Eurozone Reform Proposals: Not Quite the Way Forward!

9. April 2018 by Ricardo Cabral and Viriato Soromenho-Marques

Following Brexit, the prevailing perception by EU decision makers was that further reform of the European Union was necessary. On the one hand, one should seek to address the dissatisfaction that led to the Brexit vote. On the other hand, it is necessary to fill the European Commission budget hole left by Brexit. The UK was a net contributor to the European Union budget and its exit will leave a budget shortfall after the transition period that ends in 2020. Finally, the largest euro area public policy measure – the ECB asset purchase programme (APP) – is finally winding down, and its main author, ECB president Mario Draghi is about to step down at the end of 2019. Some policy makers in euro area creditor countries may grudgingly acknowledge that the APP was necessary to save the euro in 2012. Nonetheless, creditor countries want to put an end to an ECB crisis response policy role outside 'conventional' monetary policy. Thus, the third main driver for eurozone reform is the push to create new institutions and policy instruments that would be able to take the present and disputed role of the ECB in responding to current and future eurozone crisis.

In this post, given the limited space available, we seek to analyse two of the most 'consensual' eurozone reform proposals currently in discussion, which are likely to be at least partially enacted, and which have been advocated mainly but not only by German and French policy makers and academics: (i) the transformation of the European Stability Mechanism into an European Monetary Fund (EMF), which would replace the ECB role in tackling new crisis; and (ii) the deepening of the Banking Union.

The dangers of the EMF creation proposals

Let us first consider the EMF creation proposals which, while varying somewhat, are all based on an IMF-like paradigm, i.e., that of a multilateral lending facility for euro area member countries. Enderlein et al. (2016) argue that the EMF should end up having a total lending capacity of up to 10% of Eurozone GDP, i.e., which would be equivalent in the present to about 1.1 trillion euro. The EMF would provide loans on strict conditionality terms for crisis-stricken member countries, possibly in conjunction with IMF loans, and would, in some scenarios, have full veto power over member countries' national budgets. A July 2016 Bundesbank[1] proposal suggests that the board of the EMF should first assess the sustainability of a member country's public debt, before approving a bailout (i.e., a strict conditionality loan). If the country's public debt were deemed unsustainable, the EMF would advise the member country of the need to restructure its public debt. The EMF board would approve a bailout if and only the member country was able to reach a debt restructuring agreement with an aggregated majority of its creditors, which, if approved, would entail a 3-year debt maturity extension. Moreover, the Bundesbank proposal, as well as the Bundesbank president, Jens Weidmann, suggested that the EMF should become the enforcer of the Eurozone fiscal rules (the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, also known as Fiscal Compact, and complementary rules), since the

[1] "Approaches to resolving sovereign debt crises in the euro area", Deutsche Bundesbank Monthly Report, July 2016, pp. 41-62.

Bundesbank believes the EMF would be more rigorous and less susceptible to political pressure, in comparison with the present-day overseer of the eurozone fiscal rules - the European Commission. Jean Pisani-Ferry makes a compelling case for the need for a sovereign debt restructuring process in the eurozone, as the lesser evil, if some member countries are unwilling to 'behave'. Pisani-Ferry argues that '*rules of the game are required to deal with unsustainable public-debt accumulation in a monetary union*.' However, Pisani-Ferry fails to point out that unsustainable public-debt accumulation is a quasi-automatic and recurring consequence of the flawed design of the eurozone, which results from the negligible level of fiscal transfers between member countries (see explanation further below).

The authors of this post were 2 of the 74 signatories of a Portuguese 2014 open letter that argued for the need to restructure the debt of Portugal and that of other excessively indebted eurozone countries in an European-wide context. Thus, we support the idea of a sovereign debt restructuring mechanism, driven by the indebted country. But the devil is in the details and most of the current proposals for an ESM-led sovereign debt restructuring have, in our view, troubling and unacceptable features.

The EMF would be designed on the model of the IMF, which has its origins in the 1944 Bretton Woods negotiations and agreements. It is a multilateral lending institution designed to respond to balance of payments crises, and its *modus operandi* evolved into providing loans against strict conditionality, whereby countries receive funds in international currency which are used mainly to pay foreign creditors and to finance imports, upon agreeing to implement certain policy measures, namely adopting a fiscal austerity strategy and implementing labor market reforms. The leading British negotiator at Bretton Woods, Lord John Maynard Keynes, argued against such an institutional arrangement, against austerity policies imposed on debtor countries and against strict conditionality lending, advocating instead a solution where the burden of adjustment would have fallen to a greater degree on the creditor nations (those that run recurring current account surpluses). Instead, the views of the United States, the leading economy and creditor nation of that era, prevailed.

It is therefore all-telling that the transformation of the ESM into the EMF is currently one of the most consensual eurozone reform proposals. Twenty-first century eurozone is adopting a solution envisioned in the first half of the twentieth century, and which was imposed by the creditor power of that time against the opinion of probably the most towering macroeconomist of all eras. The EMF would contribute to a qualitative changing of the inner character of the eurozone from an Economic and Monetary Union of (near) 'equals' towards a creditor-debtor club. The EMF would face numerous conflicts of interest since it would itself be a creditor of indebted eurozone member countries.

The main risk of this proposal is thus that the EMF would end up representing and defending the interests of creditor member countries and imposing harsh economic and fiscal policy measures on debtor member countries. The new EMF role as supreme arbiter of member countries fiscal policies would mean that national democracies would be further hollowed out, as elected governments would be unable to control or to change national fiscal policies. Seen in this light, the EMF does not seem a step for the better nor does it appear as an institution that will increase the eurozone resilience or ability to respond to asymmetric economic shocks. Instead, it seems to us, it will likely result in the implementation of very restrictive fiscal policies in countries affected by crises that will increase economic and social strains and in time lead or contribute to the disintegration of the eurozone. In fact, some authors suggest that the political

tensions that we observed, for example, in the UK with Brexit and in Catalonia, are in some part the expression of dissatisfaction with the austerity policy that was implemented in response to the 2010-2012 euro crisis, which the EMF would likely pursue to a greater extent.

Surely twenty-first century eurozone economists and policy makers can do much better than imitate a second-best twentieth century design?

Three arguments against a deepening of the Banking Union

What should we then think of the second nearly consensual eurozone reform proposal to deepen the Banking Union? As is well known, the term Banking Union comprises a set of European laws (Regulations and Directives), including a new Intergovernmental Agreement on the Transfer and Mutualisation of Contributions to the Single Resolution Fund, which entered into force on the 1 January 2016. The manifest aim of this new legal institutional expansion of European competences is to harmonise banking legislation and regulation across the European Union, and particularly for eurozone member countries, as well as the transfer of banking sector supervisory and regulatory powers from member countries to new European institutions.

It is not our aim to explain here in detail what is the Banking Union. One does not have to be a rocket scientist, or more to the case, an expert in banking and macroeconomics, to understand that a significantly different Banking Union should have been built simultaneously with the Economic and Monetary Union, within the Maastricht framework. The current endeavor comes too late, after the tragic consequences of the global financial crisis. In 2008 the European banks were completely vulnerable to the contagion chains coming from the USA and became themselves illness vectors of what would be later known as the 'sovereign debt crisis'. The absence of a true Banking Union in 2008 is another huge anecdotal piece of evidence exposing the significant weaknesses of the euro area design.

For us it is important now to help the public and the reader to look beyond the technical jargon and the somewhat populist arguments put forward in favour of the Banking Union.

Source: Single Supervisory Mechanism (SSM) of the ECB

A first non-stated rationale for the Banking Union was the need to avoid fiscal transfers between creditor and debtor countries to fund losses in the latter countries' banking

systems. Further, the Banking Union, it was argued, would, on the one hand, help break the so-called 'sovereign-bank nexus' that allegedly caused the eurozone 'sovereign debt crisis' and would, on the other hand, create a new single 'super-supervisor' with 'teeth' or 'muscles' which would be a more rigorous supervisor of the banking system and of national banking champions.

These three main arguments do not stand up to scrutiny.

First, it is often foolish to pursue economic reforms to achieve certain political objectives, namely because they may be impossible to achieve. Fiscal transfers continue to be a *taboo* topic in eurozone politics, but without fiscal transfers, every single eurozone member country would have to run, on average, a balanced or an in-surplus current account balance. To consider this unrealistic 'beggar-thy-neighbour' objective as a rational and sustainable goal is one of the key weaknesses of the Economic and Monetary Union architecture which remains unaddressed, this being also the root of the growing malaise with some of the EU trade partners, namely, the US. It is therefore misguided to design a Banking Union with the main aim of avoiding fiscal transfers between member countries, because such an objective has nothing to do with banking sector supervision and regulation and is really a political objective related to the architecture and functioning of the Eurozone as a whole. An objective that is in fact detrimental to banking sector supervision and regulation.

Second, 'muscles' ('power'), as is well known, are a poor substitute for merit, hard work or competence and it is surprising to find such a feeble and ideological metaphor in the public reasoning of the SSM to depict the motivation for its own role.

Third, the deeper reason why there was a 'sovereign-bank nexus' during the 2010-2012 balance of payment crisis of the eurozone lies in the fact that according to the articles 127 and 123 of the TFEU the overarching ECB policy objective is price stability. That is, by design, the ECB is *quasi*-limited to the role of fighting against inflation, fulfilling the almost utopian desire once voiced by Friedrich Hayek: 'I am (…) led to the firm conviction that a free economic system will never again work satisfactorily (…) ***unless the monopoly of the issue of money is taken from government*** (..) unless (..) the control of government over the supply of money is removed.'[2] In the eurozone the control over the 'issue of money' belongs by law (TFEU) overwhelmingly to the operations of the financial markets, which in the European landscape is a synonym for the banking system. So, given the fact the eurozone national governments depend for the funding of their debt entirely on financial markets it is no wonder that a eurozone member country balance of payments crisis would most surely rise and spill over in problems affecting both the banking and sovereign funding markets. It is therefore counterproductive and irrational, from a macroeconomic perspective, to break the 'sovereign-bank nexus', which is a symptomatic nexus rather than a causality nexus. Once again, behind what should be expected to be a solid rationale for the Banking Union we only find a biased statement, void of common sense.

It is further important to establish what have been the main concrete results of the Banking Union since 2014, because '*what you see is hardly ever what is said*'. And one should not be convinced by the positive sounding messages about a more robust banking system that emanate from the authorities, particularly from the Single Supervisory Mechanism (SSM) at the ECB.

[2] HAYEK, F. A., *Law, Legislation and Liberty. A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 3, *The Political Order of a Free People*, London and New York: Routledge [1979], 2003, p. 148.

The picture that emerges from the early years of the eurozone Banking Union is appalling. What we can observe as facts throughout the eurozone since 2014, is a succession of often nearly overnight resolutions, bailouts, liquidations, deposit *moratoria* and sales of small, medium and very large banks in various eurozone member countries, including Portugal, Greece, Spain, Italy, Germany, Latvia and Cyprus.

In 2017, in the year following the launch of the Single Resolution Mechanism (SRM), the world's second largest bank resolution process ever was implemented nearly overnight in Spain with Banco Popular being acquired for one euro by Santander, generating large losses for the private sector and likely large tax revenue losses for the Spanish Government.

Contrary to official statements, the banking system does not seem more robust than before. Small and large banks across the eurozone are always under the regulatory risk of being one bank run away from being declared 'likely to fail' by the SSM-SRM, irrespective of their capital levels. For example, the political crisis in Catalonia has put its former two largest banks under growing pressure.

These bank crisis episodes during the first years of the Banking Union's implementation have several disturbing features, the most important of which is that large amounts of public funds, tens of billions of euros, have been permanently lost nearly overnight. For example, 17 billion euros in Italy's rescue and sale of two small 'Veneto banks', an estimated 14 billion euros in the sale of the German regional savings bank HSH Nordbank, 8.8 billion euros in public cash and guarantees, which are likely to be fully exercised, in the case of Portugal's BES/Novo Banco. In a pattern where wisdom seems difficult to spot, the transactions derived from the SSM and SRM decisions occur very rapidly. The rescued banks are either given away or sold for relatively low amounts, and there seem to be very few bidders (buyers) involved. The process is associated with layoffs, with a reduction in the number of banks, with bank branch closures, and with a negative impact on economic activity.

We believe that, regarding the current status of the Banking Union, it is really a case of '*what you see is what you get*', and not '*what you get is what is said*' (by the authorities).

Thus, what do we see is the main result of the Banking Union?

We are aware of the complexity of the issues at stake. However, we shouldn't close our eyes to the actual transfer of billions or tens of billions of private and public funds, nearly overnight, with very little scrutiny, from one set of owners, often in the public sector, to powerful private sector interest groups in the eurozone. There is no other public policy in the eurozone in which so much public money is spent and changes hands so quickly and with so little accountability. In an age in which even the nature of bank activities is being challenged by new agile non-bank institutions, the goal driving the decisions of the SSM and the SRM seems to be the restauration at the European level of the fateful 'too big to fail' banks…

The eurozone is one of the wealthiest world economic areas and as such can afford to adopt unsustainable economic policies, such as the new EMF and the present-form Banking Union, during long periods of time. But it should be noted that these are unwise policies that if implemented (EMF) or maintained (Banking Union) will have large economic, political and social costs, significantly lowering the eurozone economic growth potential and the standard of living for its citizens. Policies such as these will

ultimately result in the deepening of new and older lines of political and economic division and disruptive tension within the eurozone and the EU, alienating even more the crucial citizens' support towards the whole idea of a peaceful, prosperous and sustainable European coming together. Thus, it is high time for the eurozone to fully use its intellectual power in designing and implementing new well-founded, well-balanced, and well-calibrated economic and political reforms. The momentum for reform shouldn't be wasted pursuing a path that leads nowhere!