Chapter for MET policy paper

Prospects for governance reform in the euro area: Open during renovation?

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Introduction

The European single currency is 20 years old in 2019, the first 10 relatively quiet years have been followed up by 10 tumultuous ones. In the latter decade, many policy steps were taken to fix the incomplete nature of the original 'Maastricht assignment', but there are still a number of unfinished items on the reform agenda. Hence, the overdue completion of Economic and Monetary Union's (EMU) architecture will have to be taken forward by the newly formed European Parliament as well as by the newly appointed leaders for the top EU political posts. Even if a breakthrough of Eurosceptic forces will be avoided, there are unresolved disagreements among the mainstream political forces both about the final shape of EMU and the measures needed to strengthen its resilience. These policy choices (or further procrastinations with them) will be intensely scrutinised by Central and Eastern European Member States currently outside the euro area as their eventual decision to adopt the euro will partly be a function of the attractiveness of the reformed EMU set-up.

To understand better the economic context of the above-described policy dilemmas, the first section presents the prevailing patterns in European real convergence, with a particular focus on Central and Eastern European (CEE) Member States, who are either recently acceded to the Eurozone or are currently outside of it. This more structural picture on growth performance will be complemented by an overview on the EU's cyclical position and the related economic challenges. The next part will be devoted to a stocktaking of what have already happened in this long EMU reform drive started in 2010 and what issues are the 'leftovers' expected to be tackled during the next Parliamentary term. Finally, the last section will elaborate on the prospects of Eurozone accession in the CEE region, which is likely to turn out to be one of the most decisive EMU developments in the coming years.

Economic situation and outlook in the wake of the 2019 EP elections

This section first briefly discusses economic convergence in the Central and Eastern European (CEE) Member States, and in particular the so-called Visegrad group (Czechia, Hungary, Poland and Slovakia) vis-à-vis the EU-28 during the past decade or so; focusing on developments in Gross Domestic Product (GDP) per capita. Economic convergence has been a long-standing policy objective underpinning EU economic policy coordination and cohesion policy programmes. In general, the CEE countries witnessed considerable catch-up growth relative to the EU average (see graph below with a number of selected countries in the

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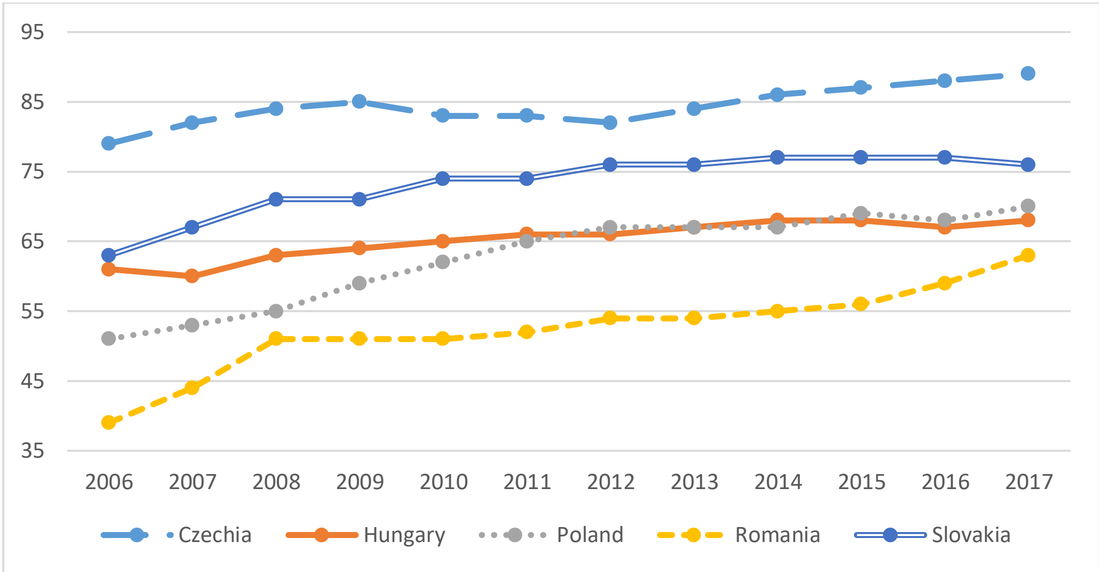
region), particularly in the period between their accession in 2004 and the eruption of the global financial crisis in 2008 (culminated in the so-called 'Great Recession'). The recent slowdown in the CEE's catching-up process should be seen against the background that real convergence effectively halted in Southern Europe since the crisis (or even reversed such as in Greece) as the accumulated vulnerabilities in the indebted countries first led to a deep recession, and then to a protracted recovery.

Graph 1: Evolution of GDP per capita (PPS-adjusted, EU-28=100)



Source: Eurostat

Note: Adjustments with the Purchasing Power Standards (PPS) make it possible to produce meaningful indicators required for cross-country comparisons, truly reflecting the price level differences across countries.

Classical economic theory suggests that lower starting levels of national income favour faster income growth, i.e. countries with initially lower levels of economic development should grow faster than higher-income countries. This being said, there have been differences in the average speed of convergence among the countries, which suggests that various policy-related and structural dimensions also played an influential role. While Poland showed a remarkably continuous catch-up growth in the region during the entire period under review (similarly to the Baltic countries and Romania), Czechia's and Slovakia's convergence significantly slowed down since the crisis. The overall performance of Hungary (together with Bulgaria and Croatia) is less spectacular, reducing its relative income gap by around 7 percentage points over the 2006-2017 period. The worst performer in the region is clearly Slovenia, whose relative development in 2017 (at ca. 85% of the EU average) was practically identical with its level at the time of EU accession.

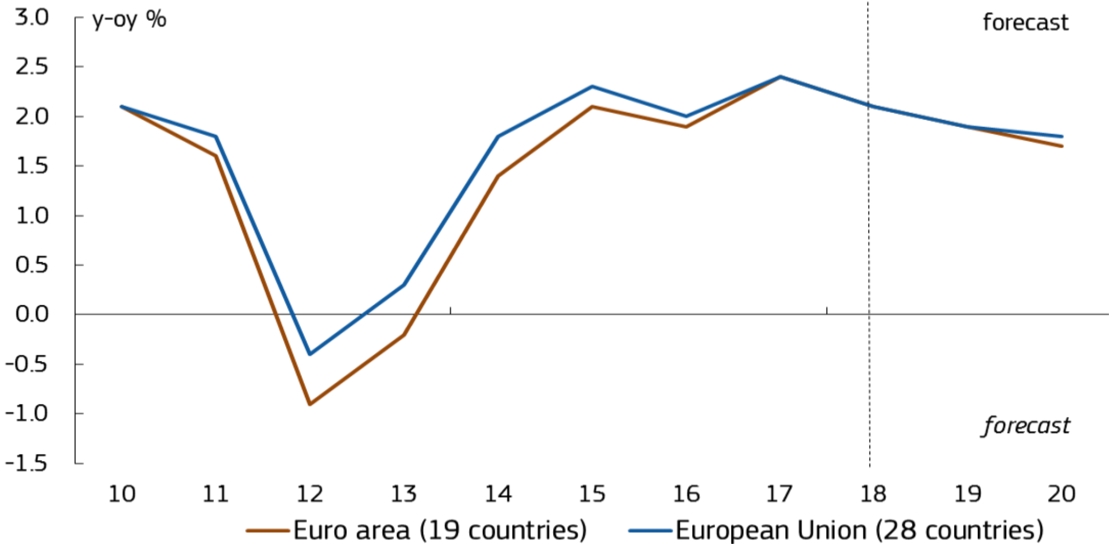
Beyond the initial starting position, comprising the industrial legacies, the key factors determining the rate of convergence include, most notably, the attractiveness for Foreign Direct Investment (FDI) as well as the general quality of labour and product markets. Indeed, the inward FDI stock has grown significantly in the region, e.g. in the Visegrad group, it

increased on average from around 10% in the first half of the 1990s to above 60% of GDP by 2017.

Furthermore, there was important contribution to the convergence process from EU financial support. Structural and cohesion funds typically finance investment in physical infrastructure and human resource development and are therefore designed to permanently increase countries' productive potential and speed up real convergence. These budgetary transfers have been playing an increasingly important macroeconomic role in the CEE Member States: there are six countries (the three Baltic States, Bulgaria, Hungary and Poland), which have received at least 3% of GNI net contribution from the common budget on average in each year between the 2007-2015[2]. Typically, more than half of these EU funds were earmarked for infrastructure investment projects, which contributed to addressing longstanding infrastructure deficits in the region.

Turning to the question of the current economic situation and short-term outlook, after years of uninterrupted growth, the EU economy has alarmingly slowed down starting from late 2018. In 2017, average real GDP growth reached a 10-year high of 2.4% in the EU, with practically all economies enjoying a robust expansion. However, according to the recent forecast vintages of the major international organisations, economic activity in set to moderate and grow by well below 2% in 2019 and 2020.

Graph 2: Real GDP growth in Europe 2010-2020



Source: European Commission, autumn 2018 economic forecast

Importantly, the balance of risks to the growth outlook is clearly tilted to the downside. Uncertainties have recently increased and stem from both domestic and external sources. In

[2] Based on these countries' operational balances as calculated in the European Commission's yearly Financial reports on the execution of the EU budget.

terms of domestic factors, doubts about fiscal sustainability in high debt countries may raise financial stability concerns and hurt the real economy. As regards external factors, most notably, further escalation of trade disputes could disrupt cross-border supply chains and negatively affect global trade and activity. This deterioration in economic prospects does not bode well for the remaining major tasks to complete the EMU, which will require spending some political capital at all levels of government.

Unfinished EMU reform agenda

The 'Maastricht assignment' provided for a clear allocation of responsibilities for economic policy: (i) monetary policy was delegated to a supranational institution, the European Central Bank; (ii) fiscal policy largely remained within the purview of Member States, but constrained by the Stability and Growth Pact; (iii) financial supervision and structural reform policies was continued to be designed and implemented by national governments.

The crisis revealed fault lines in the original EMU design and steps have been taken to address those. The main policy issues have been the following ones (see also Larch et al. (2010), Jankovics (2011)):

- It was widely observed that the favourable macroeconomic conditions prior to the Great Recession were not adequately used to build up fiscal buffers, exemplified by the overall achieved lacklustre reductions in public debt ratios. The answer were revisions aimed at better enforcement and closer monitoring of fiscal rules (as laid down in the Six-Pack and Two-Pack regulations), in particular during good economic times. These included, most notably, the introduction of the debt reduction benchmark, more automatic system of sanctions and the obligation for euro area MSs to submit their draft annual budgets for review before their Parliamentary adoption. The national ownership of the rules was meant to be improved by stipulating essential requirements for domestic budgetary frameworks in a directive and by the intergovernmental Treaty on Stability, Cooperation and Governance in the Economic and Monetary Union (whose Title III is called 'Fiscal Compact') with its obligation to establish a structural budget balance rule, preferably at constitutional level.
- Fiscal profligacy was certainly not the only reason for the severity of the economic crisis in the case of Portugal and Italy, and clearly not even among the important ones for Ireland and Spain. Instead, macroeconomic imbalances played a major role in the accumulation of both external (e.g. large current account imbalances) and internal imbalances (excess private debt accumulation or housing bubbles fuelled by capital misallocation), triggering financial crises. As part of the Six-Pack, a macroeconomic surveillance mechanism was created for the early prevention and subsequent correction of these imbalances, which was embedded in the European Semester, serving for the cross-cutting coordination of economic policies.

- When financial markets started to differentiate among sovereign securities in Europe form 2010, the ensuing sudden stops threatened the mere viability of the EMU. To deal with this existential risk, first some temporary crisis resolution instruments were established (e.g. European Financial Stability Facility), and eventually a permanent one, the European Stability Mechanism (ESM). Its main purpose is to provide support (mostly loans) to euro area countries experiencing severe financing problems. As regards the early track record of these European credit lines, the Cypriot, Irish and Portuguese EU-IMF financial assistance programmes have all been considered to be successful in restoring fiscal sustainability and the stability of financial sector, which was also demonstrated by the fact that these countries had re-established access to sovereign markets already during their programme (at least 2/3rd of the loans was provided by the European institutions.) Greece is a much more controversial case, since 2010, it has received a total of close to 290 billion euro in financial assistance in the framework of three successive programmes, the overwhelming majority was coming from the European partners. Since the expiry of the third programme in August 2018, it has been being under enhanced surveillance, which partly reflects the massive breadth of the reforms agenda undertaken guided by the policy conditionality of the assistance programmes.
- The Eurozone debt crisis got really intensified when the adverse feedback cycle between commercial banks and governments got into motion linked to the substantial holdings of government securities by banks ('doom loop'). The crisis was further deepened by the predominance of bank financing in the EU, which directly transmitted the banking problems to the real economy. In response to the financial crisis, the EU pursued a number of initiatives to create a safer financial sector by establishing the Banking Union gradually: first shifting supervision to the European level, subsequently establishing a single framework for bank crisis management, and finally setting up a common system for deposit protection. As regards the already completed steps, of November 2014, the Single Supervisory Mechanism became the new system of banking supervision in the Banking Union, comprising the European Central Bank and national supervisory authorities of the participating Member States. The Single Resolution Mechanism became fully operational on 1 January 2016. In December 2018, the European Council decided to provide a fiscal backstop for the Single Resolution Fund and extend the toolbox of the ESM with the option of precautionary credit lines.

In spite of these above undeniable achievements, the present euro area set-up is still widely assessed to have remained vulnerable to shocks. Besides a vivid discourse in academic circles, the Franco-German Meseberg Declaration[3] also enumerated a number of further

[3] On 19 June 2018, French President Macron and German Chancellor Merkel signed the Meseberg Declaration giving guidance on the way forward for renewing Europe's institutional and policy agenda on many domains of cooperation. The declaration includes a section on EMU deepening, available at: https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806

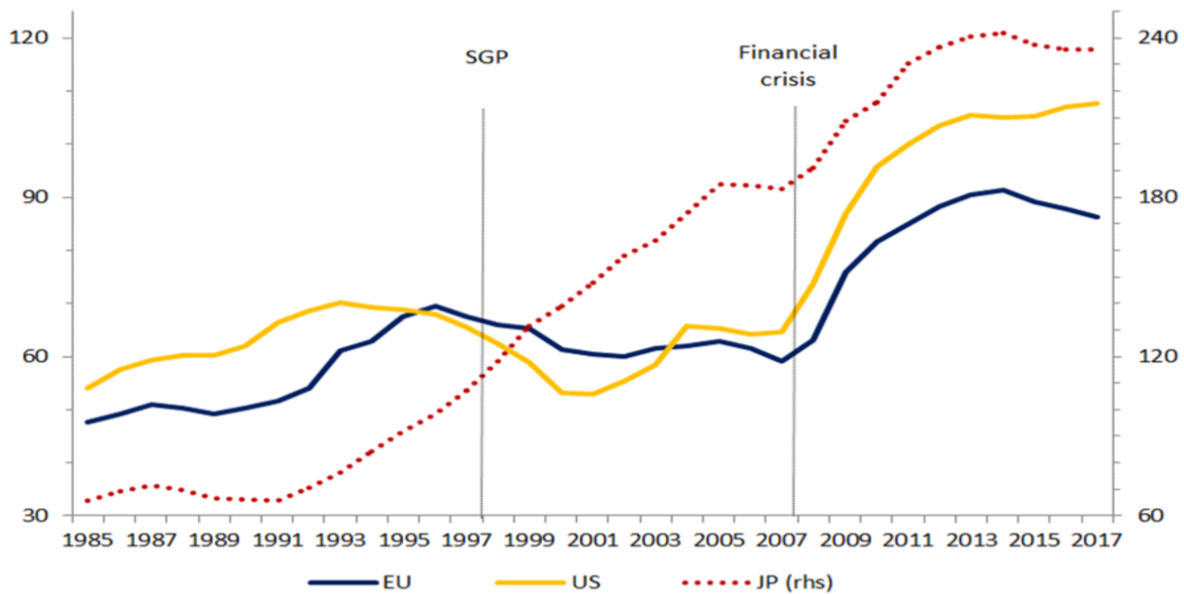
EMU reform steps. There is a widely shared consensus that the most crucial task would be the completion of the Banking Union with a European Deposit Insurance Scheme (EDIS). EDIS has been mentioned by now for years in various Council documents, but the policy debate is persistently trapped between two camps: there are those who would like to first see the reduction of legacy asset risks, and those who would rather pursue risk reduction and risk sharing on parallel tracks. Given that the even the conceptual argument about EDIS is increasingly ideological, it may take a broader package deal to achieve the necessary support among Member States.

Another controversial 'evergreen' item of the EMU reform agenda is the issue of fiscal union, or a dedicated fiscal capacity. Lack of these tools means that there is no mechanism in place to smooth asymmetric shocks impacting the euro area countries in a different way. However, strong resistance from the Northern Member States seem to have excluded the option of building up a fund predominantly for macro-stabilisation purposes. It implied that the initial, May 2018 legislative proposal of the Commission for a European Investment Stabilisation Function could be declared to be dead. In the first months of 2019, there has been an emerging consensus around a so-called 'budgetary instrument for convergence and competitiveness', which is foreseen to be part of the overall EU budget and coherent with other common spending policies[4]. There is little consent on the design and modalities of implementation for this new fund (e.g. types of expenditures to be financed by this budget, rules for eligibility for countries). Importantly, the size of this instrument will be decided in the context of the ongoing negotiations on the 2021-2027 Multiannual Financial Framework, which practically implies that there is a large likelihood that the overall amount concerned will turn out to be of rather symbolic nature in the coming years. This being said, even a relatively small euro area budget could represent a breakthrough, as the instrument could be scalable up if the political conditions will be more favourable, in particular if agreement on new resources could be found (e.g. new common tax revenues).

Finally, as regards the Stability and Growth Pact, as a side-effect of the previous reform efforts, there are now a multiplication of rules, procedures and indicators (with a key role for the structural balance, an unobservable variable), which have resulted in an increasing complexity. There is an emerging consensus on the broad principles for a comprehensive redesign, which would be organised around overall simplification, greater national ownership, and focus on main objectives. This being said, one should not neglect the recent achievements of the SGP, which was instrumental in reining in the debt dynamics in Europe in the aftermath of the Great Recession, and compared to other large advanced economies, led to a more healthier public debt trajectory (see graph below).

[4] See the 'Summing up letter' from the 11 March 2019 Eurogroup meeting in inclusive format, available at: https://www.consilium.europa.eu/media/38702/20190311-summing-up-letter-eurogroup-inclusive.pdf

Graph 3: Public debt ratios in advanced economies (% of GDP)



Source: Eurostat

Apart from the substance of the reform avenues, there are two arguably political dimensions, which will also influence the final EMU design. First, the always delicate question of who is in the driving seat within the EU? There is long and well-known history on the operation of the Franco-German axis, when the two governments negotiated bilaterally and then successfully presented the results as an action plan to their European partners. The two countries were traditionally perceived as representatives of two poles of thought about economic governance: France being the proponent of flexible solutions, while Germany is the champion of a rule-based framework. However, the emergence of the so-called new Hanseatic League showed that there are at least eight Member States whose views are no longer adequately reflected by the Franco-German duo (*Eichengreen* (2019)). Besides the increased emphasis on national compliance, the League's position represents a different approach to reforms as well: it repeatedly called for more active use of the strengthened fiscal, economic and financial procedures already in place and stressed the importance of organic improvements (c.f. *"…the discussion on the deepening of the EMU should find a consensus on 'need to haves', instead of focussing on 'nice to haves'."* [5]) . To illustrate the influence of this new group, the aforementioned debates around the underlying principles of a dedicated euro area budget could be brought up: while the June 2018 Franco-German Meseberg Declaration included a reference to possible stabilisation properties, it was in

[5] See the joint statement of the finance ministers from Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden on the architecture of the EMU: https://vm.fi/documents/10623/6305483/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf/99e70c41-6348-4c06-8ff8-ed2965d16700/Position+EMU+Denmark+Estonia+Finland+Ireland+Latvia+Lithuania+the+Netherlands+and+Sweden.pdf.pdf

parallel declared to be an anathema by the Hansa countries. When the issue was subsequently discussed by the ECOFIN/Eurogroup formations in early 2019, the reference to this potential function was simply dropped from the Conclusions.

Second, the way forward for the completion of EMU architecture will also be swayed by the competition between two traditional integration models of intergovermentalism and supranationalism ("Community method"). It is worth recalling that virtually no structure in the EU is perfectly intergovernmental or supranational, and the integration process often blends the two approaches. In the economic policy domain, the years after Maastricht had been characterized by an expansion in the supranational scope of the EU activities (most notably, the grounding of the European Central Bank and the establishment of Stability and Growth Pact). During the crisis, however, the intergovernmental approach prevailed: as was listed above, many of the adopted revisions in the economic governance framework have been based on intergovernmental instruments. This being said, in some cases, Community legislation subsequently integrated initially intergovernmental arrangements (e.g. key elements of the Fiscal Compact, in particular as regards independent fiscal institutions (fiscal councils) were later incorporated in the Two-Pack). The increased reliance on intergovernmental set-ups also revealed the associated problems of these structures. First, the often unavoidable overlaps between EU and national competences open the way to conflicts over the direction of policy (a possible example could be whose opinion takes precedence when delivering a judgement on compliance with numerical fiscal rules). Second, with the addition of new intergovernmental structures, the coordination systems may become too complex and opaque and therefore difficult to implement.

Eastern enlargement of the Eurozone

Following the accession of Latvia and Lithuania at the middle of the present decade, the debate on the introduction of the euro for former socialist European EU Member States was re-energised by Jean-Claude Juncker with his 2017 State of the Union speech. The Commission President expressed his ambition to accelerate the enlargement of the single currency bloc, and proposed a dedicated pre-accession financial instrument to increase the euro's attractiveness. There is now a clear divide in the Central Eastern European non-eurozone group: while in the one hand, Bulgaria is at the gates of ERM II accession, Croatia has officially launched its preparatory process, and Romania had a clear intention to introduce the single currency as soon as possible (without however a specific plan or timetable). On the other hand, Czechia, Hungary and Poland has so far opted to a 'wait and see' approach and do not plan to join in the Eurozone in the foreseeable future.

With the exceptions of Denmark and the United Kingdom (who possess Treaty-based opt-outs), all non-euro EU countries have a legal obligation to join the euro. However, the Union acquis do not specify a timeline for this obligation; hence de facto countries can delay their entry as long as they wish. A case in point is Sweden, a country who would have been economically ready to become part of the Eurozone virtually at any time over the last two

decades, and who deliberately did not join the current European Exchange Rate Mechanism (ERM II), and thereby 'ensures' not to meet one of the Maastricht criteria[6].

There is an emerging consensus that fulfilling the Maastricht nominal criteria is not enough for successful euro adoption. The experiences with the unfavourable predicament of southern euro members – Greece, Italy, Portugal – are used to argue against euro membership. These countries suffered from unsustainable developments between 1999 and 2008, which was partly related to their euro membership, and they had great difficulties after 2008. The overall economic record of these countries has been rather weak; looking into the reasons behind these weak outcomes can offer instructive lessons for central Europe. One of the issue, which was de facto neglected by policy-makers before the Great Recession, but proved to be an important matter is the prevention of the build-up of macro vulnerabilities, like large foreign indebtedness and bank balance sheet fragility.

However, as was stressed appropriately by Darvas (2018), there have been both good and bad performances in both inside and outside the euro area over the last decade, so the choice exchange rate regime is not omnipotent and a lot depends on the quality of economic policy on the whole. Specifically, Slovakia was one of the best performers in terms of economic growth after 2008 and outperformed the Czech Republic and Hungary. *Havlat et al.* (2018) argues that Slovakia's euro adoption in 2009 was likely to have boosted its economic advancement, with the caveat that it was probably too early for an exact quantification of this supportive effect. On the other hand, Poland showed a remarkable sustained growth performance supported by a flexible exchange rate regime and autonomous monetary policy.

In view of the above challenges, in July 2018, Bulgaria submitted to the Council a 'Letter of commitments' that it plans to undertake to prepare for the participation in ERM II, and subsequently for the adoption of the single currency[7]. First, it announces Bulgaria's firm intention to join simultaneously the Banking Union together with ERM II membership. In addition, the package of measures aim at reinforcing the supervision of the whole financial sector, as well as improving the institutional quality in other policy areas (insolvency framework, anti-money laundering regulation and governance of state-owned enterprises). This was the first time that such prior commitments were negotiated between the acceding country and European institutions plus Eurozone economies, and such an approach is expected to be followed for future candidates (de facto increasing the bar to pass for Eurozone entry). According to the Bulgarian timetable, the country should be accepted to

[6] The Maastricht convergence criteria are formally defined as a set of nominal macroeconomic indicators which measure (laid down in 1991): (i) price stability, to show inflation is controlled; (ii) long-term interest rates, to assess the durability of the convergence; (iii) soundness and sustainability of public finances, through limits on government borrowing and national debt; (iv) exchange-rate stability, through participation in the Exchange Rate Mechanism for at least two years without strong deviations from the central rate.

[7] The letter is available at: https://www.consilium.europa.eu/media/36125/st11119-en18.pdf

the ERM II in the summer of 2019, which – based on the typical waiting time in the past in the antechamber – would imply a eurozone accession date for 1 January 2022.

Croatia appears to be next in line. The government and the central bank has already jointly adopted the country's Eurozone accession strategy in spring 2018.[8] According to the announcements of senior Croatian officials[9], ERM II entry is hoped for mid-2020 (presumably as a coronation of the country's first rotating Presidency of the EU Council to be held in the first half of the year). The truth of the matter that Croatia has maintained a tightly managed exchange rate over many years by now, so the option of using the exchange rate to correct imbalances and absorb economic shocks was not used by the Croatian authorities (i.e. does not seem to be the case of sacrificing a potent tool at the altar of euro membership). Given also that the local economy is already heavily euroized, the strategy of country to introduce the euro by 2023 is well justified.

It remains to be seen that if the extension of the euro area is progressing further as it is now currently envisaged by candidate countries, how the perceived cost-benefit analysis will be changed for the Visegrad-3 countries. Needless to say, beyond the classical dilemma (Would euro membership be beneficial for economic growth and more generally, to real convergence?) the calculations will be influenced by political considerations, including the danger to be permanently stuck in the periphery of the European integration.

Conclusions

When entering into the adult age of 20, the Euro's institutional framework is yet to be profoundly reinforced. Because of both weaknesses and gaps in governance architecture laid down in the Maastricht Treaty, Member States entered the global financial crisis with too high public debt and private debt, financed from excessive bank leverages. There have been waves of policy reforms aimed at preventing the repetition of this kind of crisis, notably through the early detection and correction of macroeconomic and financial imbalances as well as the improved coordination of fiscal policies. Indeed, while important reforms were undertaken during the Eurozone sovereign debt crisis and its aftermath, EMU deepening still remains an unfinished business, and most of the remaining steps are often surrounded by vibrant deliberations.

Following the European election, the new leadership of the Parliament and the Commission should soon find out which ideas command some kind of consensus among policymakers, and which remain a matter for controversy and be rather put in the backburner. It seems that these politically painful debates should be conducted against the background of decelerating economic growth and a general slowdown in the catching-up of the poorer Member States toward the EIU averages as measured by economic indicators in Purchasing

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[8] The document is available at: https://euro.hnb.hr/documents/2070751/2104255/e-strategy-for-the-adoption-of-the-euroin-Cro.pdf/9e02b33f-665a-46a9-a1b6-ac63f9af3c95

[9] See e.g. this Bloomberg interview with Governor Vucic: https://www.bloomberg.com/news/articles/2019-01-15/croatia-sees-revival-in-political-will-to-expand-euro-area

Power Standards. In addition, the potential flare-up of the Italian economic and fiscal stability issues could further complicate the political landscape for these completion efforts.

These reforms should make the euro area more robust and attractive for those EU Member States currently outside the single currency zone. While Bulgaria and Croatia has specific plans for euro introduction and Romania is also eyeing to this possibility, the remaining Visegrad countries see euro adoption as an attractive proposition only over (very) the long term. One lesson stemming from the crisis and existing experiences with past euro area enlargements that the euro *per se* does not necessarily bring net benefits. The success depends essentially on two interlinked preconditions: first, sound domestic policies should be in place in candidate countries to achieve a high degree of both nominal and real convergence, and second, freshly joined economies should not become complacent upon entering the euro area, but rather see the convergence process as a continuum.

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