CRISIS AND REFORM OF THE EUROZONE

How we can mend the North–South divide

Andrea Boitani/Roberto Tamborini
March 2020

FRIEDRICH EBERT STIFTUNG

There is now general agreement among international scholars, authorities and even political leaders that reforms of the euro-zone architecture are necessary, ideally aimed at fostering **further integration** on the grounds of (at least) economic policy and governance. This claim has been endorsed by the top European institutions, with the Juncker Commission taking the lead of the reform agenda, and the new Commission approving some proposals.

Behind this general plea for »more Europe«, however, divergences loom large. The cleavage is normally represented in geographical terms, with the Northern euro-zone countries on one side and the Southern euro-zone countries on the other. Our reflections »from the South« are in line with this approach, although it is clear that divergences have to do more with economics and politics than with geography. As a matter of fact, suspicion runs high and mutual trust runs low between southern and northern euro-zone countries. In these circumstances it is extremely difficult to reform the euro-zone rules and institutions, while the scene is set for populist, sovreignist and anti-European movements to thrive. The very existence of the euro zone and of the EU is in jeopardy.

The aim of this paper is twofold. We attempt first to **understand the crisis and its mismanagement** by appealing to a »consensus view« that has progressively emerged, mainly around »mainstream« economic principles, which, admittedly, are not those referred to by »hardliners« in the northern or the southern euro-zone countries. This effort will help the reader to focus on why we disagree and to find out whether and how agreement can be reached. Second, we try to build on this common narrative in order to **identify possible consensus changes to the euro-zone rules and institutions**.

While there is broad agreement on the ingredients of the crisis, the narrative prevailing in the northern euro-zone countries downplays the dimension of institutional mismanagement of the crisis to emphasise the responsibilities of individual countries (notably the southern euro-zone countries, due to their fiscal indiscipline and loss of competitiveness), whereas the southern euro-zone countries predominantly put things the other way around. Our take from the consensus view is that **the crisis originated in the United States** and spread across the world, but that there was indeed a dramatic »**Europeanization**« – mainly through private financial channels – that was exacerbated and prolonged by the **interaction of the flaws** inherent in euro-zone governance and structural factors in both the southern and the northern euro-zone countries. These factors specific to different countries also caused their different responses in the course of the crisis.

Was the crisis mismanaged? Was mismanagement responsible for deepening the crisis? Are there lessons to be learned? These questions, too, are a matter of disagreement between the southern and the northern euro-zone countries, whereas we highlight three points of convergence among international observers. **Fiscal austerity was imposed too early, too much and uncoordinated.** The result was a pro-cyclical and counter-productive fiscal consolidation that led to a second recession after 2011 and an increase in the debt-to-GDP ratio in those countries where austerity measures were most severe. **The absence of common financial backstops** paved the way to public involvement in the private turmoil, fears of the insolvency of highly indebted sovereigns, and the rise of redenomination risks. **The ECB was left to fight the crisis alone,** even though it is well known that monetary policy and fiscal policy should be coordinated.

Consequently, while it is often said that the only way out of the present euro-zone maze is »more Europe«, **there are two different »more Europe« reform models**. One is the **Maastricht 2.0 model,** which seems more akin to the northern euro-zone countries, whereby the doctrine of exclusive national responsibility is reaffirmed, the Fiscal Compact is elevated to the rank of EU legislation and further sovereignty is devolved to supranational technocratic agencies with a clear mandate to enforce the rules vis-à-vis national governments. In this model, market discipline has a prominent role, while risk sharing is strictly subject to prior risk reduction on the part of financial institutions and sovereigns. Though seemingly reasonable, the two-stage strategy hinges on uncertain foundations. In fact, according to the classic theory of risk, the distinction between risk reduction and risk sharing is pointless: risk sharing is the means of reducing risk. A second weakness of the two-stage strategy arises if it is recognised that financial risks are to some extent endogenous: if there are many banks with non-performing loans that are forced by regulators to sell them at once, the effect is that the interbank market shrinks, prices plummet, volatility increases, and the market value of bank assets falls. These effects make the whole system more risky.

Implementation of the Maastricht 2.0 model would not solve the euro-zone problems brought to the forefront by the crisis, besides being hardly acceptable to southern euro-zone countries. As an alternative we put forward the **Confederal and cooperative model,** on which both the southern and the northern euro-zone countries might agree. This model is based on the premise that better rules are not enough: **new common institutions are necessary**. Key to overcoming the mistrust that permeates the euro-zone reform process is finding the right institutional model within which the reformed euro zone should be framed. This, in our view, should consist of a supranational upgrade towards **sovereignty sharing**. That is, neither further devolution of sovereignty to technical entities that are supposed to mechanically enforce rules, nor extensions of the disorderly intergovernmental approach that seized the helm during the crisis. Instead, the pursuit of cooperative policies and controlled discretion need political control on the part of a genuine supranational policymaking institution with transparent democratic legitimacy.

Within this new institutional setup, all countries should subscribe that:

(i) euro-zone members can only be **united in diversity;** there is no one-size model of the economy and society that fits all, nor can it be forced top down;

(ii) a monetary union needs a **commitment to fiscal discipline;** debts should be under control and cuts must be made where and when necessary; no new structural current expenditure should be permanently debt financed;

(iii) to this end, **fiscal rules are needed,** albeit simple, transparent and counter-cyclical fiscal rules;

(iv) **rules are aimed at disciplining discretion,** not suppressing it entirely (which is impossible anyway in the governance of a complex, evolving system);

(v) **common tools for macroeconomic stabilisation and growth** are necessary because our economies, and societies, are interconnected, and pretending the contrary is nonsense; hence a **true and serious common budget** is also necessary;

(vi) **private–public financial stability** needs risk sharing (a request of the southern euro-zone countries); in turn, risk sharing should proceed with risk reduction (which is what the northern euro-zone countries want).

In particular, political reformers should accept the view (fairly common among mainstream economists) that fiscal discipline and fiscal rules (which are necessary) in a monetary union require a common budget. Indeed, fiscal rules – even better conceived fiscal rules – may reduce the (national) fiscal space in those countries more in need of implementing expansionary policies after a negative shock.

The first building block of such a common fiscal capacity should be a European (or euro-zone) **unemployment insurance scheme** funded by each member state in proportion to its GDP. This scheme is supported politically by the German finance minister Olaf Scholz, and also present in the Mission Letter to the new Commissioner for the Economy. With such a scheme only cyclical changes in unemployment (beyond a given threshold) would be financed by the euro zone or EU funds. Countries that in bad times receive more than they have contributed should scale up their contributions when recovery is under way in order to pay back the fund and ensure that no permanent transfer between countries takes place.

Another prominent component of the euro-zone budget should be addressed at **public investments,** as the Mission Letter to the new Commissioner for the Economy, again, puts starkly: »You will coordinate the launch of the future **Invest-EU programme** and ensure it contributes to our overall objectives, notably on climate neutrality and the digital transition. Building on this approach, you will also set up and implement the **Sustainable Europe Investment Plan**.«

The final key arm of the common fiscal capacity, which combines a wide selection of proposals, is **backstops against systemic financial crises**. Paradoxically, this is the area – the so-called Banking Union – in which the reform process first started amid the crisis, but which political negotiations have since put on a slow motion track. Paralysing controversies concern the »details« of the two main institutions on which general agreement exists in principle: a **common deposit insurance,** and a **»European Monetary Fund«**. The moral-hazard problem, apparently of overwhelming importance to the northern euro-zone countries, is addressed in all the numerous technical proposals lying on the table. A simple idea at the basis of insurance is that contributions to the capital of common insurance entities should be commensurate, not with the size, but with the riskiness of the member countries. Yet this is the field area in which mistrust matters most, and challenges political will and leadership.

Besides country-level mechanisms, **coordination of national fiscal policies and a common fiscal stance vis-à-vis monetary policy** is necessary. Saying that this would jeopardise the holy independence of the Central Bank is philistine. Especially when it is the Central Bank itself, in line with the »new conventional wisdom« that is demanding more active and coordinated fiscal policies in order to overcome the limits of monetary policy in the face of today's challenges. Defining a fiscal stance for the euro zone and individual member countries should be at the heart of such a fiscal policy coordination, in order to make the euro-zone fiscal framework more symmetrical.

Cooperative policies should be envisaged **vis-à-vis political control** over them that should be retained and exerted by (representatives of) national governments. The creation of a **»European Minister – or better, Ministry – of Economy and Finance«** therefore seems consistent with the reform proposals examined so far. A lot of stumbling blocks stand in the way. The two matters that need to be dealt with first are how this new body should be appointed and with what mandate and powers. As already stressed, this innovation requires a clear commitment by all parties to create genuine supranational policymaking **institutions** with transparent democratic legitimacy (that is, members backed by a national political mandate), general rules as guidelines, and a controlled and disciplined scope for discretion.

Genuine reformers will need the credible determination to present all other players with a clear-cut alternative: either serious reform must be begun here and now, with all the necessary ingredients – some that the South dislikes and some that the North dislikes – or everyone will have to take their own share of responsibility for saying »No« to a genuine and sustainable European Economic and Monetary Union.

This paper is a short summary of a comprehensive study by Andrea Boitani and Roberto Tamborini:
CRISIS AND REFORM OF THE EUROZONE. Why do we disagree? A reflection paper on the North-South divide
FES Italia 2020

CONTACT

Fondazione Friedrich Ebert

Piazza Capranica 95, 00186 Rome, Italy

Phone: ++39 06 82 09 77 90

info@fes-italia.org
www.fes-italia.org
Facebook: **@FESItalia**