10 Ideas How France and Germany Could Strengthen Europe

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Executive Summary

- Between a pro-European government in France and early discussions of a *Große Koalition* in Germany, there is political momentum on both sides of the Rhine for a stronger Europe. Building on the principle of subsidiarity, and focusing on cost-effective institutional breakthroughs, France and Germany could drive the European project further with ten initiatives in five reform areas:
- **Building adequate stabilization mechanisms for the European Monetary Union (EMU): (1)** Creating a credible crisis resolution mechanism in the form of a European Monetary Fund (EMF); and **(2)** Financing a rainy day fund to address local shocks that endanger the viability of EMU over time.
- **Towards a Capital Markets Union: (3)** Removing economic and legal barriers for better pan European risk sharing and capital allocation; and **(4)** Expanding the scope and scale of the Juncker Plan for infrastructure investment.
- **An industrial policy focused on trade and digital innovation: (5)** Increasing the coherence and legitimacy of European trade policy; and **(6)** Promoting an integrated and innovative digital single market.
- **Working together for more inclusive growth: (7)** Improving the state of low wage earners and promoting work incentives; and **(8)** Guaranteeing the transportability of rights across Europe.
- **Preparing the workforce of tomorrow, today: (9)** Tackling youth unemployment today by adopting EU wide standards for apprenticeships; and **(10)** Ensuring lifelong training to deal with the technological disruption of tomorrow.

Reform area #1: Building stabilization mechanisms for the EMU

The emergence of populism and the recent memory of the sovereign debt crisis show that the viability of the euro area can be endangered in the absence of efficient stabilization mechanisms.

According to the IMF, while a federation like Germany absorbs 80% of shocks that affect one region more than another (the so called 'asymmetric shocks'), the euro area is only capable of absorbing 40% of similar shocks. On December 6th, 2017, the European Commission unveiled its blue print for the common currency area entitled "Completing Europe's Economic and Monetary Union" which included proposals for a European Monetary Fund (EMF) and a so-called 'rainy day' fund to address economic shocks which we explore below.

INITIATIVE #1: **As a key part of a stronger euro area, a European Monetary Fund (EMF) - an equivalent to the IMF inside the Eurozone - would build on the functions of the European Stability Mechanism (ESM). It would simultaneously provide financial assistance to member states during liquidity and solvency events and act as a fiscal backstop.**

The EMF would be tasked with providing financial assistance to governments in difficulty –conditional on a country observing EU budget rules– and with assessing whether it is dealing with a temporary liquidity problem or a long-term solvency issue.

In the case of a liquidity problem, funds would be made available in exchange for the implementation of structural reform spelled out in an adjustment program, as it was the case in Spain and Cyprus.

In the case of a solvency crisis, the focus would be on debt restructuring. Some progress in this direction has been achieved in recent years by stringently introducing collective action clauses into bond contracts that make restructurings easier.

But, indeed, a major innovation of an EMF would lie in the introduction of a tool to deal in an orderly way with sovereign solvency crises.

A debt restructuring mechanism for states would help boost sovereigns' market discipline and investors' discipline by strengthening the Maastricht Treaty's no-bailout rule and thereby help reduce the risk of future crises.

The EMF could also serve as a fiscal backstop to the European Banking Union's Single Resolution Fund (SRF).

This would be done by providing rapid access to direct recapitalization instruments or by loan extension to the governments for necessary bank restructurings.

This second EMF function would require the completion of the banking union thus would be phased in over many years. A truly integrated pan-European Banking system would reduce the funding imbalances that have shown up in the Target II system of European central banks.

Though these imbalances no longer indicate rising market tensions, they signal that perceptions of the riskiness within the euro area have not normalized either.

INITIATIVE #2: To complement the EMF, France and Germany could work towards the promotion of a macro-stabilisation tool or fund that assist those Euro area economies that are more affected by a negative growth shock.

Without the means to assist euro area members undergoing temporary difficulties (e.g. asymmetric shocks) the risks of seeing large imbalances inside the EMU increase significantly.

A mixed system of grants and loans could help address the short term difficulties of a single member sooner and avoid a crisis that jeopardizes the EMU down the road.

In case of a rainy day fund, countries would set aside money in good times to be used to mitigate economic shocks and to avoid too much fiscal restraint. The use of the funds would be limited to cushioning asymmetric shocks.

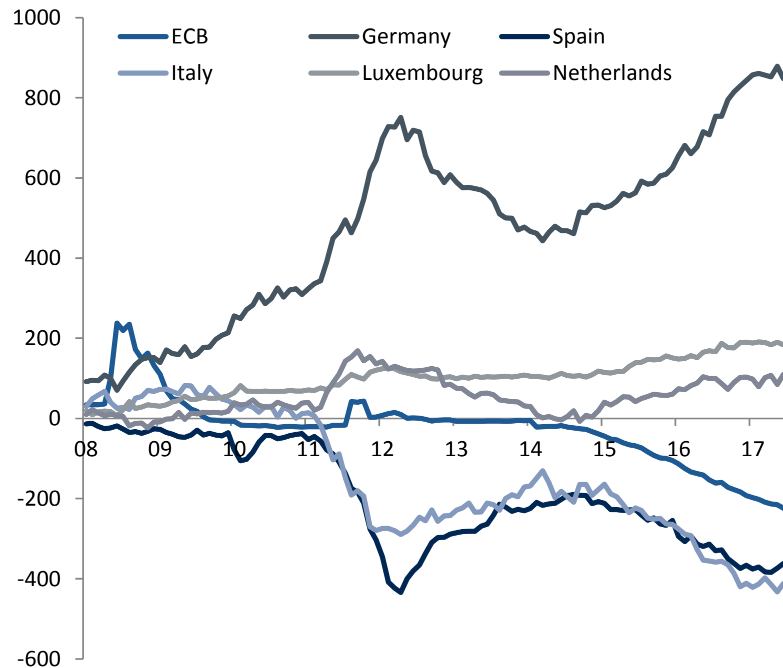
An 2013 IMF staff discussion note demonstrated that centralized mechanisms of stabilization, coupled with capital market cross ownership and cross border credit transfers in federations (e.g. US, Canada, Germany) allowed for an efficient smoothing of negative local shocks[1].

Therefore, next to a clear and workable definition of asymmetric shocks, further integration in the Eurozone would be needed to boost the efficiency and effectiveness of the stabilization fund.

The size of the restricted fund or stabilization tool should be at least 1 % of Eurozone GDP to be built up over a number of years.

[1] IMF (2013) - Toward a Fiscal Union for the Euro Area

Figure 1: Target II Imbalances on the rise with ECB asset purchase Program (€, billions)



Sources: ECB, Euler Hermes, Allianz Research

Reform area #2: Towards a capital markets union

The 2017 edition of the Allianz Wealth report highlighted that Western European households held on average 30% of total financial assets in cash and deposits against 14% in the United States.

At the same time there remains considerable disparity in the costs of financing for businesses within Europe. A Capital Markets Union (CMU) would unlock Europe's rich savings pool, allowing an efficient allocation of capital across Europe.

INITIATIVE #3: **Concretely, France and Germany could propose reforms for the gradual removal of economic and legal barriers in a bid to create truly integrated financial markets (the CMU).**

One suggestion could be the gradual strengthening of the three European Supervisory Agencies (EBA, EIOPA and ESMA) and eventual creation of a European capital markets supervisor to ensure the common implementation of rules for the financial sector as well as common enforcement.

This would mean reduced costs for financial transactions, reduced opportunity for regulatory arbitrage and more private risk sharing across borders.

Beside this, the promotion of new types of pan-European financial products could be a way to further integrate European financial markets.

Deeper financial integration and cross border flows are key if Europe is to strategically position itself as a hub for financial services and capture market share from the City and Wall Street.

At the same time, it could help reduce Europe's dependence on traditional bank intermediation which has been impaired since the crisis.

Bank loans represented 79% of non-financial corporate debt funding compared to 40% in the United States on average between 2010 and 2014[2]. This is a real problem for European businesses which suffer from highly heterogeneous financing conditions because of their reliance on domestic banks (figure 2).

INITIATIVE #4: France and Germany could spearhead a 'private investment booster' that would expand the scope and the scale of the Juncker Plan.

Expanding the Juncker plan in size and scope could be a good way to generate more investment in the Eurozone and it would help reduce the divergence in financing conditions especially for small and medium sized companies.

The European Fund for Strategic Investments (EFSI) is a system of guarantees to generate financing for the most viable projects in strategic infrastructure, education, renewable energy and SME financing.

Unfortunately it only has approved €49.6 billion in financing since inception, or less than 1.7% of total European investment in 2016[3].

Moreover, guarantees emitted remain highly concentrated. Portugal has received €1.8 billion or just under 1% of its GDP, a large chunk of which went to a single biomass factory.

Greece has received €1.6 billion (or 0.90% of GDP), a quarter of which (€400 million) went to airports. A much stronger effect could be achieved if the EFSI accepted larger risks and thus helped realize projects that would otherwise not have been funded by the private sector alone.

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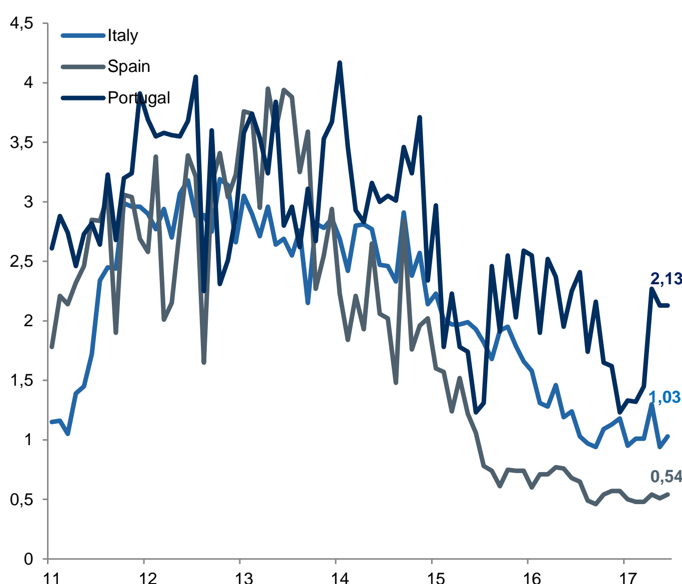
[2] Sources: BIS, IMF, ECB, Fed, BoJ, PBOC, Eurostat
[3] Eurostat (2016) – Gross capital formation in Europe was €2.96 billion in 2016.

Figure 2: Average cost of bank loans to non-financial corporates (%, spread vs Germany)



Sources: ECB, Euler Hermes, Allianz Research

Reform area #3: An industrial policy focused on trade and digital innovation

The two pillars of an industrial policy are trade and innovation. In terms of trade, European partners suffer from a lack of coordination both in supporting exporters and ensuring legitimacy of trade deals negotiated by the European Commission. In terms of innovation, Europe is lacking a coordinated effort to meet international competition. The largest market for GAFA[4] by turnover is Europe, but of the 10 largest internet companies none are from EU.

INITIATIVE #5: **France and Germany should encourage a more proactive trade policy agenda at the EU level that (i) collectively promotes European exports and (ii) levels the playing field for domestic producers.**

Europe has historically been a promoter of free trade, with a low number of protectionist measures. There are currently two and a half times fewer staff dealing with trade defense in the European Commission than there are in the United States alone.

Amongst the trade barriers that have been enacted outside and inside the customs union (fig. 3), production subsidies play a major role.

[4] Google, Apple, Facebook, Amazon

Trade policy should be both a safety net and a springboard for the European private sector. For instance, France and Germany should work together in fostering free trade and investment flows without barriers.

This does not mean that there is no protection for critical industries (as envisaged by the US CFIUS, France's Montebourg Law), but such protection should be commonly agreed in Europe.

Conversely, when boosting exports, European countries could work hand in hand maybe through a joint Export Agency broadening the EIB mandate (direct lending, guarantees, credit insurance). Consistency and credibility in trade negotiations at the EU level is needed for stronger exporters throughout the region.

INITIATIVE #6: Europe must equip itself with a concerted effort to create a single digital market and develop innovative ecosystems to compete with China and the US in fields like Artificial Intelligence (AI), big data, biomedicine where the jobs of the future will be.

There is no simple recipe for innovation: deep techs, human capital, start-ups, early adopters, strategic acquirers, stock markets are all necessary ingredients.

The European Commission believes that a digital single market could contribute an additional €415 billion Euros by 2020.

To ensure that European players take part in the digital revolution it is necessary to have a common regulatory framework governing a single integrated digital market on issues like data security, consumer protection, digital transaction taxation and many others.

Likewise, the innovation of the 21st century requires patient, long-term, committed finance. Venture capital financing in Europe is highly fractured, and increasingly short-termist, with an emphasis on an exit in 3-5 years (typically via an IPO).

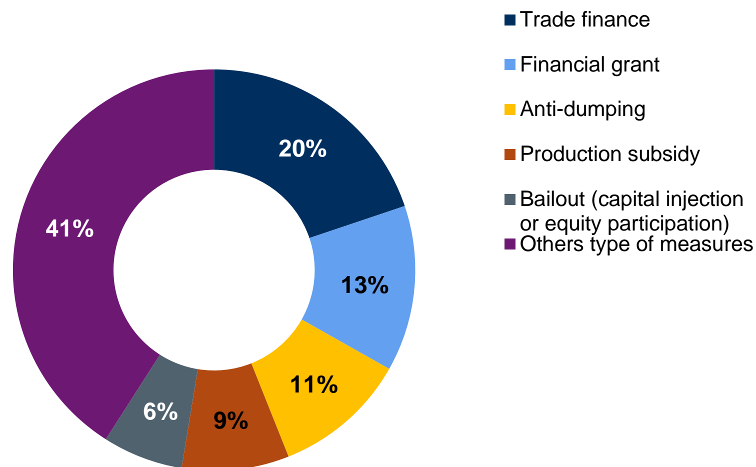
Economists have demonstrated that state actors have a role to play in an innovation cycle, which can take 15-20 years.

To this end France and Germany should mobilize resources in a bid to create a European agency modelled on the US Defense Advanced Research Projects Agency (DARPA).

The key to the long term success of this organization would lie in its ability to tackle risks and to provide an institutional structure – like private Venture Capital (VC) firms – that socializes investment gains (reward).

This would enable France and Germany to finance at a lower cost those pivotal investments in breakthrough technologies which could then be commercially incubated in a large and sophisticated European market.

Figure 3: Protectionist measures implemented by EU members (shares per type of instrument 2014-17)



Sources: GTA, Euler Hermes, Allianz Research

Reform area #4: Working together for more inclusive growth

Both France and Germany are still looking for the right mix of social protection, work incentives and competitiveness that can promote inclusive growth.

At the same time, issues like the status of detached workers must not distract from the fact that obstacles to labor mobility remain one of three significant barriers to growth in the EU according to the OECD.

INITIATIVE #7: Germany and France must work in concert to strike a right balance between progressive taxation and social security contributions on labor income.

A recent study showed that social security contributions in France are €106 bn greater than in Germany when adjusting for their respective output[5].

Conversely, at nearly 50% according to the OECD the German tax wedge is one of the highest in the world and disproportionately impacts lower wage earners.

Both countries struggle to (i) keep tax burdens and social security contributions on low wage earners as low as possible, (ii) maintain levels of benefits capable of preventing poverty at retirement and (iii) retaining incentives for low paid jobs.

Lower and less progressive social security contributions on the so-called mini- and midi-jobs in Germany should therefore be considered.

Likewise, reducing the cost of social security for both employers and employees is important. Macron's plan to reduce levies on salaries by 1.7% in 2017 will make work more attractive, supporting growth in France and the rest of Europe.

INITIATIVE #8: **France, Germany and other like-minded countries could create a 'borderless space' to allow the transportability of qualifications, benefits, and grants in order to enhance labor mobility.**

While Article 46 of the EU Treaty states de jure labor mobility is one of the EU's four core freedoms, implementing it has proven to be a difficult political exercise.

One important impediment is the lack of transportability of pension rights. Many European expatriates end up collecting small bits of pensions from different employers in different places.

Worse yet, because of the absence of a harmonized fiscal framework a pension can be taxed twice: once on the way in (e.g. Germany) and once on the way out (e.g. UK). A solution could be the adoption of a Pan European Pension Product (Pepp).

In addition to driving competition among national providers to expand their pension product offering, the Pepp would reduce the pension gap that stands respectively at EUR241 and EUR 461 billion annually in France and Germany[6].

In total, the European Commission expects that the product would unlock an additional EUR 700 billion in savings by 2030.

Chiefly, it will encourage workers to move more freely to where growth allows it, therein helping dampen the impact of asymmetric shocks.

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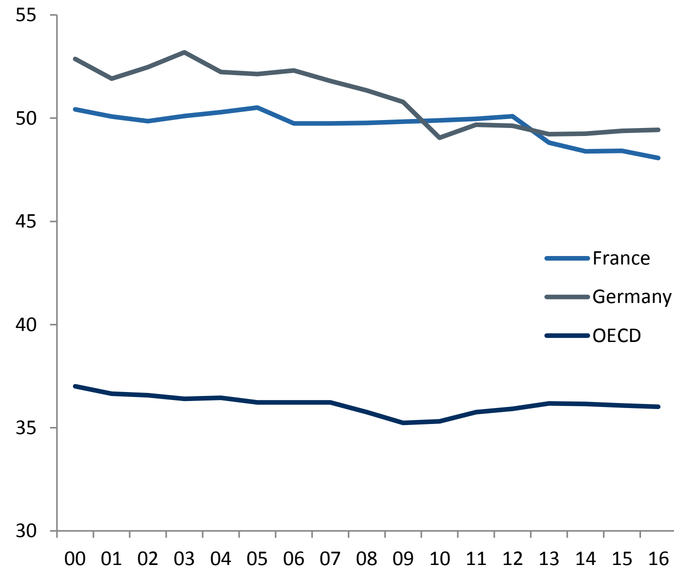
[5] Sourcr: Coe-Rexecode (2017)
[6] Mind the Gap 2016 – Aviva/Deloitte

Figure 4: Tax wedges in France and Germany remain very high
(ratio between taxes paid by employee and labour cost to employer, %)



Source: OECD, Euler Hermes, Allianz Research

Reform area #5: Preparing the workforce of tomorrow, today

In 2016, the ratio of young people that are not in Education, Employment or Training relative to the total population age 15-24 years old - the so called NEETs- stood at 15.8% in Greece, 14.6% in Spain and 19.9% in Italy[7].

High levels of youth unemployment have steep societal costs in terms of foregone earnings, higher taxpayer burden and lower economic growth.

At the same time, the increasing pace of technological change means that only those who have the appropriate skills and can adapt will thrive in an increasingly digital economy while the rest are left behind.

[7] Source: Eurostat

INITIATIVE #9: **Regarding youth unemployment, it is essential that France and Germany tackle the gap between the skills of young job seekers and the skills requested by the real economy.**

Researchers in the United Kingdom found that one year of youth unemployment at the age of 22 resulted in wages that were 13 to 21 percent lower 20 years later[8]. In France, employability of young people after their first qualification is rather low.

In Germany, around 43,500 apprenticeship positions remained unstaffed in 2016 (a new record high) while at the same time more than 20,000 applicants failed to find apprenticeship positions.

Only one out of five German companies currently trains apprentices in the so called 'dual system'. One reason for this is the persistent trend of students to pursue university studies.

In order to better match the supply and the demand for apprenticeships and increase its attractiveness, we propose that France and Germany be the first to establish the basis for EU-wide standards for apprenticeships.

Macron's proposal to extend the ERASMUS program to apprentices and to converge towards a harmonization of credentials modelled on the Bologna system are steps in the right direction.

INITIATIVE #10: **France and Germany should develop best practices in Europe for providing lifelong learning and actively retraining their populations as technology disrupts the lifecycle of job skills.**

Digitalization is affecting most professions, and those who are well prepared and flexible can be confident to have good jobs in the future.

The Digital Economy and Society Index (DESI) shows that in terms of human capital[9] there is considerable disparity within Europe itself (Figure 5).

The top two countries (Finland, Luxembourg) are twice as 'skilled' as the bottom two (Bulgaria, Romania) while Germany and France rank 8 and 10th respectively. Yet this gap can be observed within countries as well.

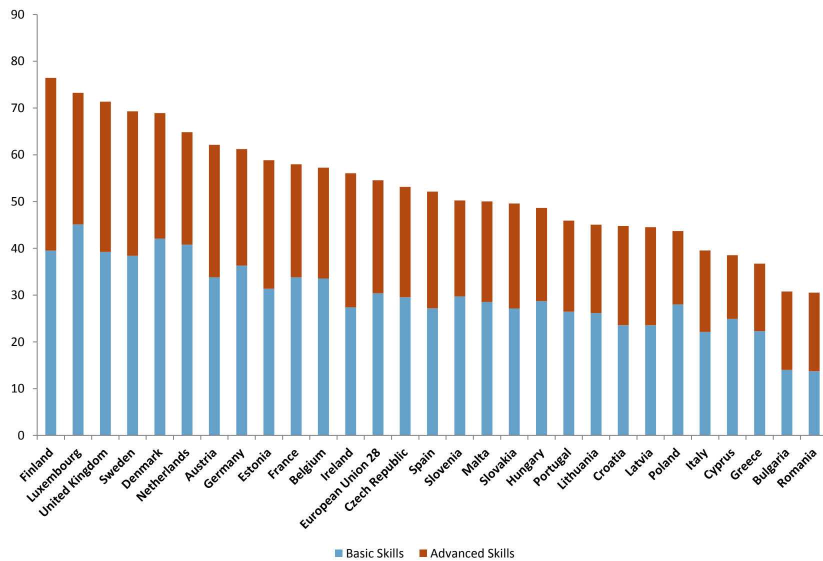
Europe must bring its human capital up to speed with the very intellectual property it is producing.

[8] "The high cost of youth unemployment", Center for American Progress, 2013, p.6.
[9] Human capital has two sub-dimensions: 'basic skills which includes indicators on internet usage and basic digital skills and 'advanced skills' which includes ICT employment and graduates in STEM (Science, Tech, Engineering, Math)

The ability to retrain and requalify its population will shape Europe's transition into the digital age.

As an example, Germany's system of *Kurzarbeit* compensates employers for the costs of training programs for lower skilled employees that have accepted reduced working hours during recessions.

Figure 5: Digital Economy and Society Index Human Capital Skills (2017)



Sources: European Commission, Euler Hermes, Allianz Research

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