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ARTICLE

What we hope, what we fear, what we expect: possible scenarios for the future of the eurozone

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Abstract Financial, economic and sovereign debt crises have called into question macro-economic and monetary integration in Europe in general, and the future of the eurozone in particular. It is possible that even the future of the European Union (EU) as a whole is at stake. Starting with the reforms of European economic governance hitherto agreed, this article develops three scenarios for the eurozone and explores their possible impact on the EU in general. The mix of procedures, both inside and outside the EU legislative framework and with varying groups of participants, offers a starting point for the emergence of an 'Optimal Institutional Architecture'.

Keywords European Union · Eurozone · Crisis · Differentiated integration

Introduction

Since mid-2007, the EU and in particular the eurozone have experienced a succession of crises, spreading from the financial sector into the real economy and ultimately leading to the current sovereign debt crisis. This turbulence has not only threatened the stability of the eurozone, but has also called into question the fundamental objectives of the EU as a political system. Consequently, over the past four years, EU leaders have taken steps to reshape

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the governance architecture by creating a set of far-reaching reforms. Many of these reforms have been highly contested and the outcome of painstaking negotiations. On more than one occasion Member States have achieved only modest success, even when under the pressure of a looming meltdown in the financial markets and the imminent break-up of the eurozone.

Faced with obstacles to dealing with major challenges, one almost automatic reaction in the process of EU integration builds on the notion of a European construction in which not all Member States participate. Over the history of the EU system, Member States have pursued such strategies of 'deepening by differentiation' in several areas of policymaking, establishing core groups and reducing the number of members participating (see Tekin 2012). In the search for optimal and feasible problem-solving areas, these proposals articulate fundamental trade-offs between the 'deepening' and the 'widening' of the Union. Is a 'two-speed EU', with closer cooperation among a group of Member States who develop common policies and actions outside the EU treaties, as recently described by Piris (2011), the future of Europe?

Against this background, this article summarises the main elements of economic governance reform. Taking this a step further, it develops three political scenarios for the eurozone and, alluding to Mundell's (1961) Optimum Currency Area, sketches some principles for an 'Optimal Institutional Architecture' against the backdrop of its possible impact on the EU system as a whole.

Economic governance reforms: an inventory

The reforms can be broadly categorised into two groups: (i) projects which are implemented within the treaty framework and address all EU Member States (sometimes with stronger rules for eurozone countries), and (ii) projects of 'differentiated integration' which are outside the treaty framework and aimed at a subset of EU Member States only (Table 1).

Reforms within the EU legislative framework

The main EU-level response to the financial crisis in 2008 (apart from the European Central Bank (ECB)'s regular and less orthodox policy measures) focused on improving supervision in the financial sector, primarily through creating the European Systemic Risk Board (ESRB). Moreover, three new European Supervisory Authorities have replaced the existing committees. Together with national financial supervisors, they form the European System of Financial Supervisors (ESFS), which focuses on individual financial institutions.

In contrast to these reforms aimed at the early detection and prevention of financial crises, the European Financial Stabilisation Mechanism (EFSM) is part of a 'firewall' established in May 2010, when the financial crisis turned into a sovereign debt crisis. It enables the Commission to provide assistance by borrowing in financial markets on behalf of struggling Member States, using the EU budget as a guarantee. The EFSM complements credit lines provided by the

Table 1 Economic governance reforms since the beginning of the financial turmoil and sovereign debt crisis

Project	Legal framework and participants
(i) EU/within EU legislative framework	
European Financial Supervision: European Systemic Risk Board (ESRB) and European System of Financial Supervisors (ESFS)	Based on EU secondary legislation. Participants: EU Member States
European Financial Stabilisation Mechanism (EFSM)	Based on EU secondary legislation. Participants: EU Member States
European Economic Policy Coordination: European semester; Six-Pack	Based on EU secondary legislation. Participants: EU Member States
Institutional Governance Architecture	Institutional reforms based on Euro Summit and European Council conclusions. A number of institutions only, but only including the eurozone members
(ii) Subsets of Member States/outside EU legislative framework	
European Financial Stability Facility (EFSF)	Private company owned by the eurozone members. European Commission involved in implementation (conditionality)
European Stability Mechanism (ESM)	Intergovernmental organisation based on European Council decision for a limited change of the EU treaties. (Revised) ESM Treaty signed by the eurozone members. European Commission involved in implementation (conditionality)
Euro-plus Pact	Intergovernmental agreement based on European Council conclusions. Adopted by the eurozone members as well as Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania. European Commission involved in monitoring
Treaty on Stability, Coordination and Governance (TSCG)	Intergovernmental treaty signed by all EU Member States except the Czech Republic and the United Kingdom. European Commission involved in monitoring. Obligation to introduce national debt brake subject to jurisdiction of Court of Justice of the European Union

International Monetary Fund (IMF) and the European Financial Stability Facility (EFSF, see below).

A third project at the EU level includes legislation geared towards supervision and coordination in order to correct macro-economic imbalances. Five regulations and one directive (known as the 'Six-Pack') have revised the rules of the Stability and Growth Pact (SGP) on the one hand, and the cyclical economic governance framework of the EU on the other. The reform is complemented by the introduction of the European semester, an annual review period geared to detect emerging imbalances at an early stage.

Finally, the institutional governance architecture has undergone decisive change. Immediate reactions to the crisis have been characterised by the escalation of decision-making to the highest political level. When dealing with

key issues of national sovereignty, the European Council has assumed a central role. In line with German Chancellor Angela Merkel's notion of the 'Union Method', which emphasises the role of the Member States, intergovernmental coordination has, to some extent, superseded supranational policymaking. At the same time, the relationship between eurozone countries and EU Member States outside the eurozone has changed, primarily reflected in the gradual emergence of the Euro Summit format since 2008. By late 2011, efforts to contain the crisis had evolved into plans to complement the EU governance structure at all levels with parallel formations for eurozone members only (Fig. 1).

Reforms outside the EU legislative framework

Beyond the EU legislative framework, the crisis has given rise to a number of intergovernmental agreements with varying circles of members.

EUROPEAN UNION

European Council (EU Summit)[a]
27 Heads of State or Government, President of the European Council, President of the Commission

Status quo:
- provides strategic orientations
- at least 4 meetings per year
- quasi-permanent president since December 2009

Reforms:
- none

Ecofin Council
27 Ministers of Finance and Economic Affairs

Status quo:
- formal decision-making body (EMU-related topics: only euro countries vote
- rotating presidency

Reforms:
- modified decision-making procedures, e.g. regarding the Stability and Growth Pact[d]
- strengthening of General Secretariat[c]

Economic and Financial Committee
Max. 54 high-ranking officials from national ministries and central banks, Commission, ECB

Status quo:
- set up in 1999, prepares Ecofin
- elects a president from its members
- own secretariat which is attached to Commission services but independent

Reforms[c]:
- strengthening of secretariat

EUROZONE

Euro Summit
17 Heads of State or Government, President of the Euro Summit[b], President of the Commission

Status quo:
- irregular informal meetings since May 2008

Reforms[c]:
- Continuity: at least 2 meetings per year
- own president designated along with President of the European Council
- President of the Euro Summit keeps non-euro countries and European Parliament informed about summits

Eurogroup
17 Ministers of Finance and Economic Affairs, Commission, ECB

Status quo:
- informal meetings since 1998, regularly on the eve of Ecofin meetings since 2000
- elects a president from its members since 2005

Reforms[c]:
- prepares Euro summits
- currently discussed: full-time president

Eurogroup Working Group
17 high-ranking officials, Commission, ECB

Status quo:
- prepares Eurogroup meetings since 2003
- chair: President of Economic and Financial Committee

Reforms[c]:
- full-time chairman
- possibly more permanent sub-group

The President of the Euro Summit, the President of the Commission and the President of the Eurogroup meet at least once a month, the President of the ECB may be invited to participate.[c]

a Art. 15 TEU; Art. 235-236 TEU.
b Pending the next election of the President of the European Council, the current President of the European Council will chair the Euro Summit meetings.
c Annex 1, Euro Summit Statement of 26 October 2011.
d Council of the European Union: Press Release. 3115th meeting of the Council. Economic and Financial Affairs, Luxembourg, 4 October 2011, Doc. 14890/11.
e Protocol (No. 14) on the Euro Group, Official Journal of the European Union, No. C 83 of 30 March 2010, p. 283.
f Art. 134 TFEU; revised Statutes of the Economic and FinancialCommittee, Official Journal of the European Union, No. L 158 of 27 June 2003, p. 58.

Fig. 1 Institutional reforms of economic governance. *Source* translation from T. Kunstein and W. Wessels. Die Europäische Union in der Währungskrise: Eckdaten und Schlüsselentscheidungen, *Integration,* Wessels (2011, 319)

The Euro-plus Pact can be described as the least binding of these reforms. Created in March 2011, it comprises a set of measures to improve the competitiveness of participating countries (all eurozone members, plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania). It is built exclusively on voluntary adherence to its rules and there are no plans to incorporate it into the legal framework of the EU.

In reaction to the imminent threat of the break-up of the currency bloc in the first half of 2010, eurozone governments created the temporary EFSF, a special-purpose mechanism located in Luxembourg and the main element of the abovementioned firewall for the eurozone. Using guarantees from eurozone countries, the EFSF can borrow funds at favourable interest rates and pass them on to struggling eurozone members.

In March 2011, the European Council agreed to a limited change of the EU treaties to allow for the creation of a permanent rescue instrument, the European Stability Mechanism (ESM). Based on an intergovernmental treaty between the 17 eurozone countries expected to be ratified in summer 2012, this international financial institution will replace the EFSF after a period of coexistence.

Funding from the EFSF and the ESM is subject to conditionality in order to avoid 'moral hazard': in exchange for support, recipient countries must undertake far-reaching economic reform under the supervision of the European Commission, the ECB and the IMF. In order to make conditionality more credible, it is planned to make ESM assistance subject to the ratification of the latest addition to the system of economic governance: the Treaty on Stability, Coordination and Governance (TSCG).

The TSCG is an intergovernmental treaty aimed at safeguarding the stability of the eurozone. Crucially, it includes the 'fiscal compact' which requires contracting parties to adopt national-debt-brake rules. The TSCG foresees that this obligation will be subject to the jurisdiction of the Court of Justice of the European Union. This is a major difference from the intergovernmental arrangements described above, where no such enforcement mechanism exists.

Signed on 2 March 2012, the TSCG will enter into force as soon as it has been ratified by 12 eurozone members (Art. 14(2) TSCG). Thus not even all euro countries are needed to form a core group within the EU, and the fundamental idea that all EU Member States have to agree has changed radically. Interestingly enough, with the exception of the Czech Republic and the United Kingdom, all EU members intend to join. The expectation that the core group will take important decisions that also have an impact on those outside has led to strong centripetal dynamics. More specifically, those countries ratifying the TSCG that are not members of the eurozone will be given the chance to participate in the Euro Summit on certain issues of a general nature (Art. 12(3) TSCG).

Following other major examples of integration arrangements originally agreed outside the EU treaties (such as the Schengen Agreement), the substance of the TSCG shall be incorporated into the EU's legal framework at a later stage (Art. 16 TSCG).

Scenarios for the eurozone and their impact on the EU in general

Scenario one: towards fiscal (and political?) union

Three variants of fiscal union can be distinguished (Begg 2011, 5). The first variant, a 'rules-based union', would be marked by enhanced coordination and fiscal and economic surveillance. As Begg notes, the Six-Pack 'moves the European Union (and more so, the euro area)' towards such an intensification of the oversight of national fiscal policies. These reforms, most of them already in place, can be considered as the mildest way of adapting the original eurozone set-up. The question is whether they will prove sufficient—the dismal record of the SGP in the early years of the Economic and Monetary Union (EMU) raises some doubts in this regard.

The second variant is a 'liquidity union' (Begg 2011, 5). Struggling eurozone states would receive support in case of liquidity (but not solvency) problems. The EFSF and the ESM represent steps in this direction. However, given that it is notoriously difficult to distinguish between illiquidity and insolvency, the firewall creates problems of its own, in particular with a view to possible moral hazard, as discussed above.

Fully fledged fiscal union with transfers to weaker Member States constitutes the third variant. Its embodiment, a eurozone Ministry of Finance (Trichet 2011), is an unlikely scenario at the present time, but eurobonds as one possible element have been frequently discussed in recent years. Their introduction (cf. European Commission 2011) would allow the eurozone to borrow as one entity, probably reducing overall borrowing costs. The cost-benefit analysis for individual countries is less clear, especially given that governments would be required to give up some control over their tax and spending decisions. Such steps remain extremely contentious in terms of political and public support. Obviously, any further move towards fiscal union would have to be complemented with progress on political union. Proposals include (1) more influence for national parliaments, or (2) a reform and further empowerment of the European Parliament (Piris 2011). Alternatively, (3) the Commission could be transformed into an economic government, controlled by the Council and the European Parliament (Collignon 2010). However, experience so far does not suggest that there is sufficient political support for a move in that direction.

More generally, the view that monetary union even necessitates a common fiscal policy is by no means uncontested. For example, Belke and Gros (2009, 49) suggest that 'a mild form of fiscal policy coordination … is likely to remain the much more useful approach'.

Scenario two: break-up of the eurozone

The contrasting scenario to the quantum leap in integration towards fiscal and/or political union would be disintegration. Different variants are also conceivable for the break-up scenario (Belke 2011), depending on whether a weak country or a strong country leaves the eurozone. Based on academic concepts of an

optimum currency area, some economists have even considered a radical reduction of the present membership—that is, a split between a northern stable area around Germany and the more southern countries, which then could devalue against the more competitive ones (Habbel et al. 2012, 23).

There is agreement that the break-up scenario would entail huge economic costs, especially for the countries leaving the euro. But whether exit would be less costly than continuing the current bail-out strategy remains controversial—especially given that (geo) political costs are normally not enumerated in scenarios which implicitly assume that large countries such as France remain part of the eurozone.

For the time being, political leaders seem unwilling to dive into the uncharted territory of a eurozone break-up. The worst-case scenario would then be a 'permanent' state of crisis and a 'lost decade' for the eurozone, resulting in the absence of confidence for many years and an economic system reliant on central bank support.

Scenario three: intergovernmental coordination outside the EU treaties

Without discussing the exit option, European leaders—particularly the members of the Euro Summit under a strong Franco–German leadership—have developed concepts in which Member States can exercise forms of economic governance clearly distinct from the rest of the EU, as reflected in the ESM and TSCG treaties. In several ways, the strategy of establishing a kind of economic government and its institutional architecture suggests the idea of a 'Europe pioneer' or an 'avant-garde' (Chirac 2000; Fischer 2000). Irrespective of its economic wisdom, it is an optimal strategy that combines political flexibility concerning membership with a deepening of the relationship which is—outside the EU Treaties—imperfect but geared towards integration into the institutional and legal architecture. Fixed membership and variations for restricted opt-ins combine the advantages of increased flexibility on substance and the disadvantages of confirming several 'classes' of EU membership, calling into question the role of supranational institutions.

The institutional architecture of the eurozone, which partly relies on less formal arrangements, exists within the treaty-based EU architecture. It follows that the nature of eurozone rules in view of existing EU laws is a major issue—one can speak of an imperfect communitarisation. The TSCG stresses the 'consistency and relationship with the law of the Union' (Art. 2 TSCG) and makes use of the legal benefits in EU law, in particular the surveillance procedure of the SGP (Art. 5 TSCG). As a minimum, the ESM requires that conditionality be consistent with EU law (Art. 13(3) ESM Treaty).

However, Article 7 of the TSCG tightens the existing procedure: in lieu of the requirement for a qualified majority in the Council to approve a Commission proposal on sanctions in the framework of the excessive deficit procedure (Art. 126 TFEU), a qualified majority against the proposal is now required to halt the procedure.

The TSCG involves the key players of the EU framework, the Council and the Commission, only in a limited way. Especially in terms of the Commission, there is the expectation that it cannot play its role as 'guardian of the treaties' by taking a sinner state to court. However, against conventional wisdom, the Commission has increased its power to monitor the compliance of major national policies by scrutinising the budgets of eurozone members. The 'partnership programmes' (Art. 5 TSCG) for countries subject to an excessive deficit procedure and the 'memorandums of understanding' detailing ESM conditionality (Art. 13(3) ESM Treaty) are a deep cut into the parliamentary sovereignty of the concerned states. For some imperfect forms of communitarisation, however, the Commission is limited to a watchdog role; it is the judgment of the Court of Justice of the European Union that will be binding (Art. 8 TSCG).

From the perspective of democratic legitimacy, only a relatively weak form of multi-level parliamentarism is envisaged (Art. 13 TSCG). A set-up along the lines of the existing Conference of Community and European Affairs Committees of Parliaments of the European Union (COSAC) does not promise sufficient control and codecision. The latest judgment of the German Constitutional Court on 28 February 2012 ruled a Bundestag Committee responsible for oversight of the ESM unconstitutional because of its small size—it included just nine parliamentarians. This reflects the resistance against the delegation of budgetary powers from the national to the supranational level without the accompanying political integration.

Conclusion

Will the common currency be salvaged? As any attempts to predict this are laden with uncertainty, we formulate our assessment of future prospects for the eurozone in terms of what there is to hope, to fear and to expect.

We can only hope that the common currency still forms a part of the European project as envisaged by the founders of the EMU. In this scenario, the steps taken thus far towards a rules-based liquidity union are sufficient to preserve a eurozone which, in the medium term, will comprise all or at least a large majority of EU Member States.

The scenario of a eurozone break-up should, by contrast, cause us concern. It might be that a country's exit is the best deal in economic terms, but setting a precedent in this way risks undermining political dedication to what is a key part of the European integration project.

Integration history suggests that neither extreme scenario will materialise. Rather, our expectation is that the eurozone will increasingly rely on intergovernmental coordination outside the treaties. To the degree that flexibility is needed, strict observation of the Community orthodoxy will take a back seat. At the same time, the fact that opt-out countries (except the United Kingdom) want to sit at the table translates into strong centripetal logic, as the TSCG demonstrates.

Against this background, an 'Optimal Institutional Architecture' would combine a mixture of procedures both inside and outside the EU legislative framework. It would require

- some element of multi-level parliamentarism (more than the COSAC-type conference referred to in Art. 13 of the TSCG),
- a wider use of 'double hats' (not only for the President of the European Council and the Euro Summit, but also, for example, for the ECOFIN and Eurogroup presidencies), and
- structured links between the eurozone and countries that do not have the euro.

Clearly, as a corollary of stabilising the eurozone, a new EU is emerging from the crisis. The chances are that it will actually look more like several thereof: various groups of Member States cooperating more closely in different areas—where possible inside, and where necessary outside, the EU treaties.

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