Clingendael
Netherlands Institute of International Relations

NOVEMBER 2017

The EMU does not have any flaws

A Critique of the European Commission's Reflection Paper on the Deepening of the EMU[1]

Article

Adriaan Schout

1 Introduction: towards a shared vision of the deepening of the EMU

In May 2017, the European Commission presented its Reflection Paper[2] to steer the debate about the deepening of the European and Monetary Union (EMU). The purpose of the Reflection Paper is largely the same as that of other recent strategy papers and speeches that also emphasise the need to strengthen the EMU. In his speech at the Sorbonne at the end of September, the new French President Macron presented a long list of measures that, amongst other things, targeted the reformation of the EMU.[3] In his State of the Union speech, Commission President Juncker emphasised the prevailing belief that there is now a 'window of opportunities' to act. And in the Netherlands, a report from the Advisory Council on International Affairs has been published that takes a similar view. First of all, these papers and speeches emphasise that deepening the EMU is necessary.
They claim that the EMU is not yet complete, which is why the euro remains a major risk, why growth continues to be sluggish and why unemployment in the southern countries is threatening to undermine the entire European project. Secondly, they argue that a debate is necessary in order to get everyone back on the same page when it comes to deepening the EMU. Thirdly, they argue that there is now both economic and political leeway to act decisively: 'It is time to let a pragmatic approach prevail over dogmas, time to build bridges and time to relinquish individual mistrust' (COM (2017) 291, p. 31).

The aim of the Commission's Reflection Paper is to arrive at a 'shared vision' of the future of the EMU. I provide below a brief critique of the Reflection Paper, outline an alternative diagnosis for the European crises and touch upon a number of measures to strengthen the euro that are not mentioned in the paper.

2 The EMU's weakness: Disagreement about the diagnosis

The first thing that needs to be done in order to have a meaningful discussion about the measures to strengthen the EMU is to be

1 First published as Schout, A. (2017), 'De EMU heeft geen weeffouten', *Beleid & Maatschappij*, No. 42017. This article is a more detailed version of the contribution to the meeting of experts about the EMU as part of the Dutch Parliamentary committee on Financial Matters, 13 September 2017. This contribution was written in a personal capacity.
2 European Commission (2017), Reflection Paper on the Deepening of the EMU, Brussels: May, COM (2017) 291.
3 Speech by the President of the French Republic – Initiative for Europe, La Sorbonne, Paris, Tuesday 26 September 2017.

clear about the causes of the problems that the euro is wrestling with. The European Commission makes far-reaching proposals about what is necessary in the longer term, including the appointment of a European Minister for Economics and Finance that includes accountability to the European Parliament (the EP), increased resources at an EU level plus European taxes and tax harmonisation, a European Monetary Fund (EMF), further steps towards a social union, the introduction of Eurobonds and a fund for the liquidation of failed banks. In essence, these proposals represent a major shift away from the current, official, basis for the euro, which is the no-bailout approach. The euro was set up based on Euro-criteria that mean that countries must have their budgets in order, that they must limit their national debt to 60% of the GDP, and that they must not expect financial bailouts from other countries. This is what the member states signed up for.[4] However, the proposals that the Commission presented in its Reflection Paper represent a systematic shift away from the EU set-up that the euro countries are familiar with at the present time. In addition to the existing requirements regarding financial soundness, the Commission now wants to introduce the principle of joint liability (i.e. risk-sharing). The Commission's proposals represent a movement towards a system of government where the EP becomes a more fully-fledged parliament that would then have the right to approve and amend budgetary policy.

The question is, however, whether this is necessary. There are major differences between, on the one hand, the vision as set out in the papers of the European Commission and, on the other, the views expressed by experts from Germany, France and international think-tanks. There are a wide range of opinions both about the causes of the problems and about the measures that need to be taken. The Commission emphasises the need for deeper integration in the long-term, and is searching for a path 'that is pragmatic and flexible whilst at the same time delivering results for everybody' (p. 18) for the short-term. In its analysis, the Commission stresses the risks posed by external shocks and advocates the implementation of European shock absorbers. It also emphasises the adverse effects of budget cuts.

Outside the Commission, there are voices saying that, in the long run, it is precisely the no-bailout approach that must be adhered to, and that ultimately member states have to stand on their own two feet. An important factor in this regard is the doubts about the significance of external shocks. An external shock is often a great deal less 'external' than the term implies, with shocks being caused by insufficient supervision in member states, delayed reforms, missed growth opportunities, and letting debt rise unsustainable levels. In the case of Italy, Portugal and France, any external 'shock' quickly becomes an unstoppable external development, simply because these countries have little or no financial leeway of their own to counteract it. If a country respects the Stability and Growth Pact rule of national debt below 60% of GDP it would be able to deal with a substantial shock. This means that leniency can be shown temporarily after such a shock or in the face of disappointing economic growth. If the 60% rule is respected, member states are more likely to have to take reforms seriously and they will become less sensitive to external economic shocks. To make the EMU a resilient system, the various components (i.e. the member states) ought to have their own primary cushioning and recovery mechanisms.

Hence, the Commission's assumption that the EMU is not yet complete is debatable. The need for a Plan B (i.e. deepening) is not clear-cut, and Plan A (no-bailout) may not be that bad after all. Where the Commission focusses on the weaknesses in the institutional implementation of the EMU, others point to the weaknesses of member states.

4 See for instance Articles 119-126 and Protocol (Nr. 12) regarding the procedure in the event of excessive deficits, Abridged version of the Treaty on the European Union and of the Treaty on the Functioning of the European Union (2016/C 202/01).

3 No shared vision for short-term solutions

Apart from that there is no agreement about the longer-term measures that are needed, there is also no agreement about the way to deal with the existing problems. There are at least two main problems in the short term, namely the debt overhang in southern Europe and the delayed economic reforms which have led to sluggish economic growth and disappointing unemployment figures. In a move intended to create stability, the Commission is advocating for the completion of the banking union through the further development of both the deposit guarantee scheme and the 'backstop' (i.e. backup) mechanism. The Commission is further proposing to aggregate debt from weak and strong countries into what are called 'safe assets'. These safe assets are packages of debt securities from various countries that would, together, create a European market for the spreading of debt risk. Economically, this makes them similar to the subprime mortgage junk bonds in the US. The Commission's proposals are intended to help bring calm to the financial markets but, politically, it is difficult to believe that Germany would be willing to accept risks that result from other countries' government debt and savings deposits.

Those people who wish to return to the no-bailout system can usually offer no better short-term response than to argue that growth is necessary to solve the current problems. Debt write-offs are discussible but this begs the question of whether there would be guarantees to ensure that member states would be, and would remain, reform-minded. The creation of a political union should help to solve the problems in the short term, but this would also mean that a political union has been implemented that in the longer term would be unnecessary, provided that the existing debt problems have been resolved by then. The problem is, however, that once a political union has been created, it cannot be undone

This leaves pressing questions unanswered. For instance, how will Italy and Portugal in particular get rid of their excessive debt burdens? This question is of essential importance because their debt is a drain on their potential growth and constitutes an existential threat for the eurozone. Is an effective system of 'bad banks' possible or will debt write-offs be necessary? It is also unclear how Italy plans to reduce the public debt to the levels that Italy signed up for. Furthermore, there is probably no backup plan in place should Italy get into trouble after all, for example as the result of an interest rate hike. Would this then be followed by another process of 'too little too late' that would leave both Italy itself and the eurozone as a whole worse off? Can Italy, given its size and political weight, actually become a 'programme country', i.e. one that can receive IMF aid? Is it realistic to offer 'safe assets' in exchange for renewed promises of reform? The Reflection Paper focuses on the longer term even though the next crisis could arrive (well) before then.

There is agreement on the need for growth. However, this requires the implementation of a broad range of reforms in such countries as Italy. The hoped-for structural convergence desired since the commencement of the Euro project in 1992 has still not arrived.[5] Structural indicators of the quality of the institutions in member states[6] indicate that the Netherlands and Germany score (very) highly in terms of the quality of government, the quality of regulation, combatting corruption, and so on. The scores of Belgium and France are average, while southern and eastern European member states figure in the lower regions. The scores on the structural convergence indicators are fairly stable over time, which gives few grounds for optimism about reaching the required structural convergence any time soon. The question remains as to how countries can be induced to reform themselves.

5 European Central Bank (ECB), 'Real Convergence in the Euro Area: Evidence, Theory and Policy Implications', in ECB Economic Bulletin, No. 5/2015 (July 2015).

6 A. Schout (2017), 'The EU's existential threat: demands for flexibility in an EU based on rules', in: Pirozzi, N. (ed.) *EU60: Re-founding Europe; The responsibility to propose*, Rome: IAI. https://www.clingendael.org/publication/eus-existential-threat.

4 Alternatives for a political union: market forces and reforms

The Commission's proposals are a move towards 'more Europe'. These measures may be viewed as necessary from a social point of view in order to regain the general public's trust in those countries with high unemployment and in order to increase confidence in banks. However, the Commission's proposals can also be viewed as distorting the markets. The Commission describes 'safe assets' as essential but it should be remembered that they will mitigate market incentives and take away financial markets' right to decide whether to invest in secure or more risky debts.

An alternative way to strengthen the EMU could be to rely more on market forces and on policy competition between states. As it stands, the EU's internal market has already for a long time been more harmonised than the markets in the USA and Canada and current EMU plans threaten to move the EU further down the road of endless harmonisation. Strengthening different kinds of competition may offer an approach towards structural reforms in member states. Market forces and policy competition

If a more market-driven approach is opted for then the key question is how the risk can be (and can remain) allocated to those parties that both assume the risk and hope to reap the benefits of doing so. One priority should be to factor in risks relating to government debt. When member states still had their own central banks, government debt was reasonably secure.[7] However, now that we have a single European Central Bank this is no longer the case. There is great agreement about this principle and it is also set out in the Commission's plans, but the road ahead to get there is still unclear, given the major risks that banks are running in such countries as Italy, given the consequences for the interest rates charged on government debt, and given the level of political resistance to this in the southern countries in particular. One possible solution is that, over the next 20 years, a certain percentage of government debt held on the books is assigned a risk premium each year. If government debt is given a risk weighting then banks will also have to pay more attention to spreading their investments in government debt over more countries. At the current time, the ties between governments and their own country's banks are much too close.

The market mechanism could also be deployed to a greater extent when it comes to calls for a banking union. Is it clear that a European deposit guarantee scheme is necessary? During the banking crisis, the Irish government immediately raised the level of savings deposits that were guaranteed to 100,000 euros, so other countries had to follow suit in order to stop savings deposits moving towards Ireland. If a household contains multiple family members then this represents a substantial subsidised guarantee. Is it possible to make deposit guarantees part of banks' risk profiles, to reduce the amount of these guarantees or to place them in the hands of private insurance companies? After all, assets mean risk.

Market forces have to be supervised and there have to be options for intervening. In this connection, there are also doubts about the need for a European Monetary Fund, as insolvent countries can go to the IMF.[8] The EMF option does not have to be ruled out but if the EMF becomes an intrinsic part of a political European Commission then there is a risk that this will open the political 'back door'[9] to the weakening of reforms. Hence, the political context of the EMU, the EMF could easily be a further erosion of market forces.

What could also be at odds with the mechanism of competition are the proposals for a Europeanisation of social and of tax

7 P. de Grauwe (2011), 'The European Central Bank as a lender of last resort', Voxeu.org, 18 August.

8 Wyplosz, C. (2017), *A European Monetary Fund*, European Parliament: ECON.

9 C. de Vries (2017), 'De staat van de Eurostaat', *ESB*, Year 102, 3 October.

models. Little attention has been paid within the EU and in the discussions about the EMU to the benefits of policy competition. The EU has always made great efforts to achieve harmonisation. In the words of Majone: 'Unfortunately, […] centralized, top-down harmonization has been practised much more than inter-jurisdictional competition'.[10] In the Netherlands, the late Ad Geelhoed was an advocate of policy competition in the EU.[11]

Of course, market forces and policy competition are not a universal panacea, but they certainly do offer alternative ways of strengthening both the EU and the EMU. However, the Commission's agenda appears to be focussed on politicisation and harmonisation as preferred options to strengthen the EMU.

Structural convergence

The European Commission emphasises the potentially important role that the EU budget plays in encouraging structural convergence. Apart from a potentially symbolic effect, the relatively small EU budget cannot be expected to have too much clout. The question here is whether member states will set in motion very far-reaching and painful changes in their national institutions merely because they have been given (small) financial incentives to do so. The EU budget is too slim to produce credible incentives, and even in some eastern European countries, where the EU budget represents about 4% of the national economy, financial pressures to reform have had little result. In the same way, one should not expect too much from the bodies created by the Commission that are the European Fiscal Board, the Structural Reform Support Service, and the Fiscal Councils or Productivity Boards. The harvest from these types of endeavours over the past 25 years has not been very encouraging.

In order to facilitate reform processes that stand a greater chance of success, we can look at past measures that have improved poorly functioning sectors in the internal market. Aviation safety, food safety, the licensing of medicines in the markets and environmental policy are examples of policy areas where - after decades of delay - much progress has now been achieved by setting up networks of independent European and national agencies.[12] This has led to the successful implementation of major reforms of the internal market that were also very politically sensitive. When it comes to the EMU, however, it is difficult to get the debate about independent supervisory bodies off the ground. In terms of independent supervision, the EMU quickly runs into the problem that the Commission keeps economic support vision (DG EcFin) and statistics (Eurostat) under the supervision of the College of Commissioners.

5 The European Commission is due for major reforms

Juncker's statement in that France cannot be brought to book about its repeated budget overruns 'because it is France', and Juncker's hope to run a 'very political Commission'[13] underlines the tendency at EU level to think in terms of a political union rather than in terms of strengthening the independent supervisory bodies. The question is whether highly developed democracies can function without decentralising tasks to independent bodies. The proposals put forward by the European Commission in the paper will lead to additional competencies for the Commission and will make it more political

10 G. Majone, G. (2012), *Europe as the would-be power*, Cambridge: COP, p. 85.

11 'Topambtenaar Ad Geelhoed: 'Marktwerking moet je afdwingen. Dat kan een softe overheid niet' ('Senior civil servant Ad Geelhoed: Market forces have to be coerced. A soft government cannot do this'), NRC newspaper, 1 March 1997.

12 Kassim, H., 'Revisiting the management deficit', in: E. Ongaro, *Multi-Level Governance: The Missing Linkages*, Bingley: Emerald, 2015; Schout, A., 'Framework for assessing the added value of an EU agency', *Journal of Public Policy*, Volume 31(3) (2011): pp. 363–384.

13 Schout, A., Commission President Juncker: 'Good intentions but wrong profile', International Spectator, July 2017. https://www.internationalespectator.nl/article/eu-commission-president-juncker-good-intentions-wrong-profile.

in nature. This is recognised in the paper, which is why greater democratic control by the EP is advocated. The Commission is accumulating duties ranging from policy preparation, policy implementation, policy supervision and enforcement whilst it is at the same time aiming to be more political. Now that the Commission's list of competencies has increased, in part as the result of the euro-crisis, the Commission as an organisation needs to be reformed. The administrative traditions in the Scandinavian countries, based on small central governments and major independent implementation and inspection bodies, could serve as a point of reference.

6 Conclusions

The EMU needs to be strengthened. The European Commission has made a first move in this direction by taking steps towards a political union. The first question that must be asked is whether the Commission's diagnosis that the EMU needs a political union is correct. This is where the Commission's proposals clash with the view that countries must comply with the budget rules that they signed up for. The Commission is proceeding on the basis that the EMU is not yet complete, whereas the alternative diagnosis is that member states are not being forced to comply with the rules. The second question is how problems can be solved in the short term that primarily relate to the debt overhang of both governments and banks. Proposals made by the Commission would probably restore calm in the short term but they are politically unfeasible and would create a political union that may not be needed, or even be risky, in the longer term. It is interesting to note that (policy) competition only plays a minor role or is even side-lined. The Commission's proposals therefore appear to be shaped by the desire of Commission President Juncker and others to create a political union than by the attempt to facilitate a balanced debate about strengthening the eurozone.

About the Clingendael Institute
Clingendael – the Netherlands Institute of International Relations – is a leading think tank and academy on international affairs. Through our analyses, training and public debate we aim to inspire and equip governments, businesses, and civil society in order to contribute to a secure, sustainable and just world.

www.clingendael.org
info@clingendael.org
+31 70 324 53 84

@clingendaelorg
The Clingendael Institute
The Clingendael Institute

About the author

Adriaan Schout is Senior Research Fellow and Coordinator Europe. He combines research and consultancy on European governance questions for national and European institutions. He has worked on projects addressing issues of the EU presidency, EU integration and Improving EU regulation, amongst others.

DISCLAIMER

This report was commissioned by the Netherlands' ministries of Foreign Affairs and Defence within the PROGRESS framework agreement, lot 3, 2017. Responsibility for the contents and for the opinions expressed rests solely with the authors. Publication does not constitute an endorsement by the Netherlands' ministries of Foreign Affairs and Defence.