public. A more cooperative approach to support demand would lead to a win-win equilibrium complementing structural reforms. The macroeconomic imbalance procedure should be implemented more effectively to this end.

The new European Fiscal Board should take a pan-European view in its analyses and **formulate fiscal policy recommendations for the euro area as a whole.** This is key to develop an aggregate policy stance and an EU-wide growth strategy which goes beyond the mere sum of national performance.

Fiscal rules should prove their adequacy to cope with a challenging economic environment. A framework designed for normal conditions of growth and inflation has proved incapable to tackle effectively the impact of very low nominal growth on potential growth and on debt dynamics. These shortcomings have implications for the measurement of fiscal indicators on which policy recommendations are based and should be addressed. **Price developments should be more effectively embedded in fiscal rules.**

2.3 Keeping the Reform Momentum

More coordination and benchmarking will stimulate reforms in all countries, facilitate domestic political support to reforms and improve implementation. The accommodative monetary policy creates a window of opportunity to boost the reform effort and enhance potential growth. A more coordinated effort among countries and policy instruments generates positive spillovers that testify for the added value of being part of an economically integrated area. Moreover, convergence and coordinated structural adjustment would bring more symmetry in macroeconomic adjustment.

All countries need to boost the reform effort. **Structural reforms would support rebalancing both in surplus and deficit countries as they open profit opportunities that stimulate investment.** This would also facilitate the implementation of a more

balanced fiscal stance for the Eurozone as a whole and reduce current overburdening of monetary policy.

Furthermore, a much closer link should be established between the **analysis and policy recommendations at the aggregate level and their implications for individual countries**, taking into account the spillover effects of national economic policies on other countries.

2.4 Boosting Investment

Investment supports demand in the short-term and strengthens supply and potential output in the medium-term. Against a backdrop of slow and fragile recovery, investment is the top priority to put the EU back on a path of sustainable growth. Over the recent past, the fall in investment in the European countries has been dramatic and widespread; its reversal is still very slow.

To help reverse this trend, the Commission has launched the Juncker Plan and created the European Fund for Strategic Investment (**EFSI**). The Plan is an important opportunity to boost private investment with public support. The Plan is expected to activate projects which would not otherwise materialize, due to excessive risk, market failures, or financial and budgetary constraints.

The potential catalyzing role of the Plan has to be exploited in full, in **synergy with resources from the EU budget and from national resources including national promotional banks**, for genuine European investment initiatives aimed at financing **European common goods** such as Trans-European networks or the Energy Union. Knowledge-intensive initiatives, focusing on human capital, research, innovation and high-level education are investments with the highest growth potential and should be adequately supported. A strong effort in structural reform would exploit boost profit and investment opportunities.

Countries should fully use their fiscal space where available, to expand investment. The governance framework should provide for further **incentives for investments in European public goods also at national level**. Further common European initiatives should be explored: projects to enhance EU growth potential could be financed by joint debt issuances.

Finally, we share the idea of a *Financing and Investment Union*, where the completion of the Banking Union, the Capital Market Union and the Juncker Investment Plan contribute to the more effective channeling of savings into investment.

2.5 Completing the Banking Union

A key priority is to complete the Banking Union and preserve the confidence in the banking sector. Increasing the resilience of our banking system while limiting the impact of banks failures have been at the top of the policy agenda and significant results have indeed been attained. **A lot has been realized to reduce risks**, notably by strengthening

prudential safeguards of banks with increased capital and liquidity requirements; by reinforcing supervision through in-depth EU wide stress tests and by creating the Single Supervisory Mechanism. Moreover, by implementing domestic legislation following the Bank Recovery and Resolution Directive and with the establishment of the Single Resolution Mechanism, the risk for the involvement of the public sector has been significantly limited.

The innovations put in place by the **implementation of the BRRD directive** are substantial and the adjustment in expectations and behavior of stakeholders to incorporate the new framework will take time to be completed. The implementation needs to be properly managed to avoid financial instability including through better information, communication, transparency and risk assessment.

However, the **Banking Union is still incomplete and needs to be endowed with effective tools to address systemic crises**. A framework for risk sharing is necessary to move forward towards credible prospects of financial stability. A **European Deposit Insurance Scheme (EDIS)** would significantly improve the functioning of the Banking Union, ensure more efficiency and financial stability. Most importantly, it would boost confidence, which is the key ingredient for the success of banking systems and **contribute, in turn, to reduce risks**. Furthermore, an early establishment of an effective common backstop to the Single Resolution Fund (SRF) is necessary to enhance the financial capacity of SRF and the overall credibility of the Single Resolution Mechanism. Risk sharing is part and parcel of a Banking Union that is to succeed in limiting market fragmentation and creating a true level playing field for firms all across the EU.

In parallel, further measures are needed to reduce – over the appropriate time horizon – high levels of private debt, to tackle non-performing loans and to improve the overall effectiveness of the insolvency frameworks. **Coupling risk sharing with further risk reduction would greatly improve financial stability**, support the recovery of credit activity and boost growth perspectives.

A fully developed **Capital Markets Union** will further strengthen the system and would facilitate diversifying sources of financing, especially for SMEs, and deepening the Single market. Moreover, it will contribute to better adjustments to shocks across the euro area, making the Economic and Monetary Union more robust and resilient.

2.6 Deepening the Single Market

Further strengthening the internal market is an opportunity that needs to be fully exploited: there is ample scope for additional benefits, through deeper integration, and stronger competitiveness. **The internal market is the great common achievement of the Europe at 28.** The Single market has been at the heart of the European growth strategy for more than two decades. However, national interests, institutional barriers and bottlenecks, both at national and at EU level, have prevented to reap the full benefits in terms of competitiveness and growth.

The ongoing efforts to revitalize the Single market, targeted at removing obstacles to the single capital market and creating a Capital Markets Union, overcoming the segmentation

of the energy market, and promoting the digital economy and innovation go in the right direction. With regard to **energy**, the integration of national markets would have a significant impact on the competitiveness of the European economy. Further steps at the national level would complement progress towards the single market by creating conditions to facilitate investment opportunities. Areas where reforms would deliver considerable benefits include **public administration reform, including access to public procurement, and reform of civil justice**. Finally, progress in addressing unfair tax competition and in achieving more transparency in the **tax area** can greatly benefit cross border business activity and improve consumers' welfare.

Ultimately we must keep in mind that the most promising source of growth in an ageing economy such as the EU is **innovation** driven productivity. In this respect the goal of a shared growth strategy should be to move towards a **fully-fledged Innovation Union**, i.e. the EU should adopt an integrated set of initiatives, to stimulate knowledge creation through investment in education and research, which are the main drivers of innovation.

Cooperation **between euro area and non-euro area countries** will be key. Further integration in the EMU and further integration in the European Union are, and should be seen, as mutually supporting and beneficial. Convergence within the euro area should not come at the expense of divergence with non-euro Member states.

2.7 A Common Tool for Adjustments in the Labor Market

An innovative approach is needed to promote and facilitate adjustments in European labor markets. In the euro area in particular, given the absence of the exchange rate most of the effort of the adjustment is borne by employment.

A macroeconomic stabilization mechanism is needed as countries under tight fiscal constraints may not be able to smooth the cycle and to deal with increases in unemployment in case of asymmetric shocks. Moreover, monetary policy may prove insufficient if the shock is country-specific.

A common mechanism to mitigate cyclical unemployment and its consequences would represent a feasible opportunity for the Eurozone to make a step forward towards sustainability and to strengthen the social dimension. Moreover, long term benefits would ensue as high levels of unemployment for a prolonged period of time entail a deterioration of human capital, lower productivity and a negative impact on potential growth.

A Fund to stabilize the labor market would provide resources to countries experiencing large increases in cyclical unemployment. Once established, it would be triggered in an automatic way avoiding complex and lengthy decision making processes.

An unemployment insurance scheme could help consolidate medium-term growth by smoothing the adjustment needed in presence of adverse shocks and limiting negative impact on other countries. It would amplify impact effectiveness and positive spillovers of national reforms. Countries that are not direct beneficiaries will gain from a more stable and prosperous macroeconomic environment. It would be a further sign of the irreversibility of the Euro, with a positive impact on confidence.

An appropriate incentive structure can be built to limit moral hazard and avoid permanent and unidirectional transfers from some countries to others while increasing risk sharing. For example, the mechanism could be triggered by a sufficiently large downward cyclical phase in a country leading to an increase in unemployment. The activation of the shared resources would be outside the control of national governments. As the mechanism would not deal with structural unemployment beneficiary countries still bear the responsibility of introducing structural reforms in the labor market . Far from being a shortcut for countries that are not accelerating reforms, the risk-sharing involved would be a driving force behind reforms and towards implementation of coherent measures across different Member states.

It could be financed either by earmarking part of the national resources allocated to unemployment benefits or with a fresh common fiscal capacity. Such an instrument could be established without Treaty changes, while building mutual trust and support for Treaty changes when needed.

2.8 Facing Pressure at European Borders

The European Union is facing an unprecedented challenge represented by the influx of migrants and asylum seekers. The refugee crisis is clearly a systemic issue, which puts Europe to the test. It is widely perceived by the public opinion as requiring a common European response. Also **the subsidiarity principle points to the need of a European dimension to deal with the size and complexity of the issues at stake.** A common and shared response is necessary. The Schengen agreement is one of the main achievements of European integration and must be preserved and strengthened.

A long term refugee policy is required as the phenomenon is expected to last. **Sharing the responsibility for the management of external borders between the EU and the relevant Member states would represent a powerful response.** Financial and human resources from the EU should complement national policies for rescue operations, administration of hotspots and first integration of refugees reaching the European frontier. These are European common goods that require EU level involvement. We need a win-win solution to balance the short term costs of funding the new policy with the long term benefits stemming from a more ordered process of transition and integration. **The scope of the new policy of a shared management of the EU external frontiers requires different funding sources and would justify the recourse to a mutualized funding mechanism which could entail issuance of common bonds.**

3. From the Short-term to the Long-term View

To make the monetary union really irreversible we must manage our European common house by adopting a systemic, common vision.

A stronger monetary union needs **strong common institutions.** In addition to the Banking Union the following should be considered.

The institution of the **European Stability Mechanism** (ESM) has been a major advance for the management of sovereign crises, through the use of pooled resources. We should focus on **how to fully exploit the benefits of this pool of resources while preserving its ultimate firewall function**. An ambitious goal would be transforming the ESM into a European Monetary Fund. In the shorter term, the ESM should become the backstop for the Single Resolution Fund to effectively safeguard financial stability in the Union.

The implementation of a **common unemployment benefit** would be a first step in developing a stabilization function to cope with asymmetric shocks and help in building the necessary trust for more ambitious initiatives in the future.

At the European Union level a **financial initiative aimed to fund the common management of the external borders** would also represent a relevant example of shared responsibility and provision of European public goods.

In the long term, the Monetary Union should be equipped with a **fiscal capacity** tailored to the tasks **of promoting investments and smoothing the cycle**. A strongly integrated area, such as the EMU, is characterized by public goods that can be better provided at a systemic level. This is the case of large-scale investments, stabilization function and financing of policies in Member states with positive spillovers.

These functions could be managed by a **Eurozone Finance Minister**. The value added of a Eurozone Minister would be to run a common fiscal policy and to ensure that a coherent and internally balanced fiscal stance is pursued at the aggregate level. To this end, a Eurozone budget would be needed, with adequate resources. Of course, such a Minister should be politically endowed to play this role. While this figure could be enshrined within the European Commission – along the lines of the High representative – it would be important to have a strong link with the European Parliament.

4. Conclusions

One lesson arising from the crisis is that the stability and progress of economic and monetary union requires more mutual trust, between citizen and European institutions and among Member states and a more forceful systemic approach, which implies more attention to the positive externalities of the integration process. Mutual trust can be accumulated by showing peers that one country abides by the rules. Rules must be designed so as to reward compliance and discourage uncooperative behavior (i.e. prevent moral hazard). At the same time, rules must provide for risk sharing mechanisms which increase payoff for cooperative behavior. Risk sharing mechanisms are a key component of well-functioning monetary and economic unions. In other words **rules must allow for mutualization**. The two elements, risk mitigation and risk sharing are reciprocally reinforcing. Preventing moral hazard strengthens trust and supports mutualisation. **Risk sharing and mutualisation offer a powerful incentive to abide by the rules and prevent opportunistic behaviour**.

Rebuilding trust among Member states, and defusing national prejudices are the principles that should guide the actions of European governments. These efforts must include all 28 Member states. Many of the above steps, notably deepening the Single market, developing

a well-functioning Capital Markets Union, the Investment Plan, as well as possible initiatives for dealing with the refugees crisis - are EU matters and will be discussed in 28 formation. The degree of **cooperation between ins and outs** on those topics will be key to make real advancements.

The debate on the future of the monetary union is a great opportunity to strengthen the resilience of the European economy and of the European project at large. How we move forward in this new challenge should be guided by a few key principles:

- The **link between short term and long term issues should be strengthened** and based on a common vision. There should be no excuse for concentrating only on the short term
- The distinction between measures that require Treaty changes and those that do not should not be an obstacle to ambitious policy goals. **Much can be done with the current Treaty and thus build support for Treaty changes when needed**
- Economic union is a multidimensional project. **Strengthening monetary and financial integration should go hand in hand with measures to boost growth and jobs.** This would show European citizens that Europe can be a part of the solution and not part of the problem
- Strengthening EMU should be an opportunity to **strengthen the relationship between EMU and non EMU Member states** with reciprocal benefits.