



Seizing the Moment for Euro Area Reform

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The election of Emmanuel Macron as French President on May 7 gave renewed hope to proponents of the European integration project after the hammer blow of Brexit and fears about a sustained revival of populism. There is a momentum in Berlin and Paris now behind the belief that the euro is incomplete and cannot last without major reforms.

We share this view and we also want the single currency to succeed and bring back growth to the euro area. Make no mistake: Europe will inevitably be hit by a fresh economic crisis. We do not know whether this will happen in six weeks, six months or six years. But we fear the Euro-

pean Monetary Union (EMU) will be ill-prepared: too few of the structural weaknesses that triggered the last (and continuing) crisis have been addressed.

The European Commission will publish a reflection paper on the deepening of EMU at the end of May. Here is what we think should be in it: We set out below (and, in more detail, in a joint report²) our proposals for a staged but lasting and workable reform. This will be more comprehensive than the previous post-2008 effort that relied excessively on the European Central Bank doing “whatever it takes” to save the euro. European governments must step in, collectively and individually, to build a stronger euro. A revived and more effective EMU must be reconstructed on the basis of both structural reforms *and* investments. That way the euro can deliver stability, economic growth and political strength.

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² Henrik Enderlein, Enrico Letta *et al.* (2016). *Repair and Prepare: Growth and the Euro after Brexit*. Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris.

Our action plan in a nutshell

Building block 1: Design a first aid kit consisting of a reinforced European Stability Mechanism (ESM+), an enhanced Banking Union and better economic policy coordination under improved democratic control. We do not have to change the EU Treaties for that.

Building block 2: Combine a focused structural reform agenda with a comprehensive investment initiative. We should put a strong emphasis on what member states can do, rather than just shift powers to the euro-area level.

Building block 3: Base EMU on significant risk- and sovereignty-sharing within a coherent and legitimate framework of supranational economic governance. We should turn the ESM into a fully-fledged European Monetary Fund and strengthen parliamentary control to enhance European legitimacy.

Today Europe does not have a coherent strategy. It is not even *muddling through*, as often in past crises, when piecemeal solutions took the place of grand strategy but still contributed to further integration. The individual elements are not connected in a consistent manner and make for political instability. Our plan does not call for a European super-state or a transfer union. It sets out a pragmatic solution designed to protect the euro. Because, if the currency fails, the entire European integration project will be in danger. We cannot take that risk.

Do not focus exclusively on Brexit

The EU and the euro area especially cannot afford to focus exclusively on the challenge posed by Brexit, significant though that it is. Europe needs to protect its citizens by making sure that its economies perform well and the benefits of growth are shared by all. The common currency is an insufficient link in Europe's architecture. In any new crisis, international market participants might question Europe's determination to engage in true risk-sharing and sovereignty-sharing to overcome such a crisis.

Do not rely on the ECB alone

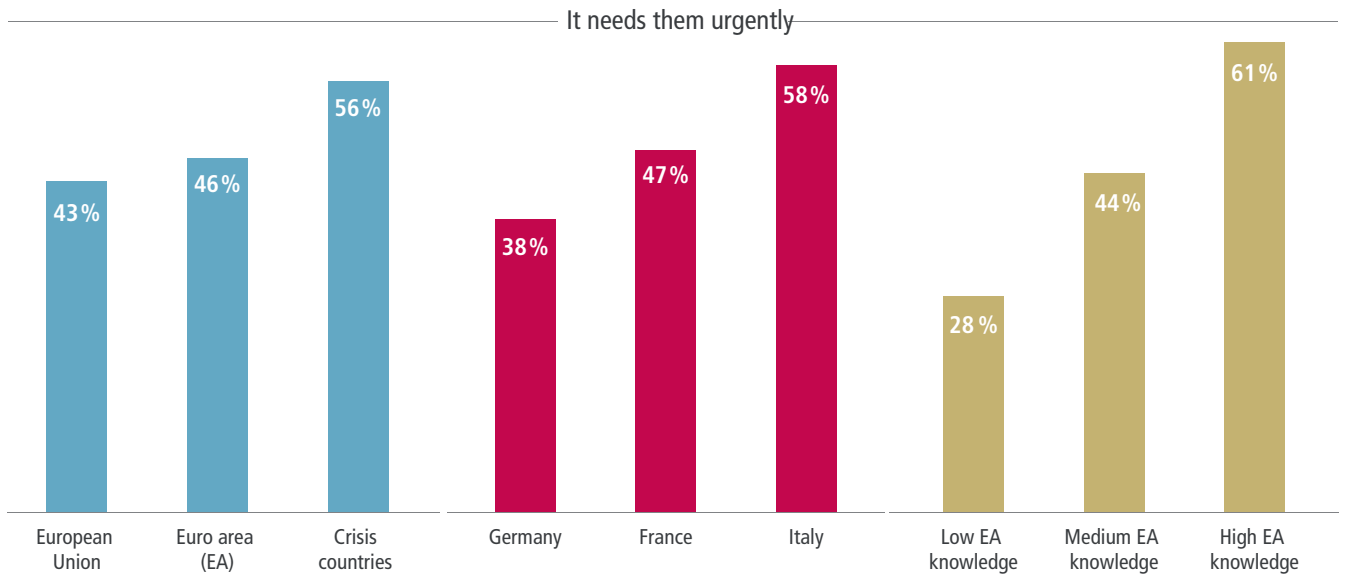
What ultimately stabilised the euro area during the crisis was central-bank action. Yet depending on the ECB alone is economically dangerous and politically unsustainable. Its policies are removed from democratic checks and public deliberation, even if they substitute for absent fiscal stimuli at national level. Consequently, many perceive the rescue measures to lack democratic legitimacy. In 2007, one out of two Europeans trusted the ECB. Today this has declined to one out of three.

Use the momentum for reform

Although confidence in European policy-making has declined, at least a third of citizens think there should be more solidarity among Eurozone countries and another third believe that even if everyone is responsible for their own actions, there should be solidarity in times of crisis. The election of the new French government opens a window of opportunity to reform the euro area. And European citizens want economic reforms.

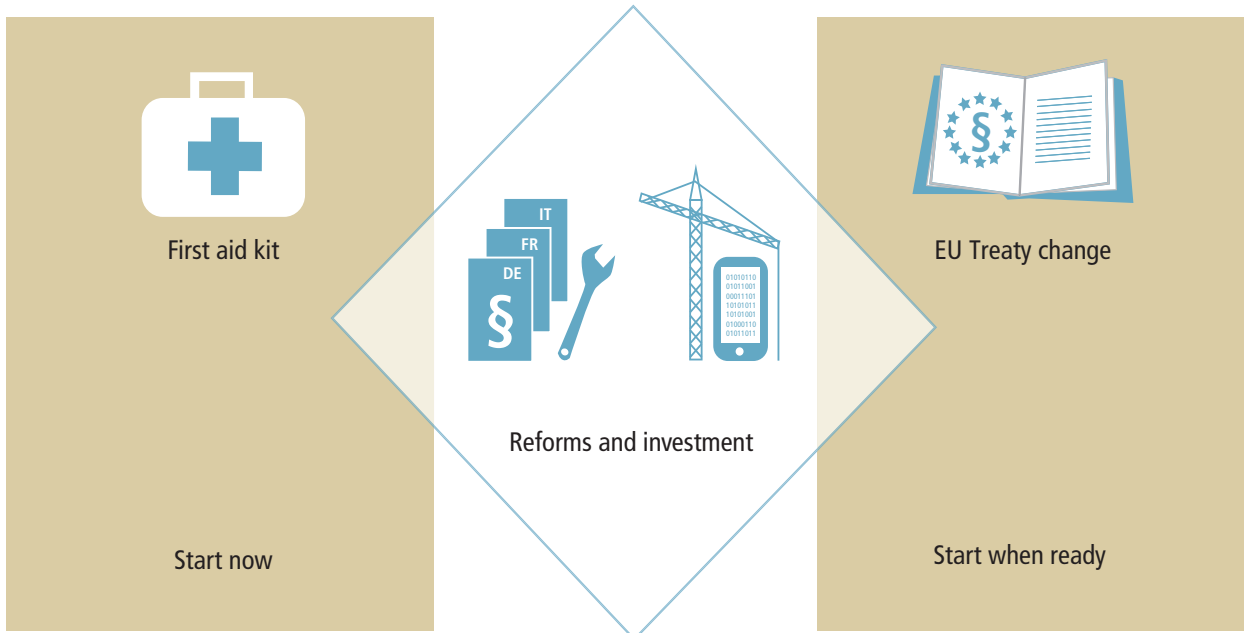
The euro may now not be in an immediate crisis but that does not mean we can declare it will be stable. Why wait for the next crisis to find out? It must be protected today. Brexit is yet another reason why Europe can no longer afford to keep taking ad hoc decisions on the euro. A credible strengthening of the single currency would be the proof that Europe can solve its challenges even in these difficult times. This would significantly enhance the credibility and resilience of the European integration project. A more robust EMU would not weaken its individual member states. On the contrary, it would strengthen their capacity to deliver the stability and prosperity that citizens are asking for. Let us repair EMU now and prepare it for whatever the future may bring.

Figure 1 To what extent, if at all, does the Eurozone need economic reforms to be politically and economically stable?



Notes: Crisis countries include Cyprus, Greece, Ireland, Italy, Portugal and Spain. Missing to 100 percent are "It would help but it's not critical", "It does not need any reforms", and "I don't know". Source: eupinions data April 2016, authors' calculations.

Figure 2 Three building blocks for protecting the euro



Source: Authors. Illustration: Cinthya Nataly Haas-Arana.

Our recommendations at a glance

We propose a comprehensive reform strategy for choosing and implementing the right euro-area reforms and restoring growth. We favour an intergovernmental approach as the right way to start the reform process with a limited sharing of risk and sovereignty. Our long-term goal is a monetary union based on a significant level of risk-sharing and sovereignty-sharing within a coherent and legitimate framework of supranational economic governance.

If a new crisis arrives, there will be no time to discuss possible solutions. Financial markets will react quickly. This is why Europe needs a first aid kit ready to use. Our kit contains quick fixes for the most dangerous weaknesses. This means relying less on ECB measures and more on a transparent sharing of risk and sovereignty.

In addition, convergence and growth should be nurtured from two sides: we need structural reforms to increase cyclical convergence and reduce macroeconomic imbalances – and we need investment to spur convergence and foster social cohesion for a better functioning of the euro area.

Ultimately, EMU would be best served with a significant level of risk-sharing and sovereignty-sharing within a coherent and legitimate framework of supranational economic governance. This is what we dub the ‘federal moment’, when crisis-fighting is left behind and replaced by a solid long-term framework designed to provide economic stability and democratic accountability for all EU citizens. It requires the treaty changes hinted at by Macron and Angela Merkel at their May 15 meeting in Berlin.

Building block 1: First aid kit

ESM+

- Transform the ESM into an ESM+ with a EUR 200 billion rapid-response facility
- Involve national parliaments directly in the scrutiny of ESM+ decisions
- Make the President of the Eurogroup the face of the ESM+
- Change the ESM Treaty, but do not change the EU Treaties

Banking Union

- Reduce risk in the national banking systems
- Create a mechanism for some risk-sharing among national deposit insurance schemes
- Introduce a backstop to the Single Resolution Fund

Economic policy coordination

- Renew convergence efforts
- Review fiscal rules
- Strengthen the role of the Eurogroup president
- Improve cooperation between the European Parliament and national parliaments in the European Semester



Building block 2: Reforms and investment

Choose structural reforms with clear guidelines in mind

- Ensure they have national ownership and fit into the common European agenda. Almost all countries lag behind when it comes to product-market and service-sector reforms
- Avoid reforms with high transitional costs, implement complementary reform packages and include a demand-side component. Compensating those who lose out because of reforms should not be an afterthought but a necessary ingredient of the package deal
- Implement product-market reforms and labourmarket reforms by paying attention to sequencing, and put more emphasis on sectors with large future growth potential in the Single Market as well as on skill-enhancing measures, which lead to higher employment and productivity

Launch a comprehensive public and private investment initiative

- Reduce regulatory uncertainty for cross-border investments
- Reduce risks for private investment with public guarantees
- Target public spending on productivity-enhancing investments and ensure that a reformed EU budget is geared to promoting investment and true European public goods

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Building block 3: That 'federal moment'

European Monetary Fund

- Convert the ESM+ into a true European Monetary Fund
- Create a euro finance minister under parliamentary control who bears the political responsibility for assistance programmes

Crisis prevention

- Introduce instruments to deal with debt: for example, combine a debt redemption fund with binding agreements on structural reforms and budget consolidation
- Transform the deposit reinsurance scheme proposed in the first building block into a European deposit insurance scheme with a common backstop

Convergence

- Turn the EU budget or the chosen fiscal capacity into a fully-fledged euro-area budget
- Add new instruments as counter-cyclical stabilisers to synchronize business cycles in the currency union

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This policy paper is based on

Henrik Enderlein, Enrico Letta, Jörg Asmussen, Laurence Boone, Aart De Geus, Pascal Lamy, Philippe Maystadt, Maria João Rodrigues, Gertrude Tumpel-Gugerell and António Vitorino (2016). *Repair and Prepare: Growth and the Euro after Brexit*, Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris.

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