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# Euro is coming back

The eurozone has become more stable, but now it needs adaptations to deal with persisting dysfunctions. This will be a long process, but the scope for action has become more promising. A column by Charles Wyplosz.

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*«Any attempt at deep reform without adjusting the treaties is excessively constrained.»*

Euro-skepticism has been chic for a while, but now it may have passed its peak. It has been fed by generations of political leaders who felt that European economic integration had reached decreasing returns and concluded that they would not tempt luck by plotting further steps. Forced by three successive crises, they had to break new ground, but they did so haltingly. A new generation of political leaders is emerging. Out of necessity, they now need to act bravely and could well be up to the challenge.

The global financial crisis exposed the lack of proper financial oversight within the Eurozone. The common currency was supposed to promote an integrated financial market. However, attempts at adopting the required rules and regulations have been fallen victims

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of long-standing cozy relationships between financial institutions and their states.

The public debt crisis followed. It revealed many shortcomings. First, the incestuous links between banks and their states. Second, the failure of the Stability and Growth Pact to establish fiscal discipline. Third, the minimalist interpretation by the ECB of its mandate, including the denial that a central bank must be a lender of last resort to both governments and banks. Fourth, the antiquated view that all budget deficits are bad and that fiscal policy is at best useless because the fiscal multipliers are negligible. Fifth, the rejection of any co-insurance arrangement among member states for fear that frugal countries would end up subsidizing their spendthrift partners.

### **A learning process from crisis to crisis**

Finally, the on-going Covid crisis challenged the lack of a common framework for health policies (large federal states like the US or Brazil faced the same issue). Through mimicry rather than coordination, most European governments adopted similar economic strategies to protect people and businesses. However, the already highly indebted governments had to restrain their support, or to resort to lending and to provide guarantees instead of outright transfers. The pandemic also led to the suspension of the Schengen agreement in order to close borders, resulting in uncoordinated decisions of dubious effectiveness.

What is really interesting is that the economic policy responses have improved from crisis to crisis. There was no cooperation during the global financial crisis, beyond contributions to the new Basel III agreement. The public debt crisis led to the creation of the European Stability Mechanism, a sort of regional monetary fund that provides conditional support. Meanwhile, it took three years for the ECB to intervene as lender in last resort to member governments. Even so, these interventions were strongly conditional and, in effect, subject to any country's veto. In the end, all crisis countries emerged from the crisis with much higher public debts than before, while 'zero-multiplier' austerity policies deepened already deep recessions. This is when euro-skepticism seriously took off.

Fortunately, things have changed. The Covid crisis has been met promptly with a slew of new policies. It has been agreed to pool vaccination purchases. Although it initially struggled, the undertaking has started to informally transfer to the European level the competence for pandemics, which theoretically is not shared. Through its Pandemic Emergency Purchase Programme, the ECB has

promptly underwritten public debts and banks as needed. The creation of the Recovery Fund has shattered existing red lines. Although it is explicitly exceptional, the fund is an embryo of a federal transfer mechanism that lends more to needy governments. Its official name, NextGeneration EU, betrays its limitations: it is heavily managed by the Commission and it is structured around fashionable objectives of questionable promise. It will have to prove its effectiveness, and there still is no agreement on how it will be funded, but it is a historical precedent. As such, it must succeed.

### **New governments at the helm**

In another major step, in the midst of the public debt crisis, the Banking Union was finally created. Supervision is now (mostly) conducted at the Eurozone level, undermining protectionism. Yet, the other leg, banking resolution, is unfinished business. The responsibility for the resolution of failing banks remains shared among European and national authorities. The eventual costs remain borne at the national level, which stands to undermine the process. This complex arrangement is ill-adapted to urgent decision making, but it can evolve.

These are game-changing innovations. Sure, they are often poorly designed and rarely complete, but this is not really surprising: getting many countries to unanimously agree to consequential decisions is inherently difficult. There is more to it, however. Ever since the failure in 2005 to change the treaties to create a European Constitution, the political leaders have been unwilling to undertake any new reform that requires changing the treaties. It does not seem to matter that the Constitution project was dealing with abstract issues far remote from citizens' concerns, unlike pressing practical needs. As a result, any attempt at deep reform without adjusting the treaties is excessively constrained.

It may be that this self-imposed impotency is coming to an end. One reason is that several new governments in several countries (Germany, France, Italy, the Netherlands) may be less inhibited. They seem more pragmatic as their views seem less shaped by old ideologies like money always creates inflation, or fiscal policies are useless and possibly harmful under any condition, or public debts are forever sinful.

### **Euro-skepticism on the retreat**

Importantly, Euro-skepticism is retreating, largely because the Euro-skeptics have accumulated errors. They enthusiastically backed Brexit, which is visibly hurting the UK. They have pronounced repeatedly the euro terminally ill, but it

has survived and is now backed by a large majority of citizens (according to the latest Eurobarometer survey, 78% think that the euro is good for Europe and 69% that it is good their own country). Many Euro-skeptics have supported the anti-vaccination movements but 68% of citizens are fully vaccinated according to the European Center for Disease Prevention and Control. They have often joined the ranks of climate change deniers but climate is now visibly changing and, according to Eurobarometer, 93% consider that it is a serious concern. On virtually any major issue of the day, the Euro-skeptics have had it wrong.

Finally, the Europeans feel increasingly lonely in an increasingly troubled world. Trump and Afghanistan imply that the USA cannot be seen anymore as a trusted protector. China and Russia have become aggressive economic and political competitors. Terrorist organizations are spreading in Africa.

A plausible scenario is that the European leaders are now going to be less shy in mooting treaty changes that make it possible to deal with the accumulated dysfunctions of the EU. Of course, this will be a long process and setbacks are likely along the way. But over the last couple of decades, the scope for serious action has not been as promising as now.