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New Challenges for the Eurozone Governance

Joint Solutions for Common Threats?

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José Caetano · Isabel Vieira · António Caleiro
Editors

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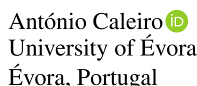
António Caleiro 
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Foreword

The leading thread of this book is quite topical. It investigates to what extent the ongoing crisis is a revealer of the euro area design shortcomings, asking at the same time whether the crisis can become a catalyst for well-known needed reforms. The crisis basically exposed two of those flaws: the vulnerability of weaker countries' national debt markets to pure liquidity squeezes and redenomination risk and the inadequacy of the fiscal policy framework. The Stability and Growth Pact (SGP) had to be suspended as fiscal policy was at the centre of the response to the crisis. In fact, direct transfers of income to households were an essential policy component as well as subsidies, capital injections, loans, and guarantees to maintain firms afloat to survive lockdowns and demand collapse in several sectors.

In an unprecedented decision, the EU countries approved a €750 bn Recovery Plan, that inaugurated a European-level fiscal stabilisation effort that has been interpreted as the beginning of fiscal union. Some even hailed it as a sort of European Hamiltonian moment. Despite being a gamechanger, there is some exaggeration in that assessment. There is no creation of a permanent Stabilisation Fund and no mutualisation of debt. Contrary to a complete Eurobond, which has "joint and several" liability, the issuance of bonds by the EU Commission does not make member States liable for more than the part of the debt proportional to their GDP and population. Nevertheless, common issuance by the Commission on that scale is unprecedented and represents a welcomed addition to European safe assets with top ratings.

Three other elements of the package are equally without parallel: it is a truly European-level fiscal stimulus; it is mostly distributed as budget transfers and not loans; and is distributed according to needs and not on a proportional basis. This last point can be illustrated by recalling that of the total €390 bn grants, Germany was proportionally entitled to 96 bn but gets only 27 bn or 0.7% of its 2019 GDP. In contrast, Greece receives 11% and Portugal 6.7% of their respective GDPs. This indisputable act of European solidarity has an overall meaning that transcends any details. First, it is proof that in situations of stress, the EU does not abandon its members to fend for themselves and takes collective responsibility. This assurance made European assets gain market value and the euro to appreciate. Second, the decision is a clear reflection of the growing awareness of the new geopolitical situation that is squeezing Europe in the great power game that is substituting a waning

multilateralism. All European countries, including the bigger ones, need more than ever the protection of a cohesive European power. The fact that the euro is the crucial cement of this community of interests makes it more unbreakable.

The big question now is to assess whether the unprecedented decision of the €750 bn Recovery Plan is the harbinger of other reforms, heading for a higher degree of fiscal union or whether the political capital spent to achieve that decision implies a greater difficulty to muster the political will to go further. As it is usual in EU history, the pressure of events will dictate the outcome. Two significant pressures for change are clearly emerging as a consequence of the crisis: first, the necessity to revise the Stability Pact and second, the need to complete the Banking Union and review adjacent regulations, as the stressful situation of the banks will deteriorate next year. In a still remote worst-case scenario, it may become necessary to tweak the BRRD and allow public support to troubled banks overwhelmed by high NPL losses and low profitability.

Regarding fiscal policy, deficits and the deep recession imply increases of more than 20 p.p. in debt to GDP ratio in many countries. The slow recovery that will follow is not compatible with an aggressive fiscal consolidation in the near future. A double deep recession, like the one in 2012–2013 must be avoided. The Stability Pact will have to be revised, and the EU Commission already announced that internal preparatory work has started. Active fiscal policy will be indispensable for years to come in advanced economies beset by secular stagnation and the insufficiencies of monetary policy.[1]

The majority of views about the SGP reform seem to point to the adoption of an expenditure growth rule. This change would eliminate any reference to cyclically adjusted deficits that were an attempt to make the initial Pact less procyclical. Despite an intelligent expenditure rule being able to be less procyclical than the existent SGP, two points of caution are warranted. First, the anti-cyclical element of an expenditure rule can be overturned if it aims at a low debt-to-GDP ratio in a short period of time. Considering the unavoidable higher debt legacy of the corona crisis, it is imperative to avoid any strict formula for the convergence to the Treaty target. Second, an expenditure rule has difficulty in dealing with severe unexpected recessions and should, therefore, be complemented by a permanent European Stabilisation Fund based on unemployment thresholds.

Desirable but apparently less pressing reforms will take more time, like the creation of a sizable permanent market for a European safe asset, indispensable for a true capital markets union, and the internationalisation of the euro.[2]

Meanwhile, monetary policy framework is being revised, hopefully, to become more flexible and symmetric, suitable for the implicit and independent cooperation with fiscal policy in situations like the current one.

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[1]Constâncio, V. (2020) "The Return of Fiscal Policy and the Euro Area Fiscal Rule" in *Comparative Economic Studies* 62, 358–372.

[2]Constâncio, V. (2019) "European Financial Architecture and The European Safe Asset" in the book from the European University Institute, Florence, *European Financial Infrastructure in the Face of New Challenges* pp. 11–22, https://fbf.eui.eu/ebook-download-european-financial-infrastructure-in-the-face-of-new-challenges/.

The present deep recession has so far wiped out 15 years of Euro Area growth and more than 20 of some peripheral countries. The recovery will be sluggish and will leave behind many socio-economic scars. Other difficult decisions and reforms may become necessary. The present book offers a thought-provoking map to explore possible policies for that challenging future.

Lisbon, Portugal Vítor Constâncio

Vítor Constâncio was Vice-President of the European Central Bank from June 2010–2018. At the central bank of Portugal, he was Director of the Economics Department, Deputy Governor, and from 2000 to 2010 was Governor of the Banco de Portugal. He was Finance Minister in 1977–1978. At the Lisbon School of Economics and Management (ISEG), University of Lisbon, he was coordinator of the Master's degree on Monetary Policy from 1989 to 2010.

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Introduction

The idea to publish this book was sparked in March 2020 by the unexpected and abrupt widening in some Eurozone sovereign bond spreads against Germany. Such episode reopened painful memories of events leading to the 2011 sovereign debt crisis, when the fears of financial market agents challenged the Economic and Monetary Union's (EMU) integrity and survival. The traumatic recollection of such period exposed the fact that, in spite of the improvements achieved in the meantime, previous flaws in the Eurozone architecture had yet to be mended. The behaviour of bond spreads in March, and the complexity of the interactions that underlie it, renewed the interest of reflecting on possible effects of the COVID-19 pandemic triggered economic, social and, eventually, financial crises on the Eurozone as a whole and, particularly, on its governance.

The previous debate over the causes and implications of the sovereign debt crisis was crucial for the process of monetary integration in the European Union (EU). In fact, events relevant within the Eurozone often end out indelibly affecting the entirety of the Union. It was thus not surprising that, faced with the evident governance flaws and with the uncoordinated political responses to the crisis, European leaders attempted to find solutions.

It was nevertheless obvious that, despite such efforts, as soon as the most impressive impact of the crisis dissipated, the major previously detected structural problems remained unresolved. And when the current crisis emerged, EMU was still facing its most relevant challenge of becoming more resilient, effective and fair. Amongst its main unattained objectives, we count the failure to complete the banking and capital markets unions, expected to reinforce risk-sharing between banks and governments and to improve the allocation of financial resources; the lack of effective articulation of national fiscal policies and of a central budgetary capacity, capable of exercising stabilization in the Eurozone; and the lack of structural reforms to anchor a more balanced EMU in what concerns creation and distribution of wealth.

Furthermore, legal obstacles to the monetization by the European Central Bank (ECB) of Member States' public debts, rooted on the questionable no bailout clause imbedded in the European Union Treaty, and the recurring doubts concerning the justification for public debt acquisition by the ECB, remain hovering as veiled threats. To attest it, the German Constitutional Court recently argued that previous ECB

actions violated the principle of proportionality. It is a fact that massive purchases of sovereign debt have generated significant side effects by bringing interest rates close to zero. Such effects have far exceeded the statutory objective of keeping inflation under control and have put the ECB under a pressure that may endanger its future course of action.

Also the divisive issue of debt mutualisation, at the heart of political debate during the previous crisis (following the high debt costs imposed by financial markets on some EMU countries, which endangered the sustainability of their public debts) did not vanish but lost momentum in political agendas. There were interesting non-explored proposals, limiting the degree of individual and collective responsibility, and eventually providing support for the emergence of safe assets, capable of providing stability and liquidity to the European Public Debt market and preventing banks' exposure to their sovereigns. But progress in exploring such possibilities was incipient and when Italy, Spain and Portugal's debt spreads significantly widened in March, in part following Christine Lagarde's reckless statement that it was not the ECB's responsibility to reduce public debt spreads in EMU, panic returned to financial markets and fears of reliving the past re-emerged in full force.

In such context, and given that the current crisis is intrinsically quite distinct from the previous one, we anticipate that there are reasons to expect that present events will play a crucial role in the enhancement of the Eurozone's sustainability. First, the current economic shock is exogenous and was not provoked by the behaviour of any government or private sector agent. Second, this is a common shock with distinct impact across EU countries. Third, the economic crisis facing the EU comprises a complex mix of supply and demand shocks. On the supply side, the restrictive measures adopted to operationalize social distance and to contain the spreading of the virus have drastically reduced production. Restrictions on human mobility and work activities have led to an unprecedented drop in aggregate demand. Such contraction justifies the anticipation that eventual inflation peaks prompted by supply restrictions will not materialise, unlike the more serious threat of a probable deflationary trend that is already emerging.

Initially, discussions over the best response to the COVID-19 crisis revived pre-existing fracture lines dividing countries and taboo issues, but they also reflected a consensus concerning the urgency of addressing the serious economic and social problems that had emerged. In a second moment, when the crisis showed impressive signs of severity and contagion over various countries, progress was made and a European level reaction was designed. Its most relevant features are the adoption by the ECB of expansionary monetary policy measures, the European Commission's actions to support Member States domestic policies, the relaxation of the rules of the common competition policy on state aid, and the activation of the safeguard clause that suspends the application of the Stability and Growth Pact.

However, it was the political agreement reached in mid-May 2020 by Angela Merkel and Emmanuel Macron that marked the third phase of the EU's response. This agreement unblocked the stalemates of previous European Council summits and allowed the planning of structural courses of action. It also leads to the creation of a €500 billion donations-based recovery fund to support countries in their combat to

the pandemic crisis and leveraged the Commission's end of May proposal of a strategy to solve current problems and to prepare the future for the next generation, which together with the new proposal for a Multiannual Financial Framework for 2021–2027, amounted to around €1.8 billion. These are relevant and innovative solutions, involving amounts of money never previously matched by any EU programme.

It was this proposal, adjusted after intense and dramatic negotiations, that was approved by the European Council in July 2020, and which includes the *Next Generation EU* instrument, to support the crisis most affected countries with a €750 billion fund, financed by new EU debt. According to the Council's resolutions, €672.5 billion will constitute the Recovery and Resilience Fund, comprising grants and loans. The remaining funds will be allocated as flexible subsidies to respond to the crisis and to support transition to a greener economy. To some, these decisions reflect a slow and uncoordinated response to the crisis, with the added disadvantage of having been achieved through discussions that deepened divergences between EU members. To others, amongst which we count ourselves, the outcome of discussions was a ground-breaking, though incomplete, plan and a renewed opportunity to address relevant gaps still pervasive in the architecture of EMU.

This agreement concerning the recovery plan and its budget are unprecedented in the EU, and it is almost impossible to identify a comparable example involving sovereign states elsewhere. It therefore has an enormous political reach, resulting in greater flexibility and capacity for the EU fiscal policy and opening new perspectives for monetary integration. The agreement breaks taboos and overcomes red lines that have divided countries. For instance, the assumption of debts at the European level and the allowance of funds based on needs, are some of the aspects that have long been undermining discussions about the functions of the Community Budget and the mutualisation of debt.

A first relevant innovation is the financing of the Recovery Fund by EU's direct issuance of debt, making it one of the largest issuers of mutualized sovereign debt in the world and creating a European asset of very low risk that will compete in a market hitherto dominated by the USA. This solution has the potential to overcome previous legitimacy problems. The crisis-specific solidarity mechanism is based on grants to be allocated to specific ends, but lacks intrusive and stringent conditionality. Furthermore, the ubiquitous rhetorical question of moral risk that the mutualisation of debt often invokes no longer applies. Given that countries are not expected to intentionally incur in situations that allow access to financial funds, such risk no longer exists.

A second novelty of this settlement follows from the first, described above, since the plan implies a superior fiscal capacity by the EU, an aspect that some European politicians have always tried to avoid. In fact, to guarantee the necessary financial resources, a higher volume of tax revenues will be needed, and so the sacred limits of the common budget of around 1% of GDP are largely exceeded. It remains to be seen whether the agreed measures are temporary or permanent. In order to guarantee reimbursement, the EU should introduce new taxes that guarantee its own revenue in addition to tariffs and the share of national VAT receipts. There is some consensus concerning the opinion that the new taxes should be directed to areas that cross

national borders, such as, for example, carbon emissions or financial and digital transactions. This is a matter on which European institutions will have to decide soon.

The third originality of the Recovery Plan is the permission given to the European Commission to borrow in financial markets and, also, the logic and terms for the repayment of loans by individual Member States (which may be extended until 2058). This goes beyond the financing of EU budget exclusively through own resources and state contributions. In view of the current low interest rates paid by the most solid sovereign debtors, this leverage will allow EU to access (almost) unlimited funding, at a low cost and with long repayment schedules.

While being relevant to unblock issues that have so far prevented the adoption of joint solutions for avoiding and resolving crises in the Eurozone, the agreed decisions apply without distinction to all EU Member States. Such measures were not designed to address specific EMU challenges, resulting from the fact that EMU has a common central bank but not an equivalent fiscal authority. The Eurozone thus faces a crucial asymmetry which, in the face of specific shocks, considerably limits its action, especially, as is currently the case, when the margin for manoeuvre of monetary policy with practically zero interest rates is very low.

A common fiscal instrument would reduce exposure to sovereign risk when issuing debt and would also allow a more adequate use of fiscal policy in response to adverse shocks. Ideally, such reaction would be provided by means of a stabilization fund capable of issuing low-risk debt. But this would also require a degree of risk-sharing that most Member States are not yet ready to accept and it is understandable that, without the backing of political union, such mechanism lacks in legitimacy. However, EU's reaction to the pandemic already exhibits signs of some risk-sharing and of some flexibility, evident for instance in the credit lines provided by the European Stability Mechanism for health care and by the European Commission to mitigate unemployment risks.

A monetary union needs a mechanism to limit externalities, operating in the presence of both deficits and surpluses. The response to crises requires coordinated fiscal policies of an anti-cyclical nature and a central fiscal capacity is an essential way of ensuring that they are provided. Such mechanism should not prevent heavily indebted countries from recurring to expansionary fiscal strategies to stimulate domestic demand in case of need, and this would only work if countries are prevented from accumulating unsustainable levels of debts when times are normal. EMU thus needs effective rules to limit moral hazard that are so far lacking. Naturally, there are structural aspects, related to the persistence in the Eurozone of distortions in relative prices of goods and services, which will remain unresolved. Fixing them would require real devaluations to reduce differences in competitiveness levels or permanent transfers between members that European leaders openly repudiate.

A new governance structure in the Eurozone must recognise the need for a common fiscal capacity and for an effective and complete banking union, with the means to prevent and manage crises. Both are well beyond the recent decisions of the European Council, for to make them possible and to allow the rules that would ensure their feasibility and functionality, EMU would require new institutions and

a higher level of political integration. The proposals approved so far reflect the will of the Member States, of which the new German position on monetary integration emerges as determinant. But they also reflect the joint efforts of academics that have for so long reflected on, and searched solutions for, EMU's underlying problems so that it may overcome its growing challenges and enhance the odds of its survival. All those reflecting on EMU's troubles have eloquently pointed out the need to change the current model of the Eurozone governance and of doing so quickly.

The pandemic crisis has re-ignited a long-lasting debate, providing new momentum for the (re)start of crucial discussions that may lead to the revision of EU Treaties. The purpose of this book is to contribute to such profound and enlightening debate, by integrating the views of more than 30 economists and political scientists, who have agreed to assess current and future Eurozone threats and challenges from multidimensional perspectives. The result is a large variety of insights and reflections that provide answers to the book's title question "*New Challenges for the Eurozone Governance: Joint Solutions for Common Threats?*".

The problems addressed by the authors are not easily classifiable into distinct categories. Most chapters overlap different subjects and provide more than one avenue for possible progress in what concerns the future of the Eurozone governance. For this reason, the book does not separate the authors' contributions into different formal parts, but presents them sequentially, opening with more wide-ranging or structural analyses, subsequently offering assessments of the monetary, fiscal, social and institutional dimensions, and closing with an overarching assessment of the impact of major crises upon theoretical macroeconomic frameworks and its implications for the future of the Eurozone.

The first three chapters focus on how the COVID-19 pandemic has provided the opportunity to implement much-needed institutional changes in the Eurozone. Boitani & Tamborini, focus on how reform has been thwarted by the so-called North-South divide, despite the current consensual view of its urgency. Heine & Herr point out examples of specific measures aimed at enhancing monetary and economic integration. Travelling back to the *Great Depression* of the 1930s, the authors illustrate possible consequences of economic policy errors in the Eurozone's reaction to the current crisis. A governance paradigm shift towards a more comprehensive and integrated approach is defended by Mendonça & Vale to both provide a better response to the pandemic and to enhance the international role of the EU.

Monetary topics are the object of the next three chapters. Braun-Munzinger, Carmassi, Kastelein, Lambert & Pires point out how the incomplete banking union has already facilitated the first responses to the COVID-19 crisis and explain how its completion will benefit the European integration project as a whole. Considering monetary stability as a guiding principle, Castañeda sets up a rule-based monetary strategy for the ECB in the current low inflation and near-zero interest rates environment. Caetano, Ferreira & Dionísio focus on the role of Eurobonds and on how they may be instrumental for a new Economic and Monetary Union governance model based on the principle of subsidiarity and putting aside concerns over moral hazard and the intrusive and stringent conditionality.

The chapters by Cruz, Rangel & Parejo, and by Katsikas address fiscal stabilisation and fiscal governance. The former discuss the utility of implementing automatic fiscal stabilisation capable of not only solving macroeconomic and social problems, but also of eliminating moral issues and the discretionary image of public spending. The later, analyses EMU's current design of fiscal governance, the short-term changes implemented to address the most pressing current fiscal requirements, and its limited and uncertain long-term impact.

The next set of chapters concentrates on labour markets and on social dimension linked to the EMU. Silva & Duarte estimate a dynamic stochastic general equilibrium model to assess macroeconomic consequences of a (COVID-19 prompted) labour supply shock. Their simulations indicate that even a shock that solely affects one of the two considered regions pushes both areas into stagflation, stressing the need for policy coordination in countries sharing a common currency.

Jurado & Pérez-Mayo show how, after serious economic crises, social inequalities are exacerbated and propose policies that allow a timely reaction to the asymmetric after-effects of the current crisis on Eurozone households. Relatedly, and given the expected loss of jobs provoked by the pandemic, Andor revisits the main characteristics of the European Commission's instrument SURE, designed to provide temporary support to mitigate unemployment risks in an emergency. The empirical assessment developed by Liotti & D'Isanto leads the authors to defend that the impact of the pandemic crisis on unemployment should be counteracted, not by means of labour market deregulation, but with measures designed to support demand.

Building on past experience of how attempts to resolve economic crises have negatively impacted human rights and social cohesion, Neves discusses Eurozone governance reforms required to adequately answer current challenges without disregarding implications for citizens' confidence in EU institutions and for the growing influence of anti-EU political parties.

The political nature of European integration developments underlies the chapters by Leitão, and by Vila Maior & Camisão. Leitão addresses the political essence substantiating the legitimacy assumed by the representatives of the so-called frugal and Southern countries that have adopted opposed positions in what regards reactions to the COVID-19 crisis. Vila Maior & Camisão analyse the differences in the institutional response to the current crisis, discuss the institutional rebalancing of the EU and assess impacts for the sustainability of the European integration project.

The final chapter, by Hierro, Atienza-Montero, Domínguez-Torres & Garzón, shows how major economic crises shape macroeconomic theoretical development. The authors defend that past and current crises have exposed the inadequacy of the theoretical framework rooting EMU's institutional design and thus that adequate policy reactions to the distinct challenges have so far required the disregard of established rules based on out-of-date economic orthodoxies.

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António Caleiro has been an Assistant Professor at the University of Évora since May 2001, after obtaining a Ph.D. in Economics from the European University Institute (Florence, Italy). His research and teaching activities plainly reveal his multidisciplinary skills, which a simple query to his curriculum would have made clear.

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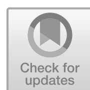
The Future of the Eurozone: A Reflection Paper on the North/South Divide



Andrea Boitani and Roberto Tamborini

Abstract There is now a wide agreement that reforms of the architecture of the Eurozone (EZ) are needed, reforms aimed at fostering further integration of economic policy and governance. Behind the plea for "more Europe", divergences loom large across member states. The cleavage is normally represented in geographic mode, the Northern EZ countries (NEZ) on one side, the Southern EZ countries (SEZ) on the other. It is quite clear that divergences have more to do with economy and polity than with geography. Suspicion runs high and mutual trust runs low between SEZ and NEZ. In these circumstances, it is extremely difficult to reform the EZ, while the conditions are set for populist, sovereigntist, anti-European movements to thrive. However the COVID pandemic may turn out to be a catalyst of reforms. We first attempt at understanding the legacy of the EZ crisis of the 2010s and its mismanagement by appealing to the present "consensus view". This effort will help the reader focusing on why NEZ and SEZ disagree and to find out whether and how they can agree. Second, we try to build on this common narrative in order to identify the possible consensus changes in the EZ rules and institutions.

Keywords Eurozone institutions and governance · North-South divide · Eurozone reform proposals

1 Introduction

The Eurozone (EZ) has been pounded by two worldwide storms of abnormal magnitude in a decade: the 2008–2009 Great Recession and the 2020 COVID-19 pandemic. While in its infancy age 1999–2007, the economic performance of the European

This chapter draws on a report of the authors prepared for the Friederich Ebert Stiftung Italia, Rome-Berlin http://library.fes.de/pdf-files/bueros/rom/16042.pdf.

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single currency area was close to that of the other European-Union countries or other comparable areas like the United States, after the 2008–2009 shock the EZ displayed poorer economic performances. Indeed, there was a "Europeanisation" of the crisis, with the double-dip recession of 2012, the public sector involvement in the bank crises leading to the sovereign debt turmoil between 2010 and 2012, growing socio-political tensions across member countries, lack of clarity and determination at the level of supranational governance institutions. The foundations of the EZ have seriously been shaken by the first stress test of its (short) history.

In 2014, Charles Wyplosz published a paper that expressed the growing discontent for the way in which the EZ was managing the crisis, with the harsh title: "The Eurozone Crisis: A Near-Perfect Case of Mismanagement". "The Eurozone crisis occurred – he wrote - because the institutional setup was imperfect" (p. 12). The idea of the institutional roots of the EZ crisis, and hence the need for extensive reforms, has gained momentum both at the academic level (e.g. Baldwin and Giavazzi 2015, 2016; Delatte et al. 2017; Franco-German economists group 2018) and at the level of top institutions.[1] The kernel of the various reform proposals is the need for further steps in institutional integration at the supranational level epitomised by the completion of the Monetary Union with a Banking Union, a Fiscal Union, and a Political Union.

The EZ, and EU at large, were caught unprepared by the disaster of the COVID-19 pandemic. More because the EU and the EZ have never developed sufficient common tools to cope with systemic crises than because the pandemic was unexpected. With the benefit of hindsight, the crisis of the 2010s has largely remained a missed opportunity (e.g. Franco-German economists group 2019). The Banking Union is on a slow-motion track with two partial achievements: the single supervision on major banks, and the single resolution mechanism for bank crises. Negotiations are instead at a stalemate on a third key element, the common deposit insurance. The Fiscal Union, i.e. resources, authorities and rules for a common fiscal policy in the EZ, is a political enigma. The general feeling is that "something has to be done", yet little is actually done. The absence of a common fiscal policy has hampered a strong and prompt collective reaction to the COVID-19 crisis. The Political Union remains the ideal end, but it is nowhere near reaching the stage of a political agenda.

In this paper, we investigate the reasons that thwart progress on the way of the completion of the Monetary Union. Certainly, there is no lack of proposals of the highest scholarly and technical quality able to balance different and conflicting aims and means. The ultimate problem is clearly one of different views of what the Monetary Union should be, rooted in national interests, attitudes of public opinion, and hence political will. Divergences have certainly yawned as a consequence of the mismanagement, and missed opportunities, of the last decade's crisis. A widely used reading grid of the divergences is of a geographical nature: the North EZ countries

[1] As testified by the so-called Five Presidents Report (Juncker et al. 2015), and the subsequent documents of the European Commission (2016b, 2017a, b). The Mission Letter to the Commissioner-designate for the Economy by the new President of the European Commission U. von der Leyen collects some of the previous proposals. Relevant speeches of the former President of the European Central Bank should also be mentioned (e.g. Draghi 2014a, b, 2015).

(NEZ) on the one side, and the South EZ countries (SEZ) on the other.[2] We abide with this practice, though the classification of countries is not so clear-cut as it may appear. The North-South divide is rooted in, and breeds, *mistrust*. This is, in our view, the deep disease that cripples EZ reforms and may pave the way to its eventual collapse. Indeed, there are reasons for *reciprocal* mistrust that should be taken seriously *on both sides*. Taking the view from the South, we seek to find a common ground description of the present shortcomings and needs of the EZ and, based on this, to reach a reasonable agreement between NEZ and SEZ on a minimal set of reforms aimed at safeguarding and strengthening the common house.

To begin with, limited, or biased, reciprocal knowledge is one of the seeds of mistrust. Hence we try to offer a better characterisation of the two camps, also warning that the consequences of the COVID-19 shock are going to change the boundaries of the earlier geopolitical map. Second, we attempt to outline a narrative of the crisis and of its mismanagement by appealing to a "consensus view" that progressively emerged mainly around "mainstream" economic principles, which, admittedly, are not those referred to by "hardliners" in the NEZ or in the SEZ. This effort will help the reader to focus on why there are disagreements about the present state and the future of the Eurozone and to find out whether an agreement can be reached. Finally, we aim at grafting on this common narrative the possible consensus changes in the EZ rules and institutions. Will the pandemic be a catalyst of goodwill or mistrust? To overcome mistrust, a common step towards *sovereignty sharing* is necessary. That is to say new rules and new cooperative policies should be envisaged and entrusted, not to newly created technocratic entities or to a purely intergovernmental arena, but to genuinely supranational institutions while national responsibilities should be strengthened. Reforming the EZ is not going to be easy. As in any "high politics" operation, a unique combination of vision, determination and brinkmanship is needed. Business as usual would stand just as a new *ascenseur pour l'échafaud* of the EZ and the whole of Europe.

2 About North and South

It is glaringly obvious that the North-South divide of the EZ has to do with economic and political cleavages more than with geography. The South of France has a lower latitude than the North of Italy and the North of Spain. Slovenia has more or less the same latitude of Northern Italy, but it is closer to Austria under many respects.

A broad-brush characterisation of the typical NEZ country, *vis-à-vis* the typical SEZ country, is higher per capita income and growth capacity, stronger fiscal discipline (smaller and less frequent fiscal deficits, lower public debt), greater competitiveness (export-driven economy, and large trade surpluses). These differences are reflected in the attitude towards the EZ institutional and governance issues, which

[2] Another popular classification system is the "Core" versus "Periphery" one (e.g. Campos and Macchiarelli 2016). By and large Core is synonymous with North and Periphery with South.

is conditioned by the performance and interests of the home economy. Hence, the typical NEZ country feels more comfortable within the existing EZ setup, with a consequent conservative attitude, whereas on the SEZ front the attitude is more critical and favourable towards change. A commonly shared view locates Austria, Estonia, Finland, Germany, Latvia, Lithuania, Luxembourg, the Netherlands, Slovakia, and Slovenia in the NEZ, whereas Cyprus, Greece, Italy, Malta, Portugal and Spain are located in the SEZ. Belgium, France and Ireland are of more uncertain classification. They share some strengths with the NEZ but also some weaknesses with the SEZ. Moreover, during the crisis of the 2010s, and more clearly in response to the COVID-19 shock, the governments of these countries took a position more supportive of the views of the SEZ than of the NEZ.

As with all aggregations across complex phenomena, the risk of void stereotypes is high. The self-imposed attribute of "frugality" by the NEZ, and other North non–EZ countries (as opposed to SEZ profligacy) may be questioned on the ground of facts. For instance, most of the NEZ display per capita public expenditure and tax revenues far higher than the SEZ countries' average. Moreover some of the "frugal" (the Netherlands, Sweden, Denmark) carry a heavy burden of private debts as a share of GDP (ranging from 250% to 300%), a much heavier burden than in some SEZ countries. Neither NEZ nor SEZ are fully homogenous areas. For a large part the NEZ consists of "small countries" economically orbiting Germany. Economic integration with Germany is both a strength and weakness of these countries as they remain highly dependent on the German business cycle and world trade trends as well as on the health of the German banking system. Apart from size and other aspects of economic development (gaps in per capita income are large), a major difference across the NEZ is that the small countries are not affected by regional dualism, unlike Germany (East-West).[3] Regional dualism, as we shall see below, is a critical factor, more important than usually believed, which the largest NEZ country shares instead with other large EZ members like Italy, Spain, France and Belgium.

In the SEZ political and cultural diversity are everywhere apparent. Structural economic features also vary widely. Italy is the second manufacturing and exporting country in Europe. Its current account balance has been positive most of the time. Northern Italian regions are closer to Southern Germany than to other SEZ countries as regards per capita GDP, productivity and industrial specialisation. The value-chain integration between some of the North-Italian and South–German manufacturing firms should also be stressed. On the other hand, more than other SEZ countries, Italy has long been affected (especially in the 1980s and in the early 2000s) by the soft budget constraint syndrome and is now overburdened by a high-debt legacy. Yet after Greece and Italy, the third country in this league is Belgium, one of the NEZ (intermittently).[4]

[3]The post-2008 increase in standard of living disparities across German regions is documented in Fink et al. (2019).

[4]As for Italy, the two German-speaking economists Heimberger and Krowall (2020) dispel some fake stereotypes widespread in the NEZ.

Even more importantly, structural features and actual performances of countries change over time, and hence their attitudes towards the EZ, particularly after major events. The four geo-economic panels of Fig. 1 highlight this point by means of the four broad-brush performance indicators of the EZ countries (variable composition) mentioned above: growth rate of per capita income, net exports as per cent of GDP, the public deficit/GDP ratio and the public debt/GDP ratio. Indeed, the North-South categories have come into use, and bear some relation with data, as a consequence of the polarisation of countries during the post-crisis decade 2009–2019. Beforehand, the geo-economic maps were more mixed. Germany was underperforming while some Southern countries (Spain, Portugal, Cyprus, even Greece) displayed some "Northern" characteristics (in terms of growth, trade and public finances) which were later overturned in the post-crisis years, when a country like Ireland was also associated with the infamous GIPSI group (to be identified with the SEZ). As indicated above, other countries, such as France, Belgium, or for some aspects Italy, seem to dwell in a mixed territory sharing some characteristics of both sides at different times.

We have also included in the four panels of Fig. 1 available early evidence of the effects of the COVID-19 shock. It has been observed that this is a symmetric shock with asymmetric consequences. Indeed, averaging the 2020–2021 forecasts of GDP growth and of public finances provided by the 2020 Spring release of the European Commission, an even more clear-cut polarisation seems to emerge along an ideal line running from the Atlantic to Piraeus, that is a North-*East* versus South-*West* cleavage (a new Curtain?), which threatens to be the hallmark of the post-COVID-19 new decade. Germany seems to always be the centre of gravity, being able to tilt the scales either way.

In conclusion, it may be argued that notwithstanding all the previous caveats, the North-South characterisation does capture a *persistent divergence* across the EU, both at the structural level and at the level of political attitudes towards the Monetary Union. In the following discussion, we shall mostly concentrate on the latter.

3 The European Crisis of the 2010s: A Tale of Sins and Expiation?

Behind the general plea for "more Europe", divergences along the North-South cleavage loom large. While there is broad agreement regarding the list of the ingredients of the crisis (see e.g. the "consensus view" gathered by Baldwin and Giavazzi 2015, 2016), the prevailing narrative in the NEZ downplays the dimension of institutional mismanagement of the crisis to emphasise the responsibilities of single countries (notably the SEZ ones; see e.g. Sinn 2014), whereas the opposite view of the causal ranking is dominant in the SEZ countries.[5]

[5]To be honest, they are not only dominant in the SEZ countries. Wyplosz (2014), Wren Lewis (2015) and De Grauwe (2013) are examples of a group of international scholars who lay the stress on institutional failures and responsibilities of dominant (NEZ) countries therein.

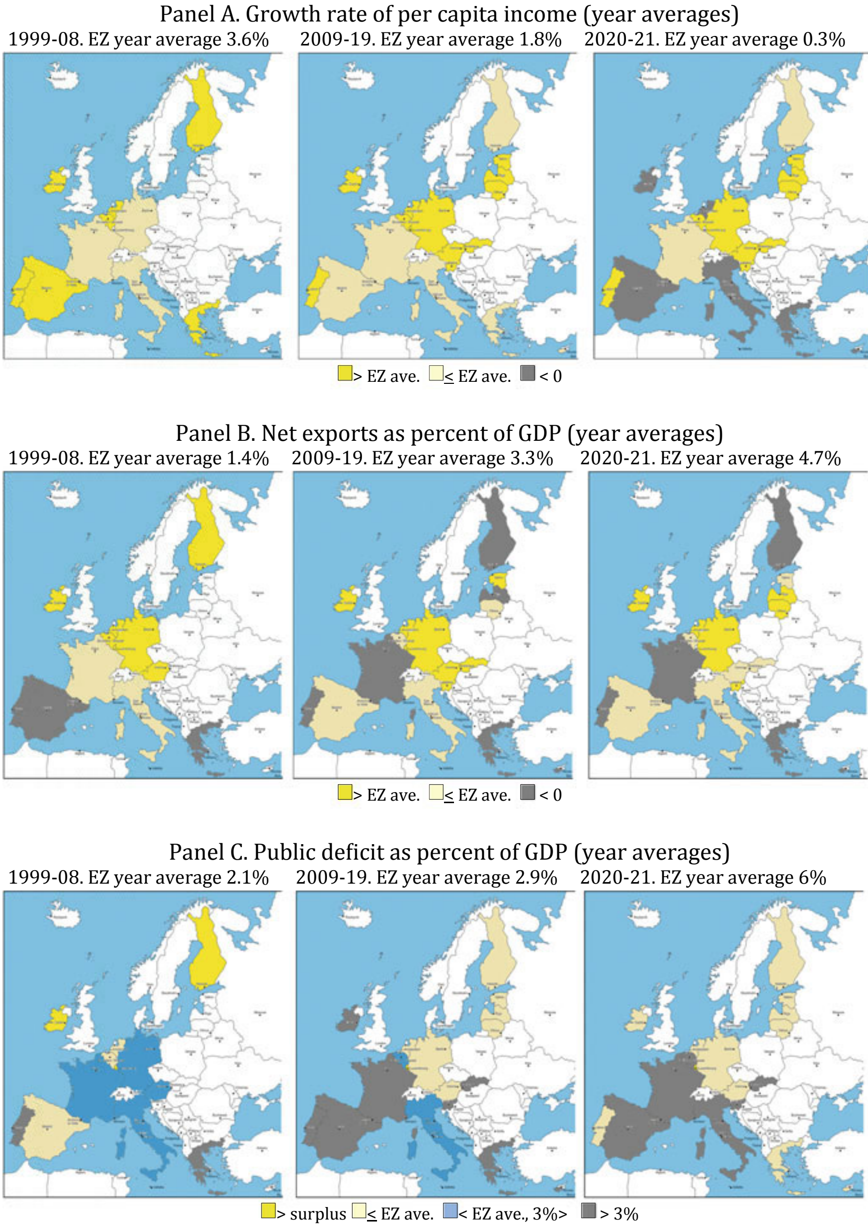

Fig. 1 Geo-economic maps of the Euro Zone. *Source* Eurostat, AMECO Database, June 2020

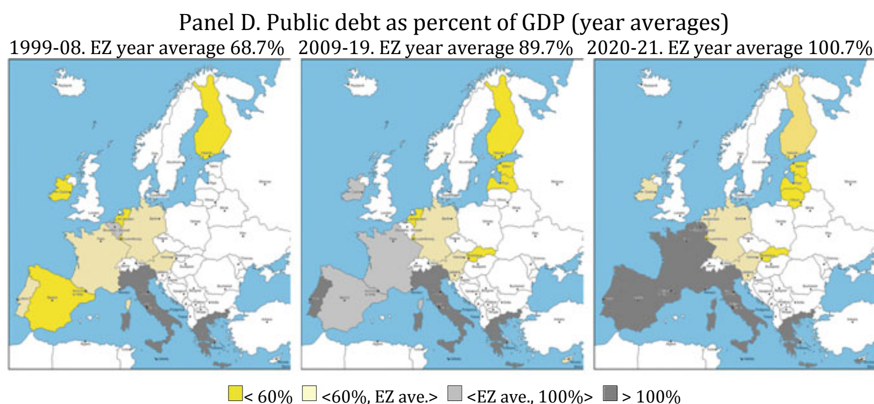

Fig. 1 (continued)

Our take on the consensus view is that the crisis originated in the US and spread across the world, but that there was indeed a dramatic "Europeanisation" of the crisis—mainly through private financial channels—which was exacerbated and prolonged by the interaction among flaws inherent in the EZ governance and structural factors *in the SEZ as well as in the NEZ countries.* These factors specific to different countries were also the cause of their different responses in the course of the crisis, but shifting the blame on the SEZ as scapegoats is misleading and feeds demagogic propaganda on both sides of the Union.

The typical NEZ narrative of the crisis points to two specific weaknesses ("sins") of the SEZ that may explain their bad response to the crisis: notably *fiscal profligacy* (excess public deficits and debts) and *loss of competitiveness* (large and persistent current account deficits) (e.g. Sinn 2014). If not the primary cause of an asymmetric (self-inflicted) shock of the SEZ, these factors have been pointed out as major determinants of the weaker resilience of these countries in the post-shock years as well as a threat to the stability of the EZ. This view quickly took hold within EU institutions, paving the way to the Macroeconomic Imbalances Procedure included in the "Six Pack" adopted in 2011 (European Commission 2010, 2016a). These macroeconomic imbalances, of which the SEZ themselves were deemed responsible, are also indicated as the causes that made "austerity" *inevitable.* Such imbalances are present in the general scenario of the crisis, but they should not be overemphasised or taken out of context.

3.1 Public or Private Profligacy?

As to public profligacy, it is hard to point to it as a general cause of the crisis. Panels C and D of Fig. 1 show a general "discipline effect" on public deficits and debts from 1999 to 2008, with perhaps deviations in the post-2009–2011 recession. The large majority of countries remained, over time, below or not far from the thresholds established by the Stability and Growth Pact. Only in the case of Greece do we have a blatant case of government profligacy (*and* disguised public accounts). More specifically, the average debt/GDP ratio of the SEZ fell from 61.8% in 1999 to 59.6% in 2007, with Cyprus (51.5%) and Spain (35.5%) at the lowest end of the ranking of public debtors. As for the budget deficit, with the 2009 exception, Italy has been running a primary surplus for more than 20 years, although it was very small in the 2001–2005 period. Spain had a primary surplus above 2% of GDP between 1999 and 2007.

The true stability threats were nested, largely unnoticed, in private debt/credit relationships across the EZ, the channel through which the financial turmoil migrated from the US to Europe (e.g. Lane 2013; Baldwin and Giavazzi 2015). Extensive empirical research has detected factors that are unrelated to the so-called fundamental valuation of sovereign debts (e.g. Caceres et al. 2010; Favero and Missale 2011; De Grauwe and Ji 2012, 2013). Particular attention has been devoted to clear symptoms of *self-fulfilling speculative attacks*, that is contagious beliefs about insolvency of a sovereign that become true as they trigger fire-sales of its debt, and an "*euro dummy*" effect, that is an extra-premium charged by investors, with respect to non-euro stand-alone countries with similar debts, due to the lack of a lender of last resort in the EZ. The immediate impact of the 2012 ECB's "whatever it takes" on interest rate spreads showed quite clearly that these factors, together with *redenomination risk* (i.e. the risk that one or more countries exit the euro) were major drivers of the crisis.

3.2 Current Account Imbalances: Whose Sin?

Shifting the focus from public to private finance implies a parallel shift from internal to *external imbalances* (Lane 2013; Gros 2013; Mazzocchi and Tamborini 2019). The large current-account deficits of almost all the EZ countries *vis-à-vis* the German surplus that opened up between 2004 and 2012 play a central role in the crisis narrative. The culprit is seen in the growing divergences in competitiveness of deficit countries. The most common indicator is the real exchange rate, measured as the ratio of the unit labour costs between one country and another (or an aggregate of trading partners). Indeed, setting the average real exchange rate of deficit and surplus countries equal to 100 in 1999, the former peaked at 117 in 2012 *vis-à-vis* the latter plunging to 98. All of the SEZ were at the time deficit countries, so that current-account imbalances appeared as another cleavage between the NEZ and the SEZ.

Competitiveness—though a notion that can hardly be applied to a whole country (Krugman 1996)—is a critical factor for growth, and the NEZ crisis narrative contains elements of truth. Yet criticisms have been raised, and alternative views have been put forward, on three main issues that ought to be taken into account: (1) the relevance of current account imbalances in a monetary union, (2) their causes and connection with the crisis, and (3) their policy implications (see Mazzocchi and Tamborini 2019, for an extended coverage).

Looking first at long-standing federative countries, the question naturally arises why *internal* current-account imbalances are so important in the EZ whereas nobody cares elsewhere (who has ever heard about current-account imbalances of Florida or Brandenburg?). The point (O'Rurke and Taylor 2013) is that intra-EZ imbalances are not comparable with intra-US (or East-West Germany) imbalances because the EZ is not a federal state with a central government and a fully-integrated capital market. On the other hand, intra-EZ imbalances are not comparable with those that may occur among independent monetary sovereigns either, for the basic reason that the latter should be ready to cover payment imbalances with foreign currencies, whereas the EZ countries share the same currency (Pisani-Ferry and Merler 2012; Collignon 2014).

Second, most of the time open economies, or regions within the same national boundaries, follow different growth paths, with different rates of growth of prices, wages, population, capital, employment. These differences quite naturally lead to large trade and capital flows. A classic argument in favour of free mobility of persons, goods, and capitals is precisely that it enables open economies to take different economic trajectories while having access to wider pools of resources (Blanchard and Giavazzi 2002).

Third, a fundamental macroeconomic law states that a net exporter of goods and services also registers *excess national saving* (private + public) above national (private + public) investment and will also be a net exporter of capitals. This is an entrenched pattern of the NEZ countries, especially Germany, where the excess of national savings over investment has escalated from 6.8% of GDP in 2005 to 10% in 2018. Hence credit-debt positions growing large are the necessary flip side of the coin in the competitiveness race. Different economic trajectories and the ensuing transfers of resources may embed long-term troubles as to their sustainability (Acocella 2016). Yet identifying pathological imbalances is a difficult task, and for some scholars a narrow notion of price-cost competitiveness is misleading (Wyplosz 2013, 2014).

Indeed, the problem with the real exchange rate is that it does not identify *for what reason* misalignments arise. Esposito and Messori (2016) show that while nominal wage growth and inflation were broadly aligned across countries, surplus countries enjoyed faster productivity gains that lowered their relative unit labour costs. In the surplus countries, wages were not keeping pace with productivity gains, that is *real wage depreciation* was under way. Is this kind of competitiveness policy sustainable in a monetary union? Is there a sense in which underpaying workers below their productivity should be a model—or a necessity—for the EZ as a whole?

3.3 *Inevitable Expiations or Crisis Mismanagement?*

Fiscal consolidation, also known as "austerity", and rebalancing of current accounts were the two hallmarks of the EZ crisis policy. This choice loaded a heavy asymmetric burden onto the shoulders of the countries with both fiscal and external imbalances—mostly the SEZ and Ireland. Those, however, were the days of confidence in neutral or expansionary fiscal consolidations (Buti and Carnot 2013). As is well known, a heated debate, that we cannot go into here, arose among scholars, politicians, and public opinion. If in 2013 the German Minister of Finances W. Schäuble declared that "Nobody in Europe sees a contradiction between austerity and growth. We have a growth-friendly process of consolidation" (*The Wall Street Journal*, April 11), as of today the "consensus view" is much less optimistic.

The change of judgement was marked by the famous *mea culpa* of the IMF about the large and persistent forecasting mistakes of the effects of austerity on growth (Blanchard and Leigh 2013). There is now agreement that austerity was applied too early, too widely and in an uncoordinated manner, with two perverse consequences. (1) the country-by-country approach (induced by the regulatory framework) contributed to the serious underestimation of the negative impact of consolidation plans activated in a large number of countries at the same time ignoring their reciprocal "spillover effects" (in't Veld 2013). (2) austerity turned out to be self-defeating for the purpose of fiscal consolidation; while it harnessed fiscal deficits quickly, the debt/GDP ratio grew more in those countries where stronger consolidation policies were enforced.[6] This triggered self-fulfilling speculative attacks. On the other hand, as was deemed necessary by Daniel Gros (2013), the domestic contraction and nominal deflation induced by austerity was, in Keynesian fashion, the main driver of external rebalancing (see Esposito and Messori 2016; Mazzocchi and Tamborini 2019, and Fig. 2[7]). Whatever the effect of austerity on growth has been *vis-à-vis* other concomitant factors (see Fragetta and Tamborini 2019), the crisis policy choices have left deep and lasting scars on the EZ economies and societies.

Were the EZ policy choices inevitable? As a matter of fact, the EZ institutions embraced the NEZ point of view, focused on fiscal indiscipline and loss of competitiveness of the SEZ. In the previous section, we have shown that such a point of view was rather narrow and skewed. It failed to understand the financial origins of the crisis, its diffusion and contagion dynamics, the private-public "doom loop", the transmission channels to the real economy, up to an overall systemic crisis. The frantic creation of new instruments and regulations—"Two Pack", "Six Pack", "Fiscal Compact", etc.—was not aimed at fixing the emergent flaws in the design of

[6]In fact, the negative impulse to GDP growth may make the debt/GDP ratio rise instead of falling (Nuti 2013; Tamborini 2013; Boitani and Perdichizzi 2019; Boitani et al. 2020).

[7]The total current account imbalance of the deficit countries as a whole peaked at 6% of their aggregate GDP in 2008. It was completely reabsorbed by 2012, and since then has been in positive territory reaching 2% of GDP in 2017. At the same time, the average nominal GDP of the then deficit countries was 48% of that of the surplus countries, reached 55% in the run-up of current-account imbalances, and eventually fell back to 45% in 2017.

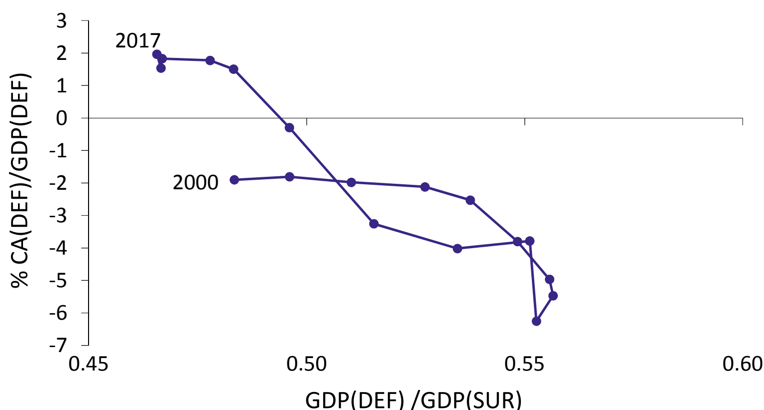

Fig. 2 The adjustment path of the current account of the deficit countries and their nominal GDP relative to surplus countries, 2000–2017. Deficit (surplus) countries are those with negative (positive) current account between 2000 and 2008. *Source* Mazzocchi and Tamborini (2019)

the system but at giving more prominence and strictness to its entrenched conceptions. The change of the disastrous course of the crisis arrived only when, in the Summer of 2012, the ECB took control of the sovereign debt crisis (Wyplosz 2014).

4 What Is the Nature of the Eurozone?

Despite the growing consensus on the inadequacy of EZ institutions and policies, so far little progress has been made in particular as far as reforming the apparatus of fiscal governance of the EZ which is on the frontline of the political divide (see, e.g., Delatte et al. 2017; and Asatryan et al. 2018, for an overview of the issues) is concerned. The state of play as of 2019 can be epitomised in two alternative reform models: the *Maastricht 2.0 model*, and the *Confederal model.*

The Maastricht 2.0 model, more akin to the view of most NEZ governments, rests on the judgement that it was not compliance with, but violation of, the Maastricht principles and rules (with the benign neglect of a "politicised" Commission) that generated the crisis, whereas these rules remain a fundamental pillar of a sound EZ. Consequently, when the followers of this view talk about "more Europe" they mean further devolution of sovereignty towards supranational agencies essentially "technocratic" in nature (e.g. the European Fiscal Board and national fiscal boards) with a clear mandate and power to enforce the rules *vis-à-vis* democratically elected governments.

Different strands of critical thinking on the EZ architecture, as well as the governments of the largest SEZ countries converge on the Confederal model, with France as possible mediator (as can be understood from Macron's famous Sorbonne speech in November 2017, and the joint Meseberg declaration with Chancellor Angela Merkel

in June 2018). In this view, the crisis has brought to the forefront two most compelling problems: (1) no one is in charge for the EZ as a whole at the supranational level with the exception, by statute, of the ECB; (2) the governance mechanisms in place have proved unable to coordinate national policies, and provide proper macroeconomic stabilisation. The confederal inspiration should be understood in a broad sense, meaning that the aim is the creation of larger pools of common resources, extension of risk-sharing tools, and in parallel the development of bits of genuine supranational government (not just governance) with clear institutional legitimacy with respect to both the EU order and the national constitutional orders.

One may wonder what the nature of the Monetary Union is. With the Single Market in an institutional vacuum, we have created a "competition union", i.e. an arena where countries are called to participate in a competition in which there are losers and winners of trade and GDP shares. The idea is that the losers will learn from the winners so that all will be winners (unlikely). Of course, the winners may be happy with this "hunger game" (Storm and Naastepad 2015), and the losers come to understand why they lose and how to improve. Yet the "competition union" requires (and to some extent creates) losers who absorb the excess capacity of the winners; hence losers (net importers) are not the doom of the winners (net exporters) but are necessary for their success. When talking about the costs and benefits of the monetary union, serious and responsible opinion makers in the winner countries ought to explain that having losers tied up in a common currency is a key factor of their success (the alternative would be a systematic appreciation of the exchange rate swallowing the competitive advantage, as it happened in the 1970s and 1980s).

A "competition union" is bound to end up in "a zero sum game". If net importers struggle (or are forced) to become net exporters themselves, the outlet markets shrink for all. The winners take home the largest share of a shrinking pie. There is only one escape route from the zero-sum game: that all countries become net exporters *vis-à-vis* the rest of the world. This is actually what has been going on after the crisis therapy (only France now has a foreign deficit), as clearly shown by Fig. 3.

Does this mean that the "competition union" is eventually a success, albeit at some cost for the laggards? Not so much. The implication is that the EZ as a whole is running production capacity in large excess of domestic demand, as indicated by the declining overall growth performance of the EZ in Panel A of Fig. 1 *vis-à-vis* its growing export capacity in Panel B. The data also show that extra-EZ trade has substituted, not integrated, intra-EZ trade. In 2000, intra-EU exports amounted to 2.2 times extra-EU ones, in 2017 1.4 times. That is to say, we have created a single market of about 400 million people and then we have our industries depending on the ups and downs of demand and political benevolence abroad.

The export-led growth model long pursued by Germany is appropriate to small open economies and to emerging economies (or countries in the aftermath of a devastating war). However this may become unsustainable for large developed economies, already commanding a disproportionate share of world trade. They become subject to the risks of sudden stops to their exports because of trade barriers set up by other countries. This argument also makes the objective of transforming the EZ, not to say the EU, into an export-led economic area highly questionable. The above-mentioned