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FOR EUROPE  
MAGAZINE



**MARCELLO MESSORI**

## SHARING RISKS, RESTORING TRUST

04.11.2015

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China's difficult transition from an economy founded on a bloated, sprawling public financial sector and excessive weight of investment in manufacturing and infrastructure relative to GDP, to a more decentralised economic model (supported by the domestic consumption of a nascent middle class), has heightened volatility on global equity markets and dampened the growth prospects of the main economic areas. These consequences risk being especially grave for the European Economic and Monetary Union (EMU).

### IN BRIEF

- *China's transition to a decentralised economic model is producing grave consequences for the European Economic and Monetary Union*

- ***There is a substantial risk that the current low growth in Europe will be confirmed in the second half of 2015 as well***
- ***Putting the EMU economy back on the path of growth requires a European public-private partnership for funding and making investments***

In the last six years, despite belonging to one of the world's wealthiest areas with the highest potential output, anaemic growth rates in most EMU countries have been based on increased net exports to markets outside the eurozone rather than on the components of aggregate demand in the **European internal market**.

Indeed, at the end of 2014 the EMU's total surplus in its current account balance exceeded 3 per cent of the area's Gross Domestic Product (GDP), while Germany's corresponding surplus was equal to almost 8 per cent of its own GDP mostly thanks to net exports to China and to other non-euro countries.

Between the end of 2014 and early 2015, there were **signs of a potentially robust economic recovery in the EMU** owing to an unusual mix of factors: low nominal interest rates and expectations of an abundant injection of liquidity following 'signals' that the ECB was about to launch a programme of quantitative easing (QE) centred not only on purchases of corporate bonds and asset backed securities (ABSs) with a low-risk profile (the so-called QE1, implemented in October 2014) but mostly on purchases of bonds issued by Member states and European institutions (the so-called QE2); the consequent sharp depreciation of the euro against the main international currencies and, in particular, the US dollar; the decline in the prices of many raw materials and of oil especially; the narrowing of China's surplus in its trade balance.

These factors promised to lend further impetus to the expansion of net European exports to the rest of the world. Today, China's woes and the probable reshaping (or deferral) of the increase in the policy interest rate by the Federal Reserve instead risk creating tensions on currency markets and slowing international demand for goods and services.

The prospects for a robust recovery in the EMU had already begun to dim in the first half of 2015, owing to the lack of reaction of a number of 'peripheral' economies and some 'central' ones (France and Finland) to favourable

external stimuli and, above all, to the Greek crisis's transformation into a serious threat to the very integrity and survival of monetary union.

Indeed, after recording modest growth in the first quarter of 2015, the average variation in the euro area's GDP in the second quarter remained positive but fell short of expectations in both quarters.

Given that the Greek economy is expected to face further serious setbacks in the late autumn/winter, there is a substantial risk that the current low growth in Europe will be confirmed in the second half of 2015 as well.

These initial considerations show that after the 'real' negative impact of the 2008-2009 international financial crisis and the prolonged recession from the second quarter of 2011 to the first quarter of 2013, EMU has yet to regain the path of solid economic recovery.

In particular, for most of the 'peripheral' Member states the last eight years has alternated periods of crisis and of stagnation so that income streams and employment levels are still well below 2007 levels; moreover, for these same States the reabsorption of their negative current account imbalances was mainly based on economic repression and wage cuts.

**As the extreme case of Greece highlights**, macroeconomic adjustments in the euro area have therefore come at a high social cost without resolving one of the disequilibria considered fundamental according to EMU rules i.e. keeping government debt-to-GDP below 60 per cent.

The result is that gaps in competitiveness and growth potential between the stronger 'central' economies and the 'peripheral' Member states have widened, while the latter continue to have limited room for manoeuvre for expansionary fiscal policies and for financing investment.

It follows that in order to tackle the weaknesses and return to a path of long-term growth in the EMU, the conditions must be created to narrow the competitiveness gaps between Member states' economies and to build the institutions needed to unify fiscal policies and to construct a single euro-area balance sheet.

The recipe, which can push in this direction and which ought to result in some form of political union is, for the most part, the one set out in the Report entitled *Completing Europe's Economic and Monetary Union*, drawn up by the President of the European Commission in close concert with the Presidents of the four other leading European institutions (European Council/EuroSummit, Eurogroup, ECB, and European Parliament).

This document, however, has the defect of underestimating the urgency of the measures that must be taken and the linkages involved; above all, it fails to address the crucial problem of the compatibility between EMU as it is now is and the translatability of the recommendations into concrete action.

In this respect there is little room for optimism. **The temporary 'solution' to the Greek crisis**, which began to take shape in mid-July 2015 with Tsipras's capitulation to the harsh conditions imposed by the European Council and Eurogroup in return for a financing program of €86 billion for Greece, subsequently hammered out in the more detailed agreement of mid-August, has left a dual negative legacy: (i) deep and mutual distrust among the governments of the Member states and weakening of EU institutions; (ii) the perception that monetary union is, in fact, reversible, and accordingly risks being downgraded to a rigid fixed exchange rate regime which would become vulnerable in the event of sufficiently strong exogenous shocks.

To begin the process of strengthening and furthering EMU, it is therefore vital that these two points be addressed. This requires that the 'peripheral' and 'central' economies in difficulty begin to adopt the reforms needed to boost the competitiveness of their economies and that the remaining 'central' countries, in addition to pushing ahead with the appropriate reforms for their internal problems, endorse European initiatives to support short and medium-term growth in the euro area.

Without an expansion of employment and income, it will be very difficult to carry out the structural reforms that almost invariably entail social costs for a portion of the population. On the other hand, without **far-reaching reforms** in the weakest countries it will be very difficult to separate European initiatives for growth from the proposals for that 'Union of transfers' which is unthinkable in the current climate of suspicion.

As we saw earlier, most 'peripheral' countries and a number of the 'central' economies of the EMU have little leeway to support aggregate domestic demand given that they must continue to adjust their public finances and unblock their financial sectors. Moreover, in many of these countries, alternate phases of stagnation and recession have compressed the private components of such demand.

Finally, even the expansionary effects of the ECB's non-conventional monetary policy are being dulled by the tensions between the major global currencies exacerbated by China's difficulties.

On the other hand, the implementation of reforms to boost competitiveness has positive but indirect effects on growth that are seen only in the medium term; and net exports cannot be the driving force behind the expansion

of one of the richest areas in the world, without the resulting 'exportation of deflation' unleashing severe currency tensions.

It is therefore unrealistic to imagine that individual Member states of the EMU, the 'peripheral' ones especially, will be able to launch autonomous and effective initiatives for economic growth. Putting the EMU economy back on the path of growth requires a European public-private partnership for funding and making investments.

A similar initiative, which could be modelled on the [Juncker Plan](#) but would require much greater resources, would present a double advantage: in the short term, the right amount of investment could reboot aggregate demand and growth in the single market; in the medium-long term, carefully selected investments could strengthen [supply-side competitiveness and support structural growth](#) in the area as a whole.

The more asymmetrical the European investment plan is in the sense of favouring the 'peripheral' or struggling 'central' economies, the greater the probability of achieving this second advantage, with the added effect of narrowing the competitiveness gaps within the EMU. In other words, the European institutions that must decide which investments to finance and implement based on the projects submitted by the individual member states (for example, the European Investment Bank according to the procedures already set out in the Juncker Plan) should favour initiatives which come from the 'peripheral' and 'central' countries with low growth and which have the best prospects for raising productivity.

This kind of asymmetry, however, risks reproducing in a different guise the problem of the 'transfer Union', which is impossible to activate without mutual trust among the Member states. To sidestep this problem it ought to be sufficient to make the plan conditional on a 'contractual arrangement' between the European institutions and the beneficiary countries.

In order to qualify those countries would therefore have to agree on a sufficiently large set of reforms for boosting competitiveness and accept European monitoring and controls on the actual implementation of these reforms at every stage.

Moreover, in addition to affecting rent-seeking positions and entailing social costs, it is clear that major reforms can often have a short-term negative impact on the public balance sheet. Therefore if the countries involved were subjected to severe budgetary policy adjustments for excessive deficits or public debts, the 'contractual arrangement' could also include a review of their fiscal programmes.

Based on the procedures set out by the 'European Semester' and reinforced by the 'Two Pack', and availing of the flexibility granted by the European Commission in January 2015 ([see the Communication](#)), each of the countries committed to onerous reforms for competitiveness could agree a multi-year plan for managing their own public finances in a way that was compatible with both the reform effort and with a credible but not overly short-term adjustment.

In this last respect, the country would have to submit to a 'double check', requesting a guarantee on its debt from one of the European institutions with adequate resources to act as an insurer of 'last resort' (such as the European Stability Mechanism).

If successful, these processes would have at least two consequences: (a) they would trigger stable growth and narrow competitiveness gaps across the euro area; (b) at the same time, they would result in a gradual transfer of national sovereignty and strengthen the hand of European institutions on fiscal policy.

Outcomes (a) and (b) could in turn produce three even more significant effects: the various contractual and insurance arrangements and the relevant cross checks should forge new ties between European institutions and Member states sufficient for restoring mutual trust; the reduction of internal divisions should pave the way for economic growth capable of exploiting the productive specificities of the individual Member states without creating unmanageable macroeconomic imbalances; the progressive centralisation of fiscal policies should act as a spur towards a single fiscal policy for the EMU.

If they materialised these effects would come close to achieving the objectives of economic and fiscal union, evoked in the document drawn up by the five Presidents but overly vague with respect to their actual implementation. This would open the way to no longer just a monetary but also a fiscal union.

The relations of mutual trust and risk sharing among Member states would stop being unresolved issues and become instead bipartisan components of a process of convergence towards a genuine economic union.

This economic union, however, can only come about within a political union. It is worth recalling that the crucial principles of representation and legitimisation, which must characterise EMU institutions and which are not dealt with in this article because they cannot be reduced to a mere economic discourse, are instead essential preconditions for a complete fiscal and budgetary union; at the same time, these preconditions can be satisfied only within a political union.

*Translated by Alice Chambers*

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