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Eurozone Reform: A Victim of Political Economy

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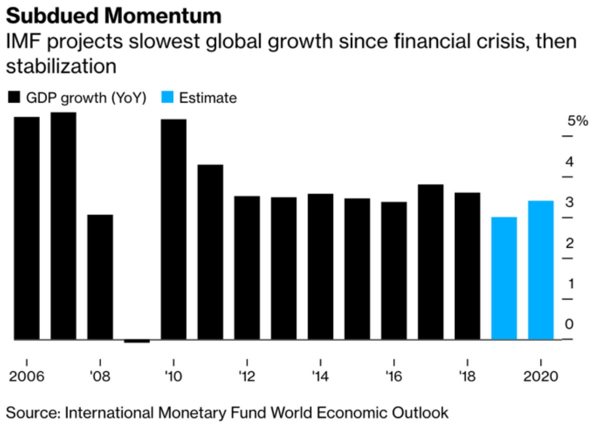
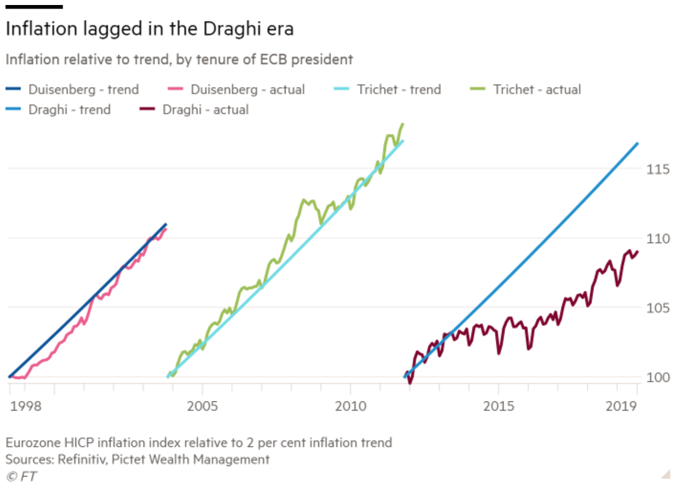
- **With a new European Commission and a new head of the European Central Bank (ECB), the Eurozone is set to have new leadership and an opening for positive change. As Eurozone faces old and new challenges, it is in dire need of improved capability to tackle both legacy and new problems.**

The European Union (EU) and Eurozone is confronted with an increasingly uncertain world, with mounting risks and a global slowdown in economic growth. On its doorstep, Brexit and the EU's future relationship with the United Kingdom still need to be finalised. At the same time, President Trump's trade war with China and beyond has had effects that have been felt by economies worldwide. The slowdown in Germany's manufacturing has shown the negative impacts of continuous trade disputes and uncertainty, the effects of which are felt especially acutely by economies reliant on manufacturing, global trading networks and supply chains. The International Monetary Fund (IMF) has slashed the global growth forecasts, predicting that it is likely that these will have to be revised further down.

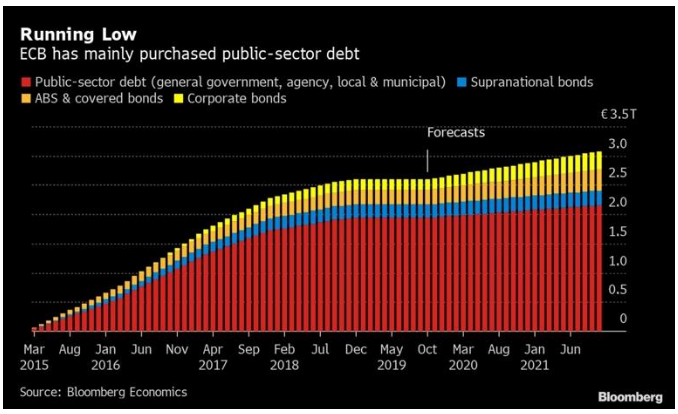


Global economic recovery will also be affected by what happens with economic growth in China, due to its systemic importance and the slowdown in its growth.

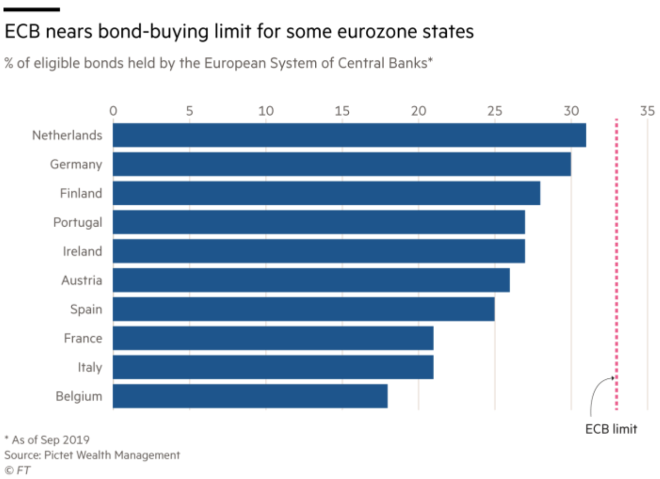
Meanwhile, Europe is struggling with low inflation, which is unlikely to change any time soon, and low growth. The ECB is not the only central bank to miss inflation targets, with the US Federal Reserve and Japan's central bank also struggling with disinflationary pressures. The IMF predicts that low inflation might become entrenched in advanced economies, constraining monetary policy space and thus limiting its effectiveness.



Europe (and Eurozone) also suffers a prolonged productivity crisis and faces challenging demographic prospects characterised by ageing populations. The growth forecasts for the Eurozone in 2019 have now been revised down to 1.2%, with inflation forecast lingering around 1.3% - instead of the close to 2% as was hoped for. The ECB's continuous quantitative easing (QE) programme and its record low interest rates have almost exhausted the available monetary space available for the bank to act decisively if another crisis hits the region. Some worry that ECB's asset purchase programme is going to reach its limits, with the bank owning close to the sovereign bond threshold for certain countries.



This means that the ECB might have to change the composition of its purchases and expand its purchasing of private debt, which might raise questions from some member states about the remits of its current mandate.



In the last couple of years, Eurozone government bonds have been selling at record low yields, which means that countries have been able to borrow cheaply, narrowing the divergence between real interest rates across the Eurozone. Even the Greek and Portuguese government debt has joined the club of countries enjoying negative rates, despite both countries' problems during eurocrisis.

The low interest rates can have some adverse effects, such as undermining the efficiency of resource allocation across the broader economy and encouraging excessive risk-taking in search for better yields, which in turn can result in financial instability later down the line. Most worryingly, IMF research shows that in case of a major economic downturn, the corporate debt at risk of default would be $19 trillion or nearly 40% of the total debt in eight major economies.

Despite its shortcomings, in the absence of any fiscal stimulus, the low interest and rates the QE programme has played an important role in helping to sustain European economic growth.

Eurozone's unresolved issues

The 2008 global financial crisis and subsequent eurocrisis in 2012 exposed how incomplete the Eurozone structural set up was, triggering ad-hoc policy responses to tackle the problems this gave rise to. While the post-2008 period was characterised by the use of emergency reactions and tools, the post-2012 reforms were aimed at more systemic transformation. The eurocrisis exposed the dangers of the sovereign-bank "doom loop", denoting the vicious cycle in which banks hold sovereign bonds and governments bail out banks, which remains an unresolved problem for the currency union. One of the greatest risks is Italy's slow growth combined with its high public indebtedness, which in the second quarter of 2019 stands at 138% of its GDP.

The legacy issues, which include this strong home bias shown by bank balance sheets [1]or the high public debt ratio of some euro countries, have remained a point of contention. These issues have been hard to tackle because of their distributional character, since they set creditor countries against debtor ones, and high-debt versus low-debt countries. While focus initially was on controlling the increasing inflationary pressure within the currency union, over time this focus has shifted, recognising the inevitability of an implicit bailout by the ECB, or an explicit one, should the financial system be in danger of collapse.

Since the Eurozone has enjoyed several years of economic expansion and low unemployment levels, the appetite for reform has now dampened. The reform process has stalled for the last few years, with no significant reforms to the Eurozone governance architecture since 2014. Yet the main structural issue remains: the lack of appropriate and robust fiscal capacity at the Eurozone level. This problem has been called out not only by the now former

[1] Home bias here refers to the national banks holding a disproportionately large amount of home country's sovereign bonds.

head of the ECB, Mario Draghi, but also by the new head of the IMF. Ahead of the UK general election, both of the main parties have announced plans for large fiscal stimulus that will increase UK's debt levels.

The recent efforts by France to create a common cash pot, or the Budgetary Instrument for Convergence and Competitiveness (BICC), to support reforms in Eurozone countries and to absorb sudden economic shocks, was a limited success. This was mainly due to the opposition by Northern countries such as Sweden and Denmark, supported by the Netherlands, wary about transfers to Eurozone periphery countries. The greater emphasis on the conditionality – linking disbursements to reforms – has helped to overcome the opposition to the BICC, which will start functioning by 2021. Its overall final figure remains to be decided, since its funding will form part of the multiannual financial framework or the EU's long-term budget between 2021 and 2027, which is already under pressure due to Brexit. The European Commission has advised the size of the fund to be €17 billion for the 19 Eurozone countries over seven years. The suggested amount is very small, raising doubts over the effectiveness of the fund.

What casts further doubt on the effectiveness of the BICC is the fact that money disbursement will not be linked to the economic cycle, so it will not be counter-cyclical and will not reduce euro risk, as its aim is not to provide support to countries during asymmetric recessions. Its goal to try reducing euro risk over longer term by focusing on structural reform that leads to better growth capacity is commendable, but until now structural reform efforts have had very limited success due to political disagreements. The common deposit insurance scheme, which was one of the initial ideas for the banking union, did not get enough support because creditor countries saw it as too much of a commitment to bail out debtor countries.

The best effect the BICC can have is to catalyse the debate on how to better deal with the structural issues and stabilisation needs. In its current form, the BICC will only provide a small contribution for reform efforts primarily due to its budgetary constraints and the emphasis on conditionality.

It is fair to say that since 2008, the euro architecture has seen significant improvements, with the establishment of the yet incomplete Banking Union, the Macroeconomic Imbalance Procedure, The European Stability Mechanism (ESM) and the Outright Monetary Transactions (OMT) Programme. All of these now offer channels for tackling problems.

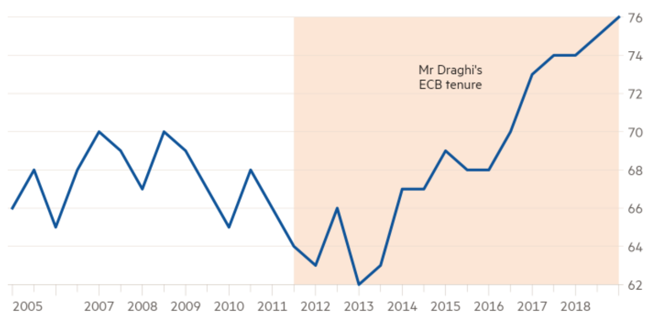
However, as it stands, the Eurozone common budget remains persistently inadequate for ensuring macro-economic stabilisation, leaving eurozone countries more vulnerable than they often realise. With the ECB's capacity to tackle macro-economic instability now also reduced and fiscal policy action lacking, it leaves the Eurozone badly equipped to deal with prolonged growth slowdown or sudden economic shocks. It would be key to re-examine the Stability and Growth Pact (SGP) that stipulates that the budget deficit should not exceed 3% of GDP and government debt should not exceed 60% of GDP. Both of these numbers are not based on scientific evidence, so the current Eurozone fiscal policy formula and its numbers is outdated: it does not match the economic reality of the Eurozone. The same applies to the ECB's 2% inflation target, something that is not talked about much but which is also an arbitrary number that might lead to suboptimal policies and outcomes.

It's politics, stupid

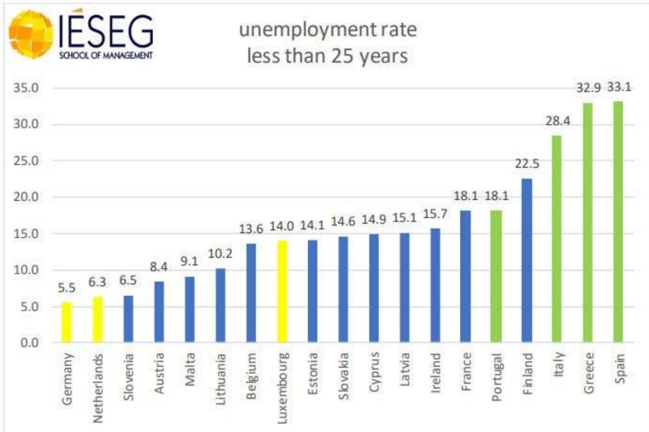
Economy and politics go hand in hand. As the graph below shows, the support for the euro in Eurozone countries has risen significantly during Mario Draghi's tenure, which also coincided with economic recovery in Europe.

Support for the euro has risen

% of the population of eurozone countries who are in favour*



*In favour of European economic and monetary union with one single currency, the euro
Source: Eurobarometer
© FT



The ECB's "whatever it takes" promise helped avert not only a deeper economic crisis, but it also might have prevented people from developing greater animosity towards the EU and especially the common currency. So why has there not been more progress with Eurozone reform and improvements to its architecture, especially since the conditions have been so benign?

The lack of progress with Eurozone governance reform also is a symptom of a greater issue: the EU collective action problem due to different perceptions of interests, risks and solutions. While the so-called Eurozone core countries (predominantly Germany and the Netherlands, but lately also some Eastern European countries) are increasingly worried about moral hazard and risk reduction, the Southern periphery countries such as Greece, Spain and Portugal have been more focused on risk-sharing.

The emergence of the new Hanseatic league has helped cement the North-South divide. The division also mirrors the different economic realities faced by the countries. For example, while Germany enjoys low levels of unemployment, up to a third of young people are unemployed in Spain and Italy.

The main Hanseatic concern that keeps blocking further Eurozone fiscal integration is that as a result of it, history will repeat itself and Southern countries will again build up big imbalances. The perception is also that the ECB's QE programme is disproportionately helping the periphery countries, with the ECB's low interest rates unfairly reducing German and other savings. Yet this view ignores the fact that the ECB's loose monetary policy has greatly helped export-oriented countries such as Germany by weakening the euro and boosting exports.

It also overlooks the fact that if an economic shock takes place or a recession takes hold, all of the Eurozone countries will be adversely affected. What is most worrying, is that it is widely acknowledged that Eurozone architecture is flawed, and that the current monetary and fiscal policies are no longer based on evidence and sound economic findings. Yet evidence-based macroprudential policy and sustainable fiscal policy - essential to prevent the building up of financial vulnerabilities – are missing.

Thus far, the French president Emmanuel Macron's efforts at substantial reform have failed. Part of the reason is that the French president is seen as arrogant, with his "lone wolf" act lacking in diplomatic finesse and consensus building. This leaves the Eurozone with a vacuum of political leadership capable of spearheading much needed reforms.

Meanwhile, the Central European (CE) countries that did not join the Eurozone have not suffered significant economic damage because of it. Research shows that convergence has not been dependent on Eurozone membership, so the decision remains more political than economic. Bearing in mind the geographical location of the Central European countries and their trade interests, it is important to strengthen their commitment to the EU and its values to avoid backsliding. Since the CE countries cannot avoid their exposure to the Eurozone economies and will be affected by their growth anyway, they should honour their commitment to joining the euro. It would provide them with a seat at the decision-making table and a say over what happens within the Eurozone. Being part of the common currency club would ensure access to the stabilisation mechanisms available for member countries in times of crises, as fellow member states will be prioritised if financial crisis strikes. Also, as highlighted in the 5 Presidents' Report, euro is more than just a currency union – it is a political and economic project. Euro membership would deepen the Central European country integration in the EU. In addition, Eurozone membership offers reputational advantages and makes it easier to attract investment and international businesses that might not be keen on working in a country with a currency other than the euro. The increased growth of automobile production facilities in Slovakia is an example of advantages conferred by euro membership.

The need for change – what now?

Almost everyone now agrees that change is needed for the Eurozone to be ready to weather the next crisis and for improved growth prospects. The legitimacy of the EU as a whole also relies on its ability to deliver prosperity to its citizens. The EU can opt for policies that maximise its chances for better growth.

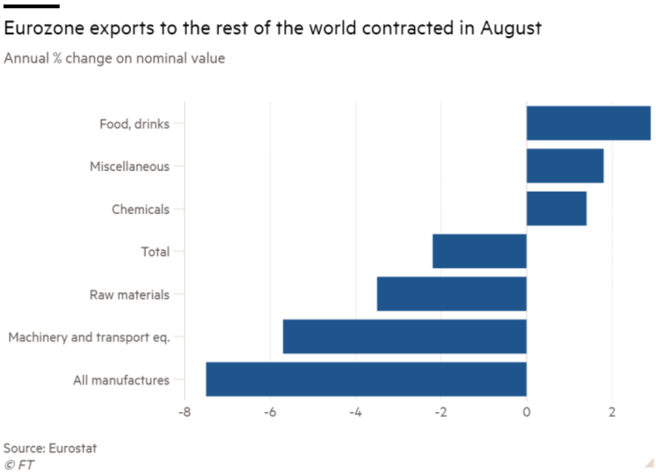
Fiscal stimulus and investment

There have been relatively small positive developments within the EU when it comes to investments in public goods. The Juncker Plan for Europe seems to have yielded some good results, according to the Joint Research Centre (JRC) and the Economics Department of the European Investment Bank (EIB) Group. Investments by the EIB Group backed by the Juncker Plan's European Fund for Strategic Investments (EFSI) have managed to increase the EU gross domestic product (GDP) by 0.9%, and have added 1.1 million jobs compared to the baseline scenario. The estimate shows that by 2022, the Juncker Plan will have increased EU GDP by 1.8% and added 1.7 million jobs.

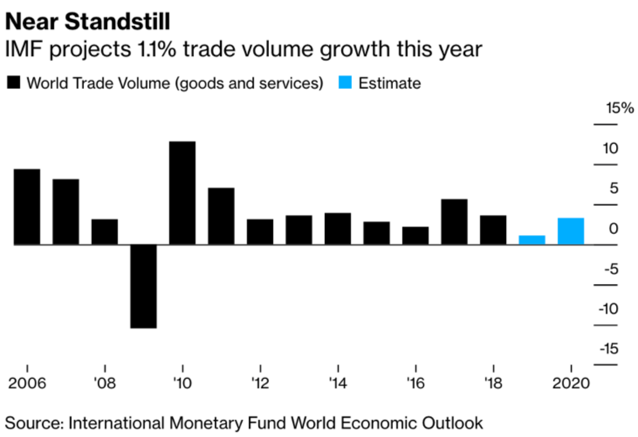
Germany's current account surplus means it does have the ability to launch a fiscal stimulus domestically, with potential effects on the wider Eurozone. The priority for investment should be to modernise Germany's and other European countries' outdated infrastructure, and to invest in other public goods. A particular focus on green infrastructure would help meet the EU's climate pledges and position the region well for its future needs. As it stands, without further action and investment, the European Commission's president-elect von der Leyen's pledge to curb EU's emissions by at least 50% by 2030 will fail. For example, much more investment is required in European railways for them to absorb extra strain and to green the transport networks. The retooling and retraining of workers would be an additional measure that would improve labour productivity and contribute to economic growth.

Trade, single market & sustainability

The EU is still a formidable force when it comes to trade. Its share of global imports and exports is above 16%, despite the fact that the EU only has 7% of the world's population. Also, one in seven jobs in the EU depends on exports. This means that trade will remain one of the most important components for Europe's prosperity - but currently it is contracting worldwide.



The contraction of Eurozone exports is linked to the US-China trade and, to a lesser extent, to the uncertainty created by Brexit. But the IMF has also observed an overall global slowdown in trade volumes.



Since approximately 70% of global growth will come from countries currently labelled as emerging, the EU should work on expanding and deepening its trade deals with developing countries. Future free trade agreement (FTA) negotiations should prioritise sustainability, digitalisation and emerging markets – all areas of increasing importance in the future. This would allow the EU to position itself better for forthcoming changes in the global economy, which will be increasingly digital and focus on decarbonisation. The EU is well placed to play a positive role in promoting the exchange of knowledge and technologies that will be needed for the transition to low-carbon economies.

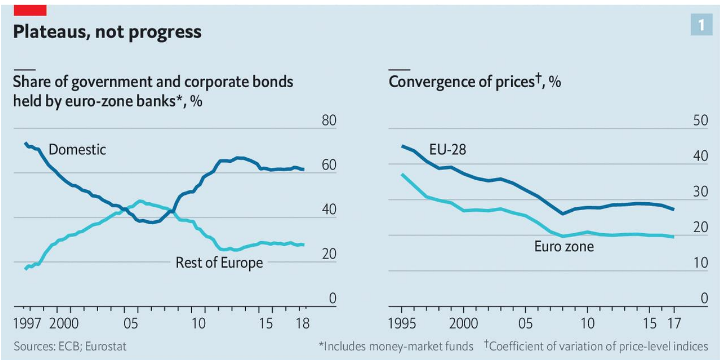
The EU should also ensure that its trade deals include sustainability criteria, taking into account the need to address climate change risks and to promote the growth of long-term sustainable business models. Strengthening the trade and sustainable development (TSD) chapters in the EU's FTAs would be a tangible way to promote sustainable development. While such an approach might create some difficulties, it would also open up opportunities for future engagement with environmental and social issues.

With digitalisation only growing in importance, the EU should support the WTOs effort to reboot the digital trade rulebook. The Union could reap the benefits of better cross border data flows and enjoy efficiency and productivity gains. Removing regulatory barriers for the EU digital single market should be one of the priorities, especially because now only 7% of small and medium-sized firms in the EU sell cross-border.

Yet the one biggest boost for European economies would be for the new Commission to work on rejuvenating the EU's single market, especially focussing on the liberalisation on services. The single market was originally created to liberalise trade in goods, which was the main output of the EU economies. But like in other developed economies, the share of services is increasing. Three-quarters of the EU's GDP is now made up by services, including financial services (such as banking), cloud computing and healthcare. Working on liberalising services and streamlining diverse national regulation should be a priority, as some of the regulation dates back to as far as medieval guilds. The current estimate is that the EU countries have 5000 national regulations protecting services, which means nearly 200 per country. Without the single market covering the growing share of services, the single market will keep shrinking.

This has also led to a large amount of smaller companies in Europe - three times as many as in the USA. Italy alone has roughly as many companies as the USA, even though its economy is one-tenth as big. The small size makes it harder for firms to adopt new technologies and to innovate, which results in lower productivity.

Similarly, the integration of the financial markets has also stalled since 2008, with banks holding a disproportionately large share of domestic company debt.



The Economist

The deepening of the single market would offer a range of benefits during a time of global low growth, and it is something within the power of the EU (unlike global trade disputes initiated by the USA). Better integration of energy markets would offer economic and sustainability benefits, and improve energy security within the EU.

The ECB's new president Christine Lagarde is set to prioritise climate change, calling it recently a "mission-critical priority". An approach that integrates climate risks could lead to ECB favouring of green bonds when reviving its asset purchase programme, amongst other policy initiatives. Other central banks, with the most well-known example being the Bank of England, have already publicly acknowledged the risks that climate change poses to financial stability. Norway's central bank has announced the need to include climate change into systemic risk estimates, and even the US Federal Reserve is exploring how to address economic impacts of climate change. Since ensuring the stability of the financial system is part of central banks' mandate, climate change presents a major risk factor. The inclusion of it is a positive development, as collapse of ecosystems, more frequent extreme weather events and reduced biodiversity amongst other effects can have major systemic implications for economies and financial markets. It is also increasingly recognised to be sound economic practice for diversifying risks and market exposure.

Any ECB's future attempts at "greening" will fuel a debate about its mandate, with the head of Germany's Bundesbank already expressing its criticism of such policy as a decision that should be left to the politicians. More valid concerns are about ECB's distortion of the relatively nascent green bond market because of very large purchases in a small pool of green bonds, which suffer from a lack of liquidity in the market. Green bond market currently comprises only 0.5% of a global bond market worth $110 trillion.

Yet ECB's greater focus on "greening" would be very welcome for sending a strong signal to the financial markets, reinforcing the message that climate risk needs to be dealt with. The recent decision by the European Investment Bank (EIB) to stop funding fossil fuel projects by end of 2021 is a step in the right decision, signalling Europe's intention to shift to more sustainable economic models and limit its carbon emissions. This policy decision is a strong indicator that gas, oil and coal projects will increasingly struggle to attract funding from the EU.

Eurozone at crossroads

Eurozone and the EU is facing stark choices. In a more uncertain world facing climate change, it needs to start future-proofing its economic competitiveness. This means starting to use fiscal policy tools to boost growth and avoid a costly recession. The current political ideology and economic dogma about fiscal policy needs to change if Europe wishes to avoid recession or to navigate well the next global downturn. And a downturn in the world economy is inevitable, whether it happens sooner or later. Eurozone politicians and some academic economists are still out of date with the paradigm shift taking place, ignoring the fact that it is time to have a more balanced monetary and fiscal policy mix.

The opportunity for bold action is now, while the global economic conditions are benign. The record low borrowing costs provide fiscal space to finance improvements in infrastructure and innovation. The use of anti-cyclical fiscal policies at this point in time would not destabilise government debts, but would enable to stimulate Eurozone economies by 3% to 4% of GDP. Meanwhile, the greening of national economies is a relatively new idea for central banks and the financial sector in general, but it is on the rise, and just like novel ideas such as inflation targeting before, it will gain momentum. The EU would stand to benefit from an early-mover advantage by focusing innovation and policies on decarbonising its economy. Decarbonisation would also offer a public health dividend.

Eurozone reform and stimulus are also important for its politics. The rise of populism coincided with fiscal austerity policies and slowdown in growth, which in turn affected people's living standards. Slow growth or recession that causes economic insecurity for societies makes them much more susceptible to politics of anger. Thus, it is extremely important to focus on restoring sustainable growth in Eurozone and wider Europe.

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