# REFORMS IN THE EU: THE INTERFACE OF NATIONAL AND COMMUNITY LEVELS[1]

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**ABSTRACT: This discussion contribution joins in the broad international academic and policy exchange on the architecture and management of the European Monetary Union. Offering five theses for discussion we argue in favor of deep going structural reforms in the member-states in order to enhance their competitiveness and meet the ever stricter set of criteria that emanate both from global financial insecurity and from the adoption of the rules of the Fiscal and Banking Union in 2012.**

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**1.There are few issues more contested in the literature on European studies than the question pertaining to the architecture of the European Monetary Union as it exists today. Opinions revolve around *two basic propositions.* In one powerful line of thought, gathering momentum in both the academe and in policy studies, but also in electoral campaigns and discussions in the European Parliament the whole construction is wrong. *First,* because it does not take into account the structural disequilibria in the trade and financial positions of the member states, emanating from their different levels of development and also from their different socio-economic models and the lack of political union. Therefore the arrangements are conducive to regular re-occurrence of structural surpluses and structural deficits, that are unable to manage via the exchange rate mechanism or monetary policy in general. Thus, as argued inter alia by Nobel Laureate Joseph Stiglitz/2016/the single currency, owing to its misconstruction, is the problem rather than the solution.**

***Second*, as explicated by analysts taking a broader analytical perspective and echoing the concerns of the southern member-states, the arrangement fortifies the inherited core-periphery relations, presses the weaker economies for an**

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[1] This chapter is a significantly revised version of a paper prepared for the conference of the ÖNB entitled *'A Modern Take on Structural Reforms',* Vienna, 20-21 November, 2017.Useful comments of conference participants on the preliminary version are appreciated, with the usual caveats.Final version forthcoming under a similarly titled conference volume by Edward Elgar Publishing Co, Cheltenham/UK, 2018. Comments are welcome and should be directed to the author.

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overly stringent set of policies without actually providing the usual benefits via fiscal transfers and allowing for delayed and managed structural adjustment, by allowing for lax fiscal and lax monetary policies/Magone, J. et al., eds.,2016/. The latter no longer counts as extreme or non-professional viewpoint, as we would have had it a decade ago: sustaining negative real rates of interest, sustaining co-existence of lax fiscal and lax monetary policies are often presented as inherent features of the “new normal”/Blanchard et al eds, 2016, chapters 2 and 3/.

We have always taken a different position, which seems to have been born out by the facts. The EMU has proven to be a great success *if measured in its own terms.* The phrase originally introduced by Helmut Kohl, namely that the single currency is to be ‘as strong as the D-mark” has proven right. Perhaps even too much right, judged by the policy-makers in the European Central Bank, who have adopted a set of policies, not originally envisaged by the mandate of the ECB, to provide liquidity and avoid the threat of a depression, especially since the famous formulation of President Mario Draghi of July, 2012, that the “ECB will do whatever it takes to save the euro”. This included a series of non-conventional measures of monetary easing, without actually pushing up inflation, as measured by the Harmonized Index of Consumer Prices anywhere close to 2 per cent/the inflation target of the ECB since 2003/.

This is not to dispute away or belittle the series of challenges faced both at the Community and national levels, be that in the sphere of environment, unemployment and low labor market participation rates, sluggish innovation and secularly low rates of macroeconomic growth in Europe, let alone the series of problems of purely political nature that have led to grave consequences, from Brexit in June 2016 to the referendum in Catalonia, in October and December, 2017. Also classical EU policies as those on cohesion and agriculture, environment and global trade relations face a series of unmet challenges. However, if we the classical *assignment problem* of economics and public administration seriously, it is certainly wrong to ascribe all tasks to a single player, in this case the ECB. As labor markets in the EU are nationally segmented, and fiscal policies are also managed nationally, with no structural policies at the Community level, growth as a synthetic indicator of economic success can and should not be measured on the performance of any single

**player/and *vica versa*/. The result is an outcome of interaction of several policies, with monetary management being only one, even if quite powerful, from among the instruments. Therefore we continue to agree with those/Brunnermeier et al, 2016; Dallago et al eds, 2016/ who appreciate the performance of the ECB and joint monetary policy in securing one of the fundamental side conditions for lasting economic growth: price stability, i.e a neither inflation nor deflation environment.**

**One of the fundamental arguments supporting our view is that *several members of the Euro-zone have been performing quite well in international standards*, from Luxemburg to Estonia and from Slovakia to Germany and more recently Ireland. Therefore it seems to be a fallacy of over-generalizing the Greek, French and Portuguese experience if claims on the alleged EMU-induced austerity and the ensuing national level secular stagnation is being theorized. If we take into account the very broad array of new monetary instruments applied by the ECB since July, 2012, and if we are aware of the *extensive liquidity provision* which has ensued ever since- that is over a period of five years, thus *exceeding the time span of the Great Depression* of 1929-33 – the claims advanced about the alleged excessively restrictive stance of the ECB following German economic thinking seems unfounded and misplaced.**

**2. One of the classical debates ever since the classical paper of Martin Feldstein/1997/ doubting the viability of EMU on both theoretical and policy grounds, two big questions have been looming- like the proverbial pink elephant in the room – in the professional debates globally. *Number one* is if it is infeasible, how come that the euro did survive, and in good shape, a period over 15 years, which is already respectable a time span in economic history terms. *Number two,* if Feldstein and his countless followers were right, has there been any *benefit of non-participation* in the EMU, and for whom and why. With the spread of political Euro-skepticism and inspired by Brexit the doubters' voice has become more vocal than say it had been a decade ago.**

**Looking from the economic angle it is hard to find relevant arguments against euro-membership for any small open economy. The debate might well have been side-tracked by the fact that English is the *lingua franca* for the economics and European studies communities. Thus the influence of British positions tend**

**to be oversized and magnified by the single language domination in the profession. The UK has never been enthusiastic about the single currency, and that with good reasons. The City being the center for global capital markets since 250 years  easily survives without the complex and also in part politically motivated arrangements of the European Union in general and the ensuing monetary model of integration, thus also the practical arrangements of the single currency in particular. It is common knowledge that British capital markets are deep and sophisticated, while continental capital markets are shallow and segmented, the Capital Market Union is in its planning stage only, with a series of pre-conditions missing. Banking in the UK is more extensive and sophisticated than on the Continent. The UK financial sector has always been global, transacting more with the rest of the globe than within Europe. The British business cycle has never been synchronized to that of continental Europe/particularly Germany/. The UK never traded more with Europe than with the rest of the globe, while continental Europe and the euro-zone tend to be relatively closed economy, on par with the US/with trade accounting for 18-20 pc with the non-EU world, measured on GDP/. In short, the UK has never been a serious candidate for monetary union[3], let alone forming an optimal currency area with the rest of EU.**

**Once we abstract away the special situation of the British Isles and return to continental Europe, *none of the above arguments hold.* The Eurozone is a relatively closed economy, with synchronized business cycles and a long history of learning by doing that  culminated in the establishment of a special construct/Issing, O  et al, 2004/. The two fundamental arguments have been the need to avoid currency fluctuations, which render the retaining of a separate currency a luxury good for any small open economy, but even for medium sized economies. Number two, importing the stability originating in the Bundesbank and complementing the single market with a single currency entailed a plethora of obvious and hardly disputable palpable benefits for the vast majority of actors, corporations, banks, households and policy-makers alike. If we exclude currency traders and members of a central bank board, very few individuals loose out, even in theory, from "giving up the exchange rate instrument", as**

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[3] The 'five economic tests' promulgated by then Chancellor of the Exchequer, Gordon Brown in June, 2003 was a clear admission of Britain not being ready for the single currency 'any time soon'.

**long as they joined a stability club with interest rates way below the accustomed historical levels.**

**Once we consider the experience of crisis management in Europe we find that no country actually benefitted from big devaluations or from applying interest rates which would not have shadowed those of the ECB. Therefore neither theory nor policy provides sound arguments for the theoretically conceivable position arguing in favor a nationally separate, arbitrary or old-fashioned monetary policy and its instruments in any real world scenario.**

**3. The study of various adjustment programs/most recently: Costa-Cabral,N, et.al., eds.2017; Ódor, L. ed.2017/has underscored the great and fundamental diversity in the member-states' coping with the crisis. In other words: there is neither a cookbook to go by, that would follow from abstract academic insights, *nor do we observe the EMU framework acting as a straightjacket* on the options taken by the member-states.**

**This is by no means a trivial observation. On the one hand there is a newly emerging consensus on the features of the 'new normal' set of policies, including the lastingly negative real rates of interest and a relatively lasting application of lax monetary conditions. Furthermore the reliance on fiscal policy tools, including some discretionary elements are no longer an anathema, although as the volumes cited above highlight, the rules-based arrangements still prove superior to ad-hoc measures, especially in the medium and longer run.**

**Meanwhile *institutional arrangements have proven to be less crucial* than it was previously theorized. Availability of complex and highly institutionalized arrangements at the EU level, such as the two pack, the six pack, the fiscal compact, and the fines introduced for trespassers could not stop the notorious non-compliance in traditional violators of fiscal discipline, as France or Italy.**

**Complex national arrangements in Belgium for instance could not impose austerity. By contrast, in some countries low level of institutionalization has not proven to be a major obstacle to fiscal solidity. As a matter of fact, some of the best performers, as the Baltics and Slovakia/until very recently/ have been**

**operating under very low level of institutionalizing solid fiscal practices by way of independent fiscal councils or budgetary guidelines anchored in the Constitution. Even in Hungary abolishing the independent fiscal council with an independent analytical apparatus of its own in 2010 has not led to major de-railment. Except for the crisis year of 2011 the government aimed and also attained to keep headline deficits under the Maastricht level and reported public debt to GDP ratio, the more relevant indicator for assessing fiscal sustainability in the medium run, has also declined from 81 pc in 2010 to 74 pc by end-2016. While the latter is much less than stipulated in the debt brake written in the 2011 new Basic Law/ that was replacing the 1989 Constitution, negotiated during the round table talks leading to peaceful transition/, *the improvement is non-trivial and rather exceptional* among the EU countries/and EMU countries in particular/.**

**What is the *explanation for this paradox?* It is less of a novelty to claim, that the basically inter-governmental nature of the EU, that is a legal-political setting anchored in the 2009/Lisbon Treaty on the European Union, puts severe limits on any supra-national practice that would directly interfere with the economic practices of the member-states. At least as important are the precedents, set inter alia in 2003-2004 on non-punishment of flagrant fiscal trespassing by Germany and France. This allowed smaller states to replicate and not only in years of deep recession. The most obvious case has been Greece/Visvizi, A. 2014/but other countries like Hungary also could allow practices that are out of line with the Community financial framework in its philosophy and its implementation alike.**

**On the national level the explanation lies in the nature of polity in each country. In the good performing countries there is a wide professional and also social consensus over the basic issues, i.e what is the right way to follow. In Ireland, for instance, big moves in the political shuttle have not prevented the successful continuation of the adjustment program and of financial consolidation of the banking sector. In Slovakia a hectic political scene never translated into a de-railment in the fiscal and monetary fields. In short, *broad consensus- both professional and political - could fill the institutional gaps with success.***

**By contrast in the trespassing countries the only commonality in the varieties of political complexities is the *lack of consensus and the weak implementation capacity of formal institutions*. This sounds as a platitude in some cases as Greece and Portugal[4]. It is less trivial but equally important in such countries as Spain, where fiscal improvements seem to have been making headway in the past 15 years or so. However as the 2008-2009 crisis has revealed, local finance revolving around the local savings institutions, the *caixas* have sustained intimate and unhealthy relationship with local political structures, thus undermining the efforts of the central government and the central bank alike.**

**From the above said it follows, that the Euro-zone framework cannot and should not be blamed for what has been, in essence, poor national crisis management. The framework, to be discussed in the next point, has not been perfect, but did not constitute a barrier to successful adjustment. True, it has also proven ineffectual in pressing for deep going changes and adjustment in the countries in difficulty, most importantly in France, Spain and Greece.**

**4. It would be grossly unfair to skip the question *if and to what degree the Euro-zone framework has been able to cope with the financial crisis* of the past and to what extent has it been upgraded to forestall *similar events in the future.***

**As far as the past is concerned, the answer is rather negative. The crisis has uncovered the improvised and unfinished nature of the EMU framework lamed by a large degree of national egoism and unwillingness to confer power to the Community level regulators even in cases, when the logic of the internal market would have called for it. What emerged in 2016 as the Single Resolution Mechanism is basically the implementation of the Lámfalussy proposals dating back to 2001/more on that in: Kudrna, Z., 2016/. The ECB could not play the role of the lender of last resort within its original mandate, which has proven to be a problem during crisis management. In a single market with lots of cross-border transactions banking supervision is bound to be transnational/that happened only in 2014/. Last but not at all least, the insight over the need to create a standing buffer to avert and pre-empt speculative attacks took a long time to get through in the form of the European Stability Mechanism.**

[4] Cf extensively Kotios,A. et al/2017/ and Bongart, A.-Torres, F, 2017/.

**It is difficult to assess *if those new arrangements* – somewhat over-ambitiously termed as the Fiscal and Banking Union – *will prove water-proof in the case of the next crises*. This is so not least because of the ever growing expansion of private finance and globalization. If back in 1994 a 50 bn US dollar bailout for Mexico was considered to be a jumbo deal, by now a 'normal' Greek re-scheduling – which is unlikely to be a singular, one-shot action as was the case with Mexico – involves similar or bigger sums without calling for headlines in the news. Monthly asset purchases in the range of 80 bn Euros/twice nominally the sum mentioned/[5] and targeted discretionary measures, as well as liquidity provision without upper limits constitute integral part of the unconventional monetary policy instruments lavishly used by the ECB since 2014/cf Alvarez, I et al, 2017/. Financial innovation implying market actors' ability to circumvent rules is unlikely to come to a halt. Also at times of crises the cohesiveness of the Community is crucial for efficient and swift action – it may or may not be forthcoming.**

**What seems to be a fundamental unresolved problem, as we argued earlier/Csaba, 2016 /, is the fact that all the institutional and policy innovations of the Fiscal and Banking Union, as well as the transformation of the ECB into a fully-fledged central bank with respective functions of the lender of last resort, have all taken place outside the framework of the Treaty on the Functioning of the European Union. This is problematic on its own right, and even more so *in terms of democratic legitimation of technically necessary measures of improvement.* With the United Kingdom leaving in 2019, the major player who opposed any changes in the Treaty has gone. On the other hand, even elementary familiarity with German, French, Italian and Spanish politics indicate, that far reaching changes as indicated in the White Paper and of the Commission paper on the financing options for the next pluri-annual framework are unlikely to receive that political backing, which is needed for such bold initiatives to materialize. Thus further deepening of the FBU through issuance of sovereign-backed securities, without this leading to the unconditional mutualization of public debt obligations, looks both technically feasible and**

[5] At the time of writing American tapering of these is over, while ECB communication to date show no sign of replicating the US practice, despite expectations of many market participants to this end.Still, from January 2018 the volume has decreased from 80 to 30 bn per month, cf: *Neue Zürcher Zeitung*, 5 January, 2018.

**economically desirable/Demarry – Matthes,2017/. Still, the likelihood of this to happen is sub-minimal, for the very reason mentioned above: the lack of political momentum in the big states in the driving seat. This bleak outlook may though change, if the political impasse is overcome with the new European Parliament and Commission coming in by mid-2019. Should the domestic political situation come to appeasement, the chance of a Treaty revision, allowed for by the conclusion of Brexit by that time/Fabbrini,F.2017/ could settle this weighty strategic question. Still, the latter seems as a highly optimistic reading of events against the sad reality, namely that *the weakness of the governance in the large member-states is structural* rather than ephemeral, ad-hoc in nature.**

**5. Our final point needs to address the underlying question of this panel. *Who should reform and in what way?* Our answer can only be partial, owing to the open-ended nature of the processes we analyzed.**

**As far as the Community level is concerned, *much of the improvements that are technically necessary as a minimum have been realized.* The 705 bn Euros managed by the technocratic team of the ESM constitute a respectable sum to deter playful market actors from speculating against the single currency and the governments of the euro-zone. The quasi unlimited liquidity provision of the ECB and its intervention in favor of ailing economies allows to pre-empt the replication of sudden stops and the drying out of money markets for them. Stress tests conducted by the joint banking supervisions serve as an early warning system to induce capital adequacy improvements and structural upgrading in banks of systemic relevance.**

**On the other hand the paradox we discussed in terms of national economies survives at the EU level. As a matter of fact, owing to the de facto two speed Europe it is likely to intensify. *Member-states which de facto opted out from the euro-zone for reasons of retaining their political room for manoeuvre* and freedom to choose any option they deem appropriate/not constrained by the joint framework/ *are unlikely to get along with the majority,* especially not in a quasi-automatic fashion. Consensus-building thus is likely to remain fragmentary and inadequate, with the unreformed system of decision-making in the Council and Parliament rendering any decision to be slow.**

**In turn, *national reforms supportive of competitiveness cum financial solidity remain the key.* Possibilities for such measures vary by the country. In France for instance, the newly elected President faced the first strikes against his labor market measures already in the prime time of his taking office. By contrast, the Baltic States continue with their tough line without encountering serious opposition. In much of Central Europe the ambition as well as the ability to change seems to have ebbed. Staying out of the Euro-zone is thus likely, though *the broader and palpable economic benefits of doing so remain unclear for any informed observer.* Keeping all policy options open against a rules-based framework is a conceivable stance, but one burdened with high risks for any small open and financially vulnerable economy.**

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