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Still under construction

Why the eurozone still needs more work

The June Summit of European government leaders this week offers yet another opportunity to make progress on eurozone integration. In the last two decades, progress has at times seemed painfully slow and only really significant through the rear-view mirror. But strengthening the eurozone is an ongoing process.

The never-ending power struggle between national interests and European influence has been reflected in every discussion about bailout packages, fiscal rules, structural reforms and now, more prominently, in the discussion on the right way forward for the monetary union. Some argue that this issue can never be resolved, and with the rise of populist parties, the conflict has become tougher and the fight nastier.

In the coming months and years, sluggish economic growth could easily reinforce these tensions. A sharp recession would probably force all eurozone governments to implement fiscal stimulus, thus limiting the damage. But a longer period of sub-potential growth could prove more dangerous.

Citizens in Southern Europe are already tired of austerity measures and structural reforms. And the situation in core eurozone countries is unlikely to be severe enough for governments to act while the adverse effects of further monetary easing (lower interest rates undermining savings and pensions) would probably play into populist hands. In our view, the EU will have to face two fundamental questions:

- 1) For the core countries, it is increasingly clear that saying no to looser fiscal rules and a significant eurozone budget would push the ECB into even more easing.
- 2) For the more Southern eurozone countries, asking for support and solidarity without giving away national sovereignty also looks like a dead-end street.

For both sides, something will have to give.

Widening gaps between the haves and have nots could accelerate these tensions. Recent decisions by the ECB, as well as the controversy surrounding Italian fiscal policies, suggest that cracks are already beginning to show.

While there are, of course, other factors at play that will determine the success or failure of the monetary union, we focus squarely on the economics to take stock of where we stand ahead of yet another crucial euro summit.

Peter Vanden Houde

Chief Eurozone Economist
Brussels +32 2 547 8009
peter.vandenhoute@ing.com

Carsten Brzeski

Chief Economist Germany
Frankfurt +49 69 27222 64455
carsten.brzeski@ing.de

Bert Colijn

Senior Economist
Amsterdam +31 20 563 4926
bert.colijn@ing.com

Important work has happened since the crisis...

The eurozone has somehow managed to survive a deep crisis, though it took numerous emergency summits to keep the boat afloat. At times, the outlook for the monetary union has seemed apocalyptic. But it is often overlooked that there have been many reforms and improvements over the last ten years.

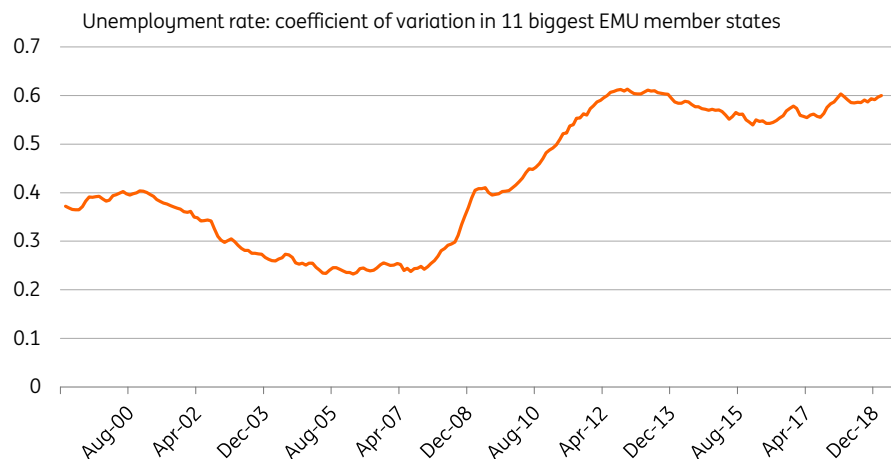
- The “no-bailout clause” has effectively been cast aside by the introduction of the European Financial Stability Facility and the European Stability Mechanism. The eurozone now has an official bailout institution, which provides loans under the condition that structural reforms are implemented.
- The start of a banking union with a Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM) has – at least in theory – reduced the risk of a new vicious circle between struggling banks and governments.
- The fiscal compact, as well as several attempts to strengthen the role of the European Commission, are all aimed at keeping fiscal policies more sustainable and harmonising economic policies through more and better coordination.
- Last week’s decisions to implement single-limb collective action clauses on sovereign bonds as of 2022 should make sovereign defaults easier to operate within the monetary union.
- Unthinkable some years ago, there will now also be a eurozone budget, though this is admittedly very small and vague. This is another tool for transfers within the monetary union although it will be of no real use in a crisis situation, given its small size, unsolved details and the explicit disclaimer that it cannot be used for stabilisation purposes.

This week’s euro summit will endorse the latest achievements. Still, the monetary union remains unfinished and needs more work.

...but stalling convergence poses a risk

Without a fully functioning fiscal and political union, the most fundamental problem for the monetary union, in our view, remains the lack of economic convergence. We shouldn’t forget that the monetary union started predominantly as a political project, with the aim of fostering convergence through the common currency. A number of countries would have liked to see more real convergence first before introducing a common currency. It was assumed that convergence would happen organically, with EMU participation itself leading to more synchronised economic cycles through increased trade integration and capital flows.

While there was indeed real convergence in the first decade of the monetary union (e.g. the Spanish unemployment rate temporarily even dropped below the German one), some of this convergence was artificial. It reflected the “Walters’ effect” (see [Buti and Turrini \(2015\)](#)), which describes how free capital flows will more or less equalise interest rates within the monetary union, thereby pushing down real interest rates in member states with higher inflation expectations. The economic boom in many eurozone countries helped convergence but at the same time, created rising imbalances, with a real estate bubble and massive current account deficits in countries like Spain and Ireland. The triple whammy of financial crisis, banking crisis and euro crisis put a painful end to this process and real convergence went into reverse.

Fig 1 Convergence in unemployment has hardly returned after the end of the crisis

Source: Eurostat, ING Research calculations

The channels or means to increase convergence within the monetary union include structural reforms, labour mobility, financial markets or more direct redistribution. Most of these channels are currently still underused.

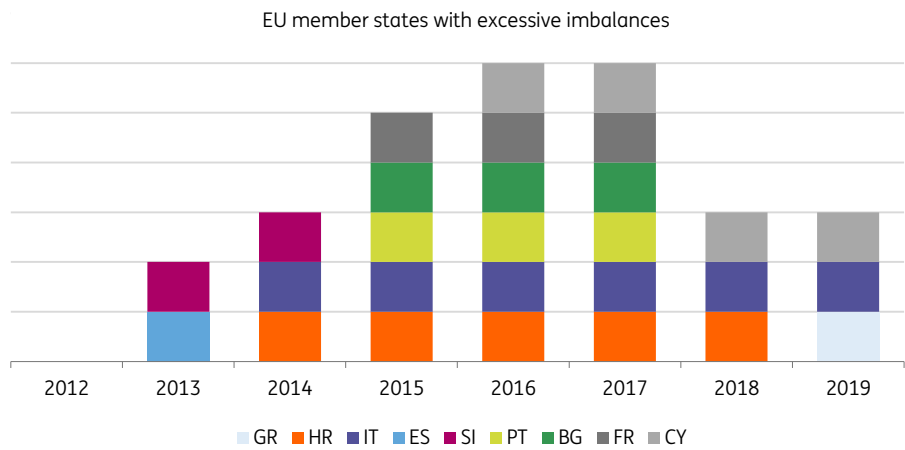
Structural reforms – between magic bullet and fatigue

In the first decade of the monetary union, structural reforms were less prominent as many of the relatively poorer countries saw strong growth rates and convergence. Despite the dotcom crisis, some countries managed to avoid recession and as such, there was little appetite for reform. The most notable exception, however, was Germany, which had a different economic cycle and was considered the “sick man” of Europe at the start of the 2000s. After years of economic stagnation and record high unemployment, the German government implemented significant reforms in the labour market. This was accompanied by corporate restructurings, low interest rates and the emergence of China as an important trading partner.

Since 2009, structural reforms have gained more prominence and are often singled out as a magic bullet to reinitiate the convergence process. Partly forced on countries by institutions that granted emergency support, a number of reforms were pushed through in the weaker Southern European economies, although this came with drawbacks. For some countries, the combination of fiscal restraint and structural reform proved too much of a burden (the economic payoff of reforms often happens years after the initial reforms occur). When the immediate need for funding subsided as economies recovered, the reform agenda stalled again. However, the need for reform has not gone away. Since the introduction of the macroeconomic imbalance procedure in 2012, Italy has been continuously assessed as having excessive imbalances.

Some reform fatigue is also visible in the fact that the Commission has found only limited progress on recommended changes for all EU member states. Particularly worrying is that in recent years, countries with excessive imbalances have not made any more progress than the EU average. Even former poster children like Germany have moderated their reform efforts. In that regard, [Demertzis and Goncalves Raposo \(2018\)](#) emphasise the need to strengthen the quality of institutions as a prerequisite for structural reform success.

Fig 2 Reform fatigue is showing



Source: Eurostat, ING Research calculations

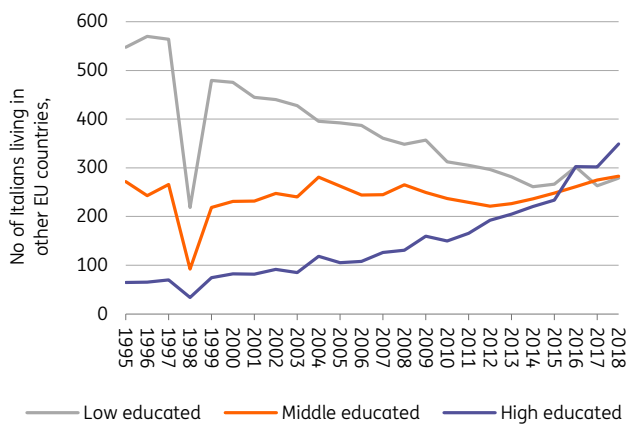
Labour mobility – still too little with risks attached

Labour mobility is often advanced as an adjustment mechanism in the wake of asymmetric shocks within a monetary union. The euro crisis has been an interesting test case in this regard, as the downturns have been very asymmetric across the eurozone. While cross-border labour mobility did increase in the aftermath of the crisis, the moves seem to have been too small to alleviate, in any meaningful way, the unemployment and social security burden caused by the deep recession.

In the absence of a more integrated social security set-up, labour mobility could actually be a destabilising factor in the longer run. It is mostly higher educated workers who tend to move abroad: Italy, Spain and Greece have all seen net emigration of highly educated workers since the start of the crisis (see [Alcidi and Gros \(2019\)](#)).

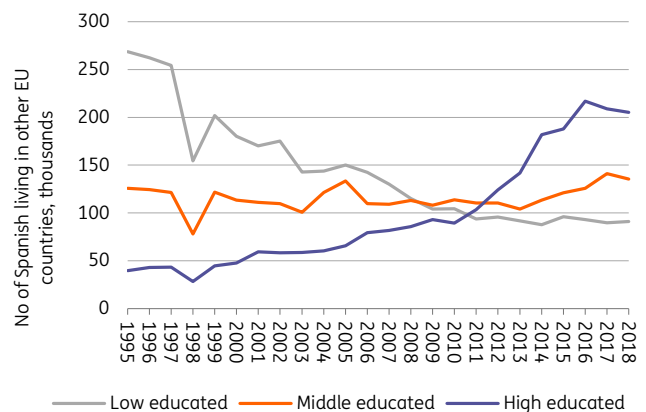
Prior to the crisis, it was primarily lower-educated people from Southern Europe who were moving to other EU countries but this changed during the crisis, with more highly educated people leaving as well. Italy, Spain and Greece currently have the largest groups of highly educated workers living abroad, and while the numbers aren't rising dramatically right now, a continuation of this trend clearly increases the risk of a brain drain from the periphery, thereby jeopardising the financing of a still national social security system.

Fig 3 Italy has seen a strong rise in the number of its highly educated living elsewhere in the EU...



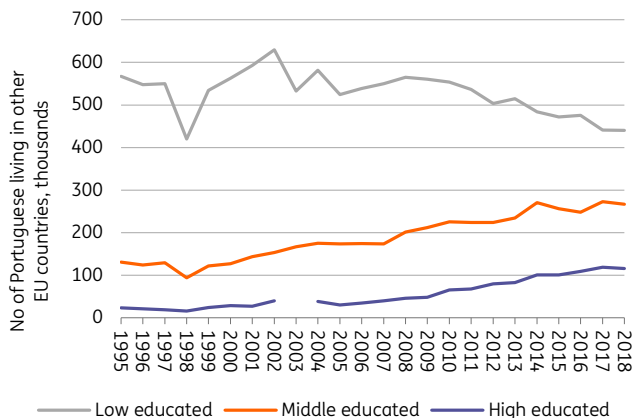
Source: Eurostat

Fig 4 ...which is also true for Spain



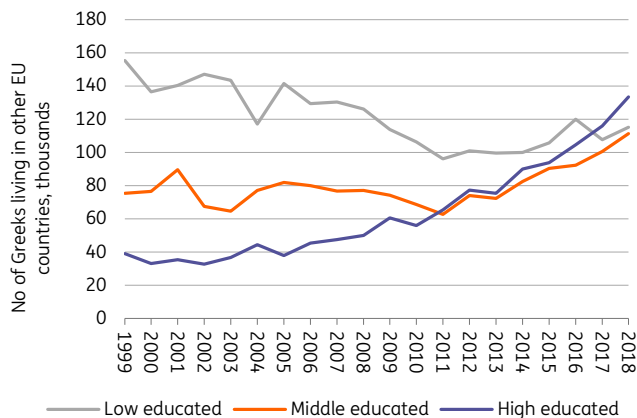
Source: Eurostat

Fig 5 In Portugal the effect is more muted...



Source: Eurostat

Fig 6 ... while in Greece we also see increases among the middle educated



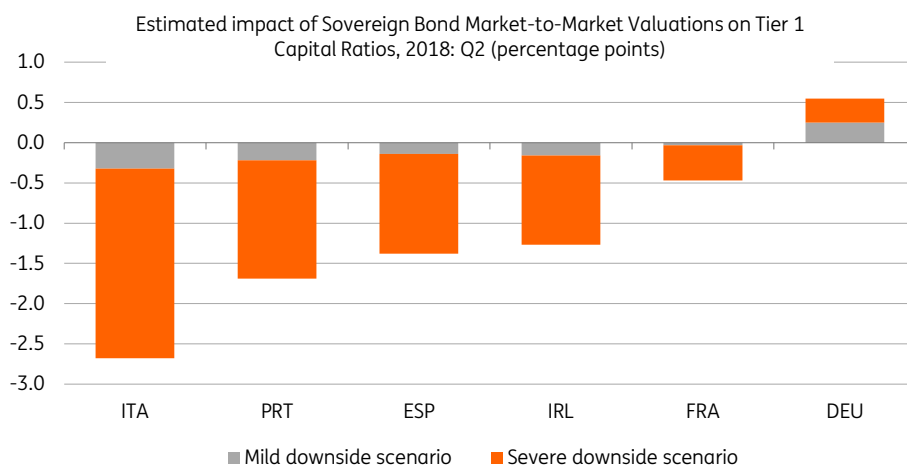
Source: Eurostat

Capital markets union – needed but still underdeveloped

In theory, capital flows could be seen as a risk-sharing mechanism to promote convergence within the monetary union. But the experience of the last 20 years tells a different story. The crisis has shown that in times of stress, eurozone financial and capital markets become fragmented again. While there have already been substantial advances in the creation of a banking union, it is not yet finished. Think of the European Deposit Insurance Scheme. Aside from that, there is a need for the creation of a euro-wide safe asset, which could limit the sovereign-bank nexus, as banks would have an alternative for the sovereign bond of their home country. The bank-sovereign doom loop was one of the key elements in the 2011-2012 eurozone crisis and the danger is still present.

In its [April 2019 Global Financial Stability Report](#), the IMF pointed out that if sovereign yields were to increase sharply, banks’ stronger links to sovereigns in countries with high government debt could result in significant losses on bank bond portfolios. This could in turn lead to tighter credit conditions, resulting in lower growth in the countries concerned. Similarly, other [studies](#) have found that the capital market channel amplified output shocks during the financial crisis due to strong fragmentation and home bias effects. [Research](#) on asymmetric shocks show that in the United States, around **70%** of shocks are mitigated and shared across the individual states through integrated financial markets, whereas in the eurozone this percentage only amounts to **25%**, showing that there is still room for improvement.

Fig 7 The sovereign – bank nexus is still present



Source: IMF

Direct redistribution – highly controversial but efficient?

With enhanced convergence through structural reforms, labour mobility and capital markets union proving difficult, the call for more redistribution between countries/regions is likely to intensify. In our view, a powerful eurozone budget or looser fiscal rules will become a much bigger topic of debate in the years ahead, even though it is already one of the most politically divisive subjects in the eurozone. Even if it were politically feasible, the question remains whether this can be a successful tool to help convergence. The success of the current regional EU funds, for example, is debatable and the experience of transfers within countries shows that the results are limited. However, a stabilisation budget might help to smooth asymmetric shocks, which could reduce the cyclical divergence between member states. As possibilities for monetary stimulus are limited at this point, fiscal policy may be the only option to kick-start sluggish growth.

Where do countries stand in the discussion on the future of the eurozone?

In his speech, "[Europe and the euro 20 years on](#)," ECB President Mario Draghi remarked that: "the Monetary Union has succeeded in many ways, but it has not delivered the gains that were expected in all countries. This is partly the result of domestic policy choices and partly the result of Monetary Union being incomplete, which led to insufficient stabilisation during the crisis. The way ahead, therefore, is to identify the changes that are necessary to make our Monetary Union work for the benefit of all member countries".

But even between members of the eurozone, there are different views regarding the path to follow. Proposals by French President Emmanuel Macron to foster further eurozone integration have received a lukewarm response. The so-called New Hanseatic League, comprising Denmark, Estonia, Finland, Ireland, Latvia, Lithuania, the Netherlands and Sweden, stated in their foundational document that, "Further deepening of the EMU should stress real value-added, not far-reaching transfers of competence to the European level". More recently, several members of the New Hanseatic League have staunchly opposed using a common budget as a countercyclical stabilisation mechanism.

The [EMU Choices](#) project, analysing member states preferences for EMU reforms, clearly demonstrates that positions are quite polarised when it comes to burden sharing, implying that further EMU reform is only likely to happen very gradually or in a situation of extreme stress that would offer countries the stark choice between catastrophic disintegration and the completion of EMU. The positioning of the countries on the scale presented by [Lehner and Wasserfallen \(2019\)](#) also reemphasises the importance of the French-German axis, as both countries are situated at opposite ends of the spectrum. The results can be seen on the vertical axis of charts 8 and 9, the higher the number the more opposed to burden sharing the country is.

One would assume that the economic importance of the EMU to individual countries matters in their decision on burden sharing. To test that, we have created a simple index including exports to the rest of the eurozone as a share of GDP, the financial exposure of a country's banks to other countries within the eurozone and the welfare gains from access to the single market, according to recent [research by the Bertelsmann Stiftung](#).

When we combine this index with the results on preferences for EMU reforms and the economic importance of the EU/eurozone to countries, we arrive at Figure 8.

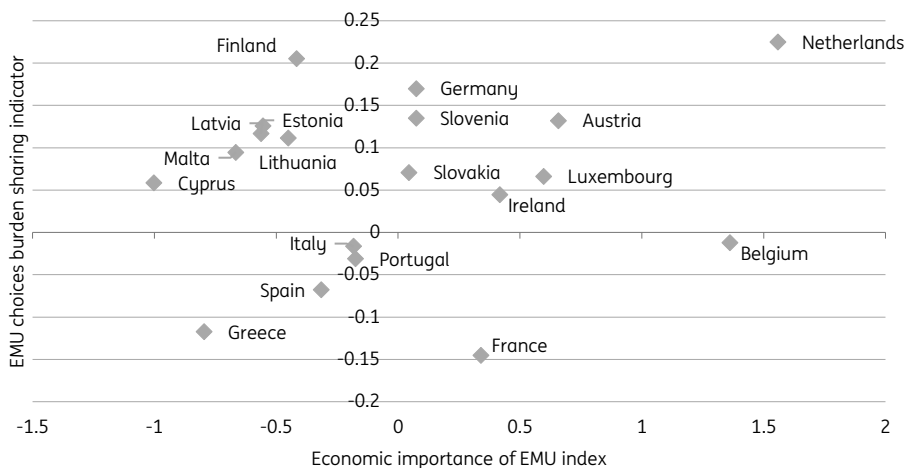
This scatterplot shows some interesting differences between political positions and the economic importance of the EU/eurozone to countries.

- The Netherlands, which has the most extreme position against burden sharing also ranks the highest on the economic importance of the EU ranking.
- Countries like Italy, Spain, Portugal and Greece benefit to a lesser degree from the EU, but are in favour of further burden sharing.
- France and Belgium are the only countries that have an above average economic interest in the EU and also favour increased burden sharing.

The correlation between the economic importance of the EU and the political positioning on burden sharing is not very high. But it does lead us to believe that when push comes to shove, countries in the top right quadrant have an incentive to move closer to the middle as they have a lot to gain from maintaining the European (Monetary) Union in the wake of an existential crisis. But as long as this existential crisis fails to materialise, these countries are likely to discourage all initiatives that lead to further integration involving burden sharing.

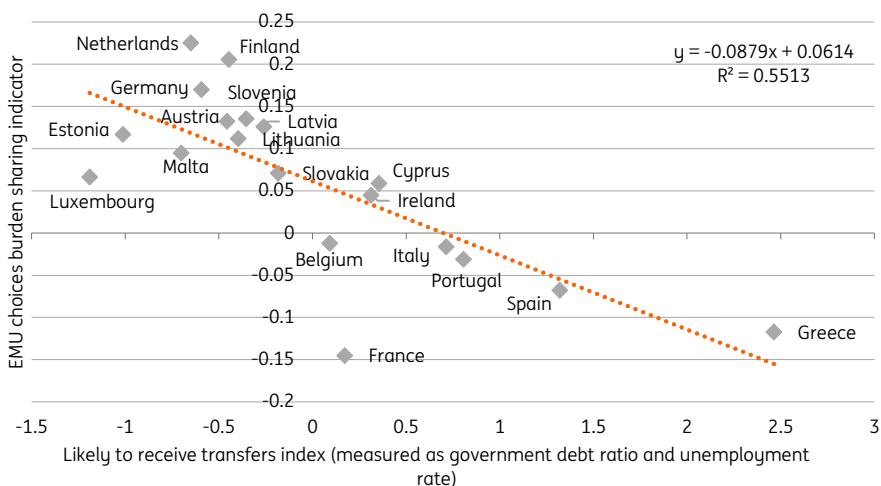
Given the low correlation, it seems that there is something else that's driving the views on burden sharing. When looking at a combination of indicators on economic vulnerability, we find much higher correlations with the burden sharing indicator. In fact, just combining the average unemployment rate and debt-to-GDP ratio of countries gives a rather convincing fit. Whether there is actual causation has yet to be confirmed, but it looks like countries that are in favour of burden sharing are the ones that deem themselves likely to be on the receiving end of it.

Fig 8 Economic importance of eurozone



Source: Bertelsmann Stiftung, BIS, EMU Choices, Eurostat, ING calculations

Fig 9 Likely to receive transfers



Source: EMU Choices, Eurostat, ING Calculations

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The euro’s 20th anniversary this year marked the end of the single currency’s turbulent teenage years and the beginning of a new chapter for the eurozone, which promises to be every bit as challenging as the last. It is striking that, according to a survey of voters in 14 EU countries, a majority of respondents in all countries, except Spain, said they thought it likely that the union in its current form would fall apart in the next 10 to 20 years.

Scarred by a sovereign debt crisis, which exposed deep fault lines in the monetary union and raised existential questions about the currency area itself, policymakers agree that reforms are necessary to ensure the euro’s survival, even as support for the currency remains strong across the bloc. While the reform process has not been halted, the last few years of strong economic growth have clearly slowed down reform efforts. The fundamental debate about the policy principles of the eurozone has still not been resolved, be it on the balance between national sovereignty and eurozone responsibility or on the role of fiscal and monetary policy.

We cannot expect the ECB to continue to compensate for an incomplete monetary union. Growing divergence within the Monetary Union also makes a one size fits all monetary policy less efficient. Monetary policy alone will not be enough to increase convergence. As a consequence, centrifugal forces will remain important.

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