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Yes, we should!

EU priorities for 2019-2024

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Deepening EMU as a win-win: How to keep the reform debate alive

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MAIN RECOMMENDATION ► Sustain the reform process towards a deeper EMU, through greater financial, fiscal, economic, political and social integration.

WHAT TO DO:

- ► Create a eurozone safe asset.
- ► Introduce a European Deposit Insurance Scheme.
- ► Create a real fiscal capacity for the euro.
- ► Establish closer tax policy integration.
- ► Strengthen the social dimension of EMU.

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The euro has celebrated its 20th birthday with a mixed record. The eurozone's most impressive achievement is that it has survived, defying the many doomsayers. The worst-case scenario has been averted. However, the legacies of the eurozone crisis weigh heavily, particularly upon certain economies whose 'adjustment' came at high cost. Moreover, despite some institutional tinkering since 2010, the eurozone remains underequipped to face the next big crisis. That is why sustaining the process towards a deeper Economic and Monetary Union (EMU), through greater financial, fiscal, economic, political and social integration, should be a strategic priority for the European Union (EU) as it moves into its next politico-institutional cycle.

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It is important to keep the quest for ambitious EMU reform on the agenda.

Euro governments remain divided over additional eurozone reforms. One side supports the bolder package promoted by French President Emmanuel Macron or the European Commission. The opposite side, the "new Hanseatic League" led by the Netherlands, opposes such reforms, claiming that risk reduction should come before risk sharing. In December 2018, the eurozone governments met and discussed a diluted and highly unambitious 'Meseberg minus' version of reforms agreed on the basis of the Franco-German blueprint proposal of June 2018 ("Meseberg Declaration"). Meseberg itself was already a watered-down version of the Macron proposals – many in Berlin were relieved they were rejected.

The main problem of the eurozone decisions of December 2018 is not just a lack of audacity. It rather relates to the circumstance that they closed the window of opportunity that had opened up following Macron's initiatives. The next window might not open before well into 2020. Nonetheless, or exactly because of that, it is important to keep the quest for ambitious EMU reform on the agenda, until a next opportunity arises.

State of play – A list of inadequate reforms

Let's briefly recap the state of play following the Eurogroup/euro summit decisions of December 2018:

► Some progress was made on enhancing the European Stability Mechanism (ESM) and amending the ESM treaty by June 2019. The principle of "no risk sharing before risks are substantially reduced" prevailed. New rules to facilitate debt restructuring in case of sovereign insolvency will be introduced by 2022.

► An ESM backstop to the Single Resolution Fund (SRF) will be introduced earlier than 2024, provided there is progress by 2020 on risk reduction concerning legacy issues.

► The European Deposit Insurance Scheme (EDIS) will be deferred. A high-level group will report back in June 2019 before a roadmap on political negotiations can be agreed.

► A eurozone budgetary instrument was agreed to be included in the next EU budget. But contrary to Meseberg, which envisaged "instruments to ensure convergence and stabilisation in the EMU", only convergence and competitiveness was mentioned, while stabilisation was dropped. The overall size of the new budgetary instrument will be determined by the European Council in the context of the next Multiannual Financial Framework (MFF) as part of a broader package deal subject to the potential veto power of non-euro member states. Finally, as in the Meseberg Declaration, no reference was made to a European unemployment stabilisation fund.

Why more ambition is needed

Bolder financial and fiscal integration is needed to bring about convergence and stability in the eurozone, for two main reasons:

LEGACIES OF FRAGILITY IN POST-CRISIS ECONOMIES

Post-crisis economies are still burdened by large public debt, high funding costs, a heavy share of non-performing loans (NPLs), and a higher government need to rely on domestic banks for debt refinancing. In addition, the flow of capital to the periphery remains constrained and gross fixed capital formation registers a wide investment gap. Post-crisis economies remain subject to contagion, bank-sovereign doom loops, and lower confidence in their banking system.

Unemployment shocks in the periphery have been resolved through extensive labour emigration, which undercuts productive capacity, growth potential, and the future sustainability of pay-as-you-go pension systems. In the worst cases, severe hysteresis effects have started to unfold Backtracking on domestic reforms (as in Italy) exacerbates the situation.

Peripheral economies will need to grow faster, but the combination of crisis legacies, procyclical adjustment, and the rigidity of policy instruments tends to make it harder for them to catch up.

TRANSITION COSTS OF THE REFORM AGENDA

Certain elements of proposed eurozone reforms, while positive, could further aggravate the woes of post-crisis economies, including Italy. Three examples stand out:

- First, debt restructuring clauses that are inserted as a precondition for an ESM bailout could further raise the risk premium for highly indebted sovereigns, incurring self-fulfilling prophecy dynamics.

- Second, transition problems could arise because of the regulatory limit on bank holdings of sovereign debt, which is a vital part of the banking union agenda. Presently, highly indebted sovereigns rely on their banks' home bias to suppress funding costs.

- Third, aggressive NPL reduction could undermine the capital adequacy of ailing banks, further impairing their ability to finance the economy.

So positive reforms could entail serious transition costs for the vulnerable economies of the eurozone, causing instability.

A more integrated EMU would have mitigated the debilitating legacies of the crisis. A eurozone fit for purpose would activate countercyclical policies to prevent crises from evolving into downward spirals and facilitate speedier recovery.

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EMU deepening is a win-win

It is also in the interest of the 'surplus' economies of the eurozone core to accept further EMU deepening, for the following reasons:

- First, a broad consensus exists among EMU experts that the eurozone crisis resulted not only from national policy failures in the periphery, but mainly from the deficient structure and inherent asymmetries of an incomplete monetary union. The EMU needs to become more closely integrated and equip itself for the next big crisis.

- Second, greater eurozone stability and cohesion is a collective good for all its members. And the eurozone needs all its members on board to be a balanced monetary union. A euro without the southern members would appreciate, undermining the competitiveness of the export-oriented 'surplus' economies.

- Third, experience has shown that crisis prevention through some degree of risk sharing is less costly and more efficient than the delayed management of crises gone out of hand. Risk sharing must be predicated upon national economic and fiscal responsibility, and an effective way of supporting national reforms. National adjustment without sufficient risk sharing and countercyclical eurozone instruments accentuate the recessionary impact of internal devaluation, debilitating human capital and productive capacity.

- Fourth, vulnerability is not limited to peripheral economies (see Germany's bank problems). Surplus countries have in the past, and will in future, run into cyclical shocks, and when that time comes they will benefit from a more integrated eurozone, equipped with effective stabilisation and risk-sharing instruments.

- Fifth, in terms of political engineering, deeper eurozone integration can be part of a broader package deal involving mutual concessions and compromises between debtors and creditors: more solidarity and risk sharing in exchange for more national reforms and policy discipline. This is a positive sum game, a win-win for all. Expanding the package deal to additional policy issues (such as migration and security) raises the chances for success, as the New Pact for Europe publication has argued.[1]

What to do: Five strategic priorities

How to better equip the eurozone to address the legacies of the last crisis and prepare for the next? Five priority areas:

PRIORITY 1: CREATION OF A EUROZONE SAFE ASSET

Several analysts and institutions, including the Commission and the European Systemic Risk Board, have supported a 'safe asset' for the eurozone. This could take the form of 'synthetic' sovereign bond-backed securities, resulting from the pooling and tranching of cross-border portfolios of national bonds.

A safe bond is not a means for fiscal transfer but a stabilising asset class for eurozone financial markets in the face of potential bank panics. It does not presuppose joint liability or mutualisation between member states. In the proposed safe asset, senior and junior tranches of the security would reflect the varying risk profile between sovereigns. Senior tranches corresponding to the debt of AAA-rated sovereigns would be absorbed by risk-averse investors, while junior securities incorporating default risk would meet investor demand for higher yield/higher risk assets.

The introduction of a eurozone safe asset would strengthen financial stability and the banking union, offering banks a safe asset in which to invest. It would facilitate market access for sovereigns undergoing cycles of acute vulnerability. It would also improve debt sustainability and prevent contagion from spreading from the sovereign to the banking sector and back. 'Core' economies of high credit rating should view a pan-eurozone safe asset as positive-sum, for its ability to stabilise eurozone financial markets without necessitating a fiscal union, transfers or debt mutualisation.

PRIORITY 2: INTRODUCTION OF A EUROPEAN DEPOSIT INSURANCE SCHEME

Next to a eurozone safe asset, a European Deposit Insurance Scheme (EDIS) is necessary to bolster confidence in national banking systems. The crisis has demonstrated the peripheral economies' vulnerability to capital flight towards the core.

National deposit insurance schemes are incapable of restoring depositors' confidence when sovereign credit-worthiness is in doubt. This is a severely destabilising, procyclical feature of the notorious bank-sovereign doom loop. Faced with the erosion of savings under an overhanging default risk translated into euro-exit risk, peripheral economies are locked into vicious cycles of banking fragility and high financing costs.

The banking union can reduce this risk, by spreading the risk throughout the financial system. The existing two pillars of the banking union must be complemented with the third pillar of EDIS, the roadmap to which must be accelerated.

PRIORITY 3: A REAL FISCAL CAPACITY FOR THE EURO

The introduction of a new budgetary instrument would be the first step. However, a real eurozone fiscal capacity is needed to complement national fiscal stabilisers in the face of asymmetric shocks. During a downturn, fiscal revenues shrink while governments are forced to cut spending. Their capacity for a countercyclical fiscal stimulus is constrained by the rules of the Stability and Growth Pact and/or debt market pressures. An investment protection scheme would prevent a more enduring erosion of a productive capacity that suppresses the member state economies' future growth potential. A similar outcome could be achieved by exempting certain categories of investment from fiscal deficit rules. In general, rules must allow for stronger counter-cyclicality: more restrictive fiscal policies when economies are growing, more expansionary to counter stagnation and recession. A fiscal capacity would support stabilisation, convergence and competitiveness.

An alternative role of macroeconomic stabilisation could be exercised by a European Unemployment Reinsurance Scheme (EURS), operating as a reinsurance fund for national unemployment schemes. Unemployment benefits automatically increase during a downturn, while at the same time, fiscal resources decline. EURS would help cover the gap between increased needs and reduced national capabilities, providing the necessary stimulus to facilitate a faster economic recovery.

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If the insured identity is not the national unemployment insurance fund but the unemployed worker, then the proposed reform is a European Unemployment Insurance Scheme. This also operates for macroeconomic stabilisation and supplements the national unemployment scheme in funding benefits for the short-term unemployed. A European scheme would help the contracting economy address cyclical unemployment while national reforms (in the labour market, education, training, and social security) tackle structural unemployment.

The EU faces an inescapable trend: welfare state costs will rise significantly due to ageing societies and slow economic growth. At the same time, tax competition erodes the ability to tax mobile factors of production such as transnational firms.

These schemes operate as stabilisation funds, to which member states are net contributors when their economies are growing, and net recipients in a downturn. What counts is the incremental loss of output (or gap between output and potential output) or the rise of unemployment. The system would be neutral over the economic cycle, eschewing permanent transfers.

This is a scheme all member states should endorse under a Rawlsian "veil of ignorance" regarding their current position in the economic cycle. Greece would have been a net recipient of stabilisation funds during 2010-2016, but a net contributor during its high-growth period from the second half 1990s to 2007; Germany would have been a net recipient during its own period of stagnation and rising unemployment in the 1990s. Fiscal capacity is thus a political win-win across eurozone countries.

For economies with acute social vulnerabilities, associated with a steep unemployment increase, it is important to target EU support for social safety nets and employment and reskilling schemes early on.

Apart from national contributions, a fiscal capacity should be equipped with own resources (such as revenue from VAT, excise duties or corporate taxes) including the ability to borrow by issuing bonds. To be macro-economically significant, it should represent at least 1% of eurozone GDP (preferably well above that) – which reminds us how inadequate the recently agreed status quo is.

The adoption of a European Pillar of Social Rights opens an important avenue, whereby specific EU actions can be launched to strengthen the E(M)U's social dimension.

PRIORITY 4: CLOSER TAX POLICY INTEGRATION

The EU faces an inescapable trend: welfare state costs will rise significantly due to ageing societies and slow economic growth. At the same time, tax competition erodes the ability to tax mobile factors of production such as transnational firms. This is shifting the burden of taxation increasingly (including social security contributions) upon citizens and employees. Popular frustration over unfair taxation has broadened the appeal of nationalist-populist and insurrectional movements like the *gilets jaunes*.

Bold and honest initiatives are needed to restore tax fairness (see also the contribution by Claire Dhéret in the present volume). The EU must lead in tackling tax havens and strengthening pan-European tax coordination, and target extremely wealthy citizens and global companies (such as big tech) able to exploit tax loopholes and bank secrecy. The process towards a Common (Consolidated) Corporate Tax base must accelerate following the UK's departure from the EU, and the Commission's proposal to introduce qualified majority voting in the Council on taxation policies must be strengthened.

PRIORITY 5: STRENGTHEN THE SOCIAL DIMENSION OF EMU

The crisis has left debilitating legacies of long-term unemployment and deprivation in countries like Greece, Italy and Spain. For economies with acute social vulnerabilities, associated with a steep unemployment increase, it is important to target EU support for social safety nets and employment and reskilling schemes early on. This would mitigate enduring social disruptions and human capital erosion. The introduction of a European unemployment insurance scheme, as discussed above, apart from macroeconomic stabilisation, also carries a social protection function. Closer E(M)U-wide coordination on fiscal, taxation and social policies can strengthen social cohesion, especially in the face of asymmetric shocks.

The adoption of a European Pillar of Social Rights opens an important avenue, whereby specific EU actions can be launched to strengthen the E(M)U's social dimension. Social benchmarks need to acquire greater salience in the coordination of economic policies. A single social security number for every European would support cross-border mobility and the convergence of social standards.

The EU needs to support the welfare system transitions to 'flexicurity' by ensuring the development of both dimensions (both employment flexibility and social protection). Overall, in both the macroeconomic and the social dimension, the EMU needs to strengthen its ability to operate as a true insurance union.

Post-scriptum: *priorities 4 and 5 are immediate, for the next institutional cycle, 2019-24. Priorities 1, 2 and 3 are deeper, longer-term reforms, requiring gradual progress. Unless the next crisis becomes the ultimate accelerator.*

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[1] New Pact for Europe (2017), "Re-energising Europe: A Package Deal for the EU27.Third Report New Pact for Europe", Brussels: European Policy Centre.