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Summary

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The Euro Crisis, Economic Governance of the Eurozone and Future Integration

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Between 2010 and 2015 the euro crisis completely dominated the EU agenda. More recently, the focus has instead been the refugee crisis and brexit. However, even though the euro crisis no longer appears to be acute, the problems of the eurozone have not been resolved. There is a latent risk that new shocks – for example, bank solvency problems in some countries – could trigger new crises. This motivates an analysis of eurozone cooperation today – how well designed it is and how it should develop.

The euro crisis was composed of several crises. Initially it was regarded mainly as a *fiscal crisis* because several countries were threatened by sovereign defaults. But the euro crisis was also a *banking crisis* that interacted with the fiscal crisis. Fiscal austerity to deal with the government debt problems, in conjunction with the banking crisis, exacerbated the *aggregate demand and unemployment crisis* that had been triggered by the international financial crisis in 2007/2008. Price and wage increases resulting from the overheating in some eurozone countries before the financial crisis also created a *competitiveness crisis.*

During the euro crisis, a number of policy measures that would earlier have been unthinkable were improvised. These included rescue loans and the establishment of rescue funds. The European Central Bank, the ECB, committed to large purchases of government securities from the crisis countries if that were to become necessary to hold down government bond yields. In parallel with the measures to deal with the acute crisis, a number of reforms to prevent and manage future crises were instituted. The system of economic governance that has been put in place encompasses more areas than the original fiscal field.

The reforms concern three areas:

- *Fiscal rules*. The changes imply more precise – and more numerous – budget rules, measures to strengthen compliance, changed decision procedures, reforms to strengthen the interaction between national and European decisions, and stronger national fiscal frameworks. The establishment of European rescue funds also forms part of the institutional changes in the fiscal area.
- *Broader macroeconomic surveillance*. A lesson from the experiences of Ireland and Spain is that fiscal crises caused by developments during upswings can also be triggered very fast in downturns in member states that have observed the fiscal rules. The aim of the broader macroeconomic surveillance is to identify and prevent macroeconomic imbalances in good times that can later develop into fiscal crises.
- *Financial supervision and crisis management*. This is the area in which the largest changes have occurred. The most radical reform is the establishment of the *banking union.* This includes a *Single Supervisory Mechanism* and a *Single Resolution Mechanism.* Under the supervisory mechanism, the ECB monitors the largest and most important banks in the euro area. Under the resolution mechanism, a *Single Resolution Board* at the EU level decides on bank resolution, that is, on the reconstruction and winding-down of insolvent banks. The costs for this are to be borne by shareholders and lenders (*bail-in)*. Only when these means are insufficient will resources from a *Single Resolution Fund*, gradually built up through contributions from the banks, be employed.

How should the monetary union develop in the future? One path would be a comprehensive deepening involving both fiscal policy and the banking union. This has been argued in the *Five Presidents' Report,* which sets *fiscal union* as a long-term goal for the eurozone.[1] Centralised fiscal policy decisions would then be taken by a common treasury for the whole euro area. Similar proposals had been advanced earlier in the debate, according to which such a European treasury would in some cases be able to veto budgets decided by national parliaments and to set budget targets for individual member states.

There is an *economic* logic behind the ideas on the comprehensive deepening of eurozone cooperation. The proposals on a further developed banking union are based on the insight that a member state can be overwhelmed by a banking crisis, with contagion effects on the whole eurozone that threaten both financial and macroeconomic stability. Far-reaching centralised control over individual member states' budget decisions is a way of handling moral hazard problems in fiscal policy. These problems have been exacerbated by the violations of the nobailout clause, represented by the rescue loans to a number of member states and the establishment of the rescue funds. Joint responsibility for individual member countries' government debt does not cause moral hazard problems to the extent that government budget and borrowing decisions are also taken jointly.

The problem with the plans for a deepening of eurozone cooperation is *political feasibility.* The plans go against the strong EU-sceptical opinions in many countries, which have led to growing political support for EU-critical, and sometimes even EU-hostile, political parties. In all probability, this means that the plans for a fiscal union with centralisation of fiscal decisions are unrealistic.

It is even questionable whether existing fiscal rules in the eurozone can function properly. Fundamental problems of *time inconsistency* have made the Commission and the Ecofin Council refrain from implementing the rules when that has been regarded as controversial. One explanation of why financial sanctions have never been employed could be that it is difficult to communicate why large budget deficits should be increased even more by fines. There is also a fear that financial sanctions could add to political hostility against the EU.

It could be argued that the existing system of financial sanctions against eurozone member states that violate the EU fiscal rules should be abandoned. It would perhaps be better to rely instead mainly on the national fiscal frameworks, that is, to *renationalise* fiscal policy. This ought to be possible with the reforms of the national frameworks that have taken place in recent years, partly as the result of EU-level initiatives. The EU-level requirements for the national fiscal frameworks could also be strengthened and could be made more binding. The main advantage of a greater reliance on national objectives, procedures and institutions (for example, fiscal councils) is that they may have more legitimacy in the eyes of citizens and that they function in the national context where most discussions on economic policy take place.

Common EU fiscal rules could mainly be used to underpin the respect for national fiscal objectives. However, this requires a radical simplification of EU rules: the number of rules must be reduced and they must be made less complex if they are to work as important benchmarks such that deviations from them cause a pressure of public opinion at the national level for a change in policy.

A renationalisation of fiscal policy is consistent with sufficiently strong incentives for fiscal discipline only if the credibility of the no-bailout clause is restored. This means that the member state itself and its creditors must bear the consequences of a government debt crisis. This is a necessary precondition for the proper market pricing of the risks of lending to member states' governments, which is necessary if early market signals are to discipline national fiscal policy. A credible no-bailout clause probably requires the establishment of an orderly procedure for restructuring government debt in default situations.

[1] Juncker (2015). The report was drafted by the Commission's President Jean-Claude Juncker in cooperation with the President of the European Council, Donald Tusk, the President of the Eurogroup, Jeroen Dijsselbloem, the President of the ECB, Mario Draghi, and the President of the European Parliament, Martin Schultz.

Another precondition for a credible no-bailout clause is that there is a way to deal with the repercussions on the financial system of a government default. This requires a well-functioning banking union, so that a write-down of government debt does not trigger a systemic financial crisis. Fiscal union and banking union should thus not be seen as complements. One should instead regard a further developed banking union as a precondition for the renationalisation of fiscal policy. Further developments of the banking union should encompass a common reinsurance system for national deposit guarantees and limits on the exposure of banks to domestic government securities. In addition, the European Stability Mechanism (ESM) should be transformed into a rescue fund that can only give bank support – either by lending to the Single Resolution Fund or by directly taking over and recapitalising failing banks – and not financial assistance to member states.

74 Eurokrisen, eurosamarbetets regelsystem och den framtida integrationen SIEPS 2017:1 There is strong resistance, especially in Germany, to a common deposit insurance scheme, because of a fear of having to contribute to the costs of bank failures in peripheral countries. However, at the same time, financial supervision, regulation and resolution decisions have been centralised in a way that has not been possible for fiscal policy. Political resistance has been much weaker, perhaps because these decisions are seen as more technical and less political than decisions on taxes and government expenditure. Decisions of this latter type are instead often regarded as lying at the core of national sovereignty. This is not the case with safety margins for banks and other financial institutions. In any event, the centralisation of financial supervision means that it takes place at the level where the costs for systemic financial crises are ultimately likely to be borne. This reduces the moral hazard problems in the banking sector that would otherwise occur with common crisis management.

The political preconditions for a centralisation of fiscal policy in the eurozone do not exist. Plans for fiscal union should therefore be shelved. These plans are in fact potentially dangerous because they go against public opinion and could thus trigger further EU-hostile sentiments. Even existing EU fiscal rules would probably be politically unsustainable if they were to be fully implemented. This is the reason why they are not, and never will be, fully implemented. Therefore, it would be wise not to try to deepen fiscal integration further, but instead to take a step backwards and focus on the incentives for fiscal discipline at the national level. These incentives will become stronger if the credibility of the nobailout clause is strengthened.

The main focus should instead be the establishment of a better-functioning banking union. This would help restore the credibility of the no-bailout clause. It would no longer be necessary to use rescue funds to give financial aid to member states' governments if the consequences of write-downs of government debts could be limited. The political preconditions for the further development of the banking union are much more favourable than the preconditions for a deepening of fiscal integration.

The conclusion is that the eurozone should *not* aim for more integration in *both* the fiscal *and* the financial field. The best way of securing a well-functioning monetary union in the future seems to be *more* integration when it comes to financial supervision and crisis management, and *less* integration of fiscal policy. A drawback of the latter conclusion is, of course, that it will be difficult to achieve coordination of fiscal policy to ensure an appropriate fiscal policy stance for the euro area as a whole. However, it is probably necessary to accept that the political preconditions for this do not exist today.

During the most acute phases of the euro crisis, a frequently asked question was whether the euro would actually survive. Today, a more frequent question is whether the whole EU will survive in the long term. An interesting observation SIEPS 2017:1 Eurokrisen, eurosamarbetets regelsystem och den framtida integrationen 75 in this context is that support for the euro in the eurozone countries (including those in the periphery) does not seem to have fallen, even though support for the EU has. A possible interpretation is that the euro, rather than being a vehicle for "ever closer union", may be the mechanism holding the EU together, because a return to national currencies is seen as too complicated and risky. The more realistic the objectives for future eurozone integration, the greater the chance of such an outcome. According to my analysis the probability of a well-functioning euro is highest if the ambitions for cooperation are raised when it comes to financial supervision and crisis management but lowered for fiscal policy.