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THE BLOCKED COMPLETION OF THE EUROPEAN MONETARY UNION

Making the case for a pragmatic use of fiscal leeway

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SUMMARY

The reform of the euro zone is stuck. Against the background of political blockades, this report examines from a combined economic and political science perspective how the Euro can be prepared for the next crisis. The report first identifies general requirements for the stabilization of economic and monetary union. Next, the report reconstructs the political logic of the euro crisis and shows that the prospects for realizing far-reaching reform proposals aiming at a fiscal union are poor. Subsequently, the report develops a proposal of how, under the given circumstances, the room for maneuver within the existing framework of economic and monetary union can be extended in a pragmatic way in order to strengthen national fiscal policy as an instrument of macroeconomic stabilization.

SEVEN OPTIONS FOR EXPANSIONARY FISCAL POLICIES AND HIGHER PUBLIC INVESTMENTS

- More active use of the “investment clause”
- Permission of temporary investment programmes (similar to EFSI)
- Interpretation of certain temporary investment programmes as structural reforms
- Realistic investment multiplier for the budget analysis
- Using of scope for more expansive fiscal policies in economically difficult times
- Making use of the exception for a severe downturn in the EU or the euro zone
- Application of improved cyclical adjustment procedures

CONTENTS

1 PROBLEM[1]

After around 2015, the acute and severe crisis in the euro area could ultimately only be mitigated by desperate emergency operations: the ECB's turnaround in monetary policy under Mario Draghi, with his publicly expressed willingness to do everything in his power to save the euro, and the turnaround in fiscal policy under Jean-Claude Juncker, whose more generous interpretation of the fiscal rules made it possible to alleviate the macroeconomically dysfunctional austerity policy in the crisis states, came just in time to prevent an end to the single currency. Since then, there seemed to be a broad consensus at the European level that the remaining time before the next crisis should be used for more or less far-reaching reforms of the euro area governance in order to make the euro area more resilient to future crises. In this sense, relatively far-reaching reform measures for completing the monetary union had already been proposed in the Five Presidents' Report (Juncker/Tusk/Dijsselbloem/Draghi/Schulz 2015).[2] So far, however, fundamental conflicts of interest between the member states of the economic and monetary union (EMU) have made such reforms impossible. The political crisis that followed the refugee crisis contributed to this.

The election of Emmanuel Macron as French President breathed new life into the debate on the further development of the monetary union. At the heart of his vision was a large budget for the eurozone with a volume of 3 to 4 per cent of the eurozone's gross domestic product. A separate eurozone parliament and a European finance minister were to be responsible for the budget. The budget was intended to contribute significantly to the stabilisation and convergence of the eurozone. These ideas met with little approval from the German government and some other northern European countries. Moreover, the EU Commission did not really take up Macron's proposals. In the Franco-German declaration of Meseberg, Macron's ambitious plans have been changed almost beyond recognition. But even this minimal compromise seems hardly feasible at the European level. As we show in this report, the difficulties in reaching agreement stem from a conflict between the member states of northern and southern Europe over the distribution of the burden of economic adjustment in a monetary union. Therefore, a far-reaching reform of the fiscal governance of the euro area seems politically unrealistic in the foreseeable future.

Against this background, this report focuses on the question of how the euro area can be stabilised without comprehensive reforms in order to prevent the euro from collapsing in the next economic crisis. We examine this question from an interdisciplinary economic and political science perspective. In section 2, we first outline from a Keynesian economic perspective the requirements that need to be met in order to stabilise the monetary union. The realisation of Macron's plans would be a big step towards fulfilling these requirements, but the Keynesian view is opposed by a neoclassical/ordoliberal perspective with diametrically different recommendations. Furthermore, as we show in section 3 from a political science perspective, the realisation of far-reaching reform ideas with a Keynesian focus is unrealistic in the current constellation. In section 4, we therefore look at how to make pragmatic use of the fiscal room for manoeuvre within the existing European regulatory framework in order to be prepared for the next economic crisis. In section 5, we draw a short conclusion and show that pragmatic solutions are not only politically more feasible, but can also have further advantages over a full constitutionalisation of the euro zone.

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1 This report is a translation of Seikel, D./Truger, A. (2019): Die blockierte Vollendung der Europäischen Währungsunion: Plädoyer für eine pragmatische Nutzung von fiskalischen Handlungsspielräumen, published in Wirtschaft und Gesellschaft 45 (1), pp. 43–65. The translation has been provided by Sebastian Streb.

2 See the detailed contributions in OeNB (2016).

2 REQUIREMENTS FOR A REFORM OF EUROPEAN ECONOMIC GOVERNANCE FROM AN ECONOMIC POINT OF VIEW

In the following, we set out requirements for a reform of the eurozone governance from a Keynesian perspective.[3] They are intentionally of a general and fundamental nature and are intended only as a rough guideline. The requirements are derived from the macroeconomic functions and national economic policy instruments that were abandoned with the transition to EMU. For these functions and instruments, a functional substitute has to be created. In this way, three central requirements can be derived: (1) better safeguarding of national government bonds, (2) upgrading fiscal policy as a macroeconomic instrument and (3) reducing macroeconomic imbalances. For each of these requirements, we also present the opposing view of the neoclassical/ordoliberal perspective, which is one of the reasons for the difficulties in reaching political agreement.

First, many proposals for reforming the governance of the euro area aim at improving the protection of national government bonds against crises of confidence on the financial markets (Eurobonds, "Euro area safe asset", European unemployment insurance, euro area budget, European Monetary Fund, etc.). This is necessary because with the introduction of EMU, the national central banks have lost their function as guardians of the respective national currency and government bonds. The implementation of at least some of the proposals could make sovereign debt crises in the euro area much less likely in the future. However, they will only achieve their full effectiveness if the ECB is entitled (and ideally even obliged) to purchase the relevant bonds, i.e. if it can and must perform its lender of last resort function – just like other central banks. Otherwise, crises of confidence and speculation in deregulated financial markets cannot be credibly contained. This requirement stands in stark contrast to the neoclassical/ordoliberal view, whose proponents favour a rigid no bail-out clause and even a forced withdrawal from the euro. From this perspective, financial support for crisis countries is only acceptable to a very limited extent and only under strict conditionality and supervision of national fiscal policy. Compliance with the rules must therefore ideally be enforced by automatic sanctions and/or by the disciplining role of the financial markets.[4] However, such a fiscal policy, which is not or only to a limited extent secured, will always be influenced by expectations and moods in the international financial markets and will not be able to guarantee lasting stability in the euro area.

Second, fiscal policy as a macroeconomic instrument must be substantially upgraded. There are various reasons why such an upgrade is necessary. The austerity crisis has shown that fiscal policy – especially in times of crisis – is macroeconomically far more effective than many had previously assumed. This is empirically well documented by the recent debate on the size of the fiscal multiplier (Gechert 2015). That means that fiscal policy in the euro area must support monetary policy in stabilising the economy, especially in times of crisis, because the effectiveness of conventional interest rate policy alone is limited. In addition, fiscal policy at the national level plays a central role as an economic stabiliser because the ECB has to follow the euro area average when setting interest rates and therefore cannot react to different economic developments in individual countries. Without (fiscal) countermeasures at the national level, there is the risk of prolonged boom and bust cycles, which threaten both the economic stability and the political cohesion of the euro area. Finally, fiscal policy must facilitate high long-term productivity growth through high and steady public investment in classical and environmental infrastructure, education and research. In addition to the reform proposals already mentioned, numerous other suggestions address this problem. These include, for example, an expenditure rule that is less susceptible to revisions in the estimation of potential output or the golden rule for public investment, which excludes public net investment from the deficit limit.[5] According to neoclassical/ordoliberal ideas, fiscal policy has at best a long-term investment-related role, while its macroeconomic effectiveness is largely denied. The multipliers are considered to be low, zero or even negative in the medium term. At the same time, fighting public debt is considered crucial for various reasons ("intergenerational justice", combating inflation, general limitation of government activity). Accordingly, the macroeconomic use of fiscal policy must be limited by strict deficit or debt rules. National stabilisation should be achieved through supply-side policies or "structural reforms" (deregulation of labour and goods markets, reduction of workers' rights and dismantling of the welfare state).

3 See in particular Hein/Detzer (2015) and the literature cited therein. While they tend to argue for decentralised solutions, the analysis carried out does not specify any instruments.

4 This also includes plans for a European insolvency regime for euro countries (for a critical analysis see Lindner 2019).

5 See also Truger (2015a, 2015b).

Third, macroeconomic imbalances need to be addressed. In addition to the lack of synchronisation in national economic cycles, some euro area economies are also becoming structurally more divergent, which is mainly reflected in high and increasing current account imbalances. Such imbalances can lead to debt crises and thus financial market crises and are therefore a source of great instability. In addition, when based on divergences in international trade, they lead to political resistance, as is currently demonstrated by Trump's trade policy. Depending on the cause, there are different approaches to tackle this problem. A divergence due to different domestic economic dynamics can be countered by a coordinated fiscal policy. If divergences are based on differing price competitiveness, the focus is more on a coordinated wage policy, which can also be stimulated and fostered by a coordinated fiscal policy. In case of differing non-price competitiveness and competitiveness problems with strong sectoral and regional concentration, an active industrial and regional policy is necessary, which mostly also requires fiscal transfers. A targeted regional and sectoral development policy to increase long-term competitiveness is preferable to simply providing funding through income transfers (Gräbner/Heimberger/Kapeller/Schütz 2018). From a neoclassical/ordoliberal perspective, the existence of a problem is denied – at least as far as the German current account surplus is concerned[6] – or it is claimed that the problem can hardly be influenced by economic policy. As far as other imbalances are concerned, especially current account deficits in the periphery, a strategy of real devaluation through (relative) wage cuts and a policy of "structural reforms" and austerity is preferred in order to adapt "living beyond the means" to actual conditions (Schulten/Müller 2013).

The requirements identified above set the direction for functional macroeconomic changes of governance in the euro area, without being instrumentally and institutionally determined. The requirements can be met by far-reaching institutional reform proposals[7] as well as by smaller, seemingly technical changes in the interpretation or design of fiscal rules. Reforms towards a European fiscal federalism as well as more modest measures such as the coordination of national fiscal policies on the basis of either agreed rules or discussions, e.g. within the framework of the macroeconomic dialogue (cf. Koll/Watt 2018), can have almost the same effect. Moreover, the requirements outlined here do not prescribe a specific distribution of competences between the national and the European level. From this perspective, Macron's ambitious plans for a large euro area budget to stabilise and promote convergence would be just as desirable as an expansion of fiscal leeway at the national level (see ► section4).

The Keynesian view presented here is perfectly in line with the findings of the modern international macroeconomic mainstream (De Grauwe 2013; Stiglitz 2016). However, this view is not shared in large parts of central, eastern and northern Europe. The following section examines the significance of these conflicting interests with regard to the reform debate.

3 REFORM PROPOSALS AND REFORM DEADLOCKS[8]

In section 2, we adopted an economic perspective to identify the reform requirements necessary to stabilise the monetary union. In the following section, we now take a political science perspective and examine the political feasibility of far-reaching reform concepts such as Macron's. To this end, we first summarise the main findings of political science research on the euro crisis. Against this background, we analyse both current reform proposals and the current state of negotiations.

3.1 Patterns of crisis-driven integration: the political logic of the euro crisis

In order to evaluate the prospects of success of different reform proposals and to realistically assess the existing scope for political action, it is necessary to understand the political logic of the euro crisis. A political science perspective on the euro crisis reveals three key findings: first, the euro crisis led to a distributional conflict between creditor and debtor countries, characterised as a conflict over risk sharing and risk reduction, i.e. how to distribute the burdens of the euro crisis (Hübner 2018; Schimmelfennig 2015; Schneider/Syrovatka 2019; Seikel 2018a). Risk sharing means the sharing of burdens between states, for example through financial transfers or joint liability for public debt. In the case of risk reduction, the main focus is on the individual responsibility of states to overcome economic problems through reforms of their political economies and/or to prevent crises through common rules at the European level. Main elements are the introduction and tightening of a rule-based economic and fiscal policy and its monitoring and enforcement by technocratic authorities. Transfers should be avoided where possible in order to maintain reform pressure and minimise moral hazard. All these measures are intended to prevent the

6 For a critical analysis of the German "undervaluation regime" from a historical perspective, see Höpner (2019).

7 See for example Andor et al. (2018).

8 This section has been adapted from Seikel (2018b).

need for burden-sharing between member states in the first place. Interestingly, this distinction not only divides the euro countries into two camps, but also corresponds with the different economic policy concepts outlined in section 2: risk sharing corresponds with a Keynesian view, risk reduction with a neoclassical/ordoliberal perspective. As a result, this leads to a coherent and, over time, stable consistency between the dominant economic policy paradigm, distributive preference and reform ideas of each country of the euro area. The affiliation to one of the camps is apparently determined by the respective economic and financial situation of a country.[9] Second, negotiations did not take place on an equal footing during the crisis, but bargaining power was asymmetrically distributed. While the countries threatened by national bankruptcy stood with their backs to the wall, the so-called surplus countries held all the aces (Matthijs/McNamara 2015; Schimmelfennig 2015). Third, however, all actors shared a strong interest in preserving the euro (Jones/Kelemen/Meunier 2016; Schimmelfennig 2015, 181f). In the negotiations, this provided the crisis countries with a bargaining chip. The research literature describes the constellation during the euro crisis as a chicken game (e.g. Schimmelfennig 2015): two opponents speed towards each other in two racing cars; the one who swerves first is the loser. In other words, the one who most credibly threatens to cause a crash determines what the solution will look like in the end. During the crisis, creditor countries were much better equipped to survive a crash than the debtor countries.

The outcome of this constellation was a minimum level of risk sharing, backed by extensive measures for risk reduction at the expense of the debtor countries. This framework largely reflects the interests of the surplus countries.[10] Table 1 illustrates this framework by assigning the key institutions of the reformed economic and fiscal governance architecture and the respective decision-making modes implemented (intergovernmentally "pooled" or "delegated" to supranational institutions) to the preferences of creditor and debtor countries. One can clearly see how closely the new European economic governance corresponds to the preferences of the creditor states.

It is also evident that all new instruments that could be used for risk sharing, such as the new bail-out funds (ESFS, EFSM, ESM), remain under national control. By contrast, only those competences that can be used exclusively for risk reduction have been delegated to supranational institutions (Seikel 2018a).

The European decision-making rules with their high majority requirements (qualified majority or unanimity) always favour the defenders of the status quo as they give them considerable veto power. This results in a strong path dependency and low reversibility of decisions taken at European level. In academic research, this is known as "ratchet effect" (Scharpf 1988, 1997, 1999). This is important for assessing the political feasibility of the various reform concepts currently under discussion, as it strengthens the defenders of the current structure of risk reduction and risk sharing and weakens the bargaining position of the challengers of the status quo, such as Macron.

Table 1

Integration patterns since the start of the crisis

	Creditor countries	Debtor countries
Risk-sharing	Decision-making mode: Intergovernmental (Pooling) *EFSF, EFSM, ESM* *Bank Resolution Fund*	Decision-making mode: Supranational (Delegation) *Capital market interventions by ECB*
Risk-reduction	Decision-making mode: Supranational (Delegation) *Stability and Growth Pact* *Banking supervision/bank resolution* *Conditions & design of capital market interventions*	Decision-making mode: Intergovernmental (Pooling) -

Source: Seikel 2018a, p. 13, own adaptations

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3.2 Reform proposals: an overview

The election of Emmanuel Macron as French president brought new momentum to the political discussions on the further development of EMU.[11] As already mentioned, the core of his vision is a large budget for the eurozone with a volume of 3 to 4 per cent of the eurozone's gross domestic product (see ► Table 2). This corresponds to about 330 to 445 billion euros. A separate eurozone parliament and a European finance minister are to be responsible for the budget.

At the beginning of June 2018, German Chancellor Angela Merkel outlined her ideas for the future of the euro (Frankfurter Allgemeine Zeitung 2018). Her proposals hardly contained any concessions to

9 This is in line with the findings of recent comparative political economic research on "growth models" (Baccaro/Pontusson 2016; Hall 2018; Stockhammer 2016).

10 However, only from a neoclassical/ordoliberal perspective this reform strategy appears to be in the long-term interest of the creditor states. From a Keynesian perspective, the evolving institutions are dysfunctional and could lead to the collapse of the monetary union.

11 See Schneider/Syrovatka (2019) for an overview of the reform debate.

Table 2

Macron's reform plans for the euro area

	Stabilisation function	Investment budget/ Euro area budget	European Monetary Fund
Functions & competences	Fiscal transfers in case of asymmetric shocks	Budget for euro area Financing of investments	Financial support of member states in emergency situations
Decision-making mode	EU finance minister Eurozone parliament		
Volume	330-445 bn		700 bn
Source of funding	Member states EU's own resources European bonds		Member states

Source: Seikel 2018b, own translation

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Macron (see ►Table 3). Although the European Stability Mechanism (ESM) should be transformed into a European Monetary Fund (EMF), as requested by Macron, it would essentially continue to function in the same way as before: the EMF should remain under the control of the member states and should be subject to unanimity. What would be new is that the EMF should also be responsible for monitoring compliance with the requirements of the Stability and Growth Pact, alongside or perhaps instead of the Commission. This would make the economic and fiscal governance of the euro area even more technocratic. The background to this is the widespread criticism in Germany that the Commission is too political and too soft in enforcing the rules of the monetary union. In order to contribute to the stabilisation of the euro area, the EMF would be allowed to grant "preventive" loans to countries in financial difficulties; more about that below.

While the Commission had previously adopted a position between France and Germany, the reform proposals presented in the 'St Nicholas package' (European Commission 2017) and thereafter indicate a convergence of its view towards the German position (see ►Table 4). Two aspects are particularly striking. First, the Commission seeks to strengthen its own position by trying to gain more influence in the intergovernmental negotiations of the Eurogroup. It wants the Commissioner responsible for monetary and financial affairs to lead the Eurogroup. Second, the Commission aims at a substantial tightening of the European semester: in the event of asymmetric shocks, only those countries that have met the requirements of the Stability and Growth Pact for two years should receive short-term aid. As a result, the significance of the hitherto non-binding country-specific recommendations would be considerably increased. This is also

Table 3

Merkel's reform plans for the euro area

	Stabilisation function	Investment budget/ Euro area budget	European Monetary Fund
Functions & competences	Short-term loans (5 years) granted by the EMF to countries in difficulties; loans are subject to conditions	Budget for investments in innovation capacity Payments linked to structural reforms	Long-term loans (30 years); subject to conditions Monitoring of stability pact & competitiveness & debt sustainability
Decision-making mode	Intergovernmental	Parliamentary	Granting of loans: intergovernmental Monitoring: EU finance minister
Volume	-	< 40 bn	700 bn
Source of funding	EMF	Member states	Member states

Source: Seikel 2018b, own translation

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Table 4

Juncker's reform plans for the euro area

	Stabilisation function	Investment budget/ Euro area budget	European Monetary Fund
Functions & competences	Interest-free loans in the event of asymmetric shocks Condition: Member state must have complied with requirements of the SGP for two years	Payments linked to structural reforms	Transposition of the ESM into EU law Backstop function for bank resolution fund
Decision-making mode	Commission	European Treasury Institutionalisation of the Eurogroup Commissioner for Economic and Financial Affairs as chair of Eurogroup and EU finance ministers	
Volume	30 bn	22 bn	700 bn
Source of funding	EU budget Member states	Structural and Cohesion Funds	Member states

Source: Seikel 2018b, own translation

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in line with the Commission's proposal to grant a part of the EU funds as a reward for structural reforms (Karras 2018). Table 5 compares the different reform plans. Macron's ideas can be summarised as an institutionalisation of the euro area parallel to EU structures with the character of a "transfer union". By contrast, Merkel envisages an intergovernmental deepening of the EU with a strong technocratic component. The Commission's proposals would lead to a supranational deepening of the EU, which would strengthen the Commission. Overall, the ideas of the German government and the Commission follow the paradigm of a "stability union".

Table 5

Comparison of the reform plans

	France	Germany	Commission
Institutional	Parallel institutionalisation of the euro area	Intergovernmental deepening of the EU	Supranational deepening of the EU
Aim	Transfer union: risk-sharing	Stability union: risk-avoidance	Stability union: risk-avoidance
Pattern of competence allocation	Risk-sharing: supranational parliamentary	Risk-sharing: intergovernmental Risk-avoidance: supranational delegation	Community method (without EP)

Source: Seikel 2018b, own translation

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3.3 Current state of the political reform debate

On 19 June 2018 in Meseberg, the French and German governments finally agreed on a common position (Bundesregierung 2018). Although the agreement was celebrated by all participants as a clear commitment to Europe, it can only be disappointing for the French side. In November and December 2018, the Economic and Financial Affairs Council discussed further reforms of the monetary union. The current state of negotiations (see ►Table 6) is largely in line with the German position.

In general, the compromise corresponds to the integration pattern presented in section 3.1. Any further burden sharing is linked to further conditionalities and has additional measures for risk reduction as a precondition. Moreover, transfers are still excluded; assistance is only granted in the form of repayable loans. The agreement on a "stabilising function" is not to be confused with a real concession to Macron's demands. The possibility to grant preventive loans to countries before they need a comprehensive financial assistance programme is already in place.[12] But this option is also subject to comprehensive conditions: the financial difficulties must be the result of an external shock (in the neoclassical/ordoliberal sense of not being self-inflicted); by and large, the country must have complied with the requirements of the SGP; overall, the country must be in a stable financial situa-

12 For this purpose, the EMS contains two credit lines: the Precautionary Conditioned Credit Line (PCCL) and the Enhanced Conditions Credit Line (ECCL).

tion and commit itself to a reform programme in a "letter of intent". Furthermore, all new instruments that could entail cross-border redistribution remain under national control, while the monitoring instruments are delegated to supranational technocratic bodies (Commission and ESM or EMF): while the ESM is supposed to be transformed into an EMF, the national veto rights in the fund's decision-making bodies remain in place. In addition, the EMF should have a credit line of approx. 55 billion euros available for the final backing of the bank resolution fund, but would no longer be used for direct bank recapitalisation. Moreover, the member states should also retain their individual right to block the backstop function. In general, the backstop function shall only be implemented if the Eurogroup and the relevant European banking supervisory authorities were of the opinion that the risks in the national banking systems had been reduced beforehand and that effective national bank security funds had been set up – i.e. if there was no longer any need for additional guarantees.

The discussions about an automatic stabilisation function (e.g. EU unemployment insurance) and a European deposit guarantee for banks are completely blocked. The decisions are thus very close to mere symbolic politics – the resilience of the euro area is hardly strengthened. None of the three economic requirements for a stabilisation of the monetary union is met.

It is important to mention that not only Germany is blocking further reform steps. In the meantime, a group of twelve countries has joined together to form a "Hanseatic League", which is not only even more uncompromising, but directly opposes the German-French compromise.[13] The prospects for a comprehensive reform are therefore low. Although minor concessions are to be expected from Germany, these are unlikely to change the fundamental character of the reformed structure of euro governance. On the contrary, instead of a Keynesian transfer union à la Macron, a neoclassically motivated strengthening of risk-reducing instruments à la Merkel is likely – accompanied by the negative consequences for the stability of EMU outlined in section 2. In light of this deadlock, in the next section we present a more pragmatic approach.

Table 6

Current state of negotiations (June 2019)

	Stabilisation function	Investment budget/ Euro area budget	European Monetary Fund
Functions & competences	Short-term loans granted by the EMS/EMF to countries in difficulties Condition: external shock, compliance with SGP, stable financial situation, reform programme	Budgetary instrument for competitiveness & convergence Payments linked to structural reforms	Transposition of the ESM into EU law Credit line (approx. 55 bn) for final backing of bank resolution fund (condition: risk reduction until 2020) No direct bank recapitalisation Monitoring of stability pact & competitiveness & debt sustainability
Decision-making mode	Intergovernmental	Intergovernmental Commission	Intergovernmental
Volume	-	< 40 bn	-
Source of funding	Member states	EU budget Member states	Member states

Source: Seikel 2018b, own translation

13 The Netherlands, Belgium, Luxembourg, Austria, Sweden, Denmark, Finland, Malta, Ireland, Estonia, Latvia and Lithuania (Süddeutsche Zeitung 2018).

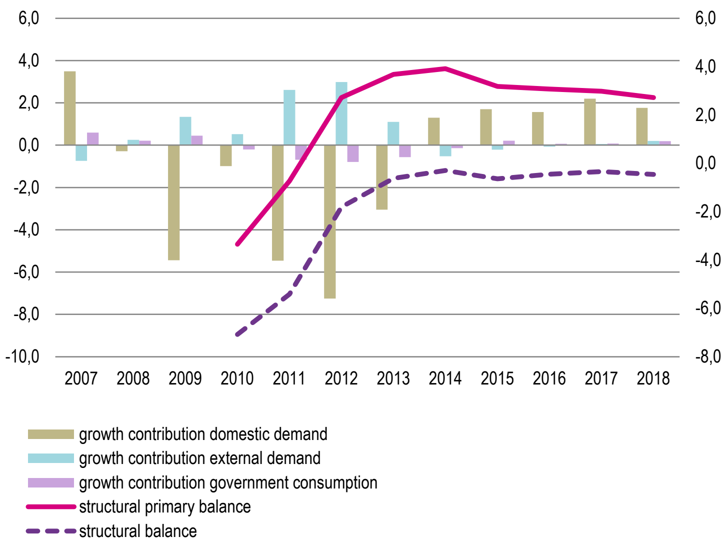
4 MAKING USE OF THE FLEXIBILITY OF THE EXISTING INSTITUTIONAL FRAMEWORK[14]

In the following, we focus on pragmatic proposals for strengthening fiscal policy, i.e. on the second requirement for reforming European economic governance identified in section 2. We thus implicitly assume that the ECB will continue its pragmatic policy of supporting the market price of government bonds, thereby ensuring that the first requirement is met. As the measures proposed here strengthen the economic development and crisis resilience of countries and are also in line with existing fiscal rules, neither economic nor legal reasons speak against them. We do not explicitly address the third requirement of reducing external imbalances. Our focus is therefore more on short-term measures to stabilise the euro area and less on corrective measures necessary in the medium to long term. Before we elaborate on our proposals, however, we will highlight the central importance of fiscal policy.

Figure 1

Fiscal policy crucial for recovery

Growth contributions in percentage points (left hand axis), structural general government budget balance and primary balance in the "EMU-12-periphery"* (2007-2018), in percent pf potential GDP (right hand axis)



* Greece, Italy, Portugal, Spain, unweighted arithmetic average

Source: European Commission (2019), authors' calculations.

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4.1 Excursus: the macroeconomic effectiveness of fiscal policy since 2015

The crucial importance of fiscal policy for macroeconomic development in the euro area is illustrated by the fact that the acute crisis in the countries of the European periphery could – at least for the time being – only be overcome by relaxing fiscal rules and thus by a much less restrictive fiscal policy. After the tightening of European fiscal rules[15] (Six Pack, Fiscal Compact, Two Pack) had led to a strict austerity policy in these countries, the new EU Commission under Jean-Claude Juncker interpreted and applied the rules in a more relaxed way (European Commission 2015; European Council 2015). This, together with the ECB's willingness, declared in 2012, to provide guarantees for the government bonds of the affected countries, finally paved the way for an economic recovery.

Figure 1 uses the structural budget balance and the structural primary balance[16] of four crisis countries (Greece, Italy, Portugal and Spain) to show the orientation of fiscal policy and compares it to economic growth contributions. If structural balances rise (decrease), this signals a restrictive (expansive) fiscal policy. As can be seen, with the austerity policy in place between 2010 and 2013 – the structural budget balance was reduced by over 6 per cent of GDP in only three years – domestic demand plummeted dramatically. The initially weak and then somewhat stronger upswing since 2014 was driven by domestic demand and coincides with a perceptible relaxation of the consolidation policy: in 2014, fiscal policy first switched to a neutral course; then, since 2015, it switched to a neutral if not slightly expansive course. Brussels' budgetary surveillance ultimately tolerated the deterioration of the structural budget balance. This was partly also a consequence of the reinterpretation of the rules of the Stability and Growth Pact (SGP). In the case of the primary balance, the switch in fiscal policy is even more pronounced. This reflects the impact of the ECB's bond purchase programme, which led to a noticeable reduction in interest expenditure and thus created additional fiscal leeway.

Another important aspect relates to the development of public investment (see ► Figure 2): between 2009 and 2012, during the acute austerity phase, net public investment in the periphery dropped by around 2.4 per cent of GDP. The multiplier of net public investments is particularly high and reductions are therefore particularly harmful (Gechert 2015). Nevertheless, they were severely affected by cuts because they are usually non-compulsory tasks and are therefore the first targets of consolidation. It was not until 2012 that net public

14 The proposals in this section are based on Truger (2015a, 2015b, 2016).

15 For further details, see Seikel (2016).

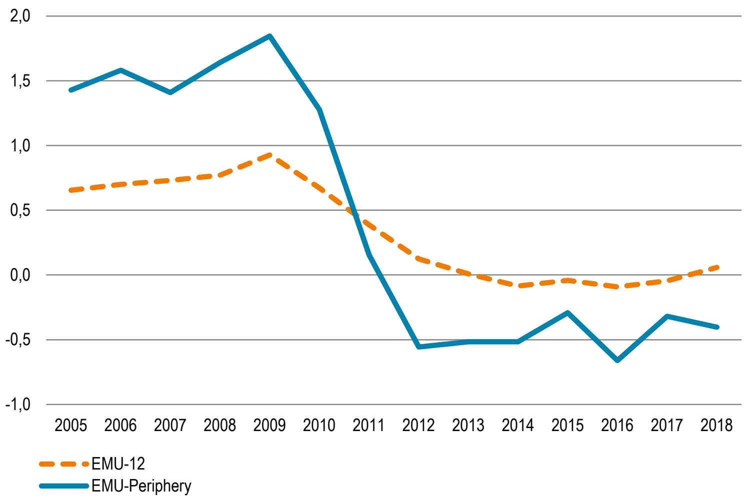
16 The structural budget balance is the government budget balance adjusted by the EU Commission for cyclical influences and one-time effects; interest payments on government debt are deducted from the corresponding primary balance. The EU Commission has published both balances since 2010 (cf. Mourre/Astarita/Princen 2014).

investments stabilised, albeit at a negative level of around -0.5 per cent of GDP. This means that the public capital stock in the periphery has been shrinking since then.

Figure 2

Public investment suffering from austerity

General government net capital formation in EMU-12 and "EMU-12-Periphery"* in percent of GDP (2005-2018)



* Greece, Italy, Portugal, Spain, unweighted arithmetic average

Source: European Commission (2019), authors' calculations.

4.2 Pragmatic proposals for expanding fiscal leeway

As explained in the previous section, increasing and stabilising public investment and enhancing cyclical flexibility in fiscal policy are essential for macroeconomic developments and the stabilisation of the euro area in the next downturn. In our view, this could be done pragmatically within the existing institutional framework.

To this end, it would be sufficient to make the fiscal leeway already expanded by the EU Commission (European Commission 2015) even more flexible. As a matter of fact, following the changes to the decision-making rules for the deficit procedure by the Six Pack and the Fiscal Pact, the Commission has considerable room for manoeuvre in decision-making,[17] which it has already used in the cases of France, Spain and Portugal. A more far-reaching interpretation of the room for manoeuvre within the existing fiscal policy framework, as proposed by us, would be a seamless continuation of the EU Commission's new interpretation.

The Infobox summarises the seven options outlined below. (1) First, the investment clause could be interpreted more broadly, e.g. all temporary investment projects co-financed by the EU could be excluded from the budget deficits without further restrictive conditions. (2) In addition, other temporary investment projects could also be exempted, similar to the Commission's approach regarding the European Fund for Strategic Investments (EFSI) (Mertens/Thiemann 2018). Otherwise, this would raise the question why the Commission supports certain projects when they are financed by the EFSI, but not when they are carried out as regular public investments by the member states. (3) Moreover, certain central investment projects (e.g. energy-efficient modernisation of buildings, infrastructure projects) could be interpreted as structural reforms, thereby justifying a temporary departure from the consolidation path. (4) In addition, the budget analysis by the member states and the Commission should include realistic (investment) multipliers of well above one: in this case, a considerable proportion of additional public investment is self-financing, which is why it could be (almost) irrelevant, at least with regard to the excessive deficit procedure. Moreover, despite the absolute increase in nominal debt the induced GDP growth would keep the public debt/GDP ratio at least constant or even reduce it temporarily.

Finally, it is generally advisable to use the scope for more expansive fiscal policies, irrespective of traditional public investment. (5) This can be done by referring to the poor economic situation in individual member states, (6) but, above all by, making use of the exceptional clause of an unusually severe recession in the euro area or the EU as a whole. In the event of a future crisis, this option would have to be used quickly. The Commission could set up a European anti-crisis programme similar to the 2008 European Economic Recovery Plan (EERP) (European Commission 2008). In fact, the EU Commission has explicitly chosen a comparison with the EERP to illustrate the exception rule (European Commission 2015). Its use should be limited to exceptional situations. A strong downturn with disinflation and a monetary policy already operating at zero interest rates would certainly offer a convincing justification. The anti-crisis programmes thus made possible could have a strong expansive effect and could indeed stabilise the economy. (7) All options for an expansionary fiscal policy would be strengthened if the EU Commission's method of cyclical adjustment, which plays an important role in budgetary surveillance, were revised. A major reason for the lack of economic adequacy of the SGP is that the procedures used for cyclical adjustment – though useful in principle – function only imperfectly. In order to assess national fiscal policy, the structural budget balance is a fundamental factor. Its development is used within the preventive arm of the SGP to assess whether member states have already achieved their medium-term budgetary objective (MTO) or whether they are taking adequate

17 For further details, see Seikel (2016).

Infobox

Seven options for expansionary fiscal policies and higher public investments

1. More active use of the "investment clause"
2. Permission of temporary investment programmes (similar to EFSI)
3. Interpretation of certain temporary investment programmes as structural reforms
4. Realistic investment multiplier for the budget analysis
5. Using of scope for more expansive fiscal policies in economically difficult times
6. Making use of the exception for a severe downturn in the EU or the euro zone
7. Application of improved cyclical adjustment procedures

Source: Own compilation on the basis of European Commission (2015).

consolidation measures to achieve it. The change in the structural budget balance is also used as part of the excessive deficit procedure (exceeding the 3 per cent limit) to assess whether progress towards consolidation is sufficient.

It is now widely accepted, however, that the change in the structural balance is a problematic indicator for the orientation of fiscal policy, because it considerably underestimates the extent of fiscal restraint in phases of crisis and overestimates the success of consolidation during an upswing vice versa. The structural balance is calculated by cyclically adjusting the actual budget balance and correcting it for one-off effects (e.g. privatisation revenues). The usual cyclical adjustment methods underestimate the extent of cyclical fluctuations and lead to procyclical policies if they are used as a yardstick for fiscal policy. The EU Commission's method in particular has proven to be problematic because the calculated potential output is strongly influenced by the current economic situation (Klär 2014). In phases of economic downturns, for example, the potential output is quickly and sharply revised downwards, although this does not reflect real conditions (Truger 2016, 169).

The downward revision of potential output has severe consequences for the calculated structural deficits and the consolidation efforts identified correspondingly. Consolidation efforts are usually estimated to be much lower than they actually were because a major part of the deficit is considered to be structural, although it may only have been caused by the economic downturn.[18] The easiest option would be to use medium-term averages for potential growth or, even better, to revise potential output estimates only in the medium term, e.g. every five years and not two or three times a year as is the case today. Such a potential calculation that is less sensitive to cyclical fluctuations, and which would have suspended the potential adjustment from spring 2010 onwards, would have opened up considerable room for manoeuvre for all member states under the preventive arm of the SGP. Italy, Luxembourg, the Netherlands, Austria and Finland would have reached their medium-term budgetary targets already by 2015 and would have had room for expansionary measures. Finally, the strongly negative output gaps would also have indicated an urgent need for fiscal action for the countries under the excessive deficit procedure. For the euro area as a whole, the output gap would have been -6.7 per cent instead of -1.7 per cent of GDP. This would have made it easy to justify the use of the exceptions to the SGP and would have made fiscal policy much less restrictive, even before 2015 (Truger 2016).

The stabilising expansionary effect of the measures outlined above would be substantial in macroeconomic terms. Multiplier-based simulations suggest that an increase in public net investment within EMU-12 to 1.5 per cent of GDP between 2016 and 2020, combined with the expected upward revision of potential GDP, could have led to a positive fiscal stimulus of 2.6 per cent of GDP and an increase in real GDP of 3.5 per cent (Truger 2017). Taking into account the positive feedback between member states, this would have resulted in a positive fiscal stimulus of 3 per cent of GDP and an increase in real GDP of over 5 per cent by 2020 (Timbeau et al. 2017). These results illustrate the strong macroeconomic potential of a pragmatic strategy of increasing public investment and revising cyclical adjustment, which seems capable of actually stabilising the euro area in the event of a crisis.

5 CONCLUSION

In this paper, we first set out general requirements for stabilising EMU from an economic perspective. We made clear that, in principle, these requirements can be met both by far-reaching institutional reforms and by more technical adjustments in the operationalisation of fiscal rules. Moreover, the

18 The EU Commission has already acknowledged this problem (Carnot/Castro 2015). It has revised the adjustment method several times (Hristov et al. 2017) and is now using additional indicators based on expenditure growth. This, however, considerably increases complexity and hardly alleviates the basic problem.

proposed changes do not prejudge a specific arrangement of national and supranational competences and institutions.

We continued by showing, from a political science perspective, that the diverging interests between the euro countries are blocking ambitious reform projects. On this basis, we looked for functional equivalents to a fully constitutionalised fiscal union. To this end, we developed a number of options on how fiscal room for manoeuvre could be extended within the existing regulatory framework, i.e. without having to follow the extremely rocky path of far-reaching institutional reforms. The core of our proposal is to make much more use of the flexibility available in the SGP in order to pursue a fiscal policy that is flanked by the ECB and supports the economy.

The completion of the monetary union in terms of a far-reaching reform would make great sense in our view. However, given the reform blockades identified in this article, this seems more than unrealistic. In light of partly antagonistic economic policy positions, it is therefore unlikely to achieve the goal of making the EMU crisis-proof through a major institutional reform before the next economic collapse. It is therefore all the more important to pursue pragmatic alternatives to a comprehensive reform of the Euro.

Apart from their greater prospects of political success, the proposals outlined here have a number of other advantages over ambitious reform projects. First, they do not require additional supranational institution-building. This would avoid a legitimatory overload of European institutions and policies in view of the still existing structural democratic deficits of European governance.[19] It would also avoid open distributional conflicts, which could lead to further cleavages between the European member states. Second, in the current political constellation it is virtually unthinkable that an institutionalized fiscal transfer mechanism at EU-level would not be directly accompanied by even more surveillance, conditionality and rights to intervene in national budgetary policies. Third, an expansion of the scope for fiscal policy at the national level would increase the democratic quality of national politics, which could then make a difference again.

However, should the political decision-makers insist on a narrow interpretation of the rules and thus a restrictive fiscal policy, as they did between 2010 and 2013, this would probably be the end of the monetary union.

19 See Mertens (2018).

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