



EPC PAPER

25 years after Maastricht: defending the euro's political core

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25 years ago, the Maastricht Treaty set the objective to establish an Economic and Monetary Union (EMU). From the Werner Report (1970), which represented the first concrete proposal for a monetary union, to the recently published Five Presidents' Report (2015) setting out a new roadmap towards a deeper EMU with the aim of "creating a better and fairer life for all its citizens", the history of the common currency fully captures the spirit of European integration. First aimed at reducing barriers to trade on the continent, the euro has over the years become the European Union's core integration project. But what has been achieved in the last two decades? What role did the euro play and how did it develop since the outbreak of the financial and economic crisis? And how can EMU objectives be reconsidered in what can be described as a 'post-growth environment'?

The 'euro-area crisis' has taught some insightful lessons on how to improve the resilience of the common currency and thus, ultimately, of the European Union. Short- and long-term developments as well as the evolving expectations of European citizens need to be considered to help define new objectives for the EMU, in a difficult political climate for EU integration.

I. The long path towards the common currency

The history of the common European currency has come a long way – with many ups and downs. The idea of a monetary union goes back to the end of the 1960's. It was a response to the growing dysfunctions of the fixed exchange rate system introduced by the Bretton Woods agreements. In 1970, the Werner Report brought forward first concrete proposals including the ultimate aim of a common currency. However, the original system rapidly proved too rigid and the single currency band ("snake in the tunnel") was finally abandoned. The project restarted again at the end of the 1970's when France and Germany, led by President Valéry Giscard d'Estaing and Chancellor Helmut Schmidt,

initiated the creation of the European Monetary System (EMS) based on a fixed Exchange Rate Mechanism (ERM).

But it took member states another thirteen years to reach the next level. At the Maastricht Summit of 9 and 10 December 1991, member states agreed to establish the European (Monetary) Union and to coordinate their economic policies and accept to be subject to multilateral surveillance and to financial and budgetary discipline. The euro construction was the result of a compromise between different schools of thoughts: on one hand, the German ordo-liberal tradition for which the common currency is based on the acceptance and obedience of common rules aimed at ensuring a healthy environment for the market economy to prosper; on the other, the French Keynesian perspective for which the currency is an essential instrument of macro-economic policy.

The euro has brought and continues to bring numerous benefits to its members. The common currency reduced transaction costs and barriers to trade, hence it was the logical consequence of the Single Market. It put an end to the uncertainty of volatile exchange rate and damaging 'beggar thy neighbour' policies, such as those aiming at "exporting unemployment" through devaluation.¹ The gradual expansion of the eurozone to now 19 members proves that the common currency has been an attractive instrument to achieve both economic and political objectives.

However, the history of the euro also shows that the common currency has always been the outcome of a political compromise and some scholars had early-on in the process warned policymakers against some of the shortcomings of the euro construction. Critics highlighted that the eurozone economies did not achieve a sufficient level of economic convergence and did not provide for sufficient mechanisms and adequate instruments to respond to so-called asymmetric shocks or shocks whereby a member state's economy would be impacted in a different manner than its counterparts. The financial and economic crisis revealed the fundamental flaws of a fully-fledged monetary union without an equally strong economic and political union. The impact of the crisis certainly pushed the EU and its governments to address some of these issues, but it also revealed the fragility of the system.

II. The crisis reveals EMU's shortcomings

The financial and banking crisis put an end to the political optimism provided by the euro adoption. Following the collapse of Lehman Brothers in 2008, the EU faced the biggest economic crisis since the Great Depression of the 1930s. This crisis involved a number of highly complex, multi-rooted and interlinked sub-crises, including a banking crisis, a public-debt crisis, a private debt crisis, a

¹ Bénassy-Quéré, Agnès and Coeuré, Benoit (2010), *Economie de l'euro*, Paris: Collection Repères, Editions La Découverte.

competitiveness crisis, a growth and investment crisis, a social and employment crisis, an institutional crisis, and ultimately, a political crisis.²

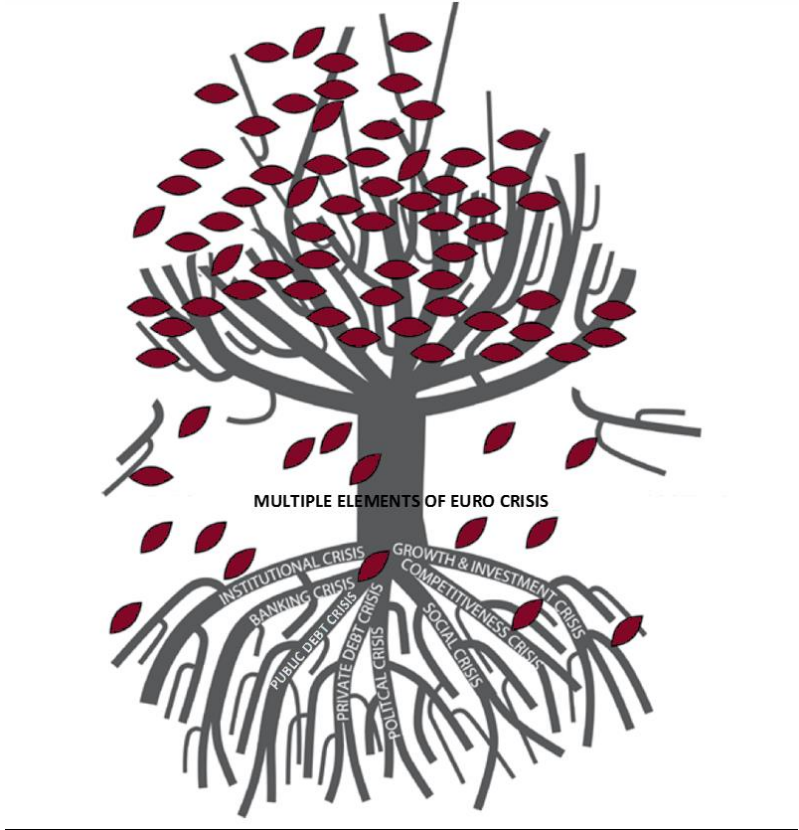


Figure 1 - multi-rooted crisis

In this context, Europe's response – both at the EU level and from its member states – proved unable to prevent a government debt crisis in one of its smaller member states to spread to other EU countries. Un-coordinated, insufficient, and often too slow responses put the integrity of the common currency at risk. But the crisis also revealed that EMU lacked the necessary institutional structures, procedures, rules, and instruments to prevent such a crisis from beginning, spreading and deepening.³

The crisis has pushed the EU and its members to acknowledge and address some of these shortcomings. Some remarkable progress has been achieved to preserve the common currency. The eurozone and its members have proved their commitment to preserving the EMU's integrity by engaging into substantial bailout programmes for Greece, Ireland, Portugal, and Cyprus. They also

² Emmanouilidis, Janis A. (rapporteur) (2014), *Towards a New Pact for Europe*, second report of the New Pact for Europe project, available at: http://www.newpactforeurope.eu/documents/new_pact_for_europe_2nd_report.pdf (last accessed on: 15 October 2016).

³ Ibid.

agreed to a partial write-off of Greek debt and created two multi-hundred-billion-euro rescue mechanisms, the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). Some members have witnessed unprecedented fiscal consolidation efforts, accompanied by deep and painful structural reforms, in order to maintain their membership in the common currency. The EMU has seen its governance strengthened by a reformed Stability and Growth Pact (based on the so-called 'Six-Pack' and 'Two Pack'), new instruments of economic and fiscal coordination (including the European Semester), and the creation of an annual system of macroeconomic surveillance aiming at assessing macro-economic imbalances and vulnerabilities. On the financial side, important steps have also been achieved with the European Central Bank (ECB) supporting the sovereign debt market and providing liquidity lines to the banking system. Finally, the creation of a limited banking union including a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM), backed by a Single Resolution Fund, could prove an important step in increasing the resilience of the eurozone.⁴

However, despite all efforts to save the common currency, the EMU remains fragile as some of its underlying challenges remain unresolved. Though some scholars had predicted that the convergence of EU economies would be fostered by increasing trade relationships between members as a result of the euro,⁵ this theory seems to have failed to materialise empirically.⁶ Divergence remains an important issue both geographically – as the EMU remains divided between North-South and East-West asymmetries – and socially with (youth) unemployment levels reaching very high or even extreme levels in certain member states. The increasing discrepancy in development and inequality levels within and between countries – emphasised by the increasing use of financial instruments in the EU budget⁷ – has impacted Europe's social cohesion. Social problems in some member states have also generated economic spill-over effects on other members (e.g. falling demand), which promise to have a negative impact on human capital and Europe's competitiveness.⁸

⁴ Emmanouilidis, Janis A. and Zuleeg, Fabian (2016), *EU@60 – Countering a regressive and illiberal Europe*, European Policy Centre, available at: http://www.epc.eu/pub_details.php?cat_id=1&pub_id=7020 (last accessed 12 November 2016).

⁵ Frankel, Jeffrey A. and Rose, Andrew K., (1996), "The Endogeneity of the Optimum Currency Area Criteria", *NBER Working Paper* No. 5700, available at: <http://www.nber.org/papers/w5700> (last accessed 12 November 2016).

⁶ Bak, Henryk and Maciejewski, Sebastian (2015), "Asymmetric shocks and international risk sharing in the European Monetary Union and the European Union", *Bank i Kredyt*, vol. 46, issue 6, pp. 523-564, available at: http://econpapers.repec.org/article/nbpnbpbik/v_3a46_3ay_3a2015_3ai_3a6_3ap_3a523-564.htm (last accessed 12 November 2016).

⁷ Huguenot-Noël, Robin and Zuleeg, Fabian (2016), "Rethinking the EU's investment strategy: EFSI 2.0 needs a Social Pillar to address economic insecurity", *EPC Commentary*, European Policy Centre, available at: http://www.epc.eu/pub_details.php?cat_id=4&pub_id=7175&year=2016 (last accessed 12 November 2016).

⁸ Andor, Lázló (2014), "Social Europe. Can the EU again improve people's life prospects?", *Challenge Europe – Challenges and new beginnings: Priorities for the EU's new leadership*, European Policy Centre, September

Remaining economic imbalances also threaten the resilience of the EMU. Recent speculations about the possible failings of German or Italian banks and the potential impact of political turmoil in individual (key) member states indicate that the risk of a re-escalation of crisis affecting the stability of the common currency cannot be excluded. Despite some improvements after the crisis, nonperforming loans are already reaching worrying levels in some member states (see figure 2). Monitoring the development of banks' nonperforming loans (NPLs) and ensuring that banks meet the capital requirements is therefore critical.

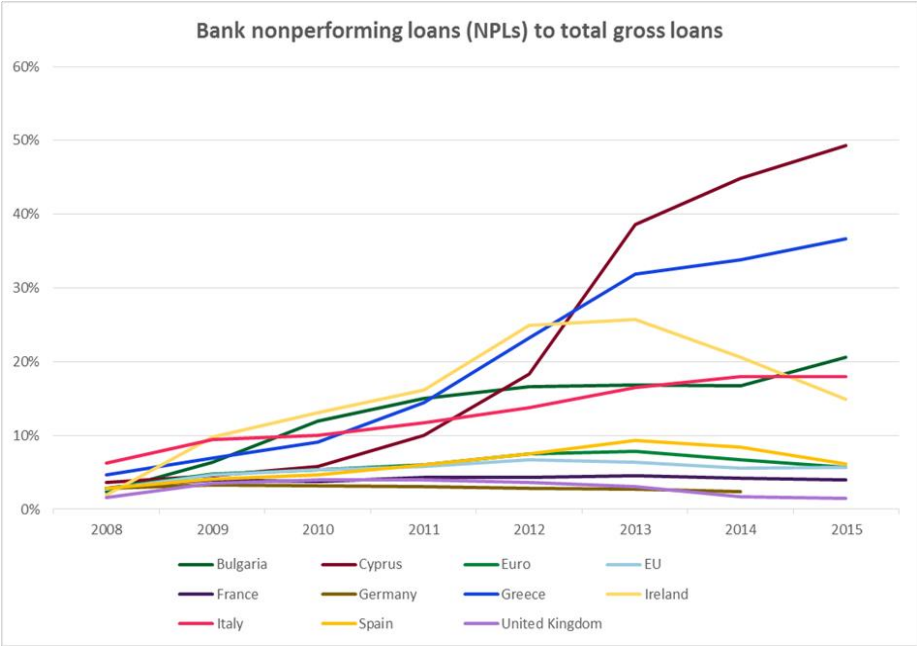


Figure 2 - Bank nonperforming loans (NPLs) to total gross loans⁹

The severe debt overhang – both in the public and the private sector – and the increasing share of countries with excessive macroeconomic imbalances are of particular concern. As long as the so-called “nexus” between banks and sovereigns – i.e. the vicious circle between banks weakening public finances and *vice versa* – has not been eliminated, the euro will remain exposed to financial markets speculation. The absence of any real fiscal capacity at the EU level, the remaining fragmentation of the

2014, http://www.epc.eu/documents/uploads/pub_4855_challenge_europe_issue_22.pdf (last accessed 12 November 2016).
⁹ Source: for country data IMF, Financial Soundness Indicators, <http://data.imf.org/?sk=388DFA60-1D26-4ADE-B505-A05A558D9A42&sid=1459341854713&ss=1469128361826>; for EU and Euro aggregates World Bank, World Development Indicators <http://data.worldbank.org/indicator/FB.AST.NPER.ZS> (last accessed 25 November 2016).

Single Market and the high level of public debt in some member states could also threaten the EU's ability to absorb future asymmetric shocks.

While the EU has not managed to close its investment, productivity and growth gaps *vis-à-vis* the US (0.6% over the last five years vs. 2.0% in the US), non-euro countries in Central and Eastern Europe are still outperforming their Eurozone counterparts. 'Surplus countries' including Germany are not using their fiscal space to stimulate growth. In this context, the implementation of EU surveillance tools, such as the Stability and Growth Pact, has been subject to political pressure. Although the recent flexibility demonstrated by the European Commission on EU fiscal rules has benefits, this approach also eroded the trust in the Commission's ability to enforce rules agreed upon by member states.

Finally, the increasing political role played by the ECB in the course of the crisis – both as a supervisory body and as *de facto* lender of last resort – has raised democratic concerns. The increasing use of financial instrument also raises legitimate questions around the independence, transparency, integrity and accountability of the European Investment Bank.¹⁰

In sum, the crisis has highlighted that by acting together, the EU and its member states could enhance the sovereignty of European public institutions *vis-à-vis* financial market fluctuations and outward shocks, and therefore better protect EU citizens. Yet, the multi-dimensional character of the crisis has also lead to increasing divergence across the continent, and a sense of social and political urgency in some member states. This has impacted the EU citizens' expectations about EMU and pushes the EU to reconsider its role in this new context.

III. Towards a strengthened EMU?

The economic context that EMU is facing today largely differs from the growth context of the 1990's during which it was initiated. The growth consensus is currently being challenged by several factors:

- the global slowdown of growth and trade, combined with the unknown impact of the digitalisation process, creates uncertainty around how to achieve sustainable growth;
- the lack of job security created by the impact of technological developments on jobs,¹¹ the perception of a widening gap between 'winners' and 'losers' of globalisation, and social and

¹⁰ Hoffmann-Axthelm, Leo, Ban, Cornel and Seabrooke, Leonard (eds.) (2016), "Transparency International, Investing in Integrity? Transparency and Accountability of the European Investment Bank", Transparency International, available at: http://www.transparencyinternational.eu/wp-content/uploads/2016/11/EIB_report_digital-version.pdf (last accessed 25 November 2016).

¹¹ Emmanouilidis and Zuleeg (2016).

political anxieties fuel diffuse ‘populist’ tendencies across Europe which in return could further impede growth prospects;¹²

- the inability of traditional economic models to factor in environmental and social costs, combined with increased criticisms about the latest developments of capitalism,¹³ challenge the paradigm of growth as lead indicator of welfare.

Fostering growth is and will undoubtedly remain part of EMU’s core objectives. But as many EU citizens fail to understand how the Union can respond to their multiple fears and anxieties, the EMU needs to develop into an ‘Insurance Union’. In his presentation of the Five Presidents’ Report, Commission President Juncker acknowledged that the “unprecedented measures taken during the crisis now need to be consolidated and complemented and made more socially fair and legitimate.”¹⁴

In order to move in this direction, the EU should focus on four key objectives: (1) defending EMU stability; (2) clarifying the role of eurozone institutions; (3) increasing citizens’ ability to influence the governance of the euro area; and (4) creating fiscal space for social and public investment.

Defending EMU stability

Increasing the resilience of Europe’s financial system has been set as a priority by the Five Presidents’ Report. The report notably suggests to enable member states to share the impact of shocks through risk-sharing, i.e. by developing common crisis resolution mechanisms. This could be achieved in two phases: first, by introducing such mechanisms in the banking sector through the provision of common backstops to the banking union; in the medium run, the Commission considers that public risk-sharing could be envisaged.¹⁵

As of today, the banking union remains incomplete as it still lacks a strong third pillar including a European Insurance Deposit Scheme (EDIS). Adopting the EDIS would reduce the risk of capital outflows and hence prevent panic from spreading whenever a systemic crisis arises. Equally, the ESM

¹² World Bank Group, Office of the Chief Economist (2016), “Polarization and Populism, Europe and Central Asia Economic Update”, available at: <http://pubdocs.worldbank.org/en/278581479765753603/ECA-Economic-Update-Nov-2016-Eng.pdf> (last accessed 12 November 2016).

¹³ Erixon, Fredrik and Weigel, Björn (2016), *The Innovation Illusion, How so little is created by so many working so hard*, New Haven and London: Yale University Press.

¹⁴ European Commission (2015), “Five Presidents’ Report sets out plan for strengthening Europe’s Economic and Monetary Union as of 1 July 2015”, press release, Brussels, available at: http://europa.eu/rapid/press-release_IP-15-5240_en.htm (last accessed 12 November 2016).

¹⁵ Juncker, Jean-Claude, in cooperation with Tusk, Donald, Dijsselbloem, Jeroen, Draghi, Mario and Schulz, Martin (2015), *Completing Europe’s Economic and Monetary Union*, European Commission, available at: https://ec.europa.eu/priorities/sites/beta-political/files/5-presidents-report_en.pdf (last accessed 12 November 2016).

would benefit from being given a rapid response facility that would e.g. rely on pre-funding joint guaranteed from member states.¹⁶

Clarifying the role of eurozone institutions

The *de facto* risk sharing responsibilities taken by the ECB during the crisis, the recent Commission's decision to take a flexible approach on the implementation of sanctions related to fiscal rules have both been subject to intense debates between member states, highlighting the absence of common interpretation of the role of eurozone institutions.

Future EMU reform efforts should aim at achieving a consensus on both the objectives of the eurozone and the responsibilities of each institution in achieving them. This should mostly concentrate on agreeing on the ECB's prerogatives when crises arise and state whether its objectives should indeed be re-assessed to better take into account its role in fostering growth, investment and employment. It could also clarify the role expected from the Commission in economic governance. In the longer run, providing the Commission with a Treasury, as suggested in the Five Presidents' Report, endowed with a real fiscal capacity would give the Commission the responsibility to act as *de facto* government of the eurozone – which would in turn boost both the coherence and the legitimacy of the EU economic governance.¹⁷

Increasing EU citizens' ability to influence the governance of the Eurozone

“The true nature of the international monetary system under which we were living was not realised until it failed. Hardly anyone understood the political function of the international monetary system; the awful suddenness of the transformation took the world completely by surprise ...”¹⁸

Karl Polanyi's description of the Gold Standard in the 1930's could well apply to today's eurozone, as it is too often forgotten that the euro goes beyond its financial stability function and also encompasses an important political dimension. Debates about the possible options to respond to the Greek crisis in the summer of 2015 have increased awareness about the political nature of decisions related to the

¹⁶ Enderlein, Henrik and Letta, Enrico, 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, <http://www.institutdelors.eu/media/repair-and-prepare-growth-and-the-euro-after-brexit.pdf?pdf=ok> (last accessed 20 October 2016).

¹⁷ Duff, Andrew (2016), *The Protocol of Frankfurt: a new treaty for the Eurozone*, European Policy Centre, available at: http://www.epc.eu/pub_details.php?cat_id=1&pub_id=6229 (last accessed 18 November 2016).

¹⁸ Polanyi, Karl (1944), *The Great Transformation*, Boston: Beacon Press.

euro. Most of the decisions taken during the crisis indeed required collective decision making and had a direct impact on European economies and the everyday realities of citizens.

The fact that vital decisions are taken at EU level needs to be matched with a higher involvement of European citizens in the decision-making process. Integrating the inter-governmental fiscal compact treaty into the existing EU legal framework, as proposed by the Five Presidents' Report, represents a necessary first step. However, in order to increase the legitimacy of the euro, the EU should also consider further reforms aiming at increasing the accountability of EU and Eurozone institutions (e.g. the Eurogroup, the ECB, the ESM, and the EIB) *vis-à-vis* the European Parliament and national parliaments, as well as simplifying and increasing the visibility of instruments such as the European Semester.

Creating a new space for social and public investment

The multidimensional impact of the crisis requires the EU's exit strategy to pursue simultaneously economic and social objectives, including growth and jobs creation. The European Commission launched a Social Investment Package (SIP) in 2013 in which it defined social investment as investment in people's "current and future capacities" that have "lasting impact (...) in terms of employment prospects or labour incomes."¹⁹ To address the long-lasting consequences of the crisis, a social and public investment approach becomes particularly relevant.²⁰ However, the Stability and Growth Pact (SGP) rules currently offer little flexibility for this in Europe's economic governance framework. And while the environment of fiscal consolidation already constraints public investment, the preventive arm of the SGP offers very narrow conditions under which investments can receive preferential treatment.²¹

More fiscal space could be created for social and public investments through reforming the EU economic framework. Introducing a "Golden Rule" enabling governments to borrow only to invest and not to fund current spending, accompanied by a European measurement framework defining precisely what constitutes such investments, supported by a fiscal capacity, could help achieve this. But in order to make such governance changes acceptable by all member states, some form of conditionality should

¹⁹ See p. 3 in European Commission (2013), "Towards social investment for growth and cohesion – including implementing the European Social Fund 2014-2020", Brussels: COM(2013), No. 23 final, available at: <http://ec.europa.eu/social/main.jsp?catId=1044&langId=en&newsId=1807&moreDocuments=yes&tableName=news> (last accessed 1 December 2016).

²⁰ Dhéret, Claire (2015), "Fostering social cohesion: the missing link in the EU's exit strategy from the crisis", *EPC Discussion Paper*, European Policy Centre, available at: http://www.epc.eu/pub_details.php?cat_id=17&pub_id=5459 (last accessed 1 December 2016).

²¹ For a detailed explanation of these conditions see pp. 8-9 of European Commission (2015), "Making the best use of flexibility within the existing rules of the Stability and Growth Pact", Strasbourg: COM(2015), No. 12 final provisional.

also be introduced. This could e.g. take the form of contractual arrangements linking creditors' support to structural reforms and/or public/social investments reflected in a revamped European Semester.²²

Drawing the lessons from the crisis, EU institutions have taken important decisions to re-launch the EMU project and reform the eurozone. Some of the suggested reforms might materialise, but more substantial changes to the current functioning of the eurozone will only be possible if EU member states agree to engage in a new consensus-building process. Although ambitious EMU reforms look unlikely in the current political context, wider threats on the EU project may incentivise governments to reassess their priorities and align their positions.

IV. Prospects: Saving the euro to save the EU?

In an ideal world, the EU and its members would have drawn the lessons from the crisis to conduct all necessary structural reforms and to develop the missing instruments increasing their resilience towards other potential shocks. Yet, member states remain subject to very similar risks as before the crisis – high public debt, nonperforming loans, nexus between sovereign and banks, etc. How can this be explained?

As the sense of emergency created by the crisis has been substantially reduced, the incentives of policymakers to introduce long-term reforms associated with high short-term political costs have decreased. In some member states, the modernisation of economies is still lagging behind, as they face reform fatigue induced by the lasting negative impact of the crisis. Furthermore, the multi-dimensional impact of the crisis, the emergence of new challenges raised by structural changes – such as automation, the evolution of the welfare system, or climate change – as well as the populations' increasing concerns about migration and security issues, have pushed economic and fiscal reforms further down the political agenda.

Although these phenomena can help explain the lack of progress at national level, the EU's inability to overcome the remaining structural short-comings of EMU seems to be mostly due to the member states' inability to agree on the main problems faced today by the euro area. Whilst on one hand, some member states consider that a better functioning EMU would rely on a better implementation of the macro-economic surveillance framework, others, which consider that the euro should aim at providing

²² Zuleeg, Fabian with Schneider, Jan David (2015) "What role for social investment in the new economic governance of the Eurozone", *EPC Policy Brief*, European Policy Centre, available at: http://www.epc.eu/pub_details.php?cat_id=3&pub_id=6086 (last accessed 1 December 2016).

greater social cohesion, would prefer the EMU to focus on measures that could enhance real convergence in the EU.²³

It is commonly accepted that new additional instruments and mechanisms would be needed to improve the euro's resilience. But opposite views on how to reform the euro area to best absorb future shocks have increased uncertainties about the EU's capacity to reach a consensus among its members. As a result, the split in member states' perspectives on the level of integration (sovereignty-sharing) and cross-border solidarity (risk-sharing) required to preserve the integrity of the eurozone has led to increasing tensions and mistrust between member states. This has hampered the cooperation between Brussels and national capitals – which in turn further reduces the likelihood of reaching a compromise.²⁴

Is this situation likely to evolve in the foreseeable future? The context of rising illiberal forces in many member states could impact the state-of-play in opposite directions. On the one hand, national policymakers may be tempted to follow domestic trends towards increased ideological polarisation and national retrenchment. This would not only affect the EU's ability to achieve a consensus on EMU-reforms, but could also further increase the fragmentation of the Single Market and threaten the common currency. On the other hand, the danger of a more regressive, illiberal, and close Europe, may incentivise progressive leaders to engage into the necessary consensus-building processes at EU level in order to save the euro and the EU projects.

As the history of the euro has demonstrated, fundamental reforms linked to the common currency can only be achieved on the basis of an agreement between France and Germany. As the two countries face elections in 2017, the post-elections period may provide a window of opportunity for the newly elected governments to agree on an ambitious EU reform agenda. Provided that these elections see a progressive pro-EU majority emerging, this could constitute a momentum for EMU reform that the EU and its members could not afford to miss. 25 years after the Maastricht Treaty, the EU's future appears as more than ever linked with the fate of the euro.

²³ Auf dem Brinke, Anna, Enderlein, Henrik and Haas, Jörg (2016), *Why the Eurozone can't agree on convergence and how structural reforms can help*, Berlin: Jacques Delors Institut Berlin.

²⁴ Emmanouilidis and Zuleeg (2016).