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PROGRESSIVE REFORMS FOR REBALANCING THE EUROZONE

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Abstract

Completing, deepening and rebalancing the Economic and Monetary Union is perhaps the most crucial point of the dense European policy agenda. For social democrats, reforms of the Eurozone cannot aim exclusively at stabilising financial and sovereign markets or introducing more fiscal discipline. From a progressive perspective, the main objective of reforming the Economic and Monetary Union is to address the problems of slow growth and high unemployment, lack of social convergence and the democratic deficit. The authors present some crucial elements for a reform inspired by progressive values; they advocate for a fully-fledged Banking Union, a Convergence Code, a real Social Dimension and a Fiscal Capacity which includes both a stabilisation and an investment function.

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1. Introduction

Almost two decades after the launching of the Economic and Monetary Union, one has to admit that the results in terms of convergence, sustainable growth, social progress, cohesion and stability have been quite disappointing. Flaws in the initial design of the single currency have made the effects of the global economic crisis deeper and longer, generating huge economic costs, social suffering and political tensions within and between member states.

Those effects, coupled with the impact of globalisation, technological change and migration flows have generated a huge discontent among many European citizens, who feel the costs of the crisis has been unfairly distributed. Such feelings have indeed largely contributed to the emerging of populist, xenophobic and anti-European forces throughout the continent, exacerbating political and social tensions and putting the EU itself into question. The result of the Brexit referendum has shaken the EU at its core and it calls for a political response that addresses not only institutional flaws, but also the democratic deficit and social imbalances. Against this background, completing, deepening and rebalancing the Economic and Monetary Union is perhaps the most crucial point of the dense European policy agenda, as it is essential to reforming the European framework for attaining robust long-term growth, socio-economic convergence and political unity in Europe.



Despite the increasing Euroscepticism experienced since the sovereign bond crisis, the confidence and trust of European citizens towards the common currency has increased. Eurobarometer registered in mid-2017 the highest level of support for the Euro since 2013.¹ That is just an indication that the Eurozone project needs to be reformed and fine-tuned but not scratched out as some populist forces advocate.

During the last year, European leaders have embarked on a reflection about the future of Europe. The European Commission's White Paper and the various reflection papers have sparked a vibrant debate on the options and scenarios in different policy aspects, including the future shape of the Eurozone.

More recently, after the French and German elections there seems to be new window of opportunity for a serious discussion on the basics of any EMU reform and its interplay with community institutions. The Paris-Berlin axis is likely to be crucial to design the path towards EMU completion, but the differences of the two governments in charge are more important than it appears.

While the launching of the debate among member states and the reflection paper are welcome initiatives, it is clear that neither the Commission's, nor Merkel's or Macron's stances necessarily reflect a social democratic view of Europe or the Eurozone. For social democrats, reforms of the Eurozone cannot aim exclusively at stabilising financial and sovereign markets or preventing the break-up of the single currency. From a progressive perspective, the main objective of reforming the Economic and Monetary Union is to address the problems of slow growth and high unemployment, lack of social convergence and the democratic deficit. The objective of this paper is to revise ideas and policy proposals under consideration for the future of the Eurozone in order to identify which should be the priorities for a progressive agenda.

2. The case for Reform

That the architecture of the European Monetary Union (EMU) was incomplete has been well known since its inception; it was supposed to bring EU economies closer and it did so for several years, until the crisis hit and showed its weakness. Since the advent of the crisis a number of reforms and initiatives were approved and implemented, improving the resilience of EMU and expanding its toolbox to cope with future crises.

As much as these advances must be praised, much work remains to be done. Many of the reforms mentioned were implemented under huge pressure from the markets, without the needed pause to take a long-term solution to the problems that arise. The year 2018 is likely going to be crucial for negotiating a reform of the EMU and delivering on long-awaited reforms; it is therefore now the time for progressive thinking and policymaking to focus on achieving concrete and ambitious reforms.

There is little doubt that the current EMU design falls short of an appropriate currency area. There is ample literature on the imperfect architecture of the Eurozone, which, in fact, presents some relevant structural problems:

¹ Within the euro area, public support for the single currency is on an upward trend since 2013 and has now reached 73%, the highest level of support since the question entered the Eurobarometer survey.

- Systemic deflationary bias, which generates low growth, leading to low employment rates.
- Persistent under-investment, which is particularly alarming in a context in which Eurozone economies should equip themselves for the digital and energy transition and switch to a low-carbon sustainable economic model.
- Systemic internal macro-economic imbalances as well as in labour markets, leading to increasing inequalities and divergence among countries, de facto contributing to destabilising the socio-political unity of EMU project.
- Vulnerable banking and financial systems, which still present some systemic risk that has not been addressed.
- Democratic deficit, due to the recourse to an intergovernmental setting that with limited transparency and weak accountability feeds the populist narrative of Eurosceptic political parties.

All of these flaws, which exist since the launching of the Euro, were magnified by the economic recession and despite the reforms undertaken to manage the crisis, they still remain there. No reform package can be successful, unless it is designed to respond to all such flaws. It is also the responsibility of social democratic and progressive forces to keep ambitions high and help define politically viable proposals for EMU reform that address all relevant structural problems.

In short, from a social-democratic point of view, we identify four main lines for an EMU reform:

- The EMU architecture should **promote upward convergence and cohesion** rather than endanger it. That implies creating those anti-cyclical and investment tools that ensure a prompt redress in case of socio-economic imbalances.
- The EMU governance should respect basic principles of **democracy, transparency and accountability**. In other words, there should be a better interplay between EMU bodies and community institutions and elected bodies.
- The EMU needs to better **align economic and social outcomes**; which means that a social dimension is needed to ensure that full employment remains as a pivotal policy objective and labour market and social imbalances are also addressed.
- The EMU should be completed with some **risk-sharing arrangements that bring together solidarity and mutual trust** to ensure stability of the banking and financial sector. It means completing the Banking Union, a fair Capital Markets Union and the common issuance of debt via Euro area safe assets. Social democrats should reject the risk-sharing vs risk-reducing framework, which is the conservative excuse to slow down further integration. Instead, progressive should stress the need for a European common solution to address national and regional problems, such as those described above, as introducing a European coverage for systemic risk is de facto an essential step into risk reduction.

3. A window of opportunity for EMU Reform

On the occasion of the 2017 State of the Union, the President of the European Commission, Jean Claude Juncker tabled the roadmap² for the EMU reform, which is based on three main points:

1. Transformation of the European Stability Mechanism into a European Monetary Fund.
2. The creation of a European Minister of Economy and Finance, which should work as a sort of super Commissioner, chairing the Eurogroup, but with direct accountability to the EP as well. In charge of promoting structural reforms, with the assistance of the Structural Reform Support Service/Programme, will also ideally coordinate the EU financial tools to stimulate the economy and promote job creation. It will also step in in case of crisis.
3. The creation of a dedicated euro area budget line within the EU budget providing for different functions:
 - structural reform assistance,
 - a stabilisation function,
 - a backstop for the Banking Union, and
 - a convergence instrument to give pre-accession assistance to non-euro area member states

At the beginning of December, the European Commission will put forward a detailed package proposal for reforming the EMU, based on such three bullet points. Such a roadmap seems to suggest that the Commission's intent is to re-design the single currency no longer as an optional feature for a Europe *à la carte*, but rather as a fundamental institution around which to build the Union. The hope is that the ambition brought up by Juncker will be matched by a far-reaching package, coherent with the idea that economic integration at the community level is the way to go.

Interestingly, President Juncker also advocated the need to move to a qualified majority on key dossiers such as the common consolidated corporate tax base, the financial transaction tax and the tax for the digital industry; all elements that, if put forward, could help give substance to a sound investment policy and equip the Union with the means to respond promptly to shocks.

According to the roadmap, the EMU package of proposals will be presented on December 6, 2017, but the Commission, with its Reflection Paper has already clarified what to aim at in the next two years of service: basically completing the Banking Union, and finalising the Capital Markets Union. Very little is expected in terms of enhancing the democratic legitimacy of the EMU governance, at least until 2020.

Whilst the emphasis on fiscal consolidation remains high, the Commission opens to two lines of reforms that appear to respond to a logic of enhanced risk-sharing:

- 1) The potential development of sovereign bond-backed securities could be a substitute for Eurobonds given the outright German rejection of debt mutualisation. The features of such systems are yet to be devised but, in essence, it is a way to pack together national debt of different countries into a single new asset, without joint liabilities. By doing so however, bonds backed by all euro area countries would help keeping borrowing costs down for the economies with weaker performance. Only beyond 2019, the possibility for a common issuance of debt could be put forward through the so-called European Safe Assets.
- 2) The beginning of a serious discussion on a fiscal stabilisation function which shall be implemented anyway after 2020.

² See https://ec.europa.eu/commission/sites/beta-political/files/roadmap-soteu-factsheet_en.pdf.

With the current term ending in 2019, if the Commission wants to see some of its proposals enacted, it should move rather fast with no overambitious plans. On top of the narrow time-span, legal barriers are also likely to impact on the ambitions for reform, as the need for treaty changes and/or referenda in various countries may be needed.

Progress toward a rebalancing of the EMU has entered into a political impasse between risk reduction and risk sharing. Structural diversities among euro area countries persist and Germany and the Netherlands, among others, are simply not willing to accept a mutualisation of risks, when risks are still high. Following the reasoning of the European Parliament Research Service (EPRS)³, the problem is the sequencing between risk reduction and risk sharing: should the EU first devise a fiscal union and a stabilisation function (with a certain degree of risk sharing) which are able to increase convergence among euro area countries or should peripheral countries first and foremost take care of setting the basis for convergence at home? It is nothing but the problem of the chicken and the egg, or as defined by the EPRS in a more elegant way, it is a political conundrum.

The Reflection Paper on deepening the EMU⁴ sets out as a guiding principle for reform the need to proceed *hand in hand* with responsibility/risk reduction on the one hand and solidarity/risk sharing on the other hand. In this respect, two obvious and too often forgotten considerations should be made for the benefit of all those who want to exit the political impasse:

- 1) **Risk reduction has been undertaken already. Risk sharing not.** Over the last few years the majority of countries that had been deeply affected by the crisis have committed to do their homework: Ireland and Portugal, for instance, appear to be back on track, Italy has gone through unpopular reforms of the pension system and of the labour market. If risk reduction and risk sharing should proceed hand in hand, isn't it now time for some small steps in the direction of risk-sharing? The risk will never be null. The design of the Banking Union included elements of risk reduction (single supervisory, for instance) done, and elements of risk sharing, the European Deposit Insurance Scheme, which have not been addressed.
- 2) **Eurozone countries share the risk already, as the risk is systemic.** They just do not share the costs, yet. Some of the structural problems mentioned above are systemic problems that can potentially affect the whole of the euro area and, hence they require a certain degree of risk mutualisation. Pretending that the risks belong only to certain nations would not help containing risk, sharing part of it would.

³ See Andrej Stuchlik (2017), [Deepening EMU and fiscal union - Risk sharing versus risk reduction](#), European Parliament Research Service, Briefing, July 2017.

⁴ European Commission (2017), [Reflection Paper on the Deepening of the Economic and Monetary Union](#), 31 May 2017.

4. Key Pillars of a Progressive Reform of the EMU

In what follows, we revise some of the measures which have been proposed to deepen and reform the EMU and point out some of the features that appear essential for an effective negotiation, which is able to include and address progressive concerns. Of course the package deal is going to be very ample and we knowingly restrict our agenda to just some aspects leaving aside certain matters that are equally relevant from a progressive standing, for instance the democratic legitimacy of the EMU.

a. Completing the Banking Union

Completion of the Banking Union is one of the leading elements of the expected EMU reform, as some key steps have been made, e.g. the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). Many inscribe the Banking Union among the successful reforms of the European governance to prevent further crisis; although the fact is that such reform is still incomplete.

One of the elements that led to the Eurozone crisis was the fragmentation of financial markets. Before the crisis there were some areas of fragmentation, in particular regarding the small amount of cross border banking operations within the Eurozone. However, one could have argued that financial markets were converging: sovereign spreads were low, and corporate spreads declined substantially to become negligible across countries. All of this changed quickly.

In the downturn, investors quickly worried that some states would not have the ability to secure banks' solvency, thus increasing the risk premium for their sovereigns. At the same time the deterioration in public accounts and the increased potential risk for default also contaminated bank balance sheets that were loaded with national bonds. This sovereign-bank nexus explains to a large extent the complications of the financial crisis.

A key aim of the banking union is to break this nexus. The Banking Union was conceived with three key pillars: i) the SSM, ii) the SRM and ii) a European Deposit Insurance Scheme (EDIS). Institutions to implement a common supervision and resolution have been created, while negotiations on the EDIS are ongoing since the EC presented its proposal in November 2015. These elements are meant to ensure that the loop between banks and own sovereigns is loosened.

In practice, there are substantial shortcomings in all the areas.

1) The need for public funds in case of resolution is supposed to be mitigated by the creation of bail-inable instruments that are to be converted into capital when banks run into trouble. In order to be effective, however, the regulation and its implementation must be clarified and harmonised on several respects: (i) the application of the financial sustainability exception to the application of bail-in must be clarified; (ii) the activation of the early recapitalisation clause, which has dealt to substantial differences in the resolution mechanics across countries, must also be clearly drawn out and (iii) the amount of bail-inable instruments issued must be different depending on the size of the bank in question. If small banks face similar needs of issuance as large banks, the risk is that the former will have substantial difficulties to meet the regulation, given their limited market access. The result could be unwarranted concentration that could limit competition.

2) The Single Resolution Fund (SRF), is being gradually built up during the first eight years until it reaches at least 1% of all covered deposits within the Banking Union by 2023. Yet, the SRF is too small to deal with a systemic crisis. It could work if one or two banks need assistance, but the key problem for fiscal sustainability arises when the liabilities are large, and cannot be covered by the SRF. It is thus critical that the SRF be completed with a **fiscal backstop ensuring stability and resilience in case of financial shocks**. That is crucial to breaking the vicious circle between banks and sovereigns. On this matter, there are serious expectations that the Commission will actually put forward a concrete proposal to expand the mandate of the European Stability Mechanism (ESM), in order to allow for the possibility of using it as a financial backstop for the SRM. If agreed, such solution would have the advantage of completing the second pillar of the Banking Union.

3) **The third Pillar of the Banking Union**, the EDIS, is also missing and it is perhaps the most visible impasse where risk sharing and risk reduction must find a prompt solution. At the moment, deposits below €100,000 are protected by national fiscal backstop only, de facto reinforcing the fatal sovereign-bank nexus. Putting in place fully-fledged EDIS is an absolute necessity to complete the Banking Union and prevent any future crisis from spreading over countries in the euro area.

Beyond the three pillars of the Banking Union, the Commission in its Reflection Paper is suggesting introducing positive risk-weights to the holding of sovereign bonds in the **calculation of banks capital requirements**. This proposal has been supported by some conservative economists, particularly in Germany. However, the idea should be rejected, since it may limit the ability of governments to borrow money in times of crisis and exacerbate financial fragmentation instead of fostering integration and making banks safer. The reason is that in the absence of an ultimate financial backstop against bank liquidity runs, banks' borrowing costs will continue to be linked to those of their sovereign. Hence, risk weight on national bonds held by banks will reinforce the perverse link between government debt and banks' balance sheets, depriving banks of the instrument needed to manage their liquidity. In fact, most non-Euro countries in the Financial Stability Board have rejected the idea.

Moreover, the creation of a **debt restructuring mechanism** as some economists are suggesting should also be taken with a lot of caution, as it may increase market fears that sovereign debts might not be honoured, making it more difficult for markets to distinguish liquidity from insolvency risk. The experience of the agreement on privately held Greek debt restructuring, reached by France and Germany in Deauville in October 2010, shows that rather than improving market discipline and confidence, such mechanisms could again pave the way to the possibility of an investor run, leading to a self-fulfilling financial crisis.

b. A Fiscal Instrument for the Eurozone

At the moment, the EMU is not equipped with any fiscal instrument to confront economic shocks. In a context in which the exchange rate cannot serve to re-balance macroeconomic and trade imbalances, the weight of the adjustment is all on labour markets. Adjustments, in this sense, take the form of a push towards low wages and higher intra-EU mobility. First, wage moderation depresses the aggregate demand and weakens growth prospects under the mirage of gains in competitiveness, which should be pursued with policies of a different nature: industrial policy, innovation policy, and strategic and social investment. Second, mobility is by all means still limited in the EU but an excessive recourse to it may compromise convergence and the sustainability of public finances in the country of origins due to excessive youth and brain drain and diminishing revenues from work.

Above all, a fiscal capacity is important because it would make the Eurozone policies more effective. In the framework of the current architecture, fiscal policy is subject to strict supervision, so that

there are not many margins at the national level for fiscal policy to act counter-cyclically. The partial restriction of a policy option at the national level has not been substituted by a European policy option. The absence of a centralised fiscal policy at the Eurozone level, in essence, limits the scope and actions that the public sector can take to drive the economy.

With limited room for fiscal policy, it is monetary policy alone that must carry out the needed expansionary policies. Now, this arrangement is inefficient for several reasons:

i) monetary policy has limits, whether it is the Zero Lower Bound in interest rates or the amount of sovereign bonds available to purchase under the bond purchase programs.

ii) it is well known that when interest rates are low fiscal multipliers are high. This means that monetary policy may have little additional room, while the additional punch from expansionary monetary policy is substantial.

iii) in the current setting, the only formal objective of monetary policy is price stability. This means that once inflation reaches the 2% target, the monetary policy stance should tighten. This can be problematic if a side effect of the expansionary monetary policy has been the assurance of the integrity of the Eurozone. Once the monetary policy stance shifts, investors and the public may question whether the Eurozone has the mechanisms needed to remain intact without that support. Given that we are, at present, shifting towards the end of the expansionary monetary policy, it would be of interest to adopt the needed mechanisms in a timely fashion.

The creation of the European Stability Mechanism (ESM) was meant to deal with financial, fiscal or balance of payment crisis. It is undeniable that the ESM has played an important role in solving relevant moments of crisis and calming financial markets. But it is also clear that the ESM in its current form has important shortcomings in terms of size and mandate and it is definitely not a substitute for a common fiscal instrument.

In recent years, a very lively debate has emerged on the scope, design and size of a potential fiscal instrument for the Eurozone. Several policy options have been tabled to move in the direction of a Fiscal Union. The underlying rationale is always based of providing some sort of shock absorption but there are two different ways in which this can be addressed. As shown in Table 1, intervention can either be automatic, i.e. with no political intervention and just subject to pre-determined thresholds, or discretionary.

Table 1 - Policy Options for a Fiscal Union

		Stabilisation scope	Payment trigger	Sources of funding
Absorbing cyclical shocks/'rainy day fund'		Macroeconomic	Automatic	Member States' contributions
Unemployment scheme	European Unemployment Insurance	Macroeconomic and social	Automatic	Member States' contributions, or individual contributions
	(Unemployment) Re-insurance fund	Macroeconomic	(Semi-)Automatic	Member States' contributions
Public investment strategy (European Monetary Fund)		Macro- and microeconomic	Discretionary	Member States' contributions, 'own resources', capital markets
Euro-area budget (Euro-area treasury)		Macro- and microeconomic	Discretionary	Member States' contributions, 'own resources', borrowing

Source: D'Alfonso and Stuchlik (2016)

In one way or another, the euro area needs to be protected from symmetric shocks as well as from asymmetric ones. Due to the high interdependence of Eurozone economies, it is in the interest of every country to have instruments preventing a significant economic shock in a member state in order to prevent long-term imbalances and avoid contagion.

The Commission's Reflection Paper on the Deepening of the EMU lays out two main options: 1) the creation of a macroeconomic stabilisation function which would serve as a stabiliser for national budgets in the event of serious asymmetric shocks, allowing also the running of smoother aggregate fiscal policies for the eurozone in unusual circumstances when monetary policy reaches its limits, 2) the Commission also opens the possibility for a eurozone budget with broader objectives, covering both convergence and stabilisation, which would need to have stable revenues possible through Euro Area own taxes. As we will describe below, ideally, such options should be put forward jointly. A macroeconomic stabilisation function of automatic or semi-automatic nature should provide coverage for asymmetric shocks, whilst ensuring no moral hazard. A discretionary measure, funded with true own resources could instead ensure against the risk of symmetric shock and provide a good framework for a sound and far-reaching European investment strategy.

The French President Emmanuel Macron spoke in favour of equipping the Euro area with the capacity to raise money together in order to finance a dedicated budget, which could serve ensuring stability and a prompt recovery in case of economic downturn or financial crisis.

On the other hand, the official German position, before the election, was quite different from the French one. Chancellor Merkel has flouted the idea of a small budget or a common fund to assist weaker economies in carrying out reform. In other words, the potential euro area budget should be seen exclusively as a means and incentive to support and attain structural reforms. A substantial investment policy and an automatic stabilisation function appear ruled out of the discussion from a German point of view.

From a Social Democratic standing, we consider it essential that the fiscal instrument for the Euro Area be founded on three key principles: it should promote convergence and solidarity as stressed in Macron's proposal; it should be countercyclical: funds should be enough to counter economic cycles, especially in downturns and it should provide European public goods, not well covered by the market and with strong spill-over effects throughout the EU, such as fight against climate change, digital infrastructure, etc.

In this sense, the fiscal capacity could rest on three key elements, in line with the European Parliament resolution of early in 2017. The EP Resolution calls for a fiscal capacity within the euro zone, including the transformation of the ESM into a European Monetary Fund (EMF) and the establishment of an 'additional budgetary capacity for the euro area'. The three elements to be considered are the following:

i. **Reform of the Stability and Growth Pact and introduction of an Aggregate Fiscal Stance.**

Any reform of the Eurozone should involve important changes in the design and implementation of the Stability and Growth Pact (SGP), the set of fiscal rules designed to prevent countries from running excessive deficits. In its current form, it is an overly complex and rigid set of rules lacking economic logic and transparency that undermine the ability at both the national and EU level to implement "counter-cyclical" fiscal policy. For a start, indicators such as structural deficit and output gaps, used as targets by the Commission, cannot be directly observed and should be scrapped in favour of more transparent and directly controlled fiscal indicators. Primary deficit, not general deficit, and net debt, rather than gross debt, should be the indicators to assess fiscal discipline.

Moreover, the implementation of the SPG is clearly biased against deficit countries, which are the ones bearing the burden of adjustment. In fact, the enforcement of the rules is quite asymmetric since surplus countries are not forced to expand demand in the same way as deficit countries. As a consequence, in times of crisis SGP rules prevent deficit countries from increasing public expenditure, while surplus countries are not forced to implement more expansionary policies which could help a rebalancing. The result is that deficit countries are forced to carry out internal devaluations of prices and salaries to regain competitiveness, thus depressing domestic demand even further. This asymmetric, pro-cyclical biased policy is destructive as it damages social and regional cohesion.

The fiscal rules should be anchored on a **European aggregate fiscal stance** which is crucial to recognise the EU as an economic actor. The annual aggregate fiscal position would pave the way for a more equitable distribution of efforts among countries and the EU, the latter equipped with the proper fiscal capacity discussed above. Progressives should defend that, as a rule, the common fiscal stance be defined as pro-growth, which in effect allows for the implementation of expansionary policies in times of crisis.

ii. **an automatic shock absorption mechanism for asymmetric shocks** which should be 'budgetary neutral over the longer cycle'. One of the proposals widely circulated for a shock absorption mechanism is a common unemployment insurance program. The logic being that after a shock that leads to a sharp rise in unemployment, if centralised resources can be tapped to pay for unemployment insurance, the country's financing needs would not be affected. As a result, the unemployed are guaranteed appropriate insurance regardless of the health of the country's finances. Consumption levels, residential investment and the aggregate demand are supported.

iii. **an investment instrument to counter symmetric shocks**, promote convergence and boost internal demand in case of downturns. This instrument would focus on funding European public goods in fields such as energy, combating climate change, science and digitisation, to fund the policies of the Union itself and promote economic growth and the achievement of the founding objectives of the EU as set out in the Treaties (Article 2, Lisbon Treaty). The "European Investment Protection Scheme", as proposed by the European Commission, could serve as a blueprint for such a stabilisation but would likely remain a very small step in the right direction.

Given the size of the necessary shock absorption, on top of instruments proper to the EMU, funds made available within the EU budget could also be reformed in order to be made more apt to provide stabilisation and kick in automatically in case of shocks to the labour markets.⁵

One thing which is crucial to underline is that such options should not be seen as substitutes, but rather as a structured package as they are different policy options responding to the different needs and risks of the Economic and Monetary Union.

Finally, in order to truly achieve the goals of both the fiscal union and the banking union, the creation of **European safe assets** is an interesting proposal that does not entail debt mutualisation. These assets would be debt issued by a vehicle backed by an asset composed of the debt of each of the member states. In theory, the creation of a Euro area safe asset could facilitate the functioning of financial markets of public debt and reduce the risk of governments losing market access in times of crisis. However, the idea of creating safe assets also entails risks since it implicitly indicates that some sovereign bonds may not be so safe, increasing their risk premium and the possibility of market runs against those sovereign. Sovereign bond-backed securities are clearly favoured by conservatives as instruments to bring market discipline to fiscal policy, but they risk undermining much of the

⁵ See for instance Rinaldi and Nunez Ferrer (2017), [Towards a EU budget with an effective stabilization function](#), First Run project.

progress made in terms of stabilising financial markets. As discussed earlier, we strongly defend the idea that all sovereign bonds should be considered as safe assets in bank's balance sheets. In short, social democrats should only accept the idea of Euro area safe assets as a way towards debt mutualisation, not as an alternative to it.

c. Conversion of the ESM into an EMF within the Community framework

The creation of a European Monetary Fund (EMF) or the inclusion of an expanded ESM in the treaties could be a very positive development for the euro area, which would complement and reinforce a reformed EMU fiscal architecture, but it is necessary to think carefully about its functions and design.

The ESM was set up as an intergovernmental instrument, to provide financial assistance to euro area countries facing temporary financial problems. It provides three main facilities: lending to governments subject to a macro-economic adjustment program (ex-post conditionality); precautionary financial assistance consisting of credit-lines available to countries meeting certain conditions (ex-ante conditionality); and lending for bank recapitalisation, including direct lending to banks.

It presents a number of weaknesses, including its legal nature as an intergovernmental agreement, its cumbersome governance system, which requires unanimity to provide financial assistance to a member country and even prior approval by some national parliaments. The emphasis should be on prevention and early action. It follows that the design of an EMF should specifically allow for the a faster and earlier assistance to governments and banks in crisis, before countries lose market access, thereby saving money and jobs. Furthermore, the current governance structure of financial assistance programs leads to uncertainty. An enhanced ESM, transformed into a true European Monetary Fund would be able to enforce the rules that would make the programs more predictable. In particular, clear rules regarding conditionality would add certainty to the financial assistance program.

Also, the EMF should be able to act as a final backstop to the SRM and to the future EDIS, in a similar way as the US Treasury can provide, and has provided, to the FDIC.

A key aspect to a new EMF is its legal nature and governance. As highlighted by Commissioner Moscovici,⁶ the EMF should not translate into another body with opaque accountability and strong powers over national budgets and structural reforms. For all these reasons, it is critical that the ESM, or any future EMF, be brought under the EU legal framework.

d. Establishing a social dimension within the EMU

It is beyond doubt that the sovereign bond crisis, i.e. the Eurozone crisis, has caused social hardship in many member states. Unemployment and internal devaluations, coupled in some cases with cramped public services, have contributed to increasing inequality and social exclusion. The inability of the current framework to recognise the relevance of the social dimension and the absence of tools to address social and labour market imbalances have factually allowed the financial crisis to transform into a social and a political crisis. The decreased trust on European institutions, the increasing disaffection towards Europe and the raise of euroscepticism are to be seen as a direct

⁶ Moscovici (2017), [Speech at the Ambrosetti Forum on the Future of the Euro](#), 2 September 2017.

consequence of a framework that prioritise macroeconomic stability to living conditions. As stressed by Jacques Delors: *“if European policy-making jeopardises cohesion and sacrifices social standards, there is no chance for the European project to gather support from European citizens.”*⁷ Thus, a push towards a solid social dimension would have the mid-term benefit of reconciling European citizens with the European project and avoid further disintegration.

Two of the main aspects that a progressive reform of the EMU should include in order to deliver on its social dimension:

- i. **Reconcile social and macroeconomic objectives within the European Semester.** The objective, admittedly politically cumbersome to be attained, should be to put social and employment imbalances on an equal footing with fiscal rules. To give a real bite to the social dimension of the EMU, soft rules on employment and social indices do not appear sufficient. In the past, the attempt to introduce hard targets for socially-relevant indicators failed; but there should be a way to make concrete steps towards reconciling macroeconomic and social objectives. The European Pillar of Social Rights certainly moves in this direction and it is necessary to explore all the ways in which it can become a concrete legislative tool to uphold social outcomes within the economic governance. At the moment, the Social Scoreboard, designed as part of the Pillar, has a purely monitoring function, not a corrective one.⁸ According to some experts,⁹ the proclamation in Gothenburg still represents the bulb of a paradigm shift that has the potential to change the approach towards labour market matters. Nonetheless, it remains necessary to continue pushing for a concrete ‘social’ revision of the European Semester in order to secure social and political stability within the Eurozone and higher wellbeing for its citizens.
- ii. **Uphold fiscal consolidation, whilst pursuing a concerted social investment strategy.** It was the beginning of 2013 when the European Commission launched the Social Investment Package (SIP), a rather comprehensive agenda on skills, education, training, child and elderly care. The initiative however, with no direct financial support and no binding targets, has been unable to provide an effective counterpart to the leading doctrine of fiscal consolidation. Although the sustainability of public finance should be necessarily preserved, European and domestic financial resources should work together to invest in human capital, and making people more skilled and resilient, more able to respond to ‘social and economic risks and to adapt to societal change’ to use the words of Commissioner Thyssen.¹⁰

The social investment approach offers a key opportunity to reconcile economic and social objectives within the EU;¹¹ on the one hand it supports a productive, motivated, resilient and skilled workforce, with clear gains for the dynamism of our economies; on the other hand, through activation policies, it allows lower spending in social protection and higher revenues from taxation. The system in which the EU economic governance support this type of highly strategic investment is still not clear, but in the framework of the EMU, reform and the potential revision of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, i.e. the Fiscal Compact, specific provisions should be made to allow for this crucial aspect of convergence to be duly addressed.

⁷ See Jacques Delors Institute, [“A New Start for Social Europe”](#), Studies & Report n. 108, February 2016, pag. 7.

⁸ In the European Semester Autumn Package, released by the European Commission on 22 November 2017, the 14 headline indicators of the Social Scoreboard entered into the draft Joint Employment Report.

⁹ See for instance Frank Vandenbroucke, [“From The Gothenburg Social Summit To A European Social Union”](#), socialeurope.eu, 27 November 2017 and Claire Courteille-Mulder, [“Social Europe: A strong message from Gothenburg”](#), Policy Network, 21 November 2017.

¹⁰ Speech of Commissioner Thyssen at the General Assembly of the Social Platform, 6 May 2015.

¹¹ See Frank Vandenbroucke, Anton Hemerijck, Bruno Palier, [“The EU needs a Social Investment Pact”](#), Opinion Paper, European Social Observatory, n. 5, 2011.

e. Designing a framework that supports convergence

In the medium run, the key to the stability of the eurozone rests in the economic and social convergence between the economies of the different countries. The European Semester has been able to strengthen economic policy coordination but its impact on promoting structural convergence is trimmed also because of a lack of financial incentives that could support the implementation of country specific recommendations (CSRs). Too often, convergence mechanisms involving financial assistance are seen as a back door to create a transfer union or financing national inefficiencies. In essence, they instead recognise that some structural reforms might involve high financial and/or political costs, and attempts to partly compensate for that.

There has been quite a debate, particularly fuelled by elections in France and Germany, about the use of investment tools, a Eurozone budget or the ESM to promote structural reforms. Now, even though delivering on structural reforms at the national level might be of paramount relevance, one has to be reminded that those instruments have been conceived to respond to other objectives and not everything can be conditioned to structural reforms. Investment tools are meant to equip economies with strategic infrastructure boosting potential long-term growth. The eurozone budget is chiefly about stabilisation and shock absorption, whilst the ESM is designed to provide a financial backstop in case of potential default or in case of financial and banking vulnerability. With the three policies correctly in place, the framework to attain convergence would be largely strengthened already.

To further set the basis for long-term convergence and promote the necessary structural transformation at the national level, a 'convergence code' may be adopted. Financial incentives, such as support to national debt issuance at favourable conditions or targeted grants can be organised in the framework of a five-year convergence code that accompanies progress on reforms with financial assistance. This approach appears superior to the two alternatives of: i) conditioning further the EU budget to structural reforms and ii) to employ the ESF/EMF to disburse a financial package linked to a Memorandum of Understanding due to the following features, also summarised in Table 2:

- 1) By being adopted through co-decision fully respect country ownership and thus set the basis for an easier implementation.
- 2) It is devised as a positive incentive scheme and not as a negative one, which could result in penalising regions and creating problems of multi-level governance.
- 3) It follows the community method and not an intergovernmental, more opaque governance.
- 4) It is based on a 'progressive' conditionality that is not centered on strong policy *dictata* but on shared targets upholding social standards, administrative capacity, sustainable growth and the fight against tax avoidance.

To further develop this policy option, lessons should be drawn from the failure in 2012-2013 to agree on the establishment of a 'Convergence and Competitiveness Instrument' (CCI) that was also intended to facilitate structural reforms through financial assistance.

Table 2 – Different options to foster structural reforms

Convergence Code	Further strenghtening of Macroeconomic Conditionality	ESM/EMF
<ul style="list-style-type: none"> • Co-decision and country ownership • Positive incentive • Community method • Progressive conditionality 	<ul style="list-style-type: none"> • Partial country ownership • Negative incentives that may endanger convergence • Multi-level governance issues 	<ul style="list-style-type: none"> • Partial country ownership • Positive incentive • Less transparent decision making • Policy-related conditionality

Source: Authors' elaboration

Essential to the well-functioning of a pro-convergence machine is to strike an agreement on the Common Corporate Tax Base and on the Common Consolidated Corporate Tax Base (C(C)CTB), proposals that are now in the hands of the Council. The support for reforming corporate taxation in Europe pins down to three motivations that touch different political sensitivities and government priorities: fairness, efficiency and modernisation of the tax system. De facto, the single market is distorted by tax competition and several new businesses with digital presence, as well as multinational, profit abundantly from disintegration within the EU. **It is essential that at least eurozone countries, by means of qualified majority or enhanced cooperation make concrete steps towards securing resources and establishing a level playing field.** The latter may entail amending the treaties to grant the EU some authority over tax policy. Ultimately, the eurozone will not be a true economic actor unless harmful tax competition and tax havens are eradicated.

5. Conclusions

The Economic and Monetary Union is more than a single currency area, it is a political project whose aim is to bring closer together its member countries, from a political and social perspective. Most importantly, it is a project to make the participating economies stronger and attain higher standards of living. Many of the flaws of the incomplete EMU architecture are well known since its inception, others have become evident during the crisis. The upcoming months will finally offer a window of opportunity to redress a policy framework that has contributed to exacerbating social imbalances and inequalities; progressive parties in Europe should gather their forces, be vocal and strong in the negotiations as we are likely to have to carry on for some time with what will be the outcome of the negotiations. By all means, one should try to avoid going on with a framework that is knowingly incomplete. *Completion* (e.g. the second and third pillar of the Banking Union) is therefore a necessary and minimum requirement, but the reform should be far more ambitious and include a *deepening* (i.e. making progress towards fiscal and financial integration and own resources) and a *rebalancing* (i.e. addressing social and labour market imbalances), increased investment and adopting the community method instead of addressing macroeconomic imbalances, fiscal consolidation only and working at the intergovernmental level.

So far, there has been little progress toward a rebalancing of the EMU due to a political impasse between risk reduction and risk sharing. Structural diversities among euro area countries persist and Germany and the Netherlands, among others, do not accept a mutualisation of risks, when they consider that risks are still high. But, by now it is clear that this is an excuse to avoid moving forward with the deepening and rebalancing agenda needed. In fact, we should not forget that risk reduction has been already largely undertaken, but not risk sharing; as a matter of facts, Eurozone countries already share part of the risk, as such risk is systemic. They just do not share the costs, yet.

Without a deep reform of the Economic and Monetary Union, we will not have solid foundations to build the Europe of the future. The keystone of the stability of the euro area lies in the economic and social convergence between the economies of the different Member States, and it should be a prerogative of the EMU to deliver on that.

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