CHALLENGE EUROPE

Challenges and new beginnings: Priorities for the EU's new leadership

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Strengthening the euro area

Daniela Schwarzer

The euro area

Since 2007, a series of acute crises have threatened the very existence of the euro area. The financial crisis which spilled into the currency union in 2007 was followed by an unexpectedly strong downturn of the real economy. As of 2010, the euro area was confronted with a severe sovereign debt and banking crisis.

Despite these troublesome developments, the euro area has proven to have a considerable degree of resilience. In each phase, governance weaknesses were revealed – and national governments together with the EU institutions have designed an impressive series of policy responses in crisis management and institutional innovation. The euro area today is completed by a banking union with a Single Supervisory and a Single Resolution Mechanism. National budgetary and economic policies are more closely overseen and coordinated. With the European Stability Mechanism, the euro area now has a permanent tool in place to manage sovereign liquidity crises and instabilities in the banking sector. Most importantly, the euro area's only true federal institution, the European Central Bank (ECB), has become its most effective crisis manager: with the announcement of its Outright Monetary Transactions (OMT) programme, the ECB finally managed to calm the self-fulfilling crisis in 2012. Meanwhile, the announcement of credit easing and quasi-quantitative easing in September 2014 is a move towards reducing financial fragmentation and countering deflation.

The euro area in 2014 is hence a lot different from the one in 2007. And yet, further challenges need to be overcome. Prevailing stagnation, fragmentation and problems of legitimacy require a rethink of policies and further governance reform.

Stagnation

Although sovereign debt markets have calmed down since summer 2012 and the euro area on average has finally emerged from recession, the economic situation in the euro area remains fragile. Economic growth rates, which for several years have varied significantly across Member States, now tend to converge, but at a low level.

The main challenge facing European and national leaders in the coming five years will be to return the troubled European economies to sustainable private sector-led growth and to fight unemployment, which has particularly affected the young generation in a number of crisis countries. Today, the social and political repercussions of years of crisis can be felt especially in those countries which underwent severe adjustment processes. Unemployment in the euro area is currently at around 12% – yet youth unemployment is close to 25% across the euro zone, and well over 50% in both Spain and Greece. Over five million young people under 25 were unemployed in the EU-28 area in July 2014. While current labour market adjustments like skills discrepancy and cyclical vacancies represent immediate

challenges for policymakers, demographic developments in the EU and skills shortage pose long-term challenges.

Strengthening growth and reducing unemployment are particularly challenging tasks in the euro area, where the tools for necessary adaptation processes are limited, as Member States no longer command national monetary and exchange rate policies. Meanwhile, the use of fiscal instruments is constrained by both the dire budgetary situations in a number of Member States, and the European surveillance and coordination mechanisms which, while enabling some flexibility to take into account national economic situations, still impose upper limits on deficits so as to enable a reduction of public debt levels over the medium term. European instruments designed to alleviate the social repercussions of the crisis have been created, but are currently underused.

Following a Finnish policy model, the European Commission is advocating all Member States to introduce youth guarantees to drastically improve school-to-work transitions and financial and administrative measures to immediately support job opportunities for young people. The European Social Fund (ESF) will provide more than 10 billion each year in the 2014-2020 period, as there is no or little money for such measures at the national level in the countries affected most by the crisis. A wide array of persisting barriers, such as delay in presenting the required operational programs by governments, a lack of awareness and still insufficient funds have so far delivered disappointing results, with only France and Italy participating one year after the programme's adoption.

While labour mobility has traditionally been significantly lower in the EU than in the United States, many EU Member States have demonstrated a greater responsiveness and stronger migration reaction to the current unemployment shock. More policy action in addition to the EURES mobility platform will be required to further remove obstacles to intra-EU labour mobility.

Fragmentation

Closely linked to the ongoing stagnation in the euro area is an increasing fragmentation of the monetary union. There are several dimensions to this which will be discussed subsequently: firstly, the North-South-divide which is most frequently attributed to varying levels of competitiveness, but is actually underpinned by deep running variations in political, administrative and civic cultures; secondly, increasing social inequality and the questioning of the social contract both within Member States and on the EU level; and, thirdly, financial fragmentation within the currency union. Moreover, fragmentation may occur between the euro area and the non-members, some of which are actually on the verge of disintegrating.

Since 2010, the euro area has rhetorically been divided into a "core" of countries which were not struck by liquidity problems and a "periphery" of crisis countries, a phenomenon that is also often referred to as a new "North-South divide" within the euro area. The two groups are visibly distinct because of substantial divergence in growth and underlying competitiveness, sustainability of public finances and employment. For instance, the gap between the

countries with the highest and lowest jobless rates for young people is extremely high, with about 45 percentage points between Germany (the lowest at 7.8% in July 2014) and Spain (the highest, at 53.8% in July 2014).

The North-South divide has been explained by structural economic factors. Recently, variations in political and administrative culture, governance approaches, and civic self-understanding and trust have been emphasised as relevant to explain the slow-down of the catch-up process. One conclusion from the insight in the institutional and socio-political underpinnings of the North-South-divide is that the path to convergence will be longer and both financially and politically more costly than initially may have been assumed. The adaptation processes that societies, political and bureaucratic systems and elites will have to undergo on top of the structural reforms of economies and labour markets encounter more obstacles than initially expected, in particular as those who would lose in the necessary reform and adaptation processes can hardly be paid off.

For policymaking in the euro area, the continuing divergence between crisis and non-crisis countries has further estranged the positions of Germany and a small group of Nordic countries from those of Southern European countries – both on short-term measures to foster growth and with regard to the differing visions of the future euro area held. Yet there is room for compromise. In terms of debt and deficit reduction, as well as structural reforms, some Southern countries have become slightly more similar to the Nordic ones. At the same time, there have been some moves by Northern countries that, to a small degree, contribute to a more symmetric rebalancing of the euro area. One example is Germany's recent introduction of a minimum wage.

It will take some time, and possibly another crisis, to make governments and citizens in those Member States that currently fair best in terms of economic and financial stability realise an important point: the euro area with one currency, one economy, and one financial market has made national states vulnerable, but instruments and mechanisms on the European level can ensure macroeconomic stability and help to alleviate asymmetric shocks. This approach, over time, would be to the benefit of all Member States. As the costs and benefits in the short term (for instance, from now to five years into the future) will be very unevenly distributed, a long-term vision is therefore necessary if the euro is to stay together. What is needed to move forward is a set of instruments that encourage growth and crisis resilience of the euro area and establishing a larger degree of mutual insurance. Part of this is achieved with banking union, other parts could take the form of a European unemployment scheme and European bond issuance. Participation in the mutual insurance mechanisms should be conditional on far-reaching domestic reforms. If this happens and structures between Member States actually converge, then more solidarity, insurance, and joint liability may be acceptable to the 'strong' Member States.

Fragmentation also occurs within societies – a phenomenon mostly felt in the crises countries. Inequality in Europe has risen substantially since the mid-1980s. While the enlargement process has added to this, large income gains among top earners have been a main driver that also increased inequality in the euro area. 4% of all the EU population (over 120 million people) live in or in risk of poverty.

In a number of nation states, the intergenerational contract no longer holds: the younger generations can no longer assume to be as well or better off than their parents – given the costs of longevity, record levels of youth unemployment and the failure to adapt education systems to tomorrow's needs. Moreover, governments can no longer maintain previously unchallenged levels of welfare provision. With a shrinking redistributive capacity and rising costs, for instance in health systems and unemployment schemes, the social contract across social classes or groups is challenged and has already put the intra-societal notion of solidarity to a serious test. In particular citizens in Member States which are going through severe adaptation processes have little reason to believe in mutual insurance mechanisms which in the past were at the heart of social systems and enabled and maintained social peace and political stability in post-War Western Europe. This is an important background to the fact that national opinion leaders have more and more difficulty to argue for intra-European solidarity mechanisms.

Reducing the social cost of the crisis therefore remains a key immediate challenge for policy makers. Improving social inclusion in Europe and reducing regional disparities through stimulating private sector-led growth in areas where incomes are relatively low remains a key policy challenge for the EU and its Member States.

The fragmentation of financial markets complicates this task further. Despite ECB actions to alleviate the situation in crisis countries such as Greece, Portugal, Ireland, and Spain, corporate borrowing rates still vary decisively, pointing to inefficiencies in the European financial market. While the OMT-programme announcement by the ECB could effectively stabilise interest on sovereign and large corporate bonds again, spreads for SMEs are still divergent. To a certain extent, structural differences and internal adjustment processes explain the reluctance of banks to increase lending within economies where capital allocation proved to be inefficient, fueling asset price bubbles and unsustainable investments. Nonetheless, a key factor for restrictive lending to small firms in Southern European countries is a bottleneck in the financial sector. Due to the ongoing deleveraging in the financial sector of Southern European countries like Italy and Spain, many banks reduce risky assets like loans as long as their profitability is impaired by rising ratio of defaulting loans.

Another important reason is the upcoming conclusion of the Asset-Quality Review (AQR) by the ECB in October 2014 that will present banks' capabilities to fulfill the new equity capital standards of BASEL III introduced in January 2014. As falling back on alternative sources of finance is not an option for many SMEs, the bottleneck in the financial sector has caused a significant private investment gap, contributing to sluggish growth and prolonging unemployment. The SME sector plays a vital role for employment and growth, especially in the compartmentalised structures of Southern European economies where they account for four in every five jobs on average.

The challenge for the European Union is to reduce these growth inhibitors in the financial sector faster and more effectively than through the slow process of structural reforms, before the operational completion of the banking union. Due to the deflationary pressure which

crisis countries increasingly experience, short-term measures have become necessary, as they create instant relief for banks and increase lending to the real economy. In the past, the vagueness of purpose of monetary tools has triggered moral hazard behaviour, for instance causing the sovereign bank nexus. Against this background, European policymakers should appreciate the plans of the ECB to expand its balance sheet with targeted purchases of securitised corporate and consumer loans from banks. While these measures would represent an improvement of banks' balance sheets, the expected increase in corporate lending and SME investments could provide a much needed cyclical stimulus to stagnating euro zone economies.

Another line of fragmentation may in the future deepen between the euro area and the non-euro area Member States. In the years 2010 to 2013, the euro area has become more integrated, both institutionally and procedurally. Closer budgetary and economic policy coordination, the creation of the financial insurance mechanism ESM, a more active and stronger role for the ECB entailing a higher degree of risk sharing, and close political cooperation in crisis management through the regularly meeting of euro area summits have given rise to the concern that a decoupling of the euro area core from the non-members may eventually take place. The political challenge is hence also to bridge this divide effectively as the return of private sector driven growth to the euro area will be made even more difficult if political divisions among the 28 EU members increase and prevent necessary steps to complete the single market, in particular in the field of the digital economy and services.

Reduced legitimacy

The dire economic situation, the high unemployment rates and the inability or unwillingness of the established political parties to effectively manage the debate on European integration by providing a strong and contemporary pro-European narrative, have given rise to eurosceptics. Anti-EU and anti-establishment movements scored high in the May 2014 European elections in a number of EU Member States. An unparalleled number of seats in the European Parliament are occupied by representatives of anti-establishment movements since, but it is not in the EU institutions that this electoral result will most be felt. The new strength of 'EU-critical' movements will impact most strongly on the national level, even if they are not part of government coalitions.

If anti-establishment movements and EU critics gain additional ground in domestic debates, then structural reforms and budgetary consolidation measures, along with further-reaching reforms of the institutions of the European Union and/or the euro zone, will become even harder to implement. Accordingly, this will have a negative impact on national governments' willingness and ability to take a proactive stance on EU affairs and projects like the Transatlantic Trade and Investment Partnership (TTIP) which are of a strategic importance to Europe. Many national debates, including in the UK, today are characterised by an EU criticism with strong anti-globalisation undercurrents.

Political leaders who believe in the merits of European integration need to trigger a substantial debate on EU reform and to improve the domestic conditions for sounder

economic development throughout the EU. Meanwhile, the long-term consequences for those societies and economies in which half of the young labour force will not find a job in the foreseeable future need to be publicly discussed, as action that would fully measure the effects of daunting social and economic challenge has not yet been taken.

Moreover, decision-making structures in the euro area need to be scrutinised. Given the potentially destabilising effects of financial and economic openness, the euro area poses a particular challenge to its Member States. Governments' ability to control economic developments in their home countries is limited as they have given up monetary policy and exchange rates as the powerful instruments of macroeconomic policy making. As there is no euro area fiscal capacity, or European economic and labour policies, macroeconomic policy developments are no longer a matter of democratic political choice, but a more or less random result accumulating national policy choices which do not usually take into account their contribution to overall macroeconomic stability and potential negative spill-overs. Moreover, capital mobility in the monetary union has increased the pressure on governments to improve price competitiveness. Monetary union and financial integration have created a bias towards supply-sided policies in order to attract investments and corporations. These new constraints were hidden until 2010 as less competitive and less fiscally sound countries benefitted from low interest rates. Today, all governments of euro area Member States face narrower policy options, in particular when it comes to impacting growth and employment in their home country.

In addition to these constraints on potential "output legitimacy", the European economic governance structures are flawed on the input side. It can hardly be argued that citizens' vote today impact macroeconomic policy choices. This problem is amplified by the rule-based, rather technocratic coordination of national budgetary and economic policy, which, in particular when it leads to the enshrining of certain policy goals into law or even constitutions, weakens the ability of democracies to self-correct.

Outlook

Europe's foremost and urgent challenge is to overcome the stalling of economic growth. A robust economic recovery is necessary to help Europe tackle the social and political challenges societies are facing and the reduction of the sovereign debt burden. Any promising path to economic recovery led by private-sector growth will have to combine measures that ensure accessible and cheap credit, in particular for small and medium sized companies in regions struck by the crisis, structural reforms that release growth potential both in deficit and surplus countries, investment in education and mobility, and finally a better macroeconomic policy mix. In the long run, it is unlikely that economic prosperity can be achieved without improving the decision-making mechanisms of the euro area.

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