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Summary of the report

The Future of the Economic and Monetary Union

Reform Perspectives in France, Germany, Italy and the Netherlands

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In the spring of 2010 a sovereign debt crisis erupted in the euro area that triggered a series of new crises and a reform process to fix what was broken in the Economic and Monetary Union (EMU). While member states' experiences differ, the crises were essentially the result of a rapid unwinding of imbalances that had been built up in the 2000s. What made matters worse was the absence of institutions that could have prevented the crises from occurring, or at least mitigate the effects once they were a reality.

Several measures were implemented as a response to the insights gained from the crises, which can be broadly summarised in three categories: intergovernmental rescue funds, the strengthening of economic governance in the EMU and establishing two out of three pillars in the Banking Union. While there is general agreement that further reform is needed, there is however disagreement as to which measures should be implemented. In a nutshell, member states disagree over the balance between risk sharing and risk reduction. Risk reduction proponents place the emphasis on crisis prevention, while those who emphasise risk sharing focus on crisis mitigation.

This book represents a concerted effort by four prominent scholars from France, Germany, Italy and the Netherlands to summarise the discussion in those countries and analyse in which areas the member states may find common ground to press ahead with reforms. The authors have been asked to provide a background to how the euro has been perceived in their respective countries and identify which EMU reforms would be acceptable in the short- to medium-term perspective.

The reason for choosing France and Germany is the well-known wisdom that meaningful reform requires their mutual consent. The Netherlands has resisted many of the risk sharing arrangements discussed and proposed, while also acting as a proxy for, and leader of, countries such as Austria and the Nordic and Baltic countries. Italy, on the other hand, would act as a proxy for other southern euro area countries, such as Greece, Portugal and Spain. However, the euro area's third largest economy is also interesting in view of its rather unique history during the Great Recession in the 2000s and weak public support for the euro.

Erik Jones on Italy

The *Italian* view on reform is in many regards close to the French approach under President Macron. They both focus on risk sharing measures and institutional reform, while taking a very sceptical view toward aggressive risk reduction measures in the financial sector. Contrary to popular belief, Italy did not experience major problems with competitiveness, government borrowing, or private indebtedness prior to the crisis. The Italian crisis narrative rather focuses on the role of the banks and cross-border financial flows. Consequently, the number one priority here is to shore up confidence in the financial market participants, to prevent a panic followed by liquidation of Italian assets in the event of a new crisis.

The history of Italy's euro membership is one of cognitive dissonance, that is, the simultaneous embrace of contradictory positions. One such example is the public's treatment of the governments that in the 1990s successfully managed to increase the Italian economy's competitiveness. Coordination with trade unions on wage bargaining and pension reforms held down the growth in relative real unit labour costs. This represented an application of external constraint: the commitment to price stability earned the government credibility in the markets, allowing it to borrow more cheaply from abroad. Not only did it mean that Italy was selected to join the euro among the first group of countries in 1998; but borrowing costs fell so quickly that neither the Prodi nor the Massimo D'Alema governments had to run primary surpluses to support consolidation efforts. Ironically, the electorate ousted the D'Alema government. At the same time, public opinion soured toward the single currency. It was widely believed the euro created inflation and that shopkeepers used the changeover to gouge consumers, despite data showing a different picture.

The Italian economy was not deeply affected by the financial crisis in the first few years. In many regards it was in a better position than Germany, for instance, with respect to larger household wealth and lower unemployment. Even though there was a loss of competitiveness compared with Germany in the years leading up to the crisis, this only meant that Italy gave up some of the competitiveness it had previously gained. It also had a more conservative banking sector, with banks still raising and using funds locally. Hence the banking sector was shielded from the direct fallout in the US real estate markets, and the full impact from the economic crisis came only in 2011. When households as a result dipped into their savings, Italian banks faced tightening funding opportunities and cut back on their lending. This sent many local economies into a negative spiral; non-performing assets piled up, adding further pressure and accelerating the spiral. In June 2011 international investors chose to exit and capital poured out of the country, moving Italy's position massively into deficit. This sell-off in Italian government bonds is important because it represented a sharp spike in local borrowing costs and a sharp contraction in locally available liquidity.

In view of Italy's history, we could expect a fairly coherent set of negotiation positions from a centrist or technocratic government. It would support a euro area budget line; a European deposit insurance scheme backed with common resources; a European finance minister with discretionary powers over joint resources; and greater political accountability for joint European macroeconomic policymaking. Furthermore, such a government would also support a simplification of the fiscal consolidation rules and some form of debt mutualisation (or Eurobonds). At the same time, there is opposition toward accelerating the disposal of non-performing assets and introducing a cap on bank exposure to home-country sovereign debt instruments.

However, the M5S/Lega government will likely depart radically from the line pursued by a centrist or technocratic government. The most obvious point relate to fiscal policy coordination and debt consolidation. The M5S/Lega government intends to introduce expensive reforms which, without funding, will not abide by the requirements of the Stability and Growth Pact. They also intend to introduce measures that e.g. go against the ethos of the Banking Recovery and Resolution Directive, which will make it harder to agree on pooled resolution funding or deposit insurance. Moreover, both the M5S and the Lega would relish a conflict with Europe to reinforce their roles as the protectors of Italian national interest. Arguably, the prospects for euro area reform will not improve with a populist government in Italy.

Christophe Destais on France

France under President Macron seems intent on achieving far-reaching reforms. The President secured a large majority in the National Assembly effectively sidelining anti-euro/anti-EU proponents. He managed to quickly achieve an audacious reform of the French labour laws. Beyond domestic considerations, such policy aims at showing Germany that France is credible on structural reforms. Furthermore, the anti-euro rhetoric has virtually disappeared from public debate in France since the elections, and the opposition is weak.

Nowadays, there is an apparent absence of an actual public debate on the future of the euro area and, especially, on what fiscal policy should be in a monetary union. However, one should not forget that anti-EU/anti-euro secured more roughly 40% of the votes during the 2017 presidential elections and that, less than one year ago, pessimism about the future of the EU and the euro was the dominant mood in France.

The French are seeking an ambitious plan with the Germans, a strategy that would cover: a) financial integration; b) crisis management with adjustments made to the European Monetary Mechanism, giving it a larger role in crisis *prevention* and c) a euro area budget of 1–2 per cent of the euro area GDP. The latter would have its own tax revenues and the possibility to borrow, hence contributing to the production of a European safe asset. The budget would be authorised by a newly created section of the European Parliament (the euro area Parliament), for which the usual qualified majority voting rules would apply. The euro area budget would contribute to stabilisation of the euro area economy in case of shocks, through the automatic reduction of its revenues rather than through an increase in its spending. These proposals display a traditional French Keynesian view with respect to fiscal policies, but do not directly address the German ordoliberal concerns (see below) that relate to fiscal rules. France may underestimate German frustrations with the euro, especially when it comes to the failure to implement the latter properly. It is thus likely that the final agreement will also include credible adjustment policies to curb public spending when deemed excessive, reduce public debt and moderate wages.

Daniela Schwarzer on Germany

Consecutive German governments have been both proponents of deepening integration and of enlarging the EU. Euro area matters have constantly been high on Germany's EU agenda, even if it, at times, caused controvery with its strong preferences and positions. Also the new government is likely to pursue a rules-based approach to euro area governance. The rules for fiscal discipline in particular should be better applied, and may need simplification, as long as implementation is pursued more convincingly than in the past years. The enforcement of the rules regarding fiscal policy, financial stabilisation, and macroeconomic stabilisation should be better insulated from political interference. However, given the political problems to implement rules, market discipline is a concept that the new German government will likely want to enhance in the euro area.

At the same time, German politicians today understand better the adverse effects of austerity in Southern Europe, e.g. that it has given rise to a negative view of Germany and risks delegitimising both the system and the rules contained therein. The strong presence of social democrats in the new German government, combined with the credibility of Macron in being able to deliver reform, add further hope of agreement between Berlin and Paris. This is amplified by the strong focus on European issues in the coalition treaty between CDU, CSU and SPD, which even leaves open the possibility of euro area countries pressing ahead on its own.

Furthermore, the coalition treaty implies strong cooperation between Germany and France, working together on ideas for the 28–29 June European Council. The treaty contains no red lines and shows openness for more money to economic stabilisation, innovation and investment, although it remains vague on the design of the euro area budget. Moreover, it explicitly argues for a stronger euro area architecture, developing the ESM into a EMF anchored in EU law. The treaty does not mention the European Deposit Insurance Scheme (EDIS) but, unlike the previous coalition, does not rule it out.

However, great differences remain even when we look at the details in the proposals where there is convergence. In some cases, such as the size, role, institutional setup and funding of the euro area budget, the views are wide apart. Even though Germany is ready to pay more for Europe, what is mentioned in the grand coalition treaty is an "investment capacity" for the euro area countries that would improve economic convergence – a measure that would also come with conditionality attached to it. In other words, it would not be remotely close to the kind of centralised stabilisation function sought by France and Italy. A related issue is the role of a future European Monetary Fund: the French argue that it should be able to bail out countries and provide support ex-ante to prevent crises. In the German version of the EMF, however, it is likely that rescue programmes come with strong conditionality, in line with what hitherto has been the case with ESM programmes.

In any Franco-German initiative, risk reduction, market discipline and risk sharing need to go hand in hand. Hence, the Germans will push for incentives to reduce the risks in euro area banks before pan-European deposit and resolution schemes become a reality. Germany wants a transparent framework for absorbing losses both on investors' exposure to banks and to sovereign debt. The German view on how to develop the ESM into a European Monetary Fund needs to be understood against this backdrop: a future EMF should get a mandate to monitor the economic situation in member countries in the interest of crisis prevention and the institution should go hand in hand with a standard debt restructuring mechanism in order to provide the private sector with clear and predictable principles ahead of time. Moreover, the coalition agreement states that the role of national Parliaments should not be impacted, which implies national veto over stability programmes.

Adriaan Schout on the Netherlands

Though a mid-sized member state increasingly described in the European press as euro-sceptical – even viewed as a candidate for taking over the restraining role traditionally played by the British – *the Netherlands* is in fact a firmly pro-European country that likely will continue to be a pragmatically constructive partner. As one of the most competitive EU countries, the Dutch society is deeply aware of the importance of the EU for its economic progress, security and global influence. The Netherlands is taking part in all initiatives to date (thus far only with the exception of the European Public Prosecutor's Office; EPPO) to make sure they have a place at the table. They are also aware of the need for solidarity across borders, provided that other countries are equally committed to national reforms.

However, Prime Minister Rutte has argued that if countries fail to reform, it should even be possible to push them out of the euro area (a view echoed by the newly formed "Value Union" in Germany). Moreover, a counter-narrative to the more positive view is emerging, out of frustration over what is described as European "integration by stealth". In essence, this means that the EU is seen as taking incremental decisions that eventually result in a different kind of EU than was on the agenda when the initial decisions were agreed on. For example, the euro area was designed to rely on member states' own ability to adhere to the rules or the Stability and Growth Pact and, in the case of rule breaking, enforcement of the rules by the Commission. However, the proposals that are currently on the table, along with reforms carried out since 2010, imply an increasing number of euro area bodies, procedures and political deals. There also have been institutional consequences, for example, in terms of the politicisation of the European Commission and the evolving powers of the European Parliament. This incremental process also blurs the checks and balances of the system.

While the Dutch fear that their preferred partner Germany seems to accept a substantial share of the current reform agenda, the Netherlands is explicitly ill at ease with it. We may therefore witness a pragmatic approach towards safeguarding Dutch influence, which is based on flexible coalitions and a strategy of accepting neither the "if-then" (or *quid pro quo*) logic, nor anything that resembles a "transfer union". Hence, there are limits to the amount of risk-sharing the Dutch will accept. On the other hand, Mark Rutte himself learned hands on that a tough autonomous strategy in the European Union (EU) is untenable for a single medium-sized country. In 2015, when a third Greek support package was agreed upon, Rutte had to break his 2012 election promise that there would be "no more money to Greece". Yet it would seem that both of the above-mentioned red lines are shared *implicitly* also by Germany.

The commitment to this strategy is likely explained by the attempt to reach a comprehensive EU compromise on the proposals currently on the table (see above), which may be hard to contest without political costs in the European Council. However, even a diluted European minister is a threat in the eyes of the cautious Dutch, since the post is linked to a range of other plans, such as a European Monetary Fund (placed under political leadership), a euro area budget, a bigger role for the European Parliament and a politically supervised backstop for weak banks. However, current discussions in the media already indicate that there is a realisation emerging that a higher EU budget and some form of EMF must be accepted. Rutte seems to be looking for ways to provide some leadership when it comes to moderating deeper and political integration by building coalitions with – depending on the specific policy – Austria, Ireland, the Nordic countries, the Benelux, the Visegrád countries, as well as other countries. The hope is that, with the Brits on their way out, the Netherlands can thus compensate for the loss of a British counterweight to the German-French axis. This should not be seen as the Netherlands taking over the obstructive role which the Brits assumed, but rather as an effort to be a constructive partner in building a "better" Europe based on strong member states that are able to deliver results themselves.

Prospects for continued EMU reforms

In conclusion, there seems to be general agreement among member states and scholars alike that flaws remain in the legal and institutional architecture of the euro area, and that more work is needed to fix the European financial markets. A convergence of views can be seen when it comes to reforming the rescue fund ESM and bringing it into the EU legislative framework, possibly transforming it into a European Monetary Fund. There is also a common view on reaching an agreement on the EDIS and making the ESM the backstop for the Single Resolution Fund. In view of a recent non-paper by eight Finance Ministers, these steps may be acceptable, not only for the Netherlands, but also for Ireland and the Baltic and Nordic member states. Another risk sharing area where there seems to be sufficient common ground for successful reform concerns the need for taking further steps in the Capital Markets Union. We should therefore expect to see some progress in these areas.

While the idea of trading risk sharing for risk reduction measures may seem like an apparent way forward, such a strategy will likely meet strong resistance. As noted, the Netherlands is not keen on the "if-then" method that has unlocked member states' resistance to reform in the past. The view here is that a greater convergence should be achieved before proceeding with risk sharing arrangements. This means economic convergence as well as further reduction of non-performing loans (NPLs) and banks' exposure to home countries' sovereign debt. For different reasons, Italy may also be expected to object. Regardless of whether there is a populist or technocratic government in Italy, there will be strong resistance against accelerating the disposal of NPLs, as well as opposition to restrictions against home-country sovereign debt exposure. The M5S/Lega policy programme implies that risk reduction measures are impossible to achieve. Hence far-reaching risk sharing reforms are ruled out as well.

In closing, a series of questions need to be addressed with respect to the dynamics between the respective member states, as well as between the member states and the EU institutions. The strong focus on possible common denominators between Germany and France implies that the process may not be inclusive. Obviously, this will not sell well in the other member states. Furthermore, the respect for the institutions, above all the Commission, is no small matter – not least in view of protecting the interests of all, rather than a few big member states. The absence in the wake of the March 2018 election of a constructive Italian government does not mean that Italy should be ignored. Doing so could quickly translate into popular discontent if euro area reforms turn out to disadvantage the country. The consequences of having to deal with proposals that are prepared and discussed bilaterally in Berlin and Paris ignore the importance of legitimising the process, something that ultimately can only be achieved when the proper legislative method is used. This implies having the Commission work out and present legislative proposals, passing them onto the Council and the European Parliament.

Finally, it is not clear to what extent the non-euro member states will be able to influence and take active part in the reform process. While Germany and the Netherlands attach importance to including all member states in both the process and legislative and institutional outcomes, the French vision – more often than not – has implied a process where the core member states spearhead the integration process and leave hesitant member states behind. Moreover, the coalition treaty in Germany also allows for a more French approach of a small group spearheading the integration process, should this be deemed necessary. Having said that, it is reasonable to assume that, should the euro area countries fail to take the interests of the remaining member states into account, the latter's future as members of the EU may never extend to also adopting the euro as their currency.