

# Future of Europe

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# Knightian uncertainty

“The reader who once asked me which black swans were most likely to materialise in the next five years could not have missed the point more comprehensively.”

- John Kay, Financial Times, April 5, 2016

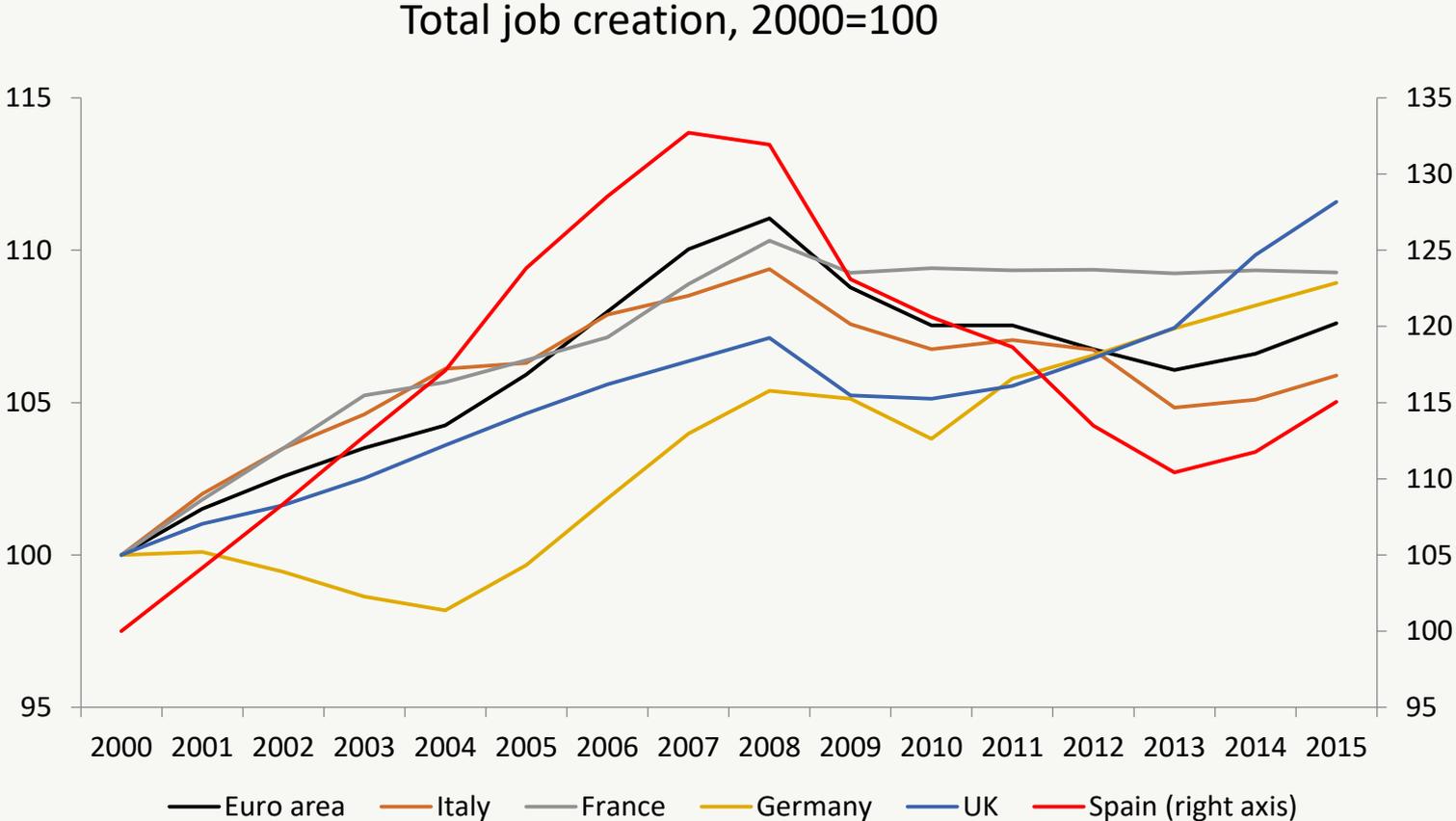
→ Key question is how *robust* the socioeconomic & political system is to deal with the unexpected (but also with the expected!).

# Think of faultlines

- A diverging instead of converging continent?
- A monetary union without a state
- External threats
- Relations between EU and neighbourhood
- “multispeed” within EU

→ Document a few of these issues and talk about options to increase robustness

# Start with some good numbers



Sources: Eurostat.

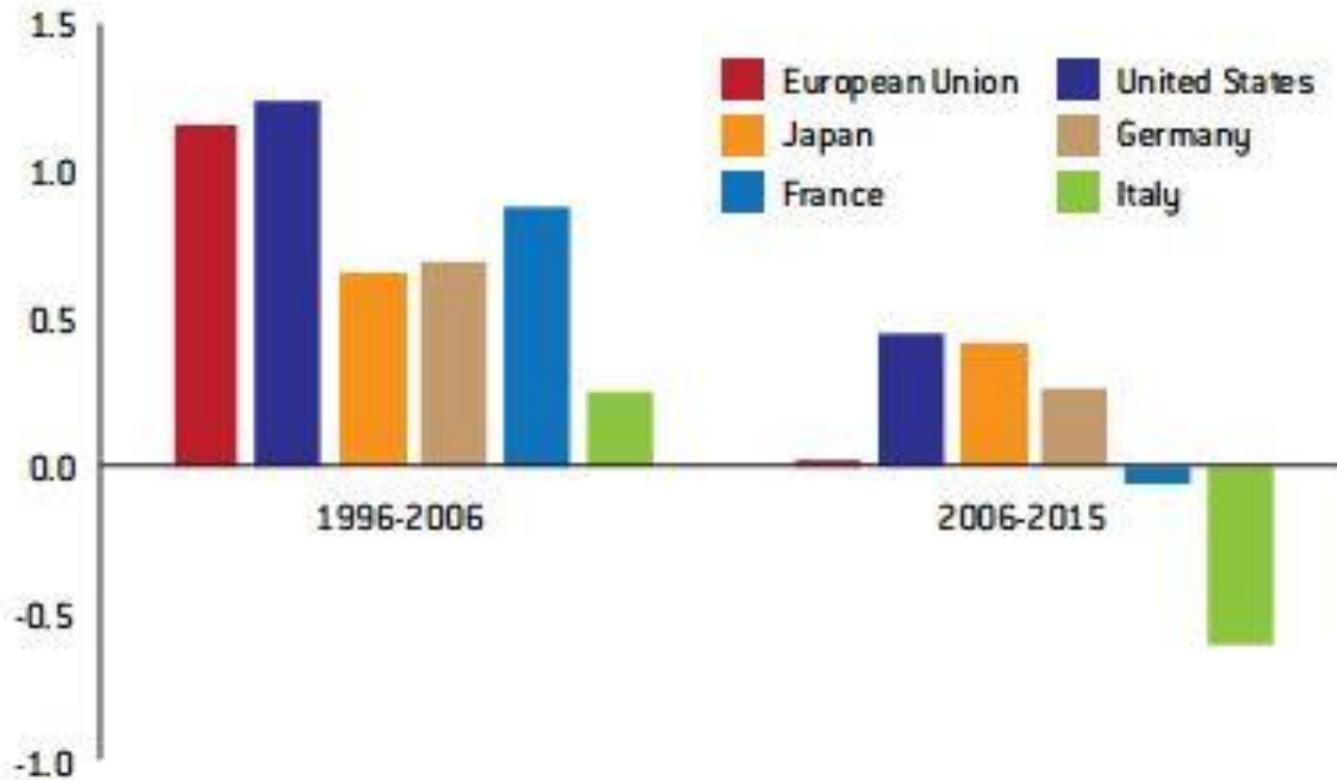
# Back to price stability?

## HICP, Euro area 19 (Year-on-Year changes in percent)



# The context: weaker productivity growth...

...reduces output legitimacy. The pie is not growing, distributional questions become more painful.



Source: Ameco.

# Divergence: TFP differences, PISA

Total factor productivity growth in the EU, average of 2000-14



● Group A ● Group B ● Group C ● Group D

PISA, Reading score, 2015



● Group A ● Group B ● Group C ● Group D

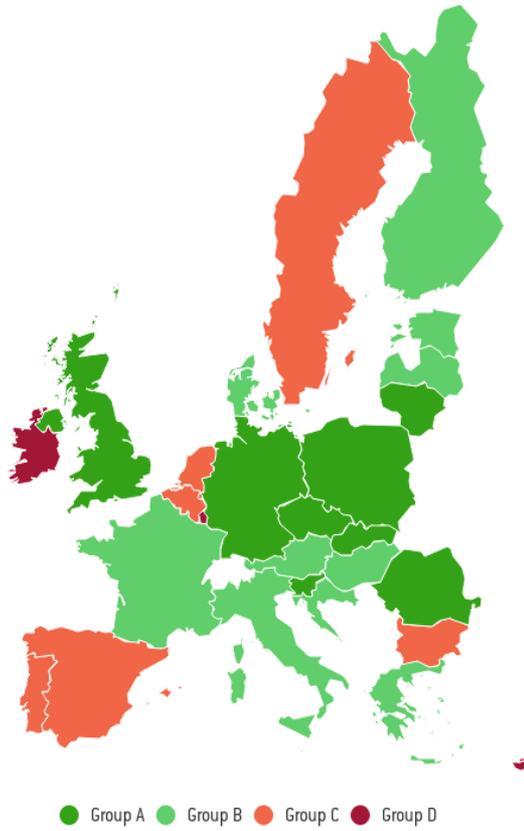
# Debt divergence

## Euro area debt, % of GDP

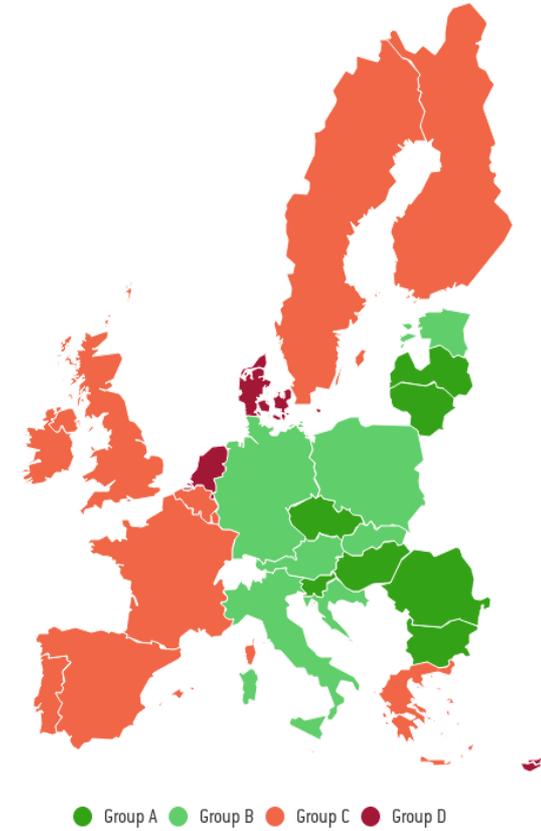
Government debt as a share of GDP, 2015



Non-financial corporate debt as a share of GDP, 2015



Household debt as a share of GDP, 2015



# Inequality

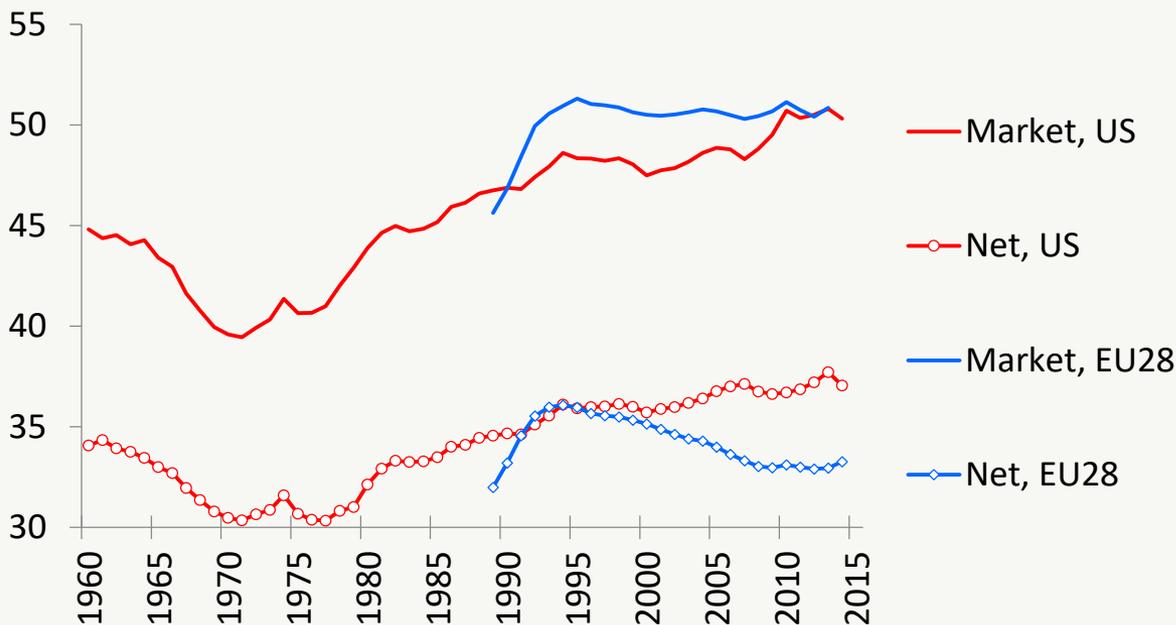
- EU as a whole, and individual EU countries, tend to be characterised by *lower income inequality than the US and most emerging/developing countries*;
- Mediterranean countries, Baltic countries and the United Kingdom exhibit relatively high Gini coefficients, while Nordic countries and 'core' continental EU countries are characterised by lower income inequality levels;
- *Europe's social problems widened* with the increase in unemployment and material deprivation in some parts of Europe;
- Polarisation between the *south and the north* of the EU has increased, as well as between the *young and the old*;
- There was *increasing intergenerational polarisation* during the economic crisis years.

Gini coefficient of net disposable income in the EU,  
average of 2000-14



# But inequality in EU going down

Gini Coefficient of market (before taxes and transfers) and net (taxes and transfers) income inequality: comparing EU as a whole with US, 1960-2014

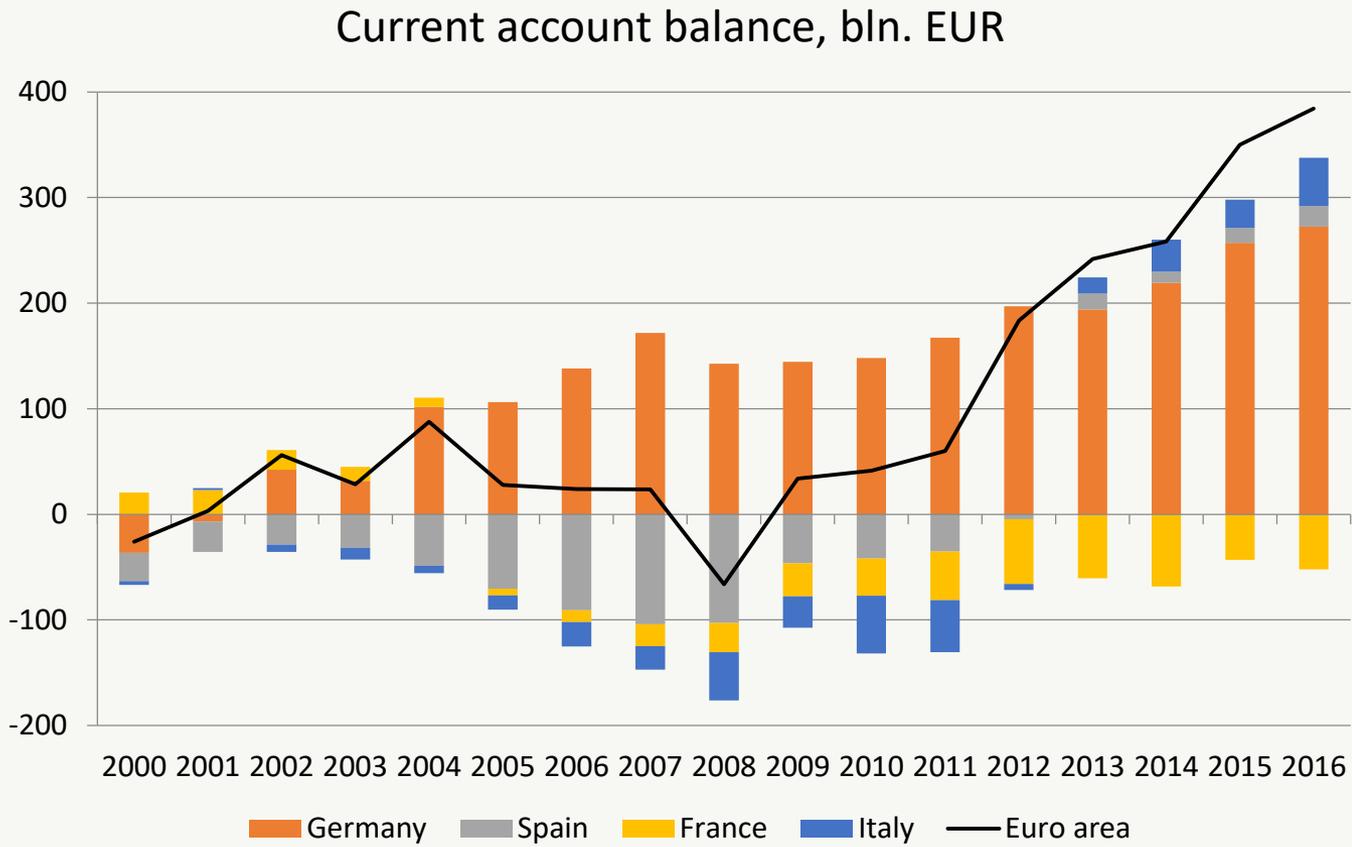


Source: Bruegel based on US data: the Standardised World Income Inequality Database (SWIID) from Solt (2016); EU28 data: Darvas (2016b), which is based on the individual country data from Solt (2016); thereby the US and EU28 data reported in this figure are comparable. Note: A Gini index of zero represents perfect equality (ie incomes are perfectly evenly distributed) and a Gini index of indicates 100 perfect inequality (all incomes are owned by one person).

Sources: Darvas (2016)

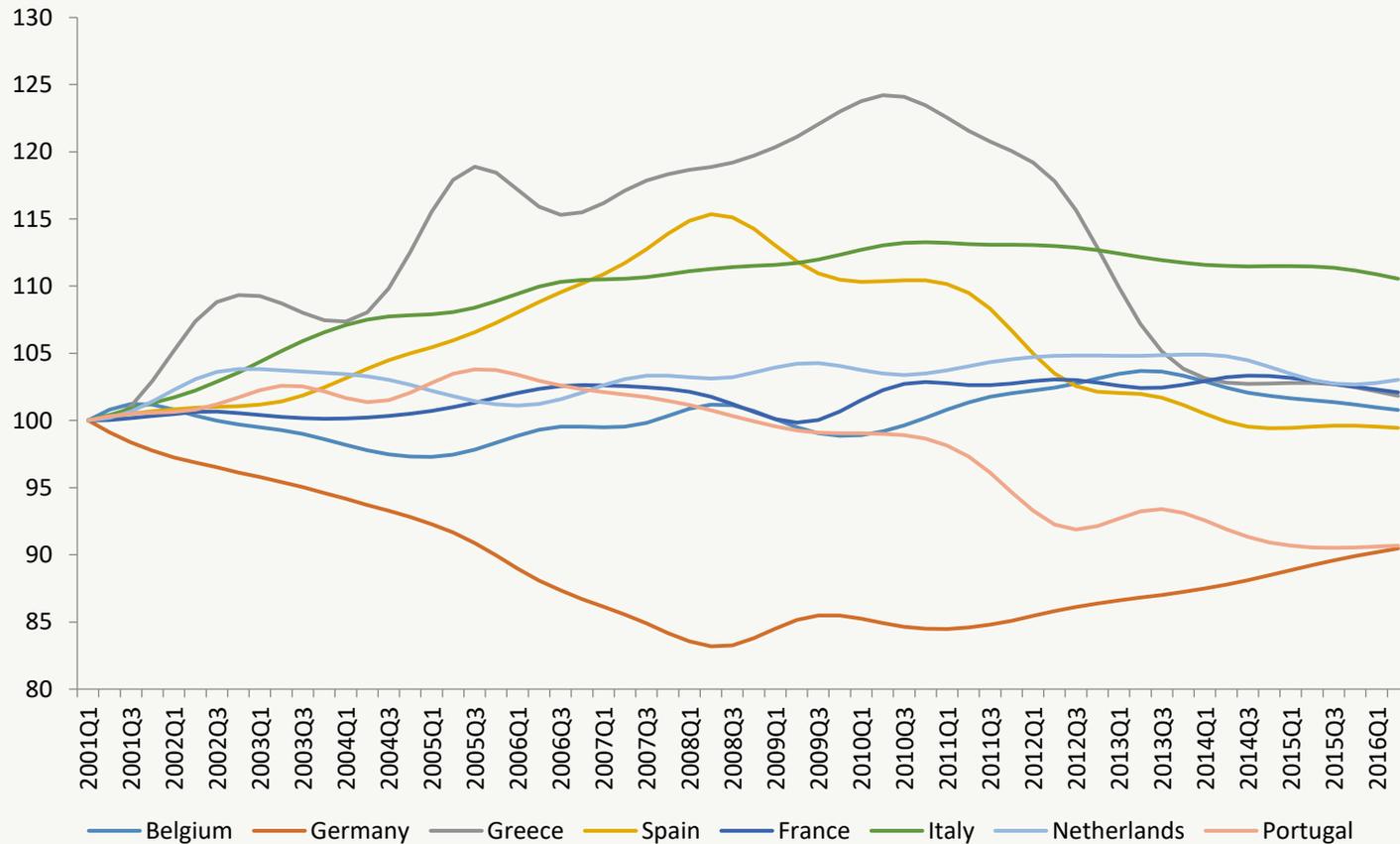
# Macroeconomic divergence...

## Euro area rebalancing remains unfinished

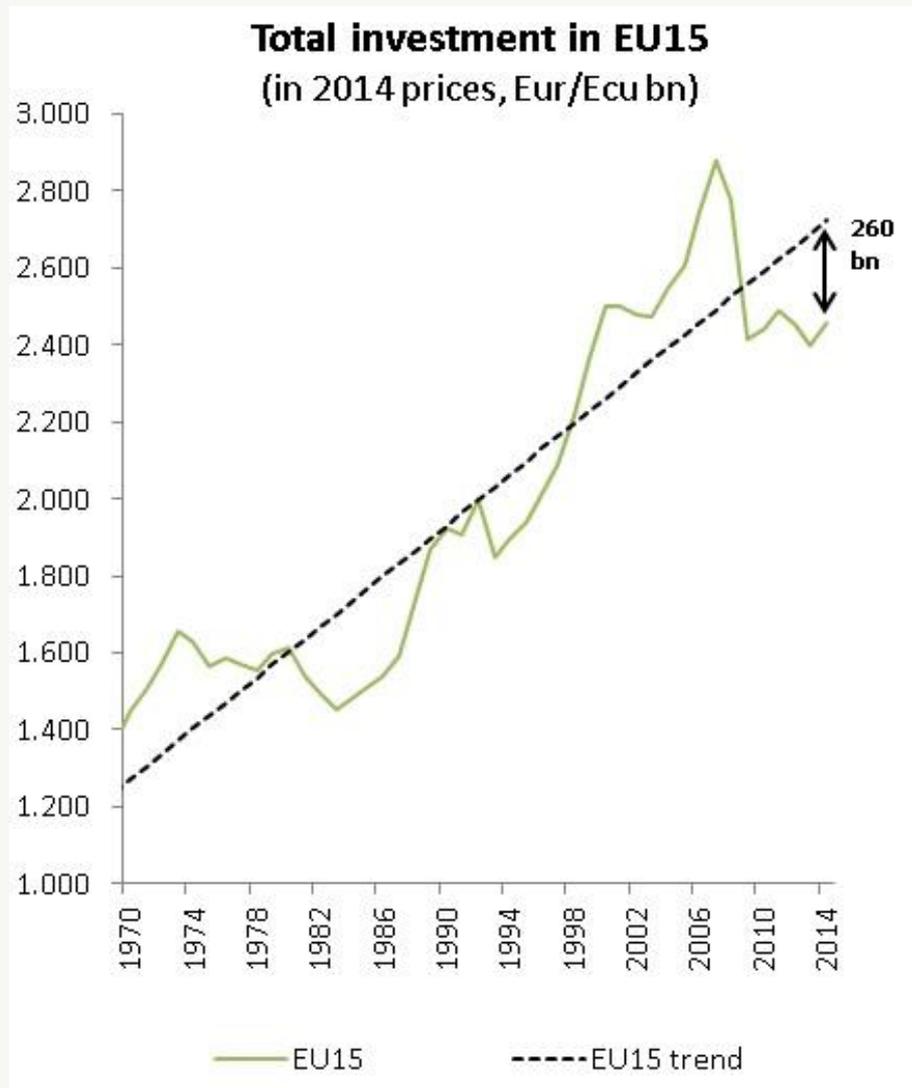


# ...and partial convergence

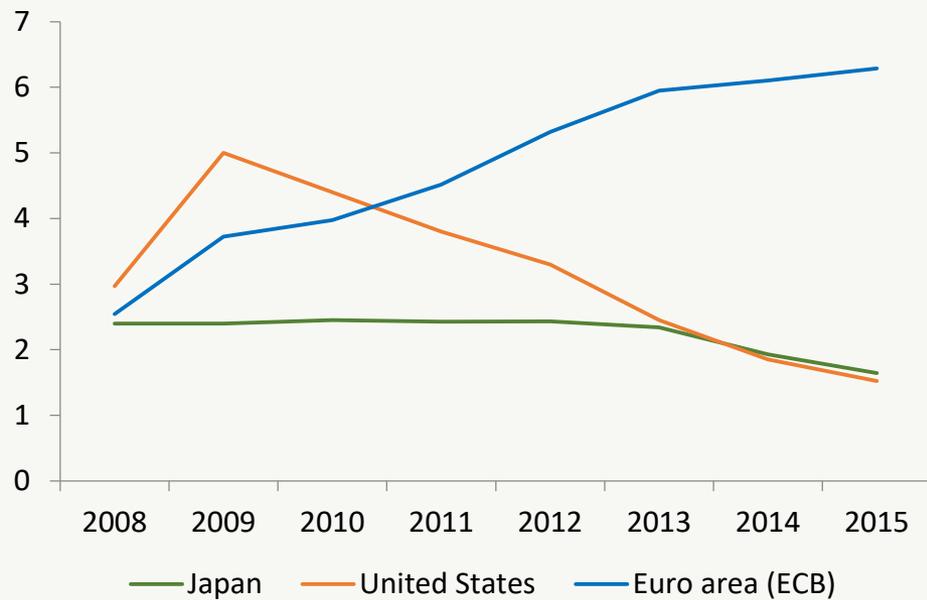
ULC-based real effective exchange rates (vs. EA19)  
(Index, 2001Q1=100)



# The investment gap



# Diverging banking problems



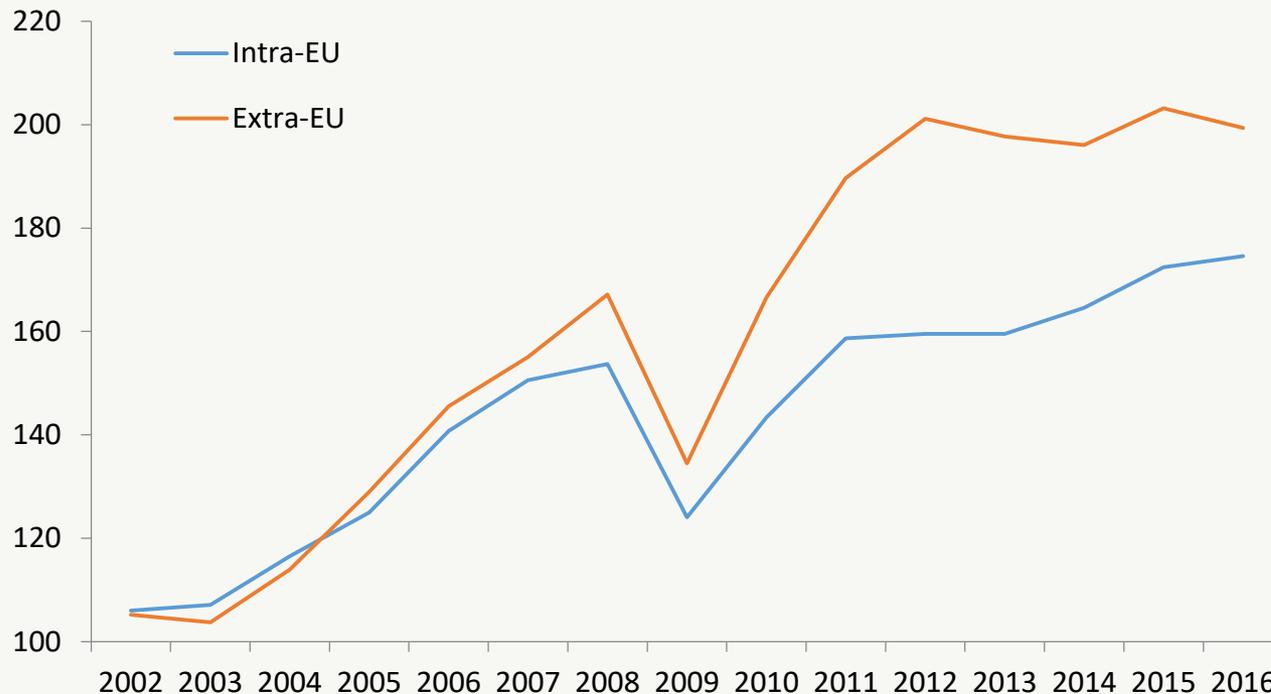
non-performing loans (in % of total gross loans)

Gross non-performing debt instruments, % of total gross debt instruments



# Changing trade patterns

Intra EU vs. Extra EU trade in goods, 2002=100

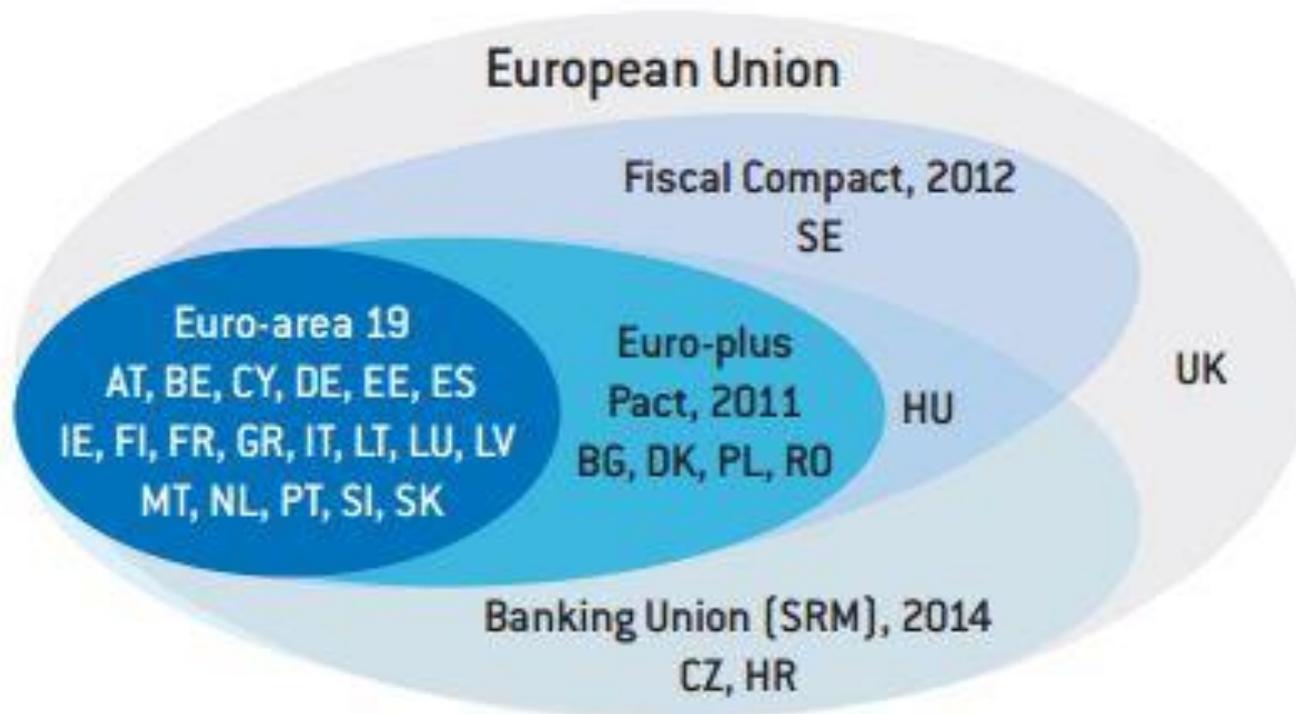


EU very open: 43% of GDP against 22 in China and 13 in US.

Trade outside matters more for some than for others in EU. Will mean increasingly diverging stances on external trade deals.

# Policy divergence or concentric circles?

Participation of euro and non-euro EU countries in inter-governmental arrangements to strengthen EMU



Source: Sapir and Wolff (2016).

**BU:** Banking Union, BU is in principle open to all EU countries, see Darvas and Wolff (2012)  
**TSCG:** Treaty on Stability, Coordination and Governance (Fiscal Compact)

# A priority list for robustness I

## Tackle existing problems

- Productivity agenda is clear and requires true national ownership (and it's not a Rob Gordon problem)
- Banks: The SSM/ECB are at risk of losing their credibility
- The European Parliament needs to hold SSM better to account

EP called on SSM chair to testify in November 2016 and March 2017. In both hearings, the EP did not seriously question the handling of Italian banks. National Parliaments rarely call on SSM.



Elizabeth Warren Destroys Janet Yellen Over JPMorgan's 'Living Will ...  
<https://www.youtube.com/watch?v=XY1SMLgaW6U>

# A priority list for robustness II

## External agenda

- US trade agenda is a real threat:
  - build partnership with China and others (but insist on EU interests),
  - Collaborate to support multilateralism
- Maintain global consensus on climate change
- Deal with migration
  - Immigration from Africa is fairly stable (~500k per year)
  - But will increase with development, demographics (Population will increase to 2.5bn) and better EU eco
  - Work on integration policy and develop a “ring of friends” and improve (economic) opportunities in North Africa. Collaborate on migration control
- Step up military cooperation

# A priority list for robustness III

## Divergence agenda

- Reduce current account and price divergence in euro area
  - Mostly concerns the large three countries
    - Germany, France, Italy
  - Germany: stop running €24bn budget surplus, increase capital stock (both private and public), open service sectors, achieve higher wage share
  - France: Size of the state and deficit, labour market
  - Italy: labour market, product market, reform of state
  - Invest
- Germany and France have both a real responsibility to overcome their divergence

# A priority list for robustness IV

## Euro area architecture

- Key issue how to deal with unsustainable debt
- Mutualisation will be politically explosive as will be non-mutualisation
- “Federal systems” typically have a clear & credible no-bail-out clause and financial and banking policies assigned to federal level. Moreover, some investment functions and social functions at federal level.

# Three steps for reforming fiscal framework

## Complete the Banking Union

- Denationalization of banking policy framework;
- Addressing NPLs;
- Legitimizing fiscal backstop.

## Add funds for public goods & investment

- Create re-insurance framework against large shocks; Unemployment re-insurance
- Review of EU budget;
- Structural convergence
- ESM becomes European Monetary Fund.

→ A euro area with a half-finished state

## The unrealistic analytical benchmark

- Shift spending items such as defense and social policy to the federal level
- Ability to raise federal taxes and issue federal debt
- Euro area fiscal capacity with allocative, redistributive and stabilization ability

Source: Demertzis and Wolff (2016)

# A priority list for robustness V

## Managing “multispeed” Europe

- It is a real challenge.
- Much of it is in the realm of political, cultural and social divergence. Germany will have to play a bridging role.
- Rule of law is fundamental (and is one of the fundamental elements of a state)

## Establishing good relations with the EU’s neighbourhood

- Towards a good deal with the UK
- How to deal with Turkey

## Reform EU institutions

- EU parliament’s legitimacy and how to improve it
- What role for the EC?
- Transforming ESM to EMF with different majority voting, debt restructuring capacity, backstop to banking union, and subject to what parliamentary oversight?

# Conclusions

A glass half ?



# Thank you!