Vienna debate on European integration 2014

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The Future of the Euro: incremental or systematic reform?

Synopsis: The policies of the European Central Bank and a series of macroeconomic and financial reforms have stabilized the Eurozone. However, further systematic reforms are indispensable for the long-term viability of the Euro. At the same time, limited legitimacy of many crisis-induced measures and their asymmetric consequences in terms of growth and employment across the Eurozone make unanimous agreement on systematic reforms unlikely. This keeps the Eurozone vulnerable to economic and political shocks that may yet force either systematic reform or break up.

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1. Introduction

This note provides background information for the Vienna debate 2014. It briefly outlines causes of the Euro crisis and describes crisis management measures implemented to date. Subsequently, it contrasts reforms to date with several blueprints that outline systematic reforms deemed necessary for the long-term viability of Euro. The comparison reveals that there are ***additional systematic reforms to be implemented***. However, political consequences of limited legitimacy and skewed distribution of austerity burdens across the Euro members make ***agreement of further systematic reforms unlikely***, if not impossible. The concluding section outlines four scenarios for the Euro's future that may facilitate the discussion.

2. Causes and consequences of the Euro crisis

Two causes of the Euro crisis stand out from the multitude of explanations: the global financial crisis and the ***incomplete institutional architecture of the Eurozone***. The Euro crisis was triggered by the external shock that originated in the US, but the build up of vulnerabilities and the difficulties of its resolution are homegrown. The single currency encompassed economically, politically and institutionally ***heterogeneous countries that did not fulfill the prerequisites of the optimal currency area*** (see Scharpf 2014, Enderlein et al. 2012). Under the single monetary policy, such heterogeneities create a risk of bank and/or debt crisis, which can be either prevented by the coordination of economic policies or resolved by robust crisis management tools. The Eurozone, however, lacked both.

The ECB ***monetary policy proved to be one-size-fits-none*** (Enderlein et al. 2012). The common interest rate was too low for the 'Southern'/debtor Member States with higher inflation and too high for 'Northern'/creditor countries with inflation rates below the Eurozone average (De Grauwe 2013, Scharpf 2014). Low interest rates fuelled investments, consumption and real estate bubbles in the 'South' while depressing investment and consumption in the 'North'. The resulting imbalances were observable through large current account deficits in the 'South', which were financed by massive financial inflows from the 'Northern' banks via global financial markets.

The ***policy coordination proved too weak to prevent imbalances***. The Stability and Growth Pact was supposed to act preventively, but it was watered down after France and Germany found it too rigid in 2005. The national authorities of 'Southern' Member States failed to address the growing imbalance with adequate fiscal policies (Scharpf 2014). Moreover, the financial sector - and 'Northern' banks in particular - mispriced the risks involved in lending to 'Southern' states and banks (Gros 2012), which provided excessive amount of credits at excessively low interest rates.

The combination of macroeconomic imbalances and leveraged finance made the ***Eurozone vulnerable***. The 2008 collapse of Lehman Brothers provided the trigger that revealed consequences. The states were forced to bail out numerous banks, which increased public debts, and in the cases of Greece, Ireland, Italy, Portugal and Spain, threatened state solvency. It morphed into the Euro crisis during spring 2010.

The ***crisis consequences*** have been felt ever since. The economic growth across the Eurozone has yet to recover, living standards in many countries are below pre-crisis levels, unemployment in the 'South' is three times higher than in the 'North' and the debt-to-GDP ratio is almost 50 percentage points higher (Pissani-Ferry 2014). Moreover, crisis management measures resulted in deep economic and political divisions and growing distrust between and within Member States (Scharpf 2014).

3. Crisis management: ECB measures and stabilization funds

The most important measures to contain the Euro crisis were introduced by the European Central Bank (ECB), which expanded its role to the limits of its legal mandate. In May 2010, it introduced the ***Securities Market Programme*** to purchase the debt of Member States on the secondary markets. In December 2011, the ECB drastically expanded its ***Long-Term Refinancing Operations*** (LTROs), providing troubled banks with liquidity for up to 3 years and effectively assuming the lender of last resort function. In August 2012, it added the ***Outright Monetary Transactions*** (OMTs) to its toolkit, which allow it to purchase unlimited amounts of national debt on the secondary markets as long as the country in question agreed to a reform programme. The ECB also participated in the '***Troika***' - along with the Commission and International Monetary Fund - that defined the conditionalities imposed on Greece, Ireland, Portugal and Cyprus as part of their official bail-out programmes. Last but not least, the ECB President Mario Draghi made a commitment to “***do whatever it takes to***

save the Euro" in July 2012, which financial markets perceived as an important signal for stabilization.

The ECB measures were complemented by expanded and novel mechanisms for funding of crisis resolution programmes. The ***European Financial Stability Facility*** (EFSF) and ***European Financial Stabilisation Mechanism*** (EFSM) were temporary arrangements backed by Eurozone governments and the EU budget respectively. They were created in May 2010 with a joint capacity of EUR 0.5 trillion. In February 2012, the EFSF was replaced by a permanent ***European Stability Mechanism*** (ESM) with total capacity of EUR 0.5 trillion. The ESM is guaranteed by Eurozone states and financed by issuing bonds on financial markets. Any ESM loan comes with strict reform conditionalities.

4. Macroeconomic and financial reforms to date

The crisis management measures stabilized the Eurozone after the summer of 2012. However, these measures only bought time for the systematic reforms necessary for the long-term viability and resilience of Eurozone. Some of these reforms are already approved, while others are yet to come.

The Eurozone has adopted four major reforms of its macroeconomic governance designed to prevent a failure of policy coordination. Firstly, the EU agreed on the ***Six-pack*** in November 2011, which recast the Stability and Growth Pact and (re)defined procedures such as the European Semester, Medium-Term Budgetary Objectives, the Commission run warning system, the Excessive Deficit Procedure that now covers both deficits and debts and the Excessive Imbalance Procedure and Alert Mechanism Report for macroeconomic surveillance. These measures aim at tightening the discipline on public finances and curbing the reemergence of macroeconomic imbalances. The ***Two-pack*** introduced in May 2013 further tightened oversight of the public finances. The ***Euro-plus pact*** was an early measure trying to promote better economic policy, while the ***Fiscal Compact*** [2] reinforced the governance of fiscal and economic policies.

[2] Specified in the Treaty on Stability, Coordination and Governance.

Since the banking failures and excessive risk-taking before the financial crisis were among the causes of the Eurocrisis, the EU reformed its financial regulation and governance as well. Reforms included the introduction of ***European Systematic Risk Board*** (ESRB) charged with oversight of ‘macro-prudential supervision’ and an upgrade of existing regulatory agencies to ***European Supervisory Authorities*** (ESAs) responsible for 'micro-prudential’ regulation in banking, insurance and securities. The EU also introduced ***30 packages of new and amended financial regulations*** such as the CRD IV reform that introduced new global banking standards (so-called Basel III).

Arguably, the most significant achievement in terms of long-term reforms is the ***banking union***. Whereas the above reforms essentially represented 'more of the same' response by providing ever more commitments to coordination, ever closer surveillance and ever more sanctions for non-compliance, the banking union includes a substantive shift of authority to the supranational level - primarily to the ECB.

The banking union is intended to cut the vicious link between solvency of banks and solvency of Member States. It creates the ***Single Resolution Mechanism*** that includes a joint resolution fund, which - together with other measures - can be used to stabilize collapsing banks. Hence, if a national bank needs to be bailed out, it can be done with Eurozone-level funding that does not count as national debt. The member state in question thus can avoid over-indebtness and insolvency due to a major bank bailout. However, in order to prevent moral hazard of states and banks, the banking union also includes joint regulation and supervision. The former in the form of the ***Single Rulebook*** overseen by the European Banking Authority and the ***Single Supervisory Mechanism*** operated by the ECB.

5. Further systematic reforms

The macroeconomic and financial reforms implemented so far do not address all sources of instability within the Eurozone formed by heterogeneous countries. A comparison of reforms to date with the EU's official reform blueprint (Commission 2012a) or with independent reports such as that of 'Padoa-Schioppa Group' (Enderlein et al. 2012) reveals there are ***further measures deemed necessary for long-term viability***. Which of the systematic reform proposals are necessary and sufficient to achieve this goal is debated, but - at the very least – a somewhat deeper banking union, some elements of fiscal union, a deepening of the single market to compensate for various rigidities, and measures to improve democratic legitimacy and oversight of new policies are practically on all blueprints.

The banking union as implemented to date remains minimalist and incomplete. The original Commission (2012) proposal included an additional pillar - the ***Single Deposit Insurance Mechanism***. This would pool deposit insurance and prevent repetition of the Icelandic situation, when EU depositors were not compensated due to insolvency of the national deposit insurance scheme.[3] Although deposit insurance rules were harmonized, they remain national as a further reform was postponed indefinitely (House of Lords 2014). The second incomplete aspect of the banking union is the absence of ***burden-sharing rules for the Single Resolution Fund*** that is to be phased in over the 6 years. This is yet to be agreed upon in an international agreement among banking union participants.[4]

There are numerous proposals for setting up various elements of fiscal union that range from minimalist to federalist. The Commission (2012a) blueprint proposes ideas such as an ***integrated budgetary framework*** that would build on the reforms to date and strengthen the fiscal discipline of indebted countries. It would be a precondition for some form of ***Eurozone budget*** that could assist the Member States in dealing with asymmetric economic shocks and implementing reforms. In turn, a combination of fiscal discipline and Eurozone budget could evolve into a ***cyclical adjustment insurance fund*** that would preclude the need for drastic austerity during cyclical recessions (Enderlein et al. 2012).

A ***debt mutilization*** is the next step towards a fiscal union. Various proposals try to balance responsibility and solidarity associated with any form of ***Eurobonds***. Depla and von Weizsäcker (2010) propose the two sets of bonds – mutualized blue bonds for countries within the Maastricht debt limits and red for those above it. The Commission (2011) proposes stability bonds with varying degrees of joint liability and there are also proposals for various forms of Eurobills (Tumpel-Gugerell et al. 2014). These proposals also include the formation

[3] Iceland is part of the European Economic Area and therefore subject to the same single market rules as any EU Member State.
[4] The banking union is compulsory for all Eurozone members, but other EU member states may opt-in on the basis of an agreement with ECB. The burden-sharing and other operational rules are to be defined in international treaty outside of EU law.

of the ***European Debt Agency*** (EDA) or a similar body that would administer any combination of tasks on the scale between a limited 'European Monetary Fund' and a full-fledged Eurozone ministry of finance (Enderlein et al. 2012).

Systematic reforms also need to foster competitiveness and labor mobility in order to approximate the prerequisites of the optimum currency area. This can be achieved by deepening the single market as proposed by the ***Single Market Act*** (Commission 2012b). In particular, the implementation of the ***Services Directive*** and a ***removal of barriers to labor mobility*** are frequently proposed measures (Enderlein et al. 2012). Furthermore, ***greater tax harmonization*** and greater ***coordination of supply-side reforms*** are suggested as complementary measures (Commission 2012a). Suggestions for improved implementation of such commitments include setting up a formal ***contract on convergence and competitiveness strategies*** between any Member State and the Commission, which would make them both accountable to the European and national parliaments (Commission 2012a).

The above proposals impose various forms of constraints on democratically elected actors and empower technocrats on the European level of policy-making. Therefore, a crucial aspect of further systematic reforms is greater ***democratic oversight of reformed policies*** (Commission 2012a). However, the enhancement of legitimacy of Eurozone decision-making is by no means certain, not least because the political and economic consequences of Eurozone reforms to date make agreements on further changes more difficult.

6. Plausibility of further systematic reforms

The Eurozone crisis management policies lack the legitimacy of both input- and output-oriented type (Scharpf 2014). This is particularly important for the stabilization programs imposed on debtor countries by the Troika. Their input legitimacy was undermined by the fact that the Troika consists of technocratic actors from the Commission, ECB and IMF. These are accountable only to the Council, where the crisis shifted the bargaining power in favor of creditor countries, and to Germany as the largest contributor to stabilization. Scharpf (2014:3) argues that this has resulted in "non-democratic expertocracy and an extremely asymmetric intergovernmental bargaining system" that can hardly be regarded as legitimate in debtor countries.

The output-oriented legitimacy is undermined by the extremely unequal distributional effects of Eurozone crisis management. The imposed "austerity policies have deepened the decline of economic activity, while severe cutbacks of social benefits, public services and public-sector wages combined with labor market deregulation have greatly increased mass unemployment, poverty and social inequality" (Scharpf 2014:12). Furthermore, employment has declined in all 'Southern' states and youth unemployment increased in some regions to over 50 percent.

In contrast, the creditor countries benefited from the crisis management policies. The collapse of the Euro and the default of the periphery has been avoided, sparing the ‘Northern’ creditors of massive losses on investments of their banks and firms in the 'Southern' periphery. Moreover, their export sectors reoriented to international markets and experience growth in profits and employment, supported by the Euro exchange rate depreciation caused by the crisis uncertainty. To be sure, the creditor countries are exposed to debtor countries’ risks through the stabilization measures – via the ECB balance sheet, TARGET2 payment system and ESM. However, there were no write-offs or losses on these funds to date.

Benefits accrued to the creditor countries provide them with strong vested interests in the continuation of the current status quo, which delivered stability without any obvious losses. They have no immediate economic interest to support further systematic reforms, such as a deeper banking union or the introduction of some elements of a fiscal union, which would redistribute more risks and costs to them. Since systematic reforms require unanimous consensus among member states - and probably also Treaty change - it is unlikely that under current preference constellations such measures could be adopted.

This current status quo, however, does not preclude the possibility of either economic or political shock that may break the stalemate. Unforeseen shock may force either fast progress of systematic reforms under extreme time pressure or a catastrophic dismantling of the Eurozone.

7. Conclusion: Alternative scenarios for the future of the Euro

The review of the crisis management measures and reforms to date, combined with the outlook for further systematic reforms and the present political stalemate, indicates four plausible scenarios which can help structure the debate:

a) Systematic reforms

The Eurozone reforms will advance towards 'Genuine Economic and Monetary Union' or some similar scenario, which ensures that all reforms that are necessary for long-term viability are implemented within a reasonable timeframe. This is the alternative promoted by the EU Commission and European Parliament. However, it assumes unanimous political agreement among the creditor countries that benefit from the current status quo, and the debtor countries that bear the full burden of austerity and experience political mobilization against it. Can they agree on further systematic reforms that will expose the creditors to more costs/risks and provide some relief for the debtors?

b) Incremental reforms

The Eurozone may become complacent with the current stabilization and avoid further systematic reform due to conflicting interests among its members. The debtor states will have to continue internal devaluation - reducing wages, public budgets and implementing structural reforms as dictated by Troika and accepted within the European Semester. The creditor states will bear risks though the ESM, ECB and TARGET2, but otherwise benefit from undervalued exchange rate that supports growth and employment in their export sectors. Reforms will be limited to the smallest increments responding to the most urgent threats. However, the absence of systematic reforms will leave the Eurozone vulnerable to political and economic shocks. Can the Eurozone grow out of the crisis by such a ‘muddling through’?

c) Shock-induced systematic reform

Unforeseen events may destabilize the current status quo and force in the postponed systematic reforms. Such an event may be one of the many 'known unknowns', including the election of an anti-Euro national coalition prepared to defect from the Eurozone, massive banking losses revealed by the ECB stress test, financial losses due to the escalation of sanctions on Russia or any unexpected instability in the global economy perhaps due to the end of the US quantitative easing. Any such event may disrupt current stability and restart the full-blown Euro crisis as the incomplete stabilization mechanisms may be overwhelmed again. The return of the 'hot' crisis could break the stalemate and enable postponed systematic reforms. Are there any ways to avoid such a myopic procrastination?

d) Shock-induced break up

A dismantling of the Eurozone is an unlikely alternative, but it cannot be excluded. This option was voiced during the early phases of the Euro crisis, but economic, legal and political analyses concluded that any unilateral exit would trigger drastic costs, extreme legal uncertainty and the potential for intense political conflicts.[5] The Euro was deliberately designed as irrevocable and provides no mechanism for organized dismantling (Athanassiou 2009). There is no procedure for redenomination of all existing contracts into successor currencies, no legal option for the Eurozone exit without exiting EU, no procedure for handling consequent bank runs or bank failures and for the inevitable suspension of the four freedoms (Spiegel 2014). A negotiated exit may reduce these risks (see Bootle 2012, Kawalec and Pytlarczyk 2013), but it is a superficial scenario, because if Member States can achieve political consensus on an organized exit, they can probably agree on policies to prevent it. At the same time, the incentives of both debtor and creditor countries to avoid break up are evolving over time (Scharpf 2014:17). Under pressure, both sides might be more willing to risk the chaos of a break up if there is no progress with the systematic reforms. Is the risk of the break up scenario increasing or decreasing over time?

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[5] For a while, the debate continued with the question whether the creditor member states, not the debtors, should exit the Eurozone (see Soros 2012, Sinn 2013).

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* denotes the most important sources for this background note. These two papers are available for download at EIF website: http://eif.univie.ac.at/events/index.php .