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The Future of the Economic and Monetary Union

Reform Perspectives in France, Germany, Italy and the Netherlands

POLICIES OF THE EUROPEAN UNION

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Preface

In 2017, a new discussion on the future of the European Union started. Several initiatives and reforms were introduced, beginning with the European Commission's white paper on the Future of Europe, followed by five reflection papers and carried further with the Leaders' Agenda. As part of this discussion and process, the Swedish Institute for European Policy Studies (SIEPS) has received instructions from the Swedish Government to analyse what the EU's future might entail. This volume delves deeper into the matter of Economic and Monetary Union (EMU) reform.

Our primary aim with this volume is to tap into the EMU reform discussion that is taking place in a number of euro area countries, with a view to providing insights into which reforms may reach the implementation stage in the future. In order to be as encompassing as possible, capturing the pan-European discussion while also keeping to a manageable number of countries, a choice had to be made as to which countries should be included in the analysis. Germany and France are obvious candidates, as they must be in agreement for any reform to be successful. Italy and the Netherlands were chosen because they serve as useful proxies for the remaining member states in the North-South divide.

Four researchers from each of the four countries were invited to analyse the discussion on EMU reform in their respective countries. In addition, they all participated in a seminar in Stockholm on 26 January 2018 to present their papers and participate in a discussion on what we can expect with respect to reform. The seminar discussion is summarised at the very end of this volume.

This volume is a contribution to the debate on the future of the European Union. By publishing this report, SIEPS hopes to enlighten our readers about what may lie ahead in the future.

Eva Sjögren
Director

About the authors

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List of abbreviations

BRRD	Bank Resolution and Recovery Directive
DGS	Deposit Guarantee Scheme
EDIS	European Deposit Insurance Scheme
EMF	European Monetary Fund
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
LOLR	Lender of last resort
MFF	Multiannual Financial Framework
NPL	Non-Performing Loans
SGP	Stability and Growth Pact
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TFEU	Treaty on the Functioning of the European Union
TSCG	Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

Table of contents

Executive summary 9

1 Introduction 16
1.1 Rationale and approach 17
1.2 Disposition 18

2 Post-crisis developments and the reform process 19
2.1 State of affairs: run-up, processes and proposals 21

3 Italy and the completion of the euro area 26
3.1 Different perspectives on the crisis 27
3.2 Italy's experience with euro membership 28
3.3 External constraint and the recent crisis 31
3.4 Negotiating positions we might expect from a centrist or technocratic government 35
3.5 The complicated future of Italian politics 37
3.6 Conclusion 38

4 France and the push for euro area reform 39
4.1 The circumstances of Macron's rise to power 39
4.2 The French view on the reform of the euro area 44
4.3 Comments 45
4.4 Conclusion 47

5 Germany's approach to euro area reform 49
5.1 Introduction 49
5.2 German euro area policies since the start of the financial crisis 49
5.3 A less hesitant Merkel IV government 51
5.4 The Coalition Treaty: No Red Lines on the euro area 53
5.5 The opportunities and challenges of Franco-German cooperation 53
5.6 Prospects and possible content of a Franco-German compromise 54
5.7 Unlikeliness of a fundamental policy change 56
5.8 Domestic political constraints and controversy 57
5.9 A broader European agenda 58

6 The Netherlands as constructive EU partner searching for an EU narrative 60
6.1 The image of the Netherlands as an awkward partner 61
6.2 European integration as drifting integration 62
6.3 Current strategy at the EU level: haste 64
6.4 Shifts in the Dutch EU narrative 65
6.5 Safeguarding influence: the Netherlands and its EU coalitions 67
6.6 Weaknesses of the new Dutch strategy 67
6.7 From deeper integration by stealth towards “better integration” 68

7 Conclusions 70
7.1 Finding a balance between risk reduction and risk sharing 70
7.2 The EU institutions and non-euro member states in the reform process 73

References 75

Appendix: The German and French academic proposal 81

Svensk sammanfattning 82

Executive summary

In the spring of 2010 a sovereign debt crisis erupted in the euro area that triggered a series of new crises and a reform process to fix what was broken in the Economic and Monetary Union (EMU). While member states' experiences differ, the crises were essentially the result of a rapid unwinding of imbalances that had been built up in the 2000s. What made matters worse was the absence of institutions that could have prevented the crises from occurring, or at least mitigate the effects once they were a reality.

Several measures were implemented as a response to the insights gained from the crises, which can be broadly summarised in three categories: intergovernmental rescue funds, the strengthening of economic governance in the EMU and establishing two out of three pillars in the Banking Union. While there is general agreement that further reform is needed, there is however disagreement as to which measures should be implemented. In a nutshell, member states disagree over the balance between risk sharing and risk reduction. Risk reduction proponents place the emphasis on crisis prevention, while those who emphasise risk sharing focus on crisis mitigation.

This book represents a concerted effort by four prominent scholars from France, Germany, Italy and the Netherlands to summarise the discussion in those countries and analyse in which areas the member states may find common ground to press ahead with reforms. The authors have been asked to provide a background to how the euro has been perceived in their respective countries and identify which EMU reforms would be acceptable in the short- to medium-term perspective.

The reason for choosing France and Germany is the well-known wisdom that meaningful reform requires their mutual consent. The Netherlands has resisted many of the risk sharing arrangements discussed and proposed, while also acting as a proxy for, and leader of, countries such as Austria and the Nordic and Baltic countries. Italy, on the other hand, would act as a proxy for other southern euro area countries, such as Greece, Portugal and Spain. However, the euro area's third largest economy is also interesting in view of its rather unique history during the Great Recession in the 2000s and weak public support for the euro.

Erik Jones on Italy

The *Italian* view on reform is in many regards close to the French approach under President Macron. They both focus on risk sharing measures and institutional reform, while taking a very sceptical view toward aggressive risk reduction measures in the financial sector. Contrary to popular belief, Italy did not experience major problems with competitiveness, government borrowing, or private indebtedness prior to the crisis. The Italian crisis narrative rather

focuses on the role of the banks and cross-border financial flows. Consequently, the number one priority here is to shore up confidence in the financial market participants, to prevent a panic followed by liquidation of Italian assets in the event of a new crisis.

The history of Italy's euro membership is one of cognitive dissonance, that is, the simultaneous embrace of contradictory positions. One such example is the public's treatment of the governments that in the 1990s successfully managed to increase the Italian economy's competitiveness. Coordination with trade unions on wage bargaining and pension reforms held down the growth in relative real unit labour costs. This represented an application of external constraint: the commitment to price stability earned the government credibility in the markets, allowing it to borrow more cheaply from abroad. Not only did it mean that Italy was selected to join the euro among the first group of countries in 1998; but borrowing costs fell so quickly that neither the Prodi nor the Massimo D'Alema governments had to run primary surpluses to support consolidation efforts. Ironically, the electorate ousted the D'Alema government. At the same time, public opinion soured toward the single currency. It was widely believed the euro created inflation and that shopkeepers used the changeover to gouge consumers, despite data showing a different picture.

The Italian economy was not deeply affected by the financial crisis in the first few years. In many regards it was in a better position than Germany, for instance, with respect to larger household wealth and lower unemployment. Even though there was a loss of competitiveness compared with Germany in the years leading up to the crisis, this only meant that Italy gave up some of the competitiveness it had previously gained. It also had a more conservative banking sector, with banks still raising and using funds locally. Hence the banking sector was shielded from the direct fallout in the US real estate markets, and the full impact from the economic crisis came only in 2011. When households as a result dipped into their savings, Italian banks faced tightening funding opportunities and cut back on their lending. This sent many local economies into a negative spiral; non-performing assets piled up, adding further pressure and accelerating the spiral. In June 2011 international investors chose to exit and capital poured out of the country, moving Italy's position massively into deficit. This sell-off in Italian government bonds is important because it represented a sharp spike in local borrowing costs and a sharp contraction in locally available liquidity.

In view of Italy's history, we could expect a fairly coherent set of negotiation positions from a centrist or technocratic government. It would support a euro area budget line; a European deposit insurance scheme backed with common resources; a European finance minister with discretionary powers over joint resources; and greater political accountability for joint European macroeconomic policymaking. Furthermore, such a government would also support a simplification of the fiscal consolidation rules and some form of debt mutualisation (or Eurobonds). At the same time, there is opposition toward

accelerating the disposal of non-performing assets and introducing a cap on bank exposure to home-country sovereign debt instruments.

However, the M5S/Lega government will likely depart radically from the line pursued by a centrist or technocratic government. The most obvious point relate to fiscal policy coordination and debt consolidation. The M5S/Lega government intends to introduce expensive reforms which, without funding, will not abide by the requirements of the Stability and Growth Pact. They also intend to introduce measures that e.g. go against the ethos of the Banking Recovery and Resolution Directive, which will make it harder to agree on pooled resolution funding or deposit insurance. Moreover, both the M5S and the Lega would relish a conflict with Europe to reinforce their roles as the protectors of Italian national interest. Arguably, the prospects for euro area reform will not improve with a populist government in Italy.

Christophe Destais on France

France under President Macron seems intent on achieving far-reaching reforms. The President secured a large majority in the National Assembly effectively sidelining anti-euro/anti-EU proponents. He managed to quickly achieve an audacious reform of the French labour laws. Beyond domestic considerations, such policy aims at showing Germany that France is credible on structural reforms. Furthermore, the anti-euro rhetoric has virtually disappeared from public debate in France since the elections, and the opposition is weak.

Nowadays, there is an apparent absence of an actual public debate on the future of the euro area and, especially, on what fiscal policy should be in a monetary union. However, one should not forget that anti-EU/anti-euro secured more roughly 40% of the votes during the 2017 presidential elections and that, less than one year ago, pessimism about the future of the EU and the euro was the dominant mood in France.

The French are seeking an ambitious plan with the Germans, a strategy that would cover: a) financial integration; b) crisis management with adjustments made to the European Monetary Mechanism, giving it a larger role in crisis *prevention* and c) a euro area budget of 1–2 per cent of the euro area GDP. The latter would have its own tax revenues and the possibility to borrow, hence contributing to the production of a European safe asset. The budget would be authorised by a newly created section of the European Parliament (the euro area Parliament), for which the usual qualified majority voting rules would apply. The euro area budget would contribute to stabilisation of the euro area economy in case of shocks, through the automatic reduction of its revenues rather than through an increase in its spending. These proposals display a traditional French Keynesian view with respect to fiscal policies, but do not directly address the German ordoliberal concerns (see below) that relate to fiscal rules. France may underestimate German frustrations with the euro, especially when it comes to the failure to implement the latter properly. It is thus likely that the final

agreement will also include credible adjustment policies to curb public spending when deemed excessive, reduce public debt and moderate wages.

Daniela Schwarzer on Germany

Consecutive German governments have been both proponents of deepening integration and of enlarging the EU. Euro area matters have constantly been high on Germany's EU agenda, even if it, at times, caused controvery with its strong preferences and positions. Also the new government is likely to pursue a rules-based approach to euro area governance. The rules for fiscal discipline in particular should be better applied, and may need simplification, as long as implementation is pursued more convincingly than in the past years. The enforcement of the rules regarding fiscal policy, financial stabilisation, and macroeconomic stabilisation should be better insulated from political interference. However, given the political problems to implement rules, market discipline is a concept that the new German government will likely want to enhance in the euro area.

At the same time, German politicians today understand better the adverse effects of austerity in Southern Europe, e.g. that it has given rise to a negative view of Germany and risks delegitimising both the system and the rules contained therein. The strong presence of social democrats in the new German government, combined with the credibility of Macron in being able to deliver reform, add further hope of agreement between Berlin and Paris. This is amplified by the strong focus on European issues in the coalition treaty between CDU, CSU and SPD, which even leaves open the possibility of euro area countries pressing ahead on its own.

Furthermore, the coalition treaty implies strong cooperation between Germany and France, working together on ideas for the 28–29 June European Council. The treaty contains no red lines and shows openness for more money to economic stabilisation, innovation and investment, although it remains vague on the design of the euro area budget. Moreover, it explicitly argues for a stronger euro area architecture, developing the ESM into a EMF anchored in EU law. The treaty does not mention the European Deposit Insurance Scheme (EDIS) but, unlike the previous coalition, does not rule it out.

However, great differences remain even when we look at the details in the proposals where there is convergence. In some cases, such as the size, role, institutional setup and funding of the euro area budget, the views are wide apart. Even though Germany is ready to pay more for Europe, what is mentioned in the grand coalition treaty is an "investment capacity" for the euro area countries that would improve economic convergence – a measure that would also come with conditionality attached to it. In other words, it would not be remotely close to the kind of centralised stabilisation function sought by France and Italy. A related issue is the role of a future European Monetary Fund: the French argue that it should be able to bail out countries and provide support ex-ante

to prevent crises. In the German version of the EMF, however, it is likely that rescue programmes come with strong conditionality, in line with what hitherto has been the case with ESM programmes.

In any Franco-German initiative, risk reduction, market discipline and risk sharing need to go hand in hand. Hence, the Germans will push for incentives to reduce the risks in euro area banks before pan-European deposit and resolution schemes become a reality. Germany wants a transparent framework for absorbing losses both on investors' exposure to banks and to sovereign debt. The German view on how to develop the ESM into a European Monetary Fund needs to be understood against this backdrop: a future EMF should get a mandate to monitor the economic situation in member countries in the interest of crisis prevention and the institution should go hand in hand with a standard debt restructuring mechanism in order to provide the private sector with clear and predictable principles ahead of time. Moreover, the coalition agreement states that the role of national Parliaments should not be impacted, which implies national veto over stability programmes.

Adriaan Schout on the Netherlands

Though a mid-sized member state increasingly described in the European press as euro-sceptical – even viewed as a candidate for taking over the restraining role traditionally played by the British – *the Netherlands* is in fact a firmly pro-European country that likely will continue to be a pragmatically constructive partner. As one of the most competitive EU countries, the Dutch society is deeply aware of the importance of the EU for its economic progress, security and global influence. The Netherlands is taking part in all initiatives to date (thus far only with the exception of the European Public Prosecutor's Office; EPPO) to make sure they have a place at the table. They are also aware of the need for solidarity across borders, provided that other countries are equally committed to national reforms.

However, Prime Minister Rutte has argued that if countries fail to reform, it should even be possible to push them out of the euro area (a view echoed by the newly formed "Value Union" in Germany). Moreover, a counter-narrative to the more positive view is emerging, out of frustration over what is described as European "integration by stealth". In essence, this means that the EU is seen as taking incremental decisions that eventually result in a different kind of EU than was on the agenda when the initial decisions were agreed on. For example, the euro area was designed to rely on member states' own ability to adhere to the rules or the Stability and Growth Pact and, in the case of rule breaking, enforcement of the rules by the Commission. However, the proposals that are currently on the table, along with reforms carried out since 2010, imply an increasing number of euro area bodies, procedures and political deals. There also have been institutional consequences, for example, in terms of the politicisation of the European Commission and the evolving powers of the European Parliament. This incremental process also blurs the checks and balances of the system.

While the Dutch fear that their preferred partner Germany seems to accept a substantial share of the current reform agenda, the Netherlands is explicitly ill at ease with it. We may therefore witness a pragmatic approach towards safeguarding Dutch influence, which is based on flexible coalitions and a strategy of accepting neither the "if-then" (or *quid pro quo*) logic, nor anything that resembles a "transfer union". Hence, there are limits to the amount of risk-sharing the Dutch will accept. On the other hand, Mark Rutte himself learned hands on that a tough autonomous strategy in the European Union (EU) is untenable for a single medium-sized country. In 2015, when a third Greek support package was agreed upon, Rutte had to break his 2012 election promise that there would be "no more money to Greece". Yet it would seem that both of the above-mentioned red lines are shared *implicitly* also by Germany.

The commitment to this strategy is likely explained by the attempt to reach a comprehensive EU compromise on the proposals currently on the table (see above), which may be hard to contest without political costs in the European Council. However, even a diluted European minister is a threat in the eyes of the cautious Dutch, since the post is linked to a range of other plans, such as a European Monetary Fund (placed under political leadership), a euro area budget, a bigger role for the European Parliament and a politically supervised backstop for weak banks. However, current discussions in the media already indicate that there is a realisation emerging that a higher EU budget and some form of EMF must be accepted. Rutte seems to be looking for ways to provide some leadership when it comes to moderating deeper and political integration by building coalitions with – depending on the specific policy – Austria, Ireland, the Nordic countries, the Benelux, the Visegrád countries, as well as other countries. The hope is that, with the Brits on their way out, the Netherlands can thus compensate for the loss of a British counterweight to the German-French axis. This should not be seen as the Netherlands taking over the obstructive role which the Brits assumed, but rather as an effort to be a constructive partner in building a "better" Europe based on strong member states that are able to deliver results themselves.

Prospects for continued EMU reforms

In conclusion, there seems to be general agreement among member states and scholars alike that flaws remain in the legal and institutional architecture of the euro area, and that more work is needed to fix the European financial markets. A convergence of views can be seen when it comes to reforming the rescue fund ESM and bringing it into the EU legislative framework, possibly transforming it into a European Monetary Fund. There is also a common view on reaching an agreement on the EDIS and making the ESM the backstop for the Single Resolution Fund. In view of a recent non-paper by eight Finance Ministers, these steps may be acceptable, not only for the Netherlands, but also for Ireland and the Baltic and Nordic member states. Another risk sharing area where there seems to be sufficient common ground for successful reform concerns the need

for taking further steps in the Capital Markets Union. We should therefore expect to see some progress in these areas.

While the idea of trading risk sharing for risk reduction measures may seem like an apparent way forward, such a strategy will likely meet strong resistance. As noted, the Netherlands is not keen on the "if-then" method that has unlocked member states' resistance to reform in the past. The view here is that a greater convergence should be achieved before proceeding with risk sharing arrangements. This means economic convergence as well as further reduction of non-performing loans (NPLs) and banks' exposure to home countries' sovereign debt. For different reasons, Italy may also be expected to object. Regardless of whether there is a populist or technocratic government in Italy, there will be strong resistance against accelerating the disposal of NPLs, as well as opposition to restrictions against home-country sovereign debt exposure. The M5S/Lega policy programme implies that risk reduction measures are impossible to achieve. Hence far-reaching risk sharing reforms are ruled out as well.

In closing, a series of questions need to be addressed with respect to the dynamics between the respective member states, as well as between the member states and the EU institutions. The strong focus on possible common denominators between Germany and France implies that the process may not be inclusive. Obviously, this will not sell well in the other member states. Furthermore, the respect for the institutions, above all the Commission, is no small matter – not least in view of protecting the interests of all, rather than a few big member states. The absence in the wake of the March 2018 election of a constructive Italian government does not mean that Italy should be ignored. Doing so could quickly translate into popular discontent if euro area reforms turn out to disadvantage the country. The consequences of having to deal with proposals that are prepared and discussed bilaterally in Berlin and Paris ignore the importance of legitimising the process, something that ultimately can only be achieved when the proper legislative method is used. This implies having the Commission work out and present legislative proposals, passing them onto the Council and the European Parliament.

Finally, it is not clear to what extent the non-euro member states will be able to influence and take active part in the reform process. While Germany and the Netherlands attach importance to including all member states in both the process and legislative and institutional outcomes, the French vision – more often than not – has implied a process where the core member states spearhead the integration process and leave hesitant member states behind. Moreover, the coalition treaty in Germany also allows for a more French approach of a small group spearheading the integration process, should this be deemed necessary. Having said that, it is reasonable to assume that, should the euro area countries fail to take the interests of the remaining member states into account, the latter's future as members of the EU may never extend to also adopting the euro as their currency.

1 Introduction

The chain of events that were set in motion by the 2007/8 financial crisis still resonates today. It triggered a European public debt crisis in the spring of 2010 and revealed a number of weaknesses in the design of the Economic and Monetary Union (EMU). The tipping point was the realisation that Greece was no longer able to finance its sovereign debt on the markets, as speculation of a default pushed interest rates up to unsustainable levels. The ensuing threat to the euro led euro area leaders and the European Central Bank (ECB) to abandon several sacred cows, among them the no-bailout principle enshrined in the Treaty.

While the member states' experiences differ, in some cases rather significantly, as will become clear, the euro area crisis was essentially a rapid unwinding of intra-euro area imbalances in lending and borrowing that had been built-up in the 2000s. In the view of e.g. Baldwin and Giavazzi (2015; and 2016), however, the underlying *causes* of the situation in which the member states found themselves were two design flaws that were built into the EMU from the very beginning. First, there were no mechanisms in place to prevent the building-up of large current account imbalances, excessive public borrowing and excessive bank leverage.[1] Second, there was a lack of institutions capable of handling the crisis once it erupted. Hence, there were no proper institutions in place, *ex-ante* or *ex-post*, to effectively prevent the crisis from becoming such a threat to the very existence of the monetary union.

Once it was acknowledged that the euro area members needed to engage in rescue operations and to initiate institutional and legislative reforms, the process got off to a rather impressive start. Several measures were implemented in the first couple of years after the public debt crisis. They can be broadly summarised in three categories: intergovernmental rescue funds, the strengthening of economic governance in the EMU and the Banking Union.[2]

We will return to this discussion in the next section. Suffice it to say that there is broad agreement that additional reforms are needed. However, contentious issues remain to be resolved. In a nutshell, the member states disagree over the balance between risk sharing and risk reduction. The relatively stronger (Northern) economies fear that risk sharing arrangements may imply permanent transfers of funds to economically weaker (Southern) member states and their ailing banks.[3]

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[1] Feld *et al*. (2016) argued in the same volume that the imbalances were rather caused by a failure to comply with the (original) Stability and Growth Pact.

[2] See e.g. Calmfors (2017) for a similar description.

[3] This includes, inter alia, the need for further labour and product market reforms and eliminating legacy problems in the banking sector.

Another way of expressing the differences is that risk reduction proponents place the emphasis on crisis prevention, while risk sharing proponents would rather emphasise crisis mitigation. The latter would imply, among other things, greater flexibility for national policies.

Although the risk sharing versus risk reduction dichotomy may not be as straightforward as it may seem, it has certainly played an important role with respect to blocking further reform initiatives. This has been further compounded by the fact that "the collective political will to make further progress has weakened" (European Council, 2017b; p. 1) as the euro area economies have begun recovering from the crisis years. Although momentum seems to have returned with the establishment of a new grand coalition in Germany, the Italian elections in March of the same year may seriously affect the pace of reform. Furthermore, while there seems to be a convergence of views on which reforms to seek in the short-term, the member states are far apart on many of the details.

1.1 Rationale and approach

This volume represents a concerted effort by four prominent scholars from as many euro area countries to analyse areas in which the member states may find common ground to press ahead on EMU reform in the short-, medium- and long-term. Secondly, it summarises the discussion in some of the most important euro area countries and should thus enable policy-makers in non-euro area countries to be better informed about where the process is heading. A third objective is to analyse the proposals on the agenda in view of the scholarly discussion on EMU reform.

The countries chosen are France, Germany, Italy and the Netherlands. The reason for choosing France and Germany is the well-known wisdom that meaningful reform requires their mutual consent. The Netherlands is, in one regard, an equally obvious candidate, in view of its resistance towards going much further in terms of risk sharing arrangements. In this regard, the Netherlands also acts as a proxy for e.g. Austria and the Nordic and Baltic countries, which see, in risk-sharing arrangements, the potential for permanent transfers of funds to weaker euro area countries.

The reason for choosing Italy is threefold. First, it acts, in a sense, as a proxy for other southern euro area countries, such as Greece, Portugal and Spain, which were also hit hard by the crisis and have experienced difficulties in recovering. However, public support for the euro has deteriorated in Italy, and as mentioned, the future looks uncertain in view of the election in March 2018. Hence, its views on reform may therefore differ significantly from its neighbours. The second reason is that Italy is the euro area's third largest economy. Considering the reported problems in the banking sector, along with the currently rather unstable political situation, there is also reason to include Italy to provide

indications of the severity of the problems that continue to threaten the euro.[4] Third, in Italy, the crisis narrative differs significantly from the one described above. This is described in some detail in the chapter on Italy (Chapter 3).

The authors have been given two very broad sets of questions to answer. First, they were asked to provide a background on how the euro and the institutional and legal framework that surrounds it have been perceived and discussed historically among politicians, the public, civil society and businesses, as well as how it has functioned in their respective countries. That is, what are the explanations for the ways in which the four countries have chosen to approach EMU reform? The second question attempts to capture the current debate on euro reform in the respective countries. The essential point here is to ascertain the possible short- to medium-term prospects for reform by finding the lowest common denominator among the four countries chosen.

1.2 Disposition

The first part of this volume will begin with a description of the steps taken thus far, followed by a discussion of the EMU's future and the legislative process in the years leading up to the ongoing process. This includes a brief overview of the Commission's reflection paper on EMU reform and a summary of the Commission's December 2017 and March 2018 proposals. The last section in the first part of the volume compares the policy driven discussion with input from academia concerning what is lacking in the euro area's institutional and legislative design. Before delving into the EMU debates in the four respective countries, we briefly describe the reform process according to the Commission and the Leaders' agenda. The second part of the volume consists of the four chapters on Italy, France, Germany and the Netherlands, respectively. The third and final part of the volume attempts to draw conclusions based on the insights provided in the country-specific chapters.

[4] The fact that we have chosen such a limited number of countries certainly makes the report susceptible to critique. Although it can be argued that they act as proxies for their neighbours, it should be acknowledged that significant differences remain. It should also be borne in mind that the greater the number of countries that wish to block a reform, the likelier it is that they will be able to do so.

2 Post-crisis developments and the reform process

Economic crises are often characterised by an unwinding of economic imbalances. The 2007/8 financial crisis began in the U.S. subprime market, but spread globally through interconnected markets, eventually reaching euro area banks and financial institutions. The effects were especially severe in the euro area. As risks were priced more or less the same regardless of geographic location, excessive public and private borrowing were allowed from abroad at low interest rates. Capital therefore flowed from the core to the periphery countries, where it was often invested in non-traded sectors, such as housing and government consumption. As pointed out by Baldwin and Giavazzi (2015), this meant that assets were not created that would have allowed the pay off of the investments. It also provoked legacy problems and a rise in non-performing loans (NPLs) in the banking sector.[5]

Moreover, the effects on the real economy were especially severe in the euro area countries that had failed to tackle rigidities in their product and labour markets during the economic upswing in the 2000s. As their labour costs increased and their products consequently became more expensive, their balance of payments deteriorated in relation to other euro area countries. When the financial crisis caused a "sudden stop" in the cross-border capital flows and individual country risk was priced more accurately, concerns were raised in the markets that banks in the periphery – and in the case of Greece, the sovereign itself – were becoming unable to finance themselves on the markets.

Several authors[6] have pointed out that certain aspects unique to the euro area's design amplified the problems. A first aspect of relevance was the inability, prior to the crisis, to prevent the building-up of imbalances and to foresee how imbalances in, for example, Ireland and Spain *by themselves* could lead to insolvency problems. When the crisis hit, and the housing markets collapsed, the banks that had financed the bubble with foreign capital quickly ran into insolvency problems. The bank rescue operation turned large amounts of private debt into public debt, which thereby rose from low pre-crisis levels to untenable post-crisis levels.

[5] NPLs are loans that are in, or close to, default. NPLs have increased in certain banks due to the crises, which negatively affect their ability to provide financing to the real economy.

[6] See also e.g. Calmfors (2017).

A second and related amplifier has been the so-called *doom loop*. A deterioration in a country's ability to finance its public debt implies that its banks also may run into solvency problems due to "home bias" (i.e. exposure to the home country's government debt). This leads to a weakening of the economy, which further aggravates the member state's solvency problems. Baldwin and Giavazzi (2015) also pointed out that the heavy dependence on bank financing in Europe implied additional pressure on the markets.[7]

A third problem was the absence of a *lender of last resort* (LOLR) in the euro area. This role is traditionally performed by a country's central bank in relation to the domestic financial market and the sovereign itself. However, in the case of the monetary union, Article 123 TFEU explicitly prohibits the ECB and the euro area's national central banks from acting in the latter role.[8] Once this principle was abandoned, although indirectly, the effect of having such an institution became abundantly clear. When the ECB President Mario Draghi made his famous announcement in the summer of 2012 "to do whatever it takes to preserve the euro",[9] and the ECB initiated its Outright Monetary Transactions (OMT) programme, it effectively ended the sense of acuteness of the euro area crisis.

The EU has responded in a number of ways to deal with the problems described above. The most important aspects can be summarised in the following three categories:

1. The establishment of intergovernmental rescue funds. Three temporary funds were created in mid-2010 as an immediate response to the crisis[10] before an agreement could be reached on the permanent European Stability Mechanism (ESM) in October 2012.
2. The strengthening and widening in 2010–2012 of economic governance in the EMU. The so-called "six-pack" and "two-pack" legislative packages *strengthened* the Stability and Growth Pact (SGP) in terms of both surveillance and compliance, while placing more weight on the role of the public debt, and *widened* its scope by introducing a Macroeconomic Imbalances Procedure (MIP). Furthermore, in 2010, the so-called European Semester introduced an annual cycle of policy coordination that was previously lacking. Lastly, 25 EU member states signed the intergovernmental Treaty

[7] The desire to lessen the dependence on traditional bank financing is the main reason for the Capital Markets Union initiative.

[8] See for example Wyplosz (2011) and De Grauwe (2011), two early proponents for ECB action.

[9] The speech was delivered at the Global Investment Conference in London on 26 July 2012; see ECB (2012). Gros (2018) argue that the intervention even reversed the doom loop, insofar as it created a positive credit cycle. The ECB's Quantitative Easing (QE) programme from 2015 and onwards then further reinforced the cycle.

[10] The Greek Loan Facility (GLF) and the European Financial Stability Mechanism (EFSM) were established in May 2010, followed by the creation of the European Financial Stability Facility (EFSF) in June the same year.

on Stability, Coordination and Governance in the Economic and Monetary Union (hereafter TSCG) in 2012.[11]

3. The establishment of the thus far partial Banking Union, the most important aspects of which were agreed upon in December 2012. At the time of writing, the Banking Union consists of common supervision through the Single Supervisory Mechanism (SSM) and common resolution through the Single Resolution Mechanism (SRM) of systemically important banks.[12] They are sometimes referred to as the first and second of the three pillars that form the Banking Union. Support for bank resolution will be provided by the Single Resolution Fund (SRF), which is being built-up gradually over a ten-year period (until 31 December 2023). Furthermore, a Single Rulebook provides harmonised prudential rules for all credit institutions in the Single Market.

It is generally agreed that the most urgent measure is to complete the Banking Union. Still lacking are the European Deposit Insurance Scheme (EDIS) – the Banking Union's "third pillar" – and backstops for both the SRF and EDIS. There are also discussions on how to proceed in other areas. We return to these issues and other proposals for consideration in section 2.2, below.

2.1 State of affairs: run-up, processes and proposals

A natural point of departure in the discussion about the future of the EMU is the Commission's Reflection paper on EMU (European Commission, 2017b),[13] one of five such papers that were published following the release of the "White Paper on the Future of Europe" (European Commission, 2017a) in March 2017. We will then turn our attention to the proposals that have been presented to date by the Commission. This will be contrasted against a recent proposal that was presented on 16 January 2018 by 14 French and German economists, which, to an extent, sums up the input to date from European economists. A brief description of the reform process, as implied by the time frames in the Reflection Paper on EMU and the Leaders' agenda, concludes the chapter.

2.1.1 The Reflection Paper on EMU

The Reflection Paper on EMU builds on the 2015 Five Presidents' Report and presents reforms with respect to economic union, financial union and fiscal union, along with measures to "increase democratic accountability and effective governance" (European Commission, 2017b). The rationale for future EMU

[11] Article 3 of the treaty, the "Fiscal Compact", obliges euro area member states to implement in national law a balanced budget rule with a correction mechanism in case of deviation.

[12] The SSM was fully established in 2014 and the SRM became operational in 2016.

[13] This is especially fitting with respect to the description of the reform process, since the Reflection Paper builds on the ideas presented in the Five Presidents' Report from 2015; see Juncker *et al*. (2015) in the references. Two earlier papers in the same vein were the Commission's "Blueprint for a Deep and Genuine Economic and Monetary Union" (European Commission, 2012) and the Four Presidents' Report (Van Rompuy, 2012) from November and December 2012, respectively.

reform is the need to remedy several persistent problems in the euro area. First, the economic and social divergences that were aggravated by the crises have not been reversed. Should they remain unaddressed, the Commission argues, public support for the euro will diminish and blur the citizens' perceptions of the true challenges. Moreover, it is argued that the EMU needs further measures to tackle remaining vulnerabilities in the financial markets, reduce high public and private debt, and increase the efficiency and transparency of euro area governance.

The process towards completion is grouped into two stages. The first stage covers the years 2017–2019 and includes measures that need no Treaty revision. Some minor steps have already been taken (see the next section). Moreover, proposals have been published for a European Deposit Insurance Scheme (EDIS), along with backstops for it and the SRF. Further measures are underway, such as reducing risks in the financial sector and introducing additional legislation within the Capital Markets Union.

Table 1 Reflection Paper on EMU: Reforms and time frame

	Period 2017–2019	*Period 2020–2025*
Financial Union	Risk reduction in financial markets Reduce NPLs Agreement on EDIS Backstop for SRF Further proposals on CMU	Implementation of CMU Implementation of EDIS Introduce a European safe asset Introduce regulation on sovereign exposure
Economic and Fiscal Union	Strengthen the European Semester Work on convergence standards Technical assistance Stronger link to euro area priorities Reflection on fiscal stabilisation function	Convergence standards linked to a macro stabilisation function Central stabilisation function Implementation of MFF Simplification of SGP
Democratic Accountability and Effective Governance	Strengthened dialogue with the European Parliament Work on external euro area representation Proposal to integrate TSCG into EU acquis	EMF Permanent Eurogroup chair Eurogroup as Council configuration Unified representation of the euro area Integration into EU acquis of remaining intergovernmental arrangements Euro area treasury

Source: European Commission (2017b).

The second stage covers the years 2020–2025 and includes the implementation of EDIS and Capital Markets Union (CMU), the inclusion of intergovernmental crisis measures into the EU acquis and the implementation of the next Multiannual Financial Framework. A set of more far-reaching measures are also discussed, with several options presented in each category. A first step that has demonstrably been taken seriously is the introduction of a macroeconomic stabilisation mechanism (see the next section). The Reflection Paper on EMU discusses a European Investment Protection Scheme for maintaining investment levels, a European Unemployment Reinsurance Scheme, and a "rainy day fund". The European Investment Protection Scheme is, as we will see, the Commission's preferred choice. The schemes would evolve over time into a central stabilisation mechanism. Moreover, it is suggested that participating member states increasingly would be required to respect a strengthened and more binding convergence framework.

The second stage also sees the creation of a European safe asset,[14] a regulation to reduce sovereign exposure and institutional reform. The latter category includes establishing the Eurogroup as a Council configuration and giving it a permanent chair. These features are discussed in the framework of a future Euro Area Treasury. Table 1 gives an overview of the ideas and discussions in the Reflection Paper on EMU.

2.1.2 Achievements and proposals currently being negotiated

Once the most urgent crisis tools had been put in place and the economic outlook improved, the pressure for reform withered. This was further compounded by the unprecedented influx of refugees in the years 2014–15, whereby migration policies took centre stage and EMU reform fell further down on the EU's list of political priorities. However, several proposals have been published during this period[15], and a few of them have also reached the implementation stage. Above all, the Bank Resolution and Recovery Directive (BRRD) in 2014 introduced EU-wide bail-in rules to protect the taxpayers; a failing bank's investors should be first in line to accept losses in case of failure. The directive also entails cooperation arrangements to tackle cross-border banking failures (see Council and Parliament, 2014).

Moreover, a new package of measures was presented by the Commission in the autumn of 2015, labelled "Stage 1 of 'Five Presidents' Report". It included a revision and streamlining of the European Semester – among other things, strengthening the link to the European Structural and Investment funds – and

[14] There have been several proposals of a European safe asset, the rationale of which is to introduce an asset that performs the same function as the US Treasury. The proposals have ranged from full to partial common issuance and from mutualisation to no joint liabilities. However, the precise nature of the European safe asset has yet to be worked out.

[15] Many of them also relate to the Banking Union, in particular to reduce legacy problems from the crisis years; see European Commission (2017g) for an overview.

it established an advisory European Fiscal Board and national Competitiveness Boards (European Commission, 2015a). Furthermore, a proposal for a European Deposit Insurance Scheme (EDIS) followed in November of the same year (European Commission, 2015b).[16]

Attempting to bridge the risk reduction and risk sharing camps in the Council, the Commission proposed that the EDIS should be implemented in three stages in tandem with further risk reduction measures.[17] In the first three years, national deposit guarantee schemes (DGS) would participate in a reinsurance scheme, implying that they would have to be fully depleted before an intervention by the EDIS could be considered. Moreover, this intervention would only come in the form of liquidity assistance and would have to be fully recovered from the banking sector. The coverage of the liquidity shortfall would increase gradually to 90% in the final year of stage one. In the second stage, the system would switch to a co-insurance scheme that would last for four years. Here, the national DGS and the EDIS would contribute together from the start, according to a key which would develop progressively. In the final stage, the EDIS would become a full insurance system. The Single Resolution Board would administer the EDIS and monitor the national DGSs. However, the EDIS has proven to be much more controversial, and agreement in the Council has so far been elusive.

In December 2017, the Commission presented a new package of proposals, all of them in line with the Reflection Paper on the EMU. Two of the proposals aim to include intergovernmental initiatives, taken during the height of the crisis, into the EU acquis.[18] First, a regulation would turn the ESM into a European Monetary Fund (EMF). Second, a directive would implement Article 16 of the TSCG, which obliges the contracting parties (without derogation) to incorporate the contents of the treaty into national law.[19] A third initiative was a communication on a European Minister of Economy and Finance. The remaining proposals were all related to budgetary measures. With the exception of the TSCG, we will now address the separate proposals in some detail.

The European Monetary Fund would be established as a "unique legal entity under Union law", superseding the ESM. The Commission's (2017d) proposal would also broaden the scope of the EMF in comparison with its predecessor.

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[16] It also included a proposal for a unified external representation of the euro area. However, as of Spring 2018, the member states still have not been able to come to an agreement.

[17] The Commission (2017g) mentions the possibility of making the transition from stage one to stage two conditional on whether the legacy problems have been sufficiently remedied.

[18] The Commission (2017c) envisions that no treaty revision will be required for any of the proposals.

[19] The text of the treaty established from the outset that it should be incorporated into EU secondary law within five years of its entry into force. So far, all the member states but Croatia, the Czech Republic and the United Kingdom have signed the treaty. It complements the Stability and Growth Pact, especially the "two pack", and many aspects have therefore already been implemented.

First, it is intended to become the backstop to the SRF.[20] Second, the EMF would be allowed to introduce new financial instruments, potentially to play a role in a future stabilisation function. Furthermore, while unanimity would be required for all major decisions that involve some form of financial impact, the proposal introduces reinforced qualified majority voting (85% of the votes cast) for certain aspects relating to stability support, disbursements and the backstop.[21]

The communication on a European Minister for Economy and Finance suggests that he or she would be President of the Eurogroup, lead the EMF and represent the euro area externally. In addition, the new Minister would have a "double hat" role, also acting as Vice President of the Commission (European Commission, 2017g).[22] However, the European Minister for Economy and Finance has proven to be a controversial idea as well (see below).

As noted, the remaining proposals all relate in some form to budgetary measures. The respective measures will be included in the proposal for the next Multiannual Financial Framework (MFF), which covers the five to seven years after the expiration of the current MFF in the year 2020. The European Commission (2017c) proposes in this context a support facility for structural reforms; a convergence facility for member states on their way to joining the euro; and the introduction of a stabilisation function to mitigate asymmetric shocks in the euro area by helping to maintain national investment levels.[23] The first two of those measures would have been tested already within the current MFF, amending two regulations that would enable the member states to utilise existing flexibility within the EU budget.[24]

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[20] The function of such a backstop is to guarantee that the SRF would be able to provide support beyond its available resources, that is, should a major shock occur that depletes the resolution fund.

[21] It is worth noting that reinforced qualified majority voting effectively ensures that both Germany and France can veto any decision (Germany's share is a little more than 24% and France's share is little more than 20%). In the case of France, this relationship would change with additional members in the euro area.

[22] In order to align the mandate with that of the Commission, it is suggested that the same person initially, by way of an informal agreement in the Eurogroup, could be elected for a two-year term.

[23] The Commission's (2017c) proposal on budgetary measures also mentions the use of the EMF as a backstop to the SRF; however, this has already been covered in the EMF proposal (see European Commission, 2017d).

[24] The first measure in the current MFF amends the Common Provisions Regulation (European Commission, 2017f), so as to enable the utilisation of the performance reserve in the European Structural and Investment Funds. The idea is to shift support from the current funding of cohesion policies to structural reforms as identified in the European Semester. The second measure would increase the resources available for the Structural Reform Support Programme, the instrument supporting the Structural Reform Support Service, for the budgetary years 2019 and 2020. The proposed increase would strengthen the funding of the current Structural Reform Support Service activities and also widen it so as to enable support for convergence in member states about to join the euro. The increase from *c.* €143 million to *c.* €223 million would be achieved by the use of the budget's so-called flexibility instrument, which allows for supplements beyond the ceiling of heading 1b (cohesion) in the budget (European Commission, 2017e; and 2017f).

3 Italy and the completion of the euro area

Erik Jones

Europe's heads of state or government are making a strong push to "complete" Europe's economic and monetary union through a raft of institutional reforms related to macroeconomic governance and financial market stabilization. There are a number of different reform packages on offer, from the very detailed proposals made by the European Commission across the course of 2017 (and building on the multiple "Presidents Reports" that emerged during the five years prior), to the telegraphic German non-paper released by Wolfgang Schäuble in October 2017 just prior to his standing down after eight years as German Finance Minister – with a range of bold and synthetic efforts scattered in between.

The challenge is to recognize where the multiplicity of proposals reflects an emerging consensus and to anticipate where there might be strong national disagreement. That is at best a piecemeal task – which explains, perhaps, why the process of agreeing on a reform package is taking longer than initially anticipated.

The purpose of this short contribution is to reflect upon the Italian perspective – both as a matter of public policy and as a reflection of popular perception. Such reflection has become urgent in light of the national elections held on 4 March 2018. Almost 55 percent of Italian voters cast their ballots for euro-sceptical political parties. The largest of these groups is the Five Star Movement (M5S), which captured just over 32 percent of the vote; the Lega emerged as the third largest political party and the leading group on the centre-right of the political spectrum with just under 18 percent of the vote; and the "Brothers of Italy", one of the Lega's centre-right coalition partners, brought in another 4.5 percent of the vote.

The M5S has flip-flopped in its views on monetary union from demanding a popular referendum on continued participation in the euro to being somewhat more accepting of the single currency; the Lega and the Brothers of Italy are more consistently opposed to euro membership. Post-electoral analysis of public opinion by polling groups like IPSOS (Formigoni and Forni, 2018; pp. 38–44) does not suggest these views moved the electorate – bread and butter issues like migration, providing a minimum income, cutting taxes or rolling back pension reforms mattered more. Nevertheless, it is important to consider why such open hostility to the euro has not generated more opposition and what Italian attitudes are toward European macroeconomic governance more generally.

The argument has five parts. The first offers a brief overview of Italy's experience in the single currency that runs from the 1992 exchange rate crisis through the onset of the global economic and financial crisis in 2009. The second looks at Italy's performance during the European sovereign debt crisis and its aftermath. The third draws lessons from this experience from the perspective of the governing Democratic Party (PD) and extrapolates from those lessons to sketch negotiating positions that any centrist or institutional government would be expected to adopt. The fourth explains why the results of the 4 March elections are more difficult to interpret in terms of negotiating positions – although the "contract for a government of change" negotiated by the M5S and the Lega suggests some worrying possibilities. The fifth part concludes with more general suggestions as to Italy's role in any future reform of the euro area.

3.1 Different perspectives on the crisis

The Italian perspective in the macroeconomic governance reform debate has two different sources – one proximate, rooted in the recent crisis, and the other more distant, emerging out of Italy's experience with European monetary integration both prior to and after the adoption of the euro as a common currency. Of the two, the recent crisis should be addressed first, if only because the current wave of macroeconomic governance reforms is meant to fix what was apparently broken. Everyone agrees that there are flaws in the architecture of European financial markets and in the single currency; where they differ is in their understanding of which flaws were important in bringing the crisis about and hence also in what should be given priority in the process of reform.

Consider four different hypotheses for why the countries of the euro area got into such serious trouble, centring on the loss of competitiveness within an irrevocably fixed exchange rate, the irresponsibility of governments in failing to match their taxes and expenditures, the willingness of households to rely on debt in living beyond their means, and the collective irrationality of financial market participants who try to safeguard the value of their assets by liquidating investments in ways that bring the entire financial system to the brink of catastrophe. There is no real necessity to choose between these "explanations"; national economies can suffer from uncompetitive firms or excessively rigid labour markets, irresponsible politicians, spendthrift households, and destabilizing financial market flows all at once. Nevertheless, the solutions to these different problems work at cross-purposes, at least when introduced all at once. Building a coherent reform agenda, therefore requires some agreement on the correct order of operations (Jones, 2015).

Politicians and policymakers in many parts of Europe tend to emphasize explanations grounded in competitiveness, fiscal irresponsibility, and excessive household borrowing. There is of course evidence to support those claims. Much of that evidence does not, however, apply to Italy. Although aggregate data for the Italian economy paints a picture of very slow productivity growth,

that aggregate data does not actually translate into a lack of competitiveness for Italian firms. It also does not result in large accumulated current account deficits. On the contrary, Italian firms have robust access to internal markets and while the country ran modest current account deficits in the years running up to the crisis, those deficits were nowhere close to the magnitudes you would expect to trigger an economic catastrophe. A similar point can be made about government indebtedness. It is true of course that the Italian state has a large outstanding public debt; prior to the crisis, however, Italy was running larger primary surpluses (meaning excesses in revenues over expenditures net of debt servicing requirements) than almost any other governments in the euro area. Meanwhile, Italian households did not borrow excessively either in relation to their net household income or as a ratio of household wealth. Italian firms were not highly leveraged either (Jones, 2016).

Whatever the problems of countries like Greece, Italy did not much evidence of huge deficiencies in competitiveness, government borrowing, or private indebtedness. Hence, Italian narratives of the recent crisis tend to focus on financial market participants and particularly on banks. They worry about the influence of cross-border financial flows in particular. If there is an order of operations in the macroeconomic governance reform process, they would address this matter first. Specifically, they seek to shore up the confidence of financial market participants so that they will not panic in moments of crisis and liquidate their Italian assets in ways that are likely to destabilize the country's entire financial system. Other countries may not see such concerns as top priority; given their understanding of the recent crisis, however, Italians have a very different perspective (Messori and Micossi, 2018).

3.2 Italy's experience with euro membership

The longer-term influences on the Italian position in the macroeconomic governance reform debate are less precise or clear-cut. Probably the best way to describe Italy's experience with euro membership – and with monetary integration more generally – is cognitive dissonance, or the simultaneous embrace of contradictory positions. Moreover, Italians are not the only ones who suffer from this psychological distress. To explain why, it is best to start with Italy's decision to join the narrow band of fluctuations for the Exchange Rate Mechanism (ERM) of the European Monetary System in the late 1980s. Economists heralded this decision as offering the credibility "advantages of tying one's hands" (Giavazzi and Pagano, 1988). Italians would be able to escape the cycle of wage and cost push inflation by using an "external constraint" (or *vincolo esterno*) to demonstrate their commitment to price stability. This would allow Italy to borrow more cheaply from abroad – hence external constraint would create new forms of flexibility.

This combination of constraint and flexibility worked only until it did not. In 1992, foreign investors lost faith in Italy's commitment to maintain its position

within the ERM and, by dint of speculative pressures, they forced the Italian government to devalue the Lira against other European currencies. Worse, in 1993, market participants attacked Italy's exchange rate position again because they saw they had the power to turn speculation into a one-way bet. In both instances, Italy was targeted because of its adherence to a transparent exchange rate target. The flexibility they sought became the instrument to undermine the constraint they reluctantly embraced.

The challenge for Italians was to decide whether currency devaluation within the ERM (or depreciation in the markets) was a good or bad thing. Predictably, the answer was both. Anyone who took advantage of exchange rate stability to take out mortgages or business loans in Deutschmarks saw the return of downward flexibility as a bad thing because the decline in the value of the Lira increased the outstanding principal of their borrowings. Workers and trade unions who saw the real value of their wages diminish were also unimpressed. Other Italian economists, however, drew the lesson from Italy's experience during the exchange rate crisis that Italy needs to maintain flexible exchange rates to ensure it can recapture its international competitiveness (De Cecco, 2007). This economic view was curious insofar as any improvement in Italy's current account position resulted more from the compression of demand for imports than from any increase in Italian exports; it was also curious insofar import price increases pass quickly through to the export sector given Italy's heavy dependence on important energy and productive inputs. Nevertheless, it was widespread.

The centre-left government elected in 1996 contained a large group of economists who did not embrace the argument about currency flexibility and manufacturing competitiveness. Instead, they argued that capital costs are more important and so Italy should make even greater efforts to commit credibly to the goal of joining the euro. To support this commitment, they pushed for coordination with trade unions on wage bargaining and pension reforms to hold down the growth in relative real unit labour costs. They also pushed for greater efforts at fiscal consolidation. This was a stronger form of the external constraint – or *vincolo esterno* – argument. The fact that Italy was selected to join the euro among the first group of countries in 1998 was a measure of this government's success. As a result, borrowing costs fell so quickly for Italy that neither the Prodi government nor the government headed by Massimo D'Alema that followed on its heels ever had to run a significant additional primary surplus to support consolidation efforts. Instead, they offset intended spending cuts (which never actually materialized) with savings they made on debt service accounts.

The point here is not that Italy failed to reform in the run-up to the euro. On the contrary, incremental Italian reform programs accumulated across the 1990s to represent a substantial change in how the economy was organized (Ferrara and Gualmini, 2000). The point is that the "*vincolo esterno*" argument delivered in terms of credibility-enhanced access to international credit. According to data

from the International Monetary Fund, where only 6 percent of outstanding Italian sovereign debt was held by foreigners in 1992, roughly 27 percent was foreign held by the end of 1998. The spread between Italian and German sovereign debt fell from six percentage points to less than one-half of one percent over the same period. Italy's domestic inflation rate declined over the period as well. The Prodi government had promised that inflation in Italy would approximate the norms in Northern Europe, and they delivered.

Ironically, Italians were the first to deny this progress. The D'Alema government collapsed and the prime minister resigned after losing regional elections between the time Italy joined the single currency and the European Central Bank substituted national currencies with euro notes and coins. Meanwhile Italian public opinion soured toward the single currency, and the changeover to the euro in particular. Although inflation was down, borrowing costs had fallen dramatically, and access to credit was increasing, Italians complained that the euro created inflation and that shopkeepers used the changeover to gouge consumers (European Commission, 2002; Tables 14, 16b). The more officials produced statistics to show that aggregate prices had not been more stable since the 1960s, the more Italians were convinced they had been swindled. This is when the Lega Nord and the centre-right began campaigning against the single currency. The issue did not gain much traction with the voters, who generally disliked the single currency and yet put other political priorities ahead of it. It is fair to say, however, that at least part of the reason that Silvio Berlusconi came to power is his rejection of the legacy of then European Commission President Romano Prodi. And while politicians on the centre-right have periodically stepped back from their more extreme attacks and promises to leave the euro, they have never fully abandoned the euro-sceptical rhetoric.

Italian industry prospered under the single currency nonetheless. This is another area of cognitive dissonance. Between 1999 and 2007, Italian real effective exchange rates appreciated by 8.4 percent against Italy's major trading partners. German real effective exchange rates fell by 17.3 percent over the same period. Viewed as a head-to-head comparison, this looks like a massive loss of competitiveness. But such a comparison ignores what happened in the years prior. Between 1991 and 1999, Italy's real effective exchange rate fell by close to 23 percent. Once relative rates of price inflation are taken into account, only about half of that was due to changes in the nominal effective exchange rate; the rest was due to the decline in relative real unit labour costs. Over the same period, German real effective exchange rates increased by 8.3 percent. By implication, what happened in the first eight years of the euro is that Italy and Germany traded places; Italy gave up some (but not all) of the competitiveness it gained while Germany recaptured the competitiveness it lost (Jones, 2016).

By the start of the global economic and financial crisis in 2007, Italy was in a better position than Germany in many respects. Italy had preserved a larger

share of the total manufacturing employment it started with in the early 1990s; Italy retained a larger percentage of its (admittedly smaller) share of global export markets as well (Jones, 2009). Italy also had comparable borrowing costs, significantly larger household wealth, and a substantially lower rate of unemployment. Most important, Italy had a more conservative banking sector. The integration of European financial markets had fostered some consolidation of the Italian banking system, but it did not change the tradition among Italian banks to focus on raising and using funds locally. Unicredit and Intesa San Paolo were notable exceptions. By contrast, the German banks took greater advantage of the opportunities they found abroad. As a result, German banks were subjected to major losses both directly from the fallout in in United States (U.S.) real estate markets and indirectly from the turmoil that arose in interbank markets when the U.S. subprime mortgage industry collapsed, dragging the major U.S. investment banks and insurance industries down with it (Hardie and Howarth, 2013).

Silvio Berlusconi, back in power after a brief two-year interlude of government on the centre-left, was quick to insist that Italy had somehow escaped the crisis (Rovelli, 2010). He was also quick to point a finger at what he described as the failings of the euro and the European Central Bank (Jones, 2009). Much of Italy agreed with him. When polled in 2009, more than 53 percent of Italian respondents asserted that Italy would have handled the global economic crisis better if it had retained the Lira as a national currency (European Commission, 2009; p. 19).

3.3 External constraint and the recent crisis

The Italian crisis started in earnest only in 2011 (Jones, 2012). Between 2009 and 2011, Italian growth slowed down and unemployment increased much as happened elsewhere in Europe outside of Germany. The explanation was a result of slack demand in Italy's traditional export markets, rising financing costs, and tightening restrictions on access to credit. This combination of factors quickly chipped away at the business models of the Italian banking system. As households dipped into their savings, they had less money to hold on deposit or to invest in bank bonds. Banks facing tightening funding opportunities cut back on their lending and raised lending requirements. Local small and medium sized enterprises faced shortages in raising working capital and deferred plans for investment. Italy's many local economies entered into a negative spiral as a consequence. Before long, both firms and households began to fall behind on their payments to the banks; non-performing assets piled up, forcing the banks to set aside additional loan-loss provisions and to raise fresh regulatory capital; the negative local spiral accelerated as a consequence.

The turning point came in June 2011. Prior to that month, international investors had been slowly and quietly reducing their exposure to Italy's sovereign debt market. Toward the end of that June, however, they stopped worrying about being quiet and focused more intently on finding the exit. The timing

is not immediately obvious, but it relates to the debate about increasing the haircuts on private investors during the negotiation of the second Greek bailout. Italy was not as fragile as Greece and so the probability of default was very low, but international exposure to Italian debt was much larger than exposure to Greece and so the expected value of any losses was very high. As investors started selling down the price of Italian government bonds, the trend quickly assumed a self-reinforcing dynamic. The capital flight can be seen in Italy's net position in the euro area's real time gross settlement mechanism called TARGET2. Italy's position was a net surplus for most of its participation in the single currency prior to the crisis; that surplus fell gradually during the period from 2008 to 2011. As the capital poured out in June 2011, Italy's position moved massively into deficit. This sell-off in Italian government bonds is important because it represented a sharp spike in local borrowing costs and a sharp contraction in locally available liquidity. No one in Italy was left unaffected – Berlusconi's centre-right coalition included.

What followed over the next five months was a series of humiliating moments both for Italy's centre-right government and for the country as a whole. The narrative is too detailed and complicated to try to summarize. Three anecdotes capture the essence of the experience. The first took place in August. European Central Bank President Jean-Claude Trichet signed a joint letter with Bank of Italy governor Mario Draghi offering to support Italian government bonds in secondary markets if Berlusconi's centre-right coalition show concrete progress in implementing a specific reform agenda. The letter was transmitted in secret at the start of the month. When its existence was revealed at the end of August, the impression it created was that politically independent central bankers were dictating terms to elected politicians. If anything, this public symbolism damaged the already fraught relationship between Berlusconi, his finance minister Giulio Tremonti, and his Lega Nord coalition partners. The euro as an external constraint made agreement on the reform package more rather than less complicated.

The second anecdote comes after six weeks of trying to find agreement on necessary reforms within the centre-right coalition. As this process dragged on, European leaders quickly and very visibly lost patience with Italy. They also lost any semblance of respect for Berlusconi. He had always been a problematic figure, but he was a head of government and so publicly other European leaders treated him with some measure of respect. By this time, however, not even his official status seemed to matter. Hence when German Chancellor Angela Merkel and French President Nicolas Sarkozy were asked in a joint press conference held on the margins of a 23 October 2011 European crisis summit whether they trusted Berlusconi, they smirked. Such disregard only increased tensions within the Berlusconi government and the Italian centre-right put those tensions on full display. Berlusconi and Tremonti travelled together to a G20 summit at Cannes in early November. The focus for concern at the summit was the escalating crisis in Greece and yet Italy was also attracting attention. Berlusconi and Tremonti

held a joint press conference at the summit. Their mutual distain was apparent. So was their disagreement on how to proceed (and specifically whether to seek support from the International Monetary Fund). Their very public infighting was broadcast widely on Italian television. Once again, nothing constructive emerged from Italy's "external constraints".

The third anecdote took place toward the end of that November. That is when Italian President Giorgio Napolitano accepted Berlusconi's resignation as prime minister. The symbolism was awkward. Napolitano was a centre-left president who showed no great affection for Berlusconi's centre-right government. Napolitano also named the two-time European Commissioner Mario Monti a life Senator shortly before Berlusconi resigned. Everyone knew at the time that this was in order to be able to appoint Monti as head of a technical government should Berlusconi step down as prime minister. So there was nothing unexpected in the sequence of events. What was unexpected was the way these events were characterized by U.S. Treasury Secretary Timothy Geithner in the memoirs he published after he left office. Geithner cited unnamed European Commission sources to support a rumour that there was a broader conspiracy to oust the Berlusconi government and replace it with something more trustworthy. To explain the impact of this allegation, it is worth quoting Geithner specifically:

> At one point that fall [2011], a few European officials approached us with a scheme to try to force Italian Prime Minister Silvio Berlusconi out of power; they wanted us to refuse to support IMF loans to Italy until he was gone. We told the President about this surprising invitation, but as helpful as it would have been to have better leadership in Europe, we couldn't get involved in a scheme like that. (Geithner, 2014; Chapter 11).

In reading this, it is important to emphasize that Geithner is a former U.S. cabinet secretary and not a journalist. That status gives him a certain unimpeachability even in the lack of corroborating evidence. If true, this would be a massive interference in Italian domestic politics. No additional material was uncovered to support Geithner's allegation. Unsurprisingly, though, the conspiracy theory has flourished among Berlusconi's supporters and on both fringes of the Italian political spectrum. For them, accepting European constraints offers few if any advantages.

These anecdotes are not meant to suggest that there was a sudden break in Italy's perceptions of the merits of having an external constraint to support its domestic reform processes. On the contrary, both the Monti government and the government that followed it cooperated very closely with European partners and institutions. Both governments also made significant progress in pushing domestic reform agendas on complicated policy matters; pensions, first and foremost. Nevertheless, the symbolism of cooperating with Europe was tainted by the crisis experience and so the advantages of tying one's hands have been diminished as a consequence.

Italian Prime Minister Matteo Renzi was conscious about pushing back against the whole notion of Italy needing a *vincolo esterno* (Jones, 2017). He and his team argued rather that Italy should take advantage of the credibility that it acquired through domestic achievements to push Italy's agenda abroad. The PD-led coalition that Renzi took over from Monti's successor, Enrico Letta, in February 2014 made a point of reversing the logic of the external constraint. They argued that Italy should constrain Europe rather than the other way around. This is a complicated argument that has involved Renzi's ministers pushing back against a number of different European policies. Renzi also made a point about his reluctant willingness to follow rules with which he disagreed and his frustration with being given warnings or instructions by European institutions which lacked his democratic legitimacy. To understand his position, however, it is necessary to take stock of the domestic political context. By the time Renzi was prime minister, his party was the only major political force in the country to espouse a pro-European position.

Renzi also found himself facing problems that his immediate predecessors had not anticipated and yet that flowed directly from Italy's unique position in the crisis. The first of these problems concerned Italy's banks. The negative spiral of economic activities in Italy's local economies took a significant toll on the balance sheets of the countries smaller and mid-sized financial institutions. If there were €78 billion in non-performing assets in 2010, that number had doubled by 2013 and continued to grow at a slower pace even as the crisis abated. By 2016, Italian banks had more than €200 billion in non-performing assets to manage, due primarily to the collapse of local small and medium sized enterprises and the prolonged decline in real estate prices (Banca d'Italia database). If these losses had been reported in 2008, the Italian government would have recapitalized the banks directly. In 2014, however, European heads of state or government engaged a new Banking Recovery and Resolution Directive that required banks to impose losses on investors before receiving public support. From an Italian perspective, this meant imposing losses on the local community, because of the way in which Italian banks recruited their funding. When Renzi tried to do this with four small banks in December 2015, it was a political disaster. When it looked as though Renzi would have to do it again with Monte dei Paschi di Siena the following year, the implications were even worse. The lesson Renzi drew from that experience was that Europeans could not be allowed to dictate how Italians deal with their banks. The challenge was to convince his European partners to agree.

The second problem has to do with Italy's sovereign debt crisis. The popular myth is that the crisis was resolved once Monti replaced Berlusconi. On the contrary, international investors continued to shed their exposure and, apart from a brief interlude that resulted from a communications failure at the ECB, the spread between the yields on Italian and German sovereign debt instruments continued to increase despite the change in political leadership. What changed the situation was a shift in ECB lending strategy. The ECB offered two tranches

of three-year loans at very low fixed interest rates against high quality collateral for banks to use in funding their operations. What this meant in Italy and Spain is that banks used their existing sovereign debt holdings to borrow money to buy more sovereign debt which they collateralized into loans that they used to purchase sovereign debt. This pattern worked well to stabilized sovereign debt markets in both countries through March 2012, but at the cost of increasing the exposure of banks in both countries to their own country's debt instruments. By implication, domestic banks became the sovereign creditors of last resort. Italy's banks hold large volumes of Italian sovereign debt as a result. When other Europeans began to complain that this constituted a new source of financial risk, the Renzi government could only respond that moving away from this legacy would be a long-term project.

The former Prime Minister, Paolo Gentiloni, found himself in a similar situation to Renzi on both counts. Gentiloni had considerable work to do in dealing with Italy's banking sector, including tackling new bank failures in the Veneto region in addition to finalizing the solution to Monte dei Paschi di Siena and strengthening the rest of the financial sector. He was less combative than Renzi and his methods were less abrasive for European partners. But he was no less constrained than Renzi was by the structure of Italian public opinion toward Europe as a *vincolo esterno* and the euro in particular. According to November 2017 Flash Eurobarometer public opinion polling, Italy has the second lowest percentage of respondents (45 percent) who agree that the single currency was good for their country and it is tied with Cyprus for the lowest percentage of respondents (62 percent) who agree that the euro is good for the European Union. Only 33 percent of Italians will even admit that having the euro has made traveling easier (European Commission, 2017; various tables).

3.4 Negotiating positions we might expect from a centrist or technocratic government

Given this complicated history, what we could expect from a centrist or technocratic Italian government, is a fairly coherent set of positions. At the time of writing, the President of the Republic, Sergio Mattarella, has just accepted a populist cabinet. Such a government would win a majority in both chambers of the Italian parliament. However, the alternative reality of a centrist or technocratic government provides a useful baseline for understanding just how much change a populist alternative could bring about.

To begin with, a centrist or technocratic government would support a euro area budget line or additional financial resources to foster investment or to facilitate structural reforms. Such a government would also embrace a European deposit insurance scheme backed with common resources and they would like to see common funding for bank resolution and recovery measures as well. A centrist or technocratic government would acknowledge the advantages of having a European finance minister (or similar actor) to exercise some

discretion in allocating these joint resources and in representing the euro to the outside world. They would also like to see greater political accountability for joint European macroeconomic policymaking and for the whole structure of European macroeconomic governance. Such accountability would reach from the top-down and would include greater discretion at the national level – both to facilitate adjustment to the new regime and to adapt common policies to national requirements. Finally, a centrist or technocratic government would argue for simpler, more transparent rules in setting targets for fiscal consolidation both relating to deficits and to dealing with legacy obligations (or large outstanding public debts). In an ideal world, they would also support some form of debt mutualisation (or Eurobonds) in order to create a common European risk-free asset – although everyone acknowledges that idea is far from being on the table.

That positive agenda would be ring-fenced by a negative agenda. There are reform elements that any centrist or technocratic Italian government would oppose in order to protect the integrity of the European system. The Gentiloni government was already on record as objecting to pressure from the European Central Bank to accelerate the disposal of non-performing assets in the Italian banking system. The Gentiloni government also opposed efforts to introduce a cap on bank exposure to home-country sovereign debt instruments as well either directly, through quantitative limits, or indirectly, through capital levies. Such risk reduction measures are not problematic in principle; they are problematic in practice, given where Italy is at the moment. With an appropriate transition period and policies, a centrist or technocratic government would be happy to see the Italian banking system with a much lower level of non-performing assets and a more diversified asset portfolio. The point is simply that most of the economic policymakers who would staff a centrist or technocratic government do not believe it is helpful to damage the Italian economy in order to achieve that goal. That is why the 14 March 2018 proposal by the European Commission (later echoed by the ECB) to raise loan-loss provisioning requirements for future loans was met with Italian opposition.

Other areas where we would expect resistance from a centrist or technocratic government pivot on the notion of "external constraint". They would not support the transformation of the European Stability Mechanism (ESM) into a European Monetary Fund (EMF) outside the institutional framework of the European Union with the goal being to insulate such an institution even further from political oversight. The idea of transferring ever greater authority to the ESM or to a new EMF to manage fiscal policy coordination through strict conditionality both before and after giving program assistance would also not be welcome. The Gentiloni government – like the Renzi government before it – had already pushed back against the interference of the European Commission; a more rigid ESM (or EMF) would only complicate an already problematic situation from the Italian perspective. This is a qualification on the creation of a euro area budget line as well. Such common resources should be a carrot, not a stick.

The unifying themes in the baseline Italian position would be solidarity, risk sharing, and national ownership. These themes are not to deny the importance of issues related to moral hazard, risk reduction, and national responsibility. Rather these themes put those concerns in perspective. The Gentiloni government believed that Italy has shown the capacity to reform and the willingness to make sacrifices on behalf of Europe. It has also shown its ability to tackle significant legacy issues. What it sought is a supportive framework for those efforts; what it did not want is an external constraint on what it believes to be good policies. A centrist or technocratic government would be expected to adopt a similar point of view.

3.5 The complicated future of Italian politics

The problem for the rest of Europe is that the Gentiloni government has already stepped down as a political actor and Italy is, at the time of writing, heading for a populist government rather than a centrist or technocratic government. Using the M5S/Lega policy programme as an outline scenario for this new populist government, we can anticipate a number of different areas where it would depart radically from what we might expect from a technical or institutional government. The language here is conditional insofar as we cannot be sure precisely how the new coalition will evolve.

The most obvious point of divergence would be in the area of fiscal policy coordination and debt consolidation. A populist government would likely bring a raft of expensive new social items, such as the reversal of recent pension reforms, the topping up of low pensions, and the introduction of a basic minimum income that it does not yet have the resources to fund. Such a government would also eliminate some excise taxes, remove an increase in value-added taxes that is scheduled for January 2019, and work to introduce a two-tiered flat tax arrangement for individuals, households, self-employed workers, and enterprises that will greatly reduce tax yields in the short to medium term. The M5S/Lega agreement says that this combination of expenditure increases and tax reductions would be financed in the out years by higher rates of growth and stricter compliance with the tax regime. In the meantime, they would negotiate with their European partners to relax the requirements for the current stability program and to make use of deficit spending. This is a negotiating position that Italy's partners in Europe immediately started pushing back against.

There are other elements that the M5S and the Lega agreed upon that European partners found worrying. One of these was the introduction of very small, tradable government debt instruments that would be offered to government suppliers in order to cover the country's arrears. These instruments could be traded in secondary markets and also used to offset future tax obligations. In other words, they would operate as a quasi-currency running parallel to the euro. Italy's partners in Europe would likely push back against this idea as well.

At the same time, the coalition document takes a strong stand on burden-sharing in any kind of banking recovery or resolution program. The document makes it clear that bail-in rules should exclude ever wider classes of bondholders. It also suggests that low-income or unsophisticated holders of bank equity should be ring-fenced from bail-in requirements. And it calls for efforts to make it harder for financial institutions to seize collateral on non-performing loans without some form of judicial review. Such measures go directly against the ethos of the Banking Recovery and Resolution Directive and are likely to make it harder for Italy to persuade other countries that its banks should be covered by pooled resolution funding or deposit insurance.

The other thing to consider about a populist government is the likely tone that it would take on European matters. Although the M5S has gone back and forth on many of its positions, the Lega has been consistently sceptical about the virtues of European integration and critical of any interference by "unelected bureaucrats" from Brussels in Italian domestic politics and policymaking. The M5S-Lega coalition agreement shows the hallmarks of this scepticism. The document started by describing a procedure for coordinating positions between the two political parties and their ministers on all matters relating to Europe and it ends with a list of grievances related to excessive regulation, intrusive coordination efforts, and unfair foreign competition both within Europe and between Europe and the outside world. Such attitudes would antagonize other European leaders. In many ways that is the point. Both the M5S and the Lega would relish a conflict with Europe over key policy provisions to reinforce their roles as the protectors of Italian national interest. The more conflict they can demonstrate to the voters, the more credibility they gain in the eyes of the electorate.

3.6 Conclusion

The tempting conclusion would be to ignore Italy's role in the absence of a strong and cooperative Italian government. Doing so, however, would also be ignoring Italy's complicated history with the euro. The main theme that emerges from this history is ambivalence. That ambivalence could translate quickly into popular discontent if euro area reforms turn out to disadvantage Italy in some structural sense, if they impose too rapid a cost of adjustment on the Italian economy, if they create too many opportunities for European officials to lecture Italian policymakers, and if they undermine the stability of trusted institutions like historic regional banks. Italy's political weakness should be a reason to pay closer attention to what Italians have to say about the euro area reform process and not to dismiss Italian input from consideration – even if the source of that input is a political figure who is not popular at the European level.

4 France and the push for euro area reform

Christophe Destais

The publishing of this report could not be timelier. On Dec. 15, 2017, Mr. Macron and Ms. Merkel announced that they intend to reach a bilateral agreement by March 2018 before discussing the issue with other euro area members. Then, in January 2018, the Grand Coalition talks in Germany made a breakthrough, explicitly referring to euro area reform in terms that explicitly refer to those used by the French authorities. However, there is still a long way to go before an agreement can be reached between the two countries.

This contribution aims at shedding some light on the political situation in France, providing some details on the French proposals regarding the euro area reform, and finally, sharing a few comments regarding the possibility of reaching a satisfactory agreement between the two countries.

4.1 The circumstances of Macron's rise to power

In appearance, in France, things appear uncomplicated regarding the authorities' political room for manoeuvre. This is mostly thanks to a political situation and an institutional framework that have resulted in the side-lining of anti-euro/anti-EU proponents and the apparent absence of an actual public debate in France on what fiscal policy should be adopted in a monetary union. One should not, however, forget the circumstances of Macron's rise to power. Indeed, one year ago, pessimism about the future of the EU and the euro was the dominant mood in France, as elsewhere in Europe.

In France, the far right and the left-populist parties were setting the tone of the campaign for the April-May presidential election. The traditionally pro-European socialist centre-left was nearly wiped out of the campaign. The centre-right candidate, François Fillon, who advocated in favour of an extremely restrictive fiscal policy was about to be embroiled in a scandal that would deprive him of any hope of winning the election. The pro-Europe "radical centrist" (Zaretsky, 2017) Emmanuel Macron started to climb in the opinion polls but was still trailing behind Marine Le Pen. Because of this, the possibility that France would withdraw from the euro area and perhaps even the EU was discussed for the first time during the campaign. The possibility that France would withdraw from the euro area, if not the whole EU, was, for the first time, one of the most disputed issues of the campaign.

Following the success of the Brexit referendum in the UK and the election of Donald Trump as US President, Marine Le Pen, the far-right candidate from the Front National (National Front), focused her campaign on populist economic and social policies, more than on the traditional anti-immigration rhetoric of the party founded by her father, Jean-Marie Le Pen, in 1972.

Jean-Marie Le Pen had himself run as a candidate in the Presidential elections in 1974, 1988, 1995, 2002[25] and 2007. In 2002, Jean-Marie Le Pen scored second in the first round of the election, ahead of the socialist candidate, and therefore was opposed in the second round by Jacques Chirac, the incoming president, who had scored first. However, Jacques Chirac enjoyed the full support of what is sometimes dubbed in France "le Front Républicain" (the Republican Front) from the extreme left to the "Republican" right and received more than 82% of the vote in the second round.

Marine Le Pen took over the party leadership in 2011 and ran in the ensuing 2012 presidential election. Ms. Le Pen surrounded herself with people who came from different backgrounds than those of her father's closest allies.

Ms. Le Pen chose as her deputy Mr. Phillipot, who used to be a left wing, anti-Europe nationalist rather than a far-right militant. Mr. Phillipot was instrumental in expanding the focus of the Front National campaign from hostility towards immigrants to populist economics.

By contrast, most of Ms. Le Pen's allies originated from the French far right, which was initially hostile to decolonisation, and more generally, to General De Gaulle's[26] policies. The hostility to decolonisation in the 50s and early 60s turned to hostility towards immigrants beginning in the 70s. The electorate base and the militants were ideologically often close to the traditionalist Catholic circles, and socio-economically, they ranged from a middle class to a wealthy background. Not surprisingly, the Front National built up electoral bastions in areas where the density of residents of foreign origins, mostly from Nothern African countries which had formerly been French colonies, was high, especially in southeastern France.

The electoral tactic behind this move was to expand, if not change, the socio-political base of the party towards more popular categories of voters living in mostly small cities and rural areas, heavily affected by the economic decline, and hence, very sensitive to nationalistic and populist rhetoric.

[25] The presidential mandate, which had lasted seven years since 1877, was reduced to five years starting in 2002.

[26] French President between 1958 and 1969 and Second World War hero.

Populism was also represented on the left by Jean-Luc Melenchon, a former socialist MP who had succeeded in rallying most of the voters at the left of the socialist party. Though Mr. Melenchon's views on immigrants and some political issues were the opposite of Ms. Le Pen's, his economic policy proposals were rather close, namely: France should withdraw from the euro area and use its recovered monetary sovereignty to finance a very ambitious plan of additional public spending. It is worth noting that for both Mr. Melenchon and Ms. Le Pen, recovering monetary sovereignty meant not only getting out of the euro area, but also rejecting any idea of central bank independence.

Mr. Macron ranked first in the first round of the presidential election with slightly more than 24%. But it is still unclear whether this was the result of his own appeal to the voters or the lack of appeal of the socialist candidate (who ran a leftist campaign) and that of the scandal-ridden Fillon. Ms. Le Pen ranked second with 21.3% of the vote.

Between the two rounds of the election, Ms. Le Pen smoothed her anti-euro rhetoric and performed poorly during the debate with Mr. Macron. She secured 33.3% of the vote. This was less than what she expected, but much more than the far right had ever received in a national election in France.

After the election, a combination of undisputable personal skills, institutional mechanisms, and the traditional voters' inclination to give the President the means to govern in the parliamentary election that immediately follows voters' legitimism secured for Macron not only an overwhelming majority in the National Assembly, but also the capacity to disarm his opponents from both the traditional political establishment[27] and the populist movements, whether they were rightist or leftist.

In particular, Macron secured a quick and audacious reform of the French labour laws with little opposition, much less than what the socialist government had faced for reforms that were much less ambitious. Mr. Macron and his government quickly collapsed in opinion polls in the summer following the election, but they have recovered somewhat since then. We do not know, however, how long this "state of grace" will last.

Anti-euro rhetoric has virtually disappeared from the public debate in France since the elections. It is widely believed that Ms. Le Pen's monetary stance frightened part of the voters who might have, otherwise, favoured her, although not to the extent that would have enabled her to win.

[27] One key aspect of the electoral success of Mr. Macron was that he offered a reshuffling of the political personnel, while at the same time, being able to reassure mainstream voters that he would not take an adventurous path.

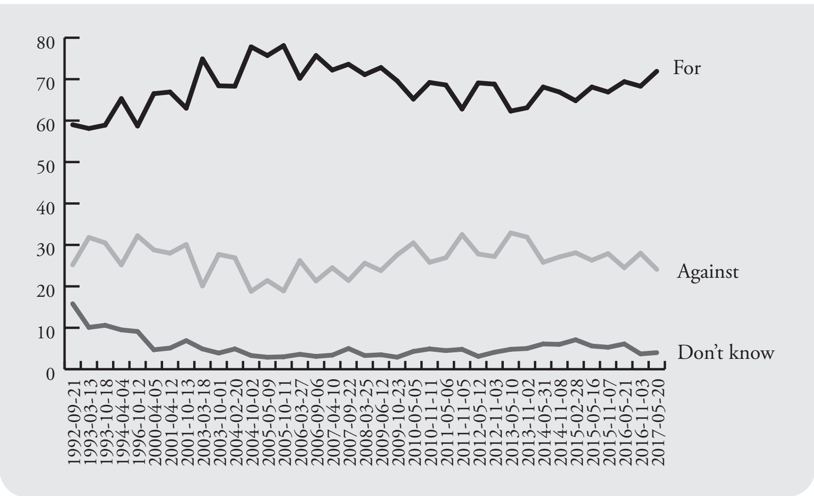
However, it is not a given that this situation will last until the end of Macron's mandate in 2022. For the past 45 years, France has been run by politicians who were committed to Europe. This, however, does not accurately reflect public opinion. In 1992, the Maastricht Treaty was ratified by a narrow majority of 51.04% of the voters who took part in the referendum. And no one, at that time, discussed the technical feasibility of the euro. In 2005, the project for a European Constitution was rejected by 54.7% of the voters.

The centre-right party "Les Républicains" has been weakened by the scandal that plagued its candidate's campaign, the disappointing score in the ensuing first round of the Presidential Election and the fact that a minority of its former senior members rallied to support President Macron. Its new leader, Mr. Vauquiez, is trying to rebuild his party on a euro-sceptical platform, presumably with the goal of rallying part of the voters of the Front National.

The left-wing populists have also been weakened because they failed to mobilise against the market-oriented reforms of Mr. Macron's government. However, they still occupy the bulk of the political space at the left of the government. The pro-European socialist party is experiencing an existential crisis, and no one really knows what will emerge from it.

Therefore, the current government and its supporters at the National Assembly occupy, almost single-handedly, the political space that favours Europe, and they are committed to unabatedly supporting the euro. In addition, it is worth

Figure 1 Views on the euro: "Are you for or against a European Economic and Monetary Union with one single currency, the euro?"



mentioning that most of the members of the President's party in the national assembly are inexperienced politicians who tend to follow their mentor.

It may be the case that the people responsible for Ms. Le Pen's campaign failed to study, in depth, the opinion of the French voters on Europe. If one refers to the Eurobarometer, it shows that a vast majority of the French population supports

Figure 2 Views on the EU: "Would you say that you are very optimistic, fairly optimistic, fairly pessimistic or very pessimistic about the future of the EU?"

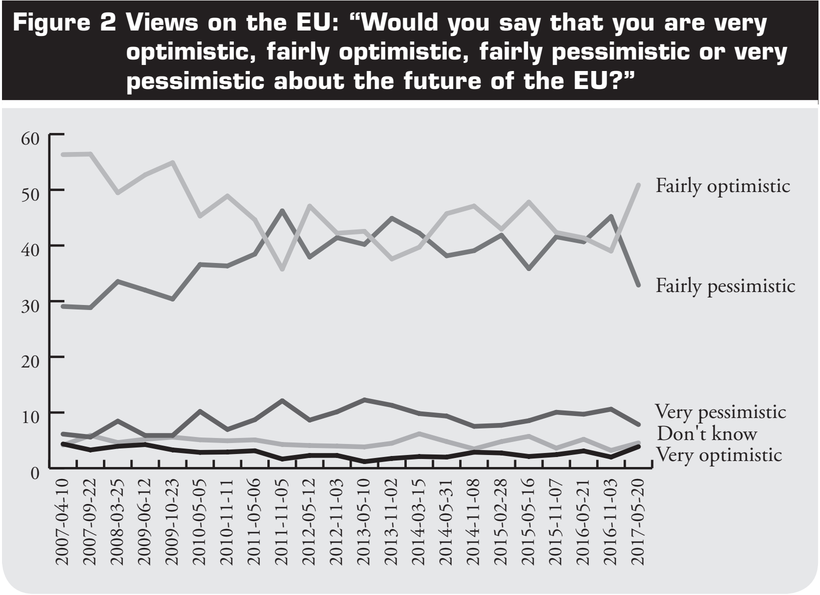
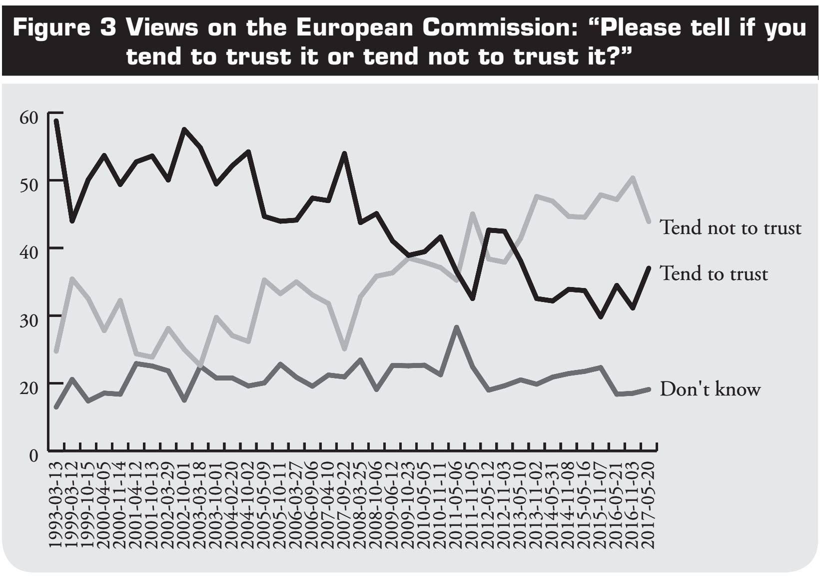


Figure 3 Views on the European Commission: "Please tell if you tend to trust it or tend not to trust it?"



the euro, even though they have rather pessimistic views about the future of the EU, and they do not trust the Commission.

In addition, neither Ms. Le Pen nor Mr. Melenchon presented the voters with a well thought out, coherent, yet simple view of their project for a reversal process to a domestic currency. They presented it as a simple sovereign decision which would be easy to implement and would not raise major economic, financial or legal difficulties. Despite the complexity of the subject, sections of Ms. Le Pen or Mr. Melenchon's electorate, especially people in the middle class and among those involved in business, realised that their financial assets might eventually be partially wiped out and/or their financial liabilities could increase substantially and their real income could be drastically reduced as a result of a unilateral decision to leave the euro area.

4.2 The French view on the reform of the euro area

Mr. Macron is making a simple bet which he keeps repeating: "I will manage to implement the structural reforms that France badly needs and neither the right nor the left has succeded in deciding or implementing during the last three decades in France. This will give me, among other things, the necessary credibility to convince the Germans to boldly reform the euro area".

Although they have been widely discussed, Mr. Macron's proposals remain schematic. The main public sources to document this view are scarce: Macron's election campaign platform and a speech – somewhat ambitiously – entitled "Initiative for Europe" he made at the Sorbonne University in Paris on September 26, 2017, that is, two days after the German general elections.

The election platform advocated in favour of "a Europe turned towards growth" with two euro area-related items:

- the creation of a budget for the euro area with three functions: investment for the future, emergency financial assistance and response to economic crises.
- a post of Minister of Finance of the euro area who will be responsible for the budget of the euro area, under the control of a Parliament of the euro area, gathering members of the European Parliament from euro area countries.

In his September 26th speech, Macron fleshed out his ideas, only mentioning possible budgetary resources: European taxes in the digital or environmental fields and "partly allocating" at least one tax to this budget, such as the corporate tax, once it has been harmonised. He also briefly alluded to the "rules": "the solidarity required for a budget must be combined with increased responsibility, which starts by observing the rules we have set ourselves and implementing essential reforms."

Beyond these public statements, it is likely that the French are willing to have an ambitious global discussion with the Germans in order to present the other euro area members with a package encompassing all the issues and a reform plan that would include all the provisions, with a long-term calendar for implementation.

Such a plan would cover:

1. financial integration (the banking union and the capital market union),
2. crisis management with adjustments made to the European Monetary Mechanism, giving it a larger role in crisis anticipation,
3. and, last but not least, a euro area budget whose size would reach 1% to 2% of the euro area GDP. The euro area budget would have its own tax revenues and the possibility to borrow, hence contributing to the production of a European safe asset. The euro area budget would be authorised by a newly created section of the European Parliament: the euro area Parliament, for which the usual qualified majority voting rules would apply.

The euro area budget would contribute to the stabilisation of the euro area economy in case of shocks through the automatic reduction of its revenues rather than through an increase in its spending.

4.3 Comments

4.3.1 Why is a new budget set up and the coordination of domestic fiscal policies not improved?

Marcron's electoral platform did not mention a role to be played by the coordination of fiscal policies throughout the euro area. In his speech at Sorbonne in September 2017, Macron briefly referred to this issue. This is quite surprising, as France, for quite some time, has been asking Germany to boost domestic demand to reduce its external surplus and stimulate the economies of the euro area member states that ran an external deficit, including France itself.

The question is whether, as suggested by the traditional French position, better coordinated fiscal policies would improve the aggregate management of demand at the level of the whole euro area and, therefore, lessen the relevance of a common fiscal tool. In other words, is there a trade-off between the coordination of fiscal policies, on the one hand, and the use of a common budget, on the other?

Beyond German aversion vis-à-vis the use of fiscal policy to stimulate growth, the answer to this question is difficult. To start with, calibrating the spill overs from one euro area country's fiscal policy to the others is hardly a feasible task. In addition, to be effective, the coordination of fiscal policies for the management of aggregate demand at the euro area level would imply that a federal entity

should be in a position to impose accommodative or restrictive policies on each euro area country, which is hardly thinkable.

However, one must acknowledge that the more the fiscal policies are coordinated, the smaller a common fiscal tool would need to be in size.

4.3.2 Who has benefited the most from the euro area?

Though it might be too late in the current context, a debate on "who has benefited the most from the euro area?" would be very useful. In conversations, most German economists, regardless of their inclination, tend to think that Germany has not been among the main beneficiaries of the euro area. Non-German economists tend to think that the euro has favoured Germany.

4.3.3 Compatibility of the French proposals with the German views

The French proposals are rather consistent with the traditional French Keynesian views with respect to fiscal policies. They do not directly address the German ordoliberal concerns that relate to fiscal rules, their implementation and the avoidance of moral hazard for big spenders and creditors alike. Actually, the French proposals are in stark contrast to the traditional German view. These views were made especially clear by Mr. Schäuble's October 9th statement (see Schäuble, 2017, in the references), which he left as a farewell gift to the Eurogroup.

The negotiations between the German Liberal Party (FDP) and Ms. Merkel's Christian Democratic Union of Germany (CDU) and Christian Social Union in Bavaria (CSU), following the German general elections, left little hope for a compromise between the French and German positions, since the FDP, especially its leader, Mr. Lindner, had made public his adamant refusal of any reform of the euro area that would have been inclined towards more de jure solidarity between the euro area members.

The latest developments in Germany – i.e. the basis for and the establishment of the grand coalition between CDU/CSU and the Social Democratic Party (SPD) – are encouraging with respect to the possibility of a compromise. Indeed, the coalition text is more open to French views than any German official stance ever has been.

This is, however, somewhat puzzling. Are we witnessing a turnaround of the German fiscal and monetary orthodoxy, 70 years after the creation of the Deutsche Mark? This is doubtful, and the extent to which the Germans are ready to take actual steps towards the French position remains to be tested.

- In France, we probably tend to underestimate the extent of German frustration with the euro. When the euro was created, we accepted that it

was, in appearance at least, designed on the model of the Deutsche Mark. In retrospect, it is not certain that what was good for Germany between 1950 and 1990 was good for the euro area. But, as far as fiscal policy is concerned, it was not and is still not being implemented the way the initial Treaty or even the many and overly complex steps taken during the crisis provided for. Therefore, there are many people in Germany who feel they were deceived and who feel we should now focus on the actual implementation of rules and adjustment policies to curb excessive public spending, reduce public debt and moderate wages. A final agreement should not neglect this dimension.

- Beyond these obstacles, we will face the complex legal issue of the German constitution. We will need to know to what extent Germany could actually implement a new fiscal framework for the euro area without changing its constitution or whether such changes can be contemplated, should they be necessary.
- The recent CEPR Policy insight signed by 14 German and French economists (Bénassy-Quéré *et al*., 2018) clearly lays out the necessity of finding a way out of the traditional opposition between the French and German views, with the latter as the starting point. This is an interesting and constructive approach. However, the document remains complex and arduous. The vocabulary is very technical and sometimes disputable, and it does not take into consideration the emotional, political, as well as symbolic charge of the words. Overall, it is difficult to grasp its general philosophy. On the German side, the signatories include the leaders of two German research institutes, Ifo and DIW, which hold very different macroeconomic philosophies (Ifo is orthodox or in German parlance, ordoliberal, and DIW is firmly Keynesian). On the French side, most if not all the signatories are centrist economists prone to searching for an adequate mix of market and government policy solutions. The leftist economists who focus on the need to avoid, at all cost, "fiscal authority", such as Thomas Piketty, are not among the signatories.
- A key issue for a sustainable compromise is the coherence in the provisions of a reform, as well as in its implementation. There is a risk that a reform of the euro area would, on the surface at least, duplicate French views, and that thanks to German resistance, we would end up with a half-baked cake, in particular, a budget that is so tiny that it has no influence on the economy. We must seek coherence. This is especially needed because it is very difficult in continental Europe to be pragmatic in these realms in the way that the US or the UK are, for well-known cultural reasons, as well as because we do not have similar market flexibilities.
- Muddling through, that is, not changing the way the euro area works beyond some cosmetic initiatives, will also be a temptation. If official statements are to be believed, this is not an option on the French side. Is it for the Germans?

4.4 Conclusion

It is important to keep in mind the potential cost of the collapse of the euro area should a new crisis occur. In this respect, it would be worthwhile, before making

a decision, to follow Daniel Kahneman's recommendation of proceeding to a "pre-mortem" analysis. The latter would consist in the decision-makers asking themselves the following question: If we are confronted in a few years with a total failure, what could have been the causes?[28]

[28] I borrow this suggestion from a recent article published in the French intellectual review Esprit; see Huberdeau and Vidon (2017).

5 Germany's approach to euro area reform

Daniela Schwarzer

5.1 Introduction

Since the beginning of European integration, German governments have been proponents of both deepening cooperation between member states and strengthening the EU. They likewise have supported subsequent rounds of enlarging the EU. While Germany hence traditionally plays the role of a pro-integrationist country and often has acted as an engine of integration, it frequently has been able to realise its national interests when it comes to shaping EU institutions and policies. In particular, on euro area matters, consecutive German governments have successfully ensured that the governance set-up was designed according to principles strongly influenced by neo-classical economic theory and supply-side approaches, as dominate German economic thinking.

The Maastricht Treaty of 1991, which established the legal base and institutional set-up for the European Monetary Union (EMU) and later treaties and EU secondary legislation which added to its governance set-up, have hence enshrined the principles of central bank independence, monetary stability, sound fiscal policies as well as the no-bail-out-rule for government debt. A low degree of risk sharing and an emphasis on national governments' self-responsibility remain fundamental principles of the functioning of the euro area from the German perspective.

5.2 German euro area policies since the start of the financial crisis

Over the past decade, the Merkel II (2009–2013) and Merkel III (2014–2017) governments supported efforts to strengthen euro area governance in the course and in the aftermath of the financial crisis of 2008 and the sovereign and banking crisis that spread in the euro area starting in 2010. This included the creation of European financial supervisory structures and tougher financial regulation. The German government, after some hesitation (see below), also supported the creation of a rescue mechanism in the euro area, first the temporary European Financial Stability Facility (EFSF), and later the permanent European Stability Mechanism (ESM). In exchange, it pushed for efforts to tighten the grip on national economic and budgetary policies. It thus supported the so-called "Six Pack" and the "Two Pack", two legislative packages to strengthen the Stability and Growth Pact and economic policy coordination in the euro area. It also triggered and pushed through the Fiscal Compact, an intergovernmental agreement which obliges governments to respect tighter limits for deficits and to introduce corresponding fiscal rules domestically.

Seen from the Southern European and the French perspectives, however, the German government acted slowly and reluctantly in the management of the sovereign debt and banking crises. At the height of the sovereign debt crisis, Germany was accused of dragging her feet and provoking EU policies that were "too little, too late", an approach that observers criticised as pushing up the price for rescuing Greece, Ireland and Spain. The debate both within the euro area and with the International Monetary Fund (IMF) on how best to deal with the sovereign debt crisis serves to illustrate two particular German views on euro area matters which at least partly prevail today.

One is the deeply rooted fear of provoking moral hazard and lowering incentives for reforms. The firm belief in Germany was and still is that governments in euro area member states should only receive financial support if they have behaved "responsibly" in terms of budgetary policy and "done their homework" in terms of implementing structural reforms, or if they subscribe to further reform programmes and budgetary consolidation efforts. Indeed, German policy-makers felt "tricked" by the policies some euro area members embarked upon as, from a German perspective, they violated the principles of the Maastricht Treaty and the Stability and Growth Pact. Increasing competitiveness remains a priority for economic policy-making from the German perspective, and there has been little openness among German policy-makers to discuss the need for German economic policies to adjust to the euro area context, for instance, by raising public investment and placing stronger emphasis on demand-side measures.

The second German perspective that proved controversial concerned the nature of crisis dynamics and how to stop them. The IMF, a number of European governments including France and external observers, for instance, in the US and the UK, interpreted the developing sovereign debt crisis at the beginning of 2010 as a market-driven crisis, which required a response that would re-establish trust in financial markets on a broad scale. Policy-makers in Berlin did not share this view at the outset. Consequently, opinions on the adequate size of financial rescue mechanisms strongly differed: those who assumed that the euro area was facing a market-driven crisis that had little to do with underlying economic fundamentals argued that the rescue mechanisms should be constructed in such a way that their financial firepower could cover worst case scenarios. From their point of view, decision-making on liquidity aid had to be rapid without risking national vetoes. Their assumption was that negative market dynamics and downward spirals could only be contained by giving markets a credible outlook that euro area member states would fend off a crisis of confidence.

At the outset of crisis management, however, Germany emphasised the importance of conditionality and that liquidity aid should not be provided too quickly, so as to maintain maximum pressure on governments and Parliaments in crisis countries that had to implement painful measures. Berlin argued that rescue mechanisms should not be devised to cover the worst possible case,

but only the most pressing, immediate challenges. Otherwise, so it feared, governments would resort to irresponsible policy choices while expecting to be rescued by their fellow euro area members. This position of the German government gradually changed in the course of the ongoing sovereign debt crisis, as it finally agreed to creation of the permanent rescue mechanism ESM. Still, critics continue to point out that the possibility of a national veto through the Board of the ESM and the limited firepower of the mechanism may lower its crisis management capacity if markets tested the euro area again.

Germany did take an active role in shaping the reforms of the governance structures during the acute crisis management period following the 2008 crisis. Its concern, in particular, was to strike a balance between financial aid and the creation of a permanent rescue mechanism on the one hand, and stricter fiscal rules, tougher economic policy coordination and more European control over national policy-making, on the other, in order to avoid moral hazard.

Beyond these efforts, Germany did not take an active role in responding to the EU institutions' attempts to engage member states in more encompassing efforts to strengthen the euro area. Germany did not, for instance, provide any answer or devise an ensuing initiative to the Four Presidents' Report of 2012 (Van Rompuy *et al.*, 2012) or the Five Presidents' report of 2015 (Juncker *et al.*, 2015). Both reports set out ambitious agendas for euro area governance reform in the fields of economic and budgetary policy, banking union, as well as on questions of legitimacy and democratic governance.

The European Commission (2017a-c) added its own proposals and road map in the course of 2017. Building on the vision set out in the Five Presidents' Report of June 2015 and the Reflection Papers on the Deepening of the Economic and Monetary Union and on the Future of EU Finances of spring 2017, the Commission set out an 18 months' roadmap to further deepen Europe's Economic and Monetary Union. Its proposals included the establishment of a European Monetary Fund, a euro area fiscal capacity, a euro area finance minister, an initiative to strengthen national reforms, as well as a proposal to integrate the Treaty on Stability, Coordination and Governance into the EU legal framework. After two euro area summits, in December 2017 and in March 2018, the euro area finance ministers are now tasked to pursue completion of the Banking Union and the transformation of the ESM into the so-called European Monetary Fund.

5.3 A less hesitant Merkel IV government

The new German government which took office in March 2018 will have to take a position on both issues, but also respond more broadly to the topics laid out in the European Commission's road map, as the two currently set priorities alone will not ensure the resilience of the euro area. Moreover, Germany owes a response to French President Emmanuel Macron's ambitious European agenda,

which he has outlined in a number of speeches before and after his election to office in spring 2017 (see contribution by Christophe Destais in this volume).

On substance, the Merkel IV government is likely to stand for considerable continuity with regard to the principles of Germany's approach to euro area matters over the past decade. However, there are two reasons to assume that the new political leadership will be more proactive than the previous grand coalitions, which mainly acted under the pressure of acute crises.

One reason is that policy-makers in Berlin take disintegrative tendencies in the EU very seriously and are beginning to acknowledge more and more vocally how tremendously Germany benefits from its integration into the Single Market and the euro area. Over the past years, concern about the North-South divide in the euro area has increased: This is partly driven by slower than expected progress, for instance, of the Greek economic recovery under the Troika programme, but also by the rise of anti-EU populism and nationalism, which leads to more political polarisation and fragmentation and has made domestic politics a risk factor for the progress of integration in a number of EU countries.

There is a certain consensus in Berlin that the euro area as such may not be crisis-resilient and that "something has to give" in the German position. In addition, there is growing concern about the East-West divide that has manifested itself most clearly at the height of the migration crisis, and which some see evolving into a new value divide in the EU. Furthermore, the risk of a large country-small country opposition is on the radar of German policy-makers, in particular since the publication of the letter of eight smaller EU countries (euro and non-euro area), which stressed that any EMU reforms must be inclusive, and should not further undermine national sovereignty or current structures of intergovernmental decision-making (Jensen *et al.*, 2018). In one of his first speeches in the German Parliament, Germany's new Foreign Minister summed up the challenge: "In many societies, Europe is no longer a given." In his view, doubts need to be encountered and policies need to be devised that guarantee that fundamental values are backed by majorities in the societies of EU member states.[29]

Given Germany's previous leadership role on EU matters, expectations are high for Germany to take a proactive stance on EMU reform: Berlin no longer has an excuse not to react to the proposals tabled by the EU institutions or French President Macron. Against this backdrop, the new German government has defined progress on EU matters as one of its priorities. The Coalition Treaty actually starts out with a full chapter on Europe, and in various other parts

[29] Translation by the author of statements made by Heiko Maas in the German Bundestag, 21.03.2018: https://www.bundestag.de/mediathek?videoid=7211402#url=L21lZGlhdGhla292ZXJsYXk/dmlkZW9pZD03MjExNDAy&mod=mediathek.

mentions the need for closer Franco-German cooperation. The new German government does not only define the task as strengthening the EU internally in order to hold the EU-27 together during and after Brexit negotiations. It increasingly looks as well at the EU's external policies, including border control and migration policy, but also foreign and security policy in a wider sense. As the German Foreign Policy review of 2014 highlighted, Germany continues to think about its own foreign policy through the prism of Europe, a view that Germany's new Foreign Minister Heiko Maas also laid out to the Bundestag on 21 March 2018.

5.4 The Coalition Treaty: No Red Lines on the euro area

With regard to the future German euro area policies, the coalition treaty of 7 February 2018 is a first reference point. Providing first elements of a response to Macron's proposals, the coalition agreement states that reforms should be developed together with France to increase the euro area's crisis resilience. It picks up Macron's proposals to put more money toward economic stabilisation, innovation and investment, but remains vague on the idea of a euro area budget. As part of a stronger euro area architecture, the coalition treaty sets out the goal of developing the intergovernmental European Stability Mechanism (ESM) into a European Monetary Fund (EMF), anchored in EU law.

On the other key issue on the EU agenda, the completion of Banking Union, the coalition agreement leaves a blank. It is good news that it does not, in principle, exclude a European Deposit insurance, as the coalition treaty of the previous government did. However, the new German government will likely want to see substantive bank restructuring and consolidations before it accepts engagement in a risk sharing scheme such as European deposit insurance.

5.5 The opportunities and challenges of Franco-German cooperation

While the Coalition Treaty places strong emphasis on Franco-German cooperation, devising a bilateral strategy on the key issues of euro area reform will not be an easy task. This was clear in the joint statement by Merkel and Macron upon the German Chancellor's first visit to Paris after starting her fourth term. Instead of providing first elements of a bilateral initiative for the euro area, which could in fact have been prepared over the past months, both announced putting forward ideas for the EU summit on 28–29 June 2018.

When working on a Franco-German approach to euro area reform, the German government will need to tackle several challenges at the same time. For the first, some in Berlin tend to think that Macron needs to be slowed down, without of course stopping him entirely. There is a concern in Berlin that rapid integration of the euro area may drive a wedge between the euro area as the EU's core and its non-members such as Poland or the Scandinavians, which are important partners for Germany. Berlin continues to believe that the single market with

its 27 members should be maintained as a deeply integrated area. The coalition agreement, however, explicitly mentions the option that, if progress with the EU-27 is not possible, smaller groups of member states should advance with focused initiatives.

Berlin continues to believe that the single market with its 27 members should be maintained as a deeply integrated area. In Paris, the thinking on core Europe is different. Monetary Union is seen as a natural core, while some policy-makers in Paris would even argue for deepening in even smaller groups, such as "the founding six". France has to date not fully politically embraced the Eastern enlargement of the EU that brought in eight Central and Eastern European (CEE) countries in 2004 and did not use the enlargement as an economic opportunity in the way that Germany did. By significantly shifting production to the region, German corporates have benefitted from lower labour costs and lower tax rates in the CEE countries, developing them as export markets.

It is explicable against this backdrop that the coalition treaty found special words for Poland, which Germany hopes to have as a close partner, but which has become an increasingly difficult issue for the EU due to its current government's stances on EU integration and on the rule of law and democracy within Poland. Seen from Berlin, Poland, alongside Hungary, symbolises the increasingly debated East-West divide that tends to be characterised as a conflict of values, at times disregarding other aspects of the relationship. While there is uncertainty about the reliability of the current Polish government as a close partner in efforts to strengthen the EU, from Berlin's perspective Poland remains a pivotal country in the EU's East. It is a key factor in keeping the whole region on track as Hungary, despite the recent re-election of Viktor Orban, is not deemed sufficiently strong to drive the centrifugal trend of renationalisation and withdrawal from EU norms and policies on its own. Reviving the Weimar Triangle, which the coalition agreement mentions prominently, is hence a German goal that will require strong political effort at times in which neither Warsaw nor Paris have a particularly strong appetite to engage with each other.

5.6 Prospects and possible content of a Franco-German compromise

The second challenge the German government will need to tackle is that it does not agree with a number of Macron's proposals. Berlin will need to be open to some compromise in a complicated domestic political situation (see below), without surrendering its principles. But despite different views in Berlin and Paris, it is highly likely that Angela Merkel and Emmanuel Macron will prepare a joint proposal ahead of the European Council meeting in June 2018, in particular after announcing their intention to do so at their bilateral summit in March 2018. The stakes of non-action have become too high for both leaders, particularly given rising disintegrative tendencies, populism and internal and external challenges to the EU's cohesion.

Macron has clearly set the agenda, suggesting the following elements to complete the monetary union: a euro area budget, finance minister and Parliament. Germany is reluctant to create new "euro area only structures" for its fear of dividing the single market and weakening the Brussels institutions – a traditional Franco-German divide that has surfaced on many occasions (e.g. for instance in repeated discussions on whether there should be a regular euro area summit). So, rather than creating a euro zone budget from scratch, a compromise could be to devise a euro area budget line in the EU's Multiannual Financial Framework. With regard to what the money should be spent on, providing more money for investment could get both governments' support, and Germany would further like to see more incentives for structural reforms in place. Views, however, may diverge between Berlin and Paris on the relevant group of countries to which this should apply. While Paris can well imagine an investment capacity for euro area members, Germany is likely to raise the question whether this is not a single market issue, hence for the EU-27. Meanwhile, French proposals to build an automatic fiscal stabilisation mechanism to counter cyclical divergence in the euro area, for instance by creating a European unemployment scheme, have received little support in Berlin. Such a system is seen as a potentially costly transfer mechanism rather than a remedy to divergence, which German policy-makers tend to interpret as a result of structural differences.

Meanwhile, a finance minister – from a German perspective – only makes sense if his or her job is mainly to control and supervise national budgetary policies, rather than to spend money. Indeed, from this view, being part of the euro area raised questions of legitimacy whenever fellow governments did not abide by the commonly agreed rules. Here, differences in perceptions surfaced as other governments saw problems of legitimacy in precisely the opposite situation, namely if European constraints on national policy choices were too hard, and national autonomy, for instance, in designing the countries' own national path to economic recovery, was limited by rules and principles enshrined in euro area governance mechanisms, such as the Stability and Growth Pact, the Fiscal Compact or the European semester. The German government continues to pursue its rules-based approach to euro area governance. The rules in particular for fiscal discipline should be better applied, and may need simplification, as long as implementation is pursued more convincingly than in the past years. The enforcement of the rules regarding fiscal policy, financial stabilisation, and macroeconomic stabilisation should be better insulated from political interference. However, given the political problems to implement rules, market discipline is a concept that the new German government will likely want to enhance in the euro area.

Any Franco-German initiative will need to balance market discipline and risk-sharing as complementary pillars of the euro area financial architecture which should be improved simultaneously.[30] Risk reduction, market discipline, and risk

[30] See also the proposal by 14 French and German economists in Benassy-Quere *et al.* (2018).

sharing need to go hand in hand. The German view, hence, is that banks across the euro area need to be given very strong incentives to reduce the risks on their balance sheets before they can be part of a pan-European deposit and resolution schemes. Indeed, Germany would want to see a transparent framework for absorbing losses both on investors' exposure to banks and to sovereign debt. The German view on how to develop the ESM into a European Monetary Fund needs to be understood against this backdrop: a future EMF should get a mandate to monitor the economic situation in member countries in the interest of crisis prevention. For instance, the EMF could get a role in monitoring compliance with the 2012 Fiscal Compact. The future EMF should go hand in hand with a standard debt restructuring mechanism in order to provide the private sector with clear and predictable principles ahead of time. With respect to EMF governance, the coalition agreement states that the role of national Parliaments should not be impacted, which reads like safeguarding a national veto over stability programmes. Indeed, from a German legal perspective there is little question: if financial assistance is based on national contributions to the mechanism, the German Parliament should ratify each assistance package given the constitutionally guaranteed budgetary autonomy of the Bundestag. The situation could only be changed if the coalition partners acknowledged that this setup bears inbuilt political risks that can potentially be harmful in case of renewed crises of confidence in the euro area. Theoretically, initiatives could be taken to structure the funding of the future EMF in different ways than the current one of the ESM, e.g. based on own European resources, but politically this move seems rather unlikely.

Finally, a Franco-German compromise could include a European Deposit Insurance scheme, which, from Berlin's perspective, should only be introduced when banks have been cleaned up by member states. Germany would probably appreciate stronger convergence in the way bank risks are treated in member states' laws as well as limits on banks' exposure to sovereign bonds.

5.7 Unlikeliness of a fundamental policy change

At first sight, the fact that Social Democrats head both the German Foreign Ministry and the Finance Ministry of the new German government makes a much-awaited Franco-German initiative on euro area issues appear more likely. The fact that the Economics Ministry is headed by a pro-European CDU politician, Peter Altmaier, has generated a certain optimism that the Franco-German initiative will be more than symbolism.

However, it would be wrong to assume that Germany abandons its previous focus on stability, budgetary discipline, competitiveness, self-responsibility of euro zone members and its refusal to install permanent transfers. The new Finance Minister, Olaf Scholz (SPD), dampened exaggerated expectations with one line: "A German Finance Minister is a German Finance Minister" (Die Zeit, 2018). Indeed, the Stability and Growth Pact as a way of guaranteeing the

stability of the euro area is mentioned prominently in the coalition treaty. It is also important to consider that Germany enshrined a so-called "debt brake" into its Constitution in 2009 under a social democratic-led grand coalition. This rule is to make sure that German regions and the federal state do not run a structural deficit (or only a minimal one).

Moreover, any German government faces constitutional constraints as to which euro area reforms and policies it can embark upon: Fiscal bailouts for other member states or any kind of move that endangers the "stability union" are incompatible with the German Constitution. Meanwhile, the constitutional guarantee of budgetary autonomy of the Bundestag continues to set the limits for any initiative to deepen fiscal union or to step up a rescue mechanism that relies on national contributions.

5.8 Domestic political constraints and controversy

The German Parliament, which plays a key role in Germany's European policy, is far more divided than the government of the previous legislature. The most visible change is the arrival of the far-right party "Alternative für Deutschland" which has 94 seats in the Parliament and hence leads the opposition. This role gives it access to highly visible positions (such as the chair of the budgetary committee which is traditionally given to the largest opposition party) and prominent speaking times in Parliamentary sessions. The presence of the far-right AfD makes Parliamentary debates a platform for populist polarisation.

Secondly, sceptical voices are also found among the Free Democrats (FDP), which made their way back into Parliament in the September 2017 elections, with some candidates questioning whether the ESM should actually be maintained. Generally, the FDP puts an even stronger emphasis on supply-side reforms and the need to increase competitiveness as the prerequisite for the catch-up process in the euro area; beyond this, the party insists on firm fiscal rules and rules out debt "mutualisation". It therefore wants to prevent the introduction of any tool that may serve to transfer German money to euro area partners, be it through a euro area fiscal capacity, an enhanced ESM or EMF or a completed banking union.

Similar positions can be heard from the conservatives within the Christian-Democratic and Christian-Social parties (CDU/CSU). The recently created "Value Union", an association of CDU/CSU members which has organised to ensure a leadership and programmatic renewal of the two sister parties, not only speaks out against any form of transfer union, but also wants to create the opportunity for countries to leave the European Monetary Union if they do not respect the stability criteria.

Splits within the CDU/CSU may become relevant to the prospects of euro area reform if they endanger Chancellor Merkel's majority in Parliament. The

current grand coalition has a slimmer majority of 399 out of 709 seats than its predecessor (which had 504 out of 631 seats). Hence, the CDU/CSU and SPD leadership must ensure they maintain strong followership among their own MPs.

5.9 A broader European agenda

Like Macron, the new German government also sees the need to act in and on Europe beyond just euro area issues. The coalition treaty emphasises the need to strengthen EU foreign, security and defence policy, for instance, by enhancing cooperation within the framework of PESCO. Pushing ahead with euro area reform and progress on other issues such as migration or security may indeed make it easier to ensure acceptance, both domestically as well as among EU partners. To what extent Germany will be able to push Europe's international role further will first depend strongly on how the grand coalition will decide to strengthen its own defence capabilities. Strong signals from EU partners that point out the importance of a stronger engagement of Germany within NATO and the new EU structures can enrich the domestic debate on Germany's interest and responsibility in that regard. Second, it will be crucial whether France, which continues to place its focus on hard security, will agree to support efforts strengthening the EU's civilian role internationally.

Another priority is to improve the steering and handling of migration, including European border protection and an equally responsible distribution of immigrants within the EU. On this issue, Berlin needs to assume a bridging role between those countries, in particular in Central and Eastern Europe, that continue to refuse immigrants and those who insist on more intra-European cooperation on the issue. A common asylum policy and management of the system is key, as the problem of immigration continues to have a huge conflict potential within the EU. As further immigration flows must be expected given the fragile situation in the Middle East and parts of Africa, as well as the desperate situation of millions of displaced people there, combatting the causes for migration is of high importance.

The new government faces the challenge of bringing the EU forward while, at the same time, bridging the perceived North-South and East-West divides. This will require diplomatic skills and the will to compromise. It will also require more German investment in EU matters and bilateral relationships, based on an honest recognition of Germany's self-interest in a strong, political stable and prosperous EU and euro area.

It is important in that regard that the coalition does not draw any red lines or exclude any options that could become a serious problem for a possible Conservative and Social Democrat coalition that seeks to seriously advance integration in the fields of the euro area, the single market as well as migration, security and defence. Germany's coalition agreement acknowledges the possibility of moving ahead in smaller groups, in particular around France and Germany.

More differentiation, however, if not managed well, can lead to disintegration. Moving ahead with one group may alienate others. This is particularly important if the German government's goal remains keeping the EU-27 together after Brexit, while others envisage a future with a smaller number of member states.

6 The Netherlands as constructive EU partner searching for an EU narrative

Adriaan Schout

European integration is controversial in most member states. Germany is caught between a traditionally strong pro-EU narrative and the rise of anti-EU and anti-migration parties. The UK referendum in 2016 displayed the tensions between Bremain (48%) and Brexit (52%). The tensions in the French elections are evidenced by Macron's victory in the first round when more contestants were in the race: 24% for Macron, 21% for Le Pen, and 20% for Mélenchon. Such tensions have been persistent. France had its *petit-oui* (51%) in the 1992 referendum over the Maastricht Treaty and a 55% "no" in the 2005 referendum on the Constitutional Treaty. Yet the reasons for these domestic divisions differ. Each country has its own narratives and counter-narratives as regards European integration, and these change over time (Schout and Kassim, 2018). It is important to understand these dynamics particularly now that the EU is again preparing itself for major changes.

This article offers an assessment of the official Dutch EU narrative and of the emerging (EU-critical) counter-narrative. Though a mid-sized member state, the Netherlands, is of interest because other countries, as has emerged in interviews in the Nordic countries and Austria, are hoping that the Dutch will take over the British (restraining) role in the EU negotiations, e.g. as regards the EU budget. However, it remains to be seen whether the Dutch will lead the opposition against the French-German axis, which is the traditional motor of integration. As argued below, the Dutch will most probably continue to be pragmatically constructive.

Yet despite the constructive EU narrative in the Netherlands, a counter-narrative is emerging out of frustration over European "integration by stealth".[31] Section two of this article provides a discussion of the, so far, false image of the

[31] Majone (2012) introduced the notion of integration by stealth to describe the form of creeping integration presented as a "fait accompli" without critical assessment or systematic evaluation and in which process becomes the objective. It is a form of integration in which incremental decision-making transforms "the Union into something very similar to a fully-fledged federal state" or at least leads to "suboptimal outcomes". In other words, an initial decision for European integration can have much wider (intended) federalisation consequences.

Netherlands as an EU-critical country. The subsequent sections assess some of the current trends in the EU and how they are influencing the Dutch narrative and counter-narrative. Within the constraints of this short article, the final section opens a preliminary discussion on a kind of deeper integration that might lead to a better EU and possibly a more convincing narrative.

6.1 The image of the Netherlands as an awkward partner

Deeper European integration, enlargement of the EU and of the euro area, and, especially, deepening forms of risk sharing, are high on the European agenda. In relation to deeper integration, or even to Schulz' creation of "the Ever Closer Union and those who do not want it should leave" (Politico, 2018), it is easy to present the Netherlands as EU-critical. It has had this reputation for some time. In July 2016, the BBC (2016) posed the question: "Will the Dutch follow Brexit with Nexit?". The Financial Times (2011) presented the Netherlands as the "most obstructionist" country in the EU, and Van Rompuy (NRC, 2017a) underlined that the Netherlands should say "yes" more often.

This reputation stems from, among other things: the rise of EU-critical parties such as Geert Wilders' Freedom Party (the second party in the 2017 elections, with 13% of the votes) and new young anti-EU philosopher and party leader Thierry Baudet of the "Forum for Democracy" (from a newly created party in 2017 to the second party in the polls in early 2018), the earlier resistance to rescue funds for the euro (European Fiscal Stability Facility and European Stability Mechanism – EFSF and ESM), resistance to the use of the ESM to bail out banks, the "no more money to Greece" election promise made by Prime Minister Mark Rutte in 2012, and the "no" to the EU–Ukraine Association Agreement in the referendum of April 2016.

Yet the Netherlands has been, and still is, one of the most pro-EU countries and is a strong supporter of the euro, as is clear from the Eurobarometer. As a small, open and economically advanced trading country ranking in the top five in terms of the most competitive countries[32], the Dutch society is deeply aware of the importance of the EU. Part of the official Dutch EU narrative is that, as repeated many times by Prime Minister Rutte (spokesman of the formal EU narrative), the Netherlands depends on the EU for its economic progress, security and global influence (Tweede Kamer, 2017a). The Dutch are content with their national political and social systems and see the EU as an essential complement. However, they might be afraid that the EU's political-administrative system is not on par with the reform-oriented Dutch society (Nixon, 2018). The Dutch are also aware of the need for solidarity across borders, provided that other countries are equally committed to national reforms. As Rutte has repeatedly stated, the Dutch agree to be net contributors and are willing to help other countries and to accept deeper integration;

[32] For an analysis, see Schout (2017a).

however, if countries fail to reform, it should even be possible to push them out of the euro area or to punish those that do not want to participate in relocating refugees (Guardian, 2011; HP/De Tijd, 2015; and Algemeen Dagblad, 2015). Solidarity comes with obligations (Kathimerini, 2017). This also underlines that the Dutch want an EU based on strong member states that are able to carry through reforms and to respect the rules that have been agreed. Yet it also indicates that the pro-EU inclination coexists with fears that other member states have insufficiently converged and will look to the EU for help instead of getting their own act together.

The generally pro-EU DNA explains the omnipresence of the Netherlands in all EU areas despite the reservations listed above. Although it appears that the Netherlands has (Schout and Rood, 2013) been looking for a tougher position for years, it wants to be included in all EU initiatives. As a senior diplomat put it: EU negotiations are like judo (De Telegraph, 2018), you have to wrestle with the force, not against it. One example of the deep desire to sit around the table is the European Public Prosecutor's Office (EPPO). In June 2017, the Netherlands did not join this initiative based on flexible integration (Council of the European Union, 2017). As a senior European Commission official remarked: It may take some time, but the Netherlands will join in a few months. This assessment was proven right when, in October 2017, the new Rutte government indicated it would take part in the EPPO (Het Financieele Dagblad, 2017). The Netherlands is deeply committed to having influence, sitting around the table and looking for compromises.

The pro-EU position has so far not been fundamentally challenged. Despite sometimes uncomfortable debates and bouts of resistance, no serious Nexit-type discussions have emerged (Elsevier Weekblad, 2018a). However, the ambitious speeches by Macron and Juncker and the German support for a potentially far-reaching EU reform agenda have sharpened the EU debates and have challenged the Dutch EU narrative and the Dutch EU strategy.

6.2 European integration as drifting integration

A review of some major trends in EU integration may illuminate an emerging Dutch concern. Although this list can be neither exhaustive nor precise given the constraints of this article, it may serve to explain the emerging Dutch counter-narrative of an unstable integration process.

- During the formative years leading up to the Maastricht Treaty, the Netherlands was in favour of the monetary union, but first wanted convergence in the member states and hence a selective number of countries to join the euro area. A discussion on the date for introducing the euro was therefore avoided. However, during the Maastricht negotiations, France and Italy suggested the date of 1999 so that discussions over prior convergence and participating countries were effectively overruled (Marsh, 2011).

- To support convergence, Germany subsequently proposed a Stability Pact. This plan was quickly altered, under French pressure, into the Stability and Growth Pact (SGP) in 1997 (Verdun, 2013). The Stability Pact would have been in line with the traditional Dutch preference for a euro area based on strong member states. The addition of "Growth" opened the euro area to a more accommodating – French-type – euro area.
- The euro was based on the no-bail-out rule and supported by an independent ECB. The no-bail-out was effectively bypassed by the European Stability Mechanism (ESM). Open debates between the presidents of the national central banks have arisen on whether the ECB has become political (de Volkskrant, 2012), and economists have criticised the delayed ECB interventions in Italian banks due to the Italian referendum under Prime Minister Renzi (Bénassy-Quéré *et al.*, 2018).
- The Dutch opposed the initiative for a globalisation fund of about €500 million. This fund was aimed at supporting EU investments in regions with rising unemployment due to changes in international competitiveness (European Commission, 2006). In the meantime, this initiative has been surpassed by the so-called Juncker funds (EFSI) of initially €315 billion, which was later doubled to €630 billion (Juncker, 2016) in 2016, even though an evaluation by Bruegel concluded that it had resulted in few additional investments (Claeys and Leandro, 2016).
- At the start of his presidency, Juncker acknowledged that enlargement was a sensitive issue and that a pause was needed. In his State of the Union of 2017 and in his reform plans for the euro, Juncker announced the enlargement of both the EU and the euro area.
- Although the Netherlands had major reservations about the creation of the EFSF (for political reasons termed a "Facility" and not a "Fund") and an EMF, and about using the ESM as backstop, the European Commission now proposes an EMF including a backstop mechanism (COM(2017) 827 final).
- The Netherlands lobbied hard and successfully for independent monitoring of the SGP and reinforcement of the EU Semester, including a strengthening of the independent decision-making powers of the Commission through Reversed Qualified Majority Voting. This resulted in the trustworthy "budget tsar" Olli Rehn (Schout and Mijs, (2015), who, however, was soon replaced by the highly political duo, Juncker and Moscovici.
- Despite the long-held preferences of the Netherlands for an independent Commission and for independent economic supervision, the Commission has now proposed an Economics and Finance Minister (COM(2017) 823) and new instruments to support the euro, as well as the enlargement of the euro area (COM(2017) 822).
- As a smaller country, the Netherlands has been strongly in favour of an independent Commission, but is now confronted with the *spitzenkandidaten* procedure and a Commission that wants to be highly political (Schout, 2017b).
- The Netherlands has been (even without support from other countries; see Schout and Rood (2013)) against the accession of Bulgaria and Romania to

Schengen until the requirements are fulfilled. Despite Commission reports that these countries are not ready, Juncker keeps on stating that these countries are ready to join Schengen (Elsevier Weekblad, 2018b).

- Aiming for an independent Commission and supporting Better Regulation principles, the Dutch have also been pleading for impact assessments (IAs) and for independent monitoring of the quality of the IAs (Schout and Sleifer, 2014). However, the IAs have become less important under Juncker. Even the abovementioned major proposals for creating an EMF and EMU minister were not accompanied by IAs. Evidence-based policies are becoming less important, as is also clear from the premature claims that EFSI is a success, and the media are displaying mistrust in Commission statements, e.g. over the success of the Spitzenkandidaten procedure: "that claim is hardly backed up by any evidence" (EUobserver, 2018).

The list of contested developments of the EU and of the euro area towards deeper integration and political union is far from exhaustive.[33] The list nevertheless indicates the willingness of consecutive Dutch governments to subscribe to deeper integration. However, the policies that were initially agreed often turned out to be different in reality. These examples create the impression of an EU taking incremental decisions that eventually result in a different kind of EU than was on the agenda when the initial decisions were taken ("integration by stealth"). From a Dutch perspective, the euro area has been drifting away from a system in which the member states are responsible for their economic performance and that is based on rule of law and law enforcement, towards an area with an increasing number of euro area bodies, procedures and political deals. Moreover, these developments have also had institutional consequences, for example, in terms of the changing nature (politicisation) of the European Commission and the evolving powers of the European Parliament.

This incremental process also makes it more difficult to see how checks and balances are designed (see below). Hence, with the euro area becoming 85% of the EU's GDP after Brexit, the fundamental question has emerged of whether this EU is a good system – i.e. whether it is a top-quality political-administrative system or a muddled EU-style political system with insufficiently designed checks and balances.

6.3 Current strategy at the EU level: haste

The present EU statements underline its haste when it comes to further deepening the political union. Juncker has emphasised that the roof must be fixed now that the sun is shining and that the window of opportunity will not stay open. EU Council President Tusk has initiated a full "leaders agenda" in the run-up to the EP elections in 2019. The idea is, as underlined in the discussions in Brussels, to arrive at a comprehensive EU compromise that can be presented as a

[33] See e.g. the case of EPPO above.

win-win outcome for everyone. This will have to be done before the next crisis. Moreover, the EU needs a new multiannual financial framework (MFF), which also demands a comprehensive perspective on new policy objectives and sources of fresh money so that an EU that delivers can be constructed (Oettinger, 2018). In sum, the current EU narrative at the EU level is one of "a comprehensive agenda", "win-win solutions", "deeper integration", "fresh money", "an EU that delivers", and "haste". This has triggered debates about the formal Dutch EU narrative and has sharpened the emerging EU-critical counter-narrative.

6.4 Shifts in the Dutch EU narrative

The traditional Dutch EU narrative of economic progress and security hinges on a rule-based perspective on European integration. However, to some diplomatic chagrin[34], the European legal principles have proven stretchable, and this flexibility has tended to take the Dutch policy makers by surprise. The Dutch preferred partner, Germany, seems to be quite at ease with the current trends (including a higher EU budget, an EMU minister, etc) (Financial Times, 2018), but the Netherlands is having difficulty coming to terms with the current agendas.[35] With the politicisation of the European Commission, the Netherlands has not only lost the UK as a liberal partner, but also the European Commission, and possibly, to some extent, Germany due to its current search for compromises with France and Macron's insistence on a political union. The ambitious plans of Macron, Juncker and the *Sozialdemokratische Partei Deutschlands* SPD in Germany (amongst others) have led to questions in the media about the Dutch responses and the Dutch influence in the EU.

As a reaction, we may now be seeing the emergence of a new official narrative and a pragmatic approach towards safeguarding Dutch influence based on flexible coalitions. In addition, the development of an EU-critical counter-narrative may take further root. As regards the modified Dutch narrative, the new Rutte government (which started in October 2017) could hardly be expected to have a clear EU strategy. First, as the Prime Minister of the previous government, Rutte had to break his 2012 election promise of "no more money to Greece" when the third support package for Greece was adopted in 2015. The political lesson was that a tough autonomous Dutch position is untenable in the European arena. Second, the current government coalition seemed divided between the pro-integrationist Liberal Democrats (D66) and the three more reserved parties (Rutte's Liberals, the centre Christian Democrats and the right-of-centre Christian Union). As a result (and in the absence of a new German government), Rutte tried to avoid commenting on the vision speeches of Juncker and Macron in 2017 by paraphrasing Helmut Schmidt, who said that people with visions should see a doctor (NRC, 2017b).

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[34] See for example remarks by the President of the Dutch Central Bank Klaas Knot in 2011 (Reuters, 2011) and 2017 (Bloomberg, 2017).

[35] Compare Eichengreen (2015).

However, at the December 2017 European Council meeting, Rutte was forced to commit himself, again, to a hard line (in his own words, “a narrative”) (Tweede Kamer, 2017b). He no longer wants to reason in “if-then” terms, which has dominated European history: *If* the member states promise to reform, *then* they may count on European support. Rutte’s new narrative is that the member states have to reform because they themselves believe it necessary, and not to get something from the EU. This underlines the red line of the new government: no transfer union. Rutte’s commitment to a vision is probably the result of attempts by Juncker and others to reach a comprehensive EU compromise that will be hard to contest without high political costs in the European Council. The comprehensive compromise will include a European Minister of Finance, financial support for national economic reforms, a euro area budget, tax harmonisation or even European taxation, preparations for EU and euro area enlargements, a European Monetary Fund that also includes a backstop for banks, greater emphasis on innovation, and demands by the European Commission for a higher multi-annual EU budget. Even a diluted European minister is a threat in the eyes of the cautious Dutch because this post is linked to a range of other plans, such as a European Monetary Fund (placed under political leadership), a euro area budget, a bigger role for the European Parliament, and a politically supervised backstop for weak banks.

Considering the fact that the Netherlands has, nationally and internationally, an administrative “polder” culture,[36] an EU vision will tend to be interpreted pragmatically when it comes to negotiations over specific policies. Current discussions in the media already indicate that there is a realisation emerging that a higher EU budget and some form of EMF must be accepted. A tough line would most likely lead to political defeat in the (European) Council, which can be prevented by timely pragmatism. Yet there is one red line that this government has embraced: It will not accept a transfer union.

In addition to this relatively new narrative of “no transfer union”, we can also see a longer-term development in the Dutch view on the European Commission. For a long time, the Commission was regarded as the best friend of the smaller member states (Schout and Rood, 2013). It was regarded as a rule-based organisation that was supposed to treat all countries equally and that would think in the interest of the EU, not in that of the big countries. Increasingly, the trust in the European Commission has dwindled. Consecutive governments have now argued that monitoring executive tasks should not be allocated to the European Commission. With Dutch support, banking supervision went to the ECB, and the European Financial Stability Facility and the European Stability Mechanism to the intergovernmental bodies in Luxembourg. Moreover,

[36] Polder-model is a typical term to describe the Dutch consensus-oriented decision-making processes involving opposing interest groups against the background of the continuous danger of polders being flooded.

contrary to Juncker's emphasis on the Commission being "very political", the Dutch continue to stress the importance of a neutral judge-like Commission. As underlined by the current discussions on the creation of the ESM under the Commission, the Netherlands now leans more towards intergovernmentalism.

6.5 Safeguarding influence: the Netherlands and its EU coalitions

Support for a comprehensive compromise comes from the European Commission, France, the SPD in Germany, and many (European) thinktanks, such as the well-funded German Bertelsmann Stiftung.[37] There is a great deal of intellectual leadership behind the coherent plans, while countries that do not want deeper integration are diverse and have few plans or strategies. Rutte seems to be looking for ways to provide some leadership when it comes to moderating deeper and political integration by building coalitions with, depending on the specific policy, Austria, Ireland, the Nordic countries, the Benelux, the Visegrád countries, as well as other countries. The hope is that, with the Brits on their way out, the Netherlands can thus compensate for the loss of a British counterweight to the German-French axis. This should not be seen as the Netherlands taking over the obstructive role which the Brits assumed, but rather as an effort to be a constructive partner in building a "better" Europe based on strong member states that are able to deliver results themselves.

Rutte now has the European status (Schout, 2017c) and narrative to – supported by countries around Germany – become an actor that the French-German axis should not be able to ignore.

6.6 Weaknesses of the new Dutch strategy

Though imbued with the need to be pragmatic, the current Dutch narrative centres around "no if-then" and "no transfer union". Gaining acceptance for this narrative in the EU requires coalitions. This two-sided approach involves certain risks.

6.6.1 Political consequences

A first risk is that Rutte will have to cave in during the EU negotiations because a country cannot thwart a major European compromise without a loss of status. The combination of a tough red line and a deep-seated desire to sit around the table, to have influence and to be pragmatic easily creates the impression among the Dutch that European integration happens by stealth.[38] The counter-European narrative that is developing is that it does not really matter what position the Netherlands takes, European integration (transfer union, enlargement, etc.) will progress.[39] This counter-narrative doubts the relevance of the traditional Dutch

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[37] See, for example, Emmanouilidis (2017).

[38] For a general discussion on integration by stealth, see Majone (2012).

[39] E.g. Baudet in Tweede Kamer (2017b).

EU priorities of a rule-based EU combined with a neutral and independent supervision role of the European Commission. Instead, it posits that the political union is unstoppable. This was most clearly vocalised by newcomer Thierry Baudet, who even refused to enter into a debate on the EU in Parliament, insisting that such a debate would not alter the unstoppable nature of an ever-deepening integration (de Volkskrant, 2017). One of the elements in the narrative of the unstoppable EU is the role of the French-German dominance. In relation to the EU plans of the new German CDU-CSU-SPD coalition, Socialist EU spokeswoman Leijten stated in the Dutch Parliament: "I did not vote in the German elections" (Tweede Kamer, 2018). If steps are taken towards an indistinct European minister, a stretchable European Monetary Fund, a higher EU budget, or some forms of EU taxes, then EU critics will find their view that the EU is ruled by integration by stealth (pushed by French-German compromises) vindicated.

6.6.2 Lack of clarity

The dislike of "if-then" compromises and of a transfer union is difficult to translate into policies. The EMF, for example, is presented by the European Commission as financially neutral, but bank resolutions can be loss-making, neutral, as well as profitable (see the restructuring of Union Bank of Switzerland). Moreover, probably influenced by the reality of the German position, Rutte is willing to agree to a European Monetary Fund and thus seems to accept the risk of the politicisation of economic surveillance (Wyplosz, 2017). Furthermore, negotiating on the basis of "if-then" is practically inevitable in the European arena. Rutte is willing, quite constructively, to be pragmatic, but this puts his red line at stake. More important than the actual content of the EU vision is the following question: How fiercely is Rutte prepared to defend it?

6.6.3 Coalitions with member states: the weakness of weak ties

In order to influence the French-German axis, the Netherlands is searching for coalitions also with a view to being, as the biggest of the smallest, the spokesperson for the small countries. However, the required coalitions in the EU vary greatly. For example, Sweden is not in the euro, Hungary and Poland have their own idiosyncratic controversies with the EU, Austria favours enlargement, as well as EU taxes such as the financial transaction tax, Ireland supports the EU's agriculture and cohesion funds (IIEA, 2018), and the Benelux tends to have difficulties formulating clear goals (see the Benelux contribution to the Bratislava process, which remained short and limited to some general statements) (Michel, 2016).

6.7 From deeper integration by stealth towards "better integration"

In the EU, tensions are building up between those pushing for deeper (political) integration and those advocating moderation or red lines. Pragmatic compromises may be found, involving economic policies and haphazard institutional changes

(such as the open-ended Commission proposals for an EMF or EMU minister), but the real question is whether simply pragmatism is required or whether a more fundamental decision is needed on the direction of European integration.

An alternative approach could start from the realisation that the European Union is here to stay, but that after 60 years of the Treaty of Rome and 25 years of "Maastricht" (creation of the euro), the relevant question is: Is this EU a good political-administrative system? Pragmatism or simply tweaking policies and institutional arrangements may be far from sufficient. This is not the place to detail what a good federation should look like. Yet some leads can be given related to better integration based on checks and balances (i.e. a political-administrative model in which tasks are distributed between different branches of government to allow the separation of roles and to avoid muddled power relations). The European Parliament, the European Commission and possibly the Court and the ECB seem to be too close (even physically, with their offices concentrated between Place Luxembourg and Rond-point Schuman in Brussels). Moreover, the European Commission combines all kinds of tasks ranging from gathering information, formulating policies, implementation, and monitoring, to enforcement. By the same token, monitoring and enforcing seem to be ill placed in an increasingly political Commission or under an elected *Spitzenkandidat*. This situation suggests that checks and balances are poorly designed, and that the EU is ripe for a separation of powers, as was on the agenda in the USA around 1800 under the leadership of James Madison and Alexander Hamilton (Matthews, 1995). Yet inspiration need not come from the USA. Different political cultures in the EU can also be used as models, such as the Swedish national administrative system, which is based on small ministries and strong independent agencies. The current EU is in need of a more mature system of checks and balances that matches the EU's ambition of being a leading global actor.

A European political-administrative system based on the rule of law principle of the separation of tasks may also facilitate the regaining of trust in the European Commission. The current Dutch preference for intergovernmentalism may not be suitable for a mid-sized country that needs many – highly differentiated – partners to safeguard its influence. So far, European integration has developed pragmatically and incrementally. It is now time to ensure that the EU will move beyond pragmatism and will start to apply the essential principles of checks and balances.

7 Conclusions

7.1 Finding a balance between risk reduction and risk sharing

There is general agreement that flaws remain in the legal and institutional architecture of the euro area and that more work is needed to fix the European financial markets. However, views differ as to which measures should be chosen, their internal order of priority in the reform process and, to the extent that there is agreement, their respective reach. This is not surprising in view of the different crisis narratives that member states tend to emphasise. There are, as pointed out in chapter 3, several hypotheses for why member states had to be rescued, including a loss of competitiveness of certain member states within an irrevocably fixed exchange rate; irresponsible governments that failed to match taxes and expenditures; and financial market participants who acted irrationally, eventually bringing the financial system to its knees. They are all evident in the run-up to, and during, the crisis years. As noted in the introductory chapter, moreover, no institutions were in place to prevent the crisis, or to mitigate the effects once it occurred.

In the process of reforming the euro area, two groups of member states are visible: on the one hand, those who prioritise risk sharing measures, and on the other, those who argue instead that further risk reduction initiatives are needed. Of the countries chosen for this book, Germany and the Netherlands come out as strong defenders of risk reduction and rules-based measures, while France and Italy share many traits in arguing for further risk sharing reforms and a greater centralisation of macroeconomic governance.

Much has been said about Germany and France's willingness to compromise to achieve meaningful reform and the fact that they are both ready to take advantage of the opportunity created by having two new governments with fairly strong mandates. There are indeed areas where both governments wish to see movement, such as reforming the intergovernmental rescue fund ESM and bringing it into the EU legislative framework, possibly transforming it into a European Monetary Fund; reaching an agreement on the EDIS; and making the ESM the backstop for the Single Resolution Fund. In view of a recent non-paper by eight Finance Ministers, it would appear that these steps may also be acceptable for Ireland, the Netherlands, and the Baltic and Nordic member states, even where risk sharing steps are involved. Another risk sharing area where there seems to be enough common ground for successful reform concerns the need to take further steps in the Capital Markets Union. Investments in securities are more cross-border in nature than traditional bank lending and might therefore allow funds to flow from core to periphery countries. We should therefore expect to see some progress in these areas. In view of the European elections in 2019,

there is additional pressure to act in 2018 and that would indicate a likely early agreement at the June 2018 European Council.

German politicians have come some way in understanding the risks of euro area disintegration. The assessment of the political and market driven consequences came rather late in the sequence of crises that plagued the euro area. Today, however, there is an understanding that some of the policies have been seen as being imposed on Southern Europeans. This not only leads to a negative view of Germany in those countries but also to a delegitimisation of the system and hence a delegitimisation of the *rules* of the system. There is some acknowledgement, first, that the policies have been too harsh, but also, second, that poor policy implementation actually weakens the whole system and the credibility of the rules as such.

The strong presence of the SPD in the new German government adds further hope that there will be a new understanding between Berlin and Paris. Importantly, Macron is perceived as getting it right in terms of the French domestic policy. This underlines the importance of trust, of political communication, but also of hope that there will be policy alignment. Success in France in terms of economic and budgetary policy is crucial for German policy-makers to be able to actually advocate a close cooperation on reforming the euro area. The Italian government that governed until the 4 March election argued that Italy too had shown the capacity to reform and the willingness to make sacrifices on behalf of Europe, and that it had also shown its ability to tackle significant legacy issues.

However, once we go into the details in each of the reform proposals, and particularly those that are more far-reaching, we see a significant divergence in views. The idea of a euro area budget, or a euro area budget line in the EU budget, is the first case in point. France has advocated a separate and quite significant budget, e.g. financed by a share of corporate taxes that would give it a stabilising quality (member states in trouble would then automatically pay less into the budget). The French have stressed that such a budget would not be redistributive but would only fund common undertakings at a federal level. Moreover, the grand coalition agreement between the CSU, CDU and SPD seems to imply a new thinking regarding the next MFF, where Germany stands ready to open its wallet and pay more. However, what Germany seems to accept is an "investment capacity" for the euro area countries that would improve economic convergence, a measure that would also come with conditionality attached to it. In other words, it would not be remotely close to the kind of centralised stabilisation function sought by France and Italy.

A related issue is the role of a future European Monetary Fund. As noted, there is general agreement to incorporate the ESM into EU legislation. The French argue that it should replace the IMF and be able to bail out countries, even providing

support *ex ante* so as to prevent crises. In the German version of the EMF, however, it is likely that rescue programmes come with strong conditionality, in line with what has hitherto been the case with ESM programmes. The French therefore fear that it will be a vehicle for renewed German austerity. In addition, it seems unlikely that Germany will give up the national veto on future rescue programmes.

Furthermore, the German willingness to pay more into the next long-term budget does not imply acceptance of steps that would hint at any kind of transfer union, a known red line for the Netherlands as well. The case of EDIS shows this very clearly, where Germany – along with the Netherlands, the Northern countries and the Baltic countries – will likely continue to push for further risk reduction in the financial sector (as was also evident during the Euro Summit on 23 March 2018) before agreeing on the completion of the Banking Union, that is, to make EDIS fully financed at the European level.

When it comes to controlling national policies, Germany takes a twin-track approach: the existing rules-based approach is complemented by a market-driven approach. The latter would entail some kind of sovereign default mechanism, that is, that crisis management is only possible after a sovereign debt restructuring imposing losses on debt holders, to enhance market discipline in the euro area. The idea is to relieve governments, EU institutions and the framework of rules that thus far has produced less than impressive results. However, both France and Italy oppose the introduction of a sovereign default mechanism, as they fear such a step would scare the markets and risk becoming a self-fulfilling prophecy.

To a great extent, the twin-track approach was also visible in the proposal by 14 French and German economists in January 2018 (see the Appendix for a summary). The response to the proposal showed where the difficulties lie in getting the balance of the risk reduction/risk sharing dichotomy right. There is a fear in both Paris and Rome that too strong a push for risk reduction in the banking sector would trigger a new crisis. Regardless of whether this holds true, it underlines how important it is to get the mix right in whatever measures are implemented. But it also means that a sovereign default mechanism is not well received in Paris and Rome.

Adding more complexity to the process is the fact that Italy, unlike France, has found itself in a politically complicated situation since the election in March. The new government backed by M5S and the Lega will likely depart radically from the line pursued by its predecessor. However, a number of the risk sharing measures previously (and perhaps still) supported by Italy have also been raised by Paris. This would include, first, a euro area budget – either a separate line in the EU general budget or from additional financial resources. Rome would also support common funding for bank resolution and recovery

measures, in line with the trouble its banking system is in and the way they are funded. It is not clear, however, whether this would also find support in France. Nevertheless, both countries support the notion of a European finance minister with discretionary powers for allocating common funds, combined with the role as the euro area's external representative. Another rather far-reaching measure sought by both countries is common debt mutualisation (Eurobonds), although it is acknowledged that this will not be on the table in the near future.

While the idea of trading risk sharing for risk reduction measures may seem like an apparent way forward, such a strategy will likely meet strong resistance. The Netherlands are not keen on the "if-then" method that has unlocked member states' resistance to reform in the past. The view here is that a greater convergence – economic convergence as well as further reduction of NPLs and banks' exposure to home countries' sovereign debt – should be achieved before proceeding with risk sharing arrangements. For different reasons, Italy will also object to this strategy, regardless of whether there is a technocratic or political government in place. There is strong resistance against accelerating the disposal of NPLs and also opposition towards the idea of introducing some form of restrictions against home-country sovereign debt exposure.

7.2 The EU institutions and non-euro member states in the reform process

In closing, two additional aspects that have been addressed in this book relate to the dynamics between the respective member states, as well as between the member states and the EU institutions. The first point is that there is a tendency to focus all attention on the potential for a cooperation between Germany and France. There are several facets to this. Arguably, if the conversation is not inclusive, it is not going to sell well in the other member states. With strong euro-sceptical movements in several euro countries, a non-inclusive reform process would imply a lack of national ownership of the reforms and would also risk adding poison to an already toxic situation.

The second point concerns the extent to which the non-euro countries will be able to influence the process. While Germany attaches great importance to including all member states in both the process and the legislative and institutional outcome, the French vision has more often than not implied a process where the core member states spearhead the integration process and leave hesitant member states behind. It is perhaps easy to overstate this difference but the proposals from President Macron show very clearly that he heralds the euro area as an entity in its own right that deserves attention beyond the Single Market. The German view, conversely, is that the Single Market should be protected and that all – not just the euro area – member states count in the reform process. The fact that Germany has not changed its position in this regard should be comforting to the seven member states (not counting the United Kingdom) that have yet to adopt the euro.

In fact, a growing political concern in Germany and elsewhere at the moment is the East-West divide in the EU. It is interesting in that regard to see how the North-South divide – which has dominated the agenda in the past few years – is now moving into the background and that people now say that this can be solved, whereas the real problem is the East-West divide. All this means that when Germany looks at the Franco-German initiatives, it does so while increasingly taking into account the repercussions for others. Germany has a very close alignment with the Nordic and some of the CEE countries in terms of thinking about economy and politics. That is probably an important difference between Paris and Berlin in terms of assessing the cost of pressing ahead and losing countries along the way.

Finally, we need to ask ourselves what role will be played by the institutions, above all the Commission. Respect for the EU institutions is no small matter, not least in terms of protecting the interests of all, rather than a few big member states. The consequences of having to deal with proposals that are prepared and discussed bilaterally in Berlin and Paris ignore the importance of legitimising the process, something that ultimately can only be achieved when the proper legislative method is used; and that implies having the Commission work out and present legislative proposals, passing them onto the Council and the European Parliament.

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Appendix: The German and French academic proposal

Table A The Franco-German EMU reform proposal

1. Remove doom loop	**2. New fiscal rules**
• Introducing common deposit insurance and "sovereign concentration charges" for banks in tandem. The former prevents bank runs. The latter means banks must post more capital if a sovereign creditor's debt exceeds an established level in proportion to the bank's capital. Common funds may only be used after depletion of national compartments. • Strengthen the bail-in mechanism in BRRD, increase pressure to reduce NPLs and tighten bank regulatory standards.	• Current rules replaced by principle that government expenditure must not outgrow long-term nominal output. • Member state monitoring by independent national institutions, which in turn are supervised by independent euro area institution. • Member states must finance deficits with junior bonds ("accountability bonds"); the cost of issuing bonds would depend on member state's long-term fiscal credibility. • Bond's maturity automatically extended if member state enters an ESM programme.
3. Sovereign debt restructuring	**4. Euro area fund**
• Legal mechanisms to protect sovereigns from creditors that attempt to "hold out" for full repayment. • No ESM bail-out for countries with unsustainable debts. • Automatic haircuts or maturity extensions of all maturing debt in the event of an ESM programme. • Tougher ESM lending policies, to be phased in gradually after debts are sustainable and in combination with sovereign risk reduction.	• Funded by member state contributions. • Triggered only if employment falls below certain level. • Higher national contributions for countries that use or are more likely to use the fund. • "First losses" borne by member states. • Participation requires compliance with fiscal rules and the European semester.
5. European safe asset	**6. Institutional reform**
• Financial intermediaries to purchase standardised diversified portfolio of sovereign bonds, to use as collateral for security issued in several tranches. • Risks to be mitigated through careful design. • Test phase before full introduction.	• Separate watchdog and decision-maker functions. • Independent fiscal watchdog within the Commission. • Eurogroup presidency assigned to the Commission ("double hat"). • Crisis lending fully assigned to ESM. • ESM Managing Director accountable to the EP.

Source: Bénassy-Quéré *et al*. (2018a). See also Bénassy-Quéré *et al*. (2018b) for a summary of the proposals.

Svensk sammanfattning

Våren 2010 bröt en statsskuldskris ut som startade en ny serie kriser i euroområdet. Även om medlemsstaternas erfarenheter skiljer sig åt, kännetecknades kriserna generellt av ett återställande av ekonomiska obalanser som hade byggts upp mellan euroländerna under eurons tidiga år. Ett viktigt skäl till att kriserna blev så allvarliga var att det inom den ekonomiska och monetära unionen (EMU) saknades institutioner som kunde upptäcka och motverka dem, eller ens mildra deras effekter. Statsskuldskrisen 2010 blev även startskottet för en reformprocess som vi är mitt uppe i när denna antologi publiceras.

Flera steg togs under krisens tidiga år, vilka kan summeras i följande tre kategorier: mellanstatliga räddningsfonder, förstärkning av de finanspolitiska reglerna samt etableringen av bankunionens första två pelare: gemensam banktillsyn och bankkrishantering (resolution). Även om medlemsstaterna är eniga om behovet av ytterligare reformer, står de förhållandevis långt ifrån varandra när det gäller såväl djup som bredd. Främst handlar det om olika syn på riskdelning kontra riskminskning, både vad gäller inbördes ordning och omfattning. Riskdelningsgruppen tenderar att betona krishantering i ljuset av kvardröjande negativa kriseffekter, medan riskminskningsgruppen fokuserar på förebyggande av nya kriser. Generellt tenderar den senare gruppen att ha en mer restriktiv syn på eventuella institutionella reformer.

I den här antologin har fyra forskare från Frankrike, Italien, Nederländerna och Tyskland bidragit med analyser av deras respektive medlemsstaters syn på euron och reformprocessen. Syftet är att finna svar på frågan om vilka reformer vi kan vänta oss, både på kort och på lång sikt. Valet av Frankrike och Tyskland förklaras av att inga reformer kommer till stånd utan att det råder enighet dem emellan. Nederländerna har å sin sida varit skeptiskt till flera av de senaste årens reformer och tjänar som en ”proxy” för länder med liknande hållning. I den här gruppen, som bland annat består av Österrike liksom de baltiska och de nordiska länderna, har Nederländerna även något av en ledarposition som det största av de mellanstora medlemsstaterna. Italien står i många avseenden på den andra sidan, med liknande problem som övriga sydeuropeiska medlemsstater. Samtidigt är Italien på andra sätt unikt: landet är euroområdets tredje största ekonomi och har en befolkning som är mycket mer kritisk mot euron än i grannländerna.

Erik Jones om Italien

Italiens syn på EMU-reformer är i många avseenden lik den franska ansatsen under president Emmanuel Macron. Båda fokuserar på riskdelning och förhållandevis långtgående institutionella reformer som ger större utrymme att aktivt agera när det råder lågkonjunktur. De är båda skeptiska till aggressiva riskminskningsåtgärder i finanssektorn. I motsats till vad som ofta antas upplevde Italien inte några större problem med sin konkurrenskraft och inte

heller med den offentliga eller privata skuldsättningen. Snarare fokuserar Italiens krisnarrativ på bankernas roller och de gränsöverskridande kapitalflödena. Av dessa skäl prioriterar man att återbygga förtroendet för finansmarknadens aktörer, för att på så vis förebygga paniksituationer som leder till likvidering av italienska tillgångar om en ny kris skulle uppstå.

Det italienska euromedlemskapets historia kännetecknas av något som kan betecknas kognitiv dissonans, det vill säga att man på samma gång intar två motstridiga positioner. Ett sådant exempel rör de italienska väljarnas behandling av de regeringar som på 1990-talet lyckades öka den italienska ekonomins konkurrenskraft. Koordinering med facken om löneförhandlingar och pensionsreformer innebar att reallöneökningarna hölls nere. Italiens förmåga att etablera prisstabilitet ökade samtidigt regeringens trovärdighet på marknaderna, vilket i sin tur ledde till billigare lån. Det innebar inte bara att Italien valdes ut i första omgången 1998 att delta i euron; kostnaderna för statsskuldsräntorna föll så snabbt att varken Prodi- eller D'Alema-regeringarna var i behov av budgetöverskott för skuldkonsolideringen. Ironiskt nog kastade väljarna ut D'Alema-regeringen. Samtidigt försämrades stödet för den gemensamma valutan, då italienarna ansåg att den hade lett till inflation och att affärsinnehavarna hade passat på att höja priserna när euron introducerades. Det spelade ingen roll att statistiken gav en annorlunda bild.

Den italienska ekonomin var inledningsvis förhållandevis opåverkad under finanskrisens första år. På flera sätt var ekonomin i en bättre position än den tyska: exempelvis satt hushållen på större tillgångar och arbetslösheten var lägre. Även om Italien på 2000-talet tappade konkurrenskraft i förhållande till Tyskland var detta i hög grad en återställning efter 1990-talets förbättring av den italienska konkurrenskraften. En annan mycket viktig faktor var den konservativa italienska banksektorn, som fortfarande finansierade sig och agerade inom ramen för de lokala ekonomierna. Det innebar att bankerna med få undantag var skyddade från de mer direkta effekterna av den amerikanska bolånemarknadens kollaps.

Krisen slog till med full kraft först 2011. Hushållen tvingades i allt högre grad att använda sina besparingar, vilket ströp bankernas finansieringskälla och ledde till minskad utlåning. Det försatte många lokala ekonomier i en negativ spiral. I juni 2011 började internationella investerare att överge den italienska ekonomin, med följden att kapital flödade ur landet och skuldsättningen ökade drastiskt. Denna försäljning av italienska statsobligationer är viktig eftersom den innebar en kraftig ökning av lånekostnaderna och en skarpt minskad likviditet för de lokala ekonomierna.

Mot bakgrund av Italiens historia skulle vi kunna förvänta oss ett basscenario för förhandlingspositioner, exempelvis stöd för en post för euroområdet i EU:s budget samt etablerandet av ett europeiskt insättningsgarantisystem (EDIS) med gemensamma finansiella muskler för resolution (bankkrishantering) och

återhämtningsåtgärder. Även en europeisk finansminister med befogenhet att spendera gemensamma medel och representera euroområdet externt skulle ges stöd, liksom en förenkling av reglerna i stabilitets- och tillväxtpakten och gemensam skuldsättning (”Eurobonds”). Däremot skulle man opponera sig mot att öka takten i hanteringen av nödlidande lån, att införa begränsningar för bankers exponering mot hemlandets statsskuld samt att införa en tyskinspirerad europeisk valutafond (EMF) som agerar på grundval av strikta villkor i mottagarländerna.

Den i skrivande stund nyligen etablerade populistiska regeringen avviker emellertid radikalt från den linjen på ett antal områden. Den har inte minst en helt annan inställning till finanspolitisk koordinering och skuldkonsolidering. Framför allt kommer en sådan regering troligen att söka genomföra dyra reformer som saknar finansiering. Det innebär att Italien kommer att bryta mot stabilitets- och tillväxtpakten, något som kommer att möta starka reaktioner i både Frankrike och Tyskland. Man vill även söka lättnader, undantag och reformer avseende flera av de regler som styr hanteringen av bankernas verksamheter, och även här är motståndet kompakt i Berlin och Paris. Ytterligare en aspekt som talar för att Italien kan komma att hindra reformer är att både M5S och Lega kan få politiska vinster på hemmaplan av en konflikt med övriga euroländer: det skulle stärka deras roll som beskyddare av italienska nationella intressen.

Christophe Destais om Frankrike

Under president Emmanuel Macron verkar *Frankrike* sträva efter långtgående reformer i linje med italienska prioriteringar, men vi ska inte glömma bort att de euro- och EU-kritiska krafterna var starka även här. För mindre än ett år sedan rådde fortfarande en stämning av pessimism angående såväl eurons som EU:s framtid, både i Frankrike och på andra ställen i Europa. Dessa krafter har för tillfället satts ur spel, men idag saknas det samtidigt en fransk offentlig debatt om finanspolitiken i EMU.

Emmanuel Macron lyckades inte desto mindre säkra en bekväm majoritet i franska nationalförsamlingen och kunde åstadkomma en snabb och ganska djärv arbetsmarknadsreform. Det är viktigt inte minst i ljuset av hur viktigt det är att visa Tyskland att Frankrike är en trovärdig partner som klarar att reformera sig. Den sittande regeringen föll kraftigt i opinionsmätningarna under sommaren 2017 men har lyckats att återhämta sig en aning sedan dess. Därtill har anti-euroretoriken mer eller mindre försvunnit, och oppositionen är svag.

Fransmännen vill etablera en ambitiös plan tillsammans med tyskarna. Strategin skulle täcka a) finansiell integration, b) krishantering med justeringar av Europeiska stabilitetsmekanismen så att den får en större roll i krisförebyggande åtgärder samt c) en budget för euroområdet på mellan 1–2 procent av områdets samlade BNP. Euroområdets budget skulle finansieras via egna skatter och även ha möjlighet att låna upp pengar och därigenom bidra till bildande av ett europeiskt skuldebrev. Den skulle godkännas av en ny avdelning av Europaparlamentet (ett parlament för euroområdet), som skulle rösta med

kvalificerad majoritet. Budgeten skulle bidra till att stabilisera euroområdets ekonomi genom en minskning av budgetintäkterna, snarare än genom en ökning av utgifterna. Förslagen ger uttryck för en traditionell fransk-keynesiansk syn på finanspolitik som inte tar hänsyn till tyska ordoliberala förbehåll (se nedan) vad gäller gemensamma finanspolitiska åtgärder. Det är inte osannolikt att Frankrike underskattar tyskarnas frustration när det gäller eurons effekter i andra länder, särskilt när det gäller oförmågan att respektera reglerna i stabilitets- och tillväxtpakten. Därav följer att en överenskommelse på området även måste omfatta trovärdiga åtgärder för att motverka alltför stora offentliga utgifter och minska såväl statsskulder som löneökningstakter.

Daniela Schwarzer om Tyskland

När det gäller eurofrågorna i synnerhet har regeringarna i *Tyskland* framgångsrikt sett till att EMU-regelverket har utformats i enlighet med neoklassiskt ekonomiskt tänkande, det vill säga den typ av utbudsstyrda resonemang som starkt har påverkat det tyska ekonomiska tänkandet. Under en lång tid var också den dominerande tolkningen av vad som gick fel under krisen att de krisande medlemsstaterna inte hade följt stabilitets- och tillväxtpakten. Den roll som finansministern ska spela är enligt det tyska synsättet att kontrollera och övervaka den nationella budgetpolitiken snarare än att spendera pengar. Ur det perspektivet restes legitimitetsfrågor närhelst andra medlemsstaters regeringar undvek att följa det gemensamma regelverket.

Den tyska regeringen fortsätter att driva den regelbaserade ansatsen när det gäller styrningen av euroområdet. Man menar att reglerna för finanspolitisk disciplin måste följas med större trovärdighet än vad som har varit fallet historiskt. Vidare vill man att såväl tillämpningen av de finanspolitiska reglerna som den makroekonomiska och finansiella stabiliteten måste skyddas bättre från politikers inblandning. Eftersom efterlevnaden av befintliga regler har varit ett problem är det sannolikt att den tyska regeringen kommer att vilja stärka marknadsdisciplinen i euroområdet.

Samtidigt har tyska politiker idag en större förståelse än tidigare för de ogynnsamma effekterna av åtstramningspolitiken i Sydeuropa, exempelvis i form av en negativ syn på Tyskland och en ökad risk för att systemets legitimitet och regler drabbas. Den starka närvaron av socialdemokrater i den nya koalitionsregeringen i kombination med den franske presidentens reformtrovärdighet stärker hoppet om en förhandlingsuppgörelse mellan Paris och Berlin. Dessutom ges Europafrågorna en mycket framträdande roll i den överenskommelse som de tyska partierna SPD, CDU och CSU ingick för att bilda koalitionsregering. Här lämnar man till och med öppet för att euroländerna går vidare på egen hand om motståndet skulle vara för starkt från icke-euroländerna.

Det står även inskrivet i överenskommelsen att man ska ha ett starkt samarbete med Frankrike och gemensamt arbeta fram förslag till eurotoppmötet den 28–29 juni. Till skillnad från tidigare överenskommelser saknas här uttalade

gränslinjer som inte får passeras, och även om det närmare innehållet är höljt i dunkel visar man också en större öppenhet för till exempel makroekonomiska stabiliseringsåtgärder. Vidare argumenterar man för att låta Europeiska stabilitetsmekanismen omvandlas till EMF och förankras i EU:s samlade regelverk. Överenskommelsen inkluderar inte EDIS, men till skillnad från tidigare koalitionsöverenskommelser utesluter man den inte heller.

Det måste samtidigt konstateras att det återstår stora skillnader när vi går in på detaljerna även i de förslag som nu ligger på agendan och där det kan verka finnas samstämmiga uppfattningar. I vissa fall, exempelvis när det gäller storlek, roll, finansiering och institutionell utformning av budgeten för euroområdet, är skillnaderna milsvida. Även om både Tyskland och Frankrike har sagt sig stå redo att betala mer till EU:s budget, är den investeringskapacitet för euroländerna med vidhäftade villkor som nämns i koalitionsöverenskommelsen långt ifrån den centrala stabiliseringsfunktion som har eftersökts av Frankrike och Italien. En relaterad fråga gäller den roll som det framtida EMF skulle spela: Frankrike har argumenterat för att möjliggöra stöd som kan förhindra framtida kriser genom att undsätta medlemsstater i nöd, medan den tyska versionen av samma institution innehåller strikta villkor innan räddningsprogrammen kan komma på fråga. Därtill är det inte sannolikt att man från tysk sida släpper det nationella vetot. Ett fransk-tyskt initiativ måste således kombinera marknadsdisciplin, riskminsknings- och riskdelningsåtgärder för att vara gångbart. Tyskland kommer att trycka på för att man ytterligare ska minska riskerna i euroområdets banker innan EDIS kan bli verklighet. En annan önskan är att införa transparenta regler som innebär att investerarna tar förluster för deras bank- och statsskuldsexponering i fall av krishantering.

Adriaan Schout om Nederländerna

Nederländerna är ett medelstort EU-land som allt oftare betecknas euroskeptiskt, till och med arvtagare till den begränsande roll som britterna har spelat, trots att landet är starkt rotat i kärnan av unionen och har en befolkning som är positivt inställd till såväl EU som EMU. Nederländerna har för avsikt att vara en konstruktiv och pragmatisk spelare. Som ett av EU:s mest konkurrenskraftiga länder är holländarna medvetna om unionens betydelse för landets ekonomiska utveckling, säkerhet och globala inflytande. De är även medvetna om behovet av solidaritet över nationsgränserna, under förutsättning att andra länder tar sitt ansvar när det gäller åtagandet för nationella reformer.

Samtidigt har exempelvis premiärminister Mark Rutte fört fram argumentet att länder som inte klarar att genomföra nödvändiga reformer till och med ska kunna slängas ut ur euroområdet. Vidare är en motberättelse på väg att etableras, vilken har sin grund i vad som har benämnts ”smygande integration” (*integration by stealth*). Det innebär att EU tar stegvisa beslut som resulterar i ett system skilt från hur det var tänkt att fungera från början. Euroområdet är ett exempel på ”smygande integration”, där systemet utformades så att medlemsstaterna själva skulle ansvara

för att följa stabilitets- och tillväxtpaktens regler och i fall av regelbrott rätta sig efter kommissionens anvisningar. Men förslagen som nu förhandlas i rådet, liksom tidigare initiativ, har inneburit ett ökande antal institutioner och politiska överenskommelser. Det har även fått konsekvenser för befintliga institutioner, så som politiseringen av kommissionen och Europaparlamentets ökande makt. Den här stegvisa processen innebär även att maktfördelningen i EU blir oklar.

Nederländerna är obekväma med reformagendan, ännu mer än Tyskland som är ett av de länder holländarna helst samarbetar med. Det är därför sannolikt att Nederländerna väljer en pragmatisk strategi baserad på flexibla koalitioner. Däremot kommer man varken att acceptera den typ av motprestationslogik som är vanlig i EU-sammanhang eller lösningar som kan leda till permanenta omfördelningar av pengar till risktagande länder. Det finns med andra ord gränser för hur mycket riskdelning holländarna kan acceptera. Å andra sidan har Mark Rutte egna erfarenheter av hur svårt det är att föra en oberoende förhandlingslinje i EU som medelstort land. När det tredje grekiska stödpaketet godkändes 2015 innebar det ett brott mot hans vallöfte 2012 om att det inte kunde bli tal om mer pengar till Grekland.

Valet av just den här strategin beror förmodligen på försöken att nå en uppgörelse om de förslag kommissionen hittills har lagt, vilka blir svåra att motverka utan höga politiska kostnader. Men även en tandlös europeisk ekonomi- och finansminister skulle vara svår för Nederländerna att acceptera. Posten är kopplad till en rad andra initiativ, som exempelvis ett framtida EMF, en budget för euroområdet och en större roll för Europaparlamentet. Samtidigt blir det allt tydligare att en större EU-budget och någon form av EMF kommer att bli verklighet.

Mark Rutte tycks leta efter sätt att leda koalitioner bestående av likasinnade, exempelvis Irland, Österrike, Visegradländerna samt de nordiska och de baltiska medlemsstaterna. Syftet skulle vara att kompensera för att britternas återhållande inverkan försvinner och agera motvikt mot den tysk-franska axeln. Det innebär inte att Nederländerna skulle ta över britternas roll som besvärlig partner, utan istället agera konstruktivt för att tillsammans nå bättre gemensamma lösningar.

Förutsättningar för fortsatta EMU-reformer

Sammanfattningsvis tycks det råda samstämmighet hos såväl medlemsstaterna som forskare om att det fortfarande finns brister i euroområdets institutionella strukturer samt att mer behöver göras för att åtgärda de europeiska finansmarknaderna. Det finns områden där båda lägren vill eller kan tänka sig att gå vidare. En samstämmighet är synlig när det gäller att reformera ESM, föra in den i EU:s regelverk samt omvandla den till EMF. Man vill också nå en överenskommelse om ett europeiskt insättningsgarantisystem (EDIS), under förutsättning att ytterligare riskminskning kommer till stånd, samt göra ESM/EMF till säkerhetsspärr för den gemensamma resolutionsfonden (SRF). Att döma av ett inofficiellt dokument publicerat våren 2018 av åtta finansministrar verkar

även Nederländerna, Irland och de nordiska och de baltiska medlemsstaterna acceptera dessa steg. Ett annat riskdelningssteg som medlemsstaterna tycks vara ense om är att gå vidare med kapitalmarknadsunionen. Vi borde därför kunna förvänta oss vissa framsteg inom de här områdena.

Även om en motprestationsstrategi verkar möjlig, det vill säga att olika riskdelningsverktyg accepteras mot ytterligare riskminskningsinsatser och regelförstärkningar, lär ansatsen stöta på patrull. Nederländerna är nämligen djupt obekvämt med den typen av strategier och anser att de historiskt har lett till en smygande integration med resultat som avviker från de ursprungliga intentionerna. Holländarna menar att länderna måste konvergera mer – såväl ekonomiskt som riskmässigt – innan riskdelningsinstrument kan diskuteras. Även Italien får svårt att acceptera den här ansatsen, oavsett om regeringen är teknokratisk eller politisk. Det har funnits ett stort motstånd mot att öka takten i arbetet med att minska antalet nödlidande lån och en stark skepsis mot att införa begränsningar av bankernas möjlighet att exponera sig mot det egna landets statsskuld.

Valet i mars 2018 resulterade inte i en konstruktiv italiensk regering. Det vore dock olyckligt om denna omständighet leder till att Italiens behov ignoreras i EMU-reformförhandlingarna. Det redan skeptiska opinionsläget skulle kunna förvandlas till missnöje om reformerna missgynnar landet strukturellt och ger europeiska tjänstemän möjlighet att läxa upp italienska politiker och beslutsfattare eller underminerar stabiliteten hos pålitliga institutioner som historiska regionala banker.

Avslutningsvis återstår det ett antal frågor som rör dynamiken såväl mellan medlemsstaterna som mellan institutionerna och medlemsstaterna. Hittills har mycket i den allmänna diskussionen handlat om utrymmet för eventuella tysk-franska kompromisser. Faran här är att processen inte tar tillräcklig hänsyn till övriga medlemsstaters intressen, vilket inte lär tas emot väl av respektive befolkningar. Inte heller ska dynamiken mellan medlemsstaterna och EU:s institutioner underskattas. Det gäller i synnerhet kommissionen som är den bästa garanten för att hänsyn tas till allas intressen; stora som små medlemsstater. Bilaterala uppgörelser mellan Berlin och Paris riskerar att urholka legitimiteten för såväl processen och förslagen som reformgenomförandet. Det är därför viktigt att det ordinarie lagstiftningsförfarandet följs.

En sista aspekt rör icke-euroländernas roll i reformarbetet. Det är oklart vilket inflytande de kommer att ha. Medan både Tyskland (med vissa förbehåll) och Nederländerna vill inkludera samtliga medlemsstater i processen har den franske presidentens vision exkluderat icke-euroländerna i exempelvis den institutionella utformningen. Det är emellertid rimligt att anta att en exkluderande process riskerar att få flera av de kvarvarande sju icke-euroländerna (efter brexit) att avstå från att införa euron i framtiden. I förlängningen skulle även dessa länders EU-medlemskap kunna ifrågasättas, något som öppnar upp för en helt ny dynamik i den europeiska integrationsprocessen.

"There is general agreement that flaws remain in the legal and institutional architecture of the Eurozone [...] However, views differ as to which measures should be chosen, their internal order of priority in the reform process and, to the extent that there is agreement, their respective reach. This is not surprising in view of the different crisis narratives that member states tend to emphasise."

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