EconoMonitor

A Roubini Global Economics (http://www.roubini.com/) Project

EMU 2.0: Yes or No?

Author: Roberto Tamborini, January 9th, 2013

link http://www.economonitor.com/blog/2014/01/emu-2-0-yes-or-no/

In the Summer of 2012 the Euro-crisis seemed to be at a turning point. First, an ambitious programme of institutional reforms of the EMU was launched aimed to the creation of a "Genuine Economic and Monetary Union" (EU Council, 2012). The founding idea of this 'EMU 2.0' is that there should be a clear, consensual and contextual exchange of fiscal discipline for fiscal solidarity mechanisms in a context of enlarged common institutions of "sovereignty sharing". These are essentially two, the so-called Banking Union and Fiscal Union (and in a more remote future, the Political Union). As a matter of fact, this reform plan also certified that the two-stage strategy pursued mainly by Germany – fiscal discipline now, fiscal solidarity (maybe) tomorrow – was not working and was not taming the investors' fears of the euro breaking up. Second, the ECB announced its new Outright Market Transactions Programme – accompanied by the now famous commitment to doing "whatever it takes" to stabilize the sovereign debt market – which immediately appeared remarkably effective in harnessing spreads (Draghi, 2012). Concomitantly, under the pressure of the crisis, new political leaders came to power in most stressed countries determined to reform their countries consistently with the requirements of the prospective EMU 2.0.

2013 was a year of (relative) financial quiet (see also R. Keenan, RGE, December 8th, 2013), possibly as an outcome of the three events recalled above. Spreads have shrunked, stock markets have been bullish, Spain and Ireland accomplished their rescue homeworks, Italy overcame its financial emergency. Fiscal deficits were brought under the 3% limit of GDP in almost all countries. Actually, sovereign debts went on rising, but with negligible effects on interest rates. The largest portion of merit should be acknowledged to the OMT, given that the other two events of 2012 have, so far, produced no memorable results. The Banking Union is muddling through slowly; the Fiscal Union is still out of sight. As to the OMT, it is worth stressing that it proofs that the previous "market-discipline" approach was wrong: it is not from the lashes of unfettered spreads that governments get the will and strength to consolidate public finances.

2013 was, instead, yet another gloomy year for real economies and lives. The following table summarizes the data relative to growth rates for the first 12 EMU countries (Eurostat, December 2013).

	Countries in recession	Growth rate ≥ 00-07
2013	FIN,GRE,IRE,ITA,NET, POR, SPA	None
2014	None	None except GER
2015	None	None except GER

7 countries out of 12, and the EMU as a whole, ended in recession or almost zero growth. The others are on the track of very weak growth, notably less than the pre-crisis average year rate. Further forecasts are that the EMU countries will muddle through slow recovery. In fact, if all countries will escape recession from 2014 onwards, only Germany is expected to catch up with the pre-crisis growth pace (which, however, was rather poor). Regaining the pre-crisis growth rate would be important, but the *level* of GDP as the basis of the standard of living is equally so. The largest subset of countries is still suffering a net output loss with respect to 2007 (Finland -2%, Greece -22.8%, Ireland -5.4%, Italy -8%, Netherlands -1.2%, Portugal -7%, Spain -6.4%); two are around zero (France and Luxembourg); and only three have barely gained a net output growth (Austria, Belgium, Germany). The unemployment rate in the EMU as a whole has reached 12.2%, almost 5 points above 2007; it has constantly increased in all countries except Germany (Greece +18.7, Spain +18.7, Ireland +9.5, Portugal +9,3, Italy +5.7). The countries with most severe output losses have also recorded sharp cuts in real compensations per employee: Greece -18.6%, Ireland -9.7%, Portugal -5,8% (Italy and Spain have contained the cuts below 1%, thereby being accused of labour market rigidity). All in all, there is not much ground either for optimism or for declaring the end of the crisis in Europe. Is this the fallout of the Great Recession or the failure of the austerity therapy? The debate is open, though, after the IMF, also the EU Commission begins to admit the recessionary effects of austerity have been worse than expected (for a comprehensive analysis you may see my "Transatlantic austerity 2010-…", 2013).

Be as it may, the crisis management (and part of the crisis) is the offspring of the Maastricht institutional setup, which brings us back to the need for reforms. At the beginning of this seventh year of crisis, the perception (or the hope) is that 2014 may be the time for final decisions for the future of the EMU. *Each and all* members should be aware, or should be made aware, that the time of maquillage of the Maastricht Treaty is over (De Grauwe, 2013; Steinherr, 2013). *Each and all* members will have to decide, and state clearly, whether they really wish the EMU reforms that are necessary the give the euro a future, or go for the (possibly orderly) resolution of the single currency marriage.

The reasons are compelling. The figures presented above are only the alarm bells of what is happening deep in economies and societies. A paradoxical, but crucial, fact is that the discontent with the euro is generalized throughout the EMU, in the most severely distressed countries as well as in those which have dictated the agenda of the crisis management and have suffered less. Not only are the euro and other European institutions at their all-timel low. The application of the Maastricht doctrine to the crisis, the idea that all problems only arise because of the misconduct of some members, has resurrected the demon of European history: economic nationalism. Now everyone believes that domestic troubles are the consequence of foreigners' swindle or greed.

The capacity of political containment of the anti-euro, and anti-Europe, forces is rapidly exhausting (Italy is paradigmatic in this respect). We shall see the outcome of the next European elections.

Yet the strategic scenario is even more complicated. The true, and far more difficult battle will not be between pro-euro and anti-euro forces in the next European elections, but within the pro-euro camp in Brussels. Behind the pro-EMU 2.0 façade, one can hardly find sincere reform efforts. Uncertainty about the willingness, and capacity, of most distressed countries to reform themselves and withstand the constraints of a monetary union is legitimate, but uncertainty about their counterparties' will is legitimate as well. The popular narrative of the crisis in the countries that feel virtuous boosts strong political pressure to the effect that all the responsibility and the burden of adjustments fall onto the shoulders of those they see as fiscal profligates (PIIGS). Let financial markets do their job freely and inflict a hard lesson to the PIIGS. The EMU as it is will work well when the PIIGS will be redeemed – even better if they give up. The preferred strategy of the virtuous is the status quo, not the reform of the EMU. In fact, the status quo is propaedeutic to the unilateral exit of the PIIGS, with the creation of the most beloved "Northern euro" as a free lunch. The true battle will be between genuine reformers and disguised conservatives.

Another factor of uncertainty is that reformers and conservatives for the time being fight on the ground of opinion making, but neither camp has yet expressed, or conquered, a political leader sitting where decisions are actually taken. The cradle and natural leader of conservatives is Germany, but the Merkel governments have hitherto maintained an enigmatic role in this game. The new *Grosse Koalition* appears no less enigmatic, but the attractiveness of, and pressure for, the Northern euro is increasing in the German area (see e.g. A. Steinherr, "Why Germany should leave the euro", 2013). As to reformers, the may find voice and leadership in France and Italy. However, France, which is certainly hostile to the Northern euro today as it was at Maastricht, set the Sarkozi-Merkel diarchy aside has disappeared from the stage of European policy. Further, France is not very credible as genuine reformer owing to its notorious jealousy for national sovereignty. As to Italy, it has clear benefits from staying in a reformed EMU instead of leaving the euro, and this option still gains a (shrinking) majority of the public opinion. Also, Italy will have its window of opportunity in the next semester of presidency. However, Italy's handicaps are even heavier than for France, given its present economic, political and reputational weaknesses.

What can, and should, the leader of genuine reformers do? As in any high politics operation, a unique combination of vision, determination and brinkmanship is needed. First, to conquer the trust of the others, the leading country should convince itself that the EMU 2.0 will not be a tricky system of bypasses of the fiscal responsibilities, sovereignty limitations, and economic reforms that are necessary to live and prosper in the Europe of the euro. Second, the trap of the mirage of the United States of Europe should be avoided – that is the avenue to the *status quo*. A viable monetary union does not require immediate massive doses of federalism, neither fiscally nor politically. What is urgently needed is an effective system of protection and stabilization of large

economic and financial boom-bust cycles wisely articulated at the national and super national levels:

1. new financial micro and macro-prudential regulation, inclusive of early warning systems, and effective means of correction, of serious financial imbalances in the private sectors within and across the borders
2. robust and credible financial stabilization mechanisms (banking crises resolution, enhancement of the European Stability Mechanism) decoupling private finances from public finances
3. complete redesign of the fiscal regulation system based on : a) substitution of the "country-by-country" approach with a system oriented towards coordination of fiscal policies (see point 4); b) removal of the apparatus of fixed rules on current fiscal budgets, in favour of direct monitoring of long-term sustainability of public debt; c) flexibility of long-term fiscal plans in relation to the business cycle, domestically and Union-wide, under monitoring and coordination of the EMU authorities (see point 4); d) transfer of a few national fiscal competences (e.g. defence, infrastructural expenses, automatic stabilizers) to the Union's budget
4. coordination between monetary and Union-wide fiscal policy in view of stabilization of the aggregate business cycle
5. realignment of the ECB statutes and latitude of competences with the those of standard central banks in developed countries (remove prohibitions that are not enforceable when they may endanger the stability of the system).

(If you think you see nothing new in this list you are right. These ideas have been around for years. Had they been implemented in due time instead of insisting with the Maastricht zombie doctrine, we would have been spared some of the pains of the crisis, public opinions would have seen some benefits from sharing common institutions, and the general climate would be more favourable to pro-growth reforms).

Last but not least, the leader of genuine reformers will need the credible determination to present all the others with the clear-cut alternative: either a serious EMU reform is started here and now, with all the necessary ingredients, those which the "South" dislikes as well as those which the "North" dislikes, or everyone will have to take its own part of responsibility in saying 'No' to the European economic and monetary union.