Deepening the Economic and Monetary Union: What the Commission missed in its reflection paper

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The European Commission published a reflection paper at the end of May on deepening economic and monetary union. **Enrico Marelli** *and* **Marcello Signorelli** *present an analysis of the Commission's proposals and respond to some of the paper's key weaknesses in laying out a path for future reforms.*

The European Commission's recent reflection paper on deepening economic and monetary union raises several key questions about the past and future of the Eurozone. The paper certainly represents a positive contribution to the ongoing process of European integration, after the impasse caused by the deep and prolonged economic crisis, the political developments in some European countries (including the Brexit referendum) and the severe social situation (the well-being of many citizens of the Eurozone is lower now than when the euro started). However, some proposals were notably weak and some key issues are still lacking. We think it is more useful to focus on these latter points in responding to the paper.

An overly positive assessment that misses key points

In the second section of the paper – titled 'The story of the euro so far*'* – we disagree on the largely positive assessment regarding economic performance in the Eurozone, before and, especially, during the crisis. A simple comparison with the performance of the US or also EU countries outside the Eurozone (e.g. the UK, on the West side, or Poland, on the East) would support our judgement. Not only has the overall performance been rather unsatisfactory in the euro area, but wide differences have appeared within the area itself.

Considering the period after the euro's introduction, for example, the Commission's paper does not mention that the hypothesis of the so called "endogeneity of optimum currency area criteria" had been substantially rejected even before the crisis, since real convergence has not been more evident in the Eurozone compared to other EU countries. As the Commission rightly admits, before the crisis, convergence in economic growth was partly achieved by unbalanced growth, which in some countries fuelled “bubbles” of different kinds. However, the competitiveness gaps persisted until the crisis and have been partly reduced only thanks to the (economic and socially damaging) “internal devaluations” of the recent period. It is also surprising that the Commission’s paper does not discuss the different current account positions (excessive deficits in some countries but also too high surpluses in some others) within the euro area and their implications.

In addition, as dramatically emerged during the crisis, the lack of stabilisation instruments – together with the obvious absence of flexible exchange rates within the monetary union – and the institutional limitations of the ECB (e.g. as lender of last resort for sovereign bonds) have been especially deleterious for the peripheral countries of the Eurozone. These weaknesses and their consequences are only partially discussed in the Commission’s paper.

Austerity and structural reforms

More importantly, there is no adequate discussion of the fiscal rules and the largely pro-cyclical (austerity) policies adopted in all Eurozone countries as the main response to the sovereign debt crisis. Although the Commission admits that, in the future, such rules could be simpler and that “some see the rules today as too lax, others see them as unduly constraining”, no remarks are made about the underestimation of the fiscal multipliers (as ultimately recognised also by the IMF) and the failure of the so-called “expansionary austerity”.

The role of structural reforms for economic growth is overemphasised in the Commission’s paper, also suggesting new incentive mechanisms for their adoption in member countries. However, in the account of the recent crisis, the lack of “effective aggregate demand” has not been adequately stressed; no mention is made of technical questions such as methods for computing the “output gaps”, the consequent “structural deficits” and the structural and cyclical components of unemployment. Within the aggregate demand, the Commission recognises that a large fall concerned investments, which are still below the pre-crisis level in the Eurozone as a whole; but it should be added that, in some countries, the collapse has been equal to or above 30%, and the recovery in the past three years has been largely insufficient.

In particular, the decline in public investment has been damaging on both the demand side (it reinforced the above mentioned pro-cyclical impact of austerity policies) and the supply side (causing permanent losses in potential growth, employment trends and productivity dynamics). From this point of view, the judgment of the impact of the Juncker Plan seems too favourable in the Commission’s paper, without mention made of the very small amount of resources from the EU budget and institutions (while the European Investment Bank could play a much greater role) and without an assessment of the real “additional effect” on increasing private investment.

Completing economic and monetary union

In the third and fourth sections of the paper, there is a discussion of the ways to achieve a more complete “economic and monetary union”. Completion of the EMU has been urged on several occasions by many policymakers and scholars. In the Commission’s paper, there are some specific proposals to make the Eurozone more resilient to future shocks and crises. The two options for introducing a “stabilisation function” – the European Investment Protection Scheme and the European Unemployment Reinsurance – are both interesting.

However, on the one hand, they could effectively work only with more resources devoted to the EU – or, much better, to a specific Eurozone – budget, and on the other hand, the 2025 deadline is too far away for contrasting the current economic and social situation still hampering some countries. As for the Financial Union, looking beyond the Banking Union and the Capital Markets Union (that also according to the Commission’s paper should be achieved within a couple of years), the “sovereign bond-backed securities” proposal seems an ingenious (although second best) solution, alternative to the Eurobonds, for which the political consensus is still lacking.

It is true that much more rapid steps towards "economic union" are not politically feasible at the moment, although Germany and other "core" countries might be reassured by appropriate incentive schemes that risk-sharing goes hand-in-hand with risk-reduction. Nevertheless, without a strong improvement in the employment and income situation in the peripheral Eurozone countries, most affected by the long crisis, it is extremely difficult to overcome the lack of trust, the upsurge of nationalist and populist movements, with the effect of stopping the process toward further integration.

Although the Commission's paper cites the high popular support for the single currency (according to Eurobarometer figures from 2017), it seems that in the past decade, in several countries, the European project has been increasingly associated with crisis and austerity rather than with opportunities and growth. In any case, it is hard to believe that if a big country like Italy exited the monetary union, then the euro could survive. In particular, the Commission's paper fails to stress to a sufficient extent the dramatic situation of young people in several Eurozone countries (according to both unemployment and NEET rates). It does not mention that it is the support of the young generations that is crucial for the future of a European project, as dreamed by the "founding fathers", which is able to avoid the progressive (economic and political) irrelevance of the national economies of the old continent in the new global context.

Thus, the economic and social situation should be rapidly ameliorated in all of the Eurozone's countries, continuing the accommodative monetary policy stance, although with more effective solutions for the non-performing loans and the other structural problems of the banking sector (rightly emphasised in the Commission's paper). Yet this should be accompanied by more growth-friendly fiscal policies, also increasing the weight of public investment on national and European budgets: an immediate demand shock imparted by a very large European Investment plan (regarding both infrastructure, research and education) is necessary and could be politically feasible if designed according to an appropriate distribution across countries.

A "golden rule" on national budgets seems an easier option but, for several reasons, it is a second best solution with respect to the use of a specific Eurozone budget, also to avoid a "second lost decade". Only after the strengthening of the recovery, the reduction of unemployment (especially among young people), and improvement of the social conditions, will public opinion in the Eurozone really become much more sympathetic toward the steps necessary for further economic and political integration. Finally, the Commission's paper also contains some interesting proposals for improving European democracy and governance, although the final goal of a "political union" is not clearly defined.

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