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PERSPECTIVE

What Is Missing for a »Genuine« Monetary Union?

Assessing the Plans for a Eurozone Roadmap

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1. Why is completing the EMU necessary?

The Eurozone crisis is moving to a new stage. The EMU has been equipped with new crisis management instruments to deal with a series of national bailouts of states and/or banks to avoid skyrocketing spreads and bank collapses and prevent the risk of default or exit, with their unforeseeable consequences. EFSF/ESM and the ECB's non-conventional instruments are learning how to perform this job. On the preventive side, more stringent fiscal discipline has been codified in the reformed Stability and Growth Pact (»six-pack« and »two-pack«) and a new process of macroeconomic surveillance is under way. Nevertheless, the crisis is far from over and is showing the limits of this »muddling through« process.[1]

This new stage of the Eurozone crisis has the following features:

With financing costs still differing considerably, the Eurozone member states have started to diverge increasingly in terms of investment rates, growth rates, job creation, unemployment and poverty rates. More recently, this cumulative trend has been dragging the aggregate Eurozone and EU economy into a drawn-out recession, chronic unemployment and deeper social inequalities in and between the member states. These tensions have clear implications in the political domain, with the strengthening of anti-European movements, weakening of pro-European political parties, spreading Euro-scepticism and a legitimacy crisis affecting democratic institutions at both European and national level. This is leading to a crisis of the European integration which is also having implications for the EU international status and role.

1. For an analysis of the sustainability of the »muddling through« process, see Scenario Team Eurozone 2020 (2013): Future scenarios for the Eurozone. 15 Perspectives on the Euro crisis, Friedrich-Ebert-Stiftung Berlin, online at: http://library.fes.de/pdf-files/id/ipa/09723.pdf

This Eurozone crisis appears now to be not only a sequence of national cases of financial disturbance, but also a systemic and multidimensional crisis which can be overcome only by a more systemic and comprehensive solution aimed at addressing the major flaws and completing the architecture of the EMU.

2. Long-Term Plans for the EMU

It is against this background that a series of more fundamental reform proposals have come to the fore. Four basic frameworks have been under debate to complete the EMU: the financial; the economic and social; the budgetary; and the political. The major official proposals under discussion include, notably:

- the document »*Towards a Genuine EMU*« coordinated by President Van Rompuy involving the Presidents of the European Commission, the Eurogroup and the European Central Bank (with several versions since June 2012);

- the European Parliament's *Thyssen Report* (adopted in November 2012);

- the European Commission's »*Blueprint for a Deep and Genuine EMU*« (launched in November 2012)

These documents have significant common ground but also some noticeable differences. The report of the European Parliament went further in the economic, social and political dimension and the one from the European Commission went further with regard to fiscal union and the implications for Treaty changes.

The European Council of December 2012 was supposed to discuss these proposals but its final conclusions reveal an important set-back in the scope of the EMU reform process. They excluded the bolder proposals, limiting ambitions for the following months to:

1. Moving forward in *banking union* construction with a single supervisory mechanism, a harmonised deposit guarantee system and a common bank resolution mechanism.

2. Defining the procedures for an *ex-ante coordination of reforms.*

3. Testing a small financial instrument to be called the *Convergence and Competitiveness Instrument or CCI,* access to which should be conditional on contractual arrangements.

4. Introducing a new *social dimension* to be considered when completing the EMU.

Until March, progress had been made only with regard to banking union (and at a slower pace than scheduled) and in the organization of the Eurozone summit (with procedural rules included in the European Council conclusions of March 2013).

3. Analysing the EMU in the Context of the Current Crisis

Before assessing the long-term plans for the EMU we will present the assumptions on which our assessment is based. They concern: the nature of the current crisis, the nature of the current divergences in the EMU and the conditions for the long-term sustainability of a monetary union, notably in the fiscal and social dimensions.

The nature of the current crisis

The EMU reform process can be effective only if the nature of the component crises can be clearly identified:

- the crisis of a growth model which is no longer sustainable in the present context of globalization;

- the financial crisis starting in 2008;

- the economic and social crises which have followed;

- the Eurozone crisis combining sovereign debt with bank debt and exposing the imbalances in the Eurozone, as well as the flaws of the EMU architecture;

- the crisis of EU integration triggered by controversial reforms of the Economic and Monetary Union.

The nature of the current divergences in the EMU

The EMU reform process can be effective only if the different types of divergences to be addressed are distinguished clearly:

First type: cyclical divergences created by asymmetric shocks hitting particular regions or countries due to their pattern of productive specialization. These kinds of cyclical divergences of growth and employment will always exist due to a natural – and desirable – variety of productive specializations. In other monetary zones, these divergences are reduced by federal instruments for macroeconomic stabilisation. In the EMU, the national instruments with this purpose were left with only a little room to manoeuvre in budgetary policy and there are no instruments at European level. This means that if a Eurozone member state is hit by an asymmetric shock, there are few means to cushion the social impact in terms of wage and benefit cuts and job losses. Another source of cyclical divergences are the different national inflation rates affecting the real interest rate and price competitiveness; they can notably be reduced by better coordination of wage bargaining in line with productivity gains across the member states.

Second type: the higher pressure of globalization and the need to move to a new growth model that is more knowledge-intensive and less carbon-intensive, adapting structures and preparing people for new jobs. This transition requires significant new investment and structural reform: in business conditions, labour markets, social protection, education and innovation systems, which should be better coordinated at European level, because they have many spillover effects. So far, the divergences between the Eurozone member states have increased due to lack of investment and coordinated reforms. These structural divergences in competitiveness have led to macroeconomic imbalances that were not identified and corrected in time.

Third type: the recent financial crisis has led to a general credit crunch and magnified the macroeconomic imbalances that were already building up in the Eurozone. More recently, the crisis of the Eurozone linking high sovereign debt with high bank debt has created cumulative divergences between member states regarding financing conditions, investment rate, growth rate, unemployment rate and sustainability of welfare systems. The instruments created so far – notably the European Stability Mechanism and the new ECB instruments – are able to reduce the divergences regarding the financial conditions, but not the other divergences regarding growth and the social indicators.

The implications for the social dimension of the EMU

If these EMU flaws are not addressed, the most likely sequence of events will be:

- in the most vulnerable Eurozone countries, significant reductions in wages and social benefits, followed by major jobs losses, triggering a recessionary spiral, high unemployment and uncontrolled emigration;

- in the other Eurozone countries, increasing pressure on their social standards; risk of social dumping;

- in the EU as a whole, erosion of the existing instruments supporting the social dimension; reduction of aggregate internal demand, thereby shrinking the internal market; systemic pressure towards lower growth or recession.

In order to reverse these trends, the EMU should be completed in terms of its missing instruments in the financial, fiscal, economic and social dimensions. It could certainly be useful to make full use of the existing social instruments. But the current financial and economic pressure is so high that they will be eroded if they are not complemented by some stronger instruments for a social dimension in the EMU.

Implications for the fiscal dimension of the EMU

What are the basic conditions under which a monetary zone can work and survive? A rich and long international experience tells us that two basic conditions are required: sufficiently integrated markets and mobility of factors to facilitate a certain degree of convergence in the competitiveness of the member states, and monetary integration must be coupled with a considerable degree of fiscal integration.

The current European debate recognises these two conditions but is divided about the importance to be given to the two conditions: For some, it is only a matter of defining and enforcing a common fiscal discipline. For others, it is also about coupling this common fiscal discipline with a common budget based on a number of common taxes and with better instruments to issue and manage public debt.

The available international experience shows that fiscal unions with a shared currency have a basic set of similar features:

- common principles of fiscal discipline in the sub-central governments;

- in this common framework, sub-central governments enjoy different degrees of fiscal autonomy to meet their financial obligations with their own fiscal resources;

- a central government with a relevant budget based on own tax resources and a Treasury responsible for issuing common debt.

The roles of this central government budget are usually the following:

- a macroeconomic stabilisation and anti-cyclical function to protect regions under asymmetric shock, whatever their relative level of wealth (richer or poorer regions);

- a mutualisation of risks if there is mutualisation of decision-making, notably on issuing public debt;

- a redistributive function, involving a transfer of resources from more competitive and wealthy regions to less competitive and wealthy ones. A vertical fiscal imbalance between revenue and spending is accepted to enable this redistribution, provided free riding and moral hazard are prevented. In the EU, this is the only function, but it is limited by a tiny Community budget.

4. Assessing the Long-Term Plans for the EMU

Our assessment will focus on ways to reduce the current divergences between member states that are undermining the Eurozone as a whole and identify available and missing solutions.

EMU IMBALANCES	AVAILABLE SOLUTIONS	MISSING SOLUTIONS
General macroeconomic imbalances	– Macroeconomic surveillance	– More comprehensive and balanced scoreboard and evaluation. Improving current accounts, increasing productivity or reducing unemployment should be re-balanced as key objectives – Macroeconomic coordination, notably between surplus and deficit countries
Competitiveness divergences due to productive specialization	– National industrial/innovation policies – Europe 2020 Strategy	– European industrial/innovation policy – Credit for investment – European economic adjustment fund
Competitiveness divergences due to unit labour costs	– Wage negotiation/productivity increases – Structural funds to increase productivity	– Wage coordination – European industrial policy
Competitiveness divergences due to reform gaps	– Europe 2020 strategy – National Reform Programmes	– Selection of reforms to reduce recession and improve growth potential – Ex-ante coordination of reforms – Balanced contractual arrangements
Divergences in public deficit and debt	– Stability and Growth Pact – Treaty on Stability, Coordination and Growth	– Smart interpretation of fiscal rules: focus on long-term sustainability of debt, structural deficit, room to manoeuvre for investment – Controlling tax evasion and improving tax coordination
Divergences in spreads	– EFSF, ESM instruments – EIB instruments	– Improving public debt management with a redemption fund for past debt and a European debt agency for debt issuance
Divergence in interest rates	– ECB instruments – Financial regulation	– Normal inter-bank lending based on single EU bank supervision, harmonized deposit guarantee and EU bank resolution mechanism
Divergences in investment rates	– ECB instruments – Structural funds	– Normal access to credit in the framework of a banking union
Divergences in growth rates	– Step up export efforts	– Sustain internal demand, avoid downward spirals and reduce spillover effects to other member states – Win new external markets via new trade agreements
Divergences regarding job creation	– Active labour market policies (though with decreasing resources) – Lifelong learning – Tax incentives for job creation – Structural funds	– Normal access to credit – Stronger EU Youth Guarantee – Stronger EU Globalization Fund – EU industrial policy
Divergences in social inequalities	– Directives defining common standards – Social Fund	– Stronger social objectives and standards – Principles of minimum wage and minimum income – Avoiding recessive welfare cuts – Coordinating national policies for welfare financing
Divergences in the political management of the Eurozone	– Organization of the *Eurozone* summits, with possible contributions from different ministerial formations	– Democratic legitimacy involving the European and national parliaments

5. Political Sequences and Treaty Changes

One of the most difficult issues to be solved is identifying the right path for the EMU reform process. This should involve a sequence of package deals, which should be balanced enough to work politically.

It is important to notice that the first draft conclusions for the European Council meeting of December 2012 were also proposing a sequencing of these reforms in three stages, which were not balanced in most respects:

- *The first stage (2012–2013)* was aimed at ensuring fiscal consolidation plus breaking the link between banks and sovereign debtors. Something fundamental was missing: fostering growth should also become an overriding priority and fiscal consolidation should be carried out at a more reasonable pace, otherwise it will be counterproductive.

- *The second stage (2013–2014)* was focused on completing the financial framework and promoting sound structural policies (reforms) to be supported by the new fiscal capacity. Something fundamental was missing: this new fiscal capacity needs to be designed to support a balanced approach focusing on investment, job creation and better social standards; furthermore, national budgets should have more room to manoeuvre to invest and have access to stronger European instruments to reduce spreads.

- *The third stage (post 2014, meaning post European elections)* was envisaged to create a common stabilisation function together with stronger coordination of economic and budgetary policies. Something fundamental was also missing: This stronger coordination of national policies should be accepted only if it is balanced and more democratic and if it can count on a strong European Treasury with borrowing power via Eurobonds, spending power and taxation power with more European democratic legitimacy.

The political divergences about the sequence of these package deals were so high that in the final version the European Council conclusions dropped an explicit sequencing of stages, even if the underlying – very unbalanced – political deal was kept.

Another critical issue concerns the Member States to be involved in this EMU reform process. It is assumed that the development of the EMU architecture should involve not only all Eurozone member states but also, by appropriate means, all EU member states willing to take part in this monetary zone. This crucial development for European integration should be kept as inclusive as possible.

Last but not least, the most controversial issue concerns the implications for Treaty change. We assume that the legal solutions should first exhaust all the possibilities open by the Lisbon Treaty, notably Article 136, which is specific to the Eurozone, and the method of enhanced cooperation, which allows all member states to move forward that are willing to do so.

Nevertheless, some of the new instruments can overcome the limits of the Lisbon Treaty and, in this case, other solutions should be considered: either a proper revision of the EU Treaties based on a European Convention or, if this is not possible, an Intergovernmental Treaty designed to be included in the Treaties as soon as possible.

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