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NEW BEGINNINGS

A NEW APPROACH TO EUROZONE REFORM

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proposals for the EU's next
institutional cycle.

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A new approach to Eurozone reform

The Eurozone is undoubtedly in better shape than when the Juncker Commission took office in 2014. Growth has been robust; unemployment has fallen significantly pretty much across the board. Most importantly, the Eurozone is still in one piece. We tend to forget that it was only in 2015 that Grexit was a real possibility only averted at the last minute.

At the same time, the ECB has been struggling to push inflation rates closer to its objective and has deployed a wide range of instruments along the way. Debt levels greatly vary across member states and some have more ample room for fiscal manoeuvre than others. The Eurozone will thus likely enter any future crisis with a strained monetary policy toolbox and a very unequally distributed capacity to lean against a downturn. This is particularly relevant now that Eurozone growth is slowing down and global downside risks are rising by the day. The next crisis might not be as far away as we think.

The fact that the Eurozone is ill-prepared is also because the last five years have seen little or no progress in building a Eurozone

architecture fit for purpose. Banking Union is still missing relevant parts and, critically, a shared understanding of how "European" our banking system should be. There is no agreement whatsoever what form a common fiscal response to any new crisis should take and whether the European level should play any part. There is simply no common vision of where member states want the Eurozone to go. The Five Presidents' Report in 2015 was the last attempt to provide a (very modest) frame for the Eurozone's future architecture but member states have not yet even endorsed its general direction.

So, the new Commission inherits a rather timid policy package consisting of the backstop for the Single Resolution Fund, a mini-budget for the Eurozone, and a cosmetic reform of the European Stability Mechanism (ESM). This package still requires some political effort to be completed.

Its timidity results, however, not only from the above-delineated lack of shared political vision but also from a lack of trust among member states. Accordingly, a meta challenge for the new Commission is to foster that trust with every action it takes.



In addition, political capital is scarce and needs to be used wisely. Eurozone matters aren't central on anyone's mind for the moment, neither in Brussels nor in the member states, and Eurozone fatigue has set in. Therefore, instead of investing ever more political capital in smaller and smaller technical fixes and improvements, the new Commission should look for the biggest bang for the political buck.

The new Commission faces a dual-pronged challenge at the start of its mandate: On the one hand, the economy has been doing well but is getting worse. On the other hand, the political and institutional foundations of the Eurozone are still shaky and unlikely to improve: a combination that precludes any complacency.

The new Commission should concentrate on two parallel tracks:

- First, it should shift its focus to replenishing political capital and recreating trust by developing new ways to build a lasting consensus on the direction of Eurozone reform.
- Second, it should take targeted steps to prepare the Eurozone for the next downturn, namely
 - * Finalise the current package on the table and improve it where possible;
 - * Make Banking Union work in the next downturn;
 - * Prepare the playbook for a joint fiscal response.

These tasks need to be tackled in parallel. Ideally, we would focus on the former. But the current global environment makes time short.

1 ■ Focus on building political consensus

The binding constraint on practically all future Eurozone reform steps is political as

outlined above; examples of fundamental disagreements include

- Some member states strongly favour a form of common fiscal policy that might include a common safe asset; others are deeply hostile.
- Some think a different regulatory treatment of sovereign debt and a sovereign debt restructuring mechanism are indispensable; opponents find this dangerous.
- For some, the threat of exit is still a viable policy option; for others, this is completely out of the question.

And the list could go on. For all these questions, myriad technical solutions have been produced over the last decade by think tanks, academics, and institutions such as the IMF. But none of these has any chance of seeing the light of day unless the underlying political questions are answered.

The discussion on the new Eurozone budget is a good example: Member states agreed on its parameters without agreeing at the same time on the fundamental question of whether or not they wanted a common fiscal instrument. This led to a very messy process with two undesirable outcomes: First, ministers had to discuss every nitty-gritty detail because the fundamental political orientation was missing and therefore the technical level was unable to prepare the ground for proper debate. Second, the instrument now does not make much sense policy-wise because its objective is not clear.

This kind of dysfunctional process not only leads to suboptimal reform outcomes. It can even be dangerous when reform steps are taken with no clear political consensus on policy direction. [Think of the current ESM reform](#): Some member states wanted to *improve* the usability of the precautionary lending instruments but failed to ensure that all were on the same page when the

technical discussions were opened. As a consequence, usability has substantially *deteriorated* as conditions were hardened up and, rather accidentally, the Eurozone's crisis management arsenal is now smaller than before the reform.

The Commission has also bolstered the dysfunctional process in recent years by trying to bridge political chasms with technical fixes. This often proved both impossible and damaging: The Commission proposed for example [a stabilisation function based on loans rather than transfers](#), assuming that this would alleviate concerns among those member states opposed to common fiscal policy. This technical feature practically killed the macroeconomic impact of the proposed instrument and set the bar very low for all other debate participants to propose similar ideas (cf. the German idea of an unemployment reinsurance based on loans). At the same time, it left the political disagreement intact and indeed stabilisation was excluded from the objectives of a future Eurozone budget in the end.

Thus, to be able to move ahead significantly, the Eurozone needs above all a new way to reach political agreements before kicking off technical work. This will require first that all relevant actors – member states as well as EU institutions – have a clear position. And, second, this necessitates an entirely new process to arrive at these agreements. The Eurogroup has proven to be the wrong forum for this kind of work – this requires the European Council/Euro Summit itself to weigh in.

For the new Commission, this has three important implications:

- **First, it should develop its own clear, and above all coherent, stance on Eurozone reform. Given its political balance, this will be no easy task.**
- **Second, it should push for a new political process better suited to fixing clear mandates for technical work.**

- **Third, it should refrain from making legislative proposals that internalise perceived political constraints in areas where there is fundamentally no political consensus on the right direction of reform. Any proposals to drive the political process should be geared to steering the debate and hence be both bold and coherent.**

The first test here will be the review of the economic governance (Six-Pack/Two-Pack review) this fall and the proposal by president-elect Ursula von der Leyen to revive the idea of a European unemployment re-insurance: In both instances, building political consensus on the right way ahead should take precedence over making detailed technical proposals. This kind of approach will slowly increase trust all round and ultimately prepare the ground for bolder steps.

It is far from guaranteed that such a new process would succeed. But it is clear that without the ambition to find new political agreements, the next five years will see even more limited progress than the last.

2 ■ Prepare the Eurozone for the next downturn

In an ideal world, building a new political consensus would precede any future reform steps. But both the global environment from trade wars to Brexit and the economic situation in the Eurozone itself are such that there is simply no time to wait. The Commission should therefore take concrete steps in three areas:

2.1 Finalise the package on the table

In a series of decisions of increasing granularity, member states have in recent months agreed on a three-pronged package:

- The ESM treaty will be changed to include a possibility for the ESM to be used as a backstop to the Single Resolution Fund (SRF).

- The functioning of the ESM will also be slightly amended, in particular as regards the use of precautionary instruments and the role of ESM staff in designing programmes.
- As part of the overall new Multiannual Financial Framework (MFF), the Eurozone is supposed to get its first common fiscal instrument, now known as the Budgetary Instrument for Competitiveness and Convergence (BICC).

The main political parameters of this package were agreed in [December 2018](#) and [June 2019](#); the new Commission essentially inherits it without significant political wiggle room.

This is especially true for the parts related to ESM treaty reform: With the amended text essentially complete, most discussions now focus on the guidelines supplementing the treaty. The new Commission could help to bring this reform over the finishing line by continuing to provide technical compromise solutions for the remaining questions. But scope is limited to make any meaningful changes on substance.

There is however an exception: The Commission retains a considerable grip on the future of the BICC as it will be part of the MFF and hence member states depend on Commission legislative proposals and on the approval of the European Parliament for it to become law. Within the confines of the December 2018 Euro Summit decision on the BICC's basic parameters, there was scope to build a useful instrument ([here](#) a detailed proposal). But since then, member states have [significantly narrowed down](#) this scope and it is now questionable whether the BICC in its current form would enhance Eurozone architecture.

The Commission can change the scope of the negotiations and make legislative proposals to enact the BICC that ensures it makes real sense. Member states will not be thrilled – but the EP might take a different

view and both co-legislators have to agree. In the end, the BICC will be part of the overall MFF package. Nothing is agreed until everything is agreed.

Concretely, the new Commission should aim at ensuring that the BICC embraces two important features:

- It should be *flexible*: This requires in particular avoiding the *juste retour* logic of the EU budget, i.e. that member states know in advance what they will get in return. If the BICC is supposed to be of any use in a future downturn, money should be able to flow where it is needed most. The mechanics should be sufficiently flexible to allow for just that with no pre-allocated expenditure to member states for the next seven years.
- It should be *scalable*: The funds currently foreseen for the BICC (17 billion euros for 19 member states over seven years) clearly do not suffice to have a sizeable macroeconomic effect. But this is not a problem as long as there is scope to increase the BICC's volume later on. The best way to do this is to include a plug for an intergovernmental agreement.

A BICC that is flexible but not scalable will never be large enough to have an impact. A BICC that is scalable but inflexible will mean that funds will still not flow to where they have the desired effect. So both conditions have to be met. This may well be the only shot we have to create a common fiscal instrument in the foreseeable future – we should not miss it.

Therefore the new Commission should make sure the package makes it over the finish line, but should focus its political energy on making the BICC actually useful by ensuring that is both flexible and scalable.

2.2 Make Banking Union work in reality

The next five years will show whether Banking Union means Banking Union. Large European

banks are now supervised by the ECB. The Single Resolution Mechanism provides a common regime for dealing with ailing banks and should soon be complemented with a backstop for the SRF in case it runs out of money. In principle, this creates the conditions for further financial integration and risk-sharing by moving steadily towards a single European banking system.

But this will only work if the system as a whole is credible – indeed if the promise that member states will no longer deal with banks individually but collectively holds when push comes to shove. For this to work, the issue is not to immediately complete the whole long list of actions usually associated with “completing Banking Union”. Instead, the most important task to prepare for a future crisis is to ensure that the resolution framework is credible and works properly.

Three factors could help here:

- First, even though it has major design flaws, getting the backstop for the SRF approved and ratified significantly increases the available resources for resolution in a major crisis. The option of early introduction should be kept on the table for emergencies.
- Second, the agreed rules should be applied in letter and spirit. Precautionary recapitalisation, which essentially repatriates resolution decisions to member states and reinstates the doom loop between sovereigns and banks, should remain the exception, not the norm. If we come to the conclusion that bail-in rules are too strict, we should change them, not circumvent them.
- Third, there is a gap in Banking Union: Some banks seem, for whatever reason, too locally important to simply be liquidated when they go bust but are from a European perspective not important enough to be resolved by the SRB. Member states can then use their national insolvency frameworks to de facto bail out these banks, which undermines the very premise of Banking Union. A first step to

remedy this problem could include a limited harmonisation of insolvency frameworks for such eventualities.

However, these three aspects will not suffice in the medium to long run: Fundamentally, host member states need to have confidence that in a crisis, their banking systems will not be sucked dry by their banks’ parent companies. At the same time, the development of a pan-European banking system means that complete ringfencing of liquidity also needs to be avoided. Solving the home-host issue boils down to the question whether or not we want a single European banking system – and this issue is, again, fundamentally political. Thus this would be a good starting point for the Commission to start trying to build consensus. Part of this consensus could then also be additional long-term solutions like an agreement on common deposit insurance and a clean solution how to provide liquidity in resolution cases.

Therefore the Commission should focus on first making sure that the backstop becomes a reality, second that Banking Union rules are applied coherently, and third on limited fixes to deal with smaller banks. For all further steps such as EDIS, developing a consensus on what the European banking system should look like in future should be the priority.

2.3 Prepare the fiscal response to the next recession

Eurozone growth has slowed down this year – 1.2% compared to 1.8% in 2018 according to the latest ECB projections in June. Germany, the zone’s largest economy, has posted negative growth in the second quarter of 2019. The global outlook looks extremely shaky while Brexit, trade wars, and uncertainties over Europe’s long-term business model loom large. A crisis or even a substantial downturn may not be just around the corner. But we cannot exclude

such a scenario either. The EU should at least be prepared.

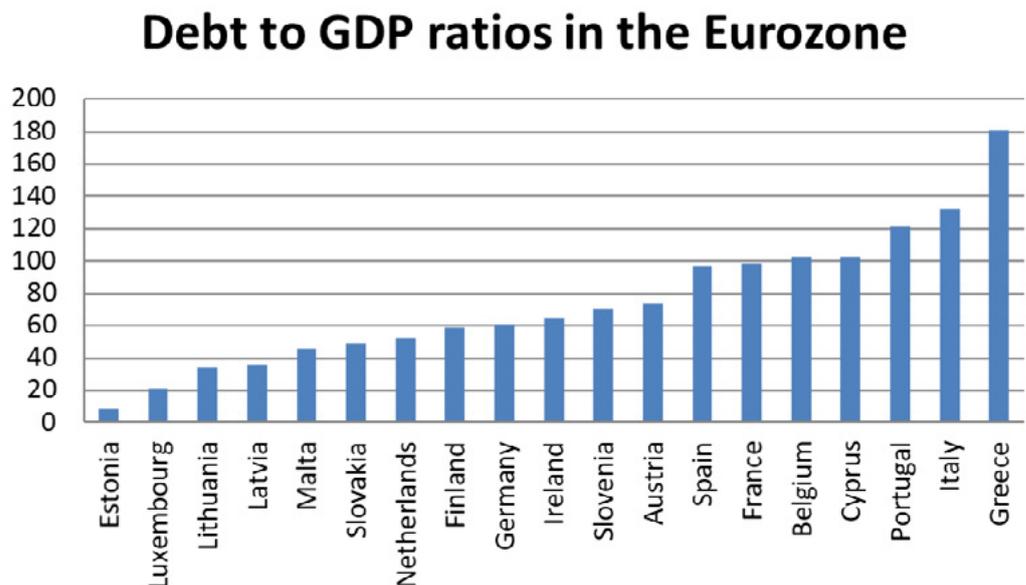
Alas, it does not seem to be so. The ECB, which has done much of the macroeconomic heavy lifting, has strained its arsenal already. This means that any future downturn will likely require a more forceful fiscal response than in the last recession to be contained. But the capacity of member states to respond individually will likely diverge strongly as debt-to-GDP ratios vary substantially. This suggests that those with lower debt such as Germany (60.9%), Ireland (64.8%) or Slovenia (70.1%) will have more room to spend countercyclically than those saddled with higher debt such as Belgium (102.0%), Portugal (121.5%) or Italy (132.2%). It is far from obvious that this distribution of fiscal stimulus would be optimal in every crisis scenario, especially in a Eurozone-wide downturn.

In principle, this problem could be remedied by a common instrument that ensures that fiscal resources go where they are most needed. However, given the failed attempt to create a meaningful Eurozone budget, it is now very unlikely that the Eurozone will have such a tool in place to facilitate a joint response anytime soon.

The new Commission should still try to improve the BICC as much as it can. But it should start in parallel to build an alternative: In the event of a Eurozone-wide recession, fiscal policies should respond in a coordinated way. This cannot be agreed politically under current circumstances. But the groundwork needs to happen now. This preparation could inter alia include a clear idea of how to apply the fiscal rules in a downturn in a way that does not constrain necessary stimulus and an identification of expenditure items at national level that have the biggest Eurozone-wide spill-over effects. Even so, the elephant in the room remains constant: are member states willing to pool fiscal resources in an ad-hoc way and send them wherever they are most needed so as to ensure stimulus happens where it should.

Thus, the new Commission should prepare the playbook for a coordinated response of national fiscal policies to the next recession. This is realistically the only line of defence the Eurozone can rely on if it does not want to leave the ECB out in the cold on its own.

FIGURE ■ Debt to GDP ratios in the Eurozone



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