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Reforming the Eurozone without a "Grand Bargain"

New Instruments and Power-Sharing in Incomplete Monetary Union

Paweł Tokarski

Emmanuel Macron's success in the French presidential elections in May 2017 has given fresh impetus to the debate on reforms in the eurozone. However, since there is no consensus on fiscal or political integration, the reforms will be limited. Long-discussed ideas, such as extending the tasks of the European Stability Mechanism (ESM), a finance minister for the eurozone or the creation of new stabilization instruments within the European Union's Multiannual Financial Framework (MFF), will probably dominate the agenda. In addition, negotiations to find a successor for Mario Draghi, President of the European Central Bank (ECB), will be conducted over the next two years. Although the main elements of the new EU reform package will be brokered between France and Germany, both countries must take account of the specific challenges faced by Italy.

The eurozone has not been as stable as it is today since the outbreak of the sovereign debt crisis in 2010. The economic recovery is continuing. Nevertheless, monetary union remains very heterogeneous and is still plagued by an air of reluctance. Rigid labour market structures, toxic credit on bank balance sheets, high public debt and a tense social situation are all making the process of economic recovery more difficult, particularly in southern Europe. The most commonly used indicator of real convergence, per capita growth in gross domestic product (GDP), shows mixed economic development in the eurozone. Since the introduction of the single currency in 1999, per capita GDP has grown much less strongly in southern European countries than, for example, in Germany and other eurozone countries (see Figure 1, p. 2). In Italy, this indicator was actually lower in 2016 than in 1999.

The different economic performance of the eurozone countries has an impact on the assessment of credit risks. The slow pace of normalizing the ECB's expansionary monetary policy will create a "cushion" for Italy where elections will take place on March 4th 2018. However, unconventional monetary policy measures cannot last forever and sooner or later Italy's credit risk will be re-evaluated. This also applies to Portugal whose debt has exceeded 130% of GDP. In July 2017, Greece has succeeded

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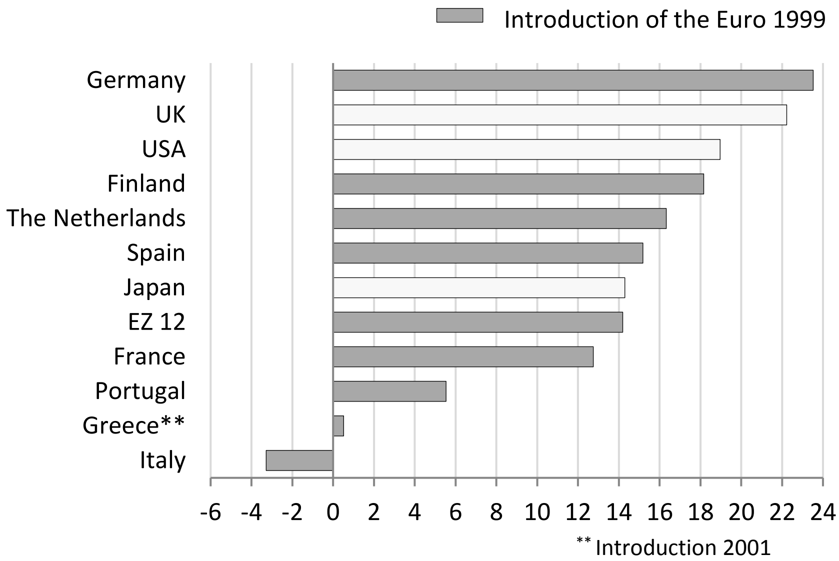
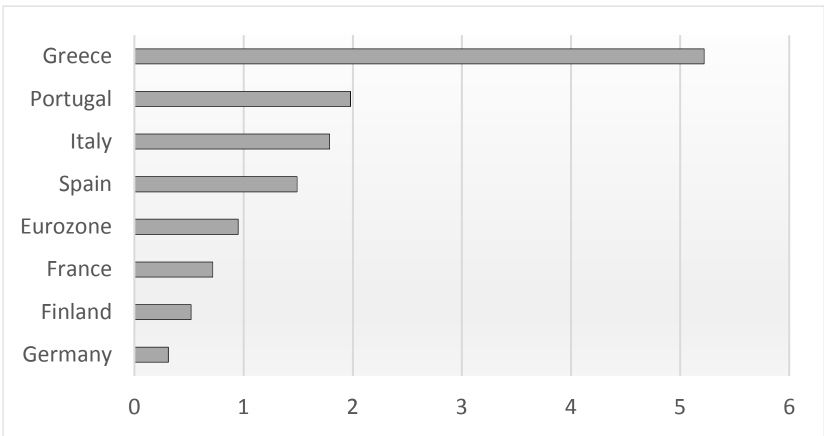
Figure 1
Gross domestic product (GDP) per capita, real growth 1999-2016



Sources: International Monetary Fund (IMF), *The Economist*.

Figure 2
Long-term government bond yields in percent, November 2017 (Eurostat)



in selling bonds again for the first time since 2014, but the country's long-term economic prospects are uncertain.

In this context, France's President Macron is increasing pressure on Berlin to make concrete concessions on eurozone fiscal integration. The background to this is Macron's project to 'reboot' Europe, in which creating a budget and appointing a finance minister for the eurozone would play a key role.

However, the number of possible pathways to further integration are limited, as the European Commission's May 2017 and December 2017 papers show. While there is a lack of willingness to mobilize resources and share risks in the eurozone, specific small-scale reforms could be undertaken to strengthen monetary union before the next crisis. Some ideas, such as creating the post of finance minister for the eurozone, may seem ambitious at first. But if they were realized, their impact would be limited given the current institutional and legal limits.

No fiscal pillar in the eurozone

The main criticism of eurozone architecture is the lack of fiscal integration. Other federations have common shock absorption mechanisms in their budgetary frameworks. In the eurozone, however, stabilization is more or less achieved via the back door: through Eurosystem interventions and the European Stability Mechanism (ESM). But these measures are largely aimed at limiting pressure exerted by the financial markets. A joint eurozone budget could help offset economic shocks. Fiscal capacity funds could then be spent quickly, preferably in automated form. The gradual introduction of a common unemployment instrument in the eurozone financed by the eurozone budget could provide incentives for labour market reforms and legal harmonization. Money from fiscal capacity should be used to tackle the most urgent problems in the south: youth unemployment and the low labour force participation of women.

Instead of having a separate budget for the EU-19, it could be integrated into the EU budget. After Brexit, those EU Member States that are not part of the eurozone will account for only 15 percent of EU GDP. This raises the question as to whether new eurozone instruments, such as the ESM, should be created outside the EU framework. Referring to Article 311 of the Treaty on the Functioning of the European Union (TFEU), the European Parliament's Committee on Constitutional Affairs has published its opinion on how a group of eurozone countries could set new upper limits for own resources and introduce new categories of own resources. A eurozone budget of this kind could be established alongside general negotiations on the new Multiannual Financial Framework in the EU budget. In view of Brexit, EU finances are likely to undergo a major transformation. If non-euro members that fear cuts in the EU budget to their detriment were to participate, this could make it easier for Berlin to reject demands from southern eurozone countries to significantly increase the eurozone budget. Establishing a eurozone budget within the MFF would also put pressure on cohesion spending. However, non-eurozone net recipients may find it easier to accept a eurozone budget as part of the MFF than a new budgetary instrument for the EU-19 created outside the EU legal framework.

Moreover, with a budget for the eurozone of limited size, it would be almost impossible to achieve different goals at the same time. Fiscal capacity is unlikely to be large enough to adequately mitigate against macroeconomic shocks in the largest eurozone Member States or to provide effective incentives for politically costly reforms, largely for political reasons and the aversion to permanent financial transfers within the eurozone.

Establishing a eurozone budget could significantly strengthen its safety net – consisting of the European Stability Mechanism, the ECB's monetary policy and national economic policy instruments. Financial capacity for the eurozone within the existing EU budget would also increase transparency and strengthen the obligation of democratic accountability for this new mechanism. However, there is little political will among members of the eurozone to create such an instrument. The European Commission has adopted a more pragmatic approach in its December 2017 proposals. It suggests reinforcing the stabilizing function of the EU budget in various ways, for example by creating investment protection or financial incentives for the reforms. More specific ideas will follow in May 2018 when the Commission presents its proposal for the new Multiannual Financial Framework. The fiscal capacity for the EU-19 will probably be created by gradually developing different mechanisms dedicated to the eurozone which, at a certain point, will be merged under a common umbrella when the next political "window of opportunity" comes.

Furthermore, EU finances can also be used as extra protection for the eurozone in the event of a crisis. The UK has always rejected this option. In particular, it concerns the role of the EU budget as collateral for the European Financial Stabilization Mechanism (EFSM). The European Commission's reactivation of the EFSM, which is still operational, might represent an additional protective element in monetary union.

Transforming the ESM into a European Monetary Fund

One of the most widely discussed proposals, which is also included in the European Commission's December 2017 proposals, is the further development of the ESM into a kind of European Monetary Fund (EMF). Of all the proposals for further developing the eurozone, this idea has the greatest development potential but should mean much more than merely renaming the ESM.

Firstly, the ESM does not have the financial resources required to provide adequate assistance to the largest members of the eurozone or a group of member countries. With the eurozone currently relatively stable, the time is right to introduce some changes, such as increasing the capital of the ESM or adjusting lending conditions. An option might be to limit the scope of future financial support packages: As suggested by the Bundesbank, it might be possible to reform the collective clauses in the terms for government bonds by introducing an automatic extension of the maturity of government bonds should a eurozone Member State receive financial support from the ESM. This would lead to a limiting of required financial assistance and cause investors to be more cautious when investing in government bonds.

The eurozone still lacks an effective process for sovereign default. After all, a scenario in which some members of the monetary union are no longer able to repay their debts is not inconceivable. The ESM seems to be the institution most suited to playing a leading role in such a case. For example, it could act as an intermediary between the country concerned and its creditors and provide the necessary financial support. The ESM could continue to play a leading role in formulating and implementing conditions for aid packages.

The question as to whether sovereign insolvency proceedings would take place within the monetary union or whether it would be associated with an exit from this union is significant. After all, it is easy to imagine that a country with high debt becomes insolvent when it leaves the currency union and its new currency is devalued as a result. However, the creation of a procedure to regulate an orderly exit from monetary union would contradict the ECB's assurances that the euro is irreversible. Such a procedure would also impact the effectiveness of future ECB verbal interventions.

Many are calling for the ESM/EMF to assess the budgetary deficits of eurozone members as objectively and soberly as possible, based on their economic and fiscal situation. However, it is questionable whether the ESM/EMF could actually put significant pressure on these Member States. In addition, a transition from the ESM to the EMF would raise the issue of International Monetary Fund (IMF) participation in future European financial assistance packages. The developments in Greece have shown that IMF involvement makes the negotiations more complex. On the other hand, the IMF, which has learned from past mistakes, now provides more realistic assumptions about the development of the Greece's financial situation than the European Commission. Its presence, therefore, as an observer in securing and awarding future aid packages remains meaningful. At the same time, efforts should be made to make the ESM less vulnerable to political pressure.

Economic governance between centralization and flexibility

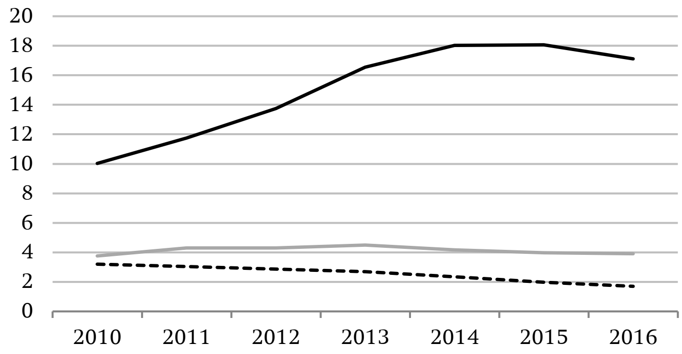
With a lack of effective economic policy integration at the supranational level, the new position of finance minister would add fuel to old conflicts between the various political interests of Member States. It is likely that France or Italy would go to great lengths to lay claim to the post of finance minister. There is also a risk that the new finance minister would serve as a scapegoat for domestic problems resulting from errors in national economic policies. As long as the conflict over economic policy at EU and national level continues, a eurozone finance minister could not fully perform his or her tasks.

Creating common institutions in an area as sensitive as economic policy only makes sense if more efficient compromises can be found in economic policy decisions, which all members of monetary union then accept and implement. Since such a move would entail transferring considerable economic policy competences to the supranational level, it is unlikely to occur. The best example of how the various national interests in the eurozone are effectively reconciled is the ECB's Governing Council, which decides on monetary policy for the EU-19. However, even if it leads to the redistribution of wealth, monetary policy causes much less controversy at national level than would be the case with decisions made by a hypothetical eurozone finance minister, which, for example, might lead to pension cuts. The fundamental question is, therefore, to what extent would it be efficient to centralize economic policy-making in a heterogeneous economic area such as the eurozone? The success stories of Ireland, Finland and Portugal after the crisis show that economic governance through the eurozone is not crucial to their success. After all, it is the national political establishment and national institutions that have to implement the reforms.

However, the process of simplifying governance in the eurozone should continue. In December 2017, the European Commission proposed merging the posts of Vice-President of the European Commission and President of the Eurogroup. The eurozone's new super-Commissioner would also represent the EU at the G20 and the IMF. Although this would simplify economic governance of the eurozone, the new position cannot be described as "finance minister of the eurozone", as this would lead to unrealistic expectations.

In terms of economic governance of the eurozone and the future tasks of a eurozone finance minister, one of the key questions is what degree of flexibility should apply in implementing the agreed rules. Although fiscal regulations have been tightened, they are still not respected by Member States. None of the large or medium-sized economies in the eurozone have a sovereign debt level below 60 percent of GDP. Since the beginning of monetary union, France has constantly had problems complying with deficit rules. Germany has flouted current eurozone regulations by consistently ignoring Commission warnings and recommendations

Figure 3
Non-performing loans: Italy, France and Germany, as a percentage of all loans, 2010-2016



Sources: International Monetary Fund (IMF), Bundesbank.

to reduce its persistently excessive current account surplus.

However, the problem is not just about fiscal regulations or current account surpluses. An elephant in the room is the situation in the banking sector which will be the challenge for the current eurozone economic governance system. The link between taxpayers and banks cannot be broken as long as banks are restructured and capitalized with public money. Italy, the eurozone's third largest economy, has a very high share of non-performing loans (NPLs), accounting for 17.1% of total loans. This figure is 1.7 percent in Germany and 3.6 percent in France (see Figure 3). On the positive side, the aim of limiting the number of non-performing loans remains on the EU's political agenda. In July 2017, the Council adopted special provisions for non-performing loans, calling on the Commission to prepare legislative work on the development of secondary markets for NPLs or to review the effectiveness of national insolvency systems for loans. The creation of a 'bad bank' that could accelerate and simplify bank restructuring would be a politically appropriate price to pay. Unless the situation in the banking sector improves significantly, the economic situation in southern Europe is unlikely to recover any time soon. However, if no EU-wide solution to the banking problems in Italy is sought, such as a 'bad bank' for the eurozone, current and future Italian governments will be forced to exploit loopholes in the banking union's legal framework and pump public funds into the banking system. The result would be a further deterioration of Italy's public finances.

Moreover, the third pillar of the banking union, the European Deposit Insurance Scheme (EDIS), should be finalized. Support should be given to Finland's proposal to establish a set of conditions for the EDIS. This includes risk mitigation which is to be achieved by measuring shares of NPLs or government bond holdings against bank capital. These measures might encourage the countries concerned to address problems in their banking sectors.

Expected German 'Takeover' of the ECB

The issue of what influence Germany has and should have on eurozone institutions, in particular on its strongest institutional actor, the European Central Bank, will be raised in the current political cycle. The President, the Vice-President and two other members of the Executive Board of the ECB must be replaced between 2018 and 2019. The battle for the ECB's top positions will flare up in 2018, at the same time as the discussion on the future of monetary union.

For the German public, who sees the adverse effects of its expansionary monetary policy, having the current Bundesbank President assume the highest ECB office could be a reassuring signal. In addition, if expansionary monetary policy came to an end under a new German ECB President, this could be communicated as a success at the national political level.

However, such a scenario might also be dangerous for Germany: Firstly, this appointment would strengthen European perceptions that Berlin dominates decision-making in the eurozone. Secondly, in the event of a renewed economic downturn, Germany would be given primary responsibility for ensuring the survival of the single currency. Even if the ECB President were to come from Germany, he or she would be in a minority position in the ECB's Governing Council and leading a bank involved in path dependency. Since the ESM does not yet have sufficient financial resources and eurozone Member States are not prepared to share sovereign debt, in a crisis, the ECB will be expected to intervene. Any signs to the contrary from Frankfurt would seriously undermine confidence in monetary union. As long as there is a lack of fiscal integration, the ECB will continue to play a dominant role in stabilizing the eurozone. What's more, the ECB may be forced in the future, under German leadership, to make a judgement on a country's eurozone participation by deciding whether or not to provide emergency liquidity to banks in that country.

In view of all this, the pros and cons of the ECB presidency should be considered pragmatically. A central bank president from a smaller northern European eurozone Member State (such as Finland or a Baltic state), backed by a vice-president from southern Europe, might be a better alternative.

Outlook

Germany, which benefits most from the single currency because of the strength of its exports, would bear the highest costs and risks of further integration. The most plausible scenario would be for Germany to progressively promote fiscal integration in parallel with structural reforms in Italy and France, as these represent the greatest risk to the eurozone in the short and medium terms. However, this is and will not be easy. The experiences of Italian Prime Minister, Matteo Renzi, in his country have shown that it is very difficult to keep such large and politically unstable economies on track for reform. One major problem is society's mistrust of the 'traditional' political classes. Populists still have a great deal of influence in Italy. In addition, among EU-19 members, Italy's population is the most sceptical about the benefits of eurozone membership. It is therefore essential in the debate on the southern eurozone to persistently remind the public of the benefits of the single currency and the enormous costs of alternative scenarios.

French President Macron sees labour market reforms and fiscal discipline as prerequisites for negotiations with Germany on greater redistribution and the introduction of more demand-driven mechanisms in the eurozone. Expectations were high, especially in Paris, that Berlin would be ready for greater flexibility after the general elections. After the autumn round of the European semester, French budgetary policy does not look convincing. Instead of declining, its structural balance will deteriorate in 2018. The Commission's assessment of France's budget for 2018 was that it finds itself at high risk of a non-compliance with the benchmark for debt reduction in 2018. This weakens France's position in talks with the new government in Germany. Coupled with persistently high levels of sovereign debt in Italy, this calls into question their ability to sustain this debt if expansionary monetary policy and the current phase of stable economic growth come to an end. When the next financial crisis hits, the EU's main anti-crisis strategy will be based on the ECB's monetary policy instruments. However, it is unclear whether these instruments will be as effective as they have been previously. The most important factor stabilizing the eurozone is the conviction of policy-makers in all eurozone countries, including Germany, that everything possible must be done to maintain the single currency. The latest Eurobarometer surveys in December 2017 show that confidence in the eurozone is growing in line with the positive development of the economic situation.

The political situation in Germany will have a significant impact on reform ambitions in the eurozone. The collapse of negotiations on a Jamaican coalition could have a positive impact on the prospects of eurozone reforms. A new grand coalition or minority government could simplify the creation of room for agreement between Paris and Berlin on new investment spending in the eurozone through a common budget and the development of the ESM. Much will depend on the extent to which the SPD raises eurozone issues in negotiations with the CDU/CSU on a possible minority government or grand coalition. The fact that Germany is expected to be governed by a transitional government until February 2018 will put a dampener on the debate over reforms. According to Donald Tusk's proposed timetable for the leadership agenda, the European Council meeting in June 2018 will need to take concrete decisions on eurozone reforms. However, it is increasingly doubtful if this deadline can be met.

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