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Is the EU Robust?

With the acceptance of EU austerity measures by the Tsipras administration, a path now exists towards a solution to the Greek debt crisis which has threatened the Eurozone. However, this does not resolve the systemic weaknesses of the Euro, and given that Spain, Italy, and other member nations face their own potential financial crises, the future of the EU as an entity remains unclear. What are the issues facing the EU in forming a stable regional economic zone?

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What must the EU Do to Create a Stable Regional Economic Zone?

The response to the Greek debt crisis has highlighted numerous issues, including the question of the legitimacy of the application of austerity measures to Greece, the dominance of Germany in the EU, and the systemic weakness of the Euro. What are the issues facing the EU in forming a stable regional economic zone, and what concrete measures should be adopted towards their solution? In this issue of *My Vision*, we seek opinions from Japan's ambassador to the European Union, the Director of a Belgium-based think tank, and scholars in the fields of international finance, European economics, and European politics.

Interviewer: Nao Toyoda, NIRA Senior Researcher
Editor: Kazuyoshi Harada
Period of interviews: August - September 2015

The EU possesses a flexible toughness

Keiichi Katakami

Ambassador of Japan to the European Union

Tension between the centralization of authority and the sovereignty of member nations is an inherent factor in the 60-year history of the European Union. Amid the ongoing confrontation between these two elements, the EU's integration has proceeded two steps forward to one step back, with political and practical intelligence constantly at work seeking to strengthen its unity. The Eurozone is therefore not inherently a finished system. The European sovereign debt crisis which commenced in 2009 sparked moves to enhance the supervision of banks and bolster fiscal discipline, and a plan to strengthen the Economic and Monetary Union which envisions the creation of a Eurozone finance ministry, with its final stage projected for 2025 at the latest, is currently under discussion.

Nevertheless, "The Politics of Europe" took the top position in the Eurasia Group's Top Risks 2015 rating, with the potential exits of Greece from the euro ("Grexit") and Britain from the EU ("Brexit") and the rise of Euroscepticism receiving particular attention. Distrust and dissatisfaction regarding the actual utility of the EU in light of its failure to improve the performance of European economies has come together with factors including criticism of pressure from the EU for more stringent fiscal discipline and of its lack of effective measures to respond to the refugee crisis to fuel rising skepticism regarding the benefits of EU membership. Because this distrust and dissatisfaction is directly rooted in the daily lives of the citizens of EU member nations, it has appeared with a new severity.

The European Commission has taken adequate cognizance of the depth of these sentiments under the presidency of Jean-Claude Juncker, which commenced in November 2014, and has responded with the Investment Plan for Europe mobilising at least 315 billion euro three years, which will encompass a succession of measures including the establishment of a European Fund for Strategic Investments, the creation of a digital single market, and the establishment of an energy union. Concrete projects based on the European Fund for Strategic Investments are already moving towards implementation, and real outcomes are also beginning to appear in the digital area, for example the abolition of roaming fees within the EU. I believe that the presentation of positive outcomes to member nations and EU citizens through measures of this type will be the key to the restoration of confidence in the EU and the creation of a stable regional economic zone. ■

Mr. Katakami is a diplomat and an expert in the field of Japanese economic diplomacy, with a curriculum vitae including involvement in negotiations towards the conclusion of economic partnership agreements (EPA) and the Trans-Pacific Partnership (TPP).

Honing Policy Literacy

Sahoko Kaji

Professor, Faculty of Economics, Keio University

The existence of voters with a low level of policy literacy and a consequent failure of democracy to function adequately lie in the background of the crisis in the EU. As a result, policies which would have been unpopular in the short-term but desirable from the long-term perspective were not adopted, and the possibility of realizing sustainability was lost. Like Aesop's fable, in every country there are the “ants,” who push ahead with reform and prepare for the future, and the “grasshoppers,” who emphasize the immediate status of the economy and postpone reform. If the grasshoppers were to give adequate consideration to the situation and recognize the danger of continuing as they were, they would no doubt support alternative policies themselves. I believe that the future of the EU will be determined by the balance between the fundamentally different philosophies of the ants and the grasshoppers in the political and economic infrastructure created from confrontation and compromise between these two ways of thinking.

In its 2000 Lisbon Strategy, the EU declared its aim to decisively push ahead with reforms, dispel social and administrative ossification, and become the most competitive economy in the world. However, reforms did not proceed in certain European nations; for example, amid the desperate fiscal situation of Greece, the country’s key industry, maritime transportation, was largely exempt from taxation. Greek politicians did not recognize this as a problem, and the majority of voters chose to leave politics to the politicians; crisis ensued. The future continues to be difficult to predict in Greece, with the advent of a politically inexperienced left-wing administration creating the potential for further disorder. This should not be viewed as merely a problem occurring elsewhere; it is not impossible that a crisis might occur in Japan itself in the not-too-distant future.

In order to avoid this possibility, it will be important to ensure that democracy functions effectively, with citizens understanding the costs and the benefits of policies and able to make choices based on consideration of the ultimate outcomes of those choices. To this end, it is vital that we establish easily accessible venues for town meetings in every location (as easy for people to reach as their local gym, say), and to increase opportunities for ordinary citizens to hone their policy literacy. ■

Professor Kaji is a specialist in European economic issues. She stresses the urgent need to reform the functioning of democracy in Japan based on lessons learned from the EU debt crisis.

The difficulty of realizing pan-European fiscal democracy

Ken Endo

Vice Dean, Graduate School of Public Policy, Hokkaido University

The ongoing crisis has created divisions in public sentiment in the nations making up the EU. The correction of intra-regional economic disparities through the cultivation of a European identity is an essential element in ensuring the self-regulating functioning of the EU as a supranational entity, and this is an almost impossible task to achieve in a short period.

Intra-regional economic disparities originated in differences in the speed of structural adjustment in individual nations following monetary union. Funds tend to accumulate in productive and competitive wealthy countries, and monetary transfers in the broad sense of the term are essential in correcting this tendency. Monetary transfers can be accomplished via the market economy, for example through expansion of internal demand or remittances from migrants, but this by itself is not enough. Financial transfers from rich countries to poor countries are the commonsense solution. It would be necessary to create, step-by-step, mechanisms that enhance the official redistribution of income between governments, for example enabling the sharing of the funds and credit won by countries such as Germany and Holland with countries which have been pushed aside in the competition.

What will be necessary for the redistribution of national income within the EU is the cultivation of a feeling of solidarity that transcends national borders, and a pan-European democracy based on this feeling of solidarity. When democratic checks are available to ensure the public that their hard-won funds and credit are being used appropriately, fiscal democracy begins to function. However, at the level of the EU, the European parliament, the entity which should oversee this check function, is regarded as a Brussels elite, distant from public sentiment. Voter turnout is low, so is the public interest. The fostering of European democracy remains a difficult task. It will be up to the EU to overcome the disjunction between advancing regional unification on the economic front and the weakness of regional identity. ■

A specialist in the area of European politics, Professor Endo views the present EU as being in a type of limbo, neither a state nor simply an international organization, but as nevertheless possessing its own form of stability.

Controlling debt via market mechanisms

Kenichi Ueda

Associate Professor, Graduate School of Economics, The University of Tokyo

One of the weaknesses of the EU has been made clear by its economic crisis. This is the failure of several member countries to maintain fiscal discipline. On the flip side, European banks lent to these countries at very low interest rates before the crisis, as they expected possible bailouts of the countries concerned or the banks themselves by larger countries in the EU.

If the fiscal needs of a member country in recession, such as unemployment benefits, were supported by a central EU authority, these fiscal needs would not cause sovereign debt crises. However, to build such a fiscal union would require an EU-wide consensus, and this would appear to be difficult for the foreseeable future. At present, therefore, the EU has no choice but to design an institutional setup to ensure that member countries adhere to fiscal discipline at the country level.

Naturally, the necessity for fiscal discipline has been recognized, and was embodied from the beginning, in the Maastricht Treaty, as a condition for joining the euro zone. However, this condition was soon rendered ineffectual, since Germany and France were the first to breach the requirement. Still, as a response to the current crisis, the EU has strengthened its fiscal rules and maintained fiscal targets, in particular the 60 percent limit for government debt to GDP ratio.

However, an institutional framework to implement the fiscal rules is essential. A promising mechanism has recently been proposed by a group of leading European scholars. In a nutshell, their proposal is as follows: Debt restructuring would be automatically triggered when the debt to GDP ratio reached 95 percent, and then the European Stability Mechanism (ESM) would monitor the country's fiscal condition. From the investors' point of view, expected losses due to debt restructuring would become clear. Therefore, investors would be likely to require higher and higher risk premiums when the debt to GDP ratio went over 60 percent and was increasing. This increase in the interest rate would work as a market discipline to promote fiscal prudence and to ensure that fiscal targets were met. Moreover, in case excessive debts were accumulated, this mechanism would replace ad hoc numerous negotiations on debt restructuring and thereby avoid worsening of economic conditions during such a lengthy negotiation process. Indeed, economic theories and empirical evidences suggest that a speedy mechanism for debt restructuring is essential for the rapid and sound recovery of the economy of a heavily indebted country. Moreover, because of a higher growth, the required restructuring would be minimized, so that not only borrowers but also creditors would gain from the speedy debt restructuring mechanism. ■

Associate Professor Ueda specializes in the study of finance-macroeconomic linkages, including the effects of the international financial system. He points to the necessity for an international legal framework for speedy debt restructuring, which would bring quick economic recovery ex post and create market discipline to promote fiscal prudence ex ante.

Priorities for euro area governance reforms

Guntram B. Wolff

Director, Bruegel

Spring has brought signs of economic recovery to the euro area. This is obviously good news, especially for the millions of unemployed who need growth to increase their hopes of finding a job. But recovery has also its dark side. It has lowered the appetite of EU and national politicians to continue the process of euro area reform that they launched at the height of the crisis. Yet euro area economic governance remains unsatisfactory. The banking union was a major achievement, but it remains unfinished.

Besides improving banking union, two other subjects require urgent attention to calm fears about weak euro area governance: better fiscal governance and a mechanism to ensure competitiveness despite the absence of the exchange rate instrument.

The euro area requires a fiscal governance system that ensures two objectives: the fiscal sustainability of its members, and co-ordinates an appropriate area-wide fiscal stance that supports the ECB's monetary policy geared towards price stability. We propose five measures.

First, the closer a country moves toward fiscal unsustainability, the tighter European intervention should be. Ultimately European institutions must be able to completely remove a euro area government's ability to borrow. As events in Greece have demonstrated, this should have been introduced much earlier.

Second, in order to ensure an appropriate area-wide fiscal stance, the euro area needs to be able not only to ban borrowing by some member states, but also to force others to run higher deficits. In both instances, this means having the possibility, during exceptional circumstances like euro area recessions, to overrule decisions by national parliaments.

Third, fiscal governance should be organised in a "Eurosystem of Fiscal Policy" (EFP) comparable to the Eurosystem of central banks, which would also oversee the current European Stability Mechanism (ESM). The EFP would be chaired by a euro area Finance Minister. The members of the EFP would be the national Finance Ministers of the euro area countries, plus five other members, including representatives from the European Commission. The EFP would take fiscal policy decisions by majority – which, in times of substantial danger to debt sustainability or a substantial euro area recession, would be binding on the national level.

Fourth, in a reformed ESM, the EFP would have the power to call on fiscal resources for special purposes in a reformed ESM. This would include providing essential support to member states, and backing up banks in cases of severe systemic stress.

Fifth, decisions by the EFP that overrule national decisions would need approval by a new euro area chamber of the European Parliament. This would be an essential element in making the new governance framework democratically accountable. An independent euro area Fiscal Council would give guidance on whether or not the EFP assessment of exceptional circumstances were correct.

The other proposal concerns measures to prevent wage and competitiveness divergences between member states, which are often due to the functioning of national labour market and social systems that are in some instances in contradiction with their membership of a monetary union. Since the euro area cannot hope to overcome these divergences by creating a single labour market with common rules and high mobility, national systems must produce wage outcomes that closely reflect labour productivity developments.

The euro area needs a mechanism to prevent and correct substantial misalignments of wage productivity competitiveness that complements the existing Macroeconomic Imbalance Procedure (MIP) used by the European Commission to monitor competitiveness and other developments. The new mechanism would bring two innovations to the existing system. It would add national bodies and be binding in some circumstances. It would involve the creation of a Eurosystem Competitiveness Council (ECC), consisting of national competitiveness councils and the European Commission. The ECC's primary task would be to coordinate the actions of national competitiveness councils to ensure that no euro area country fixes and enforces a wage norm that implies significant competitiveness problems for itself or others. In case coordination fails, the ECC should be able to overrule national councils and make a wage norm binding.

Our proposals require significant powers to be handed over to the European level by euro area countries. They may sound radical and far-reaching, but are in fact much less radical than proposals by some academics, or by the Four-president report initiated by the former President of the European Council, that propose creating a euro area budget and call for high labour mobility to smooth adjustment. Contrary to these proposals, ours accept the notion that labour markets and fiscal policy remain mainly national. Nonetheless, our relatively modest proposals would require changes to the European Union treaty, or at least a new intergovernmental treaty. This may be a painful process, but in order to establish a stable basis for renewed growth and employment, the euro area needs to continue reforming its architecture. ■

Dr. Wolff is well-known as a commentator possessing considerable influence on the European Parliament, and his opinions are frequently taken up in international media organs, including the FT, the NYT, and the WSJ. Dr. Wolff believes that fiscal integration of the EU will be vital to overcoming the euro crisis.

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NIRA bears full responsibility for the translation presented here.
Translated by Michael Faul.

About this Issue

Is the EU Robust?

The European economy has a significant effect on the Japanese economy and the world economy. Despite this, compared to the US economy, insufficient information reaches Japan concerning the actual status of the European economy. The direction of the European Union has a particularly strong impact on the European economy and European societies, but again, Japan tends not to receive an adequate amount of information regarding the structure and status of the EU. Given this, this issue of *My Vision* offers diverse perspectives regarding the future of the European economy and the future direction of the EU from a group of experts in EU issues.

Discussion of the Greek economic crisis reveals a variety of unstable elements affecting the future of the EU. It should be remembered, however, that considered objectively, the attempt to unify Europe in itself faced significant obstacles; it is only natural that the process should have been completed in a “two steps forward, one step back” fashion, as Keiichi Katakami indicates in this issue. Nevertheless, the present crisis is replete with issues which possess the potential to shake the foundations of the EU, making the various prescriptions offered by our interviewees both valuable and of considerable interest.

The fact that, despite monetary unification, European fiscal unification remained inadequate and the redistribution of income beyond national borders was limited is inherently a structural issue. However, political reform can still be advanced as far as possible with these issues taken into consideration. The direction of the resulting changes in the EU must be the subject of close attention.

The Volkswagen scandal came to light after the interviews for this issue of *My Vision* had been completed. More than a problem for one company alone, this represents a situation that will affect the German economy as a whole. And the effects of the situation will not only be felt in Germany, a nation which has maintained its economic strength within the EU, but will have a significant impact on the EU and the European economy. The future of the EU is a subject which increasingly demands our attention.

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