

Repair and Prepare

Growth and the Euro after Brexit





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Please cite as:

Henrik Enderlein, Enrico Letta, Jörg Asmussen, Laurence Boone, Aart De Geus, Pascal Lamy, Philippe Maystadt, Maria João Rodrigues, Gertrude Tumpel-Gugerell and António Vitorino (2016). *Repair and Prepare: Growth and the Euro after Brexit*, Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris.

or

Henrik Enderlein, Enrico Letta *et al.* (2016). *Repair and Prepare: Growth and the Euro after Brexit*, Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris.

This report is supported by the project “Repair and Prepare: Strengthen the euro” of the Bertelsmann Stiftung and the Jacques Delors Institut – Berlin.

Repair and Prepare ||||| Strengthen the euro

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Preface

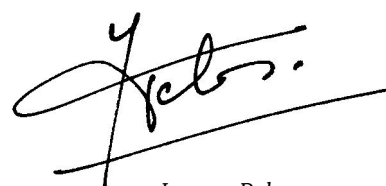
When the 2008 crisis shook the Economic and Monetary Union to its core, I was seriously worried, but I was not surprised. I knew that Maastricht had laid the foundations for a strong monetary union and a much weaker economic one. Governments accepted certain recommendations of the report paving the way for the euro which I was asked to put together in 1989. They happened to be the ones that were politically feasible. Those aiming for greater cooperation and economic coordination between Member States seemed too difficult to implement and were discarded. The euro came to stand on uneven legs. Little wonder then that it would limp along.

And limp it did. When it tried to run, it nearly fell, as was plain for everyone to see. The self-consciously active support of the European Central Bank has helped avoid the crash. But experience has taught us a lesson. We have to get both legs of the Economic and Monetary Union to stand on an equal footing. Over the last years, this readjustment has begun in slightly disorderly fashion, arguably owing to the urgency of the situation. Now that we have hopefully reached less troubled waters, we have to take the time to make the necessary changes – before the next crisis will put the European edifice to the test again.

The recommendations of this report try to map these changes. Many of them, as will be evident, have been on the table for some time. The report, however, prioritises them and regroups them into a coherent and viable whole, suggesting a sequence of implementation that takes account of the technical and political difficulties ahead. Rebalance, repair, consolidate, protect the achievements of the euro (even though purist partisans of the “optimal currency area” will continue to deplore its hybrid nature) so that it can thrive and create growth and jobs like it has

done in the 1990s. We have to get back on a path of convergence that brings together a complex but characteristically European mix of discipline and solidarity, of stability but also of public and private investment into the future.

Pragmatism is the order of the day. We should proceed step by step and begin with those measures that present the least political difficulty, as has been European practice and the winning approach for all the major advances of the last sixty years. The motivating force is clear: to regain public trust and to garner majority support for European integration. After the Brexit vote, we have to be able to demonstrate convincingly that when it comes to social and economic policy, we are better off together. That it is possible to enjoy higher growth and to create more jobs. Like the authors of this report, I think this is the right moment to take stock of the successes and failures of our Economic and Monetary Union. We have to face up to this task before it is too late. In light of the facts, humility is key. Some taboos should no longer be off-limits. If we are to rise to the challenge of restoring the confidence of Europe’s disenchanted peoples, we have to set it on a path where it can do better both economically and socially.



Jacques Delors

Executive Summary

The European integration project is currently undergoing one of the most challenging periods in its 60-year history. The Brexit vote is creating large political and economic uncertainties. Growth is still sluggish across the continent. Political leadership in Europe is weakened by the rise of populists and non-traditional parties.

In this context, some want more integration, some less integration, others a different type of integration. Our ambition is of a different nature: we want the single currency to succeed and to bring back growth to the euro area. Strong economic performance is a key ingredient to political strength. This is why we want Europe's Economic and Monetary Union (EMU) to perform better. Today, the euro is still vulnerable and the uncertainties surrounding EMU are among the root causes of some of Europe's main economic and social weaknesses.

Europe will be hit by a next economic crisis. We do not know whether this will happen in six weeks, six months or six years. But we fear EMU will be ill-prepared for such a crisis. Too few of the structural weaknesses that triggered the past euro-area crisis have been addressed. It was the European Central Bank (ECB) that ultimately brought back stability to the euro area. And it bought time for the governments of the euro area to strengthen EMU, to invest and to reform their domestic economies. We consider this time has not been used effectively. And Brexit may well have further increased political vulnerability.

Europe is taking a very risky bet by hoping the next crisis could again be solved by last-minute stabilisation measures and by relying on a powerful ECB response. The current criticism of the ECB and the discussions about the limits of its mandate are indications that the scope for another forceful ECB intervention may be limited. That is why European governments should step in today and build a stronger EMU.

We propose a strategy that brings together the most compelling proposals of the ongoing discussion on EMU and translates them into a comprehensive reform plan, based on three building blocks.

The first block is a first aid kit. We do not know when the next crisis will hit, but putting into place an effective crisis response today is much more rational and less costly than doing this once the crisis is there. Essential quick fixes that should be implemented immediately include a reinforcement of the European Stability Mechanism (ESM), a further strengthening of the Banking Union and better economic policy coordination under improved democratic control. This first aid kit does not require changes to the EU Treaties.

Secondly, EMU needs more convergence and growth: to make this happen we propose combining a focused structural reform agenda with a comprehensive investment initiative. The second step offers a package deal combining adjustments at the national level and economic stimulus. It puts a strong emphasis on what Member States can do, rather than just shifting powers from the Member States to the euro-area level.

Thirdly, we consider that, in the longer term, a true economic and monetary union still needs to be built. It will have to be based on significant risk sharing and sovereignty sharing within a coherent and legitimate framework of supranational economic governance. This third building block includes turning the ESM into a fully-fledged European Monetary Fund and significantly strengthening parliamentary control to enhance European legitimacy. Step three in our proposal is the federal moment, when the crisis-fighting is left behind and is replaced by a solid long-term framework designed to provide economic stability and democratic accountability for all EU citizens.

These are difficult times in which to propose further steps towards deepening European Economic and Monetary Union. Indeed, many claim that further integration is exactly what Europe does not need right now. But that logic is not compelling. A wait-and-see approach might seem convenient now but is costly in the long run. If we want the common currency to deliver stability, economic growth and political strength, we need to prepare and reform the euro area now.

A. Europe is unprepared for a new crisis

Trapped in a vicious circle

1. As it nears its 60th anniversary, the European project lacks dynamism. The decision of the British people to leave the European Union (EU) is certainly the biggest political challenge in Europe today. Brexit opens a new era in the history of European integration and will lead to a natural but difficult discussion about the very foundations of the European Union project. A lot of political capital and energy will be concentrated on the implications of Brexit. And the Brexit debate itself is complex and is likely to drag on for years. The final outcome is uncertain. Furthermore, such different phenomena as the euro-area crisis, with its devastating social consequences, the arrival of several million refugees and external and internal security concerns have created challenges without precedent to the integration project.
2. Some want to respond to these challenges with more integration. Others favour less integration. And then there are those who want a different type of integration. Europe does not have a coherent strategy today. It is not even *muddling through*, as often in past crises, when piecemeal solutions took the place of grand strategy but still contributed to further integration. Today, the European Union is trapped in a vicious circle of EU-scepticism and lacklustre economic performance.
3. Calling for a reform of the Economic and Monetary Union (EMU) in this context will sound overly ambitious to many. “This is not the right moment”, they will say. And: “Let us focus on other areas.” We believe this

assessment is dangerous. Reforming the euro might not be popular. But it is essential and urgent: at some point in the future, Europe will again be hit by a new economic crisis. We do not know whether this will be in six weeks, six months or six years. But in its current set-up, the euro is unlikely to survive that coming crisis. What is more: Europe is still not creating enough growth for its citizens. The economic, social and political consequences of that failure to deliver are well-known. Finally, one area in which the EU seeks to deepen integration in the current context is the area of common security and defense. This goal is right. But a stable and crisis-resilient euro area is clearly one of the necessary conditions for long-term collective security in Europe.

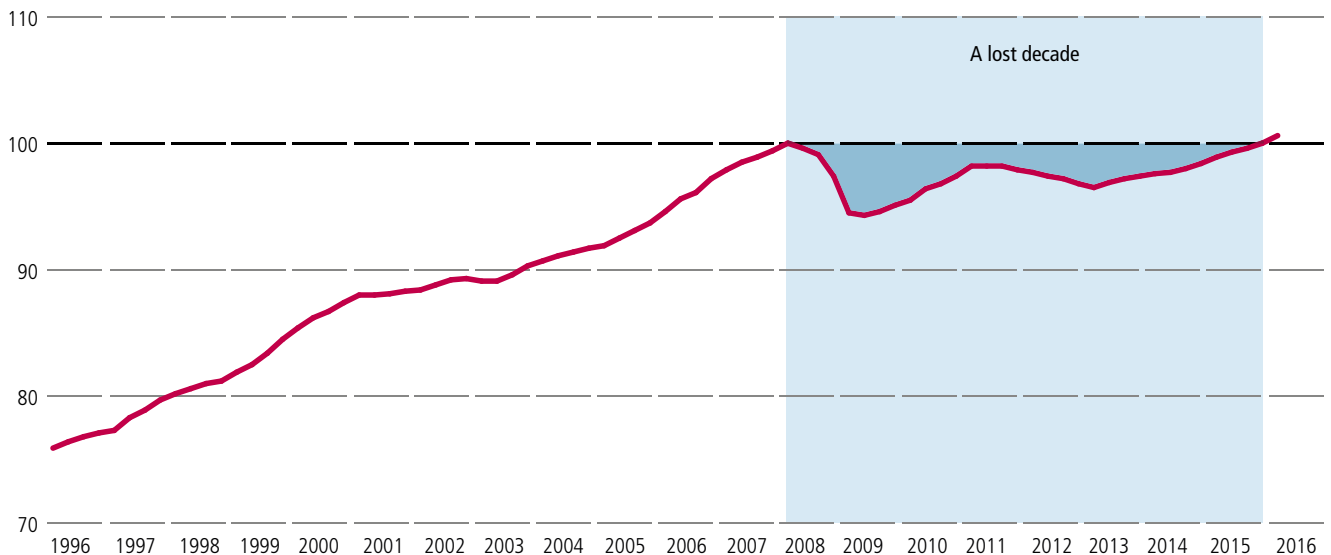
4. This is why we need to act now. The plan presented here does not call for a European super-state or a transfer union. It sets out a pragmatic minimal solution designed to protect the euro. Because, if the euro fails, the entire European integration project will be in danger. We cannot take that risk.

Political and economic weaknesses

5. Europe looks politically vulnerable. Politics in many European countries is in a state of rapid change. Traditional parties are under pressure. Eurosceptic and anti-European parties are on the rise. The economic crisis, the influx of refugees and the threat of terrorism have undermined trust and support for a borderless continent in key EU Member States such as Ger-

Figure 1 A lost decade: Euro-area GDP only returned to its 2008 level in 2015

Gross Domestic Product, Index, Q1 2008 = 100



Source: Eurostat, authors' calculation.

Box 1 Europe's economic weakness in numbers

- Gross Domestic Product (GDP) in the euro area has only now reached its 2008 level. In the main crisis countries, there is still a gap.
- Average euro-area growth over the last five years was at only 0.6 percent compared to 2.0 percent in the United States.
- Euro-area investment in 2015 was as low as during the global recession in 2009, while in the United States investment increased by 19 percent over the same period.
- Five euro-area Member States still have youth unemployment rates of more than 30 percent.
- Europe's single market underperforms in particular when it comes to services. This is also true for digitalisation. Europe remains a net importer of digital services from the US.

many and France. Throughout the EU, seemingly easy national solutions are gaining approval while public support for a European approach is eroding. The fact that one of the most powerful EU Member States has voted to leave the EU is a sign in itself. And many fear it could encourage centrifugal forces across the continent.

6. This overall assessment of the current state of the EU's politics would be worrisome even if Europe's economy was strong and stable. But the contrary is the case. Following seven years of crisis, the lack of strong and equitable growth exacerbates the political problems (see box 1). In the crisis countries, we see that opposition to austerity and reform fatigue are prominent drivers of Euroscepticism and hinder reform implementation. In the non-crisis countries, the EU has become a synonym for costly bailouts, and solidarity fatigue has become entrenched.
7. The longer Europe remains politically and economically vulnerable, the less likely it is to withstand a new crisis.

Brexit is both a sign and a wake-up call in that respect. Business as usual is no longer an option. At the same time, there is the danger that Britain's exit will consume all the available time and effort when Europe should instead be focusing on protecting its citizens by making sure that its economies do not underperform and the benefits of growth are shared by all. The common currency is an insufficient link in Europe's architecture.

The euro is vulnerable

8. Contrary to what many argue, the euro is not prepared for a new crisis. There are several reasons for this.
 - Firstly, European governments rely too heavily on the European Central Bank (ECB). The ECB's extraordinary measures were meant to provide a temporary breathing space for governments to solve the structural challenges of the euro area. But Member States have proved all too willing to let the ECB permanently shoulder the risk and responsibility for stabilising the system in crisis. We fear that structurally relying on the ECB alone is economically dangerous and politically unsustainable.
 - Secondly, in most Member States, there is little fiscal room for manoeuvre left. This means that countercyclical measures would be difficult in a potential future crisis. At the same time, the EU does not have the tools required to create an effective policy mix by coordinating the fiscal policies of its members or by stabilising the euro area through EU-level action.
 - Thirdly, the willingness of many Member States to reform their economic structures is increasingly limited. There is very little further political capital that could be spent in a possible crisis, should countries be asked to engage in new rounds of reform measures in exchange for a support programme.
 - Fourthly, promising new projects such as the Banking Union and the Capital Markets Union are still at an early stage, while risk exposure is still high in European

Box 2 EU citizens see the need for euro area reforms, but they want a convincing agenda

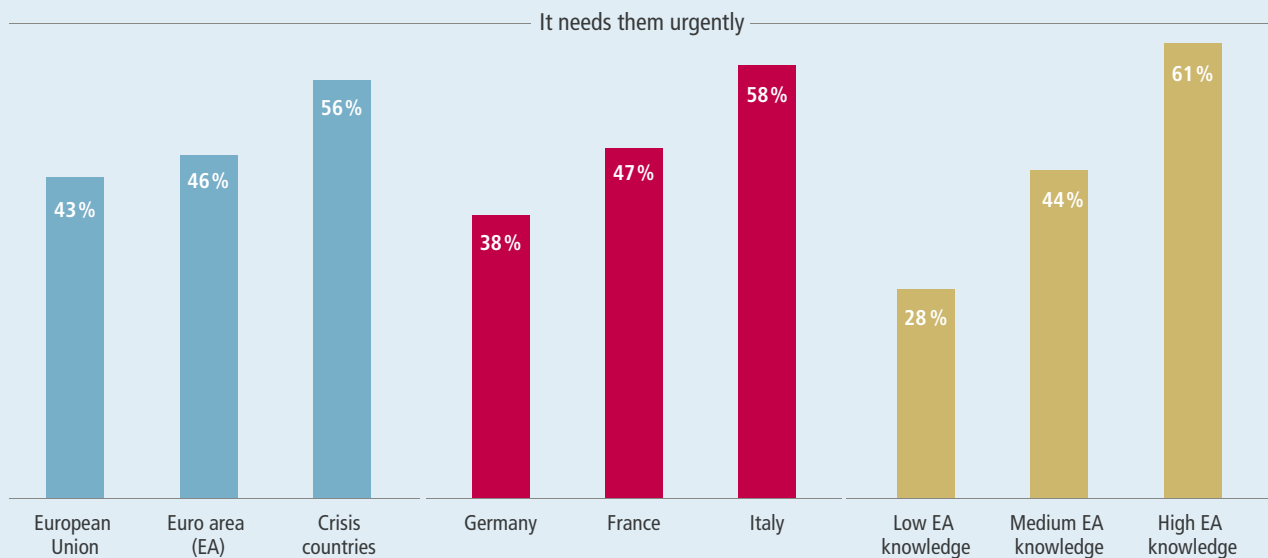
- EU citizens agree that the euro area is in trouble. New public opinion data for the European Union show that low growth, high unemployment, too much debt and a potential new financial crisis are still on most people's minds.¹ It is no surprise that they see a bleak future: only one in five thinks that the euro will be a stable currency in 10 years' time. Many believe that the euro will still be in crisis or that countries will have returned to their national currencies.
- There is broad awareness that the euro area needs reforms to be economically and politically stable: more than 40 percent of the EU population think that the euro area needs reforms urgently.² In crisis countries even more agree, as figure 2 shows. The more people know about the euro area, the more they see the need to reform.³ Of those with a high level of euro-area knowledge, more than 60 percent think that the euro area needs reforms now. In general, the data suggest that those who know more about the euro area are also more aware of benefits and challenges.

1 Catherine de Vries and Isabell Hoffmann (forthcoming). "Ein europäischer Finanzminister mit eigenem Budget? Reformbedarf und Reformpotenziale des Euroraums angesichts der öffentlichen Meinung in Europa", *eupinions* No. 2016/03, Gütersloh: Bertelsmann Stiftung. The data were collected in April 2016, the sample includes all EU28 Member States (n=10,992). Data are weighted to make them representative.

2 Of the others, 32 percent say that reforms would help but they are not critical, 3 percent say that the euro area does not need any reforms and 22 percent do not know.

3 The knowledge indicator is based on a set of 12 questions on euro-area institutions and actors. Correct answers are added up. Low, medium and high knowledge corresponds to the first, second and third terciles of the index.

Figure 2 To what extent, if at all, does the Eurozone need economic reforms to be politically and economically stable?



Notes: Crisis countries include Cyprus, Greece, Ireland, Italy, Portugal and Spain.
 Missing to 100 percent are "It would help but it's not critical", "It does not need any reforms", and "I don't know".
 Source: eupinions data April 2016, authors' calculations.

- Contrary to what many have speculated, a majority of Europeans believe that solidarity is important for the euro area: about a third think there should be more solidarity between Eurozone countries and another third believe that even if everyone is responsible for their own actions, there should be solidarity in times of crisis. These numbers are also fairly similar in net contributor countries like Germany.
- While Europeans see the need for reform and are willing to help each other, there are no reform favourites: there is no clear direction for how to spend the European budget, whether or not we need a European finance minister and what his or her competence should be. It is also unclear how best to deal with countries in financial difficulties.
- In short, there is general awareness that the euro area needs reforms. However, when it comes to concrete reform proposals, there is no reform coalition that clearly favours one over the other. The higher the degree of knowledge about the euro area, the higher both the awareness that reforms are needed and the willingness to reform.
- There are two important messages for policymakers here: firstly, knowledge is key. Presenting accurate information about Europe will reduce the danger of a public backlash against any reform agenda. Secondly, there is widespread agreement that the euro area needs to be reformed. We should build on this consensus by presenting a consistent and convincing reform plan to the public.

banking. Also, some long-running projects, such as the full integration of the Single Market in services, have made less progress than expected. As a result, the euro area's internal adjustment capacity is limited.

- Finally, and perhaps most importantly, in a new crisis – or even before a new crisis –, international financial-market participants might question Europe's determination to engage in true risk sharing and sovereignty sharing to overcome such a crisis. Given that it was mainly the ECB that stabilised the euro in 2012 (see below) but that progress on how to complete EMU has been scarce, can one be sure that European leaders would be sufficiently determined in the next crisis to do whatever it takes?
9. Neglecting the euro's vulnerabilities and hoping that the next crisis can be solved once it has arrived is a both dangerous and costly approach. Developing the right toolkit now might be politically less attractive, but it is wise to think about an insurance policy before the risk actually materialises. This is especially true because the absence of such an insurance policy makes a new crisis more likely.

Escaping the dilemma

10. We believe many policymakers share the above assessment. But they face a dilemma: on the one hand, there seems to be the concern that further reforms might undermine public support for the euro because of additional risk sharing and sovereignty sharing. Politicians are wary that they might not be re-elected or might face a political backlash. On the other hand, the alternative option – to do nothing – is also politically dangerous and potentially very costly in economic terms. If further steps towards protecting the euro now are politically not an option, the euro area will face the next crisis unprepared.

11. Many have argued that the EU needs to address what some have called its democratic deficit by overhauling the broader political set-up to enhance legitimacy. We agree with the general contention and offer suggestions in that direction. But building legitimacy is a long and arduous process that involves more than a few legal or institutional changes. Waiting for enhanced legitimacy before stabilising EMU is not the right approach. Europe needs to go ahead with small steps today.
12. In our view, a pragmatic but still ambitious initiative to reform EMU would provide a way out of the vicious circle. A strong euro area is the foundation on which a stable and prosperous European Union can be built. The reverse also holds true: without taking the necessary steps, our continent might be undermining one of the most important political projects since the emergence of the nation state. If no one takes the necessary bold measures, then we fear the damage to the common currency and the European project could become permanent.

B. Why protecting the euro should be the priority

13. In its current form the euro is not viable in the long run. Some have argued that integration has gone too far and the common currency should be replaced by national currencies again. We do not share this view. Instead we believe that abandoning the euro would bring with it costs and uncertainty that would dwarf the already daunting problems Brexit is causing. Neither can excluding the weaker members solve the problem. On the contrary, it would actually transform the euro area into a system of fixed exchange rates similar to the failed European Monetary System. Thus the response to the current challenges must not be a break-up of EMU but its reform. The time to prepare and to put Europe back on solid economic foundations is now.

14. It is worth remembering that there were good reasons for introducing the euro in the first place. It was a necessary step towards completing the single market. A patchwork of multiple small currencies in a world of fast moving capital would be vulnerable and prone to speculative attacks. During the global economic crisis of 2008/09, it was the euro that initially protected troubled economies in Europe. The single currency also delivered on its promise to bring low inflation while supporting growth and employment through low interest rates for a decade. The euro is a landmark achievement in the broader process of political integration as envisaged by the founding fathers of a united Europe.

Still an incomplete currency union

15. Yet the euro remains incomplete. In fact, at its inception, the euro area's institutional set-up was not meant to be final: it was a political compromise which was expected to be improved over time.¹ The incomplete architecture did not lead to convergence and produced large imbalances that were one of the root causes of the crisis. These issues were not addressed decisively by the key actors over the course of the first decade. Membership of a monetary union thus stripped the national economies of their traditional adjustment channels, but did not provide a viable replacement at the European level. Furthermore, the original set-up did not include a crisis management toolbox.²

16. When the crisis hit Europe in 2008/09, the euro area was unprepared. Large private and public debt imbalances started to unravel. The crisis was aggravated by uncertainty about whether the "no-bailout" clause (Art. 125 TFEU) would be interpreted and enforced strictly or whether troubled Member States would receive some support and on what conditions. EMU did not have the instruments to share risk and sovereignty that would have been required to stabilise the currency union. Euro-area Member States responded with a

¹ Jacques Delors (1989). *Report on economic and monetary union in the European Community*, Committee for the Study of Economic and Monetary Union, Brussels: European Commission.

² For a detailed analysis of how the crisis evolved and what adjustment mechanisms EMU was lacking, see Henrik Enderlein, Joachim Fritz-Vannahme and Jörg Haas (2014). *Repair and Prepare: Strengthening Europe's Economies after the Crisis*, Gütersloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin.

Box 3 Poor convergence record threatens the euro

- EMU has failed to bring about convergence. This is a key weakness of EMU because in contrast to other monetary unions the euro area has no powerful federal budget that could mitigate the consequences of divergence. Contrary to what many expected, EMU has underperformed in two key dimensions: real convergence and cyclical convergence.¹
- Real convergence: EMU has not led to a gradual narrowing of income gaps between economies. Convergence accelerated following the Single Market initiative of the mid-1980s and the Maastricht Treaty in 1991, but slowed down around the creation of EMU. Divergence has become the dominant trend since then, and was exacerbated during the crisis. People in crisis countries, in particular, have seen their wages fall, their savings diminished and their benefits cut. Unemployment rates are at staggering levels. As social cohesion comes under threat, political support for the euro weakens.
- Cyclical convergence: EMU has also failed to promote better-synchronised business cycles in the euro area. As a result, in the absence of adequate macroeconomic policies, the ECB's monetary policy was less effective than it could have been. It has contributed to the build-up of inflation differentials, competitiveness divides and excessive current account imbalances. Accumulated debt ultimately led to a sudden stop in external financing in some euro-area countries, causing the severe recession from which Europe is still struggling to escape today.
- Getting the convergence process right could enhance the effectiveness of monetary policy in the euro area, which would in turn reduce imbalances in the economies, and bolster public support for the euro and the European Union as well. We therefore suggest putting a renewed focus on the topic and make proposals for strengthening convergence through coordination, reforms and investment (see sections D, E and F).

¹ Anna auf dem Brinke, Henrik Enderlein and Jörg Haas (2016). "Why the euro area can't agree on convergence", *Policy Paper* No. 165, Berlin: Jacques Delors Institut – Berlin.

quick-fix strategy. This created *ad hoc* risk sharing and *ad hoc* sovereignty sharing, mainly through the European Financial Stability Facility (EFSF), and later the permanent European Stability Mechanism (ESM).

17. Discussing the exact causes of the crisis can be useful in order to identify EMU's potential weaknesses. At the same time, it too often draws attention away from what needs to happen next. For this reason we do not go further into a retrospective in this report but refer to a short consensus paper on the root causes of the crisis.³
18. Numerous reforms have been implemented in order to stabilise the euro area. They aimed at reducing the vulnerability of its members against self-fulfilling insol-

³ Jörg Haas and Katharina Gnath (2016). "The euro area crisis: a short history", *Policy Paper* No. 172, Berlin: Jacques Delors Institut – Berlin.

vencies, preventing future imbalances and avoiding future taxpayer bailouts of banks. The creation of the EFSF and ESM lowered the sovereign borrowing costs of crisis countries in return for strict conditionality. Both instruments contributed to keeping the crisis under control, and the ESM has become an important political institution in EMU. Other innovations include stricter fiscal rules under the Stability and Growth Pact (SGP) and the Fiscal Compact, surveillance of private-sector imbalances, and a partial banking union.

19. However, the EU's improvised crisis management system has serious drawbacks. The political responsibility for negotiations is dispersed among too many participants and the large number of veto players makes any rescue process unpredictable. The political battles to negotiate bailout terms are indicative of an over-

burdened institutional framework. Over the last seven years, the Eurogroup held 130 meetings in total. In crisis years such as 2012 and 2015, half of the meetings were extraordinary meetings outside the regular schedule.

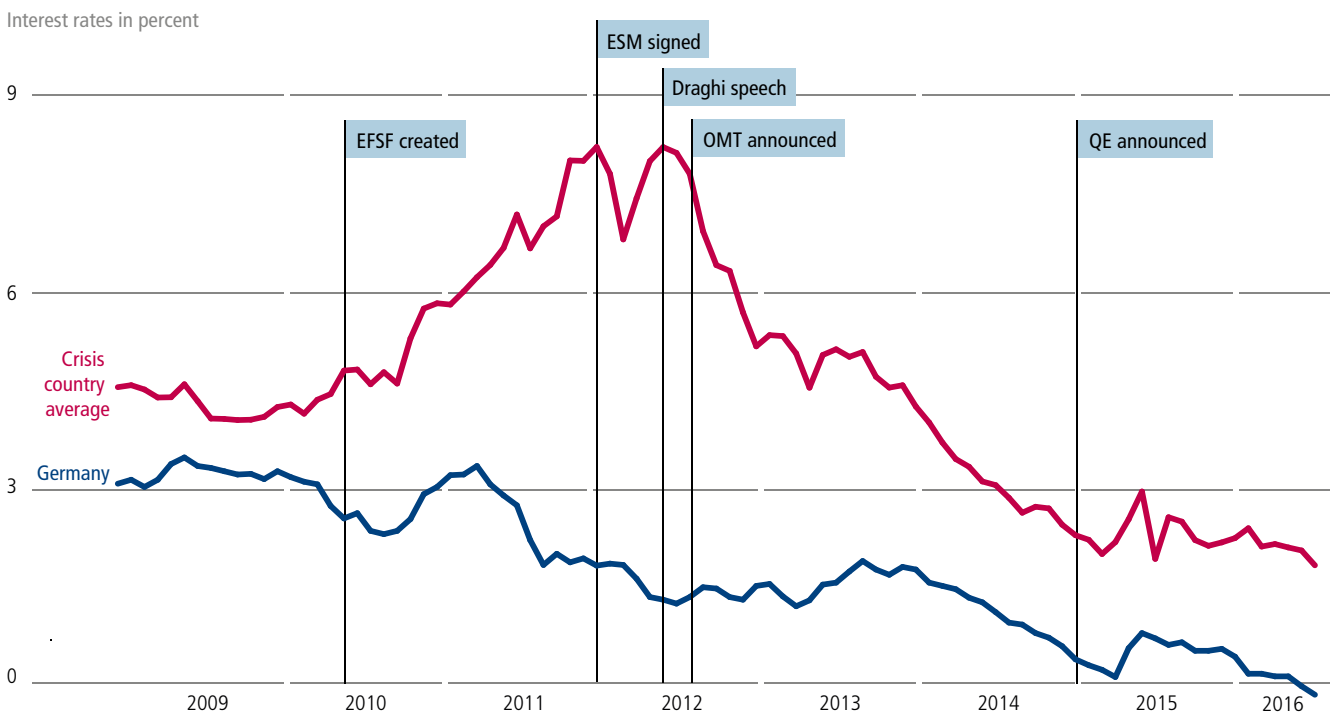
20. Also, the rescue packages were generally adopted after the economic damage to the economy had already been done. There certainly has been a lot of debate over the question of who is to blame for the imbalances that led to the need for rescue packages in the first place. As a result, creditor and debtor countries do not trust each other anymore. Creditor countries feel that they have insufficient control over their taxpayers' money, while debtor countries complain that the conditions imposed on them are arbitrary and excessively intrusive.

21. Summing up, the reforms European policymakers have enacted so far are steps in the right direction. However, the individual elements are not connected in a consistent manner and generate political instability. They were not capable of bringing about sufficient stabilisation in the last crisis, and would probably be unable to do so in a potential new crisis.

The ECB should be supported by other actors

22. What ultimately stabilised the euro area during the crisis was central-bank action. The ECB has intervened in two crucial ways:

Figure 3 ECB interventions were crucial in calming government bond markets



Notes: The figure shows interest rates on long-term government bonds (percentages per annum; period averages; secondary market yields of government bonds with maturities close to ten years) and major EMU stabilisation efforts. Crisis country average shows the average for Greece, Ireland, Italy, Portugal and Spain, weighted by the ECB capital key (five-year average as of 2014). No data for Greece in July 2015. Source: ECB, authors' calculations.

- Firstly, the ECB has alleviated the country risks. It announced that it would buy the debt of euro-area members including those threatened by self-fulfilling insolvency. While the 2010 Securities Markets Programme (SMP) was limited in terms of its size and effect, the 2012 announcement of unlimited Outright Monetary Transactions (OMT) sent a strong signal to the markets that the ECB was willing to do “whatever it takes”, as ECB president Mario Draghi put it in a decisive speech in the summer of 2012, to prevent the euro area from disintegrating.
 - Secondly, the ECB has reduced deflationary risks in the euro area. There are indications that standard monetary policy measures as well as extraordinary measures such as the negative interest rate policy and Quantitative Easing (QE) have contributed to rising inflation expectations and a recovery of growth rates.
23. We believe that the ECB was right to intervene forcefully. It had to maintain its ability to implement monetary policy, even in the absence of far-reaching political action by the euro-area Member States. As the European Court of Justice ruled in June 2015: “A monetary policy measure cannot be treated as equivalent to an economic policy measure merely because it may have indirect effects on the stability of the euro area”.⁴
24. The rescue measures were effective, but at the same time have given rise to criticism and scepticism:
- The ECB has introduced *de facto* risk sharing, i.e., a shared responsibility for public finances at the euro-area level without proper parliamentary control or oversight. Because of the central bank’s independence, its policies are removed from democratic checks and public deliberation, even if they substitute for a missing fiscal stimulus at the national level. Consequently, in the national context, many perceive the rescue measures to lack democratic legitimacy.
- Public support for the ECB has decreased. Its policies are perceived in the north of Europe as too lenient towards debtors, while in the south they are associated with harsh economic adjustment. Consequently, trust in the ECB has declined. In 2007, one out of two Europeans trusted the ECB. Today this has declined to one out of three.⁵ Even a central bank that is independent of direct political influence relies on trust and public support to be credible and effective in the long run.
25. While the ECB’s stabilisation measures were temporary in nature, they could not address the structural problem of insufficient risk sharing and sovereignty sharing at the euro-area level. It calls upon Member States’ fiscal policy, structural policies and further integration measures to complement its actions. Euro-area governments need to heed this call and accept their responsibility for stabilising EMU.

4 European Court of Justice (2015). *Judgment of the Court in Case C-62/14, Gauweiler and others v Deutscher Bundestag*, 16 June 2015.

5 European Commission (2016). *Standard Eurobarometer 85, Public Opinion in the European Union, First Results*, Brussels.

C. Three building blocks

26. Seven years after the start of the crisis we still lack a consistent strategy to ensure that the common currency benefits the EU and its citizens instead of being a burden, and to address the imbalance between the economic and the monetary dimension of EMU. The debate on how best to strengthen the euro area has a long tradition. The Delors Report of 1989 already argued for the need to complement a monetary union with an economic union.⁶ In 1997, Jacques Delors proposed a pact for economic policy coordination.⁷ The Tommaso Padoa-Schioppa Group offered a road map towards fiscal union in Europe.⁸ The Four Presidents' Report and the Five Presidents' Report have laid out clear steps for completing the euro area.⁹ Those are just a few examples. There is an abundance of proposals.

27. What Europe lacks is a comprehensive strategy for choosing and implementing the right euro-area reforms and restoring growth. We recognize that EMU reform is a difficult topic for most euro-area governments. Even

6 Jacques Delors (1989). *Report on economic and monetary union in the European Community*, Committee for the Study of Economic and Monetary Union, Brussels: European Commission.

7 Jacques Delors (1997). *Pacte pour la coordination des Politiques économiques*, Paris: Notre Europe.

8 Henrik Enderlein, Peter Bofinger, Laurence Boone, Paul De Grauwe, Jean-Claude Piris, Jean Pisani-Ferry, Maria João Rodrigues, André Sapir and António Vitorino (2012). "Completing the Euro: A roadmap towards fiscal union in Europe, Report of the Tommaso Padoa-Schioppa Group", *Studies and Reports* No. 92, Paris: Jacques Delors Institute.

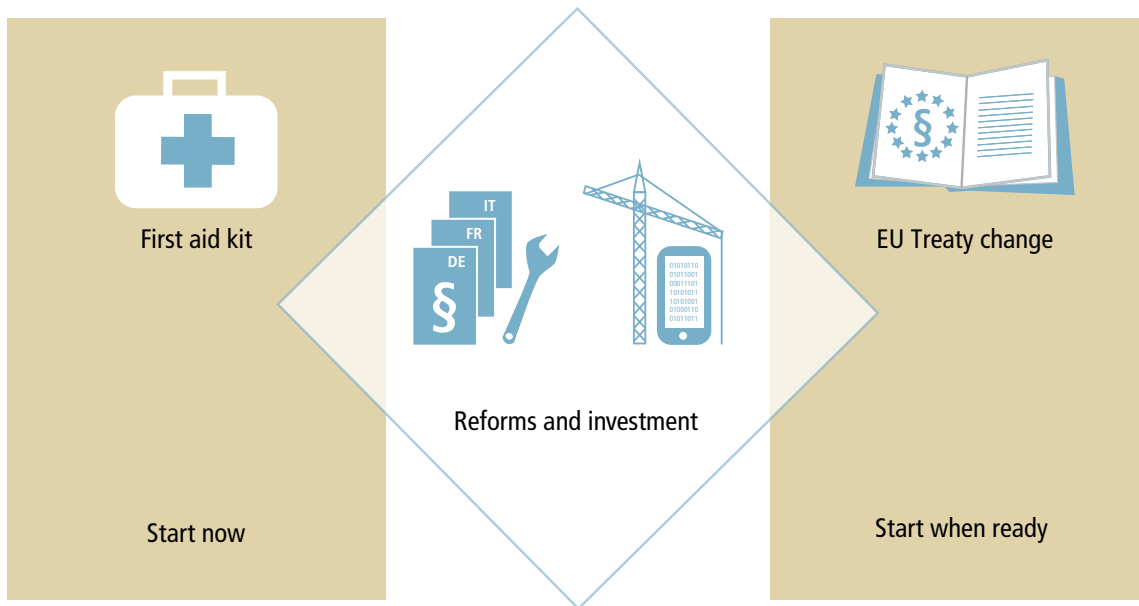
9 Four Presidents' Report (2012). *Towards a Genuine Economic and Monetary Union*, Herman Van Rompuy in collaboration with José Manuel Barroso, Jean-Claude Juncker and Mario Draghi, Brussels: European Commission; The Five Presidents' Report (2015). *Completing Europe's Economic and Monetary Union*, Jean-Claude Juncker in cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz, Brussels: European Commission.

though we are convinced Europeans, we think that an intergovernmental approach is the right way to start the reform process. Indeed, we believe effective negotiations about stabilising EMU are largely hindered by governments' concerns that even the start of a narrow discussion about how to protect the euro in a potential future crisis could lead to far-reaching policy decisions on fiscal transfers, on sovereignty or on shifts in power that they do not feel ready to take at the current juncture in EU politics. Our reform strategy avoids this dilemma.

28. We suggest a three-pronged action plan. The first two building blocks are package deals that are limited in scope and tackle immediate problems. By improving the functioning of EMU they also lay the foundations for a more visionary third building block further down the road:

- We should start with a first aid kit for EMU. There is an urgent requirement to protect the euro against a possible new crisis in the short to medium term (approximately over the next five years). The guiding principles in the discussion of the first aid kit should be pragmatism and consensus. Uncertainty about future crisis management needs to be reduced through some limited sharing of risk and sovereignty. In addition, stronger coordination of economic policies should contribute to avoiding a new crisis in the first place. In political and institutional terms, such a first aid kit should not yet seek to make a federal leap. In order to start soon, it should instead make the best of the prevailingly intergovernmental character of current policy-making in Europe.

Figure 4 Three building blocks for protecting the euro



Source: Authors. Illustration: Cinthya Nataly Haas-Arana.

- The second building block combines investment and reforms. There is a need to lay the economic foundations for more growth and convergence in the medium term. For this, EMU needs to become a better integrated economic area by promoting further deepening of the Single Market. This set of reforms needs to start now and in parallel with the first aid kit, but would continue over a longer time horizon (about ten years).
 - Thirdly, there will still be the need for EU Treaty change to accompany monetary union with a true political union. There should be no misunderstanding: an improved EMU based on the first two building blocks would still remain incomplete. We therefore believe that in the longer term the goal should be to establish a monetary union that is based on a significant level of risk sharing and sovereignty sharing within a coherent and legitimate framework of supranational economic governance. This would then be the moment for a shift from the intergovernmental to a more federal approach in Europe.
29. Europe cannot afford to wait any longer. We therefore propose that the first building block should be implemented immediately, i.e., without waiting for eventual changes in the political landscape of the large Member States. In parallel, there needs to be an agreement on the reform measures in the second building block. Then, and by analogy with the run-up to EMU, we believe these reforms of the second building block are the prerequisite for Member States to join the strengthened monetary union described in the third building block. All euro-area members would have to make the transition at the same time.
30. If we want the euro to become truly sustainable in the long run, we need a system to govern the common currency that is fair, effective, and accountable. The building blocks pay careful attention to enabling a package deal that gets different interests on board: the smaller and larger Member States as well as the creditor and debtor countries. The report also accommodates different preferences as to whether sovereignty sharing or risk sharing should come first by allowing both to move in tandem.

D. First building block: A first aid kit for the euro area

31. When the next crisis strikes, Europe will not have the time to embark on a new series of summit all-nighters to discuss a strategy. Each delay will make the ultimate crisis responses more costly – both politically and financially. This is why Europe needs to keep a first aid kit at the ready. It needs to have a stable framework in place *now*.
32. Governments need to accept their responsibility for stabilising the euro area in a crisis. But given the current political climate and the multiple crises that the EU has to deal with, we cannot be dependent on whether EU Treaty change is on the cards at this point in time. We therefore have to ask ourselves what can be done within the given treaty framework. Our first aid kit contains quick fixes for the most dangerous weaknesses. This means relying less on ECB measures and more on a transparent sharing of risk and sovereignty.

Upgrading the European Stability Mechanism (ESM+)

33. The main channel through which stabilisation emerged during the last crisis was the *de facto* risk sharing through the ECB with only indirect conditionality. This needs to change, because risk sharing and conditionality are only credible if based on solid political backing and strong institutions. While the ECB will certainly contribute to euro-area stability, it should not take over political responsibilities. But stabilising a monetary union requires intense political negotiations. The ESM

The first building block at a glance

ESM+

- Transform the ESM into an ESM+ with a EUR 200 billion rapid-response facility
- Involve national parliaments directly in the scrutiny of ESM+ decisions
- Make the President of the Eurogroup the face of the ESM+
- Change the ESM Treaty, but do not change the EU Treaties

Banking Union

- Risk reduction in national banking systems
- A mechanism to create some risk sharing among national deposit insurance schemes
- A backstop to the Single Resolution Fund (SRF)

Economic policy coordination

- Renew convergence efforts
- Review fiscal rules
- Strengthen the role of the Eurogroup president
- Improve cooperation between European Parliament and national parliaments in European Semester

- should therefore be strengthened. To be clear: without the ESM, the euro-area crisis would not have been stabilised. However, the ESM still has weaknesses that need to be addressed:
- Firstly, the ESM is not a real lender of last resort given that each country is liable only for its own share (i.e., its risk sharing logic is *several* not *joint*). While this approach is reasonable as a general rule, there needs to be an exception in a very severe crisis.
 - Secondly, the ESM can only take measures after the involvement of many players.
 - Thirdly, its democratic oversight is indirect and purely intergovernmental.
34. An upgraded ESM, or ESM+, can improve the *status quo* without the need for a fundamental EU Treaty change. Changing the ESM Treaty requires ratification in the euro-area member states and will not be easy. However, the procedure is less cumbersome than calling a European Convention. We believe that three changes could address the main concerns.
35. Firstly, the ESM+ should be given a rapid-response facility. That facility should be pre-funded or earmarked at the level of EUR 200 billion and could, e.g., be based on the competence for purchases on the secondary market for government debt. The sum would be jointly guaranteed by the Member States, thus providing a clear message of risk sharing in the context of a crisis. National parliaments would issue the guarantee for the facility without linking it to a specific country or crisis.
36. Through this facility, the ESM+ would thus become the principal stabiliser of the euro area. The time is right for this step. One reason why the ECB had to become involved so heavily in European crisis management was that the Member States were unable to solve a difficult trade-off: markets could only be calmed by a rescue fund with unlimited resources but that was incompatible with the national parliaments' budgetary sovereignty. The solution Europe favoured at the time was the ECB's unlimited firepower. We believe that today it is time for a fiscal solution and consider such a fiscal instrument, even if it is limited, to be credible, as long as it is jointly guaranteed.
37. The rapid-response facility is also needed because the ECB's proposal to conduct Outright Monetary Transactions (OMT) is based on important constraints that might affect the ECB's rapid reaction in a possible next crisis: to activate the OMT with respect to a specific country, that country needs to implement an approved programme, and meet the conditionality requirements of the EU institutions. But the negotiation of such a programme requires time, and the political hurdles are often high. It might be worth recalling the difficult negotiations in the context of the activation of the ECB's Securities Market Programme in August 2011. Given the high time pressure in a crisis situation in combination with the inherently political nature of the discussions involved, it would be more appropriate to shift the first crisis response to the ESM. Decisions on conditionality could then be taken directly through the ESM+.
38. Secondly, in order to improve the democratic oversight of ESM+ decisions and the use of the EUR 200 billion rapid-response facility (and all the other current ESM facilities), there should be a permanent Control Committee based on the interparliamentary conference established in Article 13 of the Treaty on Stability and Coordination and Governance (or Fiscal Compact).¹⁰ This Committee would bring together national and European parliamentarians. The composition and voting rights would have to broadly reflect the voting rights in the current ESM and take national constitutional constraints into account. A solution would have to be found to adequately reflect the weight of the members of the European Parliament. The Committee should mandate a small sub-committee that could be convened in emergency situations, in particular to decide on the rapid-response facility.

¹⁰ Valentin Kreiling and Morgan Larhant (forthcoming). "Does the Eurozone need a Parliament?", *Policy Paper*, Berlin: Jacques Delors Institut - Berlin.

39. Thirdly, the President of the Eurogroup should become the face of the ESM+ and be responsible for negotiating assistance programmes in the name of the euro-area Member States. This would improve transparency and shift ownership for ESM decisions and crisis negotiations to where it belongs, namely to the Eurogroup.

Enhancing the Banking Union

40. During the financial crisis it became clear that the so-called sovereign-bank nexus posed a major problem for the euro area: failing banks increased public debt and unsustainable public debt weakened the banking system. Steps towards a banking union established a European oversight function (the Single Supervisory Mechanism), rules for bailing in creditors, and a common framework for winding up failing banks (the Single Resolution Mechanism (SRM) and the Single Resolution Fund (SRF)). Taken together, these institutional changes mark very important steps towards reducing this dangerous link, but further work is needed to solve the problem permanently.

41. The necessary condition for further risk sharing to be implemented is some further risk reduction in many euro-area banking systems. To enhance risk sharing, the overall likelihood that adverse developments could trigger large aggregate losses needs to be reduced. This process of risk reduction has already started and is well under way. It should be continued and be accompanied by further steps to reduce the nexus between banks and sovereigns.

42. As long as the credibility of national insurance schemes is tied to the solvency of their governments, banking crises still have the potential to threaten sovereigns and *vice versa*. This has wider implications for the financial sector. If deposit insurance schemes in fiscally weaker euro-area countries are less reliable, banks from those countries face higher funding costs, e.g., via higher interest rates to their depositors. Furthermore, in times of crisis, savers are more likely to transfer their money

to safe havens, which reinforces capital flight. The banking union needs to address this challenge. Possible solutions include a direct European deposit insurance scheme but also a re-insurance mechanism or even well-designed lending arrangements between national schemes. The ESM+ could also be given a role in linking national deposit insurance schemes to improve risk sharing.

43. The SRM needs to be enhanced by a common fiscal backstop. Taking the recapitalisation costs of the previous crisis as a yardstick, the final capacity for the SRF of EUR 55 billion as currently envisaged would be exhausted relatively quickly. In such an event the doom loop between banks and sovereigns described above would loom again. The ESM+ could take on this task, building on its instrument for direct bank recapitalisation. Depending on the design of such an ESM+-based backstop for the resolution fund, it could also incorporate the tasks of a common deposit insurance.

Convergence: Improving fiscal and economic policy coordination

44. The euro area should undertake substantial efforts to improve real and cyclical convergence. This implies that clear convergence targets are identified and the macroeconomic imbalance procedure is taken seriously. In our view, those targets should focus on prices (measured in inflation differentials), competitiveness (unit labour cost differentials), and the external balance (current account balance).¹¹ Implementation of these targets needs to happen at the national level and involve structural reforms and investments.

45. However, it is unlikely that cyclical and real convergence in the euro area will significantly increase in the short to medium term. And it is probably not even possible or desirable to aim for full real convergence in the

¹¹ Anna auf dem Brinke, Henrik Enderlein and Joachim Fritz-Vannahme (2015). *What kind of convergence does the euro area need?*, Gütersloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin.

euro area, as Member States should be given the freedom to develop country-specific sectoral specialisations or undertake country-specific reforms. Such specialisation would naturally lead to cyclical and probably also temporary real divergence. But this is not a problem *per se*.

46. What EMU needs is a framework to deal better with certain divergences. The past crisis was to a very large degree triggered by the absence of resilience in the context of divergence. We believe the broader institutional proposals we make in this report will help the euro area to become more stable even in a context of only slowly declining real and cyclical divergences, especially if there were to be new shocks or crises.
47. Two possible ways of improving the current system of policy coordination are now often proposed: either through a strict and mechanistic rules-based approach or through a well-designed political surveillance system that takes context-based decisions on whether Member States deliver on their coordination obligation or not. Today's system is a hybrid, resulting from complex political compromises. The rules-based approach of the Treaty lacks credibility. And the more discretionary surveillance tools are criticised as overly vulnerable to political pressures.
48. In our view, there is no quick-fix solution to this challenge. But there are a few simple changes that might contribute to improving the system in the very short term. Even such minor reforms are urgently required because the complex current system leads to mistrust and counterproductive political gaming between Member States. The political price paid for this is simply too high and might limit the will for solidarity in the next crisis.
49. Firstly, Europe needs to review the interpretation and enforcement of the fiscal rules. To date, the European Commission has initiated close to 40 excessive deficit procedures. Yet no country has ever paid a fine. This track record suggests that the rules have mostly stirred

controversy rather than contributed to a sound coordinated fiscal policy stance. Europe needs to ask itself whether sticking to rules based on aggregate indicators makes sense and accurately captures the challenges of economic policy coordination.

50. It is therefore necessary that the European Commission, the Council, the Eurogroup and the European Parliament agree on a common interpretation of the fiscal rules in the Treaty. Having a uniform approach to how SGP rules should be interpreted would certainly be beneficial to greater transparency and predictability. In so doing, it is crucial to recognise that debt and deficits are generally very high, and that reform efforts, the quality of public spending and the business cycle need to be taken into account when evaluating them.
51. The background is simple: in the past, Europe focused too much on the narrowly defined 3 percent deficit-to-GDP threshold. The quality of the fiscal budget and the position of the economy in the business cycle were not taken sufficiently into account – even though they are at least as important. A 1 percent deficit-to-GDP ratio can already be far too high if the budget is mainly spent on consumption during an upswing. At the same time, a 3 percent deficit can be healthy if the economy is in a deep recession and the government pursues, for instance, a long-term investment strategy.
52. Secondly, the Commission should take a very fundamental decision on how it sees its role in economic policy coordination. Currently, it has two conflicting objectives. It is expected to provide European leadership and, at the same time, to be a neutral arbiter between EU Member States. While we do not want to take a position in this debate, we see two possible options:
- **Emphasis on rules:** the European Commission would enforce the rules without regard to the political context, leaving it to the Council to reject sanctions when they are considered unsuitable. This would be the technocratic approach, combined with discretion at the Member-State level. Integrating the provisions of the Fis-

cal Compact into the EU legal framework would help in this regard. Two main challenges need to be addressed to make a rule-based framework credible: firstly, how to strike the right balance between too few and too many rules? Simple rules may not always be applicable depending on the macroeconomic context, while complex rules are not transparent and may allow for creative accounting. Secondly, what could a clever system of sanctions look like? Paying fines may just cause the budget position to deteriorate further and would be counterproductive.

- Emphasis on discretion: for the second option we move from rule-based governance to a qualitative assessment of the conduct of economic policy. The Commission would necessarily become more political. It would need discretion and thus more power to react to unforeseen events. This approach also has challenges: firstly, how can we pin down what constitutes a healthy and balanced public budget from a national as well as a European perspective? Secondly, how can we ensure a productive balance of power between the Commission and the national governments?

53. Thirdly, Member States need to take the country-specific recommendations (CSRs) more seriously. The European Semester has made things better but not perfect. CSRs are still too often considered a technocratic instrument, at distance from political realities. Furthermore, there are no credible tools to encourage compliance with CSRs, apart from conditionality on the use of EU Structural Funds. There are several viable options to improve the situation.¹²

- Today we observe competition between national parliaments and the European Parliament in controlling economic policies. Instead of competing, they should work together. National parliaments have to implement the reforms. Involving them deeper in the European Semester would strengthen their ownership of CSRs and give

12 Henrik Enderlein and Jörg Haas (2016). "Structural policies for growth and jobs: best practices, benchmarking and the role of the Eurogroup", *Briefing Paper for the European Parliament provided in advance of the Economic Dialogue with the President of the Eurogroup*.

them a more European outlook over time. Currently, Member States' executives dominate the process, but parliaments could change this by securing a greater say in the formulation of the proposals their governments send to the Commission such as the National Reform Programmes and Stability and Convergence Programmes. The European Parliament, in turn, should have a greater say in the definition of EU-level economic policy priorities and the recommendation for the euro area as a whole, finalised around the time of the Spring European Council.

- The Eurogroup meetings attract a lot of attention. Its coordination capacities could be enhanced by strengthening the role of its president. If he or she had some discretion over the use of an investment budget (see second building block), he or she could reward reform efforts. Ideally, the Eurogroup would elect a member of the Commission as its president in order to maximise synergies, which is possible even under the current Treaty (*double hat*). Such a solution would increase the political weight of the position.

54. Taken together, the quick fixes presented above strengthen EMU in two regards. Firstly, with the new tools of an ESM+ and a stronger banking union the euro area can reduce and share risks and consequently be less dependent on external stabilisation. Secondly, the euro area shares sovereignty by assigning the Eurogroup President a stronger role and stepping up the involvement of parliaments in overseeing Europe's crisis management and policy coordination. The proposed improvements require a change of the ESM Treaty, but no revision of the EU Treaties. However, a first aid package can only address the emergencies in the short term. Starting in parallel, Europe needs a medium-term strategy to boost convergence and growth.

E. Second building block: Reforms and investment for growth

55. Despite its name, EMU is still not a real economic union. This hinders convergence and growth and increases dangerous imbalances between euro-area countries. Only a common effort with simultaneous reforms at the European level and in the Member States can overcome the *status quo*. Convergence and growth need to be nurtured from two sides: on the one hand, we need structural reforms to increase cyclical convergence and reduce macroeconomic imbalances. On the other hand, we need investment to spur convergence and foster social cohesion for a better functioning of the euro area.

56. Structural reforms that go hand in hand with a strong demand-side component and necessary investment resources will be easier to implement. We propose a politically feasible package deal that combines structural reforms in exchange for investment in order to get Europe back on track for growth.

Structural reforms: Getting the focus right

57. Structural reforms are notoriously hard to define and are often subject to competing definitions. It is easy to get into a situation where the concept means everything and nothing. In theory, structural reforms are any reforms that increase potential output and growth. The list therefore includes measures as diverse as increasing competition in the product market, reducing the labour tax wedge, or reducing dualism in the labour market. In the case of the euro area, the most promising strategy

The second building block at a glance

Choose structural reforms with clear guidelines in mind

- Ensure that reforms have national ownership and fit into the common European agenda
- Avoid reforms with high transitional costs, implement complementary reform packages and include a demand-side component
- Implement product-market reforms and labour-market reforms by paying attention to sequencing, and put more emphasis on sectors with large future growth potential in the Single Market as well as on skill-enhancing measures

Launch a comprehensive public and private investment initiative

- Reduce regulatory uncertainty for cross-border investments
- Reduce risks for private investment with public guarantees
- Target public spending on productivity-enhancing investments

might be to define a structural reform agenda in terms of what it needs to do, and then think about the right mix for each country, and how best to implement it.

58. The euro area needs reforms on two levels. On the one hand, reforms need to address the economic fragmentation in the euro area. This requires a further strengthening and deepening of the Single Market, which is still an unfinished project. When the Single Market Act was agreed in 1985, it was a strong force for convergence in Europe. Supported by an increase in structural funds, the poorer Member States experienced a catching-up in living standards with the richer economies. However, the Single Market effect has worn off. While the goods market is largely complete on paper, many products are in fact still not tradable, and services remain poorly integrated. This matters because it hampers adjustment through the real exchange rate channel, which is an important stabiliser and counterweight to internal competitiveness imbalances. On the other hand, national economic systems need to perform better and achieve higher productivity, employment and natural resource efficiency.

59. So far, the implementation record at the Member State level has been poor. Better institutions could help make structural reforms a success.¹³ In addition, we need more national ownership to improve the implementation record. To that effect, we need to find the best policy mix for each country when it comes to structural reform priorities. This agenda needs to be agreed between the Member States and the EU institutions, taking into account their effect on all European economies. Although there is a lot of variation when it comes to country-specific recommendations, here are three important lessons that we have learned:

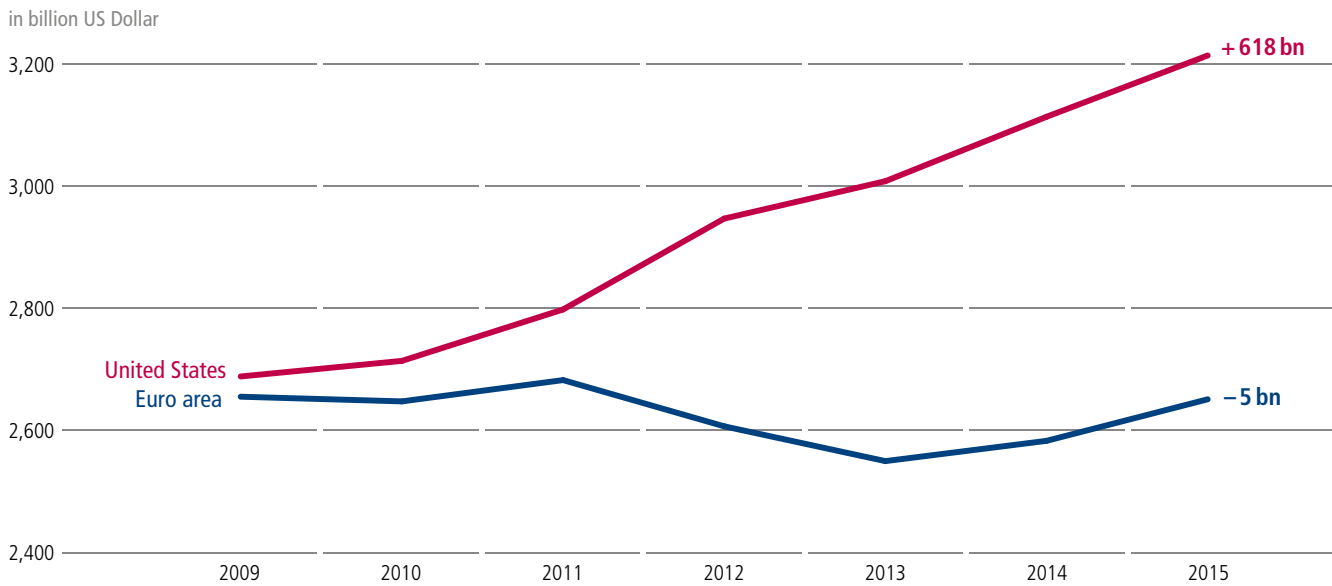
- Firstly, almost all countries lag behind when it comes to product-market and service-sector reforms. The potential of integrating the service sector in particular is well

¹³ See for instance, European Central Bank (2015). "Increasing resilience and long-term growth: the importance of sound institutions and economic structures for euro area countries and EMU", *ECB Economic Bulletin Issue 5/ Article 3*, Frankfurt.

known: it employs the most people and produces the most value added in the euro area. It is also the fastest growing area in trade. Harmonising the rules of entry and implementing best practices will increase competition as regards both goods and services. By sheltering large service sectors from competition, we hamper the functioning of the Single Market and prevent the citizens from reaping its benefits. This is especially true when it comes to exploiting the efficiency and productivity gains from digitalisation and pushing out the digital frontier.

- Secondly, we need a smart mix of labour-market reforms, facilitating higher employment and higher productivity through skill-enhancing measures and openness to new forms of work, while taking care of social risks and preventing widespread economic insecurity. We need to put more emphasis on investment in training and education. This means child-care provision for parents, more vocational training for the young and immigrants, lifelong learning for the elderly and active labour-market policies for job seekers. Such reforms require continuous investments and qualitative improvements rather than one-off regulatory changes, but they are indispensable for innovation and productivity and they pay off in the medium to long run.
- Thirdly, labour-market and product-market reforms are important but we have not got the sequencing right. Labour-market reforms were not supported by product-market reforms in the past. As a result, employees were laid off but no new jobs were created. This weakened demand even further, causing more people to lose their jobs. Such an effect will be even stronger during a recession. Therefore, any reform proposal should from the outset map out a plan of how the most vulnerable losers will be protected. Compensating those who lose out because of reforms should not be an afterthought but a necessary ingredient of the package deal.
- Finally, the business environment can still be improved through the continued modernisation of public administration, notably as regards the speed and efficiency

Figure 5 Investment in the euro area has stagnated while it has recovered in the United States



Notes: Figure shows gross fixed capital formation in constant 2010 US Dollars.
Source: World Bank, authors' calculations.

of judicial proceedings, quality of public spending, cost-effective public procurement, improved tax collection, greater public sector transparency and the fight against corruption.

60. Once we have found the right mix of reforms for each country, we need to think about how to implement them. Policymakers should have three guidelines in mind:

- Firstly, many countries have still not recovered from the crisis, and reforms with significant transitional costs in the short run should be avoided.
- Secondly, implementing complementary reforms jointly tends to produce larger positive effects and might thereby also strengthen public support for reforms.
- Thirdly, reforms should always include a demand-side component and necessary investment resources to support the economy.

Launching a comprehensive investment strategy with three layers

61. An ambitious reform agenda will be much more effective if it is accompanied by a comprehensive investment strategy at the European level as had started in the years before the financial crisis. Our broader diagnosis is clear: at the current juncture, public and private investment is far too low. This threatens Europe's economic prospects and the EU might fall behind its global competitors. Only a strong push for more investment on all fronts and ambitious reforms can restore growth in the European Union.

62. We therefore propose an investment strategy that is strictly targeted on areas that enhance productivity and where investment outcomes are highly visible. This will supply politicians with tangible arguments as to why strengthening the euro area is worthwhile. The strategy should operate on three layers:

- Improve the regulatory framework to reduce uncertainties for private cross-border investment
- Mobilise additional private investment with public funds by further reducing investment risks
- Gear public spending towards more productivity-enhancing investment

First layer: Better regulation to promote cross-border investment

63. Firms and investors still face barriers and regulatory uncertainty when investing in other Member States. Especially in sectors that have a strong transnational dimension, common rules can considerably boost investment due to the new growth opportunities offered by borderless sectors.¹⁴ Since the beginning of the crisis, however, cross-border capital flows have declined, especially because banks suffered losses during the crisis and withdrew from foreign markets.

64. In the short run we propose to incentivise firms to bring investment decisions forward. Temporary accelerated depreciation offers companies – including small and medium-sized enterprises (SMEs) – the possibility of writing down their investment faster than usual. This instrument has a broad effect, is fast and easy to implement, and can speed up the renewal of the capital stock. The main caveat is that governments have to agree to a loss of revenue in the early phase of the investment, which would, however, be recouped at a later stage.

65. In the medium run Europe needs to ease the cross-border flows of capital and create borderless sectors. Regulatory predictability and a harmonised legal framework should become Europe's competitive advantage in the race for global capital. Unstable and fragmented regulatory conditions in some sectors, including the retroac-

tive changes to laws that have occurred in some countries, are a serious obstacle to investment. On the road towards a true Capital Markets Union, even small steps will add up quickly and unleash investment. At the same time, a regulatory agenda also needs to foster the integration of other transnational industries. Here are the most important changes needed:

- We need a true single rulebook with harmonised implementation of capital-market regulation. The European Securities and Markets Authority should be upgraded to serve as an effective regulator. In its current coordination function it cannot provide sufficient regulatory predictability to significantly lower transaction costs for market participants.¹⁵
- We need more favourable prudential treatment of long-term investment. For instance, the EU's Solvency II Directive could be modified. As it stands, this regulation decreases the incentives for insurance companies to take on riskier forms of investment, especially equities.¹⁶ Long-term-oriented investors, such as insurances, could, however, contribute to a significant additional investment stimulus. This applies particularly to network industries such as the energy sectors that are dependent on stable financing over longer time horizons.
- Information-sharing needs to be improved: reliable information about corporate risk and creditworthiness is important in order to stimulate market-based investment. Even though situations differ from one Member State to another, capital-market participants in the EU other than banks and central banks have only limited access to credit information about SMEs, and even many larger companies which are not rated by credit agencies.
- It is time to relaunch securitisation. It was discredited during the financial crisis but, if well-regulated, it can

14 Henrik Enderlein and Jean Pisani-Ferry (2014). *Reforms, Investment and Growth: An agenda for France, Germany and Europe*, Report to Sigmar Gabriel (Federal Minister for Economic Affairs and Energy) and Emmanuel Macron (Minister for the Economy, Industry and Digital Affairs).

15 Nicolas Véron and Guntram B. Wolff (2015). "Capital Markets Union: A vision for the long term", *Bruegel Policy Contribution Issue 2015/05*, Brussels: Bruegel.

16 *Ibid.*

help to open up new EU-wide financing opportunities for SMEs. A Commission proposal for simple, transparent and standardised securitisation is a promising first step.

Second layer: Mobilising private investment with public funds

66. Public guarantees can act as a useful booster of private investment. The Juncker Plan will play a role in promoting additional private investment. We propose a number of amendments to the current plan that would enable more countries and firms to make use of the European Fund for Strategic Investment (EFSI):

- The EFSI could be equipped with more capital by increasing Member States' contributions. Disbursement of funds should not be hampered by lower leverage ratios than initially envisaged.
- The so-called investment clause of the SGP, which allows countries to deviate temporarily from their medium-term budgetary objectives, should set no further conditions for projects which have been approved by the EFSI.
- The EFSI could be combined with the Structural and Cohesion Funds to support innovative SMEs and other high-risk projects that are currently unable to attract private investors. In those so-called *layered funds* the Cohesion and Structural Funds would take the *first loss piece* position and the EFSI the *mezzanine tranche*. This means private investors would only be third in line when it comes to the absorption of losses. The use of these funds is very promising in terms of attracting private investors in countries with high political and regulatory risks. The Commission has already provided some guidance in this respect, but further simplification and more targeted technical assistance is required to ensure higher take-up rates.¹⁷

¹⁷ European Commission (2016). *European Structural and Investment Funds and European Fund for Strategic Investments complementarities: Ensuring coordination, synergies and complementarity*, Brussels.

- The geographical distribution of investments needs to be balanced. The Juncker Plan has to benefit all Member States, particularly those in need of a strong economic stimulus. Currently, there is a risk that projects in more developed financial markets and countries are preferred because of their previous experience in running European Investment Bank projects and the lower risk profiles. This runs counter to the Plan's stated objective of enabling risky projects that would not have happened otherwise.

Third layer: Boosting public investment

67. Today, public investment is primarily the domain of the Member States. They should be given incentives to increase it. To this end, we suggest granting public investments more favourable treatment in the context of EU fiscal surveillance and accounting rules. This would also make investment more attractive relative to expenditure on consumption. The following changes to the EU rules would have an immediate effect on the real economy:

- Investment expenditure should be promoted by recognising it in the public deficit calculation. This could be done by fully discounting it or through an amortisation rule. This means that it would have to be agreed upon prior to implementation and then checked against benchmarks. If Member States would like to benefit from a more flexible assessment of their expenditure under the SGP process, they would have to take effective ownership of the reforms they have committed to implement, knowing that failure to deliver will result in a corresponding penalty.
- Many Member States struggle to make use of the Structural and Cohesion Funds, as the requirement for co-financing is often at odds with the deficit rules of the SGP. Thus, the investment clause of SGP should be adjusted so that no conditionality applies to the co-financing of projects with the Structural and Cohesion Funds.

- The European Semester should give special attention to public investment. The CSRs should be used to specify a minimum level of public investment as well as clear indicators as to the type of the investment most needed.

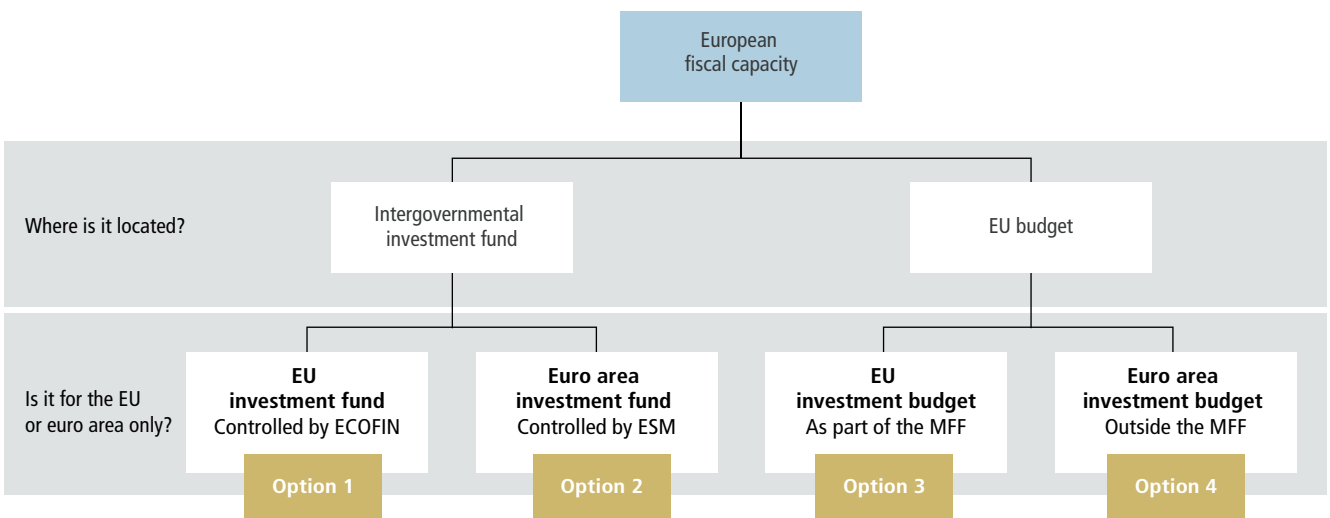
68. The question of whether Europe should play a role in public investment is a contested one. We believe that governments should agree that future-oriented public investment is a top priority. The European level can help overcome a time-inconsistency problem at the national level. Spending on consumption is often rewarded with short-term electoral success although it contributes little to enhancing productivity. Major investment in human capital and infrastructure will mostly benefit future generations and governments. Therefore governments tend to have a short-term horizon when making investment decisions. Earmarking tax revenue for investment via a European investment capacity could help overcome this dilemma.

69. How should this additional money for investment be spent? Our assessment is that Europe first and fore-

most needs better public spending. A European investment capacity should focus strongly on *smart investment* that promises the largest productivity gains for European firms. Financing highways and bridges has contributed to fostering greater regional cohesion. At the same time, it is important not to miss out on the next wave of modernisation: we have too few data highways and too little investment in research and development. A shift of resources into these pioneering areas would enable more European firms to compete successfully in the growing knowledge economy. Furthermore, Europe should more strongly promote investment in human capital, particularly education and training programmes that promote mobility across European borders, as well as measures supporting school-to-work transitions in order to reduce the number of young people in neither employment, education nor training.

70. There are many ways to embed public investment at the European level. Funds could be limited to the euro area or be made available for the entire EU. Decision-making power could remain with national governments and

Figure 6 How to bring in public investment at the European level



Source: Authors.

parliaments or could be transferred to the supranational institutions. The capacity could take the form of an additional fund, be integrated into the overall European budget or even be made part of the ESM. We give an overview of the options in figure 6.

71. If we opt for an intergovernmental investment fund we could equip it with three specific grants: targeted grants, solidarity grants, and excellence grants.¹⁸

- The least ambitious form of European public investment would be a targeted grant with *juste retour*. In this scheme, Member States would receive exactly the amount of funds that they paid in. Member States would then spend these funds on commonly agreed target areas such as research, digital infrastructure, education and training schemes. Such a vehicle would channel investment into fields that are particularly sensitive in terms of growth and productivity and would also ensure a sufficient level of public investment in fiscally constrained Member States.
- Ideally, the investment capacity would also offer solidarity and excellence grants, which would provide funds not linked exactly to Member States' contributions. The solidarity grant would help countries that undertake structural reforms cope with short-term costs. The excellence grant is intended to fund the most promising and innovative projects that promote advancement on the technology frontier or provide large positive externalities.

72. If Europe opted for including investment in the EU budget, it should use this opportunity for a comprehensive review of the EU budget. This has long been overdue but has always been hampered by political deadlock. There are two main reasons why now would be a good moment for a review:

- Firstly, Brexit could serve as a game changer. With the UK leaving, the overall budget structure will have to be reassessed. The EU should embrace this window of opportunity and make sure a reformed EU budget would be geared towards promoting investment and true European public goods.
- Secondly, the Structural and Cohesion Funds need to be better aligned with the national reform agendas. The crisis has triggered some positive changes – a stronger focus on performance, new conditionality and a clear alignment with CSRs – but further improvements are needed to take these developments up in the EU budget.

Europe needs to start growing today

73. The second building block offers a package deal which consists of reforms in exchange for investment. This should satisfy both the advocates of modernising the economies and proponents of a stronger demand-side stimulus for the European economies.

74. One unresolved issue is how to proceed with euro-area countries unwilling to support the changes necessary for a further deepening of the euro. Should they benefit from a political union without meeting the prior conditions, should they be left behind, or should the Union wait until all countries meet the criteria for moving ahead? One thing is clear: if some Member States take part in the euro-area reform process and others do not, the latter group will be exposed to speculative attacks. This would destabilise their financial markets and spill over into the real economy. Thus, peer pressure could be a strong motivation for all countries to complete the reform steps together.

¹⁸ Henrik Enderlein and Jean Pisani-Ferry (2014). *Reforms, Investment and Growth: An agenda for France, Germany and Europe*, Report to Sigmar Gabriel (Federal Minister for Economic Affairs and Energy) and Emmanuel Macron (Minister for the Economy, Industry and Digital Affairs).

F. Third building block: Risk sharing and sovereignty sharing

75. Since measures taken in the first two building blocks would stabilise EMU, some might ask whether any further steps would be necessary. From today's perspective, it is impossible to answer that question. Yet in a decade from today we might know more and conclude that further steps towards a true economic and monetary union are needed.

76. Our proposals under the third building block should thus not be misread as the necessary arrival point of the development of EMU. We simply believe that discussions on *finalité* should not be the starting point when a pragmatic and stepwise approach is more promising. At the same time, it is important to keep the vision of a completed EMU on the agenda.

77. Discussing the longer-term agenda also helps to situate our proposals in the broader debate. ECB President Draghi has repeatedly called for a *quantum leap* in integration.¹⁹ We share the sentiment behind that call: indeed, in our proposals under the first two building blocks, EMU would still preserve an intergovernmental and predominantly rule-based character. Such a set-up cannot supply the flexibility needed to react to emerging economic challenges and the strong democratic control needed to ensure public approval.

78. We believe that EMU would be best served with a significant level of risk sharing and sovereignty sharing within a coherent and legitimate framework of supra-

¹⁹ Mario Draghi (2015). *Speech by the President at SZ Finance Day 2015*, Frankfurt.

The third building block at a glance

European Monetary Fund

- Convert the ESM+ into a true European Monetary Fund (EMF)
- Create a euro finance minister under parliamentary control who bears the political responsibility for assistance programmes

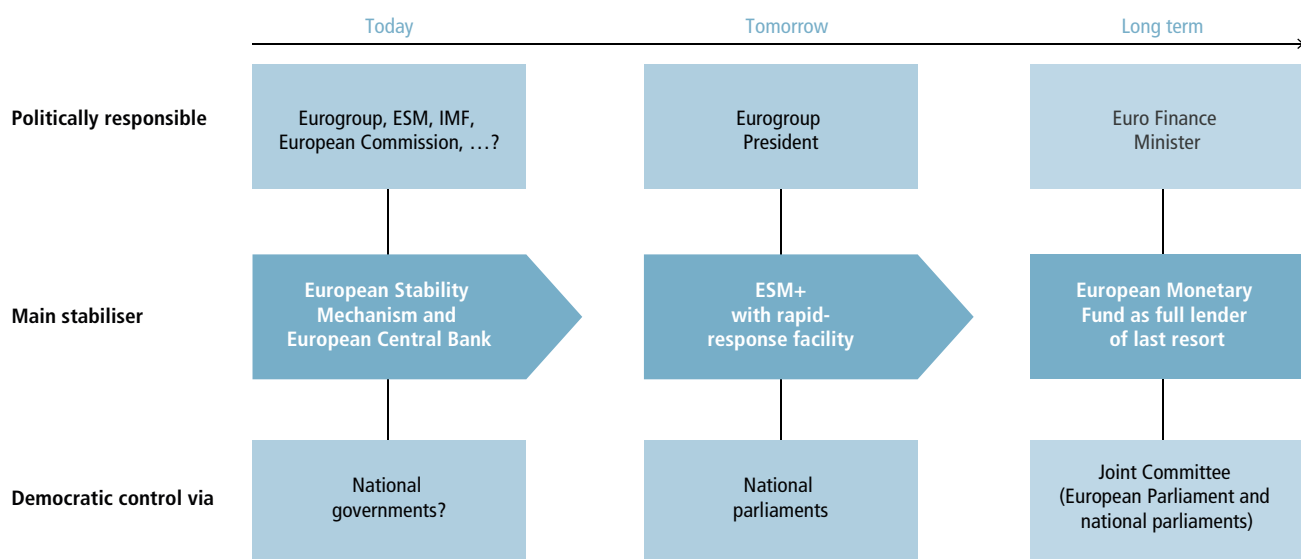
Crisis prevention

- Instruments to deal with debt
- A European deposit insurance scheme

Convergence

- A fully-fledged euro-area budget
- Better counter-cyclical stabilisers

Figure 7 The evolution of euro-area crisis management



Source: Authors.

national economic governance. For this, a full federation is not necessary. However, Europe will need to upgrade its toolbox for preventing and managing crises. This would require a major reform of the EU Treaties, but adapting the European legal framework to Brexit could make changes and ratification procedures necessary in any case.²⁰

A European Monetary Fund

79. A powerful new fund should be put in charge of crisis management. The ESM+ would be turned into a full European Monetary Fund (EMF) that satisfies three requirements:²¹

²⁰ Federico Fabbrini (2016). "How Brexit Opens a Window of Opportunity for the Treaty Reform in the EU", *spotlight europe* No. 2016/01, Gütersloh: Bertelsmann Stiftung.

²¹ This proposal is based on the idea of a European Debt Agency, presented in Henrik Enderlein, Peter Bofinger, Laurence Boone, Paul De Grauwe, Jean-Claude Piris, Jean Pisani-Ferry, Maria João Rodrigues, André Sapir and António Vitorino (2012). "Completing the Euro: A roadmap towards fiscal union in Europe, Report of the Tommaso Padoa-Schioppa Group", *Studies & Reports* No. 92, Paris: Jacques Delors Institute.

- The credible capacity to guarantee the solvency of euro-area countries even on a large scale
- Effective deterrence against moral hazard, and transparency about the costs of financial assistance for the receiving country
- Democratic control over assistance programmes and clear accountability for decisions taken

80. The EMF should become the lender of last resort for the euro area and any other members of the EU that wish to join. It would thereby relieve the burden of the ECB, which would play the same role for the financial system by providing illiquid but solvent banks with liquidity. The EMF would issue its own safe asset as a jointly guaranteed security at the level of 10 percent of GDP per euro-area country. Issuance could be increased when needed, giving the EMF great flexibility.

81. Support in times of crisis would be based on the principle of a step-wise transfer of sovereignty. A govern-

ment threatened by self-fulfilling insolvency could issue additional debt via the Fund, but would have to comply with stricter conditionality in return. Beyond a certain level of issuance via the EMF (e.g., 60 percent of a country's debt in relation to its GDP) the EMF would get a full veto over the national budget. If the country were to act against the agreed provisions, it would no longer be able to issue any more debt through the EMF.²²

82. The Fund would be chaired by a double-hatted euro finance minister who would simultaneously be a Commissioner and the President of the ECOFIN Council (which could take over the functions of the Eurogroup). The euro finance minister would be in charge of leading negotiations about assistance programmes and would carry the political responsibility. He or she would represent the interests of the euro area as a whole. This person would have to answer to a committee of delegates from the European Parliament and national parliaments. With a qualified majority, this *joint committee* could veto any decision of the euro finance minister.

Better crisis prevention

83. In the third stage, the focus should no longer lie on managing crises, but on preventing them. Devastating financial crises as happened in Greece should become avoidable. This requires the completion of Banking Union and measures to defuse the latent threat posed by high sovereign debt.

84. To overcome the sovereign-bank nexus, the deposit reinsurance scheme proposed in the first building block needs a further upgrade. It should be transformed into a fully-fledged European deposit insurance scheme with a common backstop. Such a scheme would enjoy stronger credibility as euro-area Member States could not shirk their payment obligations in the event of a cri-

sis. It would also eliminate the remaining country-specific costs for banks that arise from covering first losses through a national insurance scheme. A pan-European insurance scheme would go a long way towards enabling the banking sector to provide equal financing conditions for the real economy across the euro area.

85. Legacy debt should not be here to stay. Given that we are in a low interest rate, low inflation rate and low growth rate environment, public debt will for most countries not be a pressing issue. However, it will also not decrease by itself. Higher growth and higher inflation would help to reduce the debt but they are too low now and are no short-term solution. We therefore need an additional vehicle to deal with the debt legacy. This could ensure that we also have enough room for manoeuvre for future reforms and investment.

86. Specific options are already on the table.²³ For example, a debt redemption fund could take care of the long-term debt. It would allow Member States to temporarily transfer debt that exceeds 60 percent of GDP once, and once only, to a European fund. Redemption, however, comes at a price: Member States are required to maintain a primary surplus over the redemption period of up to 30 years. Measures to ensure repayment could include the obligatory implementation of debt brakes in constitutional law, binding agreements on structural reforms and budget consolidation as well as earmarking of tax revenues for repayment. Joint responsibility for sustainable public finances would thereby be embedded at the EU level and the national level.

87. If the proposals in this report are implemented, the euro area's debt problems should no longer be as pressing as they are today. In order to address the broader issue of high debt levels across the advanced economies, an orderly debt-restructuring mechanism could be envisaged in the global context.

22 Henrik Enderlein and Jörg Haas (2015). "What would a European Finance Minister Do? A Proposal", *Policy Paper No. 145*, Berlin: Jacques Delors Institut - Berlin.

23 German Council of Economic Experts (2011). *Annual Report 2011/2012*, Wiesbaden; Gertrude Tumpel-Gugerell (chair) (2014). *Expert Group on Debt Redemption Fund and Eurobills: Final Report*.

Instruments for maintaining convergence

88. At this stage, the EU budget or the chosen fiscal capacity (compare the options in figure 6) should take on a stronger role in supplementing national investment and buffering economic shocks in individual Member States. Consequently, it would need to be expanded. Such a budget should no longer be funded by Member States' contributions but primarily through a direct taxing capacity for the EU (so-called *own resources*). Suitable sources of revenue could include, for example, taxes on value added or on CO₂ emissions, or an EU corporate tax (based on a harmonisation of the tax base, such as the Commission's proposal for a Common Consolidated Corporate Tax Base).²⁴ The additional burden on the economy should be offset by tax cuts at the national level. A debate on the details will need to be based on the findings of the high-level working group around former Italian Prime Minister Mario Monti.²⁵

89. In the long run, we further propose a tool for short-term counter-cyclical stabilisation. Euro-area economies in an economic upswing would support economies in a downturn, leading to less volatile and better synchronised business cycles in the currency union. In the medium term, payments could cancel each other out since all countries are subject to booms and busts at one point or another. The idea could be put into practice by transferring money between Member States according to economic indicators such as the output gap, although measurement of such indicators remains a challenge to be addressed. Alternatively, a European unemployment insurance scheme could supplement national schemes by covering part of the costs of short-term unemployment allowances.

90. The third building block moves beyond the crisis mode and provides a solid framework for growth and stability. The euro area would be back on a sustainable path of

convergence. There would be an explicit and transparent framework for risk sharing and sovereignty sharing. The institutional framework of EMU would be under proper democratic control.

²⁴ Jorge Núñez Ferrer, Jacques Le Cacheux, Giacomo Benedetto and Mathieu Saunier (2016). *Potential and limitations of reforming the financing of the EU budget*.

²⁵ The report is expected in early 2017.

G. Conclusion

91. We know that there is a lot of scepticism when it comes to reforming the euro now. But this scepticism will not have helped us when the next crisis hits. Time-inconsistency is the biggest enemy of the euro today. The fact that the euro is currently *not* in an immediate crisis does not mean we can declare that the euro *will* be stable. Why wait for the next crisis to find out? The euro must be protected today.
92. The current economic context of low growth rates and sluggish investment is partly due to continued uncertainty surrounding the euro. Too many people still think the euro is vulnerable. Uncertainty is bad for investment and growth. Why not try to reduce uncertainty about the longer-term future of the euro today by starting a simple, pragmatic plan that could take a significant amount of risk out of the system?
93. Brexit is bringing even more uncertainty to Europe. But the decision by the United Kingdom to leave the EU is no excuse not to act on the euro. Quite the contrary: Brexit is yet another reason why Europe can no longer afford to keep taking *ad hoc* decisions on the euro. A credible strengthening of the single currency would be the proof that Europe can solve its challenges even in these difficult times. This would significantly enhance the credibility and resilience of the European integration project.
94. Indeed, EMU in many respects is not only a monetary and economic union but also an insurance union. The single currency is strong because it is based on the idea of mutual political support among its members. In the past crisis, this mutual support commitment was questioned by many market actors. And it took the independent ECB to bring back that idea of mutual support. But to be credible in the next crisis, this support needs to be more political.
95. Today, it should be possible to build a better insurance union, with the right checks and balances, and with the right mixture of conditionality and solidarity. It is easier to design an insurance scheme if you do not already know whether or not you will benefit from the insurance or be paying for others. Discussing the insurance scheme once the risk has materialised is simply not wise. If we are already in the middle of negotiating a Memorandum of Understanding, then the debate inevitably shifts from designing a safe and fair insurance scheme to a battle of redistribution between countries. We should not repeat the mistakes of the past.
96. There will be some kind of future crisis. Keeping on waiting is the wrong approach. Acting only when the crisis hits will be more costly and less effective and will still not take away the risk of a break-up of the single currency. A more robust EMU would not weaken its individual Member States. On the contrary, it would strengthen their capacity to deliver the stability and prosperity that citizens are asking for. Let us repair the EMU now and prepare it for whatever the future may bring.

Imprint

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Edit
ETC Europe scrl, Brussels

Translation of preface
Danilo Scholz, Paris

Design
Dietlind Ehlers, Bielefeld

Picture
“Smooth stones”
(https://www.flickr.com/photos/a_pitch/2979360799/)
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Production
Matthiesen Druck, Bielefeld

The Jacques Delors
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