ISPI Commentary
ISTITUTO PER GLI STUDI DI POLITICA INTERNAZIONALE

March 28, 2011

The next reform agenda for the Eurozone

Daniela Schwarzer (*)

The European Council meeting of 24/25 March 2011 delivered parts of a "comprehensive package" for the reform of European economic governance. In the last twelve months, the reform of economic governance moved forward at an impressive speed. But last Friday's summit by far did not solve the most pressing issues ahead. The EU, and especially the Eurozone, will have to continue tackling tricky questions some of which concern the political nature of the Eurozone. Two examples illustrate this.

New rules for budgetary and economic policy coordination: News headlines recently suggested that the Eurozone Finance Ministers had agreed on tougher rules and sanctions for budgetary policy coordination. Also, the new rules for economic policy coordination are taking shape. Indeed there is progress in equipping the Eurozone and the EU with better surveillance and coordination mechanisms in order to reduce economic imbalances and prevent future sovereign debt crisis. But there is a "but": First of all, it is neither the Ecofin, the Eurogroup nor a Eurozone summit which defines these rules. Four legislative acts are decided in co-decision procedure, so the European Parliament is fully involved – which is widely ignored in domestic political debates.

And the Parliament's draft reports rightly point out one crucial weakness: there is a risk that the new mechanisms (just like the old ones) will not manage to substantially influence national policies – if there is no automaticity, no particularly strong role for the European Commission and no strong ownership in the member states which would make Eurozone logics an integral part of domestic policy debates.

Even if this view is too pessimistic and the new framework has "teeth to bite", political problems may emerge: strong interference from the EU level is likely to raise legitimacy issues in the national context. An increasing number of observers think that this problem can only be overcome by a larger transfer of sovereignty and more democratic legitimization on the EU level. This would be a major step of political integration after the current reform. A first step in the current reform would be to involve the European and the national Parliaments more strongly than is currently foreseen.

The European Stability Mechanism: The new permanent crisis mechanism ESM is slowly taking shape. But the tedious negotiations and unresolved issues show that several fundamental problems remain to be solved. First of all, there is not yet a consensus what purpose the ESM should actually fulfill. While the German position is to have the ESM only to prevent the worst (i.e. a crisis that could endanger the Euro), there are good arguments for a more pro-active use of liquidity aid to help prevent self-fulfilling financial crises. Also, the EU is probably not politically

---

(*) *Daniela Schwarzer heads the research unit European Integration at the German Institute for International and Security Affairs, Stiftung Wissenschaft und Politik (SWP) in Berlin.*

ready to accept that providing credit may actually entail the risk of losing it. In other words: the idea that in a new round of a crisis there could be a need for transfers from some member states to others cannot be assumed as accepted. But if this case happens, it will be politically very difficult to digest and should be consciously prepared in order to prevent a severe decline in public support for the Euro in the donor countries. Finally, the ESM as it looks today, will most probably not be able to provide for an "orderly default" for those member states that are in a liquidity crisis and need debt restructuring. To make this an option, member states would have to move beyond the current framework and set up a formal legal procedure which would also allow agreements with other governments who are lenders.

The banking sector: Indeed, even with the ESM agreed sometime this summer, the EU will be far from having solved its sovereign debt crisis. The reason is that a political taboo remains – and this is the question how to deal with the problems in the European banking sector. European banks would be seriously affected if the sovereign debt crisis develops further and if debt restructuring has to be undertaken – and this fact currently limits the political options how to deal with insolvent member states considerably. The Ecofin should in a first step revisit the question of stress tests. The EU has already conducted two rounds of tests which essentially helped to hide the real problems. Effective tests would provide for transparency – and hence the fundament upon which the necessary recapitalization and restructuring of banks in some member states could then be undertaken.

Unless these questions are tackled, the Eurozone will not find its way out of the sovereign debt crisis in a way that is broadly acceptable to the European public. Solving them requires intense political debates on the political nature of the Eurozone, the degree of solidarity and the question who bears the costs for whom, not only between member states, but also with regard to the financial sector.

ISPI
Palazzo Clerici
Via Clerici, 5
I - 20121 Milano
www.ispionline.it