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The Future of the Euro Area: The Possible Reforms

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1 Introduction

The previous chapters have analysed the euro area economic governance and showed its several shortcomings. Reforming its design remains an important issue. Two fundamental principles oppose when reforms are concerned: solidarity and market discipline. They both cope with the EU original project, but they also have some perverse effects. Solidarity may induce some moral hazard, that is larger risk-taking, whereas market discipline may induce excessive limitations on deficits and debts. The road

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to economic governance reforms is thus paved with these two principles but bordered by their perverse effects.

Many proposals to improve economic governance have emerged. They can be grouped into two views. The first, usually attributed to German officials, focuses on better compliance with agreed rules and faith in market discipline. The second view is embodied by E. Macron, since his Sorbonne speech in September 2017 highlights risk-sharing and coordination between the EU Member States.[1]

These two views imply different tools. The first view requires debt-restructuring mechanisms (without transfers) for Member States to resolve legacy issues and build some fiscal space before a next economic crisis occurs, whereas the second one focuses on the creation of a Eurozone budget, funding for common European public goods (refugees' policies, defence, investment in technology) and social and tax harmonization. These two paths of reform could be insufficient though to address the vulnerabilities of the euro area like diverging competitiveness or boom–bust cycles.

2 Compliance with the Original Fiscal Framework and Market Discipline

2.1 The Fundamental View

The first path of reform has been clearly delivered by the former German Minister of Finance, M. Schaüble, in his legacy paper.[2] While his position cannot be mixed up with the official position of Germany (they are exposed at the end of the chapter), it is evocative of a legal-prone position about the EU fiscal framework. Yet, it is based upon two principles. The first one is the fulfilment of current fiscal rules. To ease their implementation, simplification of rules is required: the public deficit at 3% of gross domestic product (GDP) and the convergence rule towards the debt threshold at 60% of GDP (or 1/20th debt rule) should be the cornerstone of fiscal surveillance, and other rules (on the cyclically adjusted deficit or on public spending) should be removed. The fiscal framework would allow some margins for manoeuvre around the deficit threshold conditional on the actual decline of the debt to GDP ratio at the expected pace. Moreover, fiscal surveillance could be ultimately handled by a non-political body, for example the EMS, at the expense of the Council which continues to keep the final word. This change would remove the political interferences about the respect of fiscal rules. The legal dimension of fiscal policymaking would weigh on the economic and political dimensions so that, in the end, the fiscal framework would apply rigorously.

The second principle relates to market discipline as the natural device to reduce economic and financial risks jeopardizing cohesion between euro area Member States. In this respect, a government unable to pay interests or repay its debt claims should suffer an increase in its liquidity or default premium, that is an increase in the interest rate on its debts. This market mechanism would be expected to urge a shift in fiscal policy by the government, namely to implement a fiscal consolidation. The supporters of market discipline argue that currently there are two obstacles to its proper functioning in the euro area. First, the Assets Purchase Programme (APP) of the ECB dampens liquidity and default risks and blurs the consequences of fiscal profligacy on interest rates. The APP should then stop and the bail-out principle should be reasserted. Second, prudential regulation assumes that public bonds are risk-free. This creates a sovereign-bank loop: banks have an incentive to hold public debts to fulfil their regulatory constraint while governments easily match their supply of bonds with demand at a (relatively) low yield. This loop also intensifies the fragmentation of the banking and financial markets in the euro area: banks usually hold domestic public debts, hence raising the issue that a default on public debt might produce bankruptcy in the domestic banking sector. To break this loop, sovereign risks should differ across the euro area Member States: it would oblige banks holding riskier debts either to raise their capital or to sell debt instruments. After a change in the regulatory treatment of domestic public debts, the subsequent interest costs would not be equally distributed across banks and countries though. Indeed, where banks hold large shares of risky public debt, interest rates might increase via either higher demand for loanable funds or lower demand for public bonds. Liquidity and default crises may follow and destabilize the whole euro area.

To avoid these bad outcomes, reforming the ESM would also be on the agenda. The ESM has been a permanent "international financial institution" resulting from an intergovernmental treaty among the euro area Member States since 2012 and a successor to the European Financial Stability Facility born in 2010. The ESM can provide financial assistance to Member States experiencing or threatened by severe financing problems. The ESM can grant loans conditional on macroeconomic adjustment programmes; it can also help recapitalize banks. The total loan capacity is € 500 billion out of a capital of € 700 billion. While the ESM seems close to the International Monetary Fund (IMF) in its functioning, it does not share the preventive arm of the IMF: it has no capacity to monitor economies to prevent liquidity or default crises via, for example automatic liquidity support. The transformation of the ESM into a European Monetary Fund (EMF) would require a credible application of the no bail-out principle to limit moral hazard (Wyplosz 2017). It could be obtained via the creation of a debt-restructuring mechanism in the EMF toolkit. This would permit the orderly default of a non-complying Member State without jeopardizing the whole euro area. Finally, the EMF would monitor country risks and the implementation of the Stability and Growth Pact (SGP).

2.2 Discussion

There are a few shortcomings with this reform path. First, advocating more market discipline assumes market efficiency. This assumption is at odds with the lessons drawn from the GFC: markets were unable to prevent the crisis; worse they fuel it via systematic under-estimation of risks during upturns. Increasing the sensitivity of the European governance framework to market perceptions and market volatility seems ill-designed, unless financial stability prevails. The latter also rests on a strong assumption. Second, reliance of conditionality on the implementation of structural reforms and on former compliance with the fiscal framework is contradictory. Indeed, there are many issues with structural reforms (Manassé and Katsikas 2018): they take time to design and implement before they may be effective; they may modify the behaviours of firms and households only slowly; they are often painful in the short run and therefore prevent political consensus on the necessity for reforms. There are also many issues with the EU fiscal framework (see Chap. 4). Third, extended market discipline without a risk-free European public bond will definitely transform the domestic bonds of a Member State into the benchmark. This is already the case with German Bunds and it feeds financial divergence between a so-called risk-free issuer and the other Member States which incur a spread vis-à-vis Germany. Additionally, the introduction of risk on sovereign debt may have substantial implications for the domestic banking sectors. In light of European Banking Authority's guidelines involving the imposition of risk-weights on public debt holdings, banks capital ratios could decline unevenly across Eurozone member states, generating higher rather than lower banking risk.

To avoid having a national benchmark in a monetary union, some departures from the fundamental view are required. Supporting the creation of a European safe asset is one possibility. There have been some proposals in this respect which introduce some risk-sharing between the euro area Member States. Delpla and von Weizsäcker (2010) propose to pool the public debts that are in compliance with the 60% debt to GDP requirement in the TFEU. In the case of a sovereign default, a State would treat "blue debt" preferentially, whereas "red debt", which is the debt issued above 60%, would be junior debt. Brunnermeier et al. (2016) propose two pooled assets, next to regular bonds, that would be put into a tranched CDO. The CDO would pool the underlying debt contracts, including the safest debt in the senior tranche, called European Safe Bonds (ESBies) and the riskiest in the junior tranche, called European Junior Bonds (EJBies). Similar to Delpla and Weizsäcker, the overall pool should only contain a limited amount of government debt, so that the rest would be treated as "red bonds". The proposition of junior bonds was revived by Bénassy-Quéré et al. (2018).

There are also needs for some forms of immediate reductions in debt payments. Corsetti et al. (2015) propose that in addition to a safe bond, the ESM should be augmented with a "Stability Fund". This fund would buy back European debts above 95% of GDP of a country and swap the debt with zero yielding perpetuities. Pâris and Wyplosz (2014) argue that their Politically Acceptable Debt Restructuring Fund for the Eurozone (PADRE) regime would require that the ECB buys and swaps Member

States bonds into zero-interest perpetuities. The ECB would purchase domestic debts in proportion to the ECB capital key. To limit free riding from Member States, they add strict enforcement rules. Should a country start to accumulate debt again, the ECB could opt to swap the perpetuities back to normal yields, and countries would face market discipline. Corsetti et al. (2017) promote a "Eurozone Fund" which would be able to issue non-defaultable debt by issuing bonds which would be convertible at par into currency once they mature. In all these proposals, the fund would be financed by collecting taxes, usually part of VAT, and seigniorage incomes.[3]

3 Options for Deepening Euro Area Governance

The second path of reform departs from market discipline to highlight the necessity of shock absorbers and coordination between the Member States.

The EU framework has been built on the belief that market flexibility and nominal targets (inflation, deficit, etc.) would be sufficient to ensure real convergence in the euro area both in times of growth and in times of crisis. This was an illusion, given the evidence available since the early 1990s that even in the United States transfers from the federal budget help to absorb a substantial amount of asymmetric shocks.

Euro area countries therefore need mechanisms with which they can offset asymmetric shocks. They also need mechanisms to cope with inbuilt tendencies within EMU for countries to diverge due to the difference in real interest rates generated by a single nominal interest rate and differential inflation rates. Dealing with the asymmetry of shocks also requires some coordination. Thus, a central coordinating institution would be invaluable in maximizing real convergence and EMU-wide growth.

The Five Presidents Report of June 22, 2015 made a first attempt in setting out the principles to be followed to provide the euro area with an absorption capacity. The report highlights that a federal budget should provide for a stabilization of asymmetric shocks in normal times, be neutral from the budgetary point of view over the medium term, and not in charge of stabilization in the event of a major crisis. Moreover, the euro area budget should not hinder the functioning of the fiscal rules which discipline the Member States (irrespective of effectiveness of the rules themselves).

Since the publication of the report, the discussion has evolved and focused on the management of economic crises. The French President E. Macron, in September 2017 at La Sorbonne, defended the adoption of a Eurozone budget to provide investment, emergency financial assistance and crisis absorption capacity, to be placed under the responsibility of a European minister of economy and finance under parliamentary control. Achieving such a budget would require new funding resources, like a European tax on digital companies or ecological taxes. E. Macron also promotes social convergence via converging corporate tax rates (more precisely, a "corridor" for corporation tax rates) and the adoption of a European norm on minimum wage: "in social affairs, we need to guarantee a minimum wage for all, adapted to the economic realities of each country, and regulate social contribution competition".

A Eurozone budget may help provide transnational public investments, which could avoid the complicated construction of the Juncker Plan, and it may also help fund migration and refugees policies at European level, whose management and costs currently fall on a few countries' shoulders. A streamlined and centralized supply of these European public goods would be very important to boost growth and increase productivity; especially if one thinks of the important investment, and economies of scale, related to the environmental transition. In other areas, such as border security, the benefits are more of a political nature, resolving a collective action problem to the ultimate benefit of all countries. Thus, the coordination and management at European level of such efforts offers potentially significant improvements over the present situation. In itself this part of the European budget could not help the cyclical stabilization and the absorption of asymmetric shocks, because it is linked to structural needs. However, nothing would prevent the European minister from using it also for stabilization purposes. Directly, even if the horizon of needs remains "structural" and multi-year, the minister would have some flexibility in the management of the budget in the short term. There would be nothing to prevent or delay spending allocated to a certain region/country according to the cycle, while ensuring long-term coherence at the aggregate level. More indirectly, by centralizing part of the investment expenditure at the global level, the Eurozone budget would free up resources for member countries, which could be used for social protection and the cyclical stabilization of each country. A similar idea was put forward by Martin Sandbu (2018) regarding the use of the European Union budget, which by its very nature aims to promote the development of certain sectors and the long-term convergence of European economies. Sandbu notes that contributions and payments to the European budget could be indexed to the cyclical conditions of the economy, with a substantial stabilizing effect.

The proposal of adopting an investment strategy to dampen economic shocks contrasts with the proposal of a European unemployment insurance (EUI) scheme as pioneered in the Marjolin's Report (1975) and later relaunched by Dullien (2007). If this scheme had complemented existing domestic unemployment insurance systems during the crisis, the stabilizing effect on GDP and income would have been non-negligible (see e.g. Apparisi de Lannoy and Ragot 2017). However, the studies reviewed by Beer et al. (2014) suggest that EUI would lead to permanent transfers. If EUI had been in place since 1999, the core countries would have been net contributors and peripheral countries net beneficiaries. This result does not only depend on the fact that structural unemployment is higher in the peripheral countries, but also on the differentiated short-term (cyclical) reaction of unemployment to shocks. To remain budget neutral, EUI needs clawbacks (*ex post* additional contributions) or experience ratings (*ex ante* modifications in contributions), hence periodic re-parameterization of the EUI which greatly complicates its operations and may reduce the extent of stabilization.

4 The European Commission's Proposals

On December 6, 2017, the Commission set out its proposals of reform. They highlight a balanced focus on market discipline, with support to structural reforms, and budget integration, with a euro area stabilization function. It must be stressed that the latter element does not modify risk-sharing between the euro area Member States.

The Commission proposes a new instrument to improve the functioning of the euro area. A "reform delivery tool" should financially support Member States in committing to the implementation of structural reforms. The area of reforms is broad, from product and labour markets to public administration reforms. A complementary tool would consist in technical support. According to the Commission's communication of May 2, 2018, the Reform Support Programme would have a budget of €25 billion over the next Multiannual Financial Framework (MFF).

The Commission requires the integration of the fiscal rule on the cyclically adjusted deficit (stemming from the Fiscal Compact of 2012) into EU legal framework. This initiative would unfetter the Commission from the intergovernmental dimension of the Fiscal Compact and permit it to resume control over all the budgetary rules. It also shows its willingness to improve commitment to the rules and their stricter application, although it does not demonstrate that these rules have been effective so far (see Chap. 5).

The Commission is also proposing the transformation of the ESM into a European Monetary Fund (EMF), no doubt also to avoid an intergovernmental mechanism—the ESM—which reduces its power of initiative and control (see e.g. Creel 2018a). The EMF would make adopting a preventive component of budget crises possible. In the future, the establishment of a stabilization function could be attributed to the EMF. This function would be triggered in the case of "large asymmetric shocks". The proposal of the Commission departs from Schaüble's in two respects: first, according to the latter, the EMF would remain inter-governmental (at least in the short run); second, he claims that a European stabilization function is not necessary.

The adoption of a stabilization function at European level that the Commission proposes "would provide the possibility to activate resources rapidly to deal with shocks that cannot be managed at the national level alone". In the Commission's communication of May 2, 2018, this stabilization function is labelled the "European Investment Stabilisation Function" (EISF). While distinct from other existing fiscal instruments, national or European, it retains the usual properties of budget instruments: it must be neutral in the medium-term; and it must not lead to permanent transfers between the euro area Member States. Moreover, it is conditional on former compliance with the EU surveillance framework. Its net payments would be capped at around 1% of euro area GDP.

This proposal raises several remarks. First, the creation of the EISF would help improve resilience of euro area Member States to macroeconomic shocks. Second, it opens discussion on the identification of shocks, like "a large temporary negative deviation from the unemployment or investment trend". However, it does not propose—at this stage—a systematic method to identify these shocks and distinguish between demand and supply shocks (see e.g. Creel 2018b). Third, necessary compliance with the EU surveillance framework is contradictory with the inability of this framework at successfully achieving the EU objectives and at enforcing fiscal rules so far. Moreover, under its current form, the EU budget is balanced and therefore irreconcilable with macroeconomic stabilization of large shocks (which it was not responsible for until then). To be effective, the stabilization function should be associated with a debt capacity over the long run which has not been mentioned so far. The size of the stabilization function is also limited: According to its communication of May 2, 2018, the Commission announced "back-to-back loans under the EU budget of up to €30 billion" for the EISF for the next MFF (2021–2027). Per year, this extra financial support represents less than 0.05% of euro area gross national income. Finally, the preferred way of envisaging the stabilization function by the Commission is via a public investment support rather than a European Unemployment Reinsurance Scheme. The rationale can be traced back to the decline in public investment that follows a negative shock. The stabilization function would then remove the risk of sacrificing public investment on the altar of austerity. Nevertheless, if negative shocks on demand are clearly identified, austerity measures will no longer appear as a panacea after a shock and the slack on public investment will disappear. Moreover, as a stabilization function, automatic stabilizers are certainly more timely than public investment policy to dampen a "large asymmetric shock".

5 What About Macroeconomic Imbalances?

The causal relationship between real divergence across euro area Member States and the European sequel to the global financial crisis (see e.g. Sinn 2014) raised EU initiatives in 2011 with the adoption of the "6-pack" and the establishment of the European Semester to improve policy coordination in the EU beyond fiscal questions.

The "6-pack" adds to the preventive and corrective arms of the SGP, a Macroeconomic Imbalance Procedure (MIP) drawing on indicators related to current account positions, competitiveness and financial stability. The purpose is "to provide an early-warning signalling of potentially harmful macroeconomic imbalances in Member States". The MIP scoreboard resorts to pinpointing the position of countries regarding thresholds, an approach close to the one already used for identifying excessive deficits in the SGP.

Most indicators in the scoreboard are asymmetric. For instance, the current account threshold is set between a surplus of 6% of GDP and a deficit of 4% of GDP. There is no economic rationale for these specific thresholds; and there is no economic rationale as well for introducing an asymmetry in the current account threshold. What makes a deficit above 4% more dangerous to the stability of the euro area than a surplus above 4% (but below 6%)? Yet, a large current account deficit in Portugal might lead to default on its external debt, but a large current account surplus in Finland can mirror a lack of investment opportunities and weak internal demand. Under the current asymmetric thresholds, the risk of default on private debt in Portugal outweighs the risk of deflationary forces in Finland and it takes for granted that the spillovers of the former on the euro area are greater than the latter. This is a disputable statement.

This is certainly even more disputable if differences in the size of countries add to the asymmetry in the thresholds. Change Portugal into Greece and Finland into Germany in the above example. Can one be sure that the spillovers on the euro area of a default on private debt in Greece outweighs deflationary forces in Germany after keeping in mind that a current account deficit of 4% of GDP in Greece amounts to € 7 billion, whereas a current account surplus in Germany of 6% of GDP amounts to € 160 billion?

Other indicators in the scoreboard relating to competitiveness and market shares are even more asymmetric: the burden of responsibility is exclusively borne by deficit/debtor countries. This is notably the case for the net international investment position, which is by construction the accumulation of past current account balances. Because of this bias in signalling only a certain type of imbalances, it is possible to miss the fact that a market share loss by a given euro area country may have as counterpart a market share gain by another one. Therefore, there is a risk of gearing recommendations towards deficit countries and urging them to adjust wage costs downward or to implement restrictive policies. Conversely, it will fail to signal that surplus countries have run competitive disinflation policies. The differences in the size of countries will amplify the asymmetry in the management of macro imbalances. As stressed by De Grauwe (2012), the current governance of macroeconomic imbalances in the euro area enhances the "tyranny" of creditor countries, among which Germany, by far the largest country in the euro area. The result is that the euro area goes on implementing a global disinflationary policy. By only signalling competitiveness losses, the MIP actually misses to signal a coordination problem among euro area countries.

The same remarks hold for indicators of internal imbalances. By considering only the increases in private sector credit flows, the scoreboard only signals Member States facing overheating although weaknesses in internal demand may also be a source of disequilibrium. Macrosurveillance in accordance with the objectives of the EU should not only point out the risks of an excess development in credit and asset prices. For instance, a slowdown in credit flows may signal a situation of credit crunch or weakness in internal demand. It would then be useful to consider a lower limit to the credit flows to the private sector.

Moreover, policy coordination draws on indicators on which Member States do not have full control. While it is conceivable that governments can change at least part of their budget to abide by the SGP, it is just unconceivable that they can change even a part of the current account imbalance in the short term in order to abide by the recommendations following the MIP.

It is certainly very revealing about the current reform agendas of EU countries or institutions that no reform proposal pertains to the MIP.

Reform proposals so far do not address the vulnerabilities of the euro area like diverging competitiveness or boom–bust cycles. On the latter point, Creel (2018b) argues that the threshold on private debt included in the MIP (at 133% of GDP) should be transformed into an *operational* target and complemented with the adoption of a policy tool. This tool could take the form of a specific tax on banks to help limit the risk of a boom in a domestic credit market.

6 Conclusion

The TEU clearly states that the Union's overall "aim is to promote […] the well-being of its people" (Article 3 (1)) and goes on to specify in paragraph 3 that it shall work, amongst other things, for sustainable development, social progress and improving the quality of the environment. Reforming EMU economic governance should therefore take such primary economic objectives as a point of departure. However, since the 2008 economic and financial crisis, reforms of economic governance in the EU have been decided in an ongoing state of emergency, guided by the principle "whatever it takes to preserve the euro", formulated later on by ECB president Mario Draghi in 2012. Proposals have emphasized crisis prevention and resilience to economic shocks.

Especially now that the immediate pressure for crisis management has eased in parallel to economic recovery, policy makers should pay more attention to the longer-term overall economic objectives while reforming EMU economic governance to foster sustainable well-being and upward convergence.

In the previous sections, we have set out and analysed some of the many proposals to reform the EMU. On the one hand, proposals emphasize economic stability created by disciplining "unsound" policies at the national level, either through markets or intergovernmental institutions; on the other hand, proposals stressing the need for more risk-sharing, solidarity, and policy coordination to foster upward convergence.

The current agenda of reforms in the Eurozone may have a limited impact, for at least four reasons. First, it is not comprehensive enough. Steps to manage macroimbalances symmetrically are absent from mainstream reform agendas. Second, the outcome of these projects is not for tomorrow as the horizon to reach an agreement on the various aspects of reforms (Eurozone budget, EMF, domestic fiscal rules) could extend to 2025. Unfortunately, for the euro area, the status quo could last and macroimbalances and economic fluctuations could remain. This may lead policymakers to continue keeping an eye on the short term rather than on the long term. Third, the margins for manoeuvre embedded in a Eurozone budget (if it were adopted) would remain limited in size to produce a sharp and positive public impetus for investment that would extract the euro area from a stagnation trap. Fourth, the achievement of a more equal Eurozone requires more than the multiplicity of "productivity boards" without clear cooperation tools and a vision of structural reforms that continues to aim for flexibility and competition, even though both have already reached high levels in Europe. To promote growth that cares for the future, the EU should turn away from the recipes of the past (an accounting approach of fiscal policy and market-oriented structural reforms), which have not been helpful for fixing the European crisis. In contrast, EU governments should invest in the future and incentivize innovations via tax and fiscal policies. Last, the contradictions arising in the German government in Spring 2018 will not help choose a path of reform: both in press interviews, the German Chancellor made a step in the direction of the Commission, whereas her Minister of Finance made a step aside. Mrs. Merkel advocated the transformation of the ESM into an EMF (though in her view it should retain its intergovernmental approach), the creation of a new financial incentive for countries to adopt structural reforms and an investment budget as new cohesion funds (with "low double digits billions"). In contrast, Mr. Scholz argued for an EU Unemployment Reinsurance Scheme. If even the German government struggles to reach a consensus, the odds for a comprehensive and effective reform of European governance are slim at best.

Notes

1. Maybe it was best expressed in his speech in Aachen in May 2018: "Europe (…) can no longer function on successive hegemonies. It can only be built on constant solidarity".

2. See W. Schäuble's Non-paper for paving the way towards a Stability Union, available at http://media2.corriere.it/corriere/pdf/2017/non-paper.pdf.
3. Seigniorage income reflects the interests that the central bank earns on the money it lends to banks or the return it receives on the assets it purchases.

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