From:

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The Future of the Eurozone

How to Keep Europe Together:
A Progressive Perspective from Germany

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Europe is stumbling from crisis to crisis. The financial and debt crises are endangering the European currency union; referenda in several EU countries show widespread Euroscepticism; the economy is only slowly regaining momentum; unemployment remains high in many Member States; and the refugee crisis has deepened political divisions. We need an answer to the question of how to rescue the Euro and keep Europe together. In this volume, renowned German researchers and leading practitioners provide pragmatic recommendations. Their plea for a democratically legitimized Euro Finance Minister, a new economic approach, a common Eurozone budget, and minimum social standards are the prerequisites for a fair, stable, and prosperous Europe.

"The Brexit referendum in the United Kingdom is the latest and perhaps most urgent wake-up call to reform the European Union and the Eurozone in particular. We do not need abstract institutional debates, but specific proposals to make sure the European Union advances economic and social prosperity for its citizens. I heartily recommend this book to all those who want to get an impression of a progressive perspective from Germany."
(Sigmar Gabriel, Minister for Foreign Affairs, Germany)

"Fixing the Eurozone, rather than just diagnosing its ills, requires asking those most commonly held to be harming it with their policies, the Germans. In this superb volume, the very best analysts of both German politics and Eurozone economics sift through the problems that hurt, the politics that limit action, and policies that are needed to make the Eurozone what it should be – a place that provides a stable and prosperous home for all Europeans after a lost decade of growth."
(Mark Blyth, Professor of Political Economy at Brown University)

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Contents

Part III: reform options

1. Introduction: The future of the Eurozone

Alexander Schellinger and Philipp Steinberg

The British vote to leave the EU ("Brexit") in June 2016 plunged the Community into its deepest crisis since the signing of the Treaties of Rome in 1957. The Union is set to lose a Member State for the first time in its history. This is the fourth shock to rock the foundations of the European project within just a few years, following the Euro crisis, the war in Ukraine and the refugee crisis. Anti-European forces are gaining ground across Europe and elsewhere. Doubts about the Union are growing, along with a belief that fundamental problems can better be resolved by the nation-state.

Yet the EU has a track record of using crises as opportunities to break deadlocks and bridge political rifts. The chances for major reform are not so slim, despite the state of the EU and the Eurozone, which many regard as troubled. In fact, pending reforms could be bundled into a European package including the Eurozone, with the Brexit negotiations acting as a catalyst. The Fiscal Compact must anyway be reviewed by 2017 and the debate over adapting and restructuring the Multiannual Financial Framework has already begun. In this volume we lay out proposals for reform of the Eurozone and of the EU as a whole, along the way reprising the relevant European debates. We proceed in three steps:

We begin by analysing the Eurozone's problems in their political, economic and social dimensions. We move on to investigate the factors shaping European decision-making and reform proposals. Finally, we present reforms that offer effective solutions to the Euro crisis in political, economic and social terms. For all the proposals we make, we outline the legal framework and requirements and, given the difficulties in finding unanimity on Treaty amendments, indicate measures below that threshold wherever possible.

The challenges faced by the Union of 28 or 27 Member States are of such complexity that it would appear sensible to concentrate on the smaller Eurozone, the nineteen Member States that use the Euro as their currency. Nevertheless, many of the observations and solutions we describe can also be applied to the EU as a whole. Although the institutions of the Eurozone and EU overlap in significant respects and are indeed in certain respects identical, the Eurozone has developed a political dynamic and depth of integration of its own warranting separate analysis.

While this volume offers a perspective from Germany, we aim to develop solutions as a contribution to the European debate. We concentrate on Germany not only because we have been able to follow developments here very closely in recent years and because Germany has assumed a central role in the Eurozone and the EU, but also because we believe that understanding the specifics of the discussion in Germany is of great importance for further reforms.

Analytical framework and content

We are well aware of the political context and the obstacles to change within the Eurozone (and even more so in the EU as a whole). This led us to examine the conditions for reforms. We consider three strands or processes: Problems, politics and policies.[1] "Problems" in this context mean strong and sustained pressure in a particular area (such as the Brexit negotiations with the United Kingdom, high unemployment or a financial crisis). "Politics" stands for the positions and interests of political actors, with public debates and elections playing a central role. Successful "policies" are reform proposals that offer answers to policy problems and are taken up by politicians. These processes make up the building block of this volume: In part one we examine the problems of the Eurozone. In part two our authors examine the politically relevant actors in Germany. And in part three we lay out reform proposals, taking into account the problems of the Eurozone and the political situation as a whole.

We begin in part one by examining the problems from the political, economic and social perspective. In Chapter 2 Christian Beck examines the institutional problems of the Eurozone, including those created by the Brexit vote. Henrik Enderlein outlines the economic challenges of the Eurozone as a monetary union in Chapter 3, paying particular attention to the persistent divergence between the Member States, the single monetary policy of the European Central Bank and the difficulties of fiscal policy coordination. In Chapter 4 Michael Dauderstädt takes up the social challenges faced by the Eurozone, including unemployment, income distribution and poverty, and examines the effects of the Economic and Monetary Union (EMU) on these.

In part two, we move on to analyse the central actors in the German political discourse. Mark Schieritz traces the economic policy debate in Chapter 5 and shows why its trajectory in Germany differs from most other countries. In Chapter 6 Björn Hacker and Cédric M. Koch identify the decisive political actors in government, parties and civil society and outline their positions – and contradictions – on Europe. On the basis of those positions, they formulate a series of conditions for successful reforms. In Chapter 7 Franz C. Mayer relates the development of European law in recent years, analyses the role of the German Federal Constitutional Court and describes how the central proposals presented in this volume would be implemented legally.

In the final part we present specific reform proposals. In Chapter 8 Jeromin Zettelmeyer proposes a Eurozone budget and greater budgetary flexibility for Member States to increase growth and employment, along with the creation of a debt restructuring mechanism. In the context of the Brexit vote, Daniela Schwarzer proposes institutional reforms of the Eurozone (Chapter 9). In Chapter 10 Peter Becker presents ideas on minimum social standards and a European short-time work allowance to address the social challenges, while in Chapter 11 Armin Steinbach explores the costs and risks of reversing integration and shows how that would not solve the problems. In the last Chapter we draw together the findings and venture an outlook on possible future developments.

The debate thus far

Ever since the outbreak of the Euro crisis analysts have pointed to the structural problems of the Economic and Monetary Union (EMU). One central argument is that the Member States lost their economic flexibility without creating new compensating mechanisms at the Eurozone level.[2] The members of the Eurozone have relinquished macroeconomic policy instruments (for example the ability to adjust national exchange rates), while strict budgetary rules at the Eurozone level constrain their fiscal options. Moreover, many economists criticise the anti-cyclical configuration of the Eurozone's monetary and economic policies. The charge was for a long time directed especially at the European Central Bank and its focus on price stability and strict budgetary rules, and naturally above all at the bailout programmes for the crisis-stricken countries of southern Europe and Ireland. While these analyses have done a great deal to illuminate the relationship between monetary and economic policy between the Member States and the EMU as a whole,[3] their worst fears – the collapse or break-up of the Eurozone – have thus far proved unfounded. One reason for this may be that since the outbreak of the crisis the statute of the European Central Bank and the new fiscal rules have been interpreted much less restrictively than many may have expected; quite the opposite in fact: New ways were found to exploit the flexibility that was included in the framework.

This brings us to the political questions of the Eurozone. Whereas economists have largely concentrated on the mechanisms by which EMU functions, political scientists and legal scholars tend to concentrate on its political and social institutions. One strand, for example, uses the tools of political economy to examine how national economic models interact in the Eurozone (in particular, concerning differences in wage formation systems).[4] Institutional analysis focus on both the power relation between Member States and the European institutions (in particular, Germany's new role) and the role of inter-governmental agreements and informal coordination processes in the EU's legal system. Yet another set of literature analyses the central decision-making actors and institutions at the European level. Here there is often criticism of democratic deficits in Member-State-driven (intergovernmental) agreements and the role of national governments vis-à-vis parliaments. On the whole, these contributions highlight the political, social and legal fundamentals of the Eurozone.[5]

Our hope is that this volume succeeds in bringing together both debates and perspectives. While work on the functioning of the EMU has generated innovative and sophisticated reform proposals that have found their way into the political process, these economic analyses generally concentrate on very complex technical issues while neglecting important political/institutional aspects. In political science literature the problem is reversed: Here central political problems are spotlighted but – with a handful of notable exceptions – rarely followed up with concrete reform proposals.[6] In this volume we seek to develop reform proposals that find answers to both the technical and the political challenges facing the Eurozone. Only if both perspectives can be brought together and if we entertain a broad and well-informed public debate does the Eurozone (and the EU) have a future.

Our argument

On the basis of the contributions presented in this volume, our argument is made up of three building blocks:

1. We argue that the Eurozone crisis is not primarily – still less exclusively – an economic crisis, but also a political and social crisis. It is clear to us that what the EU and the Eurozone are experiencing is above all a fundamental political crisis in the sense of the inefficiency of European decisions and the dominance of the executives in a time of growing populism in most Member States. Worse still is the EU's apparent or actual failure to fulfil its promise of prosperity. Economic and social divergence are increasing steadily both within and especially between the Member States. We do not believe that resolving the crisis – understood as a currency crisis – will be enough to lastingly consolidate the Eurozone and the EU.
2. The outcomes of the reform process will depend both on interests, for example of national governments, and on ideas and institutions, for example in the sense of economic beliefs and the possibilities and limits of

European Treaties. This needs to be taken into account when analysing past political decisions – and when developing new reform proposals. Unlike other political commentators, we do not believe that the outcomes of the crisis management of recent years can be attributed exclusively to either national interests (related for example to debtor and creditor roles) or sets of ideologies (such as German "ordo-liberalism"). Because the political system of the EU and the Eurozone is characterised by a multitude of actors with veto rights, the status quo is especially hard to change and the need for compromise is exceptionally great. We therefore want to develop ideas that promote political coalitions over and above opposing interests, and not only abide by the rules of existing institutions but also contribute to their development.

3. We also argue that the Eurozone needs to be strengthened as a political, economic and social union. The Eurozone can only endure as a political union if it has an effective and democratic decision-making process. As an economic entity the Eurozone requires significantly better coordination of national economic, financial and budgetary policies for its stability and growth. Next to coordination of national policies, instruments need to be developed at the Eurozone level to implement policies across the union as a whole. As a social entity the Eurozone must improve social equality within and between its Member States. European integration has progressed too far for the social question to be resolvable within the national context alone. We are convinced that this will also be expedient for the EU as a whole.

Our proposals will also encounter scepticism. But we are firmly convinced that an economically successful, democratic and socially just Eurozone is the best – and perhaps also the only – answer to the growing dangers of populism and Euroscepticism demonstrated perhaps most clearly by the Brexit vote. It is our belief that the Eurozone is not in fact facing a binary choice between a European federal state or club of nation-states. Europe will continue to pursue a third way.

The challenges

The problems exposed in the course of the financial and Euro crisis underline the urgency of reforming the EMU. The need is diminished neither by the measures named above nor by better crisis management for example through the European Stability Mechanism. The underlying problem is excessive economic and social divergence combined with a lack of instruments suitable for reducing it. The main mechanism by which EU Member States have in the past been able to stimulate competitiveness and growth at least for a time – namely by devaluing their national currency – is no longer available. Instead they must conduct a real devaluation, in particular by reducing unit labour costs.

Useful mechanisms – such as the macroeconomic imbalance procedure – that take account of the entire Eurozone (and EU) remain limited, because instruments for cushioning symmetrical and asymmetrical shocks are lacking. The Stability and Growth Pact is configured to prevent excessive national deficits, which means that the policies it produces can be either too loose (in an upturn) or too strict (in a downturn). At the same time there are no supra-national balancing mechanisms, for example in the form of "automatic stabilisers", to provide for Eurozone-wide growth and convergence programmes. The constraints on national budget policies have been tightened and monitoring stepped up, but without creating instruments to boost growth and employment. The European Central Bank is alone in seeking to compensate this design fault through its monetary policy; indeed, it is the only actor with relevant powers. But it cannot succeed on its own, even if we are willing to accept the impacts on savings.

The Euro crisis has strengthened inter-governmentalism, creating an even more complex system that hampers effective and democratic decision-making. During the Euro crisis, inter-governmental solutions often represented the only possible option. The existing instruments were too weak and the disagreements between national governments too large. But the great flaw of European policy over the past five years has been to neglect to move towards an effective and democratic decision-making process at the supranational level. Instead of utilising inter-governmentalism as a means to an end, it became an end itself.

The existing coordination instruments amount to little more than ritualised recommendations and reports; only in the monitoring of national budgets are there more robust rights of intervention (and yet budgetary coordination between Eurozone states still leaves a great deal to be desired). The limits to European rules and laws are fundamentally political in nature. Even with strengthened budgetary coordination instruments such as the Fiscal Compact, Six-Pack and Two-Pack, it is inevitable that European rules will be bent and broken in the context of national elections and national responsibilities.[7] Even more problematic than the inadequate observance and application of rules is the underlying assumption of the rules-driven approach in the EMU (in particular, in budgetary policy). While institutionalized rules can enhance the stability and sustainability of political action, they cannot and must not substitute political decision-making. Indeed, the focus on a purely rule-dominated economic policy is one of the causes of the Eurozone's economic problems. The belief that ever stricter budgetary rules would represent a sufficient economic policy instrument for the Eurozone if they were only obeyed fails to account for the multidimensional challenges of a growth- and employment-driven economic policy.

The dynamic of European integration has largely been economic in nature. But the Single Market and the EMU can also curtail and threaten social policy achievements at the national level. The Eurozone's lack of policy instruments influences the especially tangible fields of social and employment policy and threatens the existence of the Eurozone as the core of the EU. Historically, social and employment policy are secondary in the EU/Eurozone.[8] This constitutional subsidiarity has been further exacerbated by economic integration in the course of the Euro crisis. Without macroeconomic instruments offering greater flexibility of adjustment, internal devaluations will continue to be conducted primarily through wages (and prices). This can lead to falling incomes and excessive austerity, as demonstrated by the painful adjustment programmes in the crisis states. But unemployment, inequality and poverty are also rising or are persistently high in other Member States, while the EU's social dimension still remains in its infancy. In almost all areas – from employment policy through labour law to labour relations – recent years have witnessed stagnation at best.

We are convinced that it is necessary to challenge some of the fundamental principles of the Maastricht regime. Strengthening the Eurozone will demand more than minor reforms of existing rules that are largely restricted to budgetary matters. Observing the rules is necessary and important. But that will not repair the underlying mistakes. The objective must be to create economic policy instruments to improve the viability of the Economic and Monetary Union and to stop and reverse the economic and social divergence processes. In a common currency area – even if it is not an optimal currency area and is not going to become one any time soon – fiscal instruments at Eurozone level will need to at least supplement the existing national ones. So for us the questions of governance and of economic and social policy are central.

Towards a sustainable economic governance

The greater the convergence of the EU economies, the smaller the costs of cushioning imbalances. Existing supply-side mechanisms (such as rules for national budgets) need to be supplemented with demand-side instruments to reduce existing asymmetries.

In the form of a common fiscal capacity (in the sense of own resources for the Eurozone, for example in the form of a Eurozone budget – as proposed by the President of France, Emmanuel Macron) a convergence instrument should be established to reduce structural differences within the Eurozone.

This could be a special instrument to increase growth and convergence in the Eurozone, similar to the EU's structural funds. Such a mechanism would be funded either through new Eurozone resources (such as a proportion of the revenues from a financial transaction tax or a small share of national corporation taxes), a new Eurozone tax or direct contributions from the Eurozone states.

Such a convergence instrument would be activated politically and could be supplemented with an automatic stabilisation mechanism – in other words a macroeconomic instrument – to counteract the effects of economic downturn (analogous to the effect of national unemployment insurance systems). Given the expected difficulty of establishing a European unemployment insurance system (even as a supplement to national social insurance systems), the introduction of smaller, more limited mechanisms such as a European short-time work allowance scheme should be considered.

These Eurozone instruments should also encourage growth- and employment-boosting policies by granting some fiscal flexibility to Member States. These mechanisms must ensure that the enlarged policy space does not serve to expand consumption without increasing sustainable investment. First of all, this requires effective governance within the Eurozone. The Commission needs to be empowered not only to apply a set of rules but also to weigh up complex economic choices.

Secondly, an institutionalised debt restructuring mechanism could be introduced in the Eurozone, to be activated when pre-defined thresholds were crossed. Such a mechanism could fulfil a dual function:

- It would ensure that the no-bailout clause (exclusion of community liability for debts of individual Member States) was observed, and avoid wasting funds bailing out insolvent Member States. Even before it was used, such a mechanism – depending on its details – would also send a message to the markets on refinancing costs.
- It would save Member States from having to implement excessive internal devaluations (especially lowering social spending, wages and salaries) which are very difficult to carry through in a democratic society.

Such an ambitious set of economic instruments would need to be accompanied by new and improved institutional structures to enhance the efficiency of decision-making processes and democratic accountability. Collective (central) coordination would need to be reinforced, for example through a Eurozone finance minister, but with democratic control by a Eurozone chamber in the European Parliament. The objective here would be to expand policy space and political responsibility: If enhanced powers are to be used at the Eurozone level there must be democratic accountability.

The social dimension

Under the given conditions, the social dimension of the Eurozone can and must be developed, too. Alongside economic aspects, the EMU also requires social and employment convergence, for example through coordinated national reforms of labour market and social policies. A European short-time work allowance scheme could serve as an automatic stabiliser. Resembling a European unemployment insurance system, it would offer support at the level of individual actors and could therefore be especially effective. Additionally, legally binding European frameworks provisions and minimum standards could be defined: For example, a floor for national minimum benefits, reintegration of long-term unemployed, or national minimum wages. Coordination between the social partners at Eurozone level should be improved through closer integration in the European Semester, expansion of European co-determination and the establishment of European coordination instruments between national social partners. To us it is clear that the Eurozone can only survive in the long term if next to financial and economic actors, trade unions are included in the decision-making process, if the hard economic requirements are balanced by binding social policy measures and if workers' representation at EU level continues to improve.

Notes

1 | We base our framework on the findings of the classical policy research after John W. Kingdon: Kingdon, John W. (2003 [1984]): Agendas, Alternatives and Public Policies. New York: Longman.

2 | The Theory of Optimum Currency Areas forms an important starting point. It demonstrates that in a monetary union shocks can no longer be cushioned by depreciating national currencies. With internal flexibility through labour mobility being comparatively weak in the Economic and Monetary Union, the European Central Bank adjusting its interest rate for the currency area as a whole and the absence of other fiscal mechanisms, economic shocks cannot be cushioned across the economy as a whole. See Scharpf, Fritz W. (2011): Monetary Union, Fiscal Crisis and the Preemption of Democracy, Max-Planck-Institut für Gesellschaftsforschung Discussion Paper 11/11.

3 | See for example Enderlein, Henrik/Bofinger, Peter et al. (2012): Completing the Euro: A Road Map towards Fiscal Union in Europe: Report of the "Tommaso Padoa-Schioppa Group", http://www.institutdelors.eu/media/completingtheeuroreportpadoa-schioppa groupnejune2012.pdf?pdf=ok (accessed 12 May 2016).

4 | Iversen, Torben/Soskice, David et al. (2016): The Eurozone and Political Economic Institutions, Annual Review of Political Science, vol. 19.

5 | See the excellently edited volume Matthijs, Matthias/Blyth, Mark (eds.) (2015): The Future of the Euro. New York: Oxford University Press.

6 | See for example Bogdandy, Armin von/Calliess, Christian et al. (2013): Aufbruch in die Euro-Union, http://glienickergruppe.eu/de/aufbruch-in-die-eurounion/ (accessed 12 May 2016).

7 | The Six-Pack and Two-Pack are secondary EU law instruments to improve fiscal coordination by strengthening the deficit procedure and coordinating national budget planning. The Fiscal Compact requires budget rules ("debt brakes") to be included in each Member State's national constitution.

8 | On the history of the EU's social dimension see Schellinger, Alexander (2016): EU Labor Market Policy: Ideas, Thought Communities and Policy Change. Basingstoke: Palgrave Macmillan.