

A stylized map of Europe composed of a grid of dots. Most dots are light gray, but several are colored red, highlighting specific regions or countries. The title 'Mapping Future Scenarios for the Eurozone' is overlaid on the map in a large, bold, blue font.

Mapping Future Scenarios for the Eurozone

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- The Eurozone is facing a systemic crisis with far-reaching consequences for the future of the Economic and Monetary Union, European integration and Europe in the world.
- Economists and political scientists, besides politicians are groping around in the dark looking for a solution to the crisis and to bring the Eurozone into calmer waters.
- Identifying the main factors influencing the future development of the Monetary Union allows us to produce various scenarios on how the Eurozone will look in 2020.
- Four major scenarios are conceivable. (i) The Member States can continue trying to muddle-through by means of crisis management, which may lead to the break-up of the Monetary Union; (ii) another variation of this leads to further reversals with regard to political integration; (iii) a specific combination of factors might lead to a two-tier Europe with a small hard core of Member States; alternatively, (iv) (some of) the Member States may press on to complete monetary union by means of a fiscal and political union.



Foreword	3
Introduction: Mapping Scenarios for the Eurozone	4
1. Framing a scenario analysis of the Economic and Monetary Union	4
2. Assessing the Evolution of the Economic and Monetary Union	5
2.1 EMU: An Unfinished Building	5
2.2 Difficult Interaction between Growth and Fiscal Consolidation Policies	6
2.3 The Financial Crisis Exacerbating the Eurozone Crisis	7
2.4 The Eurozone Crisis in Five Acts	7
2.4.1 Greek crisis, EFSF and Reform of Economic Governance	8
2.4.2 Domino Effect, European Stability Mechanism and Euro-plus Pact	8
2.4.3 The Austerity/Growth Trap, Reform of the EFSF and a New Package for Fiscal and Economic Coordination	9
2.4.4 Need for a More Comprehensive Solution	9
2.4.5 More Serious Downrating, New Inter-governmental Treaty and Agenda for Growth	10
2.5 A New Framework, But Still Many Problems	10
3. Identifying the Key Factors Shaping the EMU's Future	13
4. Possible Directions for the Selected Factors of Influence	13
5. The main scenarios for EMU development	14
5.1 Ways out of the crisis and stories about the future	14
(a) European Hierarchy and Differentiation	15
(b) European Dragmentation and Disintegration	15
(c) Fiscal Union with Smaller Core Group	15
(d) Fiscal Union in the EU	16
5.2 Scenarios for EMU evolution	16
Scenario A	16
Scenario B	17
Scenario C	18
Scenario D	19
Epilogue	20

Foreword

The crisis of the Economic and Monetary Union (EMU) has dogged and determined Europe's political agenda for over two years now. During this time not much has improved but a great deal has got worse. Greece's sovereign debt problems that came to light in 2010 appear, as things stand today, as rather a minor aspect of a crisis that in the meantime has only become more and more distended. Instrumental in this escalation has been an approach to crisis management that now threatens the very existence of the Monetary Union. Economists and politicians have endeavoured to explore this unknown territory in various directions. Some have clung to the convictions that found expression in the Maastricht Treaty at the founding of the EMU, while others have rejected this as a means of navigation in light of the outcome and have proposed alternative paths. Ultimately, however, they are all groping around in the dark trying to cope with a titanic crisis they as yet barely comprehend.

Crises of refinancing, sovereign debt, banking and solvency that can scarcely be disentangled from one another go hand in hand with

- increasing loss of market confidence in the common currency;
- social hardship, such as the explosion of youth unemployment in some states as a consequence of crisis management;
- the questionable democratic legitimacy of some of the new instruments and procedures introduced to deal with the crisis; and a shattering of people's confidence in the ability of the EU and its institutions to solve problems.

In this situation, in which also the future course of European integration depends on the outcome of the crisis and how it is dealt with, peering at the fine-print is no longer sufficient. What is really needed is to gather up the different pieces, such as bank bailouts, austerity measures, loan guarantees and many other aspects so that the situation can be viewed as a whole.

EMU's future shape is today more uncertain than ever. No one is able to look ahead and predict how the crisis will run its course and how it can be managed. What we can do, however, is to look at development scenarios

that present various narratives of the possible directions the crisis might take. This is the approach taken by the Friedrich-Ebert-Stiftung in its project »**EMU 2020: Future Scenarios for the Eurozone**«. The modelling of different development paths gives rise to a range of visions of EMU's future. The aim is to furnish crisis management with strategic resources to enable it to cope better with unforeseen events and not lose sight of the bigger picture.

The present study by **Professor Maria João Rodrigues** is the first result of an intensive pan-European exchange of views on the decisive development factors, their possible evolution and scenarios for the future shape of the Eurozone arising from their combination. Representatives of academia, politics and civil society have contributed to an analysis of the future scenarios presented here in discussion rounds and a workshop at the FES's Brussels Office. The options range from continuing to try to muddle through to completing EMU with a fiscal union, if only within the framework of a core-Europe scenario. And realistically, even the break-up of the Monetary Union cannot be ruled out.

In the course of 2012, the scenarios presented here will be evaluated and constantly developed in numerous workshops and conferences at various FES locations all over Europe. This will enrich the discourse on policy options in the crisis, both at national and European level. Hopefully, this will help to establish clear positions for or against individual scenarios and thus heighten the awareness of the actors involved in plotting the future course of the Eurozone and of European integration.

Björn Hacker

International Policy Analysis

Introduction:¹ Mapping Scenarios for the Eurozone

The Eurozone is facing a systemic crisis with far-reaching consequences for the future of the Economic and Monetary Union, European integration and Europe in the world.

The aim of this report is to map future scenarios for the Eurozone, taking into account in particular the impact of the current crisis on reshaping the Economic and Monetary Union over the long term. The chosen time-horizon is medium-term – 2020 – also with reference to the Europe 2020 Strategy for growth and jobs and the next Community budget. The chosen year also follows the second European elections in 2019, the first one taking place in 2014: both will be critical in shaping the direction of Europe.

The main purpose of this report is to provide a clearer framework for an organised discussion on the longer term implications of various policy choices that can be made today in response to the Eurozone crisis. This framework should be built up step by step, submitting each step to the assessment of experts and policymakers, whose viewpoints are likely to differ.

In accordance with well-tested scenario-building methodologies, the following questions must be addressed:

- How should a scenario analysis of the Economic and Monetary Union be framed?
- How has the Economic and Monetary Union evolved to date?
- What are the key factors that can shape the future evolution of EMU?

- In what directions may the selected shaping factors evolve?
- What are the possible main scenarios for the evolution of EMU?

1. Framing a scenario analysis of the Economic and Monetary Union

Our object of analysis must be EMU's evolution, together with its implications for the Member States, the European Union and Europe's position in the world.

Our time-line will cover the period before, during and after the crisis, in terms of a shorter but also a longer perspective up until 2020.

The analysis will necessarily be multidimensional and multilevel, as presented in Table 1:

- *multidimensional*, because we need to encompass in particular the following dimensions of EMU evolution: monetary, financial, public-finance, economic, social and political;
- *multilevel*, in particular the national, European and international levels.

The features to be analysed will be not only measurable trends – for example, economic or financial – but also the relevant institutional frameworks and political interaction between the most important actors.

As this is a particularly complex object of analysis, some effort towards »strategic simplification« will be made (with the author taking full responsibility). This is unavoidable, as we are dealing with a crisis mobilising thou-

Table 1: Framework for analysing EMU's evolution

DIMENSIONS LEVELS	MONETARY	FINANCIAL	PUBLIC FINANCES	ECONOMIC	SOCIAL	POLITICAL
NATIONAL						
EUROPEAN						
INTERNATIONAL						

1. The statistical data that provide the basis for this analysis were prepared by Anthony Ferreira. The statistical annex to this publication is available at: <http://www.fes.de/cgi-bin/gbv.cgi?id=09193&ty=pdf>.

sands of key political actors and generating dozens of new policy instruments, with implications for many other fields, which are analysed in accordance with a range of explanatory theories.

This complexity and strategic simplification are reflected in Section 2, a short but intensive history of EMU. Subsequently, we can start to fill in Table 1 with our choice of the main shaping factors to be taken into account when building up scenarios.

2. Assessing the Evolution of the Economic and Monetary Union

There are many different ways to tell the story of the Economic and Monetary Union (EMU). In this paper, we intend to highlight the constant search and conflicting views underlying this story, identifying the key problems and possible solutions, across all the different phases of EMU's development. Naturally, we shall go into particular detail concerning the most recent phase, the Eurozone crisis, dividing it into several sub-phases in order to make it easier to identify the main factors that might shape the future: socio-economic trends, institutional developments and key actors. **These shaping factors and their interaction will provide the framework for building more accurate future scenarios.** As described in Section 1, our approach will be multidimensional, connecting the monetary, financial, fiscal, economic, social and political dimensions, and also multilevel, analysing the interplay between the national and European levels, but also the international one.

2.1 EMU: An Unfinished Building

The political decision to introduce a single currency for Europe was the logical corollary of the creation of a European single market, but also a solution to the constant tensions experienced by the European monetary system: the freedom of capital movement was not compatible with autonomy of exchange rates, monetary and fiscal policy. The adoption of a single currency was also supposed to increase Europe's strategic autonomy with regard to the US dollar in an era of increasing financial market globalisation. That said, the creation of a single currency in such a diverse continent was perceived as a daunting task: an irreversible process of nominal conver-

gence towards lower interest rates, inflation and public deficits, involving the creation of a European Central Bank with exclusive competences with regard to monetary policy and strengthening the coordination of national fiscal policies, while setting the right balance regarding the potential and demands of the German economy and other national economies at different stages of competitive and social development.

Some analysts warned of the risks of trying to introduce a single currency in what was probably not an optimal currency area, but an alternative approach emerged, arguing that these risks could be overcome if nominal convergence was complemented by strong action for real convergence, to be supported by regional cohesion policies. In any case, some assumed, current account imbalances would no longer be so important under the new conditions of a common monetary zone, as capital would flow in search of the best opportunities for profitability, thus favouring the catch-up regions.

In parallel, at the heart of EMU design, there was another dispute concerning the relative calibration of the monetary and economic aspects, with victory ultimately going to those focused on controlling inflation and demanding tight fiscal discipline, reflecting monetarist influences. Therefore, the monetary side was defined in detail and became dominant in the statutes of the European Central Bank, while the economic side was confined mainly to coordinating fiscal policies in terms of fiscal discipline, disregarding other fiscal objectives, such as growth or equity. This is clearly visible in the Maastricht Treaty (1992) which created EMU, defined the ECB statutes and introduced the broad economic policy guidelines (BEPG). The same applies to the Stability and Growth Pact which was adopted in 1997 to provide the German government with more guarantees before the launch of the euro. The word »growth«, which was introduced at the last minute under pressure from the recently elected socialist French government, was scarcely translated into more precise prescriptions.

Also significant was the attempt to balance this unbalanced Stability and Growth Pact with a new Pact for Employment, which commits all Member States to converge to lower unemployment rates in parallel with their convergence towards lower public deficits. This attempt, led by Prime Minister Jean-Claude Juncker during the Luxembourg Presidency of 1997, failed in the face of

German and Spanish rejection and was transformed into a softer approach requiring the Member States to converge on the same qualitative political priorities. These would become the employment policy guidelines in the framework of a European Employment Strategy, which was subsequently enshrined in the Amsterdam Treaty.

The final outcome of these disputes were the original features of a EMU with a strong monetary aspect and with a weaker economic aspect, overlooking the role of economic and employment policies and focusing mainly on a fiscal discipline which was not smart and precise, but rather rigid and weak.

2.2 Difficult Interaction between Growth and Fiscal Consolidation Policies

The Member States were still engaged in coordinating their fiscal policies by defining national Stability and Convergence Programmes when a European strategy for growth and employment was produced, known as the Lisbon Strategy. The aim was to adapt Europe to the new global context marked by global competition, the information revolution and demographic ageing. Originally, this strategy comprised four pillars: investing in knowledge, education, research and innovation; completing the single market; updating welfare systems; and using macroeconomic policies to foster sustainable growth. However, the fourth pillar, to be based on the broad economic policy guidelines, always resisted inclusion in a more comprehensive strategy: the intention behind it was to protect the autonomy and, indeed, the dominance of fiscal policies over all other economic and social policies.

In the course of five years of disputes, notably between Ecofin, on one hand, and other Council bodies, on the other, with the European Council making the final decision, a new language was developed to increase policy coherence between fiscal consolidation and growth policies: they were said to be »mutually reinforcing« and there was frequent talk of »redirecting« public spending to support the Lisbon goals. There was a deeper discussion on the sustainability of public finances in the face of demographic ageing and on the quality of public finances with regard to supporting smart investment. Several structural reforms in pensions, education and em-

ployment were identified to ensure sustainable public finances.

This promising discussion was downplayed in the face of fiscal policy abuses with a pro-cyclical orientation (increasing deficits during higher growth periods) which led to the famous conflict between Germany and France and the Prodi Commission, involving the European Court of Justice. A revision of the Stability and Growth Pact was launched in 2005 under the Luxembourg Presidency. These debates were reflected in this revision of the Pact, which contained a long list of factors to be taken into account by the European Commission when assessing excessive public deficits. The overall positive outcome, beyond several counterproductive ambiguities, was to give Member States more time to reduce excessive deficits if they proved able to »redirect public finances towards the Lisbon goals«.

In the meantime, the mid-term review of the Lisbon Strategy was undertaken in 2005, after problems came to light concerning implementation due to lack of »ownership« and insufficient financial and political resources. This led to a significant reform of governance: the Strategy is supposed to be translated into the economic and employment guidelines and the Member States are to prepare National Reform Programmes for growth and jobs, which should interact with the existing Stability and Convergence Programmes for fiscal consolidation.

This reform of the governance of the Lisbon Strategy for growth and jobs is intended to pave the way for more consistency and synchronisation between fiscal, economic and social policies. In fact, it is the current »European Semester« in embryo. Nevertheless, the mid-term review also turned the Lisbon Strategy in a more controversial direction, weakening its social and environmental pillars and neglecting the role of macroeconomic policy in supporting sustainable growth, as well as the need for further investments in pursuit of a smarter and greener economy. The Strategy was refocused on structural reforms mainly concerned with fiscal consolidation and competitiveness, but overlooking, for instance, what was happening in the financial markets.

2.3 The Financial Crisis Exacerbating the Eurozone Crisis

Europe was caught by surprise by the financial crisis of 2008. At first, it was assumed that the continent would better resist the shock due to its positive fundamentals: sound public finances, balanced current accounts, strong welfare systems and more responsible financial systems. But the scope of the shock was so extensive that soon Europe also had to face the fact that exceptional measures were urgently needed to avoid a general financial meltdown and to prevent the recession turning into depression, with catastrophic social consequences. Hence, the EU along with the United States and other global partners have engaged in unprecedented international coordination to rescue and regulate the financial system, including enormous economic stimulus packages to try to kickstart economic and social recovery. The G20 was created in November 2008 and adopted an ambitious agenda in London in April 2009 (under British Prime Minister Gordon Brown) and in Pittsburgh in September 2009 (under President Obama).

In parallel, the EU launched its European Recovery Plan at the end of 2008, mainly aggregating the various national stimulus packages. By that time, a major European debate was under way on the need to strengthen coordination between national packages in order to make the best of their spillover effects, as well as to create new European instruments to foster Europe-wide investments, notably in greening the economy and workforce re-skilling. In that way, the crisis could be turned into an opportunity to speed up the transition to a new growth model: greener, smarter and more inclusive. It is useful to recall that, by that time, the successor of the Lisbon Strategy – namely the Europe 2020 Strategy – was already in preparation and pointing in the direction of this new growth model.

Nevertheless, with a few exceptions, political and financial constraints in Europe hindered progress. European coordination was weak, also due to problems ratifying and implementing the Lisbon Treaty and the uncertain outcome of European elections. Furthermore, the rescue of the distressed banks became much more expensive than expected, absorbing significant shares of the rescue packages. One criticism often heard at that time was that there was a clear dilemma: either European integration must respond to the crisis or the financial crisis will

undermine European integration. But no one could have guessed how prescient this warning was.

When Europe was able to overcome the recession, in which average GDP growth was –4 per cent, the average unemployment rate had reached 10 per cent and the average public deficit was 106.6 per cent of GDP, meaning that most member states were subject to the excessive deficit procedure. By that time, the implicit agreement to pay little attention to this fiscal problem, reached in 2008, had been shelved and new concerns about sovereign deficits and debts emerged under the label «exit strategy». But how could the Member States reduce their exceptional fiscal stimuli without undermining recovery? A new debate has emerged: some assert that fiscal efforts should be maintained with regard to key investments and job creation, while others argue that many member states can no longer afford such efforts and a clear shift towards austerity is needed.

This was the background discussion when the first reforms of the European economic governance were proposed by the European Commission. They focused on new mechanisms to ensure fiscal discipline, notably by making the National Reform Programmes to implement the Europe 2020 Growth Strategy more consistent with the Stability and Growth Pact and its Stability and Convergence Programmes. A new attempt was to be made to limit the growth agenda to a structural reform agenda with the goal of fiscal consolidation. This main concern was also clearly reflected in the Annual Growth Survey proposed by the European Commission to initiate implementation of the Europe 2020 Strategy in 2010. History often repeats itself: the forms may be new, but the underlying forces are similar.

2.4 The Eurozone Crisis in Five Acts

At first it seemed to be a sovereign debt crisis in a peripheral country, Greece, but it grew into a systemic crisis of the Eurozone and, even worse, a crisis of European integration, demanding a comprehensive overhaul of the Economic and Monetary Union. It is important to understand the interplay of problems and responses that have driven Europe to such a situation. It is not easy to sum up such an intensive period in a few pages, but understanding this interplay will be crucial to the development of accurate scenarios.

2.4.1 Greek crisis, EFSF and Reform of Economic Governance

After the general elections of 2009 in Greece, won by the Socialists, the new government, led by Georges Papandreou, discovered that the public deficit and public debt were much higher than expected, as a consequence of which the country faced much higher debt refinancing costs. Greek default could seriously damage several European banks, bring disaster to the Greek economy and trigger a domino effect. The Greek call for support was received with apprehension and positions ranged from pledges of solidarity to harsh criticisms of Greek »irresponsibility«. The special informal European Council in February 2010, convened by new President Herman Van Rompuy for a long-term reflection, was taken up by an urgent discussion on possible responses to the Greek problem. The European Council's final position stated the need to combine national responsibility with European coordination and solidarity, but it remained vague on concrete solutions.

In fact, opinions differed considerably between the member states: some proposed the IMF as the main solution, while others advocated a Community response, and yet others considered an ad hoc solution on an inter-governmental basis, stringent enough to discourage any repetition of this event and to rule out moral hazard. First discussions of a possible European Monetary Fund were thus initiated, although it was also pointed out that an appropriate Community instrument was already available, making it possible to provide conditional loans and issue euro-bonds to finance them, which was being used to support non-Eurozone Member States. It would be enough to adapt this to the Eurozone members. This was the European Financial Stabilization Mechanism (EFSM), managed by the European Commission and using the Community Budget as collateral.

Over the next few months a painful tale unfolded as a new solution was sought in the teeth of strong disagreements about how to adapt the Community instrument. The main arguments concerned incompatibilities with both the Lisbon Treaty and the German Constitution (Basic Law). After an emergency loan agreed at the March 2010 European Council, a final agreement was reached at an extraordinary European Council in May to create a special instrument to be known as the European Financial Stability Facility (EFSF), based on national guarantees and

inter-governmental decisions, able to issue Eurobonds to mobilise resources with a view to providing loans with strict conditions and at high cost. Furthermore, it was also decided that negotiations on this new instrument should depend on parallel negotiations on economic governance which were under way in a special Task Force chaired by Herman Van Rompuy, dealing with fiscal discipline and macroeconomic imbalances. These three issues became the core of EMU reform, which would have numerous ramifications over the coming period: solidarity in debt management was pitted against more fiscal discipline and reforms to boost competitiveness.

2.4.2 Domino Effect, European Stability Mechanism and Euro-plus Pact

By summer 2010 the Greek problem seemed to be under control, even though borrowing costs remained high, fuelled by speculation in credit default swaps on Greek sovereign debt and by successive downgrades announced by the main rating agencies. Greece's debt refinancing had been partially removed from the markets thanks to a loan conditional on a tough reform plan to reduce Greek debt and shore up the national and European banks holding Greek debt. But many doubts remained regarding the effectiveness of this solution, from the respective viewpoints of Greece (could the debt burden be reduced without growth?), the creditors point (would they get their money back?) and the guarantors (was there a risk they would lose their pledges and thus that they would have to make a real transfer to Greece?).

In parallel, the negotiations on economic governance were moving forward and a new legislative package was taking shape with the participation of the European Council and the European Parliament to strengthen fiscal discipline and develop new macroeconomic surveillance. Furthermore, the EFSF was to be converted into a permanent mechanism to be called the European Stability Mechanism (ESM). In a bilateral summit in Deauville between Merkel and Sarkozy (such summits have become commonplace on the eve of all European summits) a deal was struck to fine-tune this package: the sanctions of the revised Stability and Growth Pact would be only semi-automatic (to satisfy France), whereas the new ESM should comprise the possibility of (organised) sovereign default in the Eurozone (to satisfy Germany).

This deal has led to new uncertainties in the financial markets and deepening doubts about the debt sustainability of the national cases with more vulnerabilities. A domino effect was triggered raising borrowing costs in several other countries. Ireland was the first case under the spotlight, the country suffering from a severely unbalanced banking system, followed by the Portugal, suffering from chronically low growth, Spain, hit hard by the bursting of its housing bubble and new doubts arising about the sustainability of Italian debt. By Christmas 2010, the focus of discussion was the need to strengthen the EFSF to protect also these bigger economies.

Some member states declared that they were unable to increase their financial contribution to the EFSF and proposed instead to step up the creation of the permanent ESM. They also declared that they would implicitly accept a more active role for the ECB in buying these countries' debt, conditional on the commitment of Eurozone member states to a new Pact. This so-called Euro-Plus Pact was signed in March 2011 by all the relevant member states and several others wanting to join the Eurozone. It comprised new commitments to fiscal discipline, reforms to boost competitiveness, national responsibility with regard to bank restructuring and some first steps towards tax convergence. The Spring European Council of March 2011 was the highpoint of this shift by Europe in the direction of an «austerity only approach», combining the Euro-Plus Pact with the European 2020 Strategy focused on the reforms needed to step up fiscal consolidation. The disagreements at the G20 Summit in Toronto were evident, with Europe diverging from its international partners regarding the balance to be established between fiscal consolidation, on one hand, and growth, investment and job creation, on the other.

2.4.3 The Austerity/Growth Trap, Reform of the EFSF and a New Package for Fiscal and Economic Coordination

Fiscal consolidation without growth-enhancing policies reduced GDP in the debt/GDP ratio, making it impossible to reduce the debt burden. Furthermore, debt servicing was being magnified by increasing borrowing costs and successive rating downgrades, despite the reform efforts. This kind of «Greek trap» also threatened other member states despite several announcements of spending cuts and reforms.

Recognition of this problem by the European Council became evident in July 2011 when some announcements were made in support of growth in vulnerable economies and the EFSF was made more flexible, lowering interest rates and loan maturities, and intervening in secondary markets and in the banking system. Despite this progress, pressure started rising on Italy and Spain and the only available response was to pursue ECB support because the EFSF did not have the scope to deal with larger economies, while moving towards partial mutualisation of the debt was not accepted by Germany and other countries. For them, any further steps with regard to the EFSF/ESM would also depend on the final deal in the Council and the European Parliament regarding the so-called «six pack», meaning new legislation on, basically, a revised Stability and Growth Pact and new macroeconomic surveillance.

This final deal came in September, with the adoption of tighter rules for fiscal discipline and tougher sanctions, but with a more balanced and symmetrical approach to macroeconomic surveillance. Furthermore, the European Parliament approved an invitation for the European Commission to present proposals on euro-bonds.

2.4.4 Need for a More Comprehensive Solution

Despite the development of this diversified toolbox, the pressure was increasing on the sovereign debt of more and more member states. Even France's triple A rating was no longer sacrosanct, particularly after the downgrading of US debt over the summer. More and more voices were calling for a comprehensive solution to the Eurozone crisis, which was recognised as systemic. Such a solution would comprise fiscal discipline, economic coordination and Eurozone government. The prospect of debt solidarity also loomed. Pressure for this bolder solution was heightened by the economic indicators, which were pointing out to a European economic downturn even in Germany.

The outlines of this more comprehensive solution were sketched at the summits of October 2011 which designed an informal Eurozone government and defined a mandate for a set of limited changes to the EU treaties. The final deal on the «six pack» was no longer considered enough with regard to fiscal discipline and new mechanisms for this purpose needed to be included in the treat-

ties, more particularly a fiscal »golden rule« aligned with that of Germany, in which the structural public deficit should be 0.5 per cent of GDP. Moreover, the sanctions should become more automatic and involve the European Court. There are two clues to understanding this new move: first, the deal previously made in Deauville was recognised as wrong and to be corrected: the sanctions on fiscal discipline should become more automatic and the ESM more cautious about sovereign defaults; second, the pressure remained high on the insufficient scope of EFSF/ESM to deal with larger economies and a intensive discussion on how to give them some leverage was also taking place, while the calls for eurobonds or for the ECB to act as last resort lender were increasingly urgent.

German resistance again limited this leverage to a new insurance mechanism based on EFSF resources, alongside a special instrument managed with the IMF to attract investment from Europe's main international partners. This call for international support presented by the European leaders at the G20 Summit at Cannes met with a polite refusal, although China held out the prospect of participating at least to some extent in the bailout in return for recognition of China's market status. In any case, by that time the Eurozone crisis and Europe's inability to overcome it had already become a global problem, weakening the continent's international status.

2.4.5 More Serious Downrating, New Inter-governmental Treaty and Agenda for Growth

In the run up to the December European Council which was convened to discuss the Lisbon Treaty changes, the European Commission took the initiative to propose two regulations for stricter fiscal discipline as well as a green paper exploring different possibilities for Eurobonds to be known as »stability bonds«. A central trade-off to be addressed in the negotiations was thus clearly identified. The report on eurobonds got a cold reception from Germany and other governments, while the amendment of the Treaty was being re-focused on other divergences: should the Treaty changes be confined to fiscal discipline or should they also address economic coordination and convergence, as well as Eurozone governance? And who should be involved: all EU Member States, only the Eurozone members or also all those willing to join? This final question became the central focus in and after the Eu-

ropean Council of 2011, as British Prime Minister David Cameron demanded unacceptable conditions for changing the EU treaties, forcing a move to an inter-governmental Treaty. But behind the headlines, negotiations took place over Christmas enabling final approval at the summit in January 2012. The title of the new document changed from a fiscal compact to a Treaty on Stability, Coordination and Governance. Its main implication was to commit 25 Member States to a new golden rule for fiscal discipline directly inspired by the German rule of balanced budgets.

In the meantime, the European economy was facing renewed recession and there was general recognition of the need for a growth agenda. Nevertheless, there was disagreement on priorities: should the focus be on completing the Single Market and fostering structural reforms, or should new instruments be developed to promote investment?

2.5 A New Framework, But Still Many Problems

In conclusion, during this intensive period of political creativity a new framework was developed to address the key problems of the EMU, which can be summed up as follows.

1. *Fiscal discipline* (with new legislation, the Euro Plus Pact and the new Inter-governmental Treaty on Stability, Coordination and Governance):

- a commitment to balanced budgets;
- a new focus on public debt and not only deficits;
- more automatic and tougher sanctions;
- closer monitoring of the Member States under financial assistance;
- many new commitments to structural reforms and spending cuts were made by the Member States.



2. *Financial stability:*

- new regulations for financial systems concerning capital requirements, hedge and equity funds, some derivatives and bonuses;
- new European supervisory bodies and regular stress tests on banks;
- instruments to respond to sovereign debt crisis (EFSF and ESM);
- new roles for the ECB.

3. *Growth (Europe 2020 Strategy):*

- a long-term strategic commitment for smarter, greener and inclusive growth;
- European flagship initiatives;
- national reform programmes;
- an Annual Growth Survey and recommendations for the Member States.

4. *Macroeconomic imbalances (with new legislation):*

- A new process of macroeconomic surveillance to monitor major problems of external and internal economic and social imbalances, with a more symmetrical approach.

5. *Governance (with legislation and a new Treaty):*

- reorganisation of the annual cycle to prepare national budgets and national reform programmes with ex-ante European coordination, meaning more shared sovereignty (European Semester);
- regular Eurozone summits with a permanent President and leading team, including the President of the European Commission and the President of the Eurogroup; a inclusive approach regarding the Member States willing to join;
- involvement of the national parliaments and the European Parliament in the discussion of Eurozone issues;

- more systematic coordination of the EU with its international partners (the IMF and the G20).

The first bloc, dealing with fiscal discipline, was particularly developed, reflecting the balance of power when defining the various problems of EMU and the solutions to be prioritised. For some, the central problem has been the lack of financial discipline and the resistance to key reforms; for others, the main problem has been the lack of supportive conditions for growth, investment and job creation and, more recently, speculative pressure on public debt servicing. Furthermore, for many, the problems have been magnified by a poorly regulated financial system, while others insist that the underlying problem of macroeconomic imbalances is the root of most of the other problems. Finally, most agree that Eurozone governance lags behind the situation calls for, but there is still a range of choices regarding compliance with the Community method or the degree of transfer of national sovereignty to the European level.

Despite these important policy developments, the Eurozone crisis is still going on. The problems include:

- unsustainable debt levels in some countries;
- diverging levels of borrowing costs between countries;
- diverging growth trends, in several instances negative;
- a general trend towards recession and rising unemployment;
- increasing spillover effects for the global economy: the Eurozone crisis has become a global problem;
- political opposition to further European solidarity in some Member States;
- political opposition to more structural reforms, taxes and spending cuts in other Member States;
- a widespread sense of a loss of democratic control over general living conditions. Europe is now perceived by many as strongly shaping their lives, but not susceptible to democratic influence at national level.

In fact, these problems are now so deep and central in many Member States that the exit from this crisis will



Table 2: Main and key factors shaping the EMU's future

DIMENSIONS LEVELS	MONETARY	FINANCIAL	PUBLIC FINANCES	ECONOMIC	SOCIAL	POLITICAL
NATIONAL	Interest rates Inflation rates NATIONAL CENTRAL BANKS	Credit provision Inter-banks Lending NATIONAL BANKS NATIONAL DEVELOPMENT BANKS OTHER FINANCIAL OPERATORS EQUITY, HEDGE FUNDS <u>Break-out of major banks</u>	Public deficit/GDP Public debt/ GDP Public investment Social spending Public debt spreads NATIONAL BUDGETARY LAW STABILITY AND CONVERGENCE PROGRAMMES <u>Default or exit of MS from the euro-zone</u>	Growth rate Employment rate Unit labour costs Investment rate pattern of productive specialisation Export/import rates/ GDP Market shares Current accounts NATIONAL REFORM PROGRAMMES	Unemployment rate Poverty rate Educational attainment Pension level Wage level SOCIAL PROTECTION STRUCTURE COLLECTIVE BARGAINING	NATIONAL FISCAL SOVEREIGNTY <u>Governments, Parliaments</u>
EUROPEAN	Interest rate Inflation rates Exchange rates ECB	Stock exchange indicators Inter-bank lending EIB Financial regulations EUROPEAN FINANCIAL SUPERVISION BODIES EFSF/ESM	Public deficit limit Public debt limit Medium-term objectives Exceptions to be considered STABILITY AND GROWTH PACT Voting procedures Control procedures COMMUNITY BUDGET Spending priorities Own resources	Growth rates Employment rates Low carbon economy R&D investment Export/import rates Market shares Current account MACROECONOMIC SURVEILLANCE EUROPE 2020 STRATEGY EUROPEAN PLAN TO SUPPORT INVESTMENT	Unemployment rate Poverty rate Educational attainment EMPLOYMENT GUIDELINES	EU BUDGETARY COORDINATION EU TAX COORDINATION EU FISCAL AUTHORITY EU COORDINATION OF ECONOMIC AND SOCIAL POLICIES <u>European Council, Council, European Commission, European Parliament</u> <u>European elections</u>
INTERNATIONAL	Interest rates Inflation rates Exchange rates IMF G20	Stock exchange Indicators FINANCIAL REGULATIONS <u>Rating agencies</u> FTT IMF G20 Flow of capital investment New speculative bubbles	IMF G20	Growth rates Current accounts WTO G20	ILO G20	IMF G20

shape the future not only of the EMU, but also of European integration and Europe's position in the world.

3. Identifying the Key Factors Shaping the EMU's Future

This retrospective analysis of EMU's evolution will help us to identify the factors which can shape its future evolution. They include key economic and social trends, institutional and policy developments, as well as the interplay between key actors who are driven not only by their relative power, but also by different perceptions of the causes of and solutions to this crisis. Hence, it is not easy to identify the main shaping factors and we present here (Table 2) a first sketch to be successively revised. The main shaping factors are of three different kinds:

(i) the main economic and social trends (in small letters in the table);

(ii) the main institutional and policy developments (in capital letters);

(iii) the main political actors (underlined).

(The key factors are in bold.)

4. Possible Directions for the Selected Factors of Influence

Assuming these are the key shaping factors of the future evolution of the EMU, we must examine how they may evolve.

■ **Borrowing costs on public debt in the Eurozone:** possible outcomes include divergence, increase, divergence between a core group and the other member states or convergence downwards. Some differences would be acceptable, but cumulative divergences of borrowing costs, investment and growth rates and employment rates could lead to the implosion of the Eurozone.

■ **Medium-term objectives for public deficit and debt:** divergence; convergence within limits; failure in several Member States; or convergence downwards. All Member States should reduce their debt burden, particularly those with higher rates. But if there is no growth,

this becomes very difficult. **Growth rates:** divergence; decline; divergence between a core group and the rest; or convergence upwards.

■ **Current account:** surpluses and deficits increase; surpluses and deficits decrease; or surpluses decrease and deficits increase or vice versa. Member States with external deficits should reduce them by strengthening their competitiveness and Member States with external surpluses can boost domestic demand.

■ **Unemployment rates:** divergence; increase; or decrease. This will depend particularly on growth rates but also on demographic trends, including migration trends.

■ **Rating agencies:** divergent ratings; downgrade of all Member States; divergence between a core group and the rest; or upward convergence of ratings. If most Member States are downgraded the euro's credibility will suffer. The risk of a downgrade has become a constant pressure on democratically elected governments. A European rating agency could introduce more balance and pluralism in ratings of public finances and debt sustainability.

■ **EFSF/ESM:** maintain their imbalance regarding fiscal consolidation versus growth; remain weak and are downgraded; increase the stigma for countries receiving assistance; larger-scale bond issuance and debt management. So far, the assistance provided to Member States by the EFSF/ESM has focused on fiscal consolidation, with little concern for growth, pushing the relevant countries to implement austerity policies, thereby contributing to their plunge into deep recession. Moreover, their resources remain limited and they are not equipped to deal with larger economies or directly with banks.

■ **ECB:** under pressure; maintains limited support; reaches the limits of its ability to intervene; reduces support; or returns to a traditional but more balanced role. The ECB's intervention has been extensive and has been decisive in reducing the credit crunch and preventing meltdown of the banking system. But this inevitably has its limits.

■ **IMF and G20:** G20 partners provide support based on tough conditions; cannot provide more support; G20 partners address the EU's internal differences; or the EU's position in the G20 becomes stronger. The EU has asked its G20 partners to provide additional support for rescue



operations. But the other G20 countries are reluctant to oblige unless important concessions are made.

- **European plan for investment:** reduced to structural funds; no; or yes. This is a central building block of recovery which has been ignored so far. But Hollande's victory in France may open up new prospects.

- **Macroeconomic surveillance:** loses relevance; is blocked by internal divergences; puts pressure on deficit countries; or becomes a central and more symmetrical instrument. This new surveillance process should focus not only on Member States with external deficits, but also on Member States with surpluses. Some Member States are opposed to such a symmetrical approach, however. It should be used to improve the macroeconomic coordination of the Eurozone as a whole.

- **National fiscal sovereignty:** transfers only for weaker countries; denial of transfers; fiscal union; fiscal union in a smaller group; or EU fiscal union. A fiscal union would involve some transfer of budgetary sovereignty to the European level. Such a transfer can be more or less democratic and involve more or fewer countries.

- **European fiscal authority:** stronger with regard to weaker countries; weak; strong and democratic. See comment above.

- **Legislative power and democratic legitimacy:** weak in some Member States and strong in others; weak or stronger at European level. See comment above.

- **Collective bargaining:** cannot avoid social dumping of some Member States; cannot avoid general social deterioration; retrenchment of a smaller group against social dumping; or upward convergence of social standards. If there is no convergence of social standards, there is always a risk of social dumping.

- **Political situation in Germany:** no political shift; political shift.

- **General elections in France:** no political shift; political shift.

- **Presidential elections in USA:** no political shift; political shift.

- **European elections:** no political shift; political shift.

- **Default or exit of Member States from the Eurozone:** yes and contagion; no; permanent threat; no risk of default; or exit.

- **Failure of major banks:** some; no, but some tough haircuts; can happen outside a core group of Member States; no risk.

5. The main scenarios for EMU development

5.1 Ways out of the crisis and stories about the future

As a point of departure for working out scenarios, we will use these key shaping factors to build up possible sequences or stories about the future. We have developed four contrasted stories, paving the way for four contrasting scenarios.

(a) »Muddling-through« Scenario: European hierarchy and differentiation

(b) Break-up Scenario: European fragmentation and disintegration

(c) Core Europe Scenario: Fiscal union with smaller group

(d) Completion Scenario: Fiscal union in the EU

(a) European Hierarchy and Differentiation

The political shift in France is not strong enough. There is no major political shift either in the German general elections or in the European elections. EU management of the Eurozone crisis does not change.

There are no failures in the major banks, but there are drastic haircuts. There is no default or exit from the Eurozone, but the risks remain and borrowing costs in the Eurozone continue to diverge. This will make it more difficult to comply with a number of medium-term objectives for fiscal discipline, which will also diverge. Rating agencies downgrade more Member States. The EFSF/



ESM provides support, but with unbalanced conditionality and the ECB, under pressure, maintains limited support. G20 partners finally decide to give limited support with some tough conditions.

The European plan to support investment is reduced to structural funds. Growth and unemployment rates will also diverge. The external deficits of some Member States will increase, while the surpluses of others also increase and macroeconomic surveillance puts pressure on deficit countries. Collective bargaining is not able to avoid social dumping from weaker Member States.

The European fiscal authority becomes stronger for these countries and democratic legitimacy is weakened and remains weak at European level. Populist and anti-European movements on the Right and the Left spread across Europe.

(b) European Fragmentation and Disintegration

There is no political shift in France or Germany, or in the European elections. The EU management of the Eurozone crisis is hindered by increasing divergences.

There is a major default and exit of Member States from the Eurozone as well as failures in some major banks, triggering several contagion effects that are difficult to control. Borrowing costs in the Eurozone increase in general and several Member States fail to meet their medium-term objectives for fiscal consolidation. Rating agencies downgrade all Member States, the EFSF/ESM remains weak and is downgraded, the ECB reaches its limits as regards intervention and the G20 cannot provide more financial support.

There is no European plan to support investment, growth rates decline in general in a downward spiral involving all Member States. External surpluses and deficits decrease and unemployment rates increase. Macroeconomic surveillance is blocked by internal disagreements. Collective bargaining cannot prevent general social downgrading.

There is resistance to transferring national fiscal competences to the European level, European fiscal authority remains weak and legislative power is weakened, particularly at European level. Populist and anti-European movements on the Right and the Left spread across Eu-

rope and pro-European parties lose elections in several Member States, being replaced by anti-European ones. The European Union moves towards disintegration.

(c) Fiscal Union with Smaller Core Group

There is no political shift in France or Germany or in the European elections. There are no exits or defaults in the Eurozone, but the risks remain and failures of major banks are possible.

A smaller group of Member States decides to organise a fiscal union. Borrowing costs diverge between Member States inside and outside this smaller group and the medium-term objectives for fiscal consolidation converge downwards. Ratings of sovereign debt diverge between Member States inside and outside this smaller group. The EFSF/ESM increase the stigma of Member States receiving assistance, the ECB reduces its support and the G20 international partners address the EU's internal differences.

The European plan to support investment is reduced to the structural funds. Growth rates and unemployment rates diverge between Member States inside and outside this smaller group. External surpluses and deficits increase. Macroeconomic surveillance is considered less important. Collective bargaining in the smaller group organises a retrenchment against social dumping from other Member States.

European fiscal authority remains strong towards weaker Member States. Legislative power and democratic legitimacy are stronger in the smaller group of Member States and weaker in the others. Populist and anti-European movements on the Right and the Left spread across Europe. A two-tier Europe is institutionalised.

(d) Fiscal Union in the EU

There is a political shift in France and in Germany, followed by a political shift in the European elections.

The EMU is completed by the development of a fiscal and political union. The EFSF/ESM paves the way for larger Eurobond issuance and partial common debt management. Borrowing costs in the Eurozone converge down-



wards. There is no risk of default or exit in the Eurozone nor a risk of major bank failures.

The sovereign debt ratings converge downwards, the ECB returns to a more traditional but more balanced role and the EU's position in the G20 becomes stronger. The medium-term objectives for fiscal consolidation converge downwards.

There is a European plan to support investment. The growth rates converge upwards and the unemployment rates decrease. Macroeconomic surveillance becomes a central and more symmetrical instrument. External surpluses increase and external deficits decrease. Collective bargaining promotes upward convergence of social standards.

European fiscal authority is stronger and democratic. European citizens' support for European integration becomes more widespread.

5.2 Scenarios for EMU evolution

In this final section, we build on these stories – just four out of many possible alternative stories – in order to elaborate scenarios which will be more focused on the structural transformation of the Economic and Monetary Union and of European integration. The scenarios will now be developed to provide possible configurations of the Economic and Monetary Union and of European integration taking 2020 as the horizon and stemming from the various policy choices that can be made in response to its central problems. These crucial problems are indicated in Table 3:

Scenario A

Muddling-through Scenario: European Hierarchy and Differentiation

The Economic and Monetary Union remains incomplete, unable to ensure growth and employment and, even less, a transition to a new growth model that is greener, smarter and more inclusive.

Access to financial resources remains unstable. Regulation of the financial system to reduce volatility and un-

due pressure is still not complete. For instance, rating agencies are still free to intervene in the political arena. The European financial system supervisory bodies remain weak and there are several bottlenecks in inter-bank lending across the Member States. Such lending is constrained by hesitant last-resort provision of liquidity on the part of the ECB. As a result, there is a chronic credit shortage.

As regards the issuance of public debt, differences in borrowing costs between Member States remain too high. The resources of the European Stability Mechanism are still inadequate and thus there is always the possibility of sovereign default. Furthermore, the EU's dependence on financial support from external partners increases.

The revised Stability and Growth Pact exerts pressure towards the regular reduction of the public debt and the structural public deficit and leaves little room for supporting public and private investment. Fiscal consolidation remains difficult in many Member States because the growth rate is too low. The long-term sustainability of welfare systems is eroded. In parallel, the Euro Plus Pact committing the Member States to further convergence of corporate taxation and social contributions/benefits is difficult to implement for the same reason.

There are neither significant changes in the European instruments for supporting investment nor macroeconomic coordination for growth. Nor is there a European industrial policy to complement European trade policy. The European strategy for growth remains limited to completing the Single Market and structural reforms. In this context, the opportunities of the European Single Market and of external markets are falling in particular to the countries which have public and private financial resources to invest. As a consequence, the transition towards a greener and smarter economy is very uneven across Member States. With these constraints on European aggregate demand, the average unemployment rate remains high, hitting particularly young people in many Member States: social tensions will increase strongly in some European regions.

The new macroeconomic surveillance puts the focus on Member States with low competitiveness and high external deficits and unemployment rates. It makes individualised recommendations on how they might reduce their problems. Nevertheless, against the background



Table 3

Areas described in each scenario	Central problems of the EMU
Financial stability	Credit shortage Inter-bank lending Widely diverging borrowing costs with regard to public debt issuance Risk of sovereign default
Fiscal discipline	High public debt High public deficits Little fiscal room to support public and private investment Tax divergences Social contributions and benefits divergences
Growth	Recession Low growth Unemployment Social inequalities Slow transition to green growth Slow transition to smart growth
Macroeconomic imbalances	Increasing divergences in growth, unemployment, investment rates High current account deficits and external indebtedness
Governance	Effectiveness Legitimacy

described above, it is difficult to reduce divergences between Member States regarding growth, investment and employment rates, despite efforts to optimise use of the structural funds. Some regions are trapped in recession/stagnation, triggering emigration flows, including a »brain drain«, exacerbating the situation.

There are no fundamental changes in the budgetary process. The Community budget remains the same size and has few resources of its own. As a protectionist reaction, there is national resistance to closer coordination of national budgets and programmes at European level. The new President of the European Commission might be elected by the European Parliament, but will remain constrained by weak financial and policy instruments in any efforts to prevent or solve problems. This, together with a lack of involvement by Member States and citizens in decision-making, will lead to a weakening of popular support for European integration and to a strengthening of anti-European and populist parties.

Scenario B

Break-up Scenario: European Fragmentation and Disintegration

The Economic and Monetary Union remains incomplete, unable to ensure growth and shaken by instances of sovereign default and exit, with uncontrolled contagion effects.

Access to financial resources remains subject to constant uncertainty. Regulation of the financial system to reduce volatility and undue pressure is confronted with substantial resistance and disagreements. For example, rating agencies continue to play an active role in the political game. The European financial supervisory bodies are weak and there are a number of bottlenecks in inter-bank lending across the Member States, which cannot be reduced by last resort provisions of liquidity from the ECB. As a result, there is a chronic credit crunch, deepening the recession in several Member States.

In the issuance of public debt, differences in borrowing costs across the Member States are too high and, since the resources of the European Stability Mechanism are too low, the risk of sovereign default or of severe and disorderly debt restructuring becomes reality in some countries, with contagion effects on sovereign debt and banks.

A revised Stability and Growth Pact puts pressure on Member States to systematically reduce public debt and structural public deficits, leaving little room for promoting public and private investment. Fiscal consolidation becomes impossible in several Member States because they remained mired in recession over a longer period. Welfare systems are undermined and, in some Member States, partially dismantled, leading to a major increase in poverty. In parallel, the Euro Plus Pact, involving commitments to further convergence of corporate taxation and social contributions/benefits, becomes impossible to implement.

There are neither significant changes in the European instruments for promoting investment nor macroeconomic coordination for growth, nor European industrial policy in connection with European trade policy. The European strategy for growth remains focused on completing the Single Market and structural reforms, priorities that experience particular difficulties in countries in recession. In this context, the opportunities provided by the European Single Market and external markets benefit particularly countries with public and private financial resources to invest. As a consequence, the transition towards a greener and smarter economy is blocked and even goes into reverse in several Member States. With these constraints on European aggregate demand, the average unemployment rate and social inequalities increase to unprecedented levels. In the meantime, in the weakened economies, many strategic assets are bought up by non-European countries, reducing Europe's control over its own production chains.

The new macroeconomic surveillance puts the focus on Member States with low competitiveness and high external deficits and unemployment rates, making individualised recommendations to help them to reduce their problem. Nevertheless, given the above-described circumstances, the divergences between Member States regarding growth, investment and employment rates will increase, even with use of the structural funds. Some re-

gions are devastated by deep recession with high unemployment triggering stronger emigration flows, including a strong brain drain element, which only worsens the situation. Hostility between European regions will increase, based on stereotypes, leading to a fragmentation of the European identity.

There are no fundamental changes in the budgetary process. The Community budget remains the same size, with inadequate resources of its own. As a protectionist reaction, some countries refuse to permit closer coordination of national budgets and programmes at European level. The new President of the European Commission might be elected by the European Parliament, but will remain limited by weak financial and political instruments for preventing or solving problems. This, together with opaque centralisation and a lack of participation by Member States and European citizens in decision-making, will increase popular hostility towards Europe and strengthen anti-European and populist parties. Protectionist reactions will emerge everywhere pushing for a return to national borders and national currencies and paving the way for the breakdown and fragmentation of the Eurozone. The disintegration of the European Union will become unavoidable. A large global shock will follow, leading to a global recession.

Scenario C

Core Europe Scenario: Fiscal Union with Smaller Group

The Economic and Monetary Union is completed by a smaller core group of Member States, which adopts a new full-fledged Treaty outside the EU Treaties and excludes the non-Eurozone Members and even some Eurozone Members (a »two-tier Europe«).

Regulation of the financial system is developed and provides more financial stability and focus on the needs of the real economy. Stronger European supervisory bodies ensure sounder banking with more responsible lending and borrowing but inter-bank lending between those inside and outside the core group remains difficult. Unconventional measures by the ECB are still necessary to provide better access to credit.

A European debt agency limited to the small core group ensures joint issuance of public bonds as a last resort,



when issuance at national level becomes too difficult and borrowing costs become more reasonable in the core group. For nations in difficulty outside the core group, the European Stability Mechanism is equipped to provide financial assistance, albeit with strict conditionality.

A revised Stability and Growth Pact applies towards the regular reduction of public debt and structural public deficits. Fiscal consolidation remains difficult in the Member States outside the core group because their growth is too low. The long-term sustainability of welfare systems is strengthened in the core group but weakened outside it. In parallel, the Euro Plus Pact, with its commitments to further convergence of corporate taxation and social contributions/benefits, is implemented, but only in the core group. It has to protect itself from increasing fiscal and social dumping from outside the core group.

New financial resources for investment, combined with a European industrial policy, the Single Market and appropriate structural reforms, foster the transition to a greener, smarter and more inclusive economy in the core group. More organised and competitive European production chains under the leadership of the core group are able better to reap the potential of the European Single Market and global markets.

The new macroeconomic surveillance puts the focus on Member States with low competitiveness and high external deficits and unemployment rates, making individualised recommendations with a view to enabling them to address their problems. Nevertheless, in the circumstances we have described, the divergences across Member States regarding growth, investment and employment rates will increase, even with the use of the structural funds. Some regions are trapped in a recession/stagnation with high unemployment, triggering stronger emigration flows (including a brain drain), which only exacerbates the situation. Hostility between European regions will increase, based on stereotypes, leading to fragmentation of the European identity.

In the core group, the budgetary process is developed so that there is better coordination of national budgets and a better interface with the Community budget. Outside the core group, there are no fundamental changes in the budgetary process. The Community budget remains the same size and has inadequate resources. As a protectionist reaction, there is national resistance to closer coordi-

nation of national budgets and programmes at European level. The European Commission will remain limited by weak financial and policy instruments for preventing and solving problems. This, together with a lack of participation of Member States and European citizens in decision-making, will weaken popular support for European integration and strengthen anti-European and populist parties, both inside and outside the core group.

Scenario D

Completion Scenario: Fiscal Union in the EU

The Economic and Monetary Union is completed in the EU, keeping membership open to all Member States that want to join. A two-tier Europe will be avoided, but a two-speed Europe might be necessary, with a new Treaty for all Member States that want to join.

Regulation of the financial system is developed and provides more financial stability and focus on the needs of the real economy. Stronger European supervisory bodies ensure sounder banking activity with more responsible lending and borrowing and normal inter-bank lending across the EU. Hence, unconventional measures by the ECB are less necessary to provide normal access to credit.

A European debt agency ensures joint issuance of public bonds as a last resort, when issuance at national level reaches unreasonable levels. This favours lower and more reasonable borrowing costs in general. If certain countries encounter unusual difficulties, the European Stability Mechanism is equipped to provide financial assistance with a clear but balanced conditionality, deploying more effective and rapid rebalancing and recovery programmes.

A revised Stability and Growth Pact applies pressure on Member States to constantly reduce their public debt and structural public deficits, but leaves some room for promoting smart public and private investment. This smart culture of balanced budgets paves the way for more credible fiscal consolidation. The long-term sustainability of welfare systems is also strengthened. In parallel, the Euro Plus Pact, with its commitments to further convergence of corporate taxation and social contributions/benefits, becomes easier to implement.

Investment, growth and job creation are supported by stronger European instruments, notably Community Programmes, mobilising Community budget resources, EIB loans, guarantees and bonds, private project bonds and other available financing sources, such as pension funds or taxation sources, such as a financial transaction tax. These new resources for investment, combined with a European industrial policy, the Single Market and appropriate structural reforms, foster the transition to a greener, smarter and more inclusive economy. More organised and competitive European production chains are able to better reap the potential of the European Single Market and global markets. The macroeconomic surveillance process is also used to improve macroeconomic coordination in the European economy, taking positive advantage of spillover effects.

Macroeconomic surveillance is coupled with stronger resources for catching up, not only swifter implementation of the structural funds but also a European Fund for Economic Stabilisation to deal with asymmetric shocks. Social dialogue and bargaining are also encouraged at national and European level to better align wages and productivity. Under these framework conditions, differences with regard to investment, growth and employment rates decrease and regions lagging behind can more realistically catch up in terms of competitiveness, social and environmental standards, as well as reduce their external economic and financial deficits.

The budgetary process evolves better coordination of national budgets and a better interface with the Community budget, which can also count on new resources of its own, notably based on VAT and a financial transaction tax. With these new financial and policy means, the European Commission, with a President elected by the European Parliament, can better dynamise the European institutions to prevent and respond to problems. Closer involvement of the Member States and European citizens in decision-making also strengthens popular support of European integration, weakening the influence of anti-European and populist parties.

The Eurozone, building on a more consistent Economic and Monetary Union, will coordinate its external position and there will be a single Eurozone representation in the Bretton Woods institutions. The euro will become a reference reserve currency attracting financial resources from all over the world.

Epilogue

No one can foresee the future, so it is almost impossible to say which of these scenarios will come to pass. Different scenarios require different political strategies to manage the current crisis. Most of the shaping factors we have identified can be influenced by political decisions to develop in one direction or another. Therefore it is essentially down to political actors to decide which of the above outlined paths they want to take. There cannot be an objective scientific conclusion on the best scenario or the one which needs to be avoided. But political actors should be aware of the consequences of the decisions they take today. In light of the four scenarios drafted here, mapping future developments of the Economic and Monetary Union, political actors should make clear their preferences and align their policies accordingly.



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