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THE FUTURE OF THE EUROZONE

CROSS-PERSPECTIVE FROM FRANCE AND GERMANY

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1. Why The Euro Area Needs Reform

The euro area is not in recovery anymore—it is in full-scale upswing. According to the European Commission,[1] it will grow by 2.1% this year and still by 2.0% in 2019. With 1.7% and 1.9% in 2018 respectively, France and Germany show robust growth. Even Italy, the current worst performer, will still record 1.3% of growth this year. Looking at these figures, the crisis is clearly behind us and Europe is in decent shape.

But substantial risks surround this very flattering outlook. Some of them are economic in nature—most pressingly, the upcoming normalization of ECB monetary policy will be a substantial challenge for a number of member states with high legacy debt. But mostly, the risks are political. There are limits to which Europe can control downside risks coming from the other side of the Atlantic—but there is plenty to do to mitigate risks from within Europe.

One of the most important intra-European risks stems from the still-inadequate architecture of the euro area. This risk is twofold: First, the euro area is built in a way that unnecessarily extends crises and overly relies on the ECB's firepower to tackle downturns. This is not sustainable—neither economically nor politically—and can ultimately lead back into a political crisis. As we have seen in many countries, when voters perceive (rightly or wrongly) the euro area architecture and rules as a factor that weighs on growth or that can lead to transfers in one direction, populists gain. Second, the recent turmoil surrounding the Italian government formation has shown that contagion from one member state to another is alive and well—because ultimately, markets are still not convinced that we have ruled out once and for all that a country could have to leave the euro against its will.

To mitigate these risks, concrete steps can and should be taken. However, we also have to be clear here what euro area reform and a better architecture for the common currency can and cannot achieve. To paraphrase the Five Presidents' Report, the goal has to be that the euro area does not merely survive but thrive. **However, a well-functioning Eurozone architecture is not a panacea for ensuring long-term growth and a productive and competitive euro area economy.** It is merely the (very important) necessary condition for all member states to be able to thrive inside the common currency but is not a substitute for good economic policy making in mem-

1. European Commission, *European Economic Forecast*, Summer 2018 (interim), July 2018

ber states and at the European level when it comes e.g. to the Single Market.

The euro area is in a state of relative health but risks loom. Now more than ever, it would be timely to make good on years of commitment to EMU reform and to start implementing the most important pieces in full. The paper by 14 Franco-German economists offered in early 2018 a comprehensive vision of how this could look like. Germany and France have now agreed in broad terms their common position in Meseberg. The next months will now show what that agreement is worth.

2. Where We Stand After Meseberg

It is important to recognize that since the start of the crisis, we have come a long way in shoring up the common currency. The European Stability Mechanism (ESM) has been established as a permanent crisis-management tool to deal with member states that lose market access. Banking union has been launched—a lesson from the crisis when ailing banks were able to bring down their sovereigns. The fiscal rules have been substantially overhauled and a new framework has been set up to detect and counter the buildup of harmful macroeconomic imbalances.

But we are not there yet. Fundamentally, it is still unclear how much macroeconomic and financial risk euro area countries are ready to share and under what conditions. This translates into an uncertainty in markets and populations alike how deep the political commitment to the irreversibility of the euro really is among all member states. Therefore, this question should be answered and not put off any longer.

The Franco-German agreement at Meseberg in mid-June recognized this need and has presented a common Franco-German approach to get to the bottom of this question by opening the discussion on three core elements:

- **How should banking union be completed**—i.e. how should private risk sharing be organized?
- **Should there be some form of euro area budget**—i.e. how should public risk sharing work?
- **How can the ESM be made more effective**—i.e. what are the arrangements when crisis hits?

France and Germany presented a number of proposals to address these three questions that present a form of synthesis of French and German positions. We discuss these proposals in greater detail below.

A few days later, heads of State or government discussed euro area reform at the Euro Summit. France and Germany did not muster enough support for their common position to get it endorsed by the other member states. Instead, finance ministers will now continue exchanging views on the issues so that leaders may discuss again and take decisions in December 2018. The coming months will therefore be crucial to see whether France and Germany stick to their position and whether they will convince the other member states.

In the remainder of this paper, we will discuss these three elements mentioned above and will then conclude with a section on the two elements that are missing from the current discussion—the future of the rules governing national economic policies and of the overall institutional setup to govern the euro area.

3. Banking Union—Towards a Better Financial System for the Euro

EU financial sector reform since the crisis has been designed to address a major flaw unveiled by the crisis: to make sure that single banks or whole banking sectors would no longer be able to bring down their respective sovereign and vice versa—and by doing so, destabilize the Eurozone as a whole.

Three concrete areas were covered here:

- First, **financial sector regulation was harmonized and at the same time tightened** by increasing capital requirements and most importantly by introducing the principle of bail-in—i.e. that banks should no longer be bailed out without owners and creditors taking a substantial hit first.

- Second, **supervision of all main euro area banks was transferred to the ECB** to avoid past tendencies of supervisors being too lenient on their domestic banks to give them a competitive advantage in the Single Market.
- Third, **the Single Resolution Board was put in charge of resolving ailing banks** instead of national authorities. To do so it, it can use a number of instruments, some of which require additional funds. For these funds, it can resort to the Single Resolution Fund (SRF)—a European fund filled by sector contributions that can only be touched once bail-in has been applied. The idea here was to break the doom loop between banks and states by making sure that a banking sector problem could always be adequately dealt with even if a member state was under acute liquidity constraints.

Substantial progress has been made over the last six years since the launching of the banking union—i.e. the Europeanisation of supervision and resolution of banks—was agreed. But **crucial elements are still missing to make the system as it is designed now fully work**:

- The Single Resolution Fund is limited in size to about 60 billion euros as it is filled by banks' contributions. In a systemic crisis of the like we have seen a decade ago, the SRF could be depleted in the middle of the resolution process of major banks. This would set the perverse incentive for banks to go bust early so that they can be resolved while the Fund is still full. Therefore, finance ministers agreed already in 2013 that **the SRF needs a backstop**, i.e. a credit line to the SRF that would be repaid by the banking sector over time if used. In June 2018 the European Council has agreed that the ESM should offer this credit line but it is still very much unclear when this backstop would become operational and under what conditions. Until it is not, the resolution architecture of the euro area remains ill-equipped to deal with a major systemic crisis.
- A part of the connection between the health of banks and states works through deposit insurance: When private depositors stop trusting national deposit insurance (which depends fully on the solvency of the state), it becomes rational for them to withdraw their funds. Thus, confidence crises of member states can wreck their banking systems. This could be overcome by adding **a European dimension to deposit insurance**. It could take the form of full insurance or of a reinsurance system—what matters is that bank customers throughout the euro area can look beyond their own finance minister for assurance that their accounts are protected. The Commission has proposed to set up a European Deposit Insurance Scheme to this effect, but it has so far been met with fierce resistance, in particular from Germany.
- Even though the situation has improved, **banks in many euro area countries are still plagued by crisis legacies**, in particular non-performing loans (NPLs). This makes it all the more difficult to find political agreement on the two issues mentioned above. That is why it is important for supervisors to keep up the pressure on banks to wind down NPL stocks. In addition, with the crisis banks have increased their holdings of domestic public debt. This is in line with the rules, but aggravates the link between the health of their balance sheets and public finances. Therefore, a discussion is necessary on how to decrease the concentration of such holdings on the books of banks. So-called concentration charges that would kick in once holdings reach a certain threshold would likely be the best option here. However, while there seem to be agreement to reduce NPLs, a number of member states remain firmly opposed to the idea of limiting domestic banks' capacity to buy new sovereign debt.

In the coming months, member states have to decide if they want to complete banking union to make it a coherent, functioning set of rules and institutions or rather leave it unfinished and permanently vulnerable to shocks.

4. Towards A Euro Area Budget?

The debate about a common fiscal policy for the euro area is older than the single currency itself. Yet, its original architecture did not include any instrument for central fiscal policy. Instead, it relied on national fiscal policies to complement the ECB's monetary policy in case of economic downturns affecting the euro area as a whole. And it attributed the role of dealing with asymmetric shocks—i.e. regional downturns in one or a small number of member states—to national fiscal policies only. To be able to fulfill both roles, the rules of the Stability and Growth Pact were supposed to constrain national fiscal policies to save in good times so that they could spend in bad times.

But the crisis on the one hand showed that **the rules were ill-designed and inadequately implemented to build buffers in all member states** (cf. e.g. Greece) and, on the other hand, it made clear that **even if countries had had sufficiently prudent fiscal policies, it was still not enough not to be overwhelmed by a large enough crisis** (cf. Ireland or Spain). In addition, and as described above, the ECB was to a large extent alone in dealing with the crisis affecting the euro area as a whole as national fiscal policies provided very little stimulus.

It is against this background that recent proposals to **set up a fiscal instrument for the euro area** have to be understood. They come under a range of different labels ("euro area budget", "cyclical shock insurance", "rainy day fund", "fiscal capacity", "investment stabilization function", "unemployment reinsurance") but at the end all these proposals do one of two things:

- Either they propose to channel funds from a European pot or directly from other member states to the national budget of one or several member states that are affected by a local downturn. These proposals **support the capacity of national fiscal policies** to react to shocks.
- Or they propose to **shift certain expenditure and revenue types to the European level** to get closer to a federal budget that automatically cushions regional shocks by holding expenditure in that region constant while revenues from that region decrease.

At Meseberg, the German and the French governments have agreed to pursue a proper euro area budget that would fund European expenditure (to be defined what exactly) on the basis of dedicated European revenue and that would hence fall into the second bucket.

A number of open questions remain however:

- It is not clear whether the idea, a key campaign deliverable of President Macron, will end up **mustering enough support among** the other 17 euro-area member states. In the run-up to the Euro Summit in June, a sizeable number of member states, mostly but not only from northern Europe, had strong reservations against a new fiscal instrument. Importantly, the prospect of the proposal will depend on how much support the German side will lend to the common position found in Meseberg as well as the amount of political capital President Macron wants to spend on it.
- Another unclear aspect is the **possible interconnection between a possible euro area budget and the new multiannual financial framework** (MFF) for the EU that will span from 2021-2027. If a euro area budget was created inside the MFF, it will likely be opposed by poorer non-euro area members, which may fear that this will translate into a shrinking of the envelope for "traditional" EU expenditure for all 27 member states.
- Besides, **the Franco-German proposal is not the only one on the table**. The Commission has proposed an "investment stabilization function" that would take the form of loans to countries in a downturn to protect investment, while other

countries such as Italy and Portugal have long championed the idea of a European unemployment insurance. At Meseberg, France and Germany have also committed to study this idea.

In the coming months, member states will need to decide in principle whether they want a new common fiscal instrument and share more risk, under which conditions and in which form. The Euro Summit has tasked the Eurogroup to discuss the matter further without giving any guidance where the discussion should lead. Hence it is up to finance ministers now to come up with a viable solution or to kick the can further down the road.

5. Reforming The ESM—Making Crisis Management More Effective

It has become clear over the last months that **the European Stability Mechanism will remain for now the main locus for euro area reform**. This is because changing the ESM treaty is less cumbersome than a global overhaul of the EU treaties—and also because its intergovernmental setup and the direct control finance ministers have over it make it most appealing to Germany and other member states wary of sharing risks.

To accommodate the backstop for the Single Resolution Fund (see section 3), the ESM treaty will need to be changed. This opens the possibility to also modify other elements of the crisis management architecture that are enshrined in the treaty. The debate on ESM reform evolves around three topics:

- First, a decision needs to be made on **who should be responsible in the future for negotiating and overseeing adjustment programmes** for countries that have lost market access. The so-called troika (Commission, ECB and IMF) has evolved over time into a quadriga, with ESM staff now also participating in programme review missions. Germany has pushed for some time now for a stronger role of ESM staff at the detriment of the Commission. France and Germany have argued in Meseberg that indeed the ESM should take on more responsibilities, but in agreement with the Commission. Hence, we can expect a compromise on this matter. In addition, the future of the IMF in euro area crisis management remains unclear. Differences over how to assess the possible need for debt restructuring have made cooperation in the last Greek programme increasingly difficult and these differences are not likely to fade away. Hence a decision needs to be taken whether or not the IMF should take part in future programmes.
- Second, there is still no solution to the problem that was encountered in Greece: **What to do with a country that loses market access and whose debt is clearly unsustainable?** So far, the ESM treaty does not provide an obvious rule for this situation but leaves markets in the dark as to what would happen in the future. This is no surprise as behind this, there is a more fundamental question that has not been answered yet: Should investors rely on being bailed out in the future if they invest in euro area government bonds and the country cannot under any circumstances repay them in full? And if not, when and under which conditions should their debt be restructured? Proposals range from a fully automatic regime at the beginning of an ESM programme or a regime to negotiate debt restructurings in line with current IMF practice to relatively small technical tweaks to bond contracts that would facilitate restructurings (the latter is what France and Germany have proposed in Meseberg). However, any solution would need to take into account the potentially massive market reaction if all of a sudden euro area government bonds were not seen as safe anymore. This is why this topic is highly contentious especially for countries with high debt levels.
- Third, Germany and France have in Meseberg proposed to **change the ESM toolbox** so that countries can make use of the ESM when they are not yet priced out

- of markets but are increasingly vulnerable to market pressures or when they suddenly face liquidity constraint due to external factors. Already today, there are a number of so far untested precautionary instruments that could be used in this situation. Germany and France have proposed to use these instruments based on so-called ex-ante conditionality, i.e. based on compliance with European rules, but without a full adjustment programme. This is in line with calls by numerous observers, including the ESM itself, to review the ESM's toolbox.

By the end of the year, finance ministers have to come up with a "term sheet" when and how to change the ESM treaty. This means that finally, they will have to sort out in detail what the ESM should look like in the future. Whether or not to call the revamped ESM "European Monetary Fund" or something else is of secondary order and a question of labels. What matters are the details of the reform on substance.

6. Missing Elements

The current debate on future euro area reform focuses—at least in official fora—very much on these three areas: banking union, fiscal capacity, and ESM reform. However, we would argue that **the current focus disregards two major areas** that are vital for the functioning of the common currency:

- First, the crisis has shown that **misguided economic policies at national level** were a major source for destabilizing imbalances. This concerns both national fiscal policies and the structure of euro area economies. Policy choices in both these areas are largely a matter of national competence, even though their outcomes are vital for the functioning of EMU. Therefore, from the start of the euro, the Stability and Growth Pact (SGP) aimed at putting constraints on national fiscal policies to encourage prudent policymaking. Since the crisis, the newly-established Macroeconomic Imbalances Procedure (MIP) aims at detecting problematic economic developments beyond fiscal figures and at correcting underlying policies. However, both procedures have so far only delivered limited results in making the euro area more resilient. On top of that, the complexity and poor enforcement of current EU fiscal rules have led to mistrust and divisiveness between member states. This would call for a review of both sets of rules and, in the medium term, raises the question whether the competences between European and national level is still the right one. The crisis has clearly shown that policy mistakes in fields that are completely national can have a substantial impact on the stability of the euro area.
- Second, the current debate rightly focuses on what policies and instruments the euro area needs rather than on creating new institutions or posts. Form should follow function and hence it makes sense to first consider what the euro area needs on substance before deciding how future institutions should look like. Nevertheless, the question remains relevant: At some point, **the decision will need to be taken whether the euro area should be equipped with its own institutions** (executive, parliament) or will permanently make use of the existing EU institutions. It will also need to be decided if we need a finance minister for the euro and if yes what his or her job description would be. And most importantly, we should decide how political decisions in the Eurozone can be taken with a maximum of democratic legitimacy in the future.

7. Conclusion

The Franco-German compromise at Meseberg has put the right questions on the table. Although they cover only part of the reforms needed for the Eurozone, it makes sense to tackle the three areas now in focus first—banking union, fiscal capacity and ESM reform. They have a certain momentum behind them, are logically intertwined and present fixes to the most pressing problems. Even if the Meseberg Franco-German consensus did not muster enough support to get it endorsed by the other member states, discussions will continue at the level of euro finance ministers in view of taking decisions by December 2018. The next months will be crucial to see whether France and Germany stick to their position and whether they will convince the other member states to follow them.

But a comprehensive and lasting reform of the euro area architecture would also need to encompass two missing elements in current debates—the reform of economic policy coordination and the overall political-institutional architecture. However, given that both potentially reach deep into what is prescribed in the EU treaties, this is likely to be more for the day after tomorrow.

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