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Facts & Findings

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Deceptive calm?

Centrifugal forces in the Eurozone remain high

David Gregosz, Thomas Köster

- The economic situation of important Eurozone countries is precarious and necessary reforms have largely come to a standstill.
- Under these circumstances, the Eurozone is vulnerable to external shocks or a sharp economic slowdown.
- More than ever before, success lies in the internal economic consolidation of the Eurozone. The focus must be on currency confidence, entrepreneurship and innovation. This is where the new European Commission and the Euro Group must start after the European elections.
- As a trading and economic area, Europe only gains economic weight through its innovative companies. This pillar of a liberal European economic system must receive stronger support from the public, whilst being strengthened by a European small and medium-sized enterprises (SMEs) policy. The effects of an active industrial policy will remain limited.
- Entrepreneurial success largely depends on an adequate legal framework. Accordingly, national governments should review their economic policy priorities.
- As for the Euro Group, it should promptly start a process of self-assessment following the European elections. This is especially true in light of current economic developments and the impending Brexit.

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The European Economic and Monetary Union (EMU) has experienced an eventful history since the introduction of the Euro as currency twenty years ago. The past decade in particular was shaped by crisis. The interplay of external shocks and design flaws in the Eurozone showcased that a future-proof Euro calls for two lines of actions: firstly competitive European economies with sound public finances and the ability to address global challenges politically; secondly an institutional framework that allows for sufficient coordination of national economic and fiscal policies, enforces the liability principle, and provides emergency tools for economic crises.

If you were to examine the Eurozone in both areas, you would have to acknowledge its exposure to major economic and monetary threats. Whilst the slight improvement of most economic indicators in the European elections' year has led to a deceptive calm, this could easily be disturbed by an economic slowdown or new external shocks.

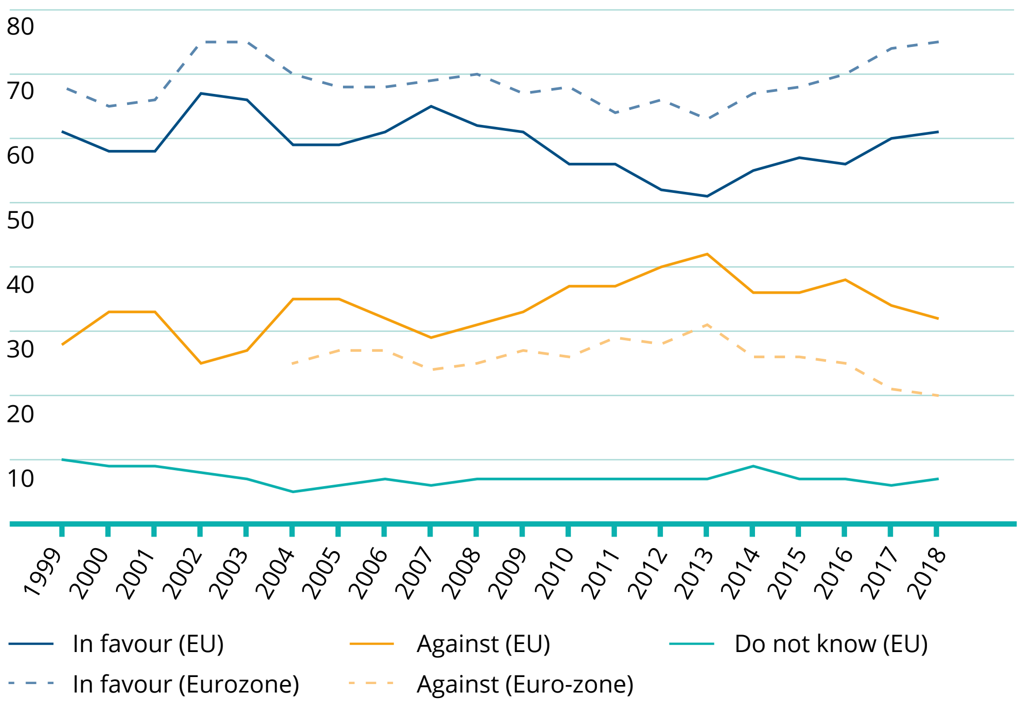
This paper seeks to provide arguments and generate momentum for EMU's further development. Strengthening the monetary union can succeed if confidence in the currency is reinforced, innovative companies are enabled to generate new wealth and a strong – and thus attractive – Eurozone attracts new members. We shall discuss here how to overcome this threefold challenge.

1. Trust is a safeguard of the currency

In many places, the after-effects of the financial and debt crisis provide fertile ground for criticism of the Euro and the monetary system as a whole, whilst conspiracy theories become increasingly popular. What is more, the controversial debate about the correct financial and monetary policy has led to a growth in general Euroscepticism. Sweeping criticism of the money and interest system boosts such trends. As a result, theories about the creation of money by the banks and "monetary rule" to the disadvantage of citizens and states have infected parts of society. These movements undermine citizens' trust in their currency and can only be offset with sound arguments. Money, a permanent and and primary symbol of statehood is based on the trust of citizens – which was the case even before the end of the gold standard. For it is only the state's guarantee to adhere to the equivalent value of coins and bills coupled with the trust of the citizens which sustains a currency's value. All too often, this psychological connection is forgotten in political debates, and thus reflected in the citizens' prevailing mood. It is noteworthy that even after twenty years of common currency use, around a fifth of citizens show sceptical attitudes towards the Euro (see Figure 1).

Money has always been a symbol of statehood.

Figure 1:
Eurobarometer: What is your opinion on the proposal: a European Economic and Monetary Union with a common currency, namely the Euro.



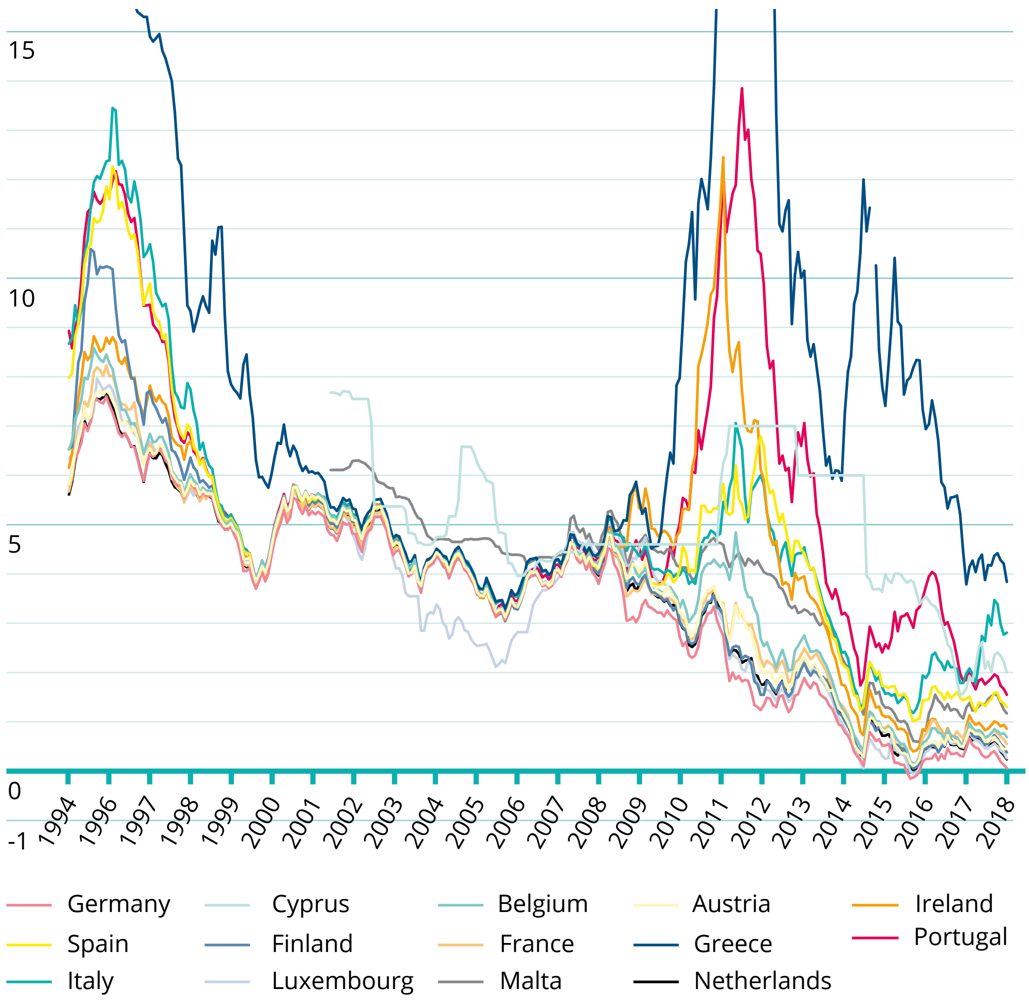
Data: EU Commission1, own figures

As the Euro was introduced, scepticism towards it was just over 30 percent, as the figures of the Commission (Eurobarometer) reveal. The introduction of the Euro as a physical currency led to a positive yet short-lived support boost. Ever since, approval for the Euro has been higher in the countries that introduced it as a currency compared to the other EU countries. The currency is part of everyday life in those countries now. With the financial crisis and in particularly the protracted recovery from the debt crisis in the Eurozone, approval rates also suffered. Although the worst seems to be past us, it is still shocking that the Euro will receive hardly any more support after 20 years relative to approval rates immediately after its launch. Instead, populists in many countries are picking up on prevailing scepticism and are frivolously calling for a return to national currencies/monetary disintegration.

Today, the Euro's approval rate is about as high as 20 years ago.

The fact that currency confidence in the Euro is back to its starting point 20 years ago also affects financial markets. Before the announcement and implementation of a single European currency, financial markets differentiated, i. e. they priced in risk premiums for government bonds of individual countries. This was followed by a phase of alleged convergence, where Eurozone countries essentially had similar financing options on capital markets. Economists still argue whether markets anticipated the rescue operations of institutions during the debt crisis, or whether they were deceived about the soundness of national finances and national economic convergence. For their part, states use the interest-rate advantages that the Eurozone allows, and are only too happy to make use of them in the state budget. From our standpoint, however, one thing is abundantly clear: the reduction in risk premiums for Eurozone debt securities has been accompanied by greater national divergence regarding economic power.

Figure 2:
Secondary market rates on Eurozone government bonds almost ten years old, excluding Estonia.



Data: ECB (2019), SDW2, own figures

The debt crisis had to show whether the Maastricht criteria would hold tight. It turns out they did not. The Commission's recommendations for a dynamic and robust economy were ignored for years, also affecting public finances in a difficult financial market environment.

The Stability and Growth Pact could not be enforced, with the Eurozone having to move towards implicit liability through the various support funds that were later absorbed by the European Stability Mechanism (ESM). Finally, the monetary policy activities of the European Central Bank (ECB) sent a strong signal to financial markets, confirming that the refinancing of state budgets in capital markets was once again possible everywhere. To do so however, the ECB had to test the limits of its mandate. Long-term consequences for savers, who on the other hand receive hardly any interest on their capital, will linger even longer. Moreover, there is fear that years of zero interest rates act as a sedative on corporate innovation and the dynamics of national reform policy. As a result, we today see low rates of corporate bankruptcy, limited productivity growth and, again, a supposed convergence in the rates of long-term government bonds.

As noted, low interest rates hamper wealth creation and innovation.

The current scenario is blatantly clear: the economic situation of key Eurozone countries is precarious and necessary reforms have largely come to a standstill. In this situation, external shocks or a sharp downturn in the Eurozone economy would be difficult to absorb, as the fiscal room for manoeuvre of nation states and the monetary policy options of the European Central Bank are almost exhausted. Shouldn't Brussels and other European capitals be alarmed? After all, the current reform fatigue is accelerating the relative economic decline of Europe, which is already challenged by demography and foreign competition. If these aspects are not addressed, economic centrifugal forces could once again put the Eurozone to the test. Therefore, the internal economic consolidation of the Euro area is as pressing as ever. Only in doing so can the Euro contribute to the EU's unity as a political-economic project, whilst also consolidating its global geopolitical position. It is time for a change in fiscal and monetary policies to strengthen the Euro, both internally and externally, supported by all member states.

Demography and reform stagnation are threatening European competitiveness.

To this end, the ESM should be taken further into a European Monetary Fund (EMF). Upon a member state calling the EMF, a resolution procedure would be automatically initiated. The EMF procedure would seek the successful rehabilitation of the state budget. It should be crystal clear from the beginning of the procedure that the temporary exclusion of the affected state from the monetary union ("monetary break") could follow as consequence if a member is not willing to change appropriately. Otherwise, there is risk of moral hazard, resulting in ever more bailouts. But before a newly constituted EMF can fulfil this task, several reforms must be implemented.

Turn the ESM into a European Monetary Fund (EMF).

First, the EMF should be legally integrated into the EU treaties so that it lies under democratic and judicial control. During this process, the EMF should inherit the *ex-ante* budget monitoring of the EU Commission. Furthermore, the EMF should assume the joint representation of the Eurozone countries in the International Monetary Fund (IMF) and thus receive additional specialist support. The expertise of the troika would thus be brought together in the EMF so that it can develop and monitor necessary aid programms. By freezing current claims, the EMF can restrict its financial grants to additional financial needs (no debt revolving during the procedure and precedence of EMF credits). The EMF draws up debt sustainability analyses and must assess whether there is a liquidity or solvency problem. If the EMF identifies sustained solvency problems or the non-implementation of programme requirements, the same institution will serve as the creditors' committee and coordinate the bail-in. This would also include an orderly exclusion procedure from the EMU without having to leave the EU. The effects of this "monetary break" would have to be socially absorbed by the state community. Such a cascade offers the opportunity to further enhance the rule-based approach in the spirit of Maastricht ("Maastricht 2.0").[3]

"Maastricht 2.0": To promote the rule-based approach in the spirit of Maastricht.

2. Entrepreneurship generates wealth

Article 3 (3) of the Treaty of the European Union (TEU) establishes a "highly competitive social market economy" as the model for the European Union. Entrepreneurship which forms the basis of social prosperity sits at the centre of this economic order. If one attentively follows current European debates be it the statements of the European Commission or the most recent European Council of the Heads of Government (March 2019), it might seem that this central fixed point of a liberal European economic order is recklessly neglected.

All sorts of European initiatives (e. g. European Fund for Strategic Investments, Industrial Policy Initiatives of the European Commission, Debate on European Unemployment Insurance) endeavour to generate the momentum that must ultimately come from the engine room of the member states' economy, i. e. the approximately 23 million small and medium-sized enterprises in Europe that create prosperity. As a trading and economic area, Europe can only gain economic weight through its companies' innovation. Accordingly, this is of interest to other economies such as Canada or Japan with whom noteworthy trade agreements have recently been concluded.

SMEs generate European prosperity.

This basic context must be much more strongly accentuated in public, especially by the European Commission, and accompanied by a true European SME policy. According to the Cologne Institute for Economic Research, "so far there is no consistent policy for SME and – despite the adoption of the **Small Business Act** (SBA) just a decade ago – no comprehensive SME policy."[4] A new Commission President should favour a fresh start on this policy area, simply because it is low-hanging fruit and many reform recommendations are already on the table[5]. Having said that, such initiatives are only a necessary but by no means sufficient condition for economic dynamism in Europe.

Ultimately, the preconditions for entrepreneurial success lie in the framework set by each member state (intelligent labour market policy, enabling social policy, moderate taxation policy, manageable administrative requirements). Rather than complaining about lack of productivity growth, private investment or adequate R&D spending by the private sector, national governments should firstly examine their own economic policy initiatives and priorities. At the same time, the European Commission must clearly and transparently tell European voters where to catch up on economic policy and how to change it. The European Semester must become more binding and EU debt rules must be enforced once again. An EU Commission with economic velvet gloves is not enough.

An EU Commission with economic velvet gloves is hardly helpful.

It is clear that reforms to encourage entrepreneurship and thus job creation must be managed by the respective member states. At the same time, one advantage of the European Union is that (still) 28 member states can learn from each other with regard to reform measures. The European Commission has been providing a tool for this knowledge transfer since 2017, the Structural Reform Support Program (SRSP), to support reform processes in member states through technical expertise. This is a hitherto little known but promising way to increase competitiveness in member states. In addition, a newly elected European Commission should vigorously pursue the Single Market Strategy that which the Juncker Commission launched in 2015. For European companies, there are still barriers to the cross-border movement of goods and services, hampering competition and resulting in missed economic opportunities and higher prices. Combined with increased labour mobility an integrated single market with deeper integrated financial markets (Capital Markets Union) can contribute to greater prosperity. In a globalised world such a market can also be interpreted as an economically fortified shelter. If this is lost through deliberate disintegration, the threat of becoming a target for external forces due to the ensuing uncertainty suddenly appears more likely. Britain's decision to leave the Single Market and the EU is likely to go down in history as a prime example of self-imposed dwarfing.

The EU budget should be geared to strengthening competitiveness.

At the same time, Brexit urges us to keep the common economic area competitive. A union solely made up of recipient countries will not survive. For this reason, a renewed, multi-annual financial programming must focus the budgetary priorities more closely on the future challenges of the EU. Final decisions on the multi-annual financial framework 2021–2027 (MFF) are expected in the autumn of 2019.

A position paper by the Konrad-Adenauer-Stiftung states: “At present, agricultural policy accounts for 39 percent and structural policy accounts for 34 percent of expenditure, but the strengthening of competitiveness is only amounts only to 13 percent; the item “Europe in the world” 6 percent, and security and citizenship 2 percent. The future budget should rather focus on the provision of European public goods and areas the merits of cooperation are clearly visible: competitiveness, external relations, security, defence and migration. In return, agricultural funds and to a lesser extent resources devoted to structural and cohesion policies should decline.[6]

Beyond the necessary focus on wealth-enhancing activities, one should not overestimate the growth emanating from the EU budget. At around 148 billion Euros, the European Commission has a state-sized yet comparatively small budget at its disposal. After all, companies and their investment that make a prosperous European future possible.

3. Strong currencies are attractive

Juncker’s statement that the Euro was meant to be “the single currency of the European Union as a whole” from September 2017 triggered some discussions within member states. It triggered some discussions within the member states. In principle, Juncker merely formulated a long-known rule: “All but two member states are obliged and entitled to join the Euro area as soon as they meet the conditions.”[7]

For Sweden, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria, the introduction of the Euro is basically mandatory.

The common currency is the official means of payment in 19 out of 28 EU countries. Under the Maastricht Treaty, Denmark and Great Britain negotiated their entitlement without obligation to adopt the Euro. For the remaining seven countries namely Sweden, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria, the introduction of the Euro is basically compulsory, provided that accession or convergence criteria are met. The relevance of these criteria is exemplified by Italy and Greece. Both countries were urged to enter the monetary union in 1999 and 2001 – for political reasons supported by Germany. Governments in Rome and Athens tend to overestimate the benefits of the single currency (lower interest rates and transaction costs), whilst greatly underestimating the resulting commitments tied to the introduction of the Euro (regularity, fiscal sustainability, permanent structural reforms, loss of the foreign exchange instrument). From a purely economic perspective, these countries are still the “sick men” of the Union and play an important role in the stability of the currency area. At the same time, their example hardly presents the Euro area as a common contract and rule-based community. Against this background, the Euro Group, the informal governance body of the common currency area, must have a paramount interest in allowing future accessions only if this strengthens the stability of the Euro.

Among other things, membership of the Euro area implies that a candidate country must participate in the exchange rate mechanism (ERM II) for two years before introducing the common currency.

None of the seven countries mentioned above meets this criterion so far. In addition, the Euro crisis ensured that the other convergence criteria (price stability, solid finances, long-term interest rates) are often not met. Against this background, it would take three things to introduce the Euro: an immense political will, support from the population and an economic policy effort to meet the convergence criteria.

Of course, this cannot be said in most non-Euro countries. Bulgaria, Romania and Croatia have the best chance of launching the Euro between 2020 and 2022, given their macroeconomic data and the pro-European attitude of their populations. And yet, these accessions will hardly increase the Eurozone's gravitational pull. On the other hand, Sweden and Poland, whose economic weight (seventh largest and eighth largest GDP within the EU) and liberal basic positions in the currency area are urgently needed, are currently no Euro advocates. It is worth taking the arguments presented seriously to increase the Euro's attractiveness. The Eurobarometer regularly shows that a clear majority of the populations in both countries speak out against the Euro. Among other things, Sweden and Poland associate the common currency with the alleged loss of national sovereignty, the risk of being party liable for misguided economic policies in other EU member states, and the risk of exchange rates leading to higher prices.

It would be worthwhile to increase the attractiveness of the Euro for entry-level candidates

By nature, each country weights the perceived disadvantages of the Euro differently. While Poland intends to keep the exchange rate instrument and a national central bank to ensure its price competitiveness at all times, the Swedes are more likely to see the threat of potentially higher payment obligations as a counterargument to the Euro. Both aspects are understandable from a national perspective and are regularly mentioned in domestic debates.

The Economic and Monetary Union will be more attractive for both countries if the institutional framework of the Euro area clearly helps to increase the prosperity of the countries involved, and a coherent market-based narrative is used. If this was the situation, the citizens' prevailing mood could swiftly change. The disadvantageous aspects (e. g. loss of the exchange rate instrument, imminent costs) must be offset by the European side with the benefits of a strong currency. Today, Warsaw is paying a higher government bond premium than Eurozone countries to borrow on the capital market. What is more, strong Swedish companies operate at higher costs than competitors in the Euro area. Intraregional trade would certainly boost the accession of Sweden and Poland and ultimately make the Euro even more attractive as a global reserve currency. Moreover, both countries could shape the general path of monetary union more strongly through their membership, which also makes them highly dependent as non-members.

Monetary union needs a conclusive market-economy narrative.

Of course, a currency cannot be strong if it is constantly challenged by economic risks (e. g. fragile banks, insolvent states, continuous rule breaks) and must fulfil its functions as a store of value and medium of exchange without large exchange rate fluctuations. Moreover, its central bank should focus on price stability instead of crisis handling and prevention, and member statse must ensure that countries ensure that the currency supports rather than hinders companies in their daily operations. Businesses, citizens and investors have a keen sense of whether their everyday currency is solid or not.

As important as the recent projects, the European Stability Mechanism as a crisis instrument and the Banking Union (i. e. banking supervision and, if necessary, bank resolution) are, it is crucial to launch a renewed attempt in the Club of 19 to find a consensus on the future shape of monetary union. There are two ways to accomplish this. The first one entails a Maastricht 2.0 consensus to secure the current division of responsibilities, with a centralised monetary policy and decentralised economic and fiscal policy. For this to happen, debt rules of the Stability and Growth Pact, the prohibition of state financing via quantitative easing the exclusion of mutual liability and permanent economic reform efforts are indispensable. As for the second way, it entails giving substantial sovereign rights in fiscal and economic policy to the EU, ensuring that action and liability remain in the same hands.

The exclusion of mutual liability and permanent reform efforts in economic policy are indispensable.

Politically, such a path can hardly be taken at present and, under the subsidiarity principle would also be undesirable, so a new narrative in the sense of a "Maastricht 2.0" is required. The Euro Group should quickly launch the necessary self-assessment process following the European elections, as it has an even greater responsibility for Europe's economic development after Brexit compared to non-Euro area countries, especially considering that from 2021 onwards, there will be a Eurozone budget (as part of the EU budget). This money is set aside to increase the cohesion and the competitiveness of the Euro countries as well as the stability of the Euro area following a Franco-German proposal. Needless to say, this will hardly succeed without a consensus on the basic direction of European economic policy and a powerful change initiative of the Treaty that corrects the flaws that the debt crisis revealed.

The Euro Group should initiate the self-assessment process shortly after the European elections.

4. Conclusion

After two decades of political euphoria (1999–2008) and crisis management (2009–2018), it is time for a third phase in the history of European Economic and Monetary Union: the dangerous dependency on financial markets, which largely arises from excessive government debt and unstable banks, must come to an end. Moreover it is crucial, for the continued existence of the currency, not to negate economic laws and keep common agreements. Both are prerequisites for a strong currency in the next ten years. More than ever before, this is about the internal economic consolidation of the Eurozone with a clear prioritisation. Precisely because the Euro's now 20-year history has path-dependencies, the sometimes bipolar debate between the extremes of "exit or transfer union" should be overcome. In the coming years, European politics must adopt a more nuanced approach between both options. This paper has covered selected aspects that should now be taken further in the ninth European Parliament and the new Commission. Doing otherwise risks a violent storm after period of deceptive calm.

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Legal notice

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