ev

EUROPEAN VIEW // 1

// VOLUME 16 / JUNE 2017

The Future of the Eurozone: A Realistic Approach

Wilfried Martens Centre for European Studies

Springer

European View

Journal Website

www.springer.com/12290
Electronic edition: link.springer.com/journal/12290

Subscription Information

European View is published twice a year. Volume 16 (2 issues) will be published in 2017.

ISSN: 1781-6858 print
ISSN: 1865-5831 electronic

For information on subscription rates please contact Springer Customer Service Center:
customerservice@springer.com

The Americas (North, South, Central America and the Caribbean)
Springer Journal Fulfillment,
233 Spring Street, New York,
NY 10013-1578, USA
Tel.: 800-SPRINGER (777-4643);
212-460-1500 (outside North America)

Outside the Americas
Springer Customer Service Center GmbH
Tiergartenstr. 15, 69121 Heidelberg, Germany
Tel.: +49-6221-345-4303

Office of Publication

Springer-Verlag GmbH, Tiergartenstraße 17,
69121 Heidelberg, Germany

Springer is part of
Springer Science+Business Media

Springer

European View

For editorial and article submission inquiries please contact:
European View
Editor-in-Chief
20, Rue du Commerce – 1000 Brussels, Belgium
e-mail: ev@martenscentre.eu
Tel.: +32 2 300 8004, Fax: +32 300 8011
www.martenscentre.eu

This publication receives funding from the European Parliament.

Springer

Wilfried
Martens Centre
for European Studies

The Wilfried Martens Centre for European Studies (previously the Centre for European Studies) was established in 2007 as the political foundation and official think tank of the European People's Party (EPP). It embodies a pan-European mind-set based on centre-right, Christian Democrat, conservative and like-minded political values. It serves as a framework for national political foundations linked to member parties of the EPP, with currently 31 foundations members. The Martens Centre takes part in the preparation of EPP programmes and policy documents. It organises seminars and training on EU policies and on the process of European integration.

The Martens Centre also contributes to formulating EU and national public policies. It produces research studies and books, policy briefs, and the twice-yearly *European View* journal. Its research activities are divided into six clusters: party structures and EU institutions, economic and social policies, EU foreign policy, environment and energy, values and religion, and new societal challenges. Through its papers, publication launches, conferences and online activities, the Martens Centre offers a platform for discussion among experts, politicians, policymakers and the European public. At the beginning of 2014, the Martens Centre was renamed in honour of its late President and founder, Wilfried Martens, the EPP's long-standing President and former Prime Minister of Belgium.

The Martens Centre has four main goals: advancing centre-right thought, contributing to the formulation of EU and national policies, serving as a framework for national political foundations and academics, and stimulating public debate about the EU.

http://www.martenscentre.eu

European View

The Future of the Eurozone: A Realistic Approach

Volume 16 • Number 1 • June 2017

Springer

EUROPEAN VIEW (2017) 16:1–2
DOI 10.1007/s12290-017-0446-6

EDITORIAL

The future of the eurozone: a realistic approach

Mikuláš Dzurinda

Published online: 29 June 2017

Only a few years ago, many renowned analysts and pundits were ready to bet money on the collapse of the Economic and Monetary Union (EMU). Today, after years of significant reforms at both the EU and national levels, far fewer would consider doing so. At the EU level, we now have a much more active monetary policy, a single banking supervision and resolution system, and a European Stability Mechanism to support countries in distress. At the national level, we have adopted stricter budgetary rules, and we have taken important steps in the direction of more modern and competitive economies.

After these early initiatives, however, progress on securing the future of the EMU seems to have stalled due to diverging views and interests among the main member states. This issue of *European View* took shape in the difficult political context of the immediate past and present, which has seen growing disaffection with the euro and often the open contestation of the currency by powerful political forces.

M. Dzurinda (✉)
Wilfried Martens Centre for European Studies, Rue du Commerce 20, 1000 Brussels, Belgium
e-mail: ev@martenscentre.eu

True, the election of Emmanuel Macron to the French presidency has recently rekindled hopes that big steps forward towards a 'genuine EMU' may be taken after the German parliamentary elections later this year. However, responsible political forces must always 'hope for the best and prepare for the worst'. They cannot ignore the significant technical and political problems that stand in the way of further economic integration.

Accordingly, the central question connecting the different contributions to this issue is the following: under what conditions can the eurozone survive and thrive as a monetary union with decentralised economic decision-making and limited fiscal integration? Contributions delving into the need for and the feasibility of a fiscal union in the EU must be read in this light. It is our conviction that future initiatives in the eurozone should not follow the goal of further centralisation but only pursue the stabilisation of the euro. They should be limited to what is strictly indispensable to achieve this paramount goal, in adherence with the principle of subsidiarity.

As can be expected of the economic analysis carried out by a political foundation, some contributions go beyond the technicalities and attach special importance to the politics of EMU reform, as well as to the legitimacy challenges posed by the most ambitious reform plans. We have tried to take a sober and realistic view of the future of the EMU and to frankly admit that difficulties exist when we see them. Europe's monetary union is an amazing achievement, and securing its future will require both intellectual honesty and political realism.

Finally, we have not forgotten that Europe's future does not only depend on the success of the EMU. This is why this issue contains contributions on a variety of other topics, including the Libyan conflict, migration and transatlantic relations, as well as an article calling for a reinvention of Europeanism.

Mikuláš Dzurinda *is President of the Wilfried Martens Centre for European Studies.*

EUROPEAN VIEW (2017) 16:3–22
DOI 10.1007/s12290-017-0429-7

ARTICLE

On the future of the EMU: Is more fiscal integration indispensable?

Jürgen Matthes · Anna Iara

Published online: 31 May 2017

Abstract It is often maintained that the euro debt crisis showed that the Economic and Monetary Union (EMU) was not sustainable without more fiscal integration. However, important causes of the crisis were extraordinary and are highly unlikely to occur again. While the legacy problems of the crisis have been grave, they can be deemed temporary. Therefore, these problems should be combated pragmatically, but with temporary instruments only. A systematic analysis shows that the root causes have been tackled with a wide variety of reforms, both to the EMU itself and by way of structural reforms

Disclaimer: the views expressed in this paper are the authors' alone and do not necessarily correspond to those of the European Commission or its services.

Electronic supplementary material The online version of this article (doi:10.1007/s12290-017-0429-7) contains supplementary material, which is available to authorised users.

J. Matthes (✉)
Cologne Institute for Economic Research (Institut der Deutschen Wirtschaft Köln e. V.), Konrad Adenauer Ufer 21, 50968 Cologne, Germany
e-mail: matthes@iwkoeln.de

A. Iara
European Commission, Secretariat-General, SG.D.1., Rue de la Loi 200, 1049 Brussels, Belgium
e-mail: anna.iara@ec.europa.eu

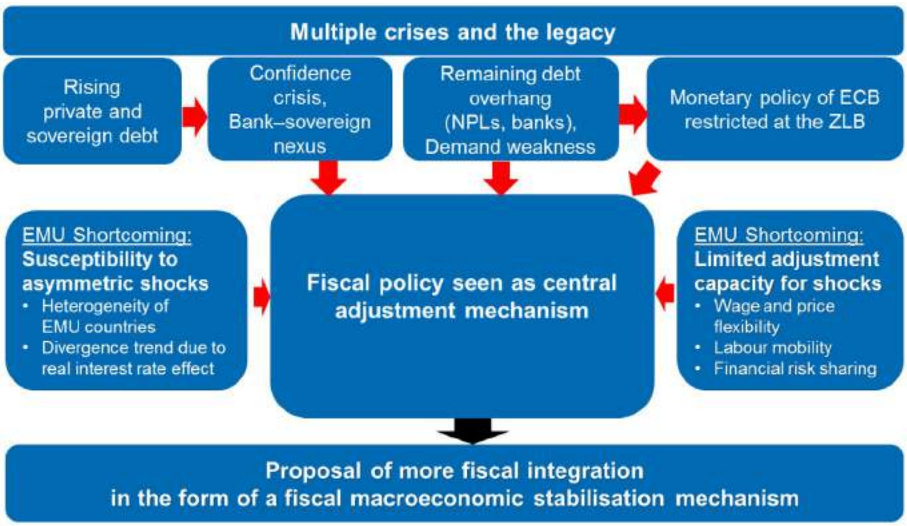
of the member states. In particular, evidence is presented that the adjustment capacities of the EMU countries are better than commonly recognised. Additional reforms are suggested, especially in the financial sector. With these reforms in place, future crises would have less serious effects. A reformed EMU should be able to withstand such crises without further fiscal integration.

Keywords Economic and Monetary Union | Structural reforms | Optimum currency area | Financial stability | Macro-prudential policy

Introduction

According to a widely accepted view, the recent euro debt crisis has shown that the Economic and Monetary Union (EMU) is not sustainable without fiscal risk sharing. The underlying line of reasoning rests on several arguments, summarised in Fig. 1. Of central importance is the understanding that fiscal policy is a key shock-adjustment mechanism (Fig. 1, central panel). It is claimed that during the euro area crisis, the national fiscal policy of EU members was constrained due to high public deficits and debts (top part, left side of Fig. 1). It is also argued that fiscal policy is of particular importance in the aftermath of the crisis, notably in the context of weak demand and monetary policy at the zero lower bound (top part, right side of Fig. 1). More generally, EMU is considered highly prone to asymmetric shocks (centre left, Fig. 1), while adjustment mechanisms other than fiscal policy are seen to lack effectiveness (centre right, Fig. 1).

Fig. 1 Arguments for a fiscal stabilisation mechanism



Source: Authors' own illustration.

Notes: NPLs = non-performing loans; ECB = European Central Bank; ZLB = zero lower bound of interest rates to be set by monetary policy.

The debate can be expected to gain new momentum as the European Commission as well as the euro area and EU member countries draw up their positions on deepening the EMU in the process launched by the release of the *White Paper on the Future of Europe* by the European Commission on 1 March (European Commission 2017).

This study contributes to this debate by challenging the above dominant narrative, arguing that more fiscal integration is in fact not needed for the stability of the euro area.[1] The analysis is based on optimum currency area theory[2] as well as an analysis of the balance of payments crises (Merler and Pisani-Ferry 2012; Lane 2013) and the private debt crises. These aspects have been recognised as being among the core factors contributing to the euro area debt crisis (Kuenzel and Ruscher 2013; Baldwin and Giavazzi 2015). In fact, credit booms and private over-indebtedness have regularly been key drivers of developments culminating in financial crises, which are typically followed by deep and long recessions (Schularick and Taylor 2012; Gourinchas and Obstfeld 2012; Koo 2011).

Exceptionality of the euro debt crisis

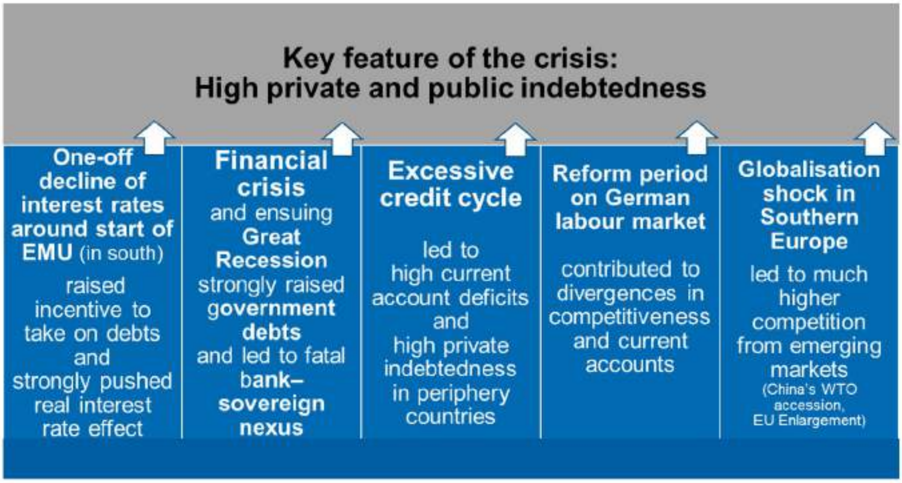
Arguably some of the challenges of the euro area crisis could have been more easily handled had a central fiscal capacity been available to cushion some part of the large shocks to fiscally strained EU members. However, the implication that a fiscal capacity is a necessity for the euro area builds on the understanding that the recent crisis is representative of crises to come. The authors challenge this view, highlighting that this was not the case: the euro area debt crisis can be considered unique, owing to a number of exceptional features. Several extraordinary factors contributed to its severity (Fig. 2), many of which are unlikely to be repeated: the one-off interest rate decrease in the euro area periphery at the onset of EMU; the ensuing extraordinary credit boom; the German labour market reforms in the mid-2000s; the large globalisation shock emanating mainly from China, paralleled by the integration of Eastern European countries into EU value chains; and finally, the context of a severe global financial crisis in 2008. Therefore, some caution is warranted when claims are put forward that the recent crisis is a template of what is to come.

Overall, the root of the crisis was mainly located in the financial sector and the private sector: private debt had grown to very high levels in the run-up to the crisis in many of the stressed countries. Contrary to the popular view, the surge in public debt was much less due to a lax interpretation of the Stability and Growth Pact than to the impact of the global financial crisis on government spending, notably on bank bailouts and fiscal stabilisation (Matthes et al. 2016).

[1] This article is an abbreviated and partly updated version of Matthes and Iara (2016) and of a more extensive version available in German (Matthes et al. 2016).

[2] For the basic references see Mundell (1961), McKinnon (1963) and Kenen (1969); for more recent developments see Mongelli (2008), European Commission (2008), Matthes (2009) and Handler (2013).

Fig. 2 Exceptional circumstances and features of the euro debt crisis



Source: Authors' own illustration.

During the build-up of imbalances that ultimately culminated in the crisis, the increase in private debt grew, alongside large capital flows from the north to the south of the euro area, which were associated with very high current account deficits (Chen et al. 2013; Acharya and Steffen 2015; Hale and Obstfeld 2014). At the same time, the windfall gains caused by the significantly declining interest rates in most southern EMU countries were often used for consumption, social spending and public wages (Busch et al. 2011). The build-up of sizeable vulnerabilities eventually resulted in multiple and mutually reinforcing crises: sovereign and private debt crises, balance of payments crises, banking crises, and the mutually reinforcing bank–sovereign nexus. In light of the well-acknowledged experience that debt crises are particularly grave and protracted, in particular because balance sheet repair becomes the key concern of the private sector (Koo 2011; Schularick and Taylor 2012), the length and depth of the euro area crisis does not come as a surprise.

This is why the legacy of the crisis is still severe, particularly in terms of high unemployment and weak investment. However, these problems are temporary, as they mainly relate to the deleveraging process after an immense debt crisis. In the authors' view, it would be a mistake to build permanent institutions with shortcomings of their own to tackle temporary problems, even if these are grave: the legacy problems of the crisis should be tackled with temporary tools instead. The unconventional policies of the European Central Bank (ECB), as well as the European Fund for Strategic Investment (which needs improving to become more effective) have been useful in this regard.

The contemplation of instruments to tackle the legacy of the crisis also has to start with an acknowledgement that a number of the measures have already been taken. In particular, strengthening banks' capital base, introducing the Banking Union (with new restructuring and bail-in tools[3]) and the reform of private insolvency laws have helped to deleverage banks and non-financial corporations in stressed countries (for more details see Matthes and Iara 2016)—albeit in Italy the clearing-up of private debts has been unwarrantedly delayed, which is significantly weighing on growth. In contrast, Spain has progressed much further in this respect, to a large degree with the help of a financial sector programme of the European Stability Mechanism (ESM). As a result of structural reforms and the earlier private sector deleveraging, Spain has experienced strong growth lately.

Reforms to mitigate future crises

The repetition of such severe crises can and must be avoided. Several reforms in the euro area—notably in the areas of macroeconomic surveillance, banking supervision, fiscal policy and national regulation, among others—do address the roots of the crisis. However, several additional reforms, mainly in the financial sector, are needed to mitigate the build-up of large financial cycles and private debt increases and to better deal with standard idiosyncratic downturns (see the table in the Appendix for a systematic presentation of reform requirements, reforms already taken and actions that are still required).

The ESM and the ECB's Outright Monetary Transactions programme are important innovations that close a gap in the institutional framework of the EMU. The use of these instruments is essential to avoid the escalation of future sovereign-debt crises. Based on the principle of conditionality,[4] these new instruments can contain crises of confidence (De Grauwe 2013).

To enhance their effectiveness, ESM adjustment programmes need to

- show a stronger focus on growth-enhancing structural reforms from the outset, in particular concerning product markets (IMF 2016);
- consider the possibility of larger fiscal multipliers during deep recessions (Blanchard and Leigh 2013; Alesina and Ardagna 2013; Kolev and Matthes 2013), that is, the possibility of larger declines in economic growth and tax revenues in response to sharp fiscal consolidation measures; and

[3] Additional reforms are needed. The most important two are: (1) ensuring that bail-in-able capital is largely held by professional investors outside of the banking sector, in order to allow for effective bail-ins in case of bank resolutions; (2) phasing out of the preferential treatment of euro area sovereign bonds and notably the disregard for their factual default risk, in order to break the sovereign–bank nexus.

[4] This principle must not be weakened by a possible integration of the ESM into EU community law or by measures to enhance its democratic accountability: the political independence of the ESM must not be compromised.

- pay attention to social fairness when designing reforms, strive to minimise negative social outcomes, and specifically consider the sequencing of reforms and seek balance in the distribution of losses (Grüner 2013).

A further improved European Semester could constitute a significant contribution to fostering reform progress (Matthes and Iara 2016).

What is more, the ESM and ECB (with the Outright Monetary Transactions programme) should be allowed to ring-fence countercyclical national fiscal policies in the event of future crises, even for highly indebted euro area countries. This should only be possible, however, if the affected country implements well-targeted growth-enhancing structural reforms and if it adheres to the fiscal rules of the EU—which provide ample room to counteract standard recessions.

However, fiscal policy needs to be countercyclical not only in recessions but also in economic (and financial) booms. This has proved to be difficult to ensure for political economy reasons, when pressures rise on finance ministers to spend more in view of higher tax revenues. Moreover, measuring the structural fiscal deficit (which is a key guide to the appropriate fiscal stance) has proved difficult, particularly during economic and financial booms when it tends to be underestimated because potential growth is often overestimated. The inclusion of a measure of the financial cycle in the calculation of potential growth and thus of the structural fiscal deficit could possibly limit measurement errors (de Manuel Aramendía and Raciborski 2015; Berger et al. 2015). This should be considered in the Stability and Growth Pact framework.

Other recent reforms have made even more important contributions to the mitigation of financial booms in the future: most importantly, the new macroeconomic surveillance framework as part of EU economic governance, and the macro-prudential supervision exercised by the ECB, which has become the Single Supervisory Mechanism in the euro area. Both have filled gaps in the institutional framework of the EMU. It is particularly important that the Single Supervisory Mechanism can overrule national supervisors: this changes their incentives, tackles the notorious inaction bias and makes supervision more effective. However, these instruments have to be actively used.

Further to the reforms already taken and additional measures suggested above, to prevent excessive financial booms, countercyclical capital buffers should be actively used. As the banking sector is more strictly regulated, more efforts are needed to prevent the build-up of financial-stability risks in the shadow banking sector (ECB 2015b; Constâncio 2015, 2016). In the short term, more transparency and stress tests for relevant institutions are needed, as well as a general leverage ratio for highly leveraged activities (Schoenmaker and Wierts 2015). In the medium term, a new central financial authority needs to be created in the euro area to cover the whole financial market (SVR 2014).

Improved functioning of EMU: less heterogeneity and divergence among EMU countries

Further reflections on the future of the euro area must take note of the fact that, in terms of regulatory and adjustment capacities, the optimality characteristics of the EMU have substantially improved in the course of the recent crisis, indeed much more than conventionally recognised.

These improvements also concern the degree of vulnerability of EMU countries to asymmetric shocks as well as to internal forces that could lead to divergence among them (Fig. 1, centre left).

Structural reforms have reduced regulatory heterogeneity

First, euro area members have recently become less dissimilar in important economic dimensions. Traditionally, the EMU has been considered too heterogeneous and therefore susceptible to asymmetric shocks (Pisani-Ferry 2012; European Commission 2015). A substantial part of that heterogeneity has been due to differences in labour and product market regulation, which are important factors in the ability of euro area members to adapt to idiosyncratic shocks via wage and price adjustments (Holden and Wulfsberg 2007; 2014; Babecký et al. 2010; Heinz and Rusinova 2011; Jaumotte and Morsy 2012). However, significant reforms to the labour and product markets in distressed countries (where regulations had generally been relatively strict) have reduced heterogeneity in this important respect, as illustrated by Fig. 3.

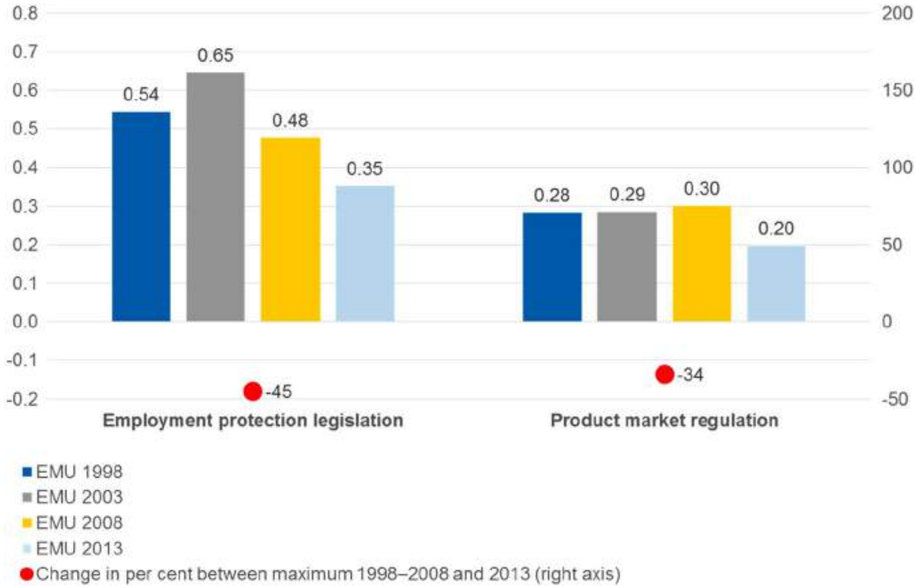
Country-specific macro-prudential measures to mitigate the real interest rate effect

The one-size-does-not-fit-all problem of the single monetary policy and the resulting real interest rate effect are key problems in every currency union and have proved to be important causes of the build-up of macroeconomic imbalances in the EMU (see, e.g. European Commission 2008; Matthes 2009; Enderlein et al. 2012; Maurer 2012; Merler 2015; European Commission 2016).

To counteract this problem and prevent large asymmetric financial cycles, macro-prudential policy tools can and should be used in a country-specific way.[5] A rapidly growing body of research has shown that macro-prudential policies are broadly effective in curbing excessive financial cycles and particularly effective at reining in credit growth (e.g.

[5] For similar recommendations see Black (2010), Maurer (2010), Houben et al. (2012), Horn et al. (2012), Brzoza-Brzezina et al. (2013), Kok et al. (2014), Remsperger (2014), Constâncio (2015), and Schoenmaker and Wierts (2015).

Fig. 3 Change in heterogeneity of regulation: standard deviation among a sample of EMU countries*



Source: Matthes 2015.

* Reduced sample due to lack of data available from 1998 for some countries. Lower standard deviation indicates less heterogeneity. There has been a reduction.

Lim et al. 2011; Vandenbussche et al. 2012; Kuttner and Shim 2013; Claessens et al. 2014; Jácome and Mitra 2015). In particular, borrower-based instruments such as loan-to-value ratios have proven to be more effective than capital-based instruments. Such instruments also have another important advantage: they can be applied to all domestic transactions, thus ensuring that they cannot be circumvented by shadow banks or foreign loan suppliers.

Improved functioning of the EMU: better adjustment capacities for idiosyncratic shocks

With EMU members not having the ability to devalue their currency or to pursue a national monetary policy tailored to their needs, other effective mechanisms need to be in place to enable their economies to adjust to idiosyncratic shocks. It is commonly held that price and quantity adjustments in labour and product markets respectively are too weak in Europe: this is why fiscal tools are seen as the prime instruments of crisis mitigation. In reality, however, these adjustment capacities are better than commonly

Table 1 Share in per cent of continuously employed full-time employees that experienced nominal or real wage declines compared to the previous year

	Spain		Portugal		Italy		France		UK (for comparison)	
	Nominal wage	Real wage	Nominal wage	Real wage	Nominal wage	Real wage	Nominal wage	Real wage	Nominal wage	Real wage
2003–4	37	50	0	51	33	45	30	50	22	32
2004–5	39	48	8	25	31	45	26	40	18	25
2005–6	33	46	25	34	21	34	26	42	21	33
2006–7	34	43	33	41	41	54	26	36	20	44
2007–8	39	51	30	45	29	49	19	42	18	47
2008–9	40	38	n.a.	n.a.	39	45	29	29	19	29
2009–10	47	59	48	55	35	46	27	43	24	65
2010–11	44	57	74	79	37	58	24	43	24	60

Source: Verdugo (2016).

Note: Results for France, Italy and the UK are based on official data; results for Spain and Portugal are based on survey data.

Table 2 Reforms of collective bargaining systems since 2008

	Portugal	Spain	Greece	Italy
Decentralisation/more firm-level flexibility				
Priority of firm-level agreements	(x)	x	x	
Reducing extension obligations	(x)		x	(x)
(More) opening clauses		x	x	x
Increasing working-time flexibility	x	x	x	x
Right to contract with non-union workers	(x)		x	
Reduced duration of new or expired agreements	x	x	x	
Inflation indexation (repeal or reduction)		x		x
Reducing (freezing) statutory minimum wages	(x)		x	
Further elements of wage moderation	x		x	x

Source: Matthes (2015), based on the author's own assessments of qualitative information from Eurofound, country surveys by the OECD and the International Monetary Fund (IMF), reports by the EU and the IMF on the implementation of reforms in the programme countries, reports within the framework of the European Semester, and the World Bank's 'Doing Business' database.

Note: x = notable reform; (x) = partial reform.

recognised and have, to a large degree, further improved due to the various reforms taken during the crisis (Fig. 1, centre right).

Downward wage rigidity is lower than recognised and has been further reduced

Insufficient downward wage flexibility during recessions has long been considered a deep rooted and notorious problem in the euro area, notably among its southern European members (Dickens et al. 2006; Holden and Wulfsberg 2007; 2014; Matthes 2009; Heinz and Rusinova 2011; and recently Sapir 2016). However, recent research based on micro-level evidence calls into question the prevalence of significant downward wage rigidities in the southern euro area countries (Verdugo 2016). Even before the crisis, the share of full-time and continuously employed employees experiencing negative annual (log) nominal wage changes was at around one-third in Spain, Italy and Portugal (Table 1). Naturally, the share was even higher for real wage declines. These ratios increased considerably during and after the Great Recession in Spain and Portugal.

In addition, the recent structural reforms in stressed euro area countries have significantly contributed to further increasing the flexibility of wages and prices (Anderton and Bonthuis 2015; Matthes 2015; ECB 2016b). Reforms of wage bargaining systems with the aim of providing more flexibility and decentralisation play an important role in this respect (Table 2).

Short-term labour mobility as high as in the US during recent crisis

If a country runs into a recession, labour mobility can contribute to reducing unemployment and can help to stabilise incomes. However, labour mobility in the EMU has traditionally been deemed low compared to in the US. In the course of the recent crisis, however, short-term migration flows have been much higher than expected (Huart and Tchakpalla 2015; *Trésor-Economics* 2015). The short-term adjustment capacity of labour migration to labour demand shocks has recently been estimated to have even reached levels comparable to those in the US (Beers et al. 2014).

This positive finding is not only due to a considerable increase in the short-term migration of citizens born in EMU member states (which remains rather limited overall), but importantly also to the emigration of immigrants from non-EMU countries (Eastern Europe and North Africa) who had formerly moved to the respective countries. These latter migration flows also fulfil the function of a pressure valve for quantity adjustment on the labour market. However, the further removal of impediments to labour mobility is still required.

Deepening financial integration, particularly in equity and longer term financing

Financial risk sharing is a key adjustment mechanism for idiosyncratic shocks (see, e.g. Asdrubali et al. 1996; Allard et al. 2013; Feld and Osterloh 2013). However, mainly due to the withdrawal of short-term debt-based assets (in particular interbank wholesale lending), it was barely able to fulfil its assigned function during the recent crisis (e.g. Balli et al. 2012; Kalemli-Ozcan et al. 2014).

This is not the whole picture, though. In fact, equity and investment fund exposures remained largely intact, as did direct bank loans (SVR 2015; ECB 2016a). Indeed, cross-border equity holdings in the euro area even increased during the crisis and are currently higher than is generally thought—they amounted to 42% of the equity issued in the euro area in 2013 (ECB 2015a). What is more, this share has nearly tripled since 1997 when it stood at below 15%. In addition, other long-term investments (which are inherently more stable than short-term assets) have further gained importance since the crisis (ECB 2016a).

Nevertheless, financial risk-sharing capacities need to improve further in the EMU. The Banking Union and especially the bail-in instrument are important achievements in this respect, and further steps need to be taken to complete implementation of the Banking Union, notably the setting-up of a common European deposit insurance scheme. However, the risk-sharing capacities of such a scheme should only be increased in parallel with the risk reduction in the European banking system, particularly regarding the reduction of non-performing loans and of the exposure of banks' balance sheets to domestic sovereign bonds. On top of this, further reforms are required: the Capital Markets Union agenda of the European Commission needs to be taken forward, and a clear roadmap must be followed to foster financial integration in the euro area. Regulatory incentives are needed for more diversification among asset classes and investors, more equity (instead of debt) financing and more long-term (instead of short-term) investments.

Finally, one more area has not yet been addressed by the recent reforms: the unambiguous assignment of responsibility for sovereign debt. Strengthening fiscal responsibility and ruling out expectations of bailouts or debt monetisation would necessitate an explicit procedure for sovereign defaults. Otherwise, financial market actors are prone to underestimate the risk involved in sovereign debt and thus demand lower risk premiums than appropriate, thereby limiting the incentive for national governments to pursue a stability-oriented fiscal policy. A reliable sovereign-debt restructuring mechanism should be adopted for newly issued debt with an appropriate phase-in period (Busch and Matthes 2015).

Conclusion

This article contributes to the debate on the future of the EMU and challenges the claim that fiscal integration is indispensable for its long-term viability. Specifically it highlights that, due to specific historical preconditions, the character of the recent crisis was unique, and that important institutional reforms have already been made. Therefore, the experience of this crisis is not a valid point of departure for contemplating permanent instruments of fiscal integration in the euro area.

Overall, the reform pressures of the recent crisis have significantly improved the structural functioning of the EMU. On this basis, and with the additional reforms suggested here, it is far from evident that the EMU would be unsustainable without further fiscal integration. The prospect of fiscal integration in the EMU thus needs to be discussed as a political choice and not as an economic necessity.

Appendix

Overview of reform progress and the remaining reforms needed to make the EMU sustainable (part 1)

Reforms required to tackle causes of the crisis	Prevention of economic imbalances, credit bubbles and excessive private debts	Mitigation of risks in the banking and financial system	OCA context: heterogeneity reduced and adjustment capacity increased	OCA context: mitigation of one-size-does-not-fit-all problem (real interest rate effect)	Improved fiscal governance	Mitigation of illiquidity crises of sovereigns and banks	Improved economic coordinationand reforms to raise competitiveness and growth
Reform progress	New macroeconomic surveillance with MIP	Banking union (SSM, BRRD, bail-in, SRM, SRB, SBRF, ESM, harmonised national deposit insurance)	Structural reforms of labour and product markets (more wage and price flexibility, less heterogeneity among EMU members)	Improved banking supervision with SSM (centralised independent SSM strong in micro-prudence, can overrule national supervisors in macro-prudence, less arbitrage and inaction bias)	Strengthening of SGP (Six-Pack and Two-Pack)	Sovereigns: EFSF, ESM (conditionality) Banks: ESM and SBRF	European Semester with country-specific recommendations
	New macro-prudential supervision with new instruments to guard against financial cycles (e.g. counter-cyclical and contingent capital buffers)	Increase in capital buffers of banks (Basel III, pre-empted since 2011 by EBA and ECB stress test 2014)	Improved labour mobility and partial financial reintegration (due to reforms and ECB intervention)	Country-specific applicability of new macro-prudential instruments	Fiscal Compact (with national debt brakes and corrective mechanism)	ECB for sovereigns: OMT (conditionality) ECB for banks: unconventional monetary policy and Target2	Competitiveness Councils (national and central) in case of reform weakness More surveillance and reform programmes (under MIP or Two-Pack)

Source: Authors' illustration.

Notes: MIP Macroeconomic Imbalance Procedure, *SSM* Single Supervisory Mechanism, *BRRD* Bank Recovery and Restructuring Directive, *SRM* Single Resolution Mechanism, *SRB* Single Resolution Board, *SBRF* Single Bank Resolution Fund, *EBA* European Banking Authority, *EFSF* European Financial Stability Facility, *SGP* Stability and Growth Pact, *OMT* Outright Monetary Transactions.

Overview of reform progress and the remaining reforms needed to make the EMU sustainable (part 2)

	Rigorous implementation / Prevention of dilution						
Remaining reforms and implementation needed	Active use of new capital buffer regulations (especially countercyclical buffers, minimum standards for internal risk models, surveillance of risks of interest rate increase)	Ensure effectiveness of banking union (Bail-in: no dilution, bail-in-able capital largely held outside banking sector; SRM: strengthen, if needed; EDIS: only in parallel with risk reduction and minimum harmonisation of insolvency rules)	Strengthen financial risk sharing (use CMU for this aim, more regulatory incentives for diversification and against short-term lending, more equity integration, effective bail-in)	Active use of country- specific macro-prudence (by national supervisors and possibly SSM)	Strengthen national countercyclical fiscal policies (create fiscal space by adhering to MTOs, improve automatic stabilisers, ensure restrictive course in booms, correct structural deficit for financial cycle)	ESM: ensure conditionality principle (for new ESM instruments, after programmes ensure IMF participation) If ESM integrated in community law: ensure sufficient independence	Continue reform of European Semester (to increase implementation of CSRs, more peer pressure needed)
	Eliminate tax distortions favouring debt over equity financing (to limit incentives for incurring private debt)	Repeal privileges for sovereign debt (introduce risk adequate capital buffers and exposure limits, abolish liquidity privileges; medium-term introduction with phase-in for new issuances from 2018)	Increase -trade integration (e.g. foster single market) -labour mobility (e.g. better recognition of qualifications and portability of pension rights)	Amend CRD-IV package: integrate borrower-based macro-prudential instruments (LTV, LTI, DSTI) (to allow their use by SSM)	Ensure independence and effectiveness of EU Fiscal Council (to improve SGP implementation and to limit political discretion of Commission)	OMT of ECB: ensure conditionality principle	Increase ownership (even more discussion with member states, more benchmarking exercises, more intensive exchange on best practices)
	Continue private deleveraging (non-banks: further improve private insolvency regimes; banks: write off NPLs faster, recapitalisation or restructuring, bad bank solutions)	Create strong supervisor for whole financial sector (shadow banking, more transparency, stress tests, countercyclical leverage ratio for highly leveraged activities)	Continue structural reforms (reform packages: adequate design and sequencing for political support and mitigation of social effects against limited negative short-term effects)	Limit circumvention (application of borrower-based instruments to all domestic transactions, maximise use of reciprocity agreements)	Medium term: consistent and effective rules for sovereign debt restructuring (to strengthen the no-bailout rule)	Monetary policy of ECB: do not delegate financial stability solely to macro-prudence	Medium term: consistent rules for countries that are unwilling to reform (and for euro area exit, but only as *ultima ratio*)

Source: Authors' illustration.

Notes: SSM Single Supervisory Mechanism, *BRRD* Bank Recovery and Restructuring Directive, *SRM* Single Resolution Mechanism, *SRB* Single Resolution Board, *EDIS* European Deposit Insurance Scheme, *CMU* Capital Markets Union, *MTO* medium-term objective (in the SGP), *IMF* International Monetary Fund, *CSR* country-specific recommendations, *NPL* non-performing loan, *LTV* loan-to-value ratio, *LTI* loan-to-income ratio, *DSTI* debt service-to-income ratio, *OMT* Outright Monetary Transactions.

References

Acharya, V., & Steffen, S. (2015). The 'greatest' carry trade ever? Understanding eurozone bank risks. *Journal of Financial Economics, 115*(2), 215–36.

Alesina, A., & Ardagna, S. (2013). The design of fiscal adjustments. *Tax Policy and the Economy, 27*(3), 19–67.

Allard, C., Koeva Brooks, P., Bluedorn, J. C., Bornhorst, F., Christopherson, K., & Ohnsorge, F., Poghosyan, T., & an IMF Staff Team (2013). *Toward a fiscal union for the euro area*. IMF Staff Discussion Note no. SDN/13/09. Washington, DC.

Anderton, R., & Bonthuis, B. (2015). *Downward wage rigidities in the euro area*. Nottingham University Centre for Research on Globalisation and Economic Policy, Discussion Paper no. 2915/09. Nottingham.

Asdrubali, P., Sørensen, B. E., & Yosha, O. (1996). Channels of interstate risk sharing: United States 1963–1990. *The Quarterly Journal of Economics, 111*(4), 1081–110.

Babecký, J., Du Caju, P., Kosma, T., Lawless, M., Messina, J., & Rõõm, T. (2010). Downward nominal and real wage rigidity: Survey evidence from European firms. *Scandinavian Journal of Economics, 112*(4), 884–910.

Baldwin, R., & Giavazzi, F. (eds.). (2015). The eurozone crisis: A consensus view of the causes and a few possible solutions. *VoxEU.org*. http://www.voxeu.org/sites/default/files/file/reboot_upload_1.pdf. Accessed 18 January 2014.

Balli, F., Kalemli-Ozcan, S., & Sørensen, B. F. (2012). Risk sharing through capital gains. *Canadian Journal of Economics, 45*(2), 472–92.

Berger, H., Taheri Sanjani, M., Mrkaic, M., Rabanal, P., Lanau, S., & Dowling, T. (2015). *Steady as she goes—Estimating potential output during financial 'booms and busts'*. IMF Working Paper no. 15/233. Washington, DC.

Beers, N. van, Bijlsma, M., & Zwart, G. (2014). *Cross country insurance mechanisms in currency unions: An empirical assessment*. Bruegel Working Paper no. 4. Brussels.

Black, S. W. (2010). Fixing the flaws in the eurozone. *VoxEU.org*, 23 November. http://www.voxeu.org/article/fixing-flaws-eurozone. Accessed 15 March 2016.

Blanchard, O., & Leigh, D. (2013). *Growth forecast errors and fiscal multipliers*. IMF Working Paper no. 13/1. Washington, DC.

Brzoza-Brzezina, M., Kolasa, M., & Makarski, K. (2013). *Macroprudential policy instruments and economic imbalances in the euro area*. ECB Working Paper Series no. 1589. Frankfurt am Main. September.

Busch, B., Grömling, M., & Matthes, J. (2011). Current account deficits in Greece, Portugal and Spain. Origins and consequences. *Intereconomics, 46*(6), 354–60.

Busch, B., & Matthes, J. (2015). *Regeln für Staatsinsolvenzen im Euroraum*. IW-Analysen no. 104. Cologne.

Chen, R., Milesi-Ferretti, G. M., & Tressel, T. (2013). External imbalances in the eurozone. *Economic Policy, 28*(73), 103–42.

Claessens, S., Ghosh, S. R., & Mihet, R. (2014). *Macro-prudential policies to mitigate financial system vulnerabilities*. IMF Working Paper no. 14/155. Washington, DC.

Constâncio, V. (2015). 'Macroprudential policy in Europe: Ensuring financial stability in a banking union'. Keynote speech at the Financial Stability Conference, Berlin, 28 October.

Constâncio, V. (2016). 'Risk sharing and macroprudential policy in an ambitious capital markets union'. Speech at the Joint Conference of the European Commission and the European Central Bank on European Financial Integration and Stability, Frankfurt am Main, 25 April.

De Grauwe, P. (2013). *Design failures in the eurozone: Can they be fixed?* LSE 'Europe in Question' Discussion Paper Series no. 57. London. February.

de Manuel Aramendía, M., & Raciborski, R. (2015). *Using financial variables to estimate the Irish output gap: do they make a difference?* European Commission, European Economy Economic Briefs no. 4. Luxembourg.

Dickens, W. T., Götte, L., Groshen, E. L., Steinar, H., Messina, J., Schweitzer, M. E., Turunen, J., & Ward, M. E. (2006). How wages change. Micro evidence from the International Wage Flexibility Project. *Journal of Economic Perspectives*, *21*(2), 195–214.

ECB. (2015a). *Financial integration in Europe*. Frankfurt am Main.

ECB. (2015b). *Financial stability review*. Frankfurt am Main. November.

ECB. (2016a). *Financial integration in Europe*. Frankfurt am Main.

ECB. (2016b). *Wirtschaftsbericht 3/16, Kasten 2*. Frankfurt am Main. May.

Enderlein, H., Bofinger, P., Boone, L., De Grauwe, P., Piris, J.-C., & Pisani-Ferry, J., João Rodrigues, M., Sapir, A., & Vitorino, A. (2012). *Completing the euro: A road map towards fiscal union in Europe*. *Report of the Tommaso Padoa-Schioppa Group*. Notre Europe. June. http://www.notre-europe.eu/media/completingtheeuroreportpadoa-schioppagroupnejune2012.pdf?pdf=ok. Accessed 18 January 2016.

European Commission. (2008). *EMU@10. Successes and challenges after 10 years of Economic and Monetary Union*. European Economy no. 2. Luxembourg.

European Commission. (2015). Business cycle synchronisation in the euro area. *Quarterly Report on the Euro Area, 14*(2), 28–36.

European Commission. (2016). *Quarterly report on the Euro Area, 14*(4), special edition. http://ec.europa.eu/economy_finance/publications/eeip/pdf/ip016_en.pdf. Accessed 10 March 2017.

European Commission. (2017). *White paper on the future of Europe*. Brussels.

Feld, L. P., & Osterloh, S. (2013). *Is a fiscal capacity really necessary to complete EMU?* Freiburger Diskussionspapiere zur Ordnungsökonomik no. 13/5. Freiburg.

Gourinchas, P.-O., & Obstfeld, M. (2012). Stories of the twentieth century for the twenty-first. *American Economic Journal: Macroeconomics, 4*(1), 226–65.

Grüner, H. P. (2013). *The political economy of structural reform and fiscal consolidation revisited*. European Commission, European Economy Economic Papers no. 487. Brussels.

Hale, G., & Obstfeld, M. (2014). *The euro and the geography of international debt flows*. NBER Working Paper no. 20033. Cambridge, MA.

Handler, H. (2013). *The eurozone: Piecemeal approach to an optimum currency area*. WIFO Working Papers no. 446/2013. Vienna.

Heinz, F. F., & Rusinova, D. (2011). *How flexible are real wages in EU countries? A panel investigation*. ECB Working Papers no. 1360. Frankfurt am Main.

Holden, S., & Wulfsberg, F. (2007). *How strong is the macroeconomic case for downward real wage rigidity?* Federal Reserve Bank of Boston Working Papers no. 07-6. Boston, MA.

Holden, S., & Wulfsberg, F. (2014). Wage rigidity, inflation and institutions. *Scandinavian Journal of Economics, 116*(2), 539–69.

Horn, G., Lindner, F., Tober, S., & Watt, A. (2012). *Quo vadis Krise? Zwischenbilanz und Konzept für einen stabilen Euroraum*. IMK Report. Düsseldorf. October.

Houben, A., Molen, R. van der, & Wierts, P. (2012). *Making macroprudential policy operational*. Central Bank of Luxembourg. http://www.bcl.lu/en/publications/revue_stabilite/Revue-de-stabilite-2012/RSF_2012_Chapitre_1.pdf. Accessed 21 January 2016.

Huart, F., & Tchakpalla, M. (2015). *Labour mobility in the euro area during the Great Recession*. 15 June. http://www.euroframe.org/files/user_upload/euroframe/docs/2015/conference/Session%205/EUROF15_Huart_Tchakpalla_revised.pdf. Accessed 19 January 2016.

IMF (International Monetary Fund). (2016). *World economic outlook*. Washington, DC. April.

Jácome, L. I., & Mitra, S. (2015). *LTV and DTI limits—Going granular*. IMF Working Paper no. 15/154. Washington, DC.

Jaumotte, F., & Morsy, H. (2012). *Determinants of inflation in the euro area: The role of labor and product market institutions*. IMF Working Paper no. 12/37. Washington, DC.

Kalemli-Ozcan, S., Luttini, E., & Sørensen, B. (2014). Debt crises and risk-sharing: The role of markets versus sovereigns. *The Scandinavian Journal of Economics, 116*(1), 253–76.

Kenen, P. (1969). The optimum currency area: An eclectic view. In R. Mundell & A. Swoboda (eds.), *Monetary problems of the international economy* (pp. 41–60). Chicago: University of Chicago Press.

Kok, C., Martin, R., Moccero, D., & Sandström, M. (2014). Recent experience of European countries with macro-prudential policy. In ECB *Financial stability review* (pp. 113–26). Frankfurt am Main: European Central Bank.

Kolev, G., & Matthes, J. (2013). *Smart fiscal consolidation. A strategy for achieving sustainable public finances and growth*. Centre for Economic Studies. Brussels.

Koo, R. (2011). The world in balance sheet recession: Causes, cure, and politics. *Real World Economics Review, 58*(1), 19–37.

Kuenzel, R., & Ruscher, E. (2013). *The future of EMU*. ECFIN Economic Brief no. 22. Brussels. April.

Kuttner, K. N., & Shim, I. (2013). *Can non-interest rate policies stabilize housing markets? Evidence from a panel of 57 economies*. BIS Working Paper no. 433. Basel.

Lane, P. R. (2013). *Capital flows in the euro area*. European Commission, European Economy Economic Papers no. 497. Brussels.

Lim, C., Columba, F., Costa, A., Kongsamut, P., Otani, A., Saiyid, M., Wezel, T., & Wu, X. (2011). *Macroprudential policy: What instruments and how to use them? Lessons from country experiences*. IMF Working Paper no. 11/238. Washington, DC.

Matthes, J. (2009). Ten years EMU—Reality test for the OCA–endogeneity hypothesis, economic divergences and future challenges. *Intereconomics, 44*(2), 114–28.

Matthes, J. (2015). Krisenländer: Relevanz von Strukturreformen für Wachstum und Währungsraum. *Wirtschaftsdienst, 95*(2), 106–13. (Similar paper in English available at http://www.iwkoeln.de/en/_storage/asset/214890/storage/master/file/7091582/download/Policy%20paper%20Structural%20Reforms.pdf. Accessed 8 May 2016).

Matthes, J., & Iara, A. (2016). *On the future of EMU. Targeted reforms instead of more fiscal integration*. IW-Report no. 17. Cologne.

Matthes, J., Iara, A., & Busch, B. (2016). *Zukunft der Währungsunion – Ist mehr fiskalische Integration unverzichtbar*. IW-Analysen no. 110. Cologne.

Maurer, R. (2010). Die Verschuldungskrise der Europäischen Währungsunion – Fiskalische Disziplinlosigkeit oder Konstruktionsfehler? *Vierteljahreshefte zur Wirtschaftsforschung des DIW, 4,* 85–102.

Maurer, R. (2012). Die Mär von den nordischen Sparern und den südlichen Verschwendern. *Ökonomenstimme.org*, 30 October. http://www.oekonomenstimme.org/artikel/2012/10/die-maer-von-den-nordischen-sparern-und-den-suedlichen-verschwendern/. Accessed 19 January 2016.

McKinnon, R. I. (1963). Optimum currency areas. *The American Economic Review, 53*(4), 717–25.

Merler, S. (2015). *Squaring the cycle: Financial cycles, capital flows, and macro-prudential policy in the euro area*. Bruegel Working Paper no. 14. Brussels. November.

Merler, S., & Pisani-Ferry, J. (2012). *Who's afraid of sovereign bonds*? Bruegel Policy Contribution no. 2. Brussels.

Mongelli, F. P. (2008). *European economic and monetary integration and the optimum currency area theory*. European Commission, European Economy Economic Papers no. 302. Brussels.

Mundell, R. (1961). A theory of optimum currency areas. *American Economic Review, 51*(4), 657–65.

Pisani-Ferry, J. (2012). *The known unknowns and the unknown unknowns of the EMU*. Bruegel Policy Contribution no. 18. Brussels.

Remsperger, H. (2014). *Der makroprudenzielle Komplex: der Prozess, das Schloss, das Urteil*. Institute for Monetary and Financial Stability, Working Paper Series no. 80. Frankfurt am Main.

Sapir, A. (2016). The eurozone needs less heterogeneity. *Bruegel.org*, 17 February.

Schoenmaker, D., & Wierts, P. (2015). *Macroprudential supervision: From theory to policy*. Bruegel Working Paper no. 15. Brussels.

Schularick, M., & Taylor, A. M. (2012). Credit booms gone bust: Monetary policy, leverage cycles, and financial crises, 1870–2008. *The American Economic Review, 102*(2), 1029–61.

SVR. (2015). *Zukunftsfähigkeit in den Mittelpunkt*. Jahresgutachten 2015/2016. Wiesbaden.

SVR (Sachverständigenrat zur Begutachtung der wirtschaftlichen Lage). (2014). *Mehr Vertrauen in Marktprozesse*. Jahresgutachten 2014/2015. Wiesbaden.

Trésor-Economics. (2015). Labour mobility in the EU: Dynamics and policies. No. 142. February. http://www.tresor.economie.gouv.fr/File/409589. Accessed 19 January 2016.

Vandenbussche, J., Vogel, U., & Detragiache, E. (2012). *Macroprudential policies and housing prices. A new database and empirical evidence for Central, Eastern, and Southeastern Europe*. IMF Working Paper no. 12/303. Washington, DC.

Verdugo, G. (2016). Real wage cyclicality in the eurozone before and during the Great Recession: Evidence from micro data. *European Economic Review, 82*(C), 46–69.

Jürgen Matthes *heads the Research Unit for International Economics and Economic Outlook at the Cologne Institute for Economic Research (Institut der deutschen Wirtschaft Köln), the largest privately financed economic think tank in Germany.*

Anna Iara, *Dr. rer. pol., is a staff member of the European Commission, working at the Secretariat-General in the area of economic governance and policy coordination.*

EUROPEAN VIEW (2017) 16:23–32
DOI 10.1007/s12290-017-0431-0

ARTICLE

The only feasible fiscal union for the euro area

Miguel Marín Cózar

Published online: 17 May 2017

Abstract The need for a fiscal union in the EU is an issue which has been debated many times and about which much has been written. However, the economic and financial crisis we have experienced in recent years has cast doubt on whether we have taken this debate in the right direction. Sometimes we tend to focus the debate on marginal issues and unrealistic proposals. Rather than helping us to move forward, this paralyses the EU and distances us from feasible targets. This article aims to give a general overview of the debate on a fiscal union to find out where we are in the process of fiscal integration and what we can really expect from it.

Keywords European integration | Fiscal union | European Banking Union | Economic crisis | Structural reforms | European deposit guarantee fund

M. Marín Cózar (✉)
Fundación para el Análisis y los Estudios Sociales, Calle María de Molina, 40-6ª,
28006 Madrid, Spain
e-mail: mmarin@fundacionfaes.org

Springer

Fiscal union: some introductory words

At this stage in the process of European integration, much has been said and written about the need to move towards a fiscal union as the only way to ensure the proper functioning not only of the eurozone, but of the whole EU. This article does not intend to provide technical arguments. Rather, it seeks to give a general overview of the debate on a fiscal union to find out what we could expect from such an arrangement. All of this is aimed at endorsing a conclusion: that keeping open debates on unattainable targets paralyses the EU and distances it from achievable targets likely to produce similar and more acceptable results for European citizens. This is particularly important now that European citizens seem to be tired of the existential debates going on in the EU and the limited results that the European project seems to have had in their daily lives, as can be seen from the increasing populist vote in recent years. This weariness has been reflected in both the outcomes of recent referendums and abstention in the European elections.

Theoretically, it would seem safe to say that the Economic and Monetary Union would work best if it rested on the foundations of a real fiscal union, even though historical evidence shows that monetary unions can work for many years without a fiscal union (Dabrowski 2015, 10–11). Examples of such arrangements are the West African Economic and Monetary Union, the Central African Economic and Monetary Community, and the nineteenth-century Scandinavian Monetary Union. Unfortunately, the EU is far from being a theoretical exercise.

The EU is possibly the greatest peaceful and voluntary integration exercise in human history. It is formed of a set of free nations and was born to build and secure peace and prosperity on the Old Continent. For many decades, the countries of the EU succeeded in this: there has been peace, Nazism and Communism were eradicated, and an area of economic stability capable of producing prosperity for hundreds of millions of Europeans has been established. However, as the EU has gradually expanded and the challenges of changing times have increased, the European project has started to lose momentum. Its effectiveness has suffered, and concerns about the EU's future viability are more present today than ever before.

At this point, one question that arises is whether we are giving the debate on fiscal union enough space. The 2008 economic crisis—probably the most devastating in modern history—has given us many clues. In fact, there is a widespread consensus that the design of the euro—with its poor institutional architecture that is yet to be completed—has much to do with the devastating effects of the crisis. To this it should be added that the economic good times that followed the creation of the euro did not provide sufficient incentives to correct this defect.

However, despite this widespread belief, we cannot know how the institutional architecture of the euro would have responded to the crisis if the member states had fulfilled the commitments made to the European institutions prior to the crisis, particularly those regarding budgetary stability. Nor will we know if the completion of the internal market would have made it possible for the EU member states to better absorb the asymmetric impacts of the crisis. Perhaps the EU itself would have been able to limit the financial fragmentation following the crisis, but we cannot be sure about this either. This is a criticism not only of France and Germany's failures to meet their obligations at the beginning of the twenty-first century—as the spiritual drivers of the EU, both countries should have shown exemplary behaviour—but of all the member states that failed to meet the obligations set out in the Stability and Growth Pact (SGP).

What we do know with certainty is that when the crisis started the euro's potential was undermined by a lack of institutional development and the weak political will of the national governments.

Is Europe ready for a fiscal union?

These initial reflections are of great relevance to the discussion on a fiscal union. But a responsible and effective initial analysis such as this must be preceded by three questions, the answers to which should determine the structure and the scope of the fiscal union that the EU can and must have:

- What do we want from a fiscal union? What is the aim pursued?
- What degree of fiscal union would make it possible to optimise these preferences?
- What degree of fiscal union is achievable, taking into account that stability and sustainability must be the fundamental pillars of the final project?

For those who believe that we need a fiscal union in order to prevent another crisis like the one we have suffered through, we could use two arguments in reply. First, a deep and profound crisis like the one we have experienced is highly unlikely to occur again in the next few decades. Second, before making any assessment of the optimum degree of fiscal union, we need to remember that many steps have already been taken to put an end to this crisis (as we will see in the next section). In fact, member states have given up a great part of their sovereignty in a short space of time and most of the steps taken are recent and still need to be tested.

As for the advocates of a more extreme version of fiscal union—we could call it the federalist path—we believe that this is a politically unfeasible option. Furthermore, opening a debate on this matter paralyses the EU's efforts and frustrates the possibilities of achieving more limited, but clearly attainable versions of fiscal union.

Furthermore, many dream of creating a European common treasury financed through tax revenues from all the member states. Managed by a central, independent authority, this common treasury would be capable of issuing debt backed by a joint and several guarantee, capable of harmonising the welfare state benefits (pension insurance, unemployment insurance, etc.) of the 28 member states and authorised by the European

Central Bank (ECB) to implement the monetary policy. Unfortunately, such a vision is still far from reality—the capacity for consensus in the EU is still very limited and, consequently, it is far from generating the stability, credibility and sustainability required, even if a multi-speed EU were to emerge.

Anticipating some of the conclusions of these initial reflections, we can say that Europe is still not ready for a fiscal union for a number of reasons. The most important of these is probably that Germany is not willing to pay for the over-expenditures of other member states. Given this, and knowing that the institutional architecture of the euro is lacking a fiscal back-stop, we need to take another viable and already known route. In particular, we need to complete the European Banking Union by adding a third pillar: a European deposit guarantee fund. In this way, the Banking Union would be able to provide the EU with a limited version of a fiscal union, which would function automatically, regardless of political decisions, and without *ex ante* winners or losers. There are differing views on which institution should manage such a fund. For instance, according to the European Commission (2015, 7), the European deposit guarantee fund could be managed by the Single Resolution Board (for more in-depth information see Juncker et al. 2015, 11; Schoenmaker and Wolff 2015; Schoenmaker and Gros 2012, 2). However, the debate should not focus on this particular question but on what really matters, which in this case is creating such a fund as soon as possible.

Fiscal union: Where are we?

One of the things that draws attention when tackling the debate about a fiscal union is the high degree of semantic confusion in terms of the dichotomous approach to the debate—the idea that it is either a ‘yes’ or a ‘no’ to a fiscal union. This creates a distorted picture of the debate, confuses citizens and frustrates the progress already made, which usually ends up looking insufficient and inefficient, even before it has been tested.

Any external and objective observer of the EU institutional framework would be unlikely to say that there is no fiscal union. The simple fact that ownership of the ECB is shared means there is a mutualisation of its balance risks—a balance that, by the way, will continue to grow for at least another year, as will the shared risks. But beyond the ECB, and knowing that the crisis has highlighted the institutional gaps and weaknesses in the euro’s economic integration, the truth is that the European Monetary Union has responded strongly to these weaknesses and today it has a much stronger institutional framework than it did in 2008.

Overall, when the crisis hit, the structural reforms needed to address it came swiftly. On the one hand, the introduction of the Macroeconomic Imbalance Procedure helped the EU prevent the emergence of new, potentially harmful macro imbalances that could endanger economic stability. In addition, the European Systemic Risk Board (responsible for macro-prudential oversight of the systemic risks to the EU’s financial system) and the Single Supervisory Mechanism (responsible for the micro- and macro-prudential supervision of the financial institutions in the countries joining it) contributed to further securing the stability of the EU's financial system.

On the other hand, however, there were also problems of sovereign debt in many European countries, as public finances deteriorated significantly when the financial crisis started. The average government debt in the euro area is still extremely high, and at the end of the first quarter of 2016 it stood at 91.7% of GDP (Eurostat 2016, 1). These problems were tackled by the SGP and the 'Fiscal Compact', which both aimed to achieve sound public finances in the member states and strengthen fiscal policy coordination. Linked to this, it should be remembered that the Fiscal Compact actually aimed to strengthen the SGP after the failure of many member states to comply with their earlier commitments, an issue that was closely linked to the euro's weakness in the face of the crisis.

The absence of a lender of last resort was another major problem that Europe faced when the crisis erupted. The European Financial Stability Facility and the European Stability Mechanism were created with the aim of providing financial assistance to the member states as necessary—as happened in Portugal, Greece and Ireland. However, this problem—the lack of a lender of last resort—was not resolved until the ECB launched the Outright Monetary Transactions programme in 2012. With this, the ECB became the lender of last resort for all euro area member states' governments and failing national banks.

With the crisis and the consequent deterioration of the economic situation throughout Europe, the banking sector was also in need of reform to clean it up so as to ensure its stability and proper functioning. The set of reform measures included in Basel III helped to achieve this goal: they aimed to strengthen the regulation, supervision and risk management of the banking sector (Bank for International Settlements 2011). These measures were complemented by the work of the European Banking Authority, whose main objective was to maintain financial stability in the EU.

Overall, these reforms have been steps in the right direction and have proved successful in tackling the roots of the crisis, as evidenced by the elimination of the 'redenomination risk'. This has enabled the economic and employment growth that we are now experiencing within the EU. It is nevertheless true that there is still much work to do, especially at the national level, and further reforms will need to be implemented—the steps already taken were necessary to solve the crisis, but are not sufficient to ensure the future stability of the eurozone.

Fiscal union: What can we expect?

Summing up all that we have seen and experienced since the economic crisis, we can say that the institutional architecture of the euro has indeed improved thanks to the strengthening of the Banking Union and the introduction of integration and economic control mechanisms. These mechanisms remain political in nature as regards the decision-making progress, but they are still proportional, or not mutualised, when bearing a financial burden—as, for example, is the case with the European Stability Mechanism.

For its part, the ECB has assumed an increasing role not only in the eurozone's economic growth, but across the whole EU, thereby offsetting the lack of political will from national governments to introduce the economic reforms to which they have committed in their national reform plans. Finally, the eternal debate continues on the need to move towards a fiscal union as the only way for the eurozone to survive. And interestingly, neither advocates nor opponents of this particular idea have changed their minds in years. That said, we must be precise and answer the questions we asked ourselves in the first section of this article, and try to reach a conclusion on what kind of fiscal union we can really seek. For this, we should bear in mind three conditioning issues, which are too often forgotten:

- First, the necessary condition for a fiscal union to function properly—that is, reaching a minimum degree of solidarity among European citizens—does not yet exist. The crisis has forced the EU to bail out countries close to collapse, something that was repeatedly justified by the argument of the 'contagion' effect—transfers were therefore seen as a lesser evil—rather than by the principle of solidarity, as should have been the case. The debate on a fiscal union is unsustainable without solidarity, and this is unfortunately something that it will not be easy to change. Schuman was the first to appeal for solidarity as a necessary condition for the EU to work (Fondation Robert Schuman 2011); 60 years later solidarity is still far from being consolidated.
- Second, we cannot act as if the euro is ideologically neutral in the eyes of Europeans. Moreover, we cannot act or open debates without taking into account that a significant part of the European population—a growing part as populism gains momentum—does not share the obligations deriving from more economic integration. The sustainability of a fiscal union—in its most advanced version—requires the constitutionalisation of strict budgetary discipline, structural reforms and market flexibility so as to remove them from the influence of political fluctuations. The stability required for a fiscal union cannot depend on political programmes, but we still seem to be far from consensus in this respect.
- Finally, if we seek a sustainable fiscal union, we need to bear in mind that the EU is still a union of sovereign and independent nations—and that they want to remain so. Therefore, any solution provided must be respectful of the parliamentary democracies on which the EU is founded, and it must include recognisable elements of national sovereignty. Any maximalist approach should be discouraged simply by thinking of the failure to enshrine the European Constitution.

In view of these restrictions, which are very much incontestable, it is easy to conclude that the only way open to us is that of creating a limited version of a fiscal union.

This being so, we should ask ourselves what the ultimate purpose of a limited version of a fiscal union would be. In this regard, taking into account the above-mentioned restrictions, trying to preserve financial stability through an effective surveillance of the effects of the banking crises would be a laudable aim. If we look at the economic history of bygone centuries, many social upheavals were preceded by banking crises, which, through their links to the state, often ended up harming citizens' daily lives.

It is true that, for the time being, the *ex ante* checks on the fiscal position of member states have actually been strengthened, and the Single Resolution Mechanism is an important step towards mutualisation on the path to financial stability. It is also true that all member states have accepted the 'almost–lender of last resort' role of the ECB—including Germany, even though it has been reluctant to do so. However, the fact remains that there is general agreement in the eyes of the international markets that a credible fiscal back-stop is still absent.

This fiscal back-stop could take different forms, but a European deposit guarantee fund that secures European citizens' savings would be the most appropriate. This kind of fund would allow the single currency to be of equal value to all the regions and countries in the EU, which is precisely the necessary condition for the proper functioning of any monetary union.

Of course, problems also result from the differing situations and conditions of the countries and their banking systems, that is, the famous legacy assets. But there are also different ways of financing the fund, in some cases through more public money and, in other cases, with less public money. And of course, it may not be possible for us to finance a fund that would enable a systemic crisis to be brought to an end. But the point of such a fund is for there to be a powerful enough deterrent, thus reflecting the euro-area countries' commitment to the single currency.

There are no successful precedents of a monetary union in which national guarantee funds compete with one another. Nevertheless, there have been positive experiences of banking unions. This is the case for the US and the Federal Deposit Insurance Corporation. Daniel Gros's (2012) article comparing the banking crises in Nevada and Ireland provides a good illustration—these two crises are perfectly comparable because of the size of the two economies and their real-estate bubbles. The US is a banking union and therefore the responsibility for banking problems is federal; in contrast, in the EU responsibility for banking losses remains national. As Gros says in his text, insolvent banks in Nevada were seized by the Federal Deposit Insurance Corporation, which covered the losses and transferred the operations to stronger banks, all without any disruption to Nevada's banking system. In short, the rescue mechanism in Nevada is automatic, removed from political decisions and has no *ex ante* winners or losers. Its automaticity speeds up the decision-making process and prevents countries from defending their own national positions. This automaticity is precisely what a European deposit guarantee fund would need.

We need to put an end to the idea of the Banking Union being a question of solidarity. It is not a north–south transfer mechanism, and history shows that no country is safe from banking crises that affect not only their financial stability but also their partners'. The success of the Banking Union is a question of efficiency, and until it is completed with a European deposit guarantee fund we will not be able to benefit from the single currency's full potential. Furthermore, we will not be able to ensure optimum functioning of the monetary policy transmission mechanisms, nor will we be able to prevent episodes of financial fragmentation such as those which followed the 2008 crisis.

This full version of the Banking Union should be the end, at least for the time being, of the debate on a fiscal union. A Banking Union that works through automatic mechanisms, independent of politics, with no *ex ante* winners or losers and with a single supervisory authority would probably produce similar results to more profound versions of fiscal integration which, we should remember, would be politically unviable.

Conclusion

Given that some versions of a fiscal union are not feasible in the short and medium term, keeping open the debate on creating a fiscal union results in two regrettable outcomes:

- First, it creates a distortion in the assignment of responsibilities, and this confuses citizens. The responsibility for the economic crisis was mainly national; therefore, solutions must also be national. Identifying a fiscal union as the solution to all the problems in Europe is indeed a mistake. The member states cannot continue to shift the responsibility for economic growth to the ECB or to a fiscal union that is politically unviable. The structural economic reforms needed to support economic growth and job creation in the long term must be taken at a national level.
- Second, it leads to unrealistic expectations which slow down and even paralyse the decision-making process on fundamental issues that, if resolved, would contribute to better economic integration. Considering the fiscal union as a necessary and natural consequence of the Banking Union is a big mistake. Such a move has been immediately rejected by some member states, especially Germany, and has thus prevented the putting forward of more limited and viable versions of risk mutualisation that would be acceptable to all member states.

The EU cannot continue to take steps forward without consolidating those it has already taken. Completing the Banking Union by adding a European deposit guarantee fund is the most important step, as this article notes. There are also other challenges, such as completing the single market and establishing free trade with other economic areas to create sufficient and sustainable growth. It must be tangible results that convince Europeans of the need for more Europe, and not flirtations with unworkable ideas.

References

Bank for International Settlements. (2011). *Basel III: International regulatory framework for banks*. Basel: Bank for International Settlements Communications. http://www.bis.org/bcbs/basel3.htm. Accessed 15 March 2017.

Dabrowski, M. (2015). *Monetary union and fiscal and macroeconomic governance.* European Commission, Discussion Paper 013. http://ec.europa.eu/info/sites/info/files/file_import/dp013_en_2.pdf. Accessed 15 March 2017.

European Commission. (2015). *Towards the completion of the Banking Union*. Communication, COM (2015) 587 final, 26 November.

Eurostat. (2016). Government debt up to 91.7% of GDP in euro area. News release, Euroindicators 147/2016 (22 July). http://ec.europa.eu/eurostat/documents/2995521/7573561/2-22072016-AP-EN.pdf/16cdaec5-3f1c-4cab-a8cf-954b917e04a9. Accessed 11 March 2017.

Fondation Robert Schuman. (2011). Declaration of 9th May 1950 delivered by Robert Schuman. *European Issue*, *204*(May). Paris. http://www.robert-schuman.eu/en/doc/questions-d-europe/qe-204-en.pdf. Accessed 2 March 2017.

Gros, D. (2012). *Banking union: Ireland vs. Nevada, an illustration of the importance of an integrated banking system*. CEPS Commentary. Brussels. https://www.ceps.eu/system/files/DG%20Banking%20Union%20NEV%20vs%20IRL.pdf. Accessed 11 March 2017.

Juncker, J.-C., Tusk, D., Dijsselbloem, J., Draghi, M., & Schulz, M. (2015). *Completing Europe's Economic and Monetary Union*. European Commission. Brussels. https://www.ecb.europa.eu/pub/pdf/other/5presidentsreport.en.pdf. Accessed 15 March 2017.

Schoenmaker, D., & Gros, D. (2012). *A European deposit insurance and resolution fund*. CEPS Working Document no. 364. Brussels. https://www.ceps.eu/system/files/WD364%20European%20Deposit%20Insurance.pdf. Accessed 11 March 2017.

Schoenmaker, D., & Wolff, G. (2015). What options for European deposit insurance? *Bruegel.org*, 8 October. http://bruegel.org/2015/10/what-options-for-european-deposit-insurance/. Accessed 11 March 2017.

Miguel Marín Cózar *is an economist, and the founder and chief executive officer of AEI-Análisis Económico Integral. He is also responsible for economy and public policy at Fundación para el Análisis y los Estudios Sociales. He has been an adviser to the economic department of the Popular Parliamentary Group in the Spanish Congress and to the Spanish prime minister. He has also advised the European Parliament Committee on Economic and Monetary Affairs.*

EUROPEAN VIEW (2017) 16:33–43
DOI 10.1007/s12290-017-0430-1

ARTICLE

'Euro 2.0': a preliminary assessment of the European Banking Union and a market-oriented monetary alternative

Juan E. Castañeda

Published online: 22 May 2017

Abstract The architecture of the original euro was flawed, and so was the commitment of the EU member states to abide by fiscal orthodoxy. However, both did convey sound monetary principles, these being (1) to preserve the purchasing power of the euro and (2) to isolate it as much as possible from political pressures. As evidenced in the euro crisis, both EU member states and European institutions have committed to maintaining the euro via further integration and the growing centralisation of monetary and fiscal powers in EU institutions. The European Banking Union is one example of this commitment. This article argues that these changes have paved the way for the creation of another modern-state currency: a currency that belongs to a supranational state and that is ultimately linked to an ever-growing supranational treasury that works hand in hand with the central bank. This article offers a more market-friendly monetary alternative to such an arrangement.

J. E. Castañeda (✉)
Institute of International Monetary Research and University of Buckingham, Hunter Street Campus, Buckingham MK18 1EG, UK
e-mail: juan.castaneda@buckingham.ac.uk

Keywords Monetary competition | Parallel currencies | Euro crisis | European Banking Union | European Central Bank

Introduction: the European Banking Union as 'euro 2.0'

The recent global financial crisis has shown quite strikingly the weaknesses in the eurozone's original institutional architecture. Moreover, the crisis has revealed—to put it mildly—the deficiencies of the eurozone as a fully functional currency union. The institutions and rules that governed the eurozone before 2007 have for the most part been neglected or superseded since then. In fact they have been substituted for a new set of rules and instruments in the aftermath of one of the most severe financial crises experienced in the last century, and the subsequent sovereign debt crisis in Europe (i.e. the 'euro crisis'). It was in this troubled and very much uncertain environment that the European institutions and the EU member states agreed on the establishment of (1) tighter fiscal discipline, (2) macroeconomic surveillance of all member states by the European Commission (the 'Fiscal Compact'[1] and the 'Six-Pack') and (3) the creation of the European Banking Union (EBU). On top of this, the desperate actions that the European Central Bank (ECB), European Commission and member states took during the crisis to rescue the euro actually had the effect of—by the back door—watering down, if not completely neglecting, some of the key pillars of the constitution of the European Monetary Union. This applies, in particular, to two of the main rules approved in the legal foundations of the euro (see Articles 123 and 125 of the Treaty on the Functioning of the European Union): the prohibitions on bailing out a member state in crisis and on (direct) lending by the ECB to public institutions and governments, that is, the monetisation of public deficits.

The EBU was instituted to tackle two major destabilising phenomena experienced during the euro crisis. The first was the vicious circle triggered by a failing banking sector and the deterioration in public finances. This problem arose because governments bailed out banks in crisis with taxpayers' money, resulting in higher borrowing costs and poorer macroeconomic performance, and ultimately leading to sovereign-debt crises. The second phenomenon was the contagion effect of banking and sovereign-debt crises across the eurozone. The Greek crisis (2009–present) provides a clear example. With its relatively small economy (amounting to less than 2% of the GDP of the eurozone), Greece posed a real threat of liquidation to the euro as a whole. As explained later in this article, the contagion of the crisis was neither unforeseeable nor unavoidable. It occurred, to a great extent, because the crisis was very badly managed, but also because the EU institutions and member states chose to tackle the crisis by creating a highly 'political' euro[2] as a means to foster a more politically integrated and, indeed, centralised EU.

[1] See a summary in European Central Bank (2012, 101–102).

[2] Of course the euro always was, above all, a political project (see Schwartz 2004).

The rationale of the EBU: centralisation and bail-ins rather than bailouts

The EBU's new institutions and procedures have assigned to the supranational level, first, banking supervision and regulation powers, but also responsibility for dealing with the recovery or the resolution of a bank in crisis. Very briefly, the main elements of the EBU are as follows:

- The establishment of the European Banking Authority, which oversees the implementation of the new Basel III[3] bank capital ratios and the liquidity ratio across all member states.
- A new banking regulator (governed by the Single Supervisory Mechanism) for 'big banks' and transnational banks in the eurozone, which is in the hands of the ECB in Frankfurt. These banks represent around 80% of the total in the eurozone, and the remaining national banks will continue to be supervised by the national central banks or by other national institutions.[4] In addition, the new Single Resolution Mechanism has been established to deal with the recovery or resolution of a bank in crisis. Thus it is no longer the national government or the national institutions where the bank in crisis is based that will make the decisions as to its recovery or final resolution, but a supranational body, the Single Resolution Authority (SRA).
- To fulfil the new EU Recovery and Resolution Directive (European Parliament and Council 2014), every bank must draft a resolution plan (a sort of 'bank will'), to be approved by the regulator, so that, if need be, banks can be resolved in an orderly and timely manner. Most importantly, should a bank under the jurisdiction of the Single Supervisory Mechanism need to be resolved, the member state will not be able to resort to using taxpayers' money to fund a bailout. Rather, the resolution and the recovery procedures will be handled by the SRA, and only when the bank's shareholders and creditors' money have been mostly exhausted—that is, when they have absorbed losses of at least 8% of the total liabilities—will the bank be eligible for other sources of funding (such as the new Resolution Fund, see below). This is what the literature calls a bail-in approach, in contrast to the idea of bailing out the banks with taxpayers' money in the first place, as we have seen happen in the recent crisis.
- Member states have agreed to guarantee deposits of up to €100,000 per depositor per bank. While this is consistent across the EU, it is a national guarantee backed by the member states and not a mutualised pan-European insurance scheme, such as the Federal Deposit Insurance Corporation established in the US during the Great Depression (1933). The distinction is very important, as a pan-EU mutu-

[3] Basel III is a set of tighter bank capital and liquidity regulations approved by the Basel Committee on Banking Supervision (Bank for International Settlements) in the midst of the global financial crisis. For further information, please see Bank for International Settlements (2017).

[4] Regardless, the national regulators would make these decisions in cooperation with the ECB, which would be able to directly supervise these banks at any time if it deemed it necessary.

alised insurance scheme would mean that all member states would contribute to a common fund, which would be used to support the depositors of any bank based in their own country or elsewhere in the EU.

- There is a final element of the EBU that is tantamount to the definition of an effective modern central bank in a fractional reserve banking system: the lender of last resort function of central banks. If a bank is solvent but illiquid, and thus is temporarily unable to pay its liabilities, the bank can always request extraordinary lending from the central bank. This is how Bagehot (1873) put it in his seminal book, *Lombard Street*: if a liquidity crisis occurs, the central bank should readily provide unlimited lending to the bank in crisis, but always against collateral and at a penalty rate (i.e. the so-called discount rate, which is higher than the normal policy interest rate).
- However, we should not forget that this competence is still in the hands of the national central banks in the eurozone. Provided that there is no objection from the ECB, these central banks can lend money to the bank in crisis on request (Lastra 2016). This division of competences between the ECB and the national central banks needs to be properly coordinated so that a banking crisis cannot be artificially 'hidden' or unnecessarily postponed by the provision of liquidity from the national central bank; this would only delay the necessary injection of capital into the banking system.[5]

It is clear that the new institutions and regulations listed above imply the delegation of greater competences to supranational institutions, and thus opting for the creation of a more centralised currency union. We will elaborate further on what this means and the alternatives in the sections below.

A functional Banking Union?

It is worth mentioning that, whether the preference is for a more market-friendly, decentralised form of monetary integration that is in favour of currency competition or a more conventional one currency–one state model, we must consider the following caveats as regards the EBU. First of all, the banking union as a whole, and more crucially the new Resolution Fund (paid for by the banks and totalling no more than 1% of the banks' guaranteed deposits), will not be completed and thus will not be fully operational until 2024. Should a banking crisis occur in the meantime, the banking sector itself will not have raised enough funding to cover the banks' liabilities, and thus will not be able to fund or pay for the actions dictated by the European regulators. Consequently, at least until its full implementation, we cannot dismiss the idea of taxpayers' money being used in the eventuality of a banking crisis.

[5] Moreover, the misuse of the provision of liquidity at the national level may well affect the outcome of the decision of the Single Resolution Mechanism later on as regards the recovery or liquidation of the bank (see Huertas 2016 for further details).

But even if the Resolution Fund were readily available in full, the procedures approved to deal with a crisis have yet to be tested, and may turn out to be too complicated and impracticable; they involve many policy actors and both national and supranational institutions. As has been very well summarised by Huertas (2016, 28–33), when the SRA adopts a resolution scheme, if the Commission objects to all or some of the points under the scheme, it has only 12 hours to draft an alternative proposal, which the European Council then has to make a decision on. Finally, the SRA has only eight hours to revise the new scheme. The test to prove the commitment of these new institutions to both the application of the bail-in option, and the timely resolution of insolvent banks, will not be definitive until we experience the next banking crisis.

Finally, and most importantly, the EBU does not resolve the fundamental underlying problems of the eurozone. As measured against any conventional economic standards, the euro is a malfunctioning currency or, in technical jargon, a 'non-optimal' currency *à la* Mundell[6] or Fleming. This is evidenced by the volatility of a wide range of indicators, including consumer price index inflation, real GDP growth, unemployment rates, labour costs, real exchange rates, and public deficit and debt figures across all the eurozone member states. By considering the dispersion of these indicators as a whole, Castañeda and Schwartz (2017) have produced several indices of monetary integration in Europe which conclude that the euro area did not become more integrated between 1999 and 2007, as it had been presumed would be the case by the architects of the euro, and that it has become less integrated since (these are the so-called internal asymmetries amongst member states).[7] If the EBU is successful, it may well contribute to breaking the fiscal–banking crisis loop and thus to better public finances in a banking crisis. However, it does not tackle the differences in competitiveness and productivity—and, in turn, the dysfunctional labour and goods and services markets—in the eurozone; these are problems that the EBU cannot and is not designed to tackle at all.

'Euro 2.0': the 'one currency–one central bank–one treasury' model

As José M. González-Páramo (a former member of the ECB Executive Council) put it very recently,[8] what the EBU actually means is the strengthening of the euro, 'euro 2.0' as it were, as it remedies some of the operational flaws and institutional weaknesses of the original euro as designed in the 1990s. True, the EBU adds consistency and predictability to the supervision and resolution of big or systemic banks in the eurozone. At least on paper, it will also make the banks pay for the losses resulting from a bank failure before resorting to any other funding, let alone taxpayers' money. In this sense,

[6] One of whose articles became the founding basis for the literature on optimal currency areas (see Mundell 1961).

[7] A good indicator to capture these imbalances is the Target-2 balances across the member states. See European Central Bank (2017).

[8] See his introductory words in González-Páramo (2017).

technically speaking, it is an improvement, as it helps to create a more consistent and credible institutional setting. However, it comes at a cost that must not be overlooked.

The original euro (i.e. 'euro 1.0', 1999–2011, when the new institutions and rules were mainly launched) meant the birth of a new—pan-European—currency, with no single treasury backing the currency or any truly credible governing rules, particularly ones related to maintaining fiscal discipline across the member states.[9] It heralded the establishment of a single currency with no fiscal counterpart nor—as shown in the mid-2000s and even more so during the euro crisis—any credible fiscal discipline, and thus it was a recipe for disaster. This is a key point that we need to clarify before proceeding further: a supranational currency without full fiscal backing, such as the euro, can only succeed over the long term if member states in crisis are not bailed out. Without this rule, there are no credible incentives not to overspend, so the costs of the deficit are ultimately shared by all member states. Crucially, it is this rule that EU institutions and member states failed to implement both before and during the euro crisis.

In view of this, the solution adopted with the 'new euro', supported by the EBU, of more fiscal discipline and more surveillance from supranational institutions, fits much better with the creation of a national currency for a more centralised EU state, and thus has paved the way for more fiscal integration in Europe. Within this rationale and this overriding political aim, the new euro consolidates the establishment of a truly national currency working hand in hand with the other political institutions of the EU and the national treasuries. However, while technically more consistent—in fact, the model used by any other modern nation-state—it also means the definitive abandonment of the founding economic principles of the original euro, which focused on preserving its purchasing power and, crucially, ensured it was isolated as much as possible from political interference and the financial pressures of the national and EU treasuries. We will return to this key debate in the final section of the article.

Currency models in dispute: the weaknesses of a 'political' euro

It is true that no *currency union* has survived for long without a political union or a supranational treasury with the powers to back the currency. However, this applies specifically to currency unions ultimately aimed at establishing a national currency in a single state, and not necessarily to *monetary unions* of sovereign states. This difference is at the core of the debate surrounding the definition of the type of euro we want, and indeed explains the flaws of the euro during the 2008–2009 global financial crisis and helps us to understand the policy decisions taken afterwards.

The classical gold standard (1870s–1913) has been taken as a benchmark for comparison with the current 'euro standard' (see, amongst others, Crafts 2014; Morys

[9] The reform of the Stability and Growth Pact in 2004, which actually meant the relaxation of fiscal discipline even more, was proof of the failure to apply credible fiscal rules across the member states.

2014). However similar the regimes, the gold standard was clearly a monetary union, where sovereign member economies fixed their currencies against gold, but crucially retained their national currencies in circulation. In contrast, the euro takes the process a step further, as it is effectively a currency union, in which the participating countries have completely eliminated their national currencies and adopted a *single* currency for all. This distinction is not at all trivial and particularly matters in times of severe crisis: a currency union is more stringent and demanding, since member states have no room to alter the parity of the currency. Even more significantly, according to current EU legislation a member state cannot abandon the eurozone, either on a temporary basis or permanently, without also leaving the EU itself. This makes the adjustment to a major crisis very much limited to what has been called an 'internal devaluation': in a nutshell, member states have no other option but to cut costs and prices in an effort to gain competitiveness and thus reduce trade deficits.

Based on the calculations provided in Castañeda and Schwartz (2017) as to the differences in competitiveness across the eurozone, an internal devaluation was indeed necessary to address the fundamental competitiveness problems in those EU economies which suffered the most from the crisis. Some of these economies, with Spain being a positive case study to consider so far, have successfully cut internal costs and prices and have turned a double-digit current account deficit into a surplus within a few years. Nevertheless, as seen in the euro crisis, this is an option that has proven not just painful but politically unfeasible if applied for a long time; EU populations do not seem prepared to accept such situations any longer. Economies' structural weaknesses cannot be addressed in a timely manner by simply applying internal devaluation measures such as a fundamental restructuring of prices and costs in the economy. To give an idea of the scale of the problem, in 2012, at the time of the negotiations for the third bailout, the price and cost adjustments required in the Greek economy were estimated to be in the region of 40%–60% (as quoted in Schwartz et al. 2013). And this is where the distinction with other, more flexible, monetary arrangements matters: under a monetary union, countries can temporarily suspend the exchange rate commitments, change the terms of the commitments and even abandon them more easily if need be. Such suspensions and realignments[10] did occasionally happen during the classical gold standard years and helped countries to overcome major disequilibria in a smoother and more timely manner.

An alternative system: a more solid currency, governed by the market

Under free-floating and competing currencies—for example, a parallel monetary system, with the circulation of both the national currency and the *common* euro—cost and

[10] This is not at all a plea for inflationary devaluations; all devaluations achieve is to ease the adjustments that the economy must go through anyway. If the suspension of the parity or currency devaluation is not followed by fiscal adjustment, cuts in costs and a monetary policy committed to maintaining the purchasing power of the currency, the devaluation will soon result in even higher inflation and greater losses in competitiveness.

price adjustments would be made on a daily basis by market participants, preventing the accumulation of such structural disequilibria amongst member states. The fluctuations in the exchange rate of the national currency and the euro would convey the markets' assessment of the credibility of the currencies. As we have seen, such diverse economies as those in the eurozone, with clearly insufficient labour mobility across borders, as well as such different monetary traditions and economies, find it extremely difficult to remain operational under a fixed—and irrevocable—exchange rate. The accumulation of internal imbalances in such a scenario is inevitable and thus, from time to time, there is a need to bail out economies unable to commit to the euro standard. The original euro (1999–2011) did offer a solution for this: the prohibition of both bailouts and the monetisation of the deficit, which meant that a member state unable to fulfil its monetary and fiscal commitments would have to leave the euro. But of course we have seen an overriding political desire in Europe to rescue all eurozone countries in need, which worsened[11] the euro crisis and ultimately paved the way for more centralisation and political union.

Alternatively, under a more decentralised and competitive monetary system, such as a parallel currency system (see Vaubel 1978; Schwartz et al. 2013 for a restatement), money users would choose one or another currency according to their credibility and purchasing power. And by so doing, they would be imposing the discipline needed to ensure that the central bank (either the ECB or the national central banks) did not overissue the amount of money in circulation. In such a system, agents may well use a different currency for different purposes; there are plenty of examples of such regimes in modern monetary history, as well as in the present.[12] Within this system, it would be for the national governments to choose how to regulate the banking sector, and to decide whether the central bank could or could not monetise the deficit. Ultimately, it would be the greater or lower demand for the currency that would keep governments and central banks in check. Of course in such a competitive system no banking union or bailouts would be needed, as each country would bear the consequences of its own policies in the form of a failing currency and an inflationary economy. In the event of a member state inflating its national currency, money holders would switch to the common currency and leave the government with no seigniorage (i.e. the money issuer's revenues, broadly defined as the difference between the nominal value of the currency and its cost of production). Ultimately, this would lead to the depreciation of the national currency and a government with virtually no access to capital markets in that currency; a severe crisis indeed, but one without contagious effects for the rest of the member states. Following Vaubel's (1978) seminal book, even if the will of the architects of the euro was—as it was—to create a *single* currency for all, it would have been better to introduce it

[11] Arguably, a timely and firm decision by the member states in 2009 to abide by these rules would have enhanced the credibility of the eurozone institutions, and very probably aborted the long-lasting contagion effect of the Greek crisis.

[12] See, for example, Castile in the modern era, with the 'maravedí' used as a unit of account for international trade, both in silver and gold coins and the newly-minted silver-copper coin in the early seventeenth century; and the 'vellón' coin, which was used for smaller payments and was later devalued as it was entirely made of copper. Today there is effectively a two-currency monetary system in Peru, with the US dollar used for saving, trade and investment, and the Peruvian sol used for smaller payment transactions.

through currency competition with the circulation of a *common* currency alongside the national ones, as this would have eventually allowed for a smoother transition and the non-political selection of the members of the eurozone. If not to the existing eurozone economies, this system could be usefully applied to eurozone candidate countries in the future.

There are other—'milder'—options that would achieve a more flexible, more functional and stronger euro over the long term. For example, there are many countries where agents can write a contract or make a payment in any currency accepted by the parties (amongst others Guatemala, which enjoys a remarkable inflation record in Latin America). If only this measure were used, it would provide an incentive both for central banks to run a sound monetary policy and for governments to keep public spending in check and not monetise recurrent deficits. In the absence of a legal tender currency, but with several currencies readily available with which to make payments, money holders (ultimately creating the demand for different currencies) would choose one or another currency for use in their contracts, depending on each currency's purchasing power. And the less stable the value of the currency and the more inflationary the currency becomes over time, the less attractive it would be to businesses and households, which would ultimately reduce the demand for the currency and thus the monetary profits of the issuer (the seigniorage), whether the government, the central bank or any other money provider. This market discipline would ensure that governments would not overspend nor ask 'their' central banks to monetise public deficits, as people would quickly stop using their currency.

Concluding remarks

The architecture of the original euro was flawed and incomplete, and so was the commitment of the member states to abide by fiscal orthodoxy. However, both did convey sound monetary principles, these being (1) to preserve the purchasing power of the euro, and (2) to isolate the euro as much as possible from political pressures. As evidenced in the euro crisis, member states and European institutions have committed to maintaining the euro 'whatever the cost', mainly via further integration and the growing centralisation of monetary and fiscal powers in EU institutions. While this has clarified and enhanced the institutional robustness of the euro, it has also meant a profound change in the economic foundations of the euro as established in 1999. It has revealed once more the willingness that has always existed to create a modern state with its own currency, ultimately linked to an ever-growing supranational treasury that works hand in hand with the central bank—that is, just another modern-state currency.

References

Bagehot, W. (1873). *Lombard Street. A description of the money market*. New York: Wiley.

Bank for International Settlements. (2017). *Basel III: International regulatory framework for banks*. http://www.bis.org/bcbs/basel3.htm. Accessed 6 April 2017.

Castañeda, J., & Schwartz, P. (2017). *Index of European monetary integration*. Institute of International Monetary Research. http://www.mv-pt.org/staff-research. Accessed 3 April 2017.

Crafts, N. (2014). What does the 1930s' experience tell us about the future of the eurozone? *Journal of Common Market Studies, 52*(4), 713–27.

European Central Bank. (2012). *Monthly bulletin, March 2012*. Frankfurt Am Main.

European Central Bank. (2017). *TARGET balances of participating NCBs.* https://www.ecb.europa.eu/stats/policy_and_exchange_rates/target_balances/html/index.en.html. Accessed 1 April 2017.

European Parliament and Council. (2014). Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms. OJ L 173 (12 June), 190–348.

González-Páramo, J. M. (2017). 'El futuro de la Unión Bancaria Europea y la City de Londres después de Brexit' [The European Monetary Union and the City of London after Brexit]. Speech at Fundación Rafael del Pino, Madrid, 2 March. http://www.frdelpino.es/en/video/futuro-la-union-bancaria-europea-la-city-londres-despues-brexit/. Accessed 3 April 2017.

Huertas, T. (2016). Banking union. The way forward. In J. Castañeda, D. G. Mayes, & G. Wood (eds.), *European Banking Union. Prospects and challenges* (pp. 23–37). London: Routledge.

Lastra, R. (2016). Lender of last resort and banking union. In J. Castañeda, D. G. Mayes, & G. Wood (eds.), *European Banking Union. Prospects and challenges* (pp. 109–28). London: Routledge.

Morys, M. (2014). Gold standard lessons for the eurozone. *Journal of Common Market Studies, 52*(4), 728–41.

Mundell, R. (1961). The theory of optimal currency areas. *American Economic Review, 51*(4), 657–65.

Schwartz, P. (2004). *The euro as politics*. IEA Research Monograph 58. London.

Schwartz, P., Cabrillo, F., & Castañeda, J. (2013). Saving monetary union? A market solution for the orderly suspension of Greece. In P. Booth (ed.), *The euro—the beginning, the middle, and the end?* (pp. 123–46). London: IEA.

Vaubel, R. (1978). *Strategies for currency unification: The economics of currency competition and the case for a European parallel currency*. Tübingen: J. C. B. Mohr.

Juan E. Castañeda, *who has a Ph.D. in economics, is the Director of the Institute of International Monetary Research and a lecturer in economics at the University of Buckingham. He has experience of working in and researching monetary policy and central banking, and has collaborated with the European Parliament's Committee of Economic and Monetary Affairs.*

EUROPEAN VIEW (2017) 16:45–56
DOI 10.1007/s12290-017-0433-y

ARTICLE

Structural reforms in the euro area: a Greek view

Michael G. Arghyrou

Published online: 24 May 2017

Abstract Events in recent years have put the European economic integration project and the euro under pressure. The main cause of the euro crisis is loss of competitiveness, particularly on the periphery of the Economic and Monetary Union. To reverse this, Union members must promote structural reforms that increase long-term employment, productivity and external competitiveness. The successful implementation of reforms, however, requires sufficient public support, which in turn presupposes measures that support demand during the implementation of reforms. To that end, important steps include taking an expenditure-based approach to fiscal adjustment and the introduction of the European Deposit Insurance Scheme. And for Greece in particular, the set of necessary steps includes taking ownership of reforms, the downward revision of fiscal targets, and medium- and long-term measures of debt relief conditional upon meeting fiscal/reform targets. Finally, the stability of the euro hinges on the moderation of all fiscal and external imbalances across all member states, regardless of whether these imbalances are apparent or not.

M. G. Arghyrou (✉)
Cardiff Business School, Cardiff University, Aberconway Building, Colum Dr, Cardiff CF10 3EU, UK
e-mail: ArghyrouM@cardiff.ac.uk

Keywords Economic and Monetary Union | Greece | Structural reforms | Demand | Expectations | European Deposit Insurance Scheme | Primary surplus | Debt relief

Introduction

The European economic integration project is a cornerstone of lasting peace for the European continent. This is sufficient reason to advocate strongly for its continuation. Nevertheless, events in recent years have put it under pressure. The most prominent manifestation of this has been the UK's decision to leave the EU. In other countries, populist and/or extremist anti-EU parties have made electoral advances; and even voters for mainstream pro-EU parties report increasing dissatisfaction with the EU (Oliver 2016).

While each country has idiosyncratic features contributing to the increasing prevalence of Euroscepticism, there are two common economic factors. The first is the effects of globalisation on world income distribution (see Milanovic 2016). During 1988–2008 average global income increased and the variance in income distribution declined. However, individuals who in 1988 were placed between the distribution's seventy-fifth and eighty-fifth percentile experienced income stagnation or reduction. Seventy per cent of the people in this category are residents of Western countries occupying places in the lower half of their nation's income distribution. The stagnation/decline of their living standards, combined with large income gains for the top percentile, which is associated with political and economic elites, have left large sections of European societies with a sense of insecurity and injustice. This provides ground for populist/extremist parties to claim that reversing globalisation will be enough to restore the previous norm. In this over-simplistic analysis the EU is identified with globalisation and thus receives reduced endorsement.

The second factor is the European debt crisis, which has divided the euro area into two groups. The first includes debtor countries that have been cut off from international bond markets and, as a result, have received official financial assistance conditional upon implementing programmes of economic adjustment. Greece is the most prominent example of this group. The second group includes creditor countries, which have underwritten the assistance programmes provided to the first. In countries such as Greece dissatisfaction with the EU is driven by the adverse effects on welfare of adjustment programmes and a sense of reduced national sovereignty due to the direct involvement of the EU and other international bodies (e.g. the International Monetary Fund) in national economic policy. In creditor countries, dissatisfaction is the result of a sense of the involuntary use of national and private savings to rescue Economic and Monetary Union (EMU) partners that are perceived as imprudent. Starting from opposite reference points, public opinion in both groups converges on a common ground: Euroscepticism.

The two factors explained above are not unrelated. They share a common economic source, namely competitiveness losses in many EMU economies, particularly those on the periphery. These losses will not be reversed if the EMU embarks upon a protectionist course and/or some EMU countries leave the euro. Economic theory and historical experience tell us that free trade promotes production efficiency and welfare standards, and living standards in the long run are determined by an economy's production capacity, that is, its supply side, on which monetary policy has no lasting impact. The only credible answer to Europe's economic and political problems is structural reform, and it is on this that the euro's sustainability ultimately depends.

Having said that, international experience also tells us that a successful programme of reforms requires the support of a critical mass of the population. For this to be in place the latter must perceive reforms to be beneficial and realistic, that is, their adjustment welfare cost should not be regarded as socially untenable. This, in turn, presupposes that until reforms yield positive output effects, economic activity is adequately supported by the demand side. With an emphasis on Greece, this article discusses the reforms necessary in the EMU countries and analyses the demand-supporting conditions that would enable their successful conclusion.

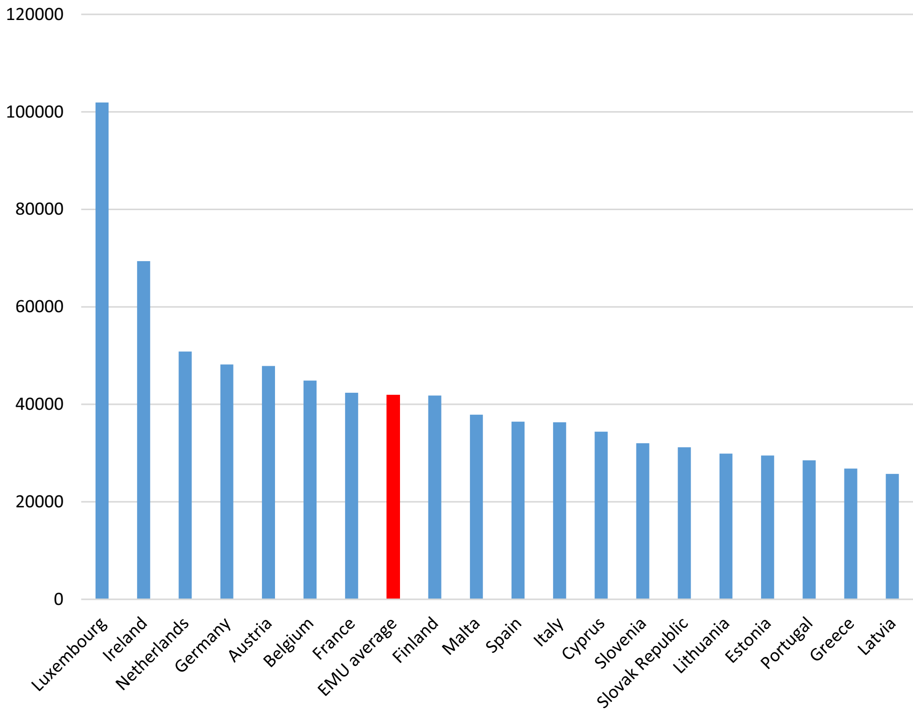
Structural reforms

Despite evidence of increased economic convergence among EMU members since 1999, the EMU continues to be divided between a core and a periphery (Campos and Macchiarelli 2016), deviating from the conditions set by the theory of optimum currency areas for the smooth operation of a single currency. The core–periphery divide is manifested in per capita income statistics (see Fig. 1) and was highlighted during the crisis, when periphery countries experienced significantly higher output losses. The policy implication of this experience is uncontroversial: for periphery countries to catch up with their core partners and upgrade their economy's capacity to withstand future crises, they need to promote supply-side policies that enhance their economies' flexibility, external competitiveness and production capacity (natural output).

Modern macroeconomics (see Corsetti and Pesenti 2009) suggests that natural output increases with long-term employment and productivity levels, while competitiveness gains involve a reduction of goods and services prices relative to those of trading partners. Long-term employment is a function of both competition in the goods and services markets and the quality of human capital. Productivity depends on human capital and capital investment, for which institutional performance across a range of areas (e.g. taxation, political stability, the rule of law and protecting property rights) is of crucial importance. Finally, external competitiveness increases with lower marginal production costs and lower mark-ups on marginal costs. The latter, in turn, are determined by the degree of competition in the goods and services markets, non-labour costs and indirect taxation. All of the above should be top policy priorities for EMU countries to engage with in future years. The example of Ireland shows that putting in place a flexible, institutionally credible and friendly-to-business environment creates long-term output gains, an ability to quickly overcome crises and a more equal distribution of income.

Ireland's experience is the most relevant for Greece, the country presenting the biggest potential for supply-side improvements in the EMU area, as suggested by its

Figure 1 Gross domestic product based on purchasing-power parity per capita GDP, US dollars in 2015.



Sources: International Monetary Fund (2016).

position in numerous international rankings relating to supply-side performance. On this front, Greece made significant progress in the period 2012–14 (see Arghyrou 2014). In 2015–16, however, this progress ended. The stagnation in which the Greek economy currently finds itself highlights the importance of resuming the process of reform.

Supporting reforms through demand

Structural reforms cause immediate welfare losses to be offset by higher benefits in the future. This is why reforms should be pursued during periods of growth, to moderate their short-term welfare impact. Unfortunately, political considerations often get in the way, resulting in reforms being pursued during recessions when accumulated imbalances make their implementation urgent. The experience of the European periphery is a prime example. But bygones are bygones. European economies must now move on with reforms. In this effort, their prospects for success will improve substantially if demand conditions are as supportive as they can be during the implementation of reforms. To that end, the following factors are important.

Optimal prioritisation

To maximise their effectiveness, reforms should be optimally prioritised. Existing literature (see OECD 2016) suggests that in periods of low demand, priority should be given to reforms that remove barriers to entry in the goods and services markets and to those that increase labour mobility. In addition to increasing natural output, such reforms have a positive effect on demand, increasing disposable incomes and the endorsement of reforms by the general public. In the context of the EMU, and as the theory of optimum currency areas suggests, flexible goods and labour markets are even more important for closing output gaps due to the absence of national monetary policies. Furthermore, in a low demand situation reforms facilitating infrastructure investment are also important for sustaining incomes. EU financing, available through European Structural Funds, the European Fund for Strategic Investment, the European Investment Bank, and the European Bank for Reconstruction and Development, provides such opportunities. In the particular case of Greece, financing from these sources is gradually gathering momentum. This is a positive development; however, on its own it is not enough to address Greece's long-term supply and short-term demand problems.

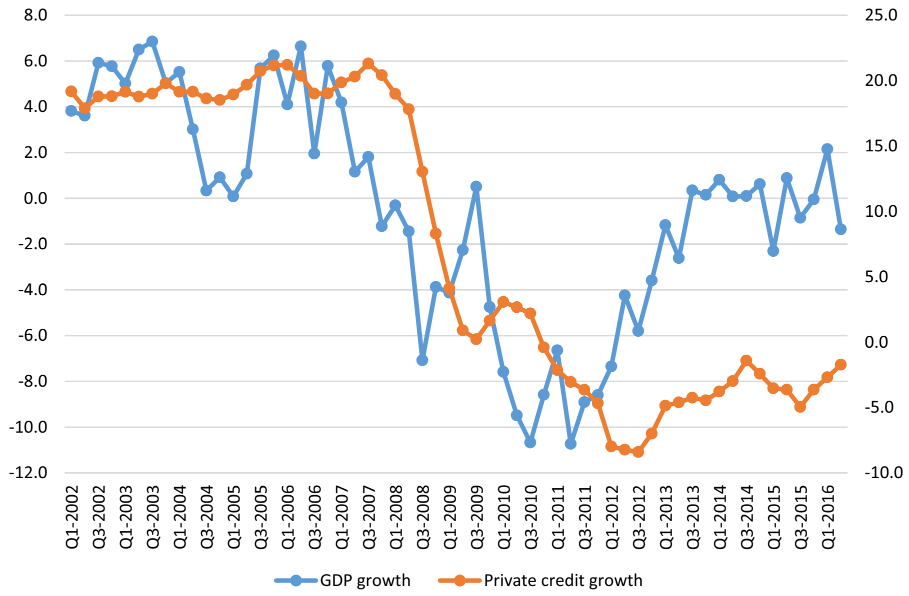
Favourable expectations

Demand conditions depend on the regime of expectations under which reforms are implemented. High confidence in the successful conclusion of reforms accelerates positive private responses to reform policies (through investment and consumption), triggering a virtuous circle of mutually enforcing expectations, increased demand and endorsement of reforms. Low confidence causes the opposite dynamics.

Improving expectations depends on two factors. The first of these is the national authorities taking ownership of the reforms. A lack of ownership causes implementation risk, restricting investment and consumption spending, which compromises the endorsement of reforms and reinforces implementation risk. EMU countries whose authorities took ownership of reforms (Ireland, Portugal and Cyprus) have concluded their assistance programmes successfully and returned to positive growth. In Greece, when ownership of the reforms has been absent, between 2009 and 2011 and from 2015 to the present, economic developments have been negative. By contrast, in 2012–14, when authorities assumed ownership of the reforms, the economy made significant progress (see Arghyrou 2014).

Second, credible crisis-prevention and crisis-management mechanisms are needed at the EMU level. These are necessary to reassure markets that the probability of major national banking and fiscal crises is limited and that, if they happen, they will not spread to the economy's real sector and/or to other countries. To that end, a number of

Figure 2 Growth rates for real GDP and bank credit to the private sector in Greece. GDP growth rates are measured on the left vertical axis; bank credit growth rates are measured on the right vertical axis.



Sources: GDP growth rates: International Monetary Fund (2017). Private bank credit growth: Bank of Greece (2017).

institutional changes have taken place, including the creation of a new macro-prudential framework, risk-sharing fiscal funds (the European Financial Stability Facility and the European Stability Mechanism), the Outright Monetary Transactions programme and the European Banking Union (EBU), which involves centralised bank supervision and resolution. These are steps in the right direction, both in terms of increasing risk-sharing and reducing moral hazard; however, they are not enough to deliver the necessary improvement in expectations (see Arghyrou 2015a). This is because many decisions continue to be subject to political discretion and the new institutional infrastructure remains incomplete. This was fully grasped by the *Five Presidents' Report* (European Commission 2015) which, among others, highlighted the importance of complementing the EBU through the introduction of a European Deposits Insurance Scheme (EDIS) and increased fiscal integration.

Liquidity and EDIS

The importance of liquidity for business-cycle movements has been well established since the 1960s, documented by the writings of Milton Friedman (1963), founder of the monetarist school of economics. Figure 2 offers evidence from Greece, depicting a strong positive correlation between the growth rates of real GDP and the provision of bank credit to the private sector. Although in the long run money is neutral, it is a potent stabilisation tool for closing negative output gaps. This approach underlies the monetary policy followed by the European Central Bank (ECB) since summer 2007, including the Quantitative Easing (QE) programme implemented since January 2015 (see Draghi 2016), which has contributed towards output stabilisation at the Union level (see Demertzis and Wolff 2016).

The ECB's expansionary monetary policy, however, has three drawbacks. First, it is not uniformly transmitted, as liquidity increases at the core of the EMU have been considerably higher than those at the periphery. This is a reflection of the fact that the ECB has one policy instrument (the Union interest rate or money supply) and numerous policy objectives (national output gaps). As a result, the single monetary policy responds imperfectly to national business cycles, particularly under the financial fragmentation observed during the crisis (ECB 2015). Greece, in particular, has been isolated from the QE programme's liquidity effects, as the capital controls in place since July 2015 imply that its economy is operating under a credit crunch. Second, this expansionary policy may threaten financial stability by disconnecting asset prices from fundamentals (Claeys and Leandro 2016). Recent evidence from European sovereign bonds markets (see Delatte et al. 2017) supports such concerns. Finally, large purchases of sovereign bonds in the context of QE may cause fiscal moral hazard.

These problems may be ameliorated through the introduction of EDIS. In certain countries EDIS is regarded with legitimate scepticism on moral hazard grounds (see Schuknecht 2016), although this may reflect national rather than EU priorities (see Véron 2016). EDIS, however, involves shared benefits that may offset such moral hazard risks. First, by increasing depositors' confidence in national banking systems (which the currently incomplete EBU has failed to do), EDIS will enhance credit-growth capacity at the national level. This will operate as a substitute for the national monetary policy instruments that are missing within the EMU, moderating national business cycles. This, in turn, will reduce the necessity for and/or size of official financial assistance programmes and, by supporting demand, will enhance the promotion of reforms. Both effects will reduce the exposure of European taxpayers to the output risks of countries that have received official financial assistance programmes. Furthermore, by smoothing national business cycles, EDIS will reduce the need for ultra-expansionary monetary policy, which will reduce financial stability risks. Finally, a less expansionary monetary policy will reduce the risk of fiscal moral hazard caused by the large purchases of sovereign bonds under QE.

Fiscal adjustment and debt relief

The EMU crisis has left many countries with excessive public debt levels. This is primarily the result of bank-rescue programmes and, in the case of Greece, fiscal imbalances built up in the run-up to the crisis. Reforms impact on the economy's natural output through the employment and investment responses of the private sector. These responses depend on expectations about future taxation on income and corporate profits. For reforms to be effective, taxation expectations need to be favourable. Therefore, reforms must be accompanied by a credible programme of fiscal adjustment, reducing expected future taxation. This raises two questions. First, how should fiscal adjustment be pursued? Second, how aggressive should it be?

Fiscal adjustment is widely regarded as causing short-term contractionary output effects. However, existing evidence (see Alesina et al. 2015) suggests that these are more pronounced in size and duration when adjustment is pursued through tax increases rather than expenditure cuts. An intuitive explanation is that tax increases reduce employment and investment incentives and cause other supply-side distortions. These effects weaken natural output, reducing output expectations and suppressing current demand. By contrast, expenditure cuts accompanied by tax reductions limit distortions and improve output expectations. Discounting higher future output in present consumption and investment mitigates the demand effects of lower government expenditure. Overall, given the supply-side profile of many EMU countries, fiscal consolidation is more likely to be successful if it is mainly expenditure- rather than tax-based. This is particularly true for Greece, where high taxation levels (increased substantially in 2015–17) have created high distortions and incentivised tax-evasion (see Artavanis et al. 2016).

Clearly, a country such as Greece, where the public debt to GDP ratio is currently in the range of 180%, must target primary fiscal surpluses to improve the dynamics of its government's intertemporal budget constraint. But in addition to the primary surplus, the intertemporal budget constraint depends on the stock of debt and the difference between the rates of growth and real interest on debt. In recent years, Greece has benefited from interest rate reductions and extensions of debt maturity. However, as evidenced by Greek long-term government bond yields, these have not been enough to restore confidence in Greece's public debt sustainability. The implementation of reforms will help do so. However, the latter's output effects will appear gradually over the medium term. In the meantime, servicing the Greek debt involves large payments from 2019 onwards. This underlies the 3.5% primary surplus set for Greece's fiscal policy starting from 2018 for an unspecified period of time. However, there are two risks associated with this target.

First, historical evidence suggests that a 3.5% fiscal surplus was relatively rare during the post-war period of 1950–2011, when in 75% of the cases primary balances had values of less than 2.5 and 1.7% for advanced and non-advanced countries respectively (see Mauro et al. 2013). Europe has seen three episodes of prolonged, substantial fiscal surpluses, in Ireland (1987–93), Italy (1995–2000) and Belgium (1994–2004). However, there are two major differences between those episodes and the situation in Greece today. The first is that they were implemented under significantly more favourable output conditions, involving average output gaps equal to +2.8, −1.9 and −0.4% for Ireland, Italy and Belgium respectively. This contrasts with an output gap of −6.5% in 2016 for Greece and an average of −6.9% for the period 2011–16 (International Monetary Fund 2016). The second is that in those countries national monetary policies were still in place, providing a channel to mitigate the demand effects of fiscal consolidation. This channel is not available in Greece, whose economy, as we have seen above, is operating under credit-crunch conditions. Although Greece needs to target considerable primary surpluses to limit fiscal imbalances, the 3.5% target is excessive and, given the current state of the Greek business cycle, amounts to a fiscal overkill that is very likely to be self-defeating. A revision of the target towards the third quartile of the historical distribution (in the range of 2%) would still set Greece a relatively ambitious fiscal target. Revising the fiscal target downwards, in turn, would allow demand conditions to better support the reform process, which is much more important for long-term growth and fiscal sustainability.

The second risk comes from the level of debt. According to all available projections, the Greek public debt to GDP ratio will remain very high for the foreseeable future. Even if Greece meets its fiscal and reform targets, Greek public debt sustainability will be vulnerable to external shocks causing output losses which, in turn, will threaten credit events. As a result, the risk premiums associated with investments in Greece will remain high, restricting capital inflows, discouraging investment and maintaining high borrowing costs, all of which will restrain growth. It is therefore necessary to further lighten the burden of servicing the Greek public debt, as per the Eurogroup's decision of November 2012, which was confirmed by the agreement on the Greek financial assistance programme in July 2015 and the Eurogroup's decision of May 2016.[1]

To achieve this objective, the Greek authorities must not delay delivering on the commitments undertaken in the context of the third financial assistance programme, and Greece's official lenders, in response, should not delay agreement on measures that reduce the cost of servicing the Greek public debt. These steps, however, may be difficult to conclude due to the presence of a coordination problem. At present, the measures to be taken to reduce the Greek debt burden have not been confirmed; they are only a possibility, to be decided after the conclusion of the third Greek programme in August 2018. As a result, the Greek authorities may be reluctant to take measures involving certain and immediate welfare losses in exchange for uncertain gains following non-guaranteed debt-reduction measures. On the other hand, due to moral-hazard considerations, Greece's partners may be reluctant to commit to debt-reduction measures without evidence of Greece's commitment to fiscal adjustment and reforms.

The solution to this coordination problem may be an agreement postulating gradual, pre-announced, specific and automatic debt reductions, conditional upon Greece meeting targets relating to fiscal policy and reforms (see Arghyrou 2015b). Such an agreement may offer a guide for resolving other outstanding debtor–creditor conflicts within the euro area, as debt relief is not necessarily a zero-sum game. Using a standard open-economy framework (see Corsetti and Pesenti 2009), it can be shown that for debtor countries debt relief implies consumption gains, which increase further as debt relief facilitates reforms and productivity-enhancing investment, thus increasing natural

[1] See Eurogroup (2012, 2015, 2016).

output. Higher output in debtor countries reduces the prices of their goods, improving the terms of trade of creditor countries, whose residents consume imports from debtor countries. As a result, debt relief for the latter involves consumption gains for creditor countries, compensating for the consumption losses caused by granting debt relief. Benign self-interest may render debt relief conditional upon reforms in a mutually beneficial scheme of crisis resolution.

Conclusion

This article has discussed the reforms that have to be undertaken in EMU countries to ensure the stability and long-term sustainability of the euro. It has also explained the steps needed to support demand during the implementation of reforms, thus enabling their successful conclusion. It has been argued that structural reforms in the EMU should target increases in long-term employment, productivity and external competitiveness. Demand measures that support reforms include an expenditure-based approach to fiscal adjustment and the introduction of EDIS. And in the case of Greece, they include ownership of reforms, the downward revision of fiscal targets, and medium- and long-term measures of debt relief conditional upon the meeting of fiscal/reforms targets.

Finally, economic adjustment in the euro area requires moderation of all fiscal and external imbalances across all member states. Within a monetary union, both excessive deficits and excessive surpluses can cause negative externalities at the union level. Furthermore, any country's participation in the euro implies that its systemic risk increases by a fraction of its partners' systemic risk, due to the increased interdependence brought about by monetary and banking integration. Imported systemic risk can be reduced, but it can never be fully eliminated. This is why the euro area needs effective risk-reduction *and* risk-sharing mechanisms, both of which are equally important in the long run. The stability of the euro will improve substantially if all national economic policies are designed with these facts in mind. European solidarity goes hand in hand with macroeconomic prudence, and leading by example requires national macro-policies involving a mix of national and Union-wide priorities that can be sustained by all of the member nations. Prudence and consideration for Union objectives are the two sides of good European citizenship, without which the euro's long-term stability cannot be guaranteed.

References

Alesina, A., Favero, C., & Giavazzi, F. (2015). The output effect of fiscal consolidation plans. *Journal of International Economics, 96*(S1), S19–S42.

Arghyrou, M. G. (2014). *Is Greece turning the corner?* CESifo working paper no. 4995. Munich.

Arghyrou, M. G. (2015a). From the euro-crisis to a new European economic architecture. In D. D. Thomakos, P. Monokrousos, & K. Nikolopoulos (eds.), *A financial crisis manual: Reflections and the road ahead—Palgrave studies in banking and financial institutions* (pp. 308–28). Basingstoke: Palgrave Macmillan.

Arghyrou, M. G. (2015b). On Greek crises, growth, market-access and debt-forgiveness. *CESifo DICE Report, 1,* 33–8.

Artavanis, N., Morse, A., & Tsoutsoura, M. (2016). Measuring income tax evasion using bank credit: Evidence from Greece. *The Quarterly Journal of Economics, 131*(2), 739–98.

Bank of Greece. (2017). Credit to domestic non-MFI residents by domestic MFIs excluding the Bank of Greece. http://www.bankofgreece.gr/BogDocumentEn/Credit_to_domestic_non_MFI_residents_by_domestic_MFIs_excluding_BoG.xls. Accessed 4 April 2017.

Campos, N. F., & Macchiarelli, C. (2016). Core and periphery in the European Monetary Union: Bayoumi and Eichengreen 25 years later. *Economics Letters, 147*(1), 127–30.

Claeys, G., & Leandro, A. (2016). *The European Central Bank's quantitative easing programme: Limits and risks*. Bruegel Policy Contribution 2016/04. Brussels.

Corsetti, G., & Pesenti, P. (2009). The simple geometry of transmission and stabilisation in closed and open economies. In R. Clarida & F. Giavazzi (eds.), *NBER International Seminar in Economics 2007* (Vol. 4, pp. 65–116). Chicago: University of Chicago Press.

Delatte, A.-L., Fouquau, J., & Portes, R. (2017). Regime-dependent sovereign risk pricing during the euro crisis. *Review of Finance*, *21*(1), 363–85.

Demertzis, M., & Wolff, W. (2016). *The effectiveness of the European Central Bank's asset purchase programme*. Bruegel Policy Contribution 2016/10. Brussels.

Draghi, M. (2016). *Introductory statements in hearing of the Committee on Economic and Monetary Affairs of the European Parliament.* Brussels. 28 November.

ECB. (2015). *Financial integration in Europe*. Frankfurt. April.

Eurogroup. (2012). Eurogroup statement on Greece. 27 November. http://www.consilium.europa.eu/press/press-releases/2012/11/pdf/Eurogroup-statement-on-Greece-27-11/. Accessed 4 April 2017.

Eurogroup. (2015). Eurogroup statement on the ESM programme for Greece. 14 August. http://www.consilium.europa.eu/en/press/press-releases/2015/08/14-eurogroup-statement/. Accessed 4 April 2017.

Eurogroup. (2016). Eurogroup statement on Greece. 22 May. http://www.consilium.europa.eu/en/press/press-releases/2016/05/24-eurogroup-statement-greece/. Accessed 4 April 2017.

European Commission. (2015). *The five presidents' report: Completing Europe's Economic and Monetary Union*. Brussels. 22 June.

Friedman, M., & Schwartz, A. (1963). *A monetary history of the United States, 1867–1960*. Princeton, NJ: Princeton University Press.

International Monetary Fund. (2016). *World economic outlook database*. Washington, DC. October.

International Monetary Fund. (2017). *International financial statistics*. Washington, DC. April.

Mauro, P., Romeu, R., Binder, A., & Zaman, A. (2013). *A modern history of fiscal prudence and profligacy*. IMF working paper 13/5. Washington, DC.

Milanovic, B. (2016). The greatest reshuffle of individual incomes since the Industrial Revolution. *VoxEU.org*, 1 July. http://voxeu.org/article/greatest-reshuffle-individual-incomes-industrial-revolution. Accessed 25 April 2017.

OECD. (2016). *Economic policy reforms. Going for growth, interim report 2016*. Paris.

Oliver, C. (2016). Enthusiasm for EU in sharp decline throughout Europe, not just UK. *Financial Times*, 7 June.

Schuknecht, L. (2016). An insurance scheme that only ensures problems. *Frankfurter Allgemeine*, 8 February.

Véron, N. (2016). European Deposit Insurance Scheme: A response to Ludger Schuknecht. *Bruegel.org*, 16 February. http://bruegel.org/2016/02/european-deposit-insurance-a-response-to-ludger-schuknecht/. Accessed 25 April 2017.

Michael G. Arghyrou *(Ph.D.) is a reader in economics at Cardiff Business School, Cardiff University. His research interests are international macroeconomics and finance, the economics of the EMU and the Greek economy. He is an expert on the Greek/European debt crisis. Since February 2016 he has advised New Democracy (Nea Dimokratia) on economics and financial affairs.*

EUROPEAN VIEW (2017) 16:57–65
DOI 10.1007/s12290-017-0432-z

CrossMark

ARTICLE

Political union and the legitimacy challenge

Michael Wohlgemuth

Published online: 24 May 2017

Abstract For the first time the EU has reached not just a stopping point, but a possible turning point. The Brexit decision has only made this more evident. Using the current crisis for a 'great leap forward' towards ever closer 'political union' hardly seems realistic, even in the absence of the notorious British opposition. Even the member states that are most ardently calling for a 'political union' do not agree on what that should actually mean. Using the examples of France and Germany and their seemingly identical calls for a 'fiscal union' of the eurozone, this article shows that the two countries have contrasting interpretations of what such a union should do, and how. Both the French ideal of a voluntarist 'economic government' of the eurozone and the German model of a rules-based 'economic constitution' would require substantial changes to the EU treaties, for which there is no real hope of democratic consent. The legitimacy challenge has thus become both more urgent and more difficult to overcome.

M. Wohlgemuth (✉)
Open Europe Berlin, Dickhardtstr. 61, 12159 Berlin, Germany

e-mail: michael@openeuropeberlin.de

Keywords European integration | Fiscal union | Political union | Democracy | Legitimacy | Eurozone

Introduction

The EU has good reasons to celebrate its first 60 years—or at least most of this period. It has promoted peace, democracy and cooperation among its members and created the world's largest single market. The seemingly unidirectional process of ever further enlargement and ever further deepening of the Union, however, has been thrown into question by the UK's decision to leave and the rejection of EU decisions (e.g. on migration) and rules (e.g. on fiscal discipline) in several member states.

Meanwhile, EU officials in Brussels are struggling to produce a coherent position on how to achieve a 'political union' or a 'fiscal union' for the EU or the eurozone. The big national players, France and Germany, both have their ideas. But these ideas are mutually incompatible. And both ignore the fact that giving far greater powers to Brussels is unpopular and, in the case of Germany, may be unconstitutional. Against this backdrop, this article offers more general thoughts on the limited and increasingly depleted resources of 'input legitimacy' and 'solidarity', on which a European political or fiscal union would ultimately have to rely.

The Brussels roadmap: many options, many unions, little unity, little clarity

President of the European Commission Jean-Claude Junker is right to complain, including in the newest White Paper (European Commission 2017), about national governments using the EU as a scapegoat for failures of their own making, thereby creating a 'mismatch between expectations and the EU's capacity to meet them' (European Commission 2017, 13). He has thrown down the gauntlet by offering five alternative scenarios: (1) 'Carrying On', (2) 'Nothing but the Single Market', (3) 'Those Who Want More Do More', (4) 'Doing Less More Efficiently', and (5) 'Doing Much More Together'. As was to be expected, the short Rome declaration of the European Council (2017) did not fully endorse any of the five options.[1]

Interestingly, only the last option explicitly referred to the 'Five Presidents' Report', *Completing Europe's Economic and Monetary Union* (Juncker et al. 2015). And it is only here that the White Paper refers to the 'risk of alienating parts of society which feel that

[1] Only option two was clearly rejected by most. This comes as no surprise since it was framed as a regressive 'neo-liberal' idea in a very incoherent way from a market-liberal point of view: it was suggested that free trade in services, the control of state subsidies and free trade abroad would not be part of the 'single market' option. See Wohlgemuth (2017) for a critique.

the EU lacks legitimacy or has taken too much power away from national authorities' (European Commission 2017, 24).

The 'Five Presidents' Report' sets out four areas where eurozone integration should be deepened: economic union, financial union, fiscal union and political union—all of which are to be completed in three stages and by 2025.

On economic union, the five presidents note correctly that the EU single market is not yet complete in key areas such as services, energy, the digital economy and capital markets. There is plenty of potential here for triggering growth within the remit of the core competences of the EU.

On financial/banking union, the presidents' paper focuses on developing a common deposit insurance scheme, something which is fiercely opposed by Germany. It also launched the 'capital markets union', which is intended to open up more diverse sources of financing to small and medium-sized businesses. 'Ultimately', the report says, this will require 'a single European capital markets supervisor' (Juncker et al. 2015, 12).

The five presidents are more cautious and nebulous in their proposals for a fiscal union than the four presidents were in their report in 2012 (European Council 2012). Even so, it remains the most controversial part of the initiative, since it envisages establishing a 'fiscal stabilisation mechanism' to make another fiscal back-stop available, and a 'European Fiscal Board' to evaluate the implementation of EU fiscal rules. The idea of euro bonds or a debt redemption fund seems to have been shelved, or perhaps just renamed, since the report deems 'a pool of financing sources' useful (Juncker et al. 2015, 5). It would be 'tapped into according to the business cycle' (Juncker et al. 2015, 15)—or, more probably, according to availability and political opportunity.

The chapter on political union is even vaguer. It correctly states that 'greater responsibility and integration' at the EU and euro area levels should come with 'greater democratic accountability, legitimacy and institutional strengthening' (Juncker et al. 2015, 17). But in terms of a 'plan D' (for democracy), there are no specifics at all. Instead this chapter hints at the establishment of yet another new institution: a 'euro area treasury', which perhaps, someday, would take 'some decisions' in fiscal policy (Juncker et al. 2015, 18).

Most tellingly, but understandably, the report avoids addressing which steps would require changes in EU treaties. Everyone knows that negotiations on EU treaty changes would open a Pandora's Box of endless disputes. Any new treaty that transferred more power from national governments to the EU would run into trouble in national parliaments and would be likely to fail in almost any national referendum.

The Berlin/Paris bifurcation: economic government or economic constitution?

Nevertheless, the discourse on political and fiscal union has also intensified in Paris and Berlin. But while officials on both sides of the Rhine agree that greater integration is needed, their ideas on how to go about it are far from similar.

Paris (consistently represented by the proposals of Nicolas Sarkozy, François Hollande and Emmanuel Macron, despite their differing political colours) wants an 'economic government'. This concept boils down to the mutualisation of public debt, more fiscal activism from the European Central Bank, a common EU or eurozone tax authority, a common eurozone budget, a common eurozone unemployment insurance and a common deposit insurance. They also want EU industrial policy to focus more on picking European (read: French) industrial champions and protecting (French) losers from global competition. Instead of binding legal commitments, France favours political discretion and intergovernmental acts of political will—legitimised or driven by a eurozone parliament—to decide how to spend the money raised from common taxes or mutualised eurozone debt instruments.

Berlin (consistently represented by its Finance Minister Wolfgang Schäuble) prefers an 'economic constitution' to an 'economic government'. Berlin wants binding balanced budget rules or 'reform contracts' that would be enforced through automatic sanctions or by independent agencies following strict criteria. This would follow the very German idea of '*Ordnungspolitik*'—a governance structure that aims to bring both governments and market actors under the rule of law. In addition, Schäuble also wants to install something similar to a eurozone 'finance minister'. However, raising and spending European taxpayers' money or issuing joint euro bonds would not fall within the minister's remit. Instead, he or she would have the power to override national finance ministers—and even parliaments—if they were to break the rules.

Both the French and the German proposals go far beyond those in the 'Five Presidents' Report'. Instead, they depict more radical visions of a federal European state, but of two very different kinds: a centralist political structure for 'planification' or a legal framework for an open market economy.[2] Both concepts would require changes to EU treaties that the member states would have to approve unanimously. But it is inconceivable that all 28 (soon to be 27) EU countries (or even the 19 eurozone members) would rally around one or other of the proposals.

[2] See Brunnenmeier et al. (2016) for a comprehensive historical analysis showing how Germany saw the Maastricht Treaty as a set of binding rules, whereas France saw the euro as a political instrument that was to be overseen by governments.

Constitutional conundrums

When it comes to a substantial transfer of national sovereignty to Brussels, it would not only be disagreement amongst national governments and negative public opinion that would erect formidable obstacles. The German Federal Constitutional Court (FCC) would also have a say. It has repeatedly stated that the EU cannot become a federal state while the German constitution remains in effect. For the EU to become a 'true political Union', Germany would have to replace its 1949 constitution with a new one. At the time when the single currency was decided upon, Germans were not asked if they wanted to give up their Deutschmark. However, something that they are less inclined to abandon is their cherished constitution.

At the core of the constitutional argument is the link between democracy and the sovereign power to tax. The FCC has frequently insisted that German taxpayers' money cannot be raised and spent by third parties beyond the control of German parliaments. 'No taxation without representation!'—the American Revolution's most famous slogan—is also deeply enshrined in the German constitution. In 2012 the FCC said:

> A necessary condition for the safeguarding of political latitude in the sense of the core of identity of the constitution… is that the budget legislature makes its decisions on revenue and expenditure free of other-directedness on the part of the bodies and of other Member States of the European Union and remains permanently 'the master of its decisions'. (Germany, FCC 2012, Rn 109)

Reference to the European (or a new eurozone) Parliament will not help move the red lines drawn by the court, since then another core democratic principle would have to be invoked: that of 'one man, one vote'. The vote of a Maltese citizen carries more than 11 times more weight than that of a German in European elections. In a parliament with such far-reaching powers, this imbalance would no longer be sustainable. This is another point already made by the FCC in 2009 (Germany, FCC 2009, Rn 280): 'the European Parliament is not a representative body of a sovereign European people. This is reflected in the fact that it is designed as a representation of peoples in the respective national contingents of Members, not as a representation of Union citizens in unity without differentiation, according to the principle of electoral equality'.

If a truly democratic 'one-man, one-vote' European Parliament wanted to mirror the national party proportions of smaller states at least somewhat, as it does now, the number of Members of the European Parliament would have to increase by a factor of 10, to over 7500.

Even EU federalists would find such a system ludicrous. They would need a pan-European party system in which voters would cast their ballots for parties whose leaders were from different countries and spoke different languages. Parties would also have to offer coherent, Europe-wide political platforms that offered clear alternatives. But this would take decades, as would the more fundamental prerequisites: pan-European debates, pan-European media and thus pan-European public opinion or even some sort of 'European identity'. Present trends point rather in the opposite direction. Attempting to implement a radical political union in this environment, and hoping that a European 'demos' miraculously appears, is putting the cart before the horse and threatens a collapse of the Union as a consequence of overzealous overstretch.

Sovereignty and legitimacy issues

Last year, as many remembered Winston Churchill's (1946) famous 'Zurich Speech', it was noted that his vision of a 'United States of Europe' has been realised beyond expectations, but also lost its allure. Churchill himself never thought that the UK would become a full member of the United States of Europe. Margaret Thatcher strongly campaigned to join the European Economic Community in 1975. And now it seems that the UK (a majority of its voters) wants to leave the EU because of concerns that they are no longer 'masters of their own destiny' (with national borders and national jurisdiction). Similar concerns hold—and perhaps even more so—for other member states, such as Greece or France.[3]

The EU's 2017 White Paper (European Commission 2017, 24) is therefore right to attach to its scenario of 'Doing Much More Together' the caveat of a 'risk of alienating parts of society which feel that the EU lacks legitimacy or has taken too much power away from national authorities'. As long as the single market could be regarded as the core of economic integration, mutual gains from trade and joint commitments, so-called output legitimacy, sufficed. As the currency union now describes the 'hard core' of Europe that requires further steps of 'positive integration', the situation is very different. Now 'input legitimacy' is needed: the explicit consent of governments and citizens to an agreed way forward which involves giving up national sovereignty. For this, the EU, or at least the eurozone, will have to be able to exploit or develop two political resources: legitimacy and solidarity.

Graf Kielmansegg (2016) defines these resources as follows (my translation):

> The EU commands legitimacy resources to the degree to which the European peoples award it the right, or at least do not dispute its right, to legislate on behalf of all member states and their citizens. Solidarity resources are at the EU's disposal to the degree to which the European peoples are ready to accept or at least endure redistribution at their own expense beyond the borders of the nation state.

Kielmansegg states quite correctly that the scarcity of these resources has been gravely underestimated since the Maastricht Treaty and that these key resources have now been exhausted, not least as a consequence of the euro crisis. The challenge of legitimacy and solidarity has been ignored for too long. Now it has become both more urgent and more difficult to overcome.

[3] Pew Research Center (2016) found that unfavourable views of the EU are held by 71% in Greece and 61% in France (compared with 48% in the UK).

Towards an ever more flexible Union

Until recently politicians, academics and the media on the Continent have held on to the belief that the EU has always been a 'political project' and would necessarily lead to 'ever closer Union' and finally to some 'kind of United States of Europe'. However, the existential crisis of the currency union should have proven that undertaking an economically dubious and risky operation as a 'political' project managed on the basis of political criteria can all too easily lead to failure.

The Commission was therefore right to offer alternative scenarios in its outline of the future of EU integration in the White Paper, including the options of 'doing less more efficiently' and 'those who want more do more'. The 'ever-closer-one-size-fits-all' project has alienated many citizens from the EU (Wohlgemuth 2017). They see their lives as regulated by a political machine that they cannot democratically hold accountable. Political leaders in member states and EU institutions have started to acknowledge this problem. Hence this year's Rome festivities and the Rome declaration were not marked by exuberance, but by a healthy dose of realism and pragmatism.

Indeed there can and should be more flexibility—but mostly in fields outside the 'core' of the European project, that is, outside of the single market, the common trade policy and the common currency. However, even in these other areas (which include the social union, tax harmonisation and the defence union), a 'two-speed Europe' is not the most convincing form of flexibility. This model takes for granted that there is a common destination agreed by all, which all members states want and will reach at some stage. An 'ever-closer-one-size-fits-all-sooner-or-later' option is not really preferable to genuine 'variable geometry', where different countries—'the willing and able'—engage in mutual integration in different policy areas. These forms of cooperation could also be open to non-EU members (e.g. single market access, foreign and defence policies, domestic security, anti-terrorism). Europe would again live up to its motto: United in Diversity!

Conclusion

For the governance of the eurozone, political and economic divergence poses an enormous problem that cannot be accommodated by legal 'flexibility'. There has to be some agreement on rules that are applicable to all members of the currency club. 'Multi-speed' does not work here—there needs to be a much higher degree of economic and political cohesion than one can find today. The problem is that there is no consensus on a European monetary, fiscal and social model, and the legitimacy and solidarity resources needed for a political or fiscal union have been exhausted.

Europe is at a crossroads. We have been hearing this since the foundation of the European Communities, but this time the metaphor is more justified than ever. In the long run, 'more of the same' would work as little as 'back to the beginning'. However, easy escape routes are also blocked. Just one thing seems clear: there is no convoy of

28 (or soon 27) member states willing or able to rush towards any ‘political union’ destination scenario. This may be regrettable, not least for geopolitical reasons. In terms of more modest steps forward, it would be welcome if at least some of the reforms as laid out in the ‘Five Presidents’ Report’ could help to stabilise the eurozone. Realistically, further steps of EU integration should be driven by, but limited to, as Churchill (1946) said, ‘those who will and those who can’.

References

Brunnenmeier, M. K., James, H., & Landau, J.-P. (2016). *The euro and the battle of ideas*. Princeton, NJ: Princeton University Press.

Churchill, W. (1946). ‘United States of Europe’. Speech at the University of Zurich. 19 September. http://www.churchill-society-london.org.uk/astonish.html. Accessed 4 May 2017.

European Commission. (2017). *On the future of Europe: Reflections and scenarios for the EU27 by 2025*. White Paper, COM (2017) 2025, 1 March.

European Council. (2012). *Towards a genuine Economic and Monetary Union*. EUCO 120/12. Brussels.

European Council. (2017). The Rome declaration. Press Release 149/17. Brussels.

Germany, FCC. (2009). 2 BvE 2/08, Judgement of 30 June 2009. https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2009/06/es20090630_2bve000208en.html. Accessed 4 May 2017.

Germany, FCC. (2012). 2 BvE 1390/12 Judgement of 12 September 2012. https://www.bundesverfassungsgericht.de/SharedDocs/Entscheidungen/EN/2012/09/rs20120912_2bvr139012en.html. Accessed 4 May 2017.

Graf Kielmansegg, P. (2016). Europäische Ungleichzeitigkeiten. Versuch einer Deutung der Krise des europäischen Projektes. *Open Europe Berlin*. http://www.openeuropeberlin.de/ourcauses/europaeische-ungleichzeitigkeiten-versuch-eine-deutung-der-krise-des-europaeischen-projektes-von-peter-graf-kielmansegg/. Accessed 4 May 2017.

Juncker, J.-C., Tusk, D., Dijsselbloem, J., Draghi, M., & Schulz, M. (2015). *Completing Europe’s Economic and Monetary Union*. European Commission. Brussels. https://www.ecb.europa.eu/pub/pdf/other/5presidentsreport.en.pdf. Accessed 4 May 2017.

Pew Research Center. (2016). *Euroskepticism beyond Brexit. Significant opposition in key European countries to an ever closer EU*. Washington, DC, June.

Wohlgemuth, M. (2017). Ein Europa der Zukunft. Von der 'immer engeren Union' zum 'Europa der Clubs'. *Schweizer Monat*, Sonderthema, May. https://www.schweizermonat.ch/uploads/assets/sm_st_mai_17_europa.pdf. Accessed 4 May 2017.

Michael Wohlgemuth *is Director of the think tank Open Europe Berlin and Professor of Political Economy at the University Witten/Herdecke. He is also an affiliated fellow of the Walter Eucken Institute, a tutor on the Social Market Economy post-graduate programme of the Konrad Adenauer Foundation, and a member of the Ludwig Erhard Foundation and the Mont Pèlerin Society.*

EUROPEAN VIEW (2017) 16:67–73
DOI 10.1007/s12290-017-0442-x

CrossMark

ARTICLE

How to ensure the survival of the monetary union

Ivan Štefanec

Published online: 20 June 2017

Abstract At present the biggest threat to the monetary union is posed by the anti-European political parties. These parties call for their countries to leave the union. They are thriving especially in countries with slower economic growth and high unemployment rates. The best remedy against them is to increase economic growth and thus reduce the unemployment rate in their home countries. The measures taken to achieve this need to be systematic, rather than merely temporary patches. In peripheral and semi-peripheral economies, undercapitalised banks and the lower competitiveness of domestic producers are slowing down growth. The correct measures to address these problems include banning dividend payouts by undercapitalised banks and creating minimum standards for competitiveness.

Keywords Euro area | Competitiveness | Banks | Dividends | Growth | Unemployment

I. Štefanec (✉)
European Parliament, Rue Wiertz 60, 1000 Brussels, Belgium
e-mail: ivan.stefanec@europarl.europa.eu

Introduction

The crisis within the monetary union is now a political one, the economic crisis having ended in 2012 when the European Central Bank (ECB) introduced a de facto guarantee for euro-area bonds (the Outright Monetary Transactions programme). The ECB thus eliminated the problems encountered by the peripheral economies (i.e. Italy, Spain and Portugal) in financing their sovereign debt, with Greece being an exception and a special case due to its extremely high levels of debt.

Currently, the greatest risk to the monetary union is political in nature. In the (semi-) peripheral economies, where slow growth has resulted in high unemployment, we have seen a sharp rise in support for parties whose programmes include leaving the euro area. Two such parties are the French National Front and the Italian 5-Star Movement. If economic growth in these economies remains slow—and the unemployment rate high—these parties may come to power and carry out their threats.

Accordingly, the principal challenge for the monetary union now is to increase economic growth in the periphery. In this regard, the ECB has already done everything it can, by guaranteeing government bonds, reducing long-term interest rates and flooding the banking sector with liquidity. It is now up to the politicians to capitalise on the space that has been created for reforms by the ECB.

The problems of the periphery take two forms: the quality of the banks and the level of competitiveness.

Undercapitalised banks must pay lower dividends

One of the main causes of weaker economic growth on the periphery is that banks are undercapitalised. This lack of capital, in turn, has four causes.

1. *Non-performing loans* Banks still have a high volume of non-performing loans on their books from the crisis period. Overvaluing these creates additional costs and thus reduces capital. According to the European Banking Authority (2016), the current volume of non-performing loans in the EU amounts to around one trillion euros, or 5.4% of all loans. This very high ratio is due to the situation in the peripheral economies: roughly 45% of loans in Greece and Cyprus are categorised as non-performing, while for Portugal, Slovenia and Italy the figure is 15–20%.

2. *Low profitability* Banks also have problems on the income side. Poor economic growth, especially in the peripheral economies, has dampened credit growth, while the ECB's policy of low interest rates is squeezing the margin in this sector. In conjunction with the costs of non-performing loans, this meant that large banks in the euro area

achieved a return on equity of less than 6% in the second quarter of 2016. Their cost of equity is estimated at 8–10%. In comparison, the return on equity in the US has been around 9% for some years. Therefore, economic activity results have a significantly lower potential for strengthening the capital position of banks in the euro area than they do in the US.

3. *Stringent capital adequacy rules* Significantly stronger rules on capital adequacy underpin the new regulatory environment created in response to the financial crisis (Basel III). Since 2013 banks have been increasing the volume of capital they are required to put aside with respect to their assets. This process will continue until 2019, making capital a scarce commodity.

4. *Payment of dividends* If a bank's situation is sound, the usual course is to pay out profits to its shareholders. Where the situation is less sound, however, profits should be used to strengthen the bank's capital adequacy instead of paying the shareholders a dividend. In many countries, this is not the case. For instance, according to the Bank for International Settlements (Shin 2016, 3), Spanish and Italian banks paid out 74 billion euros in the form of dividends in the period between 2007 and 2014—more than they spent on strengthening their capital cushion over the same period.

The lack of capital available to banks in the peripheral economies is hampering their lending role. This applies in particular to business loans, since current rules require larger capital buffers for them than for mortgages. Entrepreneurs' poorer access to credit is obstructing economic growth in these countries. Moreover, the preference for mortgages at the expense of business loans creates a risk of future problems in the real-estate market.

Putting the banking sector in order is a long-term process. Reducing the volume of bad loans or the operating costs of banks will not happen overnight. One approach is to ban dividend payouts by banks with insufficient capital. If the banks used these funds to strengthen their capital rather than to pay their shareholders, they would be able to spend significantly more on loans.

A ban on dividend payments by undercapitalised banks cannot be perceived as unfair to shareholders. The ECB saved these banks by providing unlimited liquidity to them, which allowed those that were embattled to pay their liabilities. Had it not done so, the banks would have been liquidated and the share value would have dropped to zero. Therefore, such a ban would constitute a fair tax on the shareholders of troubled banks, effectively paying for the assistance rendered in the past.

The US implemented a similar measure after the crisis. The Federal Reserve carried out robust stress testing of banks with capital-adequacy problems and restricted dividend payments to one cent per share. For years this limited-dividend regime applied even to such giants as Bank of America (until 2014) and Citigroup (until 2015). Restrictions on dividend payments significantly helped to revitalise the US banking sector, which subsequently succeeded in boosting the economy. The euro area should take these measures as an example.

More even geographical distribution of job creation

If the monetary union is to survive, investors have to be interested in creating jobs in all countries. At present, this is not the case.

A competitive economy is one in which institutions and legislation allow private firms to prosper and create jobs. Peripheral economies had been suffering from a lack of competitiveness even before the introduction of the euro. The causes vary from economy to economy, with the most important being:

- low flexibility in the labour market,
- a poor business environment,
- over-regulated product markets,
- lengthy court proceedings, and
- a large proportion of inefficient public companies.

Before the introduction of the euro, the modus operandi was to offset this competitive deficit by devaluing the currency. A weaker currency makes a country's exports cheaper and its imports more expensive, thus helping the domestic business sector. For instance, between the collapse of the Bretton Woods monetary system in 1973 and the introduction of the euro, the Italian lira depreciated on average by 5.7% per annum against the Deutschmark.

Such devaluation was no longer possible after the establishment of the euro area. Problems did not arise immediately because the peripheral economies began to tackle their low competitiveness by borrowing abroad. This was done by both the private and the public sector: in countries where private-sector loans were dominant, real-estate bubbles grew; in countries with predominantly public-sector loans, public debt rose sharply.

However, these foreign resources were not used for investment to boost competitiveness and in this way to increase exports and help repay the loans. Instead, the real-estate market and social programmes swallowed these resources. Deficits in the balance-of-payments current accounts nicely illustrate this development. They show that by 2008 the peripheral economies were importing significantly more goods and services than they exported. This was all funded by loans from the euro-area core countries. Greece and Portugal had a current-account deficit of more than 10% relative to GDP, with Spain's deficit just below that figure.

These capital flows to the periphery ceased when the financial crisis hit in 2008. Thus, the peripheral economies could not compensate for the deficit in competitiveness either by devaluing their currency or by creating major deficits in their current account (i.e. borrowing from abroad). Their problems then materialised as deep recessions and sharp increases in unemployment.

These competitiveness deficits persist to this day in most peripheral economies. Several years have passed since the financial and debt crises, and many euro-area countries have already recorded low unemployment. However, the situation in the periphery is improving only very slowly. Greece and Spain still have rates of unemployment of above 20%, while in Italy, Portugal and Cyprus they remain above 10%. Young people are especially affected as labour legislation protects employed people to the detriment of those entering the labour market.

The result is clear: when investors are deciding where to create jobs, they do not consider the peripheral economies (or some semi-peripheral economies, such as France) because it does not pay to create jobs there. These economies have improved their competitiveness little in recent years. The competitiveness rankings *Global Competitiveness Report* (World Economic Forum 2016) and *Doing Business* (World Bank 2016) show that these economies are trailing most of the other euro-area countries.

ECB policy is partly to blame for this situation. By guaranteeing government bonds, the ECB has removed any market pressure for reforms. Nevertheless, it is quite true that without the ECB, the euro area would not exist today. Doing away with bond guarantees is therefore not the way to combat the situation. Instead, measures should be taken at the euro-area level to stimulate more geographically even job creation. These measures must be systemic and not take the form of a transfer union. A transfer union does not address the problem itself, merely its consequences.

Accordingly, it would be effective to create minimum competitiveness standards. Some of these have already been outlined in the *Five Presidents' Report: Completing Europe's Economic and Monetary Union* (Juncker et al. 2015), which proposes the establishment of independent national competitiveness authorities. Their role would be to monitor whether wage trends reflect productivity developments and to propose remedial measures if they do not. Establishing such offices, responsible for coordinated activities, would certainly provide the right basis for reducing the competitiveness gap between individual euro-area countries.

To achieve this, it is necessary to reduce imbalances between euro-area countries. Developments in the balance-of-payments current accounts must be monitored, as this is the most prominent external expression of competitiveness. This applies not only to those countries with a deficit, but also to those with a surplus. For example, Germany achieved a current account surplus of 8.5% of GDP in 2016, and the Dutch surplus was one percentage point higher still.

It cannot be disputed that the most competitive euro-area countries benefit from the ECB's policy. It weakens the euro and improves their competitiveness in markets outside the euro area, at the expense of the periphery. Without the euro, their exchange rate would be much higher, and they would most probably not be able to achieve high current account surpluses and the associated low rates of unemployment.

The most competitive euro-area countries should permit faster wage growth as they currently do not face any labour-market problems. They should also take advantage of both the low interest rates and sound public finances to invest in infrastructure. Higher wages, consumption and investment within the core euro-area countries have the potential to boost the demand for products, services and labour from the periphery, allowing periphery countries to breathe more easily. Lowering current-account imbalances should therefore be part of the coordinated policy agenda for competitiveness.

However, it is questionable how seriously individual governments will consider the recommendations of the competitiveness authorities. If the measures are purely advisory, it is likely that they will remain only on paper. The enactment of certain standards in EU (or euro-area) legislation should be considered if the periphery's job-creation problems persist and the recommendations of these authorities are not implemented, as was the case in 2012 with regard to the Fiscal Compact. The *Five Presidents' Report* includes this as a medium-term goal.

Conclusion

The monetary union brings great benefits through the reduction of transaction costs for cross-border capital movements. At the same time, however, it requires responsible behaviour from national governments. With no scope for devaluing the currency, bad policies result in jobs being transferred to other EU countries. These bad policies are already in place in the peripheral countries.

Job creation in the euro area must be more evenly distributed across the member states. To achieve this, peripheral economies need to resolve their bank and competitiveness shortcomings.

The situation in the banking sector is gradually improving as the economy grows. However, a ban on dividend payments by undercapitalised banks could significantly accelerate this process—such a ban helped heal the US banking sector after the crisis, allowing it to support the growth of the economy now. On the European periphery, by contrast, the banking sector is acting as a brake on growth.

Competitiveness can only be enhanced if legislation in the periphery is more closely aligned with that of the core, so as to attract investors who are currently shunning these countries. Peripheral economies are no longer able to resolve their competitive deficits by devaluing their currency or by taking out unsustainable loans from abroad. These countries must make their economies more attractive for investors. A good starting point would be minimum standards of competitiveness for individual member states, thus providing the basis for a coordinated competitiveness policy within the monetary union.

Banning the payment of dividends by undercapitalised banks and taking a coordinated approach to competitiveness would be appropriate measures to help increase the growth of these economies—and thus the right way to reduce the anti-European sentiment which constitutes the greatest threat to the future of the monetary union.

References

European Banking Authority. (2016). *Risk assessment of the European banking system*. Luxembourg, December. http://www.eba.europa.eu/documents/10180/1315397/EBA+Risk+Assessment+Report_December+2016.pdf Accessed 1 May 2017.

Juncker, J. C., Tusk, D., Dijsselbloem, J., Draghi, M., & Schulz, M. (2015). *Five presidents' report: Completing Europe's economic and monetary union.* Brussels, 22 June. https://ec.europa.eu/commission/sites/beta-political/files/5-presidents-report_en.pdf Accessed 1 May 2017.

Shin, H. S. (2016). *Bank capital and monetary policy*. Bank for International Settlements. Frankfurt, 7 April. https://www.bis.org/speeches/sp160407.pdf Accessed 1 May 2017.

World Bank. (2016). *Doing business 2017*. Washington, DC, 25 October. http://www.doingbusiness.org/reports/global-reports/doing-business-2017 Accessed 1 May 2017.

World Economic Forum. (2016). *The global competitiveness report 2016–2017*. Geneva, 28 September. https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1. Accessed 1 May 2017.

Ivan Štefanec *is a Member of the European Parliament and a member of the Committee on the Internal Market and Consumer Protection, where he focuses on small and medium-sized enterprises, employment and the (digital) single market. Prior to joining the European Parliament, he was a member of the National Council of the Slovak Republic and vice-chair of the Committee for European Affairs. In 2004 he was appointed government plenipotentiary for the introduction of the euro in Slovakia.*

EUROPEAN VIEW (2017) 16:75–84
DOI 10.1007/s12290-017-0441-y

ARTICLE

The status quo is not an option: functional and existential weaknesses of the EMU

Juha-Pekka Nurvala

Published online: 4 July 2017

Abstract This article argues that maintaining the status quo is not an option for the euro area. The euro has functional and existential weaknesses that force us to take drastic action if we want to become resilient enough to withstand the next banking crisis. The article argues that the existential weaknesses of the euro stem from the D/Y ratio (debt-to-GDP). Euro-area members have only limited scope for using traditional mechanisms to deal with D/Y problems. What makes this especially worrying for the overall stability of the euro area is the ownership of the debt issued by the euro-area member states. It is absolutely vital to separate banks and sovereigns and to slash debt-to-GDP levels. The question is whether the political decision-making processes in the member states can deliver these structural changes.

Keywords Public debt | Real interest rate | Bank–sovereign nexus | Debt-to-GDP

J.-P. Nurvala (✉)
European People's Party, Rue du Commerce 10, 1000 Brussels, Belgium
e-mail: jn@epp.eu

Introduction

The future of the Economic and Monetary Union (EMU) is currently a hot topic. The success of the EMU will to a considerable extent determine whether the EU succeeds in fulfilling two of its core promises: prosperity and stability. This article argues that without considerable changes to the EMU, its functional and existential weaknesses will impair the EU's ability to deliver prosperity and stability. This would ultimately jeopardise the very existence of the EMU. I will start by singling out the most notable functional weakness, which results in the suboptimal functioning of the EMU. The argument is made that while this weakness does not per se endanger the existence of the EMU, it creates severe challenges for certain member states and political friction between its members. Next, I will explain the EMU's existential weakness, which stems from the D/Y ratio. I will also explain why—unless changes are made to the EMU and to the economies of the member states—the next banking crisis could be fatal. The article concludes by arguing that the euro-area member states must adopt and implement a policy programme (a) to reduce their public debt, so as to cushion the impact of the next crisis, and (b) to separate banks from their sovereigns.

Functional weakness

According to the optimal currency area theory, the euro area suffers from many weaknesses which impair its proper functioning (Mundell 1961). However, we must distinguish between functional and existential weaknesses. The two cannot be completely separated, of course. Still, functional weaknesses constantly hamper the functioning of the EMU, whereas existential weaknesses come to the fore only in crisis situations. Broad academic agreement exists on the euro area's functional weaknesses, the most important of which is the linkage between the real interest rate and real inflation, a dynamic which boosts upturns and deepens downturns. Other weaknesses, such as low labour mobility and the slow adjustment of prices, are of secondary importance.

The real-interest-rate–real-inflation dynamic was highly evident before the crisis in the euro area erupted. The countries of Southern Europe, also known as the periphery, which had traditionally had higher inflation and interest rates than the core countries, suddenly saw a remarkable drop in both. The low interest rates led to rapid private-sector credit accumulation in countries such as Spain and Ireland. In contrast, the only country with serious public-sector indebtedness prior to the crisis in the euro area was Greece. Low or negative interest rates in the peripheral countries boosted the cycle by discouraging saving and incentivising investments and expenditure, much of which went into real estate and created a bubble in Ireland and Spain. At the same time, however, the exact opposite was happening in the core countries. In Germany, very low inflation encouraged saving, with these savings being channelled by the financial markets to the Southern peripheral countries, which offered higher financial returns (but with low *real* interest rates for households and companies in those countries) (Storm and Naastepad 2015, 15–20). This dynamic led to a rapid increase in price and wage levels in the peripheral countries. When less developed countries or areas are catching up with more developed ones, it is normal for price and wage levels to increase, due to the Balassa–Samuelson effect.[1] But in the peripheral countries, a considerable proportion of the price and wage increases was not the result of increased productivity.

It is important to understand that the euro area is not the only monetary union suffering from this dynamic. However, the rigidity of the labour markets in the euro area caused the adjustments to price and wage levels to take longer and be more painful in the aftermath of the euro crisis. In both policy and political terms, the dynamic is difficult to mitigate, especially because it builds up primarily through the private sector. Politically it is challenging, to say the least, to try to slow down credit accumulation in the private sector when the economy is growing and new jobs are being created. This is the very same problem that has always weakened the effectiveness of, and the scope for, Keynesian demand management. At a technical level, countering the problem requires high-quality real-time data and a highly capable administration able to use regulatory and fiscal policy to rein in the real-interest-rate dynamics (Odendahl 2014). Moreover, even with those measures in place, it is difficult to establish whether growth is sustainable. Prior to the crisis, potential output calculations were grossly wide of the mark. For example, Irish potential output prior to the crisis in 2007 was estimated at around -1 percentage point, whereas when it was recalculated in 2014 the output gap proved to be more than +5 percentage points (Anderton et al. 2014).

As requested by the Eurogroup in April 2016, some work on this is being carried out by the European Commission. However, it remains doubtful whether, using the current methodology, potential output can be calculated in real-time accurately enough to base controversial and politically costly fiscal-policy decisions on it. Time lags make it difficult to rein in real interest rates, since slow data collection and analysis mean that policy decisions will always be taken many quarters later. With the further development of economic models and data collection, there is hope that it will become technically easier to counteract the real-interest-rate dynamic. Unfortunately, this does not lessen the political challenge of trying to cool down an economy which is growing too quickly. Moreover, the EMU still has to rely on political decisions instead of letting the economy automatically restabilise itself. Political decisions on highly complex, uncertain and politically costly issues are a major source of political friction among the member states.

Another related problem is that overall labour mobility in the euro area remains low, although new research indicates that it has increased (Ehmer 2017, 2). Mobility is crucial to providing flexibility when asymmetric shocks hit. Optimal currency area theory suggests that symmetry and flexibility are strongly connected: if the economies sharing the same currency are not synchronised in terms of business cycle fluctuations, there must be additional mechanisms in place that offer the flexibility to adjust (Natarajan

[1] 'Countries with high productivity growth also experience high wage growth, which leads to higher real exchange rates. The Balassa–Samuelson effect suggests that an increase in wages in the tradable goods sector of an emerging economy will also lead to higher wages in the non-tradable (service) sector of the economy. The accompanying increase in inflation makes inflation rates higher in faster-growing economies than it is in slow growing, developed economies.' (Investopedia n.d.)

2010). In theory, labour mobility is one of the key 'pressure valves', yet in the euro area only about 5% of the working-age population (20–64 years old) works in a member state different from the one in which they were born (European People's Party 2017, 10; Ehmer 2017, 2–3). Political reasons and structural constraints such as language, culture, recognition of qualifications and rigid national social security systems make it difficult to increase labour mobility sufficiently in the short term to have a major impact.

In a monetary union, adjustment of competiveness vis-à-vis other parts of the union requires price adjustment, in which wage adjustment plays an important role (Ehmer 2017, 1–2). We must acknowledge that some very welcome reforms have been introduced during the last five years. In the context of real-interest-rate dynamics, the most important reform in many eurozone countries has been decentralising wage setting and inserting crisis clauses into collective bargaining agreements, so as to introduce more flexibility and thus regain price competitiveness if necessary. The importance of this is highlighted by the Spanish experience, since the rigidity of Spain's labour markets and wage-setting procedures meant that wages continued to rise until unemployment hit 21.4% (European People's Party 2017, 10; Villanueva 2015, 2).

The real-interest-rate dynamic is a tangible problem for the EMU because it deepens busts and boosts booms, as well as causing friction among members. Yet it is not an existential weakness. The most potent ways to address and mitigate its effects are through measures to increase labour-market flexibility, encourage equity investments rather than credit investments and remove structural obstacles to labour mobility. Although all three are worthwhile goals, they are difficult to achieve and not without their political drawbacks.

Existential weaknesses of the euro

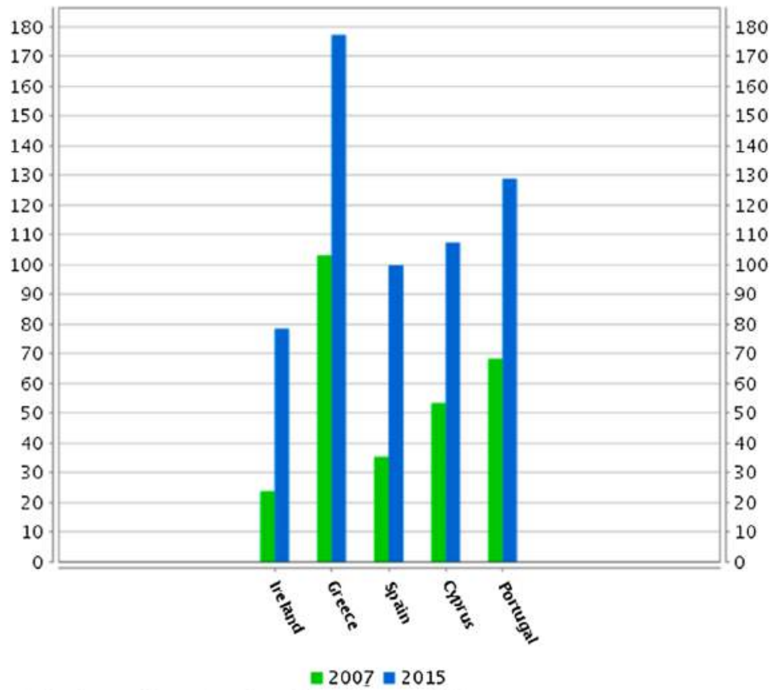
The most severe threat to the long-term success of the EMU and the euro stems from the interconnectedness in Europe of banks and their sovereigns,[2] combined with very high D/Y ratios. As argued above, the euro crisis was not caused by public debt. Nevertheless, the high level of public debt arising from the recession and the crisis puts in doubt our ability to handle the next banking crisis. Carmen Reinhart and Kenneth Rogoff have argued that national public-debt crises and banking crises have been a common problem throughout history, and that well-established policy options exist for dealing with them (Reinhart and Rogoff 2009). According to their research, the financial crisis of 2008 was not a unique event in economic history, and we should not assume that it will not happen again.

[2] 'The sovereign–bank nexus was one of the main amplifying factors of financial distress during the euro area crisis. Banks' difficulties affected sovereigns directly, through the bailout of troubled intermediaries, and indirectly, through the impact of the disruption of lending on the economy. Sovereigns' difficulties affected banks' ratings, funding costs, and balance sheets, while the recession worsened their lending portfolios.' (Visco 2016)

The interconnectedness of banks and states allows a crisis to spread from the former to the latter, and the other way around. If states had low debt levels, however, this interconnectedness, while still perilous, would not be potentially fatal. That may sound overly dramatic, but if we look at some figures, the alarmism becomes understandable. According to research by Reinhart and Rogoff (2009, 170), when a country experiences a severe banking crisis, its real debt stock increases by about 86% on average. In relation to GDP, moreover, the increases are even higher, because GDP normally falls during banking crises. Naturally, it can be argued that their research is only partially applicable to euro-area countries since these are all advanced economies. However, if we look at the recent financial crisis, a crisis originating in and concerning advanced economies, together with public debt trends in European crisis countries, the figures are sobering. In general the results seem to be very close to Reinhart and Rogoff's findings.

A country can try to solve its debt issues by reducing the amount of debt (D), or by increasing GDP (Y). To raise its GDP, a country has two main options: implementing structural reforms to increase the growth rate or increasing inflation. To reduce debt, by contrast, a country can repay or restructure debt, make the central bank absorb the debt or try to limit interest costs (Buttiglione et al. 2014, 77–81). Throughout world history, there is scant evidence of countries having grown out of debt (Reinhart and Rogoff

Figure 1 Government-debt-to-GDP ratio, 2007 and 2015, euro crisis countries



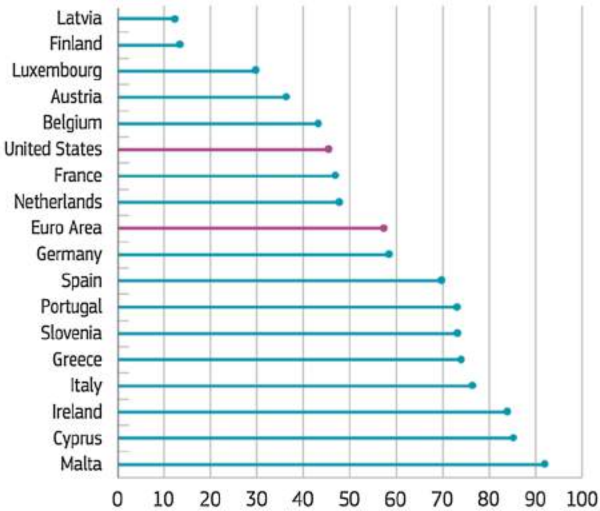
Source: Author's own illustration. Data from Eurostat 2017a.

2009, 289). This does not diminish the importance of implementing structural reforms, since boosting growth and job creation, or increasing government efficiency, can hardly be negative outcomes under any circumstances. However, we must recognise that we should not rely solely on structural reforms, which also tend to take time to take effect.

The ownership of sovereign bonds in the EU is a huge obstacle to using any means other than structural changes to lower the D/Y ratio. Sovereign bonds in Europe are largely owned by each country's own domestic banking sector. There are dramatic differences between countries, but on average the domestic banking sector owns 57% of sovereign bonds. This is considerably higher than the US equivalent of 45%, but what is especially worrying is that in all the big euro-area countries this percentage is above that of the US (European Political Strategy Centre 2015, 2–3). What makes this so concerning is that it limits the options available for countries to deal with their debt levels. For example, forcing losses on creditors through write-downs is not a realistic policy option because it would jeopardise the domestic banking system (Figures 1, 2, 3).

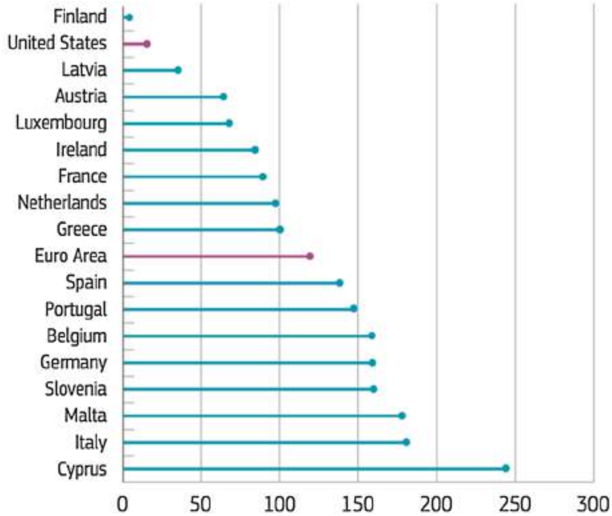
What turns this problem into an existential weakness is the already high debt levels shown in Figure 4, together with the limited scope for lowering debt-to-GDP ratios. If we assume that Reinhart and Rogoff's research and the experience we have of the recent crisis in the euro area are indicative of the effect the next crisis will have on public debt levels, we can expect the next crisis to raise countries' debt-to-GDP ratios by more than 50% compared to the pre-crisis level. It remains questionable whether the markets

Figure 2 Sovereign debt held by domestic banks at the end of 2013 (as a percentage of total government debt)



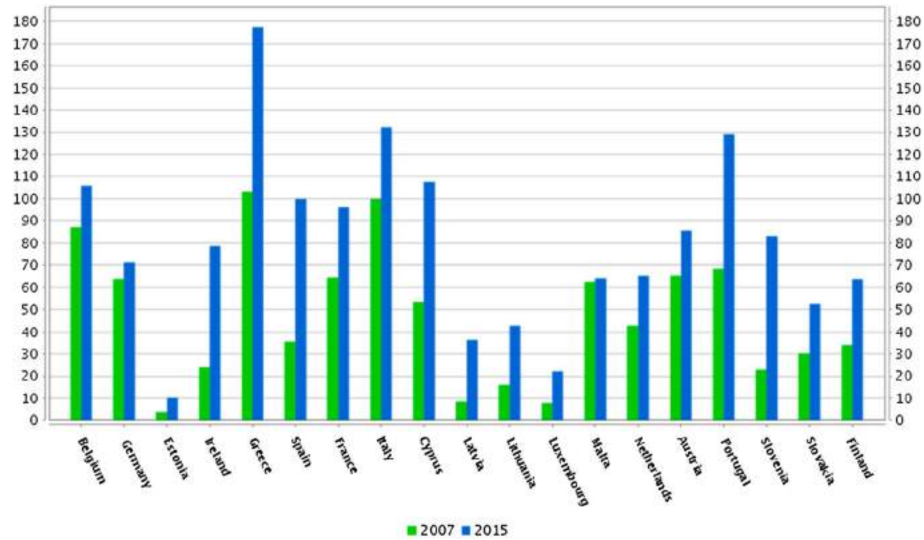
Source: European Political Strategy Centre 2015, based on data from the European Banking Authority and the Board of Governors of the Federal Reserve System. Reproduced with permission.

Figure 3 Exposure of banking system to domestic government debt at the end of 2013 (as a percentage of own funds)



Source: European Political Strategy Centre 2015, based on data from the European Banking Authority and the Board of Governors of the Federal Reserve System. Reproduced with permission.

Figure 4 Debt-to-GDP ratios in the euro area, 2007 and 2015



Source: Author's own illustration. Data from Eurostat 2017b.

would be willing to fund such an increase in public debt. For example, compared to the current levels, Italy's debt-to-GDP ratio would be well beyond 200% and France would find its ratio above 150%. Naturally, these are only back-of-the-envelope calculations. However, the dangers associated with the situation should prompt member states to adopt a strategic long-term plan to reduce their debt levels and separate banks from sovereigns, so as to have the room to cushion the next crisis, which is inevitable. The question is whether our democracies are capable of adopting and implementing strategic policy initiatives, which are politically costly and divisive, to create space to cushion the next banking crisis, since this approach will require years of considerable primary surpluses.

Conclusion

This article argues that maintaining the status quo is not an option for the euro area due to functional weaknesses which lead to the suboptimal functioning of the EMU and in turn to political friction among members. Furthermore, far-reaching reforms are needed due to the high D/Y ratios. These result in there being only limited room to cushion the next banking crisis, which, history tells us, is inevitable. If debt-to-GDP ratios are not lowered and banks are not separated from their sovereigns, the next banking crisis may prove to be an existential threat to the EMU. Nevertheless, it is absolutely clear that, rather than dismantling the euro, action should be taken to correct these weaknesses.

References

Anderton, R., Aranki, T., Dieppe, A., Elding, C., Haroutunian, S., Jacquinot, P., Jarvis, V., Labhard, V., Rusinova, D., & Szörfi, B. (2014). *Potential output from a euro area perspective*. European Central Bank Occasional Paper Series no. 156. Frankfurt am Main. https://www.ecb.europa.eu/pub/pdf/scpops/ecbop156.en.pdf?12f64165c5623d34b98b978cbe614ed9. Accessed 1 May 2017.

Buttiglione, L., Lane, P., Reichlin, L., & Reinhart, V. (2014). *Deleveraging? What deleveraging?* International Center for Monetary and Banking Studies. Geneva Reports on the World Economy. Geneva, Switzerland. http://voxeu.org/system/files/epublication/Geneva16.pdf. Accessed 1 May 2017.

Ehmer, P. (2017). *Labour mobility in Europe does little to mitigate economic shocks: National labour markets absorb adjustment pressure*. KfW Research no. 156. 18 January. https://www.kfw.de/PDF/Download-Center/Konzernthemen/Research/PDF-Dokumente-Fokus-Volkswirtschaft/Fokus-englische-Dateien/Fokus-2017-EN/

Fokus-Nr.-156-January-2017-Labour-mobility-in-Europe_EN.pdf. Accessed 1 May 2017.

European People's Party. (2017). *A safer and more prosperous economic and monetary union*. Brussels. http://www.epp.eu/papers/a-safer-and-more-prosperous-economic-and-monetary-union/. Accessed 1 May 2017.

European Political Strategy Centre. (2015). *Severing the 'doom loop': Further risk reduction in the banking union*. Five Presidents' Report Series 3/2015. https://ec.europa.eu/epsc/sites/epsc/files/5p_note_bankexposure.pdf. Accessed 1 May 2017.

Eurostat. (2017a). *General government gross debt (EDP concept), consolidated—annual data*. http://ec.europa.eu/eurostat/web/products-datasets/-/tipsgo10. Accessed 30 May 2017.

Eurostat. (2017b). *General government gross debt (EDP concept), consolidated—annual data*. http://ec.europa.eu/eurostat/web/products-datasets/-/tipsgo10. Accessed 30 May 2017.

Investopedia. (n. d.). *Balassa–Samuelson effect*. http://www.investopedia.com/terms/b/balassasamuelson-effect.asp. Accessed 1 May 2017.

Mundell, R. (1961). A theory of optimum currency areas. *American Economic Review, 51*(4), 657–65.

Natarajan, G. (2010). Euroland and optimal currency areas. *Urbanomics*, 10 May. http://gulzar05.blogspot.com/2010/05/euroland-and-optimal-currency-areas.html. Accessed 1 May 2017.

Odendahl, C. (2014). *The eurozone's real interest rate problem*. Centre for European Reform. 8 July. https://www.cer.org.uk/insights/eurozones-real-interest-rate-problem. Accessed 1 May 2017.

Reinhart, C., & Rogoff, K. (2009). *This time is different: Eight centuries of financial folly*. Princeton, NJ: Princeton University Press.

Storm, S., & Naastepad, C. (2015). *Myths, mix-ups and mishandlings: What caused the eurozone crisis?* Institute for New Economic Thinking. https://www.ineteconomics.org/uploads/papers/The-Eurozone-Crisis.pdf. Accessed 1 May 2017.

Villanueva, E. (2015). *Collective bargaining, wage rigidities and employment: An analysis using microeconomic data*. Banco De Espana, Economic Bulletin. April. http://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/15/Abr/Files/be1504-art2e.pdf. Accessed 1 May 2017.

Visco, I. (2016). Banks' sovereign exposures and the feedback loop between banks and their sovereigns. Concluding remarks, Euro50 Group, The Future of European

Government Bonds Markets. https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2016/Visco_Euro50_Bank_Sovereign_Exposure_02052016.pdf. Accessed 1 May 2017.

Juha-Pekka Nurvala *is a political adviser for economic and social policy at the European People's Party. He holds a BA in international politics from King's College London and an M.Sc. in the political economy of Europe from the London School of Economics and Political Science. In 2016 he was on the Forbes '30 Under 30' list for Policy in Europe.*

EUROPEAN VIEW (2017) 16:85–91
DOI 10.1007/s12290-017-0426-x

CrossMark

ARTICLE

A new Europeanism before it is too late

Federico Ottavio Reho

Published online: 9 May 2017

Abstract This article argues that the traditional European narrative based on the rhetoric of progress, openness, 'an ever closer union' and the ever greater sharing of sovereignty has lost traction with a significant percentage of the European electorate, who are gripped by frustration, insecurity and disarray. It sketches the broad lines of a new Europeanism, arguably one that would be better equipped to deal with populism and identity politics. It makes the case for a 'leaner Europe', less bureaucratic and intrusive, but also more openly political and culturally grounded.

Keywords Europeanism | European integration | Subsidiarity | Eurozone

F. O. Reho (✉)
Wilfried Martens Centre for European Studies, Rue de Commerce 20, 1000 Brussels, Belgium
e-mail: fr@martenscentre.eu

Introduction

For all of us who believe in European unity, these are rather disquieting times. European integration has been thrown, together with so much else, into the confused cauldron of populist anger. Crises in a number of areas, from the economy to migration, and from terrorism to turmoil in Libya and the Middle East, are filling the ranks of anti-establishment movements and casting a shadow on the future of our political systems. EU institutions have never been so unpopular, and never in living memory have parties so utterly opposed to the European project made such inroads into the mainstream. Britain has voted to leave the EU and Donald Trump, the darling of all the EU's arch-enemies, is the new US president.

Amidst this perfect storm, there is no longer time for complacency about the European project. The traditional European narrative based on the rhetoric of progress, openness, ever closer union and the ever greater sharing of sovereignty has served us well for a long and successful historical period. However, it has clearly lost traction with a significant part of the European electorate, which is gripped by frustration, insecurity and disarray. If we are to pursue the overarching aim of maintaining and hopefully strengthening a supranational order in Europe, we have a duty to recognise, before it is too late, the historical exhaustion of traditional Europeanism, and to reinvent Europeanism for the challenges of the new century. This article is a modest and necessarily incomplete attempt to give a sense of the direction we could take. It is written with full awareness that deep forces are driving the revolt against the EU, and that fixing Europeanism is unlikely to be enough to thwart it. However insufficient it may be, it is necessary nonetheless, and we should put our minds and energies to it without further ado.

Traditional Europeanism and its limits

Traditional Europeanism has dominated European integration since the late 1950s. Its founding event was probably the failure of the European Defence Community in 1954, which led to the understanding that a one-shot transition to a federal Europe was politically impossible. The solution found was a specific mode of integration consisting of the sharing of sovereignty within common European institutions in more and more policy fields, starting with the fields necessary to create a common European market. It was expected that integration in these fields would generate common problems and encourage integration in other fields, thus fuelling a self-supporting integration dynamic that would one day culminate in the need for political federalisation. This is so-called neo-functionalism: this peculiar mode of 'round-about integration' is a central component of traditional Europeanism. It has great historical merits, as it has made possible significant transfers of power to supranational institutions, while maintaining the reassuring illusion that European states are still fully sovereign entities.

Since the 1990s, however, the limits and flaws of neo-functional integration have dangerously started to surface. First, its fundamental ambiguity regarding the final competences and constitutional set-up of the EU has become less and less tenable as the European project has become more openly political since the Maastricht Treaty. Without precise constitutional content, previously harmless slogans such as ‘ever closer union’ and ‘more Europe’ have left pro-Europeans open to the accusation that they are ultimately struggling to unify the continent within a state-like polity, with little autonomy left for member states. Supporters of integration have done little to correct the impression that they consider the transfer of more and more powers to the European level to be an end in itself. Second, a technocratic sense of inevitability has been disturbingly attached to neo-functional integration, often conveying the condescending impression that political opposition to any integration initiative could only be due to technical ignorance or to dangerous nationalistic tendencies.

A second, related, component of traditional Europeanism seems to be its tendency to conceive European integration as a process of state-making, as opposed to a genuine process of federalisation. Evidence of this tendency can be found, for example, in the often displayed preference for centralisation, harmonisation and detailed regulation that is clearly not in line with well-conceived federalism. Authentic federalism would require the centralisation of very few functions (e.g. foreign policy, defence, the four freedoms of the internal market) and the complete decentralisation of everything else, while traditional Europeanism proceeds through the ‘sharing’ of sovereignty in an ever-growing number of policy fields. Hence the widespread impression that, in the EU, sovereignty can potentially be ‘shared’ in virtually all areas of public policy, unlike in traditional federations, where the federal level has competence in a limited number of clearly enumerated fields. Further evidence is provided by the striking disconnection between EU rhetoric and the cultures and traditions of Europe’s civilisation: the dominant cultural trait of traditional Europeanism seems to be a vague celebration of diversity with progressive overtones that bears little resemblance to the historically grounded identities of Europe’s nations and regions.[1] On the contrary, a federation would find its ultimate *raison d’être* precisely in the preservation and celebration of such identities, as opposed to in the exaltation of abstract ideals such as progress, equality, diversity and openness, however commendable they may be.

Recent political developments have confronted us with the unmistakable return of identity politics all over the world. This is no longer the rational identity of appeasing, cosmopolitan ideals, but the stormy identity of nations, language and historical memory. It is imperative that the European project reconnects itself with the resurging identities of its nations and regions, or it will seal its own downfall.

[1] This point allows us to signal an important distinction between what is here called traditional Europeanism and the Europeanism of the Christian Democratic founding fathers. The latter influenced the very first steps of integration: it was broadly federal in outlook, deeply attached to the cultural heritage of Europe’s civilisation, and very respectful of national and regional autonomy. The former has lost sight of much of this wisdom.

A leaner Europe for the new century

After years in denial, parts of the European establishment have started to recognise that, notwithstanding the abysmal disregard of many Eurosceptics for basic facts and the norms of civility, certain aspects of traditional Europeanism do play into their hands when they attack the EU as a distant, bureaucratic and centralising entity with little respect for national differences. During his campaign for the presidency of the European Commission, Jean-Claude Juncker used a slogan to convey a sense of change: the EU should be 'big on big things and small on small things'. In the wake of his election, the new president followed this up by drastically reducing the number of new regulations proposed by the Commission, thus trying to curb the blatant over-regulation that had grown up since the late 1980s, often beyond what was strictly justified by the needs of the single market. Most strikingly, he declared in a speech last year that 'we should stop talking about the United States of Europe, because the peoples of Europe do not want them. . . . Giving the impression that the European Union is on its way to becoming a state does not get us anywhere' (Juncker 2016).[2] Repeated warnings by President of the European Council Donald Tusk have also marked a clear break from traditional EU rhetoric. For example, in his widely commented on letter to EU leaders ahead of the informal European Council in Bratislava last September, Tusk wrote that 'we will not change the European Union into a single state' and that 'the institutions should support the priorities as agreed among member states, and not impose their own ones' (Tusk 2016). This is a clearly confederal vision of European integration that runs counter to decades of 'federalist' discourse, when 'more Europe' was seen as the inevitable response to current challenges. What could a leaner, more agile Europe look like then?

Some historical reference models for Europe's future

Whenever we imagine the future of Europe, it is almost inevitable that we do so based on some sort of reference model. As has been said, for a long time the implicit model of traditional Europeanism seems to have been some variation of the nation-state, or at best the contemporary US, a very centralised federation that long ago lost many of its genuinely federal attributes.[3] This accounts for the emphasis on legal centralism and the total harmonisation of national rules and standards (see Majone 2014, 110–12 and 285–9), which has been so widespread for the best part of the integration process. Instead, it would be advisable to take as reference models much more decentralised and multinational polities in the early phases of their history. The American or the Swiss confederation, or even the Austro-Hungarian Empire as imagined by its best reformers, are probably better models for a viable EU than any nation-state. Their examples tell us

[2] This article was written before the Juncker Commission published, in March 2017, its important '*White Paper on the Future of Europe*'. Thus, it does not refer to this document. However, signs of this change of mindset are clearly detectable in the tone and in the five scenarios provided in the white paper, in sharp contrast to the usual 'ever more Europe' rhetoric of the European Commission.

[3] On the erosion of US federalism, see, for example, Greve (2012).

that, politically and institutionally, Europe should be a group of largely autonomous entities subject to strong but very limited central authorities, primarily endowed with powers of conflict resolution and arbitration, not with powers of minute management and detailed regulation. These authorities should also administer, on a confederal or federal basis,[4] a limited number of clearly enumerated policies, which should not go much beyond defence, foreign policy, the enforcement of the four freedoms of the internal market and the prohibition of state aids.[5] All other matters should be strictly reserved to member states and smaller administrative units, with no interference whatsoever from Brussels, as the secret of a well-functioning union of states is decentralisation and respect for local freedoms and traditions. Only this clarity can end the present acrimonious situation in which everyone is responsible for everything and nothing at once, and the EU administers endless spending programmes of little transparency and dubious utility. The strictest subsidiarity should also apply to culture. The emphasis at the European level should shift from trying to promote an artificial European identity—often based on abstract, progressive values that part of the European population legitimately rejects—to rediscovering the cultural, spiritual and political foundations that made Europe 'united in diversity' for almost a millennium before the European project appropriated the motto for itself. People should come to see the EU as a guarantor of their national and regional identities, not as a competing cultural force with bizarre claims to nationhood.

The biggest challenge: the euro area

The biggest challenges to a leaner Europe that can be rationally explained to its citizens and is well-equipped for the new century admittedly come from the state of the euro area. The euro was the boldest neo-functionalist experiment in the history of European integration, and it displays all the lights and shadows of traditional Europeanism to their utmost. Its seemingly technocratic rationale—the need to eliminate price distortions within the single market and to abandon a clearly dysfunctional system of monetary cooperation among independent currencies—made possible an unprecedented integrative step that transferred one of the traditional prerogatives of statehood to the EU. However, the euro has also demonstrated the ultimate inability of neo-functional integration to generate the political capital needed to unify the continent in accordance with the model of statehood favoured by traditional Europeanism. In fact, as a consequence of the euro crisis, opposition to the EU has surged to unprecedented levels. A complex set of rules and controls has been adopted that has hollowed out national budgetary sovereignty and introduced a rather intrusive form of co-management of the national economies between national and EU authorities. Long-term plans for the

[4] The opposition between confederalism and federalism is largely exaggerated in contemporary literature. Virtually all historical federations started out as confederations and only evolved into more integrated polities when time and common practices had made it acceptable to their members and their citizens.

[5] The extent to which economic openness within the internal market requires detailed regulation from Brussels is certainly overplayed. Mutual recognition and regulatory competition between different jurisdictions should, in general, be preferred to the imposition of a unique regulatory regime on the whole continent.

viability of the euro also include an economic and a budgetary union, which would further advance the EU on its way to statehood, albeit without announcing it too loudly and in a purely neo-functionalist fashion. When one takes even a distracted look at political trends in Europe, one must conclude that the strained edifice of EU legitimacy is likely to horrendously crack—and probably collapse altogether—under the heavy weight of this dense and intrusive integration. Honest pro-Europeans should admit that increasing democratic controls at the European level is unlikely to make any difference, as it has made little difference in the past, in the presence of far less intrusive initiatives. We are dealing with a *substantive* problem of identity and political allegiance (which are still primarily national). No *procedural* solution (e.g. no increase in the powers of the European Parliament) can offer a credible way out. We are therefore left wondering under what conditions a decentralised monetary union, in which member states can recover the core of their economic and budgetary powers, could be sustainable. The subject is too vast to be dealt with here with any accuracy. However, such a monetary union would seem to require a profound restructuring of national economies in the sense of more flexibility and a drastic reduction of public debt, which is not conceivable without radical changes to our expensive welfare systems. It would also seem to demand a truly unified banking system, integrated across national borders, and in which national banks have no special bonds with national sovereigns, as well as a return to the strict no bailout framework of the Maastricht Treaty, which was repeatedly broken during the crisis by fiscal and monetary authorities alike. This also means that countries that lose market access due to their profligate fiscal policy and high debt levels must be allowed to go bankrupt and potentially leave the monetary union.

Conclusion

The challenge is daunting, but if a transition along the lines described above could be accomplished, the European economy and the political integration of the continent would move off on an entirely new trajectory. Reforms and debt reduction would breathe new life into Europe's stagnant economies, long enfeebled by an overdose of taxation, bureaucratisation and regulation. And the whole continent would be reorganised based on a new Europeanism that gave strong but clearly defined and limited powers to the supranational level, while preserving Europe's nation states as largely autonomous communities. The density of the present integration model, which penetrates so deeply into the flesh and bones of national laws and practices through pervasive regulations, ubiquitous shared competences and detailed fiscal rules, must be greatly reduced for good. Europe would become easier to explain and defend, and its benefits more visible, especially in the presence of external challenges. If we are finding it difficult to explain the present EU to our citizens and defend it from the assaults of Eurosceptic parties, it is probably a sign that something is wrong with it. Let us try to change it before it is too late.

References

Greve, M. S. (2012). *The upside-down constitution*. Cambridge, MA: Harvard University Press.

Juncker, J. C. (2016). Speech delivered at the public conference for twenty years of the Institut Jacques Delors/Notre Europe. Paris, 7 October. French text available at http://europa.eu/rapid/press-release_SPEECH-16-3348_en.htm. Accessed 21 March 2017.

Majone, G. (2014). *Rethinking the Union of Europe post-crisis*. Cambridge: Cambridge University Press.

Tusk, D. (2016). Letter from President Donald Tusk before the Bratislava Summit. Press release 511/16. 13 September. http://www.consilium.europa.eu/en/press/press-releases/2016/09/13-tusk-invitation-letter-bratislava/. Accessed 21 March 2017.

Federico Ottavio Reho *is a Research Officer at the Wilfried Martens Centre for European Studies. He previously worked in the EU Institutions and Fora Division of the European Central Bank. He has studied European political economy in four European countries, including at the London School of Economics and the Hertie School of Governance (Berlin).*

EUROPEAN VIEW (2017) 16:93–102
DOI 10.1007/s12290-017-0447-5

ARTICLE

The Libyan conflict and its controversial roots

Nicola Pedde

Published online: 4 July 2017

Abstract The Libyan conflict is the result of a complex and controversial series of developments, where local political events have been strongly influenced and driven by exogenous factors. A dual set of conflicting interests can be found in both the Euro-Mediterranean and inter-Arab dimensions, with Italy and Turkey struggling against France and Great Britain on one side, and Qatar being opposed by the United Arab Emirates and Saudi Arabia on the other. Muammar Qaddafi's regime, which was certainly not an example of good governance and respect for human rights, was quickly swept away by a conflict primarily fought by non-Libyan actors, which eventually caused the collapse of the central institutions in Libya and the creation of dozens of local militias. The failure of both local and exogenous ambitions has caused a crisis in which additional factors have been able to influence the Libyan civil war, making the situation very opaque and extremely difficult to solve.

N. Pedde (✉)
Institute for Global Studies, Piazza Guglielmo Marconi, 15, 00144 Rome, Italy
e-mail: pedde@globalstudies.it

Springer

Keywords Libyan civil war | Qatar–United Arab Emirates competition | Italy | Muslim Brotherhood | Ansar al-Sharia | Turkey | Saudi Arabia | Islamic State

Introduction

When, in February 2011, a protest erupted in Benghazi, few were expecting that Libya would see a phenomenon similar to that which had shaken Tunisia and Egypt in the previous months. In late 2010 and early 2011, the Western media were quick to label the events in Tunisia and Egypt an 'Arab Spring', making the assumption that they were a sort of revolution against authoritarianism and dictatorship. Very few understood that the roots of these protests were instead primarily driven by poverty and dignity, as a reaction to the deteriorating social environment, to corruption and to the government's abuses (Hashemi 2013, 12). The trigger for the Tunisian revolt was the suicide of a poor street vendor, who had been made desperate by the continuous abuses of the local police, while in Cairo the protest started among the youngest members of the population, who were upset by the corruption, the growing unemployment and the widespread poverty. Few talked about democracy or freedom in their protests, while the vast majority openly challenged the government, asking for dignity, employment and the possibility of a normal life (Chulov 2011). To understand today's Libya, one needs to consider the roots of the recent developments there from a more pragmatic and analytical viewpoint, thereby bringing to the surface the endogenous but also—and particularly—the exogenous factors which contributed to its making.

The roots of the Libyan crisis

The situation in Libya in 2011 was completely different from those in Tunisia and Egypt. Despite being governed by an authoritarian leader, Libya's relatively small population, combined with its outstanding economic performance, granted a certain degree of prosperity to most of the population. The oil and gas industry was able to absorb most of the skilled personnel in the country, allowing the rest to benefit from the profits. The strict control over politics and security—ensured by a system of loyalty built over the years through alliances, nepotism and money—enabled President Muammar Qaddafi to maintain power for an extraordinarily long time. Spared in the conflicts with the US of the 1980s and the 1990s, Qaddafi gradually normalised relations with the West and, in the early 2000s, was welcomed as a triumphant head of state, revered by Europeans and tolerated by the US (Mezran 2012). No significant underground opposition movements were present in Libya in 2011, as popular dissent was limited to a few elements among the diaspora. No one was expecting a protest or even a revolt in Benghazi in 2011, since it was assumed that Libya was one of the more stable states in the region. When violence exploded in the streets of Cyrenaica, most European countries were caught by surprise, and that is why they sent out ambiguous and confused messages. Even Qaddafi was taken by surprise and reacted in a confused way (Ardiç 2012, 14).

It was, however, soon clear that what was happening in the eastern region of Cyrenaica was something different from a simple revolt, and more complex than merely local insubordination. From the beginning, the coordinated series of actions, the availability of a large quantity of weapons and ammunition, and the existence of a series of targets on the ground clearly demonstrated the presence of a plan, something which is incompatible with a simple riot. Another factor of fundamental importance has to do with the rapid reactions of certain European governments, particularly those of France and Great Britain, which almost immediately supported the anti-governmental positions.

Massive global media coverage started to disseminate a narrative of the Libyan crisis that was largely built on the idea of a violent government reaction to an attempt at a peaceful popular revolt. The primary source of this narrative was the Qatari news network Al Jazeera, which started broadcasting images of violence, destruction, rage and death on a systematic basis, convincing the European public that a massacre had been started by Qaddafi with the aim of ensuring the continuation of his power and privileges (*Al Jazeera* 2011a, c, d, e). Most of the news stories which were systematically communicated to Western households described how Qaddafi's air force was indiscriminately bombing urban areas, creating thousands of civilian casualties. Thus the message was that it was a massacre which had to be stopped at all costs, with the support of the international community (Krauss 2011).

A reluctant NATO, and an even more reluctant US, was then involved in a short but significant mission which targeted Libyan governmental assets on the ground, annihilating the local air force and stopping the advance of the loyalist forces on Benghazi. The bombing quickly damaged Qaddafi's defences, and he eventually left the capital, taking refuge in Sirte, where he was born and from where his tribe originated. The rest of the story is well known (Mezran 2014a). Qaddafi was eventually killed while desperately moving from one place to another, refusing to surrender to an enemy that he had probably not even identified (Shanker and Schmitt 2011).

The role of Qatar, France and the United Arab Emirates

What emerged in the aftermath of the Libyan crisis offered a completely new and different perspective to the events which had led to the fall of Qaddafi and Libya's collapse into chaos. The revolts in Tunisia and Egypt, dictated by popular rage and provoked by poverty and a lack of dignity, had led to the collapse of the traditional authoritarian system in those countries. This had convinced Qatar of the need to implement a new strategy in the region, based on the establishment and/or support of local moderate Islamic political forces (Roberts 2011). This strategy was based on the assumption that only through a transition led by Islamic movements could the Gulf monarchies resist—and survive—the general trend of transition that was being observed by the Middle Eastern powers. While Saudi Arabia had historically linked its protection and political survival to the promotion of radical Islamist forces, such as the Wahhabis and the Salafists, the former Emir of Qatar—Hamad bin Khalifa Al Thani—preferred moderate and participative groups, such as the Muslim Brotherhood (Khatib 2013).

At the same time, former French President Nikolas Sarkozy was being persuaded by his adviser Bernard-Henri Lévy (Lévy 2016) that there was a window of opportunity in Libya to topple Qaddafi, which might open up a rich new market for both energy and the defence industry (Jacinto 2016). Thus Qatar and France—with the collateral support of the UK—combined forces (finances and military capacity) in an attempt to provoke a major popular protest in Libya. Ironically, however, most Libyans refrained from joining the riots, largely remaining passive bystanders, which thus allowed Qaddafi's troops to reconquer most of the country in few weeks and to move quickly towards Benghazi to crush the revolt and restore his power.

Facing an almost certain defeat, the rebels from Cyrenaica (composed of a mix of civilians, former soldiers and religious organisations) requested the aerial intervention of NATO (Brody 2011), which was eventually agreed upon, mostly because of the narrative broadcast by Al Jazeera (2011b, 2016), which built on the fear of carnage and violence by Qaddafi. The political environment that emerged from the collapse of the Qaddafi regime was almost immediately characterised by the historical dualism between Cyrenaica and Tripolitania, with a polarisation of interests that soon led to a de facto division of the country.

The impossibility of promoting a concrete plan for national reconciliation eventually led to the disaggregation of both the political and military powers and, with the rise of city-militias and the fragmentation of alliances, to a chaotic and confused map of interests (Zenko 2016).

The rise of the Muslim Brotherhood, among many other Islamist forces, alarmed Saudi Arabia and the United Arab Emirates (UAE), which have always considered the *Ikhwan* (from the Arabic, 'brothers') to be an existential threat to the survival of the Gulf monarchies. However, with the death of King Abdullah on 23 January 2015, and the subsequent appointment of Salman bin Abdulaziz as his successor, Saudi Arabia entered a new and more moderate phase in terms of its attitude towards the Muslim Brotherhood, leaving the UAE to lead the fierce opposition to the group in the region (Cafiero and Wagner 2015). These events led to open support for Egypt and its new president, General al-Sisi, and for Haftar, al-Sisi's proxy in Libya. Haftar had been a general under Qaddafi but defected during the 1987 Chad war, eventually moving to the US. He re-emerged soon after the collapse of Qaddafi's regime and returned to Libya with the aim of becoming its new strongman (Cafiero and Wagner 2015).

From this dualism, the Libyan crisis was dragged into its current dimension. On the one side, Haftar accuses his opponents of being dangerous jihadists, thereby trying to influence the already quite strong Islamophobic sentiment in the West (Ghanmi 2017). On the other side, the heterogeneous Islamist forces of Tripolitania accuse Haftar and his entourage of being Qaddafian restoration forces, whose aim is to topple the popular revolt which ended the authoritarian regime (Gaffey 2016). It is a chaotic situation, further complicated by the rise of dozens of local interests in villages and provinces, where militias have been organised and equipped by dubious self-proclaimed military commanders, and where organised crime has started to manage the flourishing business of controlling migratory flows.

Thus what is still impeding reconciliation and the normalisation of the situation in Libya is the outcome of this complex and articulated crisis, where personal and governmental interests are interlaced at various levels, producing an explosive combination which cannot be easily disentangled.

General Haftar's personal ambition is to govern Libya as a sort of new absolute leader. However, Islamist forces are not willing to accept what they perceive as a purely Qaddafian restoration of power, and are fiercely opposing Haftar's narrative and its financiers in the Gulf (Saleh 2017).

Egypt is looking to influence Libya—through its support for Haftar—to chase the Muslim Brotherhood out and prevent its local political consolidation, and is also hoping to gain financial support from the UAE by doing so. Such support would offer the economy a vital breath of life, which would help to contain what is almost certainly the worst economic crisis in Egypt's contemporary history (Wenig 2017).

The threat of Islamic State in Libya

Among the Libyan Islamist militias, the largest, most efficient and best organised was undoubtedly the group known as Ansar al-Sharia. The organisation was formed during the latter days of Muammar Qaddafi's rule, by combining into a unified new entity most of the existing Islamist militias that had chaotically emerged following the clashes of 2011 (Ashour 2015, 7). Ansar al-Sharia was organised around the activities of the charitable organisation Al Dawa al-Islah, which was known for its management of hospitals, schools and public services.

The leadership of the group was firmly in the hands of Mohammed al-Zahawi until his death in early 2015, which was probably caused by injuries sustained during clashes (Gratrud and Skretting 2017).

The first major activity carried out by Ansar al-Sharia took place on 7 July 2012, in Benghazi, when it burst upon the city in a convoy of about 200 armed off-road vehicles and declared its intention to impose shariah on Tripoli. There is also good reason to believe that Ansar al-Sharia planned and organised the attack on the US consulate in Benghazi on 11 September of the same year, in which Ambassador Christopher Stevens died (*Reuters* 2014).

The Islamist organisation never enjoyed great popularity in the territory of Benghazi, even when it tried to develop a stronger bond with the population by providing public utility and security services. The violent methods it adopted, its radical guiding principles and especially its ongoing attempts to impose shariah on a society which was not particularly observant, led, in September 2012, to the Benghazi population revolting against the units of Ansar al-Sharia, forcing them to fall back to more remote inland villages. With the departure of Ansar al-Sharia from the city of Benghazi, the other, smaller Islamist organisations were gradually forced to dissolve or leave the city, often reorganising themselves into smaller groups (Zelin 2015).

For much of 2013 and early 2014 the forces of Ansar al-Sharia did not represent any real threat to the security and stability of Tripoli and Benghazi, as they were mostly being sheltered in rural areas. It was General Haftar who revitalised and re-legitimated the group, by launching a campaign against terrorism and jihadism that was based on the assumption that all Islamist forces were part of the Al-Qaeda network.

Operation Dignity, officially launched on 16 May 2014, declared war on all organisations and militias politically hostile to Haftar, with the clear objective of gaining the support of Western countries and Egypt (Eriksson 2016). This move generated an almost immediate reaction, that of the reunification of many Islamist groups, radicalising some of them and promoting their partnership under the weak but functional umbrella of the Shura Council of Benghazi Revolutionaries.[1] When in early 2015, Ansar al-Sharia's leader al-Zahawi died, his organisation gradually fragmented into smaller groups, led by different commanders with quite heterogeneous backgrounds. A growing number of clashes resulted in a divide appearing among the various groups, as some decided to remain loyal to al-Zahawi's original mission, while others opted to evolve towards even more radical positions.

Within this complex crisis the first local affiliation to Islamic State (IS) emerged, mostly composed of militias that had already fought with Daesh in Iraq or Syria.

The official constitution of the local Daesh component dates back to October 2014, to the coastal city of Derna. This group almost immediately started clashing with other former Ansar al-Sharia groups, resulting in a new, long and painful period of violence. The reaction of the other Islamist groups forced IS to withdraw from Derna and move to the city of Sirte. However, even in Sirte, IS never significantly grew in size.

Nevertheless, a new narrative, built on the massive presence of Daesh in North Africa, and its potential spillover to Europe through the flow of migrants, became central to increasing support for the Cyrenaican strongman, General Haftar, who presented himself as the last bastion against IS, asking for support and—particularly—for political recognition (Sizer 2014).

The real defeat of IS in Sirte, however, came towards the end of 2016, thanks to the role of the militia of Misrata, which was allied with the official government in Tripoli and

[1] Formed in 2014 as an organisation opposed to both the anti-Islamist Operation Dignity and the newly composed Council of Deputies, the Council was mostly composed of Islamist militias afraid of being sidelined by Haftar in the domestic political framework.

opposed to both Haftar and radical Islamist groups. The fierce battle, which was fought street by street in the coastal city where Daesh had established its local command, resulted in a huge number of casualties on both sides, but eventually forced Daesh to withdraw into the desert.

Conclusion

What has been generically defined as the ‘Arab Spring’ was, in fact, a series of extremely different events which began unfolding in the Middle East at the beginning of 2011.

The Libyan crisis was completely different from the events which shook Tunisia, Egypt, Syria and Yemen, as it was the result of a local political evolution where exogenous factors contributed to maximising the effects of the crisis. Libya has been subject to a political experiment led by Qatar and managed by France (Black 2011), which has sadly resulted in a real civil war in which a Pandora’s Box of long-repressed tribal interests has been opened (El-Gamaty 2016). The interests of the various political forces which clashed, and are still fighting for predominance, have produced a narrative which is often totally detached from the reality on the ground (Mezran 2014b).

The West has been intentionally misled into the usual reading of a conflict between secular forces (the good side) and Islamist radical militias (the bad side), and has fallen into the trap of interpreting the crisis in a monolithic way. In contrast, the local narrative is based on the idea of a conflict between revolutionary and counter-revolutionary forces, in a context where a huge number of different ideological and political groups represent the mosaic of interests in post-dictatorial Libya. The threat from IS has again been part of a manipulation of the local narrative, with the precise goal of supporting the interests of one party over the other, in a zero-sum-game logic of conflict which is still far from being solved.

References

Al Jazeera. (2011a). Deadly ‘day of rage’ in Libya. 18 February. http://www.aljazeera.com/news/africa/2011/02/201121716917273192.html. Accessed 6 June 2017.

Al Jazeera. (2011b). Gaddafi blames unrest on foreigners. 10 March. http://www.aljazeera.com/news/africa/2011/03/20113944216568348.html. Accessed 6 June 2017.

Al Jazeera. (2011c). Libya protests spread and intensify. 22 February. http://www.aljazeera.com/news/africa/2011/02/2011221133557377576.html. Accessed 6 June 2017.

Al Jazeera. (2011d). 'Many killed' in Libya's Benghazi. 20 February. http://www.aljazeera.com/news/africa/2011/02/2011219232320644801. Accessed 6 June 2017.

Al Jazeera. (2011e). Mass grave of Libyan prisoners found. 25 September. http://www.aljazeera.com/news/africa/2011/09/20119251823889148.html. Accessed 6 June 2017.

Al Jazeera. (2016). Crisis in Libya: Who's to blame? 21 October. http://www.aljazeera.com/programmes/upfront/2016/10/crisis-libya-blame-161021112850279.html. Accessed 6 June 2017.

Ardiç, N. (2012). Understanding the 'Arab Spring': Justice, dignity, religion and international politics. *Afro Eurasian Studies, 1*(1), 8–52.

Ashour, O. (2015). *Between ISIS and failed states: The saga of Libyan Islamists*. Washington, DC: Brookings Institution, Rethinking Political Islam Series.

Black, I. (2011). Qatar admits sending hundreds of troops to support Libya rebels. *The Guardian,* 26 October.

Brody, R. (2011). Did Bernard-Henri Lévy take NATO to war? *The New Yorker*, 25 March.

Cafiero, G., & Wagner, D. (2015). How the Gulf Arab rivalry tore Libya apart. *The National Interest*, 11 December.

Chulov, M. (2011). The Arab spring has seen dignity being clawed back. *The Guardian*, 17 December.

El-Gamaty, G. (2016). The French connection in the West's scramble for Libya. *The New Arab*, 2 August.

Eriksson, M. (2016). A fratricidal Libya: Making sense of a conflict complex. *Small War & Insurgencies, 27*(5), 817–36.

Gaffey, C. (2016). Who is Khalifa Haftar, Libya's divisive general? *Newsweek*, 22 July.

Ghanmi, L. (2017). Algeria dismisses Islamist's role in Libya as Haftar takes centre stage. *The Arab Weekly*, 19 February.

Gratrud, H., & Skretting, V. B. (2017). Ansar al-Sharia in Libya: An enduring threat. *Perspectives on Terrorism*, *1*(1). http://www.terrorismanalysts.com/pt/index.php/pot/article/view/576/html. Accessed 6 June 2017.

Hashemi, N. (2013). The Arab Spring two years on: Reflections on dignity, democracy, and devotion. *Ethic & International Affairs, 27*(2), 207–21.

Jacinto, L. (2016). The Libyan war, brought to you by Bernard-Henri Levy. *France 24*, 7 June.

Khatib, L. (2013). Qatar's involvement in Libya: A delicate balance. *World Peace Foundation*, 7 January. https://sites.tufts.edu/reinventingpeace/2013/01/07/qatars-involvement-in-libya-a-delicate-balance/. Accessed 6 June 2017.

Krauss, C. (2011). For Qatar, Libyan intervention may be a turning point. *The New York Times*, 3 April.

Lévy, B.-H. (2016). Intervening in Libya in 2011 was the right thing to do. *The Guardian*, 21 September.

Mezran, K. (2012). Libya is still fighting for democracy. *The Atlantic Daily*, 12 July.

Mezran, K. (2014a). *Pulling Libya back from the brink*. Washington, DC: Middle East Institute.

Mezran, K. (2014b). *The political process in Libya*. Washington, DC: Middle East Institute.

Reuters. (2014). U.N. blacklists Libya's Ansar al-Sharia, involved in Benghazi attack. 19 November. http://www.reuters.com/article/us-libya-security-un-idUSKCN0J32KX20141119. Accessed 6 June 2017.

Roberts, D. (2011). Behind Qatar's intervention in Libya—Why was Doha such a strong supporter of the rebels? *Foreign Affairs*, 28 September.

Saleh, H. (2017). Renegade general triggers fears of renewed conflict in Libya. *Financial Times*, 25 January.

Shanker, T., & Schmitt, E. (2011). Seeing limits to 'new' kind of war in Libya. *New York Times*, 21 October.

Sizer, L. (2014). Rewriting Libya's post-revolution narrative. *Atlantic Council*, 16 December.

Wenig, E. (2017). *Egypt's security and the Libyan civil war*. Washington, DC: The Washington Institute, Fikra Forum.

Zelin, A. Y. (2015). *The rise and decline of Ansar al-Sharia in Libya*. Washington, DC: Hudson Institute.

Zenko, M. (2016). The big lie about the Libyan war. *Foreign Policy*, 22 March.

Nicola Pedde, *Ph.D., is Director of the Institute for Global Studies in Rome. He is also the research director for the Middle East at the Military Centre for Strategic Studies, Ministry of Defence, Italy.*

EUROPEAN VIEW (2017) 16:103–120
DOI 10.1007/s12290-017-0449-3

CrossMark

ARTICLE

Morocco's security strategy: preventing terrorism and countering extremism

Assia Bensalah Alaoui

Published online: 7 July 2017

Abstract The rising terrorist threats in the region have compelled Morocco to enhance the protection of its vast territory, long borders, 34 million citizens and over 10 million visitors per year. Morocco's comprehensive security strategy combines a wide range of policies which link the improvement of the socio-economic situation to the capacity to anticipate the risk of terrorism and the operational aspects of the strategy. Security governance and the modernisation of the security forces, religious reform and the promotion of moderate Islam, the involvement of civil society, and close international cooperation, including religious diplomacy, are all key to preventing terrorism and countering extremism. Reforms to improve human security and to lift vulnerable groups out of poverty and exclusion have contributed to enhancing sustainable security. An example for many, Morocco still has a few big challenges ahead, especially to provide quality education, both to 'immunise' the minds of the youth against extremism and to create jobs so that hope can be restored to an overwhelmingly young population.

A. Bensalah Alaoui (✉)
Avenue des Princesses, Souissi, 10170 Rabat, Morocco
e-mail: ambaba37@gmail.com

Springer

Keywords Borders | Terrorism | Governance | Intelligence | Counter extremism | Moderate Islam | Cooperation | Security

Introduction

Amid widespread regional conflicts and insecurity, the Kingdom of Morocco has succeeded in preserving its stability. The country has been spared the upheavals of Arab revolts and the new wave of terrorism.[1] The traditional security challenges facing Morocco are being increasingly exacerbated by a new set of risks and threats that loom heavily over the region. Securing a vast territory, with 34 million citizens, over 10 million tourists, numerous sensitive strategic sites and a proliferation of events (national and international economic and cultural events: conferences, forums, festivals, art fairs etc.) offering a myriad of potential targets, seems a lofty endeavour. External terrorist threats could build on the domestic vulnerabilities of a country where many angry and jobless young people are being seduced by the extremists' powerful propaganda, which offers both money and the fulfilment of dreams. To deal with such a daunting challenge, Morocco's comprehensive security strategy combines a wide range of policies which link the improvement of the socio-economic situation with the preventative capacity to anticipate the risks of terrorism and the operational aspects of counter-terrorism work.

However, looking into all the aspects of Morocco's global security strategy is beyond the scope of this article. Instead it will focus on the various dimensions of the country's comprehensive pre-emptive strategy to combat terror and counter extremism, from the operational aspects of dealing with immediate potential terrorist threats to mid- and longer-term solutions, and will conclude by discussing Morocco's involvement in international security cooperation. Constantly adapting to the changing risks and challenges, Morocco's strategy is based on interrelated principles, values and national interests, which inspire its main features and which will be briefly presented in the first section.

The principles, values and main features of Morocco's security strategy

The accession to the throne of King Mohammed VI in July 1999 was a turning point for the kingdom with regard to democracy, respect for human rights and the rule of law.[2] Not only were the ongoing reforms expanded and deepened, but new ones were initiated to launch the king's modernist democratic vision. It is thanks to the popularly anticipated reforms and King Mohammed VI's quick response to the 20 February 2011 youth demands for more democracy and the rapid adoption of a new constitution that Morocco was spared the Arab uprising.

[1] The Mediterranean security problem grew after Daesh surged to the East and towards the Sahelian border.

[2] Educated and trained to rule the country, the king spent a year in Brussels becoming familiar with the complexities of the European system, given that the EU is Morocco's primary economic partner.

The first characteristic of Morocco's security strategy, which was elaborated under the supervision of the king (who is commander-in-chief of all security forces), is its ambition to be implemented in the framework of 'the irreversible choice [of the kingdom] to build the rule of law of a democratic State', as noted in the first article of the preamble to the Moroccan constitution. The values of solidarity, freedom, justice and human rights are to be implemented across the security governance process. Accountability, transparency, the fight against corruption and good governance that is equivalent to higher international standards are to be implemented by enforcement agencies. This is perhaps an original approach in a region where turmoil has given security priority over respect for human rights.

The second characteristic of the security strategy is its holistic, multidimensional and comprehensive approach, as underlined above, of which prevention is the cornerstone.

The third feature, the defence and promotion of moderate Islam and the fight against extremism, stems from the specific character of the 'one and diverse' national identity of Morocco, as defined in Paragraph 2 of the preamble to the constitution. The values of openness, moderation, tolerance and dialogue pave the way for active cooperation.[3]

The fourth characteristic is linked to international and South–South cooperation, which is critical to addressing the root causes of and recent trends in insecurity. The fifth characteristic of the security strategy is its dynamic nature, which leaves room for its determined leadership's pragmatism and flexibility to adapt to rapidly evolving threats and contexts. Last but certainly not least, the centrality of the Sahara question, as a vital interest, is in line with the attachment of the Kingdom of Morocco 'to its national unity and its territorial integrity', as stated in the first sentence of Article 2 of the preamble to the Constitution. It is within the framework of 'the advanced regionalisation to promote the populations' self-government' (Article 136 of the Constitution), that 'the Autonomy Plan' was implemented.[4]

Security governance to face potential immediate terrorist threats?

External threats, domestic vulnerabilities

'Since 11 September 2001, 168 cells have been dismantled, leading to the arrest of 2963 people and avoiding 341 attempts of planned terrorist actions' (*Le Matin* 2017d). Even if Morocco is spared the new wave of terrorism, security officials are concerned by

[3] Morocco's national identity is 'forged by the convergence of its Arab–Islamist, Berber [amazighe] and Saharan–Hassanic [saharo–hassanie] components, nourished and enriched by its African, Andalusian, Hebraic and Mediterranean influences' (Ruchti 2012, 3).

[4] After much consultation with the political parties, Morocco proposed an 'Autonomy Plan', which UN Security Council Resolution 1754 hailed as 'serious and credible efforts made by Morocco to progress towards the settlement' of this question. These terms will be used by all subsequent UN resolutions related to this subject' (UN Security Council 2007).

the threats looming over the region since Daesh was established in Libya and the intensification of operations in the Sahel by Al-Qaeda in the Islamic Maghreb and local terrorist groups.[5]

Moreover, although their numbers have considerably decreased, the Moroccan fighters in Middle Eastern conflict zones and their potential return home are still a matter of serious concern (*Aujourd'hui* 2017).[6] Indeed, of the 40 cells dismantled in 2015–16 in Morocco, 36 were closely linked to Daesh. Of the 47 returnees arrested in 2016, 39 came from the Syria–Iraq conflict zones and the other 8 from Libya (*Huffpost Maroc* 2016). Aside from the risk of the return of trained terrorists, many of these Moroccans hold emir positions with al-Baghdadi and could act as recruiters, targeting mainly the poor, illiterate, jobless and fragile youth through their networks in Morocco.

Indeed, external terrorist threats build on domestic vulnerabilities. The diversification of the terrorists' profiles is gaining ground (Benhamou 2017). Moroccan youth are no exception to extremist radicalisation, which seems to be a generational phenomenon and one in which the 'religious factor turned out to be very secondary' (Ennaji 2016, 7). The powerful Daesh propaganda on social media is increasingly attracting female jihadists as well (*Le Matin* 2016d).

Securing the borders

For Morocco, securing the borders in this context is an imperative that goes far beyond the obvious reasons of sovereignty. The attractions of Europe are only 14 miles away, there is a hostile neighbour along the country's eastern frontier and a turbulent buffer zone in the southern Sahara, and the country has numerous ports and airports. So another objective is to keep the activities of organised crime networks and foreign terrorists, and weapons out of Morocco. The Algerian–Moroccan frontier is long and difficult to secure, although it has been closed since it was proved that the terrorist who killed two people in a Marrakech hotel in 1994 had entered Morocco from Algeria. This apparently hermetic barrier has turned out to be open to irregular cross-border trade (Belkhodja 2015). Moroccans suspect Algerian officials of having allowed a massive influx of sub-Saharan illegal migrants to flood the Moroccan territory in order to destabilise the country and tarnish its generous new migration policy (*Le Figaro* 2017; *Le Matin* 2016c). Since 2013, over 43,000 undocumented illegal sub-Saharan immigrants have been regularised on the basis of unprecedented solidarity, with the active support of non-governmental organisations (NGOs) and the National Human Rights Council (*Le Matin* 2016e). The bloody photos on the front pages of newspapers testify to occasional assaults on the eight-metre-high wire fences of the Spanish enclaves of Ceuta and Melilla. Eighty-seven assaults took place in 2014 alone, injuring many Moroccan police officers (*HuffPost Maroc* and *AFP* 2015).

[5] Morocco has been targeted three times by terrorist attacks: in May 1994, May 2003 and April 2011.

[6] Since January 2014, the number of Moroccans fighting with Daesh has fallen to 865; about 100 are members of Harakat Cham Al Islam and 52 of Jabhat Fath Cham (formerly Jabhat al-Nousra) (*Aujourd'hui* 2017).

Moroccan security officials have solid evidence, after the dismantling of terrorist cells, that many suspects and weapons enter Morocco through the Algerian border. This was the case for the spectacular operation in El Jadida, where seven people, heavily armed and on the verge of taking terrorist action, were arrested (*Maroc Diplomatique* 2017b). Morocco has considerably enhanced its surveillance methods, and Algeria intends to build a three-metre high wall all along the border.

The borders of the southern provinces are affected by the Sahara question, which is a central element in Moroccan politics but far too complex for the limited scope of this article. Morocco built a berm—a sand wall—in the mid-1980s along the southern part of the Morocco-Algeria frontier, to protect the territory from the Polisario attacks.[7] In addition, UN Security Council Resolution 690 proclaimed a ceasefire on 6 September 1991, created the peacekeeping force MINURSO and established a 3.7 km-wide buffer zone between Morocco and Mauritania. A haven for all sorts of smuggling networks and 'products' from cars and cigarettes, to arms, terrorists and migrants, this demilitarised zone is obviously an area of numerous combined risks for Morocco. It is hoped that UN Security Council Resolution 2351 (United Nations 2017) ordering the Polisario to withdraw its armed members from this zone will reduce the tension which has prevailed since summer 2016 (*Le360* 2017).[8] Morocco has to maintain extreme vigilance over the area to secure its trade with Africa. The kingdom must, above all, prevent terrorists and arms from entering the country, and this has become especially important since 100 members of the Polisario joined Daesh. There is also increasing concern about the Tindouf camps, which have become a strategic base for the terrorist operations in the Sahel of Al-Qaeda in the Islamic Maghreb (*Medias 24* 2017; *Aujourd'hui* 2017).[9]

Security governance

To deal with security challenges, the Moroccan Royal Armed Forces have been modernised and the governance of the police forces improved.[10] In this upgrading process, Morocco can count on close military cooperation with its strategic international partners. Cooperation and training have expanded to new and sophisticated domains such as cybercrime. Although the army's mission does not normally include domestic anti-terrorism tasks, some of its troops participate in operation 'Hadar'—surveillance of city streets—alongside the police force, which reassures as well the citizens. Anti-missile

[7] The Polisario (the movement claiming independence for the Sahara) was constituted in Zouirate, Mauritania, on 10 May 1973.

[8] About 40 goods trucks and 100 cars travel daily along this road, which channels trade between Europe, Morocco and Africa. Several Moroccan complaints have been addressed to the UN secretary-general about this question. See among others, the letter attached to the secretary-general's report S/2005/602; 24/02/2006 and Letter of the Moroccan Minister of Foreign Affairs to the Secretary-General on 10/04/2009.

[9] From an interview with Mr Abdelhak Khiame, chief of the Central Bureau of Judiciary Investigations, by the French media *France 24* Arabic TV channel.

[10] Bilateral cooperation with the US is getting closer in this field, as shown in the agreement (August 2014) allowing Morocco's services to benefit from the Anti-Terrorism Assistance Program, a support programme established by the US Secretary of State to train candidates in the fight against cyber-terrorism (Igmena 2016).

devices are sometimes deployed to protect strategic sites, including major airports, as in summer 2014, when Daesh targeted Morocco.

Ample restructuring/modernisation of the security forces was initiated in spring 2015 and complemented by an integrated action plan in 2016 (*Maroc.ma* 2015).[11] However, time is required to change the very culture of the sector in order to achieve strict respect for constitutional principles and good governance by all actors.

A pivotal innovation reorganised domestic security under the command of a single general director, targeting several implied benefits and more coordination (*L'Opinion* 2015).[12] The new strategy, focused on surveillance, relies on spotting the early signs of potential disruption and social unrest. Networks of proxy agents keep an eye on new inhabitants in suburbs and small rural villages (*douars*), sharing information in weekly meetings. Particular attention is paid to extremist groups but also to lone wolves, who are isolated and potentially led from outside via social media. Citizens are closely involved with these endeavours. Vigilant neighbours keep an eye on empty short-term rentals and report suspicious movements to the authorities.

More rational management has been adopted, and zero tolerance and 'clean hands' operations have been carried out. Severe sanctions, including against high-ranking officers, are publicised to enforce accountability (Alami 2015). Enhanced means and sophisticated equipment have been provided to the services. Education and training have been upgraded across the system, and closer observance of ethical behaviour has been imposed. Furthermore, a new organisation, composed of elite candidates who have received high-quality training in legal and professional matters, has been created. This new unit, the Central Bureau of Judiciary Investigations (BCIJ), was established in Salé on 23 March 2013 and has been labelled 'the Moroccan FBI' by the media (*H24 Le Figaro* 2015). A product of cooperation between the Ministries of Interior and Justice, the BCIJ is meant to operate under the supervision of the general prosecutor, launching thus a new modus operandi. Proximity, communication and efficiency are the three key concepts of the action plan adopted in 2016, while intelligence remains a central pillar of the strategy. The results published for 2015–16 illustrate the efficiency of the police force's modernisation process in fighting organised crime and terrorism (*Le Matin* 2016a). These efforts are complemented by mid- and longer-term public policies to counter extremism.

Countering extremism: the reform of the religious field

Initiated in the 1990s and accelerated in 2004, the reform of the religious field is a key element of Morocco's approach to fighting extremism and radicalisation. To that end,

[11] On 20 August 2015, a speech by King Mohammed VI underlined Morocco's mobilisation against terrorism and praised the outstanding work of the security forces.

[12] Abdellatif Hammouchi was appointed on 15 May 2015 as general director of the national police, in addition to being the head of the Territorial Security and Intelligence Branch.

the preservation of moderate Islam in Morocco, carried out through the actualised interpretation of cultural and religious tradition, is important.

As Commander of the Faithful (Article 41 of the constitution), King Mohammed VI contributes to the regulation of the religious sphere, leaving little room for overbidding. Under his leadership, the national strategy seeks to further institutionalise the large adherence to the Sunni 'Maliki School of Islamic jurisprudence and the Ash'ari theological tradition, both predominant in Morocco, [which] offer flexibility in reconciling religious practice with the modern world' (Center for Strategic and International Studies 2013, 2). The third pillar of Moroccan Islam is represented by the tradition of Sufism, which is kept alive by religious associations and structures to help people 'deepen spirituality . . . [and] achieve inner security' (Centre for Strategic and International Studies 2013, 2).

The regulation of fatwas is achieved through the creation of a single religious authority, The Higher Scholastic Council, which has 80 local councils. The council often drafts the Friday sermons, which are read in mosques across the kingdom. The reform of the training of imams, under the supervision of the Ministry of Religious Affairs, has been a central step towards securing Islamic governance. The curricula have been diversified to include history, philosophy, comparative religion and foreign languages, in order to promote open-mindedness and moderation. Opening up the field to women—*morchidate*—who can advise women believers has been another major innovation. The new Mohammed VI Institute was opened in March 2015 to receive the increasing number of candidates from Morocco and abroad. All graduates are trained to deconstruct extremist discourse and to perform social work.

The Mohammedian League of Islamic Scholars (Arrabita al-Mohammadia) carries out academic research in Islamic studies through 15 centres across the country. It encourages dialogue and interaction on websites, one of which is dedicated to children.[13] '2016 was a remarkable year for Arrabita Mohammadia des Oulamas and for Morocco in its fight against terrorism and violent extremism' (*Morocco World News* 2016). The Arrabita launched an electronic platform called Ra'ed and a series of books titled Islam and Contemporary Context that aims to deconstruct extremism discourse (TelQuel 2016). 'Research on Islamic texts is indeed essential to fight extremism' (*La Croix* 2016). The main challenge is to dispel the misconceptions about Islam, which prevail in the West. Restoring Islam's true message of peace also involves preventing and fighting risky behaviours. This approach is necessary to correct, for instance, the negative image of women, which is erroneously attributed to Islam. One must study all the texts of the Koranic concepts to conclude that Islam condemns all kinds of violence against women, insists Farida Zomorod (*Le Matin* 2016b). In 2014, the Studies and Research Centre on Women's Issues in Islam of Arrabita Mohammadia des Ulemas-Rabat-won a prize for being the best research institute on women in the Muslim world.

[13] The creation of Arrabita al-Mohammadia took place in the framework of the religious reform with various functions, from research to restoring the true image of Islam and countering extremism to carrying out assistance missions on the ground. For more information about this subject, please see www.arrabita.ma and www.arrabitacademy.ma.

Political monitoring of domestic Islamists by the government has also been skilfully carried out. As political parties could not be set up on religious bases, the main islamist movement was allowed to merge in the mid-1990s with an existing party under the name of Justice and Development. The present prime minister belongs to that party which ranked first in the November 2011 and October 2016 elections.

Beyond religious matters per se, a number of activities and festivals are carried out in the economic, cultural and social fields to promote the true image of peaceful Islam, of an Islam, which is 'women friendly'.[14] Great efforts are also being made, with the active involvement of civil society and sports stars or celebrities, to fight all forms of radicalisation and propaganda within prisons. Attempts to better rehabilitate former prisoners are also being undertaken (*Le Matin* 2017a).

The prevention of youth radicalisation is high on the agenda of the vast network of Families Against Terrorism and Extremism. A platform has been developed to support families, who are key to early identification of the signs of radicalisation. Interventions to deconstruct violent discourse and help the youth reintegrate into society are carried out.[15]

Occasionally, Moroccan efforts have convinced extremists to revoke their views, as has been the case for many detainees, including members of Salafia Jihadia, who wished to join political parties. The most spectacular change of attitude was that of the ideologist of extremist Salafism, Imam Al Fizazi, who went on to lead a prayer in the presence of the King on 28 March 2014 (Iraqi 2016). These efforts complement the long-term strategies to promote human security.

Addressing the root causes of sustainable security

External threats can exploit domestic risks and vulnerabilities. The vast reforms launched in Morocco at the turn of the century include the ambition to provide citizens with a real stake in their own society through inclusive political and socio-economic development to create jobs and enhance sustainable human security.[16] Such is also the ambition of the new sustainable and inclusive development plan for the Sahara region,

[14] The Ministry of Religious Affairs provides assistance to the women's entrepreneur association, Association des Femmes Entrepreneurs du Maroc (AFEM), and the Pioneer Programme, which was set up to help poor young women create their first company.

[15] See Families Against Terrorism and Extremism (n.d.).

[16] National and sectorial plans were established to build infrastructure, transport and communication links and to expand offshoring niche, with some outstanding projects, such as the Tangier–Med port, the first green car plant in the world established in Tangier's industrial zone by Renault, the TGV-high-speed train service, planned to be operational in summer 2018.

elaborated through a large consultation process, which proposes a new bottom-up, community-based social pact dynamic (Morocco, Economic, Social and Environment Council 2013). This model includes the project of the gradual integration of populations returning from the Tindouf camps (in Algeria) and should protect the youth of this fragile province. Over three decades, huge investments—seven times higher than the income generated by local resources—have allowed the socio-economic progress of this region to reach a human development indicator higher than that of the national average.[17]

Some targeted programmes, such as the National Human Development Initiative, launched in 2005, seek to lift vulnerable groups and territories out of poverty and exclusion. This multifaceted approach, which has benefited 10 million people, is enhancing social cohesion. It will be continued by a vast five-year programme with more equity and considerable funding. (The National Observatory of Human Development Report 2005–2016. Rmiche 2017; *Le Matin* 2017d).[18] The objectives include restoring hope and dignity for poor, illiterate young people, who are the first targets of Daesh's active recruitment.[19]

In addition to this specific programme, a large number of NGOs, business and public sectors, and universities, supported by robust bilateral cooperation, have taken the lead in countering extremism and defending democracy, human rights, youth, women and the most vulnerable groups. To fight radicalisation and secure the rehabilitation of former prisoners, initiatives are as well mushrooming. Combined efforts carry out concrete projects for better vocational training to improve the employability of youth and correct the mismatch between training and the needs of the labour market. Among numerous innovative projects, Al Ikram Lil Amal—Dignity for Hope—for instance, endeavours to give a second chance to young drop-outs from poor backgrounds and to follow up on their social reintegration.[20] Citizens' vigilance committees, such as Stop Terrorism Praise, have set up tracking systems on social media to signal any promotion of hatred, discrimination, violence or terrorism, and all illegal declarations, with the support of the Human Rights Council.[21]

However, affected by the conjunction of Europe's crises, the region's turbulence, the downturn in tourism and remittances, and recurrent droughts, Morocco has not reached the 6.5% GDP growth needed to foster youth employment.

[17] Recurrent polemics take place about the natural resources of these provinces.

[18] The National Observatory of Human Development Report 2005–2016 (Rabat) has not been published but was included in *Le Matin* (Rmiche 2017; *Le Matin* 2017c).

[19] Fifty per cent of the population is under 25 years old. The diversification of profiles complicates the identification of potential terrorists.

[20] This NGO is supported by Casal Dels Infants (a Spanish institution) and a French Technical School. See Association Al Ikram (n.d.).

[21] Anti-terror laws have been developed since 2003. Praise of terrorism is severely condemned in Article 218-2 of the Penal Code.

Enabling and immunising the mind: education reform

Education and training is the cornerstone for socio-economic development and job creation.[22] Along with culture, education is a powerful vector to give students the intellectual tools they need to develop and maintain an open-minded, interrogatory outlook (Rose 2015).

Strategic Vision 2015–30: For a School of Equity, Quality and Promotion is on track in Morocco (Conseil Supérieur de l'Education de la Formation et de la Recherche Scientifique 2015). The stakes are high. Global inclusiveness and quality should be seriously improved by the generalisation of pre-schooling, more efficiency and better coordination. Enhanced vocational training, targeting qualified labour and middle management positions, should offer better job opportunities, especially to satisfy the demands of increased investment in sophisticated fields such as the South–South cooperation brand-new joint China–Morocco project (*Huffpost Maroc* and *MAP* 2017). As well as degrees in the national languages—Arabic, Amazigh and French—the education system is adding ones in English and Spanish to its offering, to increase opportunities.[23] The reform has also been extended to Islamic studies.

Enhanced international cooperation to fight terrorism and extremism for a more secure world

Morocco's ability to look clearly into innovative questions and to develop new attitudes has empowered it to renovate and diversify its strategic partnerships and to initiate novel approaches, as with sub-Saharan Africa.[24] Its stability, moderation and leadership's determination to embrace democratisation and modernity and promote moderate Islam have made the kingdom a key partner for many in fighting terror and countering extremism (*Maroc Diplomatique* 2017a).[25]

[22] Education remains the main problem in the Middle East and North Africa, where neither quantity nor quality have been achieved.

[23] Education 'to citizenship' is a programme conducted by the National Human Rights Council and UNESCO, thanks to a textbook especially prepared to that end. See UNESCO & Conseil National des Droits de l'Homme. (2015).

[24] These approaches include solidarity and unconditional aid for the least developed countries, a new model for migration policies for African immigrants, and the choice of a green economy and renewable energy, as shown by the success of 'COP 22' at the 22nd Conference of the Parties at the United Nations Framework Convention on Climate Change.

[25] Despite some occasional clouds, Morocco enjoys 'advanced status' with the EU and leads tight cooperation with its member states.

First, on the multilateral level, Morocco participates in international initiatives, such as the Antiterrorist Committee initiated by the US and the Netherlands, and in AFRICOM.[26] It is also part of the US-led international coalition which operates air strikes in Iraq and Syria on IS positions and in the Saudi-led one to counter the Houthi rebellion in Yemen. As a member of the NATO Mediterranean dialogue and thanks to a bilateral programme with this institution, Morocco participates regularly in NATO's military, humanitarian and political commissions, and in its exercises to improve all aspects of military training.[27]

Second, on the bilateral level, Morocco's security cooperation has been considerably intensified with some of its partners in order to fight terrorism and extremism.

This collaboration has allowed European countries to avoid several terrorist attacks (*L'observateur* 2015). It is certainly 'Moroccan-Spanish cooperation [which should be] a model for the countries of the region' in the fight against terrorism (Amrani 2017). Its 'efficient results' were hailed by the Spanish minister of the interior after the arrest on 26 May 2017 of 11 jihadists in Tangier and Barcelona. Of these, four were in Brussels on the eve of the 22 March 2016 terrorist attack (Asmlal 2017).[28] Regular press announcements, both in Spain and Morocco, give a lot of visibility to the recurrent fruits of this close cooperation, which extends beyond Morocco to embrace the Sahel region (Hallaoui 2017).

With France as well, cooperation is extremely efficient, even if it is not given the same publicity. It is well known, for instance, that it is thanks to the information supplied by Moroccan intelligence that Abdelhamid Abaaoud, the 'brains' of the 13 November 2015 combined terrorist attacks in Paris, was located.[29] Regular news reveals that the Moroccan intelligence services also work closely with their Belgian and other European counterparts. Unfortunately, the early alerts they provide have not always been investigated in time.[30] This security cooperation has lately expanded to incorporate the religious dimension.

Third, religious cooperation to counter extremism is high on the agenda. The training of imams in Morocco is probably the service most requested by the country's partners. Religious cooperation international accords, mainly covering this issue, have been

[26] In this context, 'African Lion', the 14th joint US–Moroccan exercise in the south of Morocco, ended on 16 April 2017. To improve interoperability in Africa, the US Army plans for US Marines to take Darija-speaking Moroccan Arabic courses in Rabat.

[27] Morocco benefited from 59 military operations in 2013 and 40 in 2012, mainly the demining of the Sahara.

[28] The four suspects were in contact with Yassine Al Attar, who was involved in the 22 March 2016 terrorist attack on Brussels and who is the brother of Oussama Al Attar (Abou Ahmed, the coordinator of Daesh's operations in Europe).

[29] He could be traced thanks to his family connections in Agadir (Morocco) and in particular his cousin Hasna bint Ait Abou Lahcen in Paris.

[30] Such was the case before the attack on the Berlin market in December 2016, for instance.

signed with over 15 countries, with little publicity about this sensitive matter. This is the case with France (September 2015) and Russia. Most of the others have been signed with African countries during the king's numerous visits in the continent.[31] The Mohammed VI Institute has expanded its capacity to deal with the increasing demand. Over 800 future imams, mainly from France and five African countries (Mali, Senegal, Ivory Coast, Guinea and Nigeria) are now following either a two- to three-year-long course, or a three-month one, depending on the wishes of their countries. The training programmes take into account the respective countries' differences (*Le Matin* 2017e; Iraqi 2017).

In Africa, given the great number of Muslim countries on the continent; the rise of extremism and of terrorist groups; and the strong religious legitimacy of King Mohammed VI, descendant of the Prophet and Commander of the Faithful, promoting moderate Islam seems appealing to many countries. Therefore, religious diplomacy has developed progressively as a new element in Morocco's geopolitical soft power and contribution to African security (Tadlaoui 2015). The creation in June 2015 of the Mohammed VI Foundation of the African *Ulema* (religious scholars) seeks to capitalise on common fundamentals and coordinate and unify the efforts to promote a moderate Islam to counter religious extremism on the continent (Iraqi 2017).

Morocco has in fact launched a new form of cooperation with the rest of Africa, much beyond the well-known regular participation of the Moroccan military forces in peacekeeping operations since 1960 (*Le Matin* 2015).[32] More balanced, based on solidarity and a new migration policy, it seeks to promote co-development, shared prosperity and security. The National Human Development Initiative model analysed above, for instance, has attracted an increasing number of Morocco's African partners (*Le Matin* 2017b). The 'Moroccan Strategy . . . is the example we look for', declared US Undersecretary of State for African Affairs Bisa Williams (*Le Matin* 2015). Beyond its traditional francophone partners, Morocco is reaching out to English-speaking African countries as well.

Conclusion

Even if Morocco is often cited as an example in the fight against terrorism and extremism, the kingdom does not present itself as a model, given the magnitude of the challenge. However, some can learn from its expertise and experience, mainly from the involvement of its citizens and civil society in enhancing security. It seeks to constantly

[31] Among these are Mali, Senegal, Ivory Coast, Guinea, Burkina Faso, Nigeria, Sierra Leone and, more recently, Tanzania. No real publicity has been given to this matter, as most of our partners prefer discretion.

[32] The following statement was made by Bisa Williams, in a seminar about security in Nouakshott (Mauritania): 'We greatly appreciate the Moroccan experience in all of Africa, especially in the Sahel, as Morocco has endeavoured to ensure that other countries can benefit from its experience in the field of fighting violent extremism . . . and of training imams, notably in West Africa. . . . The Moroccan strategy . . . [which] conveys a great message to the sub-Saharan countries, telling them they are welcome in Morocco, is the example we look for.' (*Le Matin* 2015) (Author's translation).

fine-tune its approach and learn from events and from its partners. Moroccan officials have on many occasions deplored the lack of security cooperation between Algeria and Morocco when facing the rising terrorist threat in the region.

Morocco still has quite a few challenges to overcome to consolidate its security. Indeed, the kingdom needs to successfully achieve all of the initiated reforms, especially the provision of quality education and justice. To improve human security, the country must in particular win the battles against poverty, disparities and corruption, which can offer fertile ground for radicalisation. Above all, to create jobs and restore hope among the young, Morocco has to improve its economic productivity and its education system, as underlined recently by the World Bank 2017 *Country Economic Memorandum* (Chauffour 2017).

To achieve sustainable stability and security, Morocco is actively working to reach international recognition of its sovereignty over the Sahara. In that endeavour, the kingdom's security strategy will help the country to remain a safe haven for its citizens and visitors. In the present regional turmoil, Morocco represents a valuable asset not only for its strategic partners, but also for Africa's future, especially since the kingdom joined the African Union on 31 January.

References

Alami, Z. (2015). DGSN: valse de changements à la tête des préfectures de police. *Le 360*, 13 July. http://fr.le360.ma/politique/dgsn-valse-de-changements-a-la-tete-des-prefectures-de-police-45599. Accessed 21 May 2017.

Amrani, Y. (2017). Lutte antiterroriste La coopération maroco-espagnole, un modèle pour les pays de la région. *Le Matin*, 22 May. http://lematin.ma/journal/2017/la-cooperation-maroco-espagnole-un-modele-pour-les-pays-de-la-region/272288.html. Accessed 7 June 2017.

Asmlal, A. (2017). Terrorisme: révélations époustouflantes sur les jihadistes marocains arrêtés en Espagne. *Le 360*, 26 April. http://fr.le360.ma/politique/terrorisme-revelations-epoustouflantes-sur-les-jihadistes-marocains-arretes-en-espagne-116913. Accessed 21 May 2017.

Association Al Ikram. (n.d.). Homepage. http://www.alikram.ma; http://www.alikram.ma/qui-sommes-nous.html kram.ma/ . Accessed 20 June 2017.

Aujourd'hui. (2017). Les efforts du BCIJ portent leurs fruits: de moins en moins de Marocains à Daech. 23 May. http://aujourdhui.ma/actualite/

les-efforts-du-bcij-portent-leurs-fruits-de-moins-en-moins-de-marocains-a-daech. Accessed 4 June 2017.

Belkhodja, A. (2015). The Algerian–Moroccan border: Study of the political geography and irregular cross-border closure trade. Master's thesis, Reims University.

Benhamou, M. (2017). *Le Djihadisme international: l'ennemi invisible, mutations idéologiques et stratégies opérationnelles*. Paris: Editions l'Harmattan.

Center for Strategic and International Studies. (2013). Maghreb roundtable: Morocco's de-radicalization strategy. Washington, DC. 24 June.

Chauffour, J.-P. (2017). *Country economic memorandum: Morocco 2040: Emerging by investing in intangible capital*. World Bank. Washington, DC. http://pubdocs.worldbank.org/en/873111494618941322/Morocco-CEM2017-summary-ENG.pdf. Accessed 21 May 2017.

Conseil Supérieur de l'Education de la Formation et de la Recherche Scientifique. (2015). Pour une école de l'équité, de la qualité et de la promotion : Vision stratégique de la réforme 2015-2030, Royaume du Maroc. http://www.csefrs.ma/pdf/Vision_VF_Fr.pdf. Accessed 19 June 2017.

Ennaji, M. (2016). Recruitment of foreign male and female fighters to jihad: Morocco's multifaceted counter-terror strategy. *International Review of Sociology, 26*(3), 546–57.

Families Against Terrorism and Extremism. (n. d.). Homepage. http://www.findfate.org/en/home/. Accessed 19 June 2017.

H24 Le Figaro. (2015). Sécurité: création du BCIJ, le FBI marocain. 23 March. http://www.h24info.ma/maroc/securite-creation-du-bcij-le-fbi-marocain/. Accessed 21 May 2017.

Hallaoui, L. (2017). Lutte contre le terrorisme: le Maroc et l'Espagne s'engagent pour la sécurité de la région du Sahel. *Huffpost Maroc,* 19 May. http://www.huffpostmaghreb.com/2017/05/19/cooperation-lutte-terrorisme_n_16703202.html. Accessed 21 May 2017.

Huffpost Maroc. (2016). Maroc: le BCIJ a démantelé 40 cellules terroristes depuis sa création. 24 December. http://www.huffpostmaghreb.com/2016/12/24/cellules-terroristes-maro-bcij_n_13843208.html. Accessed 21 May 2017.

Huffpost Maroc & *AFP*. (2015). Maroc: des centaines de migrants prennent d'assaut la frontière à Sebta. 24 December. http://www.huffpostmaghreb.com/2015/12/25/maroc-sebta-migrants-_n_8876940.html?m=false. Accessed 21 May 2017.

Huffpost Maroc & *MAP*. (2017). La cité industrielle chinoise inaugurée par le roi à Tanger créera 100.000 emplois. 21 March. http://www.huffpostmaghreb.com/2017/03/21/chine-cite-industrielle-tanger-creation-emplois_n_15510530.html. Accessed 21 May 2017.

Igmena. (2016). Policies to fight against cybercrime in Morocco. 29 October. https://www.igmena.org/Policies-to-fight-against-Cybercrime-in-Morocco. Accessed 21 May 2017.

Iraqi, F. (2016). Terrorisme au Maroc: les cheikh repentis de Sa Majesté. *Jeune Afrique*, 15 February. http://www.jeuneafrique.com/mag/300003/politique/terrorisme-maroc-cheikh-repentis-de-majeste/. Accessed 21 May 2017.

Iraqi, F. (2017). Ahmed Toufiq: 'L'instrumentalisation politique de la religion est inacceptable'. *Jeune Afrique*, 31 January. http://www.jeuneafrique.com/mag/395699/societe/maroc-ahmed-toufiq-linstrumentalisation-politique-de-religion-inacceptable/. Accessed 7 June 2017.

La Croix. (2016). La recherche sur les textes de l'islam est indispensable pour contrer l'extrémisme. 31 March. http://www.la-croix.com/Religion/La-recherche-textes-islam-indispensable-pour-contrer-extremisme-2016-03-31-1200750282. Accessed 21 May 2017.

Le 360. (2017). Guerguerat: récit du calvaire vécu par les transporteurs marocains. 3 March. http://fr.le360.ma/politique/guerguerat-recit-du-calvaire-vecu-par-les-transporteurs-marocains-109983. Accessed 21 May 2017.

Le Figaro. (2017). Le Maroc accuse l'Algérie d'avoir expulsé des Syriens. 22 April. http://www.lefigaro.fr/flash-actu/2017/04/22/97001-20170422FILWWW00171-le-maroc-accuse-l-algerie-d-avoir-expulse-des-syriens.php. Accessed 21 May 2017.

Le Matin. (2015). Les États-Unis soulignent l'esprit de partage du Maroc avec les autres pays africains. 21 August. http://lematin.ma/journal/2015/les-etats-unis-soulignent-l-esprit-de-partage-du-maroc-avec-les-autres-pays-africains/229881.html. Accessed 21 May 2017.

Le Matin. (2016a). Bilan positif des efforts de restructuration et de modernisation de la direction générale de la sûreté nationale en 2016. 22 December. http://lematin.ma/journal/2016/bilan-positif-des-efforts-de-restructuration-et-de-modernisation-de-la-direction-generale-de-la-surete-nationale-en-2016/263704.html. Accessed 21 May 2017.

Le Matin. (2016b). Examens des concepts de rejet de la violence à l'égard de la femme dans le Coran et la Sunna. 19 February. http://lematin.ma/journal/2017/examen-des-concepts-de-rejet-de-la-violence-a-l-egard-de-la-femme-dans-le-coran-et-la-sunna/264304.html. Accessed 21 May 2017.

Le Matin. (2016c). La politique migratoire humaniste menée par le Royaume confirme sa vocation de terre d'accueil dans un environnement régional hostile. 18 December. http://lematin.ma/journal/2016/le-maroc-terre-d-accueil-par-excellence-pour-les-migrants-subsahariens/263478.html. Accessed 21 May 2017.

Le Matin. (2016d). Le BCIJ démantèle une cellule terroriste de 10 femmes s'activant dans plusieurs villes du Royaume. 3 October. http://lematin.ma/journal/2016/le-bcij-demantele-une-cellule-terroriste-de-10-femmes-liee-a-l-organisation--etat-islamique--et-s-activant-dans-plusieurs-villes-du-royaume/255405.html. Accessed 21 May 2017.

Le Matin. (2016e). Les Nations Unies soulignent la pertinence de la politique migratoire du Maroc et l'importance de l'accueil et des services dispensés aux migrants. 16 September. http://lematin.ma/journal/2016/les-nations-unies-soulignent-la-pertinence-de-la-politique-migratoire-du-maroc–et-l-importance-de-l-accueil-et-des-services-dispenses-aux-migrants/254449.html. Accessed 21 May 2017.

Le Matin. (2017a). La réinsertion post carcérale des détenus au coeur de la deuxième edition de l'Université du Printemps. 23 March. http://lematin.ma/journal/2017/la-reinsertion-post-carcerale-des-detenus-au-coeur-de-la-deuxieme-edition-de-l-rsquo-universite-du-printemps/269300.html. Accessed 21 May 2017.

Le Matin. (2017b). Le Maroc partage son expérience en matière de développement humain avec les pays africains. 18 May. http://lematin.ma/journal/2017/plus-de-10-millions-de-beneficiaires-de-l-rsquo-indh-en-douze-ans-pour-un-budget-global-de-pres-de-40-milliards-de-dh/272189.html. Accessed 21 May 2017.

Le Matin. (2017c). Les autorités marocaines ont démantelé 168 cellules terroristes depuis les attentats terroristes du 11 septembre aux États-Unis. 10 February. http://lematin.ma/journal/2017/les-autorites-marocaines-ont-demantele-168-cellules-terroristes-depuis-les-attentats-terroristes-du-11-septembre-aux-etats-unis/266938.html. Accessed 16 May 2017.

Le Matin. (2017d). Le taux de pauvreté a baissé de 21 points dans les communes rurales ciblées. 18 May. http://lematin.ma/journal/2017/le-taux-de-pauvrete-a-baisse-de-21-points-dans-les-communes-rurales-ciblees-par-l-rsquo-indh/272182.html. Accessed 21 May 2017.

Le Matin. (2017e). Selon Ahmed Toufiq La Fondation Mohammed VI des oulémas africains appelée à accompagner le champ religieux sur le continent en capitalisant sur les fondamentaux communs des pays africains. 23 January. http://lematin.ma/journal/2017/la-fondation-mohammed-vi-des-oulemas-africains-appelee-a-accompagner-le-champ-religieux-sur-le-continent-en-capitalisant-sur-les-fondamentaux-communs-des-pays-africains/265745.html. Accessed 21 May 2017.

L'observateur. (2015). Le Maroc à la pointe de la lutte contre le terrorisme. 28 December. http://www.lobservateurdumaroc.info/?p=16881. Accessed 4 June 2017.

L'Opinion. (2015). Abdellatif Hammouchi nommé Directeur Général de la Sûreté Nationale, tout en conservant son poste à la tête de la DGST. 15 May. http://www.lopinion.ma/def.asp?codelangue=23&id_info=46087. Accessed 21 May 2017.

Maroc Diplomatique. (2017a). Les armes de la cellule terroriste démantelée vendredi dernier, introduites via les frontières maroco-algériennes. 29 January. http://maroc-diplomatique.net/armes-de-cellule-terroriste-demantelee-vendredi-dernier-introduites-via-frontieres-maroco-algeriennes. Accessed 21 May 2017.

Maroc Diplomatique. (2017b). L'UE considère le Maroc comme un partenaire fiable sur les questions stratégiques. 18 May. http://maroc-diplomatique.net/lue-considere-maroc-partenaire-fiable-questions-strategiques/. Accessed 21 May 2017.

Maroc.ma. (2015). Discours intégral de SM le Roi à l'occasion du 62ème anniversaire de la Révolution du Roi et du Peuple. 21 August. http://www.maroc.ma/fr/discours-royaux/discours-integral-de-sm-le-roi-loccasion-du-62eme-anniversaire-de-la-revolution-du. Accessed 21 May 2017.

Medias 24. (2017). Abdelhak Khiame: 'Une centaine de membres du polisario ont rejoint Daech'. 16 April. http://www.medias24.com/MAROC/Quoi-de-neuf/172608-Abdelhak-Khiame-Une-centaine-de-membres-du-polisario-ont-rejoint-Daech.html. Accessed 21 May 2017.

Morocco, Economic, Social and Environmental Council. (2013). *New development model for the southern provinces*. October. http://www.ces.ma/Documents/PDF/Report-New%20development%20model%20for%20the%20southern%20provinces.pdf. Accessed 21 May 2017.

Morocco World News. (2016). Morocco embarks on plan to countering violent extremism. 28 November. https://www.moroccoworldnews.com/2016/11/202448/morocco-embarks-on-plan-to-countering-violent-extremism/ Accessed 20 June 2017.

Rmiche, A. (2017). L'INDH, facteur déterminant d'intégration et de cohésion sociale. *Le Matin*, 19 May. http://lematin.ma/journal/2017/l-rsquo-indh-facteur-determinant-d-rsquo-integration-et-de-cohesion-sociale/272125.html. Accessed 21 May 2017.

Rose, M. (2015). *Immunising the mind: How can education reform contribute to neutralising violent extremism?* British Council insight working papers. November. https://www.britishcouncil.org/sites/default/files/immunising_the_mind_working_paper.pdf. Accessed 22 May 2017.

Ruchti, J. (trans.). (2012). *Morocco's constitution of 2011*. Getzville, New York: William S. Hein & Co. https://www.constituteproject.org/constitution/Morocco_2011.pdf?lang=en. Accessed 12 June 2017.

Tadlaoui, G. (2015). *Morocco's religious diplomacy in Africa*. FRIDE Policy Brief no. 196. February. http://fride.org/download/PB196_Morocco_religious_diplomacy_in_Africa.pdf. Accessed 12 June 2017.

TelQuel. (2016). Les cahiers de la déradicalisation. 19 December. http://telquel.ma/2016/12/19/islam-les-cahiers-deradicalisation_1527805. Accessed 20 June 2017.

The Studies and Research Centre on Women's Issues in Islam of Arrabita Mohammadia des Ulemas-Rabat. http://www.annisae.ma. Accessed 20 June 2017.

UNESCO & Conseil National des Droits de l'Homme. (2015). (n.d.). Éducation à la citoyenneté et aux droits de l'homme: Manuel pour les jeunes au Maroc. http://www.cndh.org.ma/fr/ouvrages-de-reference/education-la-citoyennete-et-aux-droits-de-lhomme-manuel-pour-les-jeunes-au. Accessed 19 June 2017.

United Nations. (2017). *Le Conseil de sécurité proroge d'un an le mandat de la Mission des Nations Unies pour l'organisation d'un référendum au Sahara occidental*. 28 April. https://www.un.org/press/fr/2017/cs12807.doc.htm. Accessed 21 May 2017.

UN Security Council. (2007). Security Council extends United Nations mission in Western Sahara until 31 October, unanimously adopting resolution 1754. SC/9007. 30 April. http://www.un.org/press/en/2007/sc9007.doc.htm. Accessed 16 May 2017.

Assia Bensalah Alaoui, *Ambassador at Large for His Majesty the King of Morocco, was a professor of international law until 2005 (University Mohamed V, Rabat). In 2002 she co-chaired the High Level Panel for Dialogue between Peoples and Cultures in the Euro-Mediterranean Area, which published the Prodi Report.*

EUROPEAN VIEW (2017) 16:121–130
DOI 10.1007/s12290-017-0448-4

CrossMark

ARTICLE

Ambition versus reality: partnering with our neighbours on migration

Loredana Teodorescu

Published online: 4 July 2017

Abstract The EU is facing an unprecedented challenge on its southern borders in terms of instability in the region and increased migration flows. In its search for a solution that will meet with the approval of all member states, there is a new momentum for strengthening cooperation with neighbouring countries. The EU is increasingly turning to third countries to manage migration flows and reduce the number of irregular migrants arriving in Europe. Nevertheless, there are serious constraints on its ambition. The EU has failed to offer its cooperation partners real incentives, while member states have been reluctant to coordinate their initiatives and become involved, thus undermining EU action beyond its borders. The result is slow progress and uncertain partnerships. It is time to address these limitations and make the EU a reliable and coherent regional actor, able to speak with one voice when addressing third countries on migration. This calls for stronger foreign policy on migration at the EU level, the deployment of a wide range of tools and incentives, and more committed member-state support for EU action.

L. Teodorescu (✉)
Wilfried Martens Centre for European Studies, Rue du Commerce 20, 1000 Brussels, Belgium
e-mail: lt@martenscentre.eu

 Springer

Keywords Migration policy | Irregular migration | External relations | European Neighbourhood Policy | Foreign policy dimension of migration

Introduction

The EU is facing an unprecedented challenge on its southern borders. Instability and conflicts in the neighbourhood region, coupled with poverty in some countries, have produced vast numbers of refugees and turned countries such as Libya into major corridors for irregular migration. This is affecting Europe and destabilising its member states. The EU has not yet produced an adequate response but has been increasing its efforts since the Junker Commission identified migration as one of its main political priorities (Junker 2014).

Despite the new friction and divisions within the EU caused by the migration crisis, all member states appear to support both the fight against irregular migration and strengthened cooperation with third countries, measures that are considered crucial to the EU's internal-security objectives. Under the pressure of the migratory flows and the humanitarian crisis generated on its southern borders, the EU has sought to manage migration by building partnerships with neighbouring countries. Nevertheless, this willingness has yet to be translated into concrete results.

After setting out the issue, the article will discuss the two main factors that limit or undermine EU action. The first is the failure to offer real incentives during negotiations. The second is the lack of coordination and cohesion among the member states, which still retain a dominant role in this field but are often reluctant to commit themselves. Finally, the article will outline ways to move forward.

Migration as a key neighbourhood priority

That the EU is attempting to cooperate with neighbouring countries on security and migration is nothing new. Nevertheless, such efforts gained new momentum in 2015, when the EU experienced an unprecedented influx of migrants and refugees, together with a temporary loss of control of its borders. The recognition that foreign policy is as crucial as the domestic dimension for the effective management of migration is now embedded in the EU approach. There is an awareness that, in an increasingly interdependent world, immigration to Europe cannot be managed only domestically.

The launch of the European Neighbourhood Policy (ENP) in 2004 can itself be seen as 'the prime example of external policy being influenced by Justice and Home Affairs issues' (Wolff and Mounier 2011, 244). Migration is a priority field of the ENP, given that the EU's eastern and southern neighbours are both transit and source countries of migration to the EU (Lavenex 2016). The *European Neighbourhood Policy Review* in 2015 confirmed this, citing migration and security as key fields of cooperation

(European Commission and High Representative of the Union for Foreign Affairs and Security Policy 2015).

In addition to acknowledging the clear need to tackle the deep roots of the migration crisis affecting the neighbourhood region, the EU has developed a number of initiatives to strengthen dialogue with its partners and to jointly manage migration flows and border controls. These initiatives are aimed at addressing the current emergencies (for further analysis, see Garcia Andrade and Martin 2015). Fighting irregular migration, and the associated smuggling trade, remains a priority with a view to the proper and orderly management of immigration and the EU's borders.

Engaging neighbours in migration management: the toolbox

One innovative tool developed to encourage neighbours to collaborate with the EU on migration issues is the mobility partnership.[1] Launched in 2007 (European Commission 2007), the core concept of the partnerships is that they are incentive-based: enhanced legal migration channels and mobility opportunities are offered to third countries in return for their cooperation in preventing irregular immigration and ensuring border security. This initiative has so far been offered to selected countries involved in the ENP. This is in line with the Union's desire to reinvigorate its relationship with neighbouring states, and in this way to avoid the perception of a 'fortress Europe'. The instrument goes beyond purely security-based considerations. It takes into account some of the partner's concerns and requests, together with the need to offer incentives in order to secure their involvement (for further analysis, see Reslow 2015; Lavenex and Stucky 2011).

Mobility partnerships can facilitate policy dialogue and operational cooperation, and are intended to pave the way for stronger cooperation and binding initiatives. These include readmission agreements[2] with third countries which, by easing the procedures for returning irregular migrants, play a key role for the EU.

In 2016, migration pressure along Europe's external borders remained high, with over half a million illegal border crossings detected (Frontex 2017). While people in clear need of international protection have the right to stay, irregular economic migrants should be returned. In fact, fewer than 40% of the irregular migrants ordered to leave

[1] The EU has so far concluded nine mobility partnerships, namely with Moldova and Cape Verde (2008); Georgia (2009); Armenia (2011); Morocco, Azerbaijan and Tunisia (2013); Jordan (2014); and Belarus (2016).

[2] The EU has so far concluded 17 readmission agreements, mainly with the Eastern Partnership countries (Ukraine, Moldova, Georgia, Armenia and Azerbaijan), Russia and the Western Balkan countries. On its southern shore, the EU is entangled in protracted negotiations with Morocco (based on a mandate dating back to 2000) and has recently started negotiations with Tunisia, while talks with Algeria, despite a formal mandate, have never formally started.

the EU actually did so (European Commission 2015). The effective implementation of the EU's return policy depends on the willingness of third countries to take back their citizens, and in certain cases even the irregular migrants who have transited through their territories. Readmission agreements are therefore an essential part of the EU's effort to curb irregular migration—they ensure the success of EU expulsion policies and act as a deterrent (for further analysis, see Cournil 2012; Cassarino 2010).

Despite the various initiatives introduced, the EU has traditionally had difficulties with migration partnerships. To secure third countries' cooperation in the fight against irregular migration, the EU needs to use its considerable leverage and a mix of incentives and concessions. Unfortunately, the EU still lacks support from the member states, which affects its capacity to comfortably play the role of negotiator.

When the carrot is not in the EU's hand: incentives matter

For many years the member states have engaged with other countries in dialogues and cooperative initiatives on migration. The EU, on the other hand, has only taken on this role more actively in the last decade. This has come about as a result of the progressive integration of migration policy, which has been described as 'shifting up and out of the migration policy' (Lavenex 2006).

Cooperative initiatives at the supranational level seek to allow the EU to speak with one voice on migration (European Commission 2011b). Here it is assumed that the EU's potential as a negotiating partner surpasses that of any individual member state. However, the EU is limited by the competences it enjoys in the field and by its fragmented migration policy. These aspects determine the tools it can deploy and the leverage it can use with third countries.

When negotiating, the EU is not always in a position of strength vis-à-vis third countries, which have less interest in controlling borders than does the EU. Europe's governments are strongly motivated to engage with the source countries to elicit their cooperation in the fight against irregular migration. However, these countries rarely make a priority of preventing irregular migration. Moreover, they have few incentives to readmit irregular migrants. On the contrary, emigration can bring economic benefits, such as the inflow of remittances or a lower unemployment rate. When it comes to migration, third countries are primarily seeking opportunities for their citizens to move to Europe. As EU member states retain important competences, first and foremost over admission policies, the 'tastiest carrots' are not in the Commission's hands (Hampshire 2016, 580). This undermines its credibility and leverage during negotiations.

Matters are further complicated by the divergence in member states' views on the role the EU should have in the source countries. Using visa-facilitation agreements as incentives, the EU has successfully concluded a number of readmission agreements in the eastern neighbourhood (see Trauner and Kruse 2008). The EU had few concerns about extending visa facilitation or granting mobility-linked incentives to nearby countries that might, in the medium or longer term, join the EU, or at least enjoy visa-free regimes (De Bruycker 2014). This approach has contributed to deeper cooperation on migration with the eastern neighbours. In contrast, the EU encounters opposition from many member states when it comes to concluding agreements with countries in the southern neighbourhood and, as a result, visa-facilitation agreements either have not been offered in exchange for readmission agreements or have been offered only after long negotiations (after 10 years with Morocco and after 7 years with Turkey; see e.g. Wolff 2014).

The member states are mostly reluctant to become fully involved, especially when it comes to specific concessions on legal migration and mobility; and they have their own priorities, which can differ from those of the EU. Both of these factors limit the 'EU's options in terms of what it can offer partner countries in exchange for their much-needed help in managing migration' (Dimitriadi 2016, 2). Ultimately, it seems as if 'the EU as a whole has less to offer third countries in concrete terms…. Consequently, EU (external) initiatives can only play a facilitative role in the sphere of legal migration, which is an inherent limitation' (Cholewinski 2011, 494).

The crucial role of EU member states

Despite the EU's attempt to acquire a strengthened role and to establish a joint migration-management effort with partner countries, the role of individual member states remains crucial. First, the intricate distribution of external competences linked to migration explains why most EU cooperation instruments with third countries involve both the Union and its member states (Garcia Andrade and Martin 2015). Mobility partnerships, for instance, which deal with various aspects of migration policy, are signed both by the EU and by those member states willing to participate on a voluntary basis (in the form of mixed agreements). The conclusion and implementation of these partnerships strongly rely on the involvement of the member states, which propose the concrete projects and are not always willing to offer something new (thus duplicating bilateral initiatives), or to use their own incentives, especially in terms of legal migration opportunities.

Second, through international treaties or informal arrangements, member states continue to be highly active in those fields in which they preserve exclusive or concurrent powers with regard to the EU (Garcia Andrade and Martin 2015). This is the case with readmission agreements, where member states still conclude their own bilateral deals, while asking the Commission to do the same and to include tougher clauses (such as the contested clause that facilitates the readmission not only of the partner country's own citizens, but also of third-country nationals who have transited through its territory) (European Commission 2011a). As an example, while the negotiations on the EU–Morocco readmission agreement have yielded only protracted negotiations, Morocco has signed several readmission agreements with member states, namely with Germany, Spain, France, Italy, Malta and Portugal (Wolff 2015).

The result is fragmented cooperation, where EU initiatives coexist with mixed or purely bilateral approaches. This ‘à la carte’ behaviour of the member states weakens the EU’s negotiating position and impairs the effectiveness of EU migration policy (Maes et al. 2012, 59), resulting in slow progress and uncertain partnerships.

Moving forward

As underlined, the EU’s ambition to strengthen its migration policy through cooperation with third countries is affected not only by its partners’ behaviour but also by internal constraints. Progress is limited primarily by the EU’s competence in migration policy and by the tools it has at its disposal to engage with partners in a joint effort to manage migration flows.

One way to overcome this limitation would be to ensure that the individual bilateral initiatives undertaken by member states are better coordinated (e.g. by operating a quota for economic migrants or circular migration/work schemes). This could be achieved by gathering them together within a specific EU framework. Although the current emergency has refocused attention on security-related matters and domestic concerns, an effective migration policy should also include features related to mobility and legal channels. Such a balanced approach is necessary to create real partnerships and to be effective in the end.

In addition, the EU should offer incentives to third countries based on the competences it enjoys in areas other than migration, for example trade policy and other components included in the ENP. This would allow the EU to make greater use of the leverage it has, also taking into consideration the fact that relying only on financial incentives is unsustainable in the long term. However, such an approach could be problematic and generate criticism, especially if it were to give the impression that the provision of development aid is conditional on cooperation on migration issues.

Moreover, to secure the implementation of agreements, the EU should use a combination of positive and negative incentives—rewarding those countries that cooperate effectively with the EU on migration management and ensuring that there are consequences for those who do not (European Commission 2016). Retaliation measures by the EU in cases of persistent and unjustified refusal of cooperation by a partner country have been discussed for many years and proposed by the European Commission, but rarely applied. This is partly due to the reluctance of the various EU institutions involved to compromise their broader external relations on the grounds of inadequate cooperation in the field of immigration. The EU should also use its leverage to insist on adherence to human rights standards in partner countries.

Finally, while member states’ prerogatives and competences must not be interfered with and their different geopolitical priorities must be taken into account, all member states need to have a common position which clearly identifies the role the EU is expected to play and includes a commitment to all the initiatives developed at the EU level.

Bilateral initiatives must be embedded in a comprehensive European strategy in order to become of added value to the whole Union. Where member states have privileged relations with third countries—for historical, cultural or other reasons—they should use them to obtain fruitful cooperation for the EU as a whole. There is still a great need for better coordination and synergies among the various initiatives at the EU and the national levels, as well as a clear consensus on the EU's goal and the tools it can use to reach it.

The new migration partnership framework suggested by the European Commission (2016) one year ago seems to move in this direction. With the new initiative, characterised by a dose of pragmatism, the EU is seeking tailor-made migration partnerships with selected key countries, with the intention of using all policies and instruments at its disposal to achieve concrete results and reduce irregular migration. It is still too early to assess whether this ambition will become a reality.

Conclusion

The EU is increasingly turning to third countries to manage migration flows and reduce the number of irregular migrants arriving in Europe. All EU member states agree that strengthening the foreign-policy dimension of migration policy is crucial for migration management. In the last decade, together with the further integration of migration policy, the EU has acquired a stronger role in this field, developing new tools to cooperate with neighbouring countries.

While the member states have given the EU the difficult task of establishing partnerships and agreements on migration with neighbouring countries, they have failed to support EU action. National priorities have rarely converged, and member states have been reluctant to become fully involved, especially when it comes to offering mobility opportunities as incentives. The support and involvement of the member states are crucial as they retain a decisive role and have competence concerning admission policies.

The result thus far is a big gap between intentions and the actual implementation of a coherent approach to migration. Although the current migration crisis has given new and greater importance to cooperation with third countries in the neighbourhood, it has also highlighted that it is time for the EU to address its challenges.

Some member states are hesitant to take responsibility for the management of migration, relying on partner countries for solutions. Nevertheless, the role of the EU as negotiator with and partner of the countries on its periphery is inexorably linked to what happens within the EU itself. Better coordination between EU member states is essential not only for internal reasons, but also to increase the credibility of the EU as a reliable and coherent partner, able to speak with one voice when addressing third countries.

This calls for a stronger foreign policy on migration at the EU level, the deployment of a wide range of tools and incentives, and more committed support from member states for EU action as a whole. Only in this way will the EU be able to develop a credible, and effective, strategy when cooperating with third countries.

References

Cassarino, J. P. (2010). *Readmission policy in the European Union*. Study for the European Parliament, DG for Internal Policies, Policy Department C. Brussels. http://www.europarl.europa.eu/RegData/etudes/etudes/join/2010/425632/IPOL-LIBE_ET(2010)425632_EN.pdf. Accessed 8 May 2017.

Cholewinski, R. (2011). The external dimension of the EU immigration policy. In M. Maes, M.-C. Foblets, P. De Bruycker, D. Vanheule, & J. Wouters (eds.), *External dimensions of EU migration and asylum law and policy* (pp. 485–500). Brussels: Bruylant.

Cournil, C. (2012). La politique de réadmission de l'UE avec les pays tiers: Diversification et expansion de l'externalisation des contrôles migratoires. In L. Dublin (ed.), *La légalité de la lutte contre l'immigration irrégulière par l'Union Européenne* (pp. 187–51). Brussels: Bruylant.

De Bruycker, P. (2014). L'approche globale des migrations de l'Union européenne: quel progrès suite au partenariat de mobilité avec le Maroc? In R. Mehdi (ed.), *La Méditerranée, espace démocratique?* (pp. 95–101). Marseille: Presses Universitaires d'Aix.

Dimitriadi, A. (2016). *Deals without borders: Europe's foreign policy on migration*. London: European Council on Foreign Relations. April. http://ecfr.eu/page/-/ECFR-165-DEALS_WITHOUT_BORDERS.pdf. Accessed 8 May 2017.

European Commission. (2007). *Circular migration and mobility partnerships between the European Union and third countries*. Communication, COM (2007) 248 final, 16 May.

European Commission. (2011a). *Evaluation of EU readmission agreements.* Communication, COM (2011) 76 final, 23 February.

European Commission. (2011b). *The global approach to migration and mobility.* Communication, COM (2011) 743 final, 18 November.

European Commission. (2015). *EU action plan on return*. Communication, COM (2015) 453 final, 9 September.

European Commission. (2016). *Establishing a new Partnership Framework with third countries under the European Agenda on Migration*. Communication, COM (2016) 385 final, 7 June.

European Commission and High Representative of the Union for Foreign Affairs and Security Policy. (2015). *Review of the European Neighbourhood Policy*. Joint Communication, JOIN (2015) 50 final, 18 November.

Frontex. (2017). *Risk analysis for 2017*. February. http://frontex.europa.eu/news/frontex-publishes-risk-analysis-for-2017-CpJiC8. Accessed 8 May 2017.

Garcia Andrade, P., & Martin, I. (2015). *EU cooperation with third countries in the field of migration*. Study for the European Parliament, Policy Department of Citizens' Rights and Constitutional Affairs, 2015/PE 536.469, Brussels. http://www.europarl.europa.eu/RegData/etudes/STUD/2015/536469/IPOL_STU(2015)536469_EN.pdf. Accessed 8 May 2017.

Hampshire, J. (2016). Speaking with one voice? The European Union's global approach to migration and mobility and the limits of international migration cooperation. *Journal of Ethic and Migration Studies, 42*(4), 571–86.

Junker, J. C. (2014). *A new start for Europe: My agenda for jobs, growth, fairness and democratic change*. Political guidelines for the next European Commission. Opening statement in the European Parliament Plenary Session, Strasbourg. 15 July. https://ec.europa.eu/commission/sites/beta-political/files/juncker-political-guidelines-speech_en_0.pdf. Accessed 8 May 2017.

Lavenex, S. (2006). Shifting up and out: The foreign policy of European immigration control. *West European Politics, 29*(2), 329–51.

Lavenex, S. (2016). Multilevelling EU external governance: The role of international organisations in the diffusion of EU migration policies. *Journal of Ethic and Migration Studies, 42*(4), 554–70.

Lavenex, S., & Stucky, R. (2011). 'Partnering' for migration in EU external relations. In R. Kunz, S. Lavenex, & M. Panizzon (eds.), *Multilayered migration governance: The promise of partnership* (pp. 116–42). London: Routledge.

Maes, M., Foblets, M.-C., De Bruycker, P., Vanheule, D., Wouters, J., & Foblets, M.-C. (2012). The international dimension of EU asylum and migration policy: Framing the issues. In M. Maes, M.-C. Foblets, P. De Bruycker, D. Vanheule, & J. Wouters (eds.), *External dimensions of EU migration and asylum law and policy* (pp. 9–60). Brussels: Bruylant.

Reslow, N. (2015). EU 'mobility' partnerships: An initial assessment of implementation dynamics. *Politics and Governance, 3*(2), 117–28.

Trauner, F., & Kruse, I. (2008). EC visa facilitation and readmission agreements: A new standard EU foreign policy tool? *European Journal of Migration and Law, 10*(4), 411–28.

Wolff, S. (2014). The politics of negotiating EU readmission agreements: Insight from Morocco and Turkey. *European Journal of Migration and Law, 16*(1), 69–95.

Wolff, S. (2015). Challenges of trans-Saharan migration. In E. Lannon & S. Gstöhl (eds.), *The European Union's broader neighbourhood: Challenges and opportunities for cooperation beyond the European Neighbourhood Policy* (pp. 37–52). London: Routledge.

Wolff, S., & Mounier, G. (2011). The external dimension of JHA: A new dimension of EU diplomacy. In S. Wolff, F. Goudappel, & J. Jaap de Zwaan (eds.), *Freedom, security and justice after Lisbon and Stockholm* (pp. 241–55). The Hague: T.M.C. Asser Press.

Loredana Teodorescu *joined the Wilfried Martens Centre for European Studies as a visiting research fellow in May 2016. Her main areas of expertise are migration, linkages between European internal security and foreign policy, borders and neighbourhood policies. She also has a keen interest in gender issues. She has recently completed a Ph.D. in political science, focusing on EU foreign policy on migration.*

EUROPEAN VIEW (2017) 16:131–139
DOI 10.1007/s12290-017-0428-8

CrossMark

ARTICLE

The future of the European welfare states: the intriguing role of demography?

Juhana Vartiainen

Published online: 16 May 2017

Abstract Many European countries are currently facing serious challenges related to weak public finances and political populism. This article suggests that the ageing phenomenon has been a major contributory factor to both of these problems. The European welfare states were created in a period of favourable demography, and it has now become politically much more difficult to keep them fiscally sustainable because of the ageing population and the associated deterioration of the dependency ratio. The rational policy response to ageing is to increase the labour supply by trimming unemployment benefits, increasing retirement ages and encouraging employment-based immigration. It is precisely such policies, however, that have eroded the support for traditional political parties and created a fertile ground for nativist populism. Thus, the European welfare arrangements may turn out to be politically unsustainable, even if it were theoretically possible to 'rescue' them with stringent and fiscally conservative economic management.

Keywords Ageing | Populism | Fiscal sustainability | Labour supply

J. Vartiainen (✉)
Parliament of Finland, 00102 Helsinki, Finland
e-mail: juhana.vartiainen@eduskunta.fi

Introduction

European politics is in a mess, and many of the institutions and values that we have learnt to cherish are being threatened by new and radical political initiatives. Aggressive nationalism and right-wing populism have assembled an agenda that in the eyes of many combines the worst ideas of the old-fashioned left and right. From the (paleo-) left there is a distrust of open markets, free trade and international integration; and, from the (paleo-)right there is aggressive nationalism or even racism, anti-feminism and overall hostility to modernist individualism.

The cause of this new political 'nastiness' has been ascribed to economic phenomena. Globalisation has brought benefits to the elites of rich countries as well as to the rising middle class of formerly poor countries. In the jargon of economists, the positive labour supply shock due to China's modernisation has exerted downward pressure on labour costs. This has contributed to sluggish wage growth in low-skilled tasks (Chusseau and Dumont 2012; Dabla-Norris et al. 2015). Of course, technology has probably also contributed to the widening wage disparities. This combination of technological advances and competition from Asian low-wage economies has, in many countries, decimated traditional manufacturing jobs. According to many accounts, this disruption of traditional communities has been the main source of discontent and has thereby contributed to the ascent of populist and nativist politics.

At the same time, the public finances of many European countries are perennially weak. Since 2008 this problem has been exacerbated by the financial crisis, but there was a structural issue even before the long recession that began in that year. Economic growth will to some extent alleviate this problem, but, as the European Commission's ageing reports have made clear, many European countries are in the danger zone of fiscal unsustainability. The European working-age population started to shrink around 2010 and will continue to shrink for at least three decades to come (European Community 2015).

In this article I shall argue a point that has been underemphasised in European political debates. The point is that demographic change in the form of ageing can play and has played a large, though indirect, role in the current European economic and political malaise.

Supply-side policies are a rational response to ageing

At some juncture in their histories, most successful societies reach a point at which longevity is increasing while fertility is shrinking. This usually entails a deterioration in the dependency ratio. There is nothing inherently wrong with this: longevity is something most of us like, and it is good that the global population is becoming more stable. Yet this transformation of the age structure implies a problem for public finances in countries with large public sectors. This is so because an individual's net contribution to the public purse varies considerably with age. We consume public services as children and young people, contribute to them while working, and again become net consumers of public resources when old. As the number of pensioners increases and the number of working-age people shrinks, the public sector deficit inevitably increases, even with unchanged policies and unchanged welfare entitlements. This is mostly due to two factors: the increase in demand for publicly provided and age-correlated health care and elderly care services, and, of course, the consumption of pension assets.

There are differences between countries as to the severity of this challenge for the public finances. The responsibility of the public sector for health care and elderly care expenditure varies, and the same is true for pensions. In some countries, the provision of pensions is formally a part of the general government finances, while in others it is a private arrangement; it is also common that a basic pension insurance is publicly provided, which individuals are free to top up with additional private pension arrangements. Be that as it may, it is generally true that the ageing population is affecting the sustainability of public finances quite significantly in most European countries (European Community 2015).

The European working-age population, as measured by the number of 20–64 year-olds, started shrinking in 2010 and this trend will continue until the 2050s (European Community 2015). This downward trend is quite slight and, by itself, is an undramatic supply-side shock. However, from the point of view of sound public finances, this trend is significant. The European politicians who learnt their political skills in the decades following the Second World War became accustomed to an economic environment in which it was quite risk-free to increase public expenditure. The need to finance new spending programmes was easily met when the work force was growing. This was the (somewhat hidden) material basis for the economic optimism of the Keynesian era. We know now that, from a demographic point of view, this phase of ambitious welfare policies was quite a special one. The large cohorts born immediately after the war were active in the labour force, while life expectancy had not yet increased markedly. Thus there was a lot of leeway for increasing public expenditure.

As this special phase is now definitely over, European welfare policies must adapt to a more austere and constrained policy environment. In a demographically stable economy, there is no similar scope for increasing welfare entitlements and publicly provided services such as education and health care. Furthermore, for many countries, the specific phase of transition to the new equilibrium poses an 'extra' policy dilemma, since the large cohorts born after the Second World War will soon be old and retired.

With the workforce shrinking relative to the number of pensioners, the only sustainable way of stabilising the public sector's finances is to increase the number of employed individuals. In other words, reforms that increase the supply of labour become necessary to ensure the sustainability of the public finances. Policymakers can, to some extent, alleviate the pressure on public finances by increasing taxes or cutting expenditure, of course. However, the scope for those two lines of defence is limited. On the one hand, tax increases that are acceptable to the electorate tend to be those that, according to many studies, hamper economic growth. Welfare expenditures, on the other hand, are quite solidly entrenched in the political preferences of the European electorates. Therefore, the main policy reaction to the deterioration of public finances must be an increased supply of labour. The severity of these policy challenges is well emphasised by Börsch-Supan et al. (2014).

The supply-side reform agenda

A rational reform agenda to increase the supply of labour consists of many elements which to varying degrees have been adopted by policymakers in different countries:

- raising mandated retirement ages,
- trimming unemployment benefits and social security entitlements and introducing conditionality and workfare to make it economically more attractive to work,
- reforming labour legislation and wage bargaining systems to reduce structural unemployment, and
- encouraging work-based immigration.

Such policy measures are precisely what Europe needs to counteract the effects of ageing. Those countries that have had the political will to undertake such reforms have clearly reaped a lot of benefits, even during the economically difficult period since 2007. The UK after Thatcher and Blair, Germany after Schröder and Sweden after the reforms of the Reinfeldt administration (2006–2014) have exhibited robust employment growth [see Dölvik and Martin (2015) for accounts of the reform experiences of various European countries].

However, many such policies have probably also contributed to the political strength of populist parties. More stringent unemployment insurance, for example, may be a resourceful and adequate reform, but such reforms are resented by working-class voters, who are then more easily tempted by populist parties. Many European countries suffer from high structural unemployment rates, meaning that unemployment seldom falls below 6%–7%, even in economic booms. In these situations it is difficult to argue for supply-enhancing reforms when there is 'already' a lot of domestic unemployment. Economists can, of course, point out that according to standard economic models the unemployment rate does not depend on the size of the labour force. Yet this is a complicated expert argument and it is therefore politically difficult, even for responsible policymakers, to argue for supply-side reforms when unemployment is high. In Germany, the justly celebrated Hartz reforms have led to strong employment growth and low structural unemployment, but they also initiated a lasting decline in support for the Social Democrats (SPD, Sozialdemokratische Partei Deutschlands). Instead of voting for the Social Democrats, many frustrated working-class voters have set their hopes on new nativist and populist political alternatives such as the Alternative for Germany (Alternativ für Deutschland).

No political prizes for good economic policy?

Moreover, of course, the aforementioned reform route regarding work-based immigration has become a politically delicate matter in many countries. For many economists and policymakers, the idea of increasing work-based immigration is a well-motivated and adequate way of tackling the problem of insufficient employment. Many probably also believe that the political success of liberal immigration regimes ultimately depends on whether the labour market functions well. If the answer is yes, immigrants will be duly integrated into the host society and in the long run everybody will be better off thanks to immigration.

The UK is an example of a flexible economy that has successfully tapped into the European and international skills markets. Unemployment is now under 5%, and a large part of British economic growth and employment growth can be ascribed to successful immigration. Employment has grown healthily, at a pace of about 1.6% per year during the last five years (2012–16) (OECD 2016). This is why the Brexit referendum result is such a shock and, in the eyes of many commentators, has altered assumptions about what is politically possible. I do not know of any economic analysis or other well-argued document that would vindicate the idea that immigration has been an economic burden for the UK. On the contrary, most serious economic analyses suggest that work-based immigration has been beneficial for the UK's economic growth, and that the net effect has even been beneficial and probably will be beneficial for the public finances as well (see UK Government, Office for Budget Responsibility 2015). Inasmuch as there have been negative effects on domestic wages, these have been very small. Yet, against all these rational facts, the British public has voted to leave the EU, and the main motive is to reduce immigration. It is hard to tell to what extent the result was due to poorly informed voters. It is also perfectly possible that they just do not like migration and are prepared to pay the price for this dislike in the form of weaker economic growth and weaker public finances.

Germany, with its flexible post-Hartz labour market, has been able to sustain a moderate unemployment rate, even after the macroeconomic shock of 2008, in spite of it being an attractive place for many migrants from both within and outside the EU. Germany's labour force has grown every year during the current decade, and so has employment, albeit at a slightly slower pace than in the UK. Germany's unemployment rate is also under 5%, thanks to the muscular Hartz reforms undertaken from 2003 onwards. Yet even in Germany, with its obvious and almost splendid economic record in recent years, a powerful wave of protest politics against immigration has emerged in the form of support for the Alternative for Germany.

The same goes for Sweden, where, even during the long recession, employment growth was quite satisfactory (from 0.5% to 1% each year), to a large extent thanks to a liberal work-based immigration regime. The unemployment rate has clearly declined since 2010. Yet even in Sweden, one can see that neither of the traditional political blocs (the left and the right) now seems able to form a majority in the Swedish

Parliament. Instead, the Sweden Democrats (Sverigedemokraterna), which is partly heir to the Swedish neo-Nazi movement, has emerged as a party that at times competes with the two biggest traditional parties.

Of course, it is difficult to present watertight proof of the major role of supply-side policies in the success of populist policies. Yet this causal chain seems quite plausible. More stringent unemployment benefits, higher retirement ages, and, first and foremost, a steady increase in the migrant population are all rather plausible explanations for the current political instability.

European welfare states and their fragile finances

The British experience suggests that economic success is not enough to dissuade the electorate from seeking unrealistic and nativist political alternatives, and that immigration can be rejected even when it functions reasonably well. If the same holds for other European countries, this poses a policy dilemma for the financing of the welfare state. As explained above, it is hard to see how the European welfare undertakings can be adapted to meet the needs of an ageing society without a stringent supply-side policy package that includes a dose of work-based immigration. If such policies prove politically unsustainable, then there are few good policy alternatives. In the long run, the large and generous welfare undertakings typical of EU countries are not feasible if they are not underpinned by quite ambitious and robust employment policies. Such policies are possible and feasible in principle, but they do not leave much room for economic mismanagement and irresponsibility.

Thus, the ageing problem and the transition to a new demographic pattern do present a kind of litmus test for the feasibility of the European ‘social economies’. Many voters liked the welfare state and the public pension system in the 1960s and 1970s when both seemed to be easy to finance and neither demanded much sacrifice. As they now presuppose stringent supply-side policies, and even an acceptance of much more work-based immigration, their political feasibility is another matter. If this policy challenge is not adequately dealt with, future historians will have to conclude that the (currently) much-celebrated European welfare state was in fact only a temporary arrangement, made possible by the special and provisional demographic structure.

The jury is still out on this question. We have mentioned the countries with successful reform records, such as Sweden and Germany, but the travails of France and Italy—and even Finland, the Nordic outlier with an employment rate somewhere between those of the Mediterranean and the Nordic countries—show very clearly how difficult it is to build political support for effective labour market reforms that raise the employment rate.

Demography also constrains countercyclical fiscal policy

On top of the long-term policy dilemma outlined above, demography also constrains macroeconomic demand management. The state of European politics would be less strained if the macroeconomic management of the financial crisis had allowed more Keynesian reflation and less austerity. Many left-wing commentators have interpreted the macroeconomic policy during the crisis as an outright 'neoliberal' attempt to roll back the welfare state.

However, the sober truth is that the demographically constrained welfare state financing has also constrained ambitions for more Keynesian stimulus policies during the crisis. Again, there is a difference here vis-à-vis the decades after the Second World War. When the labour force was growing strongly, it was perfectly okay to assume that economic growth would take care of the deficits incurred during economic slumps. However, when the number of economically active workers and taxpayers stagnates or shrinks, bold Keynesian demand management during a crisis becomes a much riskier proposition. To introduce a policy of Keynesian stimulus and a deliberate increase of the deficit, one has to show that this will generate an economic growth path on which the increased public debt and public deficit will not place insurmountable pressures later on. In times of low labour force growth, this is often surprisingly difficult. Any responsible fiscal policy must therefore seek a compromise between fiscal consolidation and sustaining aggregate demand (see Kanada (2011) and Carnot (2014) for such analyses).

Thus, in an indirect way, the stringent demographic constraints have also constrained countercyclical fiscal policy during this crisis. Following through with such a policy is by no means impossible, but it requires a structural reform policy bold enough that today's deficits can be met with strong employment growth and thereby a growing tax intake during the decades to come. For example, the Swedish administration of Fredrik Reinfeldt and Anders Borg, after taking office in 2006, immediately introduced an array of structural reforms in order to boost future employment growth (see Dölvik et al. (2015) for a description of the Swedish reforms). When the crisis struck in 2008, there was enough fiscal room to let the public balance deteriorate, and indeed Sweden ran a moderately expansive fiscal policy during the subsequent recession. Thus, there is no contradiction but instead a symbiosis between adequate supply-side policies and Keynesian demand management. Keynesian demand management is only feasible in fiscally hawkish countries. This basic truth is not appreciated in all political circles, unfortunately.

Conclusion: Are economically sustainable policies politically sustainable?

I have argued that the demographic transformation due to an ageing society is a major factor behind the current political instability in Europe. It has made supply-side policies and large-scale immigration necessary policy orientations, but this has, in turn, encouraged the very political protest that, in the form of populist nativism, is now challenging responsible economic policymaking. It has also limited the scope for expansive fiscal policy during the long recession since 2008. Responsible economic policies for fiscal sustainability have run into problems of political unsustainability.

There is no crystal ball that can reveal how these contradictions will play out in the decades to come. Fortunately, the European economies are now solidly on a path to recovery, with shrinking unemployment rates and fiscal deficits. The current challenge of populism might therefore run out of steam. Sooner or later it will also become apparent that the populist and nativist political parties do not actually have any solutions to the fundamental economic challenges of our time. They have not sought public office by wanting to dismantle the welfare states and if the European welfare states are to be sustained there is no alternative to responsible economic management—even if this is in the form of supply-side policies that at times may feel politically painful.

References

Börsch-Supan, A., Klaus, H., & Ludwig, A. (2014). Aging in Europe: Reforms, international diversification, and behavioral reactions. *American Economic Review, 104*(5), 224–9.

Carnot, N. (2014). *Evaluating fiscal policy: A rule of thumb*. European Economy Economic Papers 526. Brussels, August.

Chusseau, N., & Dumont, M. (2012). *Growing income inequalities in advanced countries*. ECINEQ working paper 2012–260. University of Padova, August.

Dabla-Norris, E., Kochhar, K., Ricka, F., Suphaphiphat, N., & Tsounta, E. (2015). *Causes and consequences of income inequality: A global perspective*. International Monetary Fund Staff Discussion Note, Washington, DC.

Dölvik, J. E., Goul Andersen, J., & Vartiainen, J. (2015). The Nordic social models in turbulent times: Consolidation and flexible adaptation. In J. E. Dölvik & A. Martin (eds.), *European social models: From crisis to crisis* (pp. 246–86). Oxford: Oxford University Press.

Dölvik, J. E., & Martin, A. (eds.). (2015). *European social models: From crisis to crisis*. Oxford: Oxford University Press.

European Community. (2015). *The 2015 aging report. Economic and budgetary projections for the 28 EU Member States (2013–2060)*. European Economy 3. Brussels.

Kanada, D. (2011). *Modeling optimal fiscal consolidation paths in a selection of European countries*. International Monetary Fund working paper 11/164. Washington, DC.

OECD. (2016). *OECD economic outlook, volume 2016 issue 2*. Paris: OECD Publishing.

UK Government, Office for Budget Responsibility. (2015). *Fiscal sustainability report*. June.

Juhana Vartiainen *is Finnish and Swedish, has a Ph.D. in economics from the University of Helsinki, and is a Finnish Member of Parliament, representing the National Coalition Party. Until 2015 he worked as the director general of the VATT Institute for Economic Research, and, prior to that, he led the research team at the Swedish National Institute of Economic Research (Konjunkturinstitutet). His research focuses on Nordic macroeconomics and labour market institutions.*

EUROPEAN VIEW (2017) 16:141–151
DOI 10.1007/s12290-017-0440-z

ARTICLE

Ledgers, anecdotes and leadership: guidelines for partnering with the new US president

Nathan Shepura

Published online: 22 June 2017

Abstract President Trump's foreign policy remains paradoxical and as yet highly uncertain. European leaders face the challenge of communicating both their interests and values in ways that the new president will welcome. Thus far, practical discussion combined with a personal connection seems the likeliest path to success. Ultimately, the EU has the opportunity not only to partner with the US but to lead the way forward based on the EU's own fundamental commitments and values. Three important areas this could affect are security and defence, climate change policy and global trade.

Keywords EU approach | Trump | Trade | Climate change | Leadership

Introduction

President Trump's 'America First' doctrine is both fraught and paradoxical. Though it invokes the isolationist politics of the 1940s, the doctrine, as Trump explains it, includes few historical touchstones. And though it suggests a foreign policy based solely on

N. Shepura (✉)
European People's Party, Rue du Commerce 10, 1000 Brussels, Belgium
e-mail: ns@epp.eu

Springer

American interests, it does so seemingly irrespective of traditional American values, values which have come to define the very American exceptionalism Trump has promised to revive.

The US strike on Syria's Shayrat airfield on 7 April—in response largely, it seems, to President Trump's moral outrage over the Assad regime's use of chemical weapons—only highlights this paradox. While many Republicans, Democrats and foreign leaders, including those in the EU, praised the strike as an example of decisive action, critics worried it could drag the US into yet another Middle East quagmire. Even longstanding supporters such as Nigel Farage and Marine le Pen pointed out the inconsistency between the strike and Trump's campaign promise (though not always clear) to stay out of foreign entanglements (Labott and Gaouette 2017). Harsher critics claimed the action revealed the administration's lack of direction or even coherence, giving rise to headlines like 'The Emerging Trump Doctrine: Don't Follow Doctrine' (Baker 2017) and 'The Trump Doctrine was Written by CNN' (Boot 2017). The White House communications director himself reportedly told staffers during a brainstorming meeting on 9 April, 'There is no Trump doctrine' (Goldmacher 2017).

One outstanding question following the April strikes has focused the world of politics ever since Trump's election: how to get through to the president. Perhaps the influence of CNN and other news organisations is indeed pivotal. Certainly, the president makes no secret of his relationship with Fox News programmes like *Fox & Friends*, *Hannity* and *Justice with Judge Jeanine*. What does seem clear, at least, is that any approach to the Trump team will only be successful insofar as it engages the 'America First' paradox: in other words, both the bottom line resulting from any deal with the US as well as the underlying values buttressing the president's own ideology or intuition of American greatness.

How to talk to Trump

One of the takeaways from an 8 February round-table discussion in the European Parliament was the extent to which a bottom-line approach to President Trump had improved the standing of countries like the Baltic states, Poland, Morocco and Saudi Arabia, all of which had rightly understood, early on, the importance of bringing forward clear and practical demands (European Ideas Network and Hudson Institute 2017). Mexico's Economy Minister Ildefonso Guajardo demonstrated a similar awareness in his March 2017 address to the Detroit Economic Club (Butters 2017). Chinese President Xi, in a recent state visit to Mar-a-Lago, seems to have parleyed very explicitly, and with success, his nation's influence over North Korea for more favourable status regarding currency and trade (Trump 2017; Dickerson 2017).

Perhaps an even more specific, and instructive, example in this vein is that of Chancellor Merkel and her team during their first visit to the White House, on 17 March. Despite Trump's apparent unwillingness to shake the chancellor's hand, and despite his apparently handing her a 'bill' for overdue NATO contributions, the two leaders' first meeting seems to have been an overall success (Vinocur 2017). Significantly, the president has lately moderated his public criticism of NATO, the EU and Germany itself. Indeed, Ivanka Trump and the chancellor even seem to have hit it off; and the president's influential daughter travelled to Germany in the final week of April, at Merkel's special invitation, to attend the W20 Summit.

This personal connection merely speaks to the broader point. Chancellor Merkel's on-the-record round-table discussion with the president on vocational training was notable for two distinct themes: first, a clear demonstration of the specific benefits which German investment and trade have contributed to the American economy; and second, a focus on specific, personal stories of real Americans whose lives have been improved by these contributions. Regarding the former, Chancellor Merkel cited 810,000 jobs created in the US by German firms, along with foreign direct investment of over $270 billion. Her remarks were followed by those of leaders from companies like Siemens, Schaeffler, BMW and Dow, all touting specific investments and US production figures. (Notably, the states singled out—South Carolina, Michigan and Ohio—all voted for Trump in 2016, with Michigan and Ohio representing crucial swing states.) Also included in the round-table introductions were two young graduates of successful vocational training programmes: one from an IBM programme in Brooklyn, New York, the other from a BMW programme in South Carolina. Each told an inspirational story of skills training and expansive future possibilities. And it was the personal stories, in fact, more than the impressive numbers, which seemed to make the deepest mark on both President Trump and Vice-President Pence (The White House 2017).

The point here is to suggest that the president's agenda, and not just regarding German vocational training, is likely to be guided both by hard, actionable numbers and by the personal connections he develops on a particular issue—rather than, say, by abstract theories, aggregate data or long-term projections. If this analysis is sound, it could help to inform constructive approaches by European leaders, potentially affecting several crucial policy areas.

Security and defence, handled diplomatically

One such area is security and defence. Even before the US election, NATO and EU member states alike were feeling pressure to increase what have, in many cases, been long-stagnant defence budgets. Even Germany, with a defence budget of only 1.2% of GDP, has now committed to meeting its 2% NATO commitment by 2024. But these frank discussions have not been without costs: fear remains in Germany, for example, with elections scheduled this September, that the Socialists could use the prospect of heightened militarisation against Merkel (Donahue 2017; Siebold et al. 2017). And at an even deeper, European, level, the language of boosting defence capacity has called into question long-standing EU priorities for diplomacy and development aid. President Juncker and Chancellor Merkel themselves have both argued that the military is not, and should not be seen as, the sole contributor to security (Farmer 2017).

Unsurprisingly, by contrast, on the US side the Trump administration has proposed significant long-term cuts, of up to 31%, to the US Department of State and the US Agency for International Development, tilting even further an existing imbalance in favour of the Department of Defense and signalling an even greater, and problematic, militarisation of culture and policy (Schwartz 2017; Brooks 2016).

It is certainly clear that European countries must do more to pull their fair share of the security load, both for their own sake as well as to convince the US not to 'moderate' its own commitment to NATO, as Secretary Mattis suggested in Europe in February (Lamothe and Birnbaum 2017). Although a rising China and a belligerent, and nuclear, North Korea threaten Europe less directly than they do the US and various US allies, this is not the case for several other looming threats: from jihadist terrorism, from a revanchist Russia, from a potentially nuclear Iran or from ungoverned cyberspace (Cohen 2016).

Despite this, however, it is not clear that Europe should abandon altogether its arguments in favour of robust investment in diplomacy and aid as necessary parts of a holistic security strategy. Indeed, this investment, in the form, for example, of new trust funds for Africa and Syria, is providing resources important in addressing the root causes of instability. But perhaps the case must be differently framed. For starters, as Michael Benhamou (2017) pointed out in a February piece in *Foreign Affairs*, EU development funds on the whole can and should be more strategically deployed in support of EU goals and objectives, rather than those of individual member states or of the UN writ large. This, indeed, is part and parcel of developing coherent EU foreign and security policies.

Further, what must become clear from such a defence of EU soft power, vis-à-vis the Trump administration, is what tangible, measurable difference such power is actually making—and how it complements, rather than detracts from, ongoing US efforts. Ultimately, the argument may need to include examples, at the level of personal anecdote even, of how European development work, humanitarian aid, educational exchanges and the like are serving to make Americans themselves safer and more secure. That is to say, *this* family, in *this* district, is the reason we should accept refugees. The case of *this* individual demonstrates the vital importance of international law.

Creativity in responding to climate change

Another major area where a nuanced approach could prove helpful is climate change. While President Trump has at times seemed to soften his position on the Paris Agreement since his election, his commitment remains highly uncertain. It seems unlikely he will be convinced to take more serious action by scientific projections or by scathing editorials. (In line with my general argument, Leonardo di Caprio may actually stand a better chance—and Ivanka Trump better still—at changing the president's mind.) What may prove more constructive, however, is the approach outlined by Oren Cass (2017), former domestic policy director for Mitt Romney's presidential campaign: a positive, as opposed to a negative, approach to the whole issue, an approach focused on innovative new solutions rather than worst-case scenarios. This kind of pragmatism would, for instance, generally support fracking as an improvement over coal, and it would focus at least as much on adapting to climate change as on preventing it.

A more localised approach may also be in order. In their 2017 book *Climate of Hope*, former New York City Mayor Michael Bloomberg and former Executive Director of the Sierra Club Carl Pope argue that top-down, Washington-based solutions to climate change have ultimately contributed little to the overall reduction in greenhouse gases, whereas tremendous progress has been made at the municipal level (Bloomberg and Pope 2017). It is cities, after all, they argue, which produce by far the greatest share of greenhouse gases—yet also, ironically, the places most equipped to implement ingenious new solutions. It is cities which represent by far the largest percentage of world GDP. And even more significantly, they argue, it is cities themselves, in the digital economy, which are now competing for talent—not the other way around—such that local governments have strong economic and political incentives to push for cleaner air and water and for more efficient buildings and public transportation systems.

The European Committee of the Regions could play a pivotal leading role here. Reporting on its Conference of the Parties 22 Climate Summit for Local and Regional Leaders, which gathered over 1500 local and regional leaders from around the world, the Committee of the Regions touted initiatives such as the Global Covenant of Mayors and stressed that 'local governments surpass national government targets'—with 'local and regional authorities… responsible for executing around 70% of climate change reduction measures and up to 90% of climate adaption actions' (European Commission 2016; European Committee of the Regions 2016).

As just one case in point here, both *Climate of Hope* and National Geographic's 2016 film *Before the Flood* (National Geographic 2016), featuring Leonardo di Caprio, highlight the ongoing damage which rising sea levels are already inflicting on Miami, Florida. The personal stories of Americans adversely affected by this phenomenon, in addition to the stories of those innovators learning how to overcome it, may prove essential in garnering real support from the administration. And it does not hurt, after all, that Miami finds itself in a crucial swing state.

Trading on success: the opportunity for EU leadership

Finally, when simple deal-making or inspirational anecdotes do not suffice, the EU will still have an opportunity to appeal to President Trump in the name of global leadership. Even if his intuitions on a number of issues remain forever antithetical to those of pro-EU parties and citizens, Trump will value strength and leadership. He has built his public persona and political career on being perceived in these terms.

Thus, though President Trump has decried the negative effects of unfair trade policies on American workers, it remains highly uncertain to what extent his own policies will be able to generate long-term gains in American manufacturing. He has filled out his own administrative team only slowly, for various reasons; and with major legislative hurdles yet to be overcome with regard to tax reform and infrastructure, to say nothing of health care, major new initiatives on trade will likely prove daunting. So far, the president has focused on trade enforcement and on the renegotiation of existing agreements rather than on new deals. Meanwhile, his protectionist rhetoric has already caused several US partners, foremost Mexico, to begin looking to other markets (Beasley et al. 2017; Summers 2017; Webber 2017; AFP 2017a; Donnan 2017; Misculin 2017). At a global level, the International Monetary Fund and the WTO warn that heightened protectionism (and not just in the US) could impede or derail an otherwise favourable economic outlook over the medium term (AFP 2017b; WTO 2017).

The EU, meanwhile, has recently ratified provisional implementation of the Comprehensive Economic and Trade Agreement with Canada. It is engaged with Mexico in intensive talks over modernising the bilateral free trade agreement concluded in 2000 (European Commission 2017d). EU negotiations with Mercosur have also intensified, and a deal is expected by the end of 2017 or early 2018 (Valero 2017). Talks with Japan have reached a similarly advanced stage (European Commission 2017c). The EU is set to begin trade negotiations with Australia and New Zealand (European Commission 2017a, b). And it is exploring a free trade agreement with the Association of Southeast Asian Nations (European Commission 2017e).

In Asia, the Regional Comprehensive Economic Partnership, including both China and India, is moving forward. Despite major ongoing challenges, China's 'Belt and Road Initiative' is projected to alter dramatically the infrastructure and trade patterns of both Europe and Asia over the next several decades (Khanna 2017; Jun 2017; *The Economist* 2017). Even the Trans-Pacific Partnership has shown signs of struggling back to life, despite the Americans' withdrawal (Fujii et al. 2017).

The lesson here is that world trade has not stopped, whether or not the US plays a central role in shaping its course. US Congressman Paul Ryan (at the time not yet Speaker of the House) made this point forcefully in a speech on the House floor in June 2015—well before Donald Trump's election (US House of Representatives: Ways and Means Committee 2015). With the new administration pulling back from pending negotiations and seeking to renegotiate existing deals, the EU and China will have an even greater opportunity to exert leadership in this area. If they get results—if they can actually sign and implement deals—President Trump may feel pressure to rejoin the multilateral fray, simply because he will see US leadership, and his own leadership, as more important in the long run than the margins of any particular balance sheet. Currently, he seems to believe he can exert global leadership unilaterally. The EU, in particular, will have a strong case to make for the inherent value of multilateral cooperation, especially on trade, based on a fundamental commitment to international law. President Trump will not want to appear to be following a trend.

Conclusion

While it will remain essential for European leaders to make the case, in clear and practical terms, as to why this or that policy will benefit not only the transatlantic partnership but the world order in general, there will be times when this approach may simply fall on deaf ears. For regardless of the extent to which any given assets may outnumber their corresponding liabilities, numbers alone will not inspire, will not elicit empathy, will not speak to deep-seated national or cultural identities. President Trump has often been dismissive of nitty–gritty or historical detail, but has shown himself deeply committed to narrative per se. Even aside from his metanarrative of 'American carnage' and, under his leadership, 'American renewal', it is clear that smaller-scale stories, human stories, often shape his thinking. European leaders should partner with the new US president fully prepared to engage his own idiosyncratic vision of American greatness—and fully prepared to lead in their own right.

References

AFP. (2017a). Chile, China start talks to expand trade deal. *Yahoo News*, 11 April. https://www.yahoo.com/news/chile-china-start-talks-expand-trade-deal-232858203--finance.html. Accessed 13 April 2017.

AFP. (2017b). IMF warns against protectionism as Trump, Brexit loom. *EURACTIV.com*, 21 April. https://www.euractiv.com/section/elections/news/imf-warns-against-protectionism-as-trump-brexit-loom/. Accessed 24 April 2017.

Baker, P. (2017). The emerging Trump doctrine: Don't follow doctrine. *The New York Times*, 8 April. https://www.nytimes.com/2017/04/08/us/politics/trump-doctrine-foreign-policy.html?_r=0. Accessed 13 April 2017.

Beasley, A., McClean, P., & Wagstyl, S. (2017). Europe ponders Asia pivot to fend off protectionism. *Financial Times*, 14 February. https://www.ft.com/content/52a46184-ed5c-11e6-930f-061b01e23655. Accessed 16 February 2017.

Benhamou, M. (2017). The EU's misplaced foreign aid: Why it's spending in the wrong places. *Foreign Affairs*, 9 February. https://www.foreignaffairs.com/articles/europe/2017-02-09/eus-misplaced-foreign-aid. Accessed 24 April 2017.

Bloomberg, M., & Pope, C. (2017). *Climate of hope: How cities, businesses, and citizens can save the planet*. New York: St Martin's Press.

Boot, M. (2017). The Trump doctrine was written by CNN. *Foreign Policy*, 10 April. http://foreignpolicy.com/2017/04/10/donald-trumps-incredible-shrinking-syria-intervention/. Accessed 13 April 2017.

Brooks, R. (2016). *How everything became war and the military became everything: Tales from the Pentagon*. New York: Simon & Schuster.

Butters, J. (2017). Nafta has room for improvement, Mexico's economy minister says. *Bloomberg*, 3 March.

Cass, O. (2017). The problem with climate catastrophizing. *Foreign Affairs,* 21 March. https://www.foreignaffairs.com/articles/2017-03-21/problem-climate-catastrophizing. Accessed 3 April 2016.

Cohen, E. A. (2016). *The big stick: The limits of soft power and the necessity of military force*. New York: Basic Books.

Dickerson, J. (2017). President Trump: An interview on his first 100 days in office. Washington, DC: *Face the Nation*. *YouTube.com*, 30 April. https://www.youtube.com/watch?v=4YLKFylRM9o. Accessed 2 May 2017.

Donahue, P. (2017). Merkel rival questions NATO defense goals in anti-Trump stand. *Bloomberg*, 10 April. https://www.bloomberg.com/politics/articles/2017-04-10/merkel-rival-questions-nato-defense-goals-in-anti-trump-stand. Accessed 24 April 2017.

Donnan, S. (2017). American farm belt anxious about Trump trade threats. *Financial Times*, 17 April. https://www.ft.com/content/96160542-1a18-11e7-a266-12672483791a. Accessed 21 April 2017.

European Commission. (2016). Supporting local climate action worldwide: the Global Covenant of Mayors moves to North America. 4 November. https://ec.europa.eu/clima/news/articles/news_2016111401_en. Accessed 24 April 2017.

European Commission. (2017a). Countries and regions: New Zealand. Last updated 6 April. http://ec.europa.eu/trade/policy/countries-and-regions/countries/new-zealand/. Accessed 24 April 2017.

European Commission. (2017b). EU and Australia one step closer to launching trade negotiations. 6 April. http://trade.ec.europa.eu/doclib/press/index.cfm?id=1643. Accessed 24 April 2017.

European Commission. (2017c). EU and Japan conclude 18th round of trade talks. 10 April. http://trade.ec.europa.eu/doclib/press/index.cfm?id=1649. Accessed 24 April 2017.

European Commission. (2017d). EU and Mexico agree to accelerate trade talks. 1 February. http://trade.ec.europa.eu/doclib/press/index.cfm?id=1617. Accessed 24 April 2017.

European Commission. (2017e). Overview of FTA and other trade negotiations. http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf. Accessed 24 April 2017.

European Committee of the Regions. (2016). COP22: Governments must uphold and go beyond Paris climate promises. 14 November. http://cor.europa.eu/en/news/Pages/marrakech_2016.aspx. Accessed 24 April 2017.

European Ideas Network & Hudson Institute. (2017). *Transatlantic relations after the US presidential elections*. Brussels: EIN.

Farmer, B. (2017). Angela Merkel and European leaders resist Donald Trump's ultimatum to increase defence spending or risk losing US commitment to Nato. *The Telegraph*, 18 February. http://www.telegraph.co.uk/news/2017/02/17/european-leaders-resist-trumps-ultimatum-increase-defence-spending/. Accessed 24 April 2017.

Fujii, A., Yasoshima, R., & Shigeta, S. (2017). Japan looks to revive moribund TPP, sans US. *Nikkei: Asian Review*, 15 April. http://asia.nikkei.com/Politics-Economy/International-Relations/Japan-looks-to-revive-moribund-TPP-sans-US. Accessed 24 April 2017.

Goldmacher, S. (2017). White House on edge as 100-day judgment nears. *Politico.com*, 10 April. http://www.politico.com/story/2017/04/donald-trump-first-100-days-237053. Accessed 24 April 2017.

Jun, D.-G. Z. (2017). China's economic diplomacy entered the new era. *MFA News*, 19 April. http://www.fmprc.gov.cn/mfa_eng/wjdt_665385/zyjh_665391/t1454825.shtml. Accessed 20 April 2017.

Khanna, P. (2017). Trade grows—without the U.S. *Politico.com*, 23 February. http://www.politico.com/agenda/story/2017/02/trade-grows-without-us-000321. Accessed 24 February 2017.

Labott, E., & Gaouette, N. (2017). After Syria strike, populist supporters abandon Trump at home and abroad. 10 April. http://edition.cnn.com/2017/04/07/politics/donald-trump-syria-populist-support/. Accessed 24 April 2017.

Lamothe, D., & Birnbaum, M. (2017). Defense Secretary Mattis issues new ultimatum to NATO allies on defense spending. *The Washington Post*, 15 February. https://www.washingtonpost.com/news/checkpoint/wp/2017/02/15/mattis-trumps-defense-secretary-issues-ultimatum-to-nato-allies-on-defense-spending/?utm_term=.e923a472cc5f. Accessed 24 April 2017.

Misculin, N. (2017). Mexico, looking south, sees trade deal with Argentina around year's end. *Nasdaq.com*, 18 April. http://www.nasdaq.com/article/mexico-looking-south-sees-trade-deal-with-argentina-around-years-end-20170418-01387. Accessed 24 April 2017.

National Geographic. (2016). *Before the Flood.* 30 October. https://archive.org/details/youtube-90CkXVF-Q8M. Accessed 24 April 2017.

Schwartz, F. (2017). Trump seeks major cut to State Dept., USAID. *The Wall Street Journal*, 16 March. https://www.wsj.com/articles/trump-to-propose-30-cut-to-state-dept-usaid-1489623424. Accessed 24 April 2017.

Siebold, S., Shalal, A., Nienaber, M., & Heneghan, T. (2017). Germany to boost defence spending, but legacy also important: Gabriel. *Reuters*, 22 February. http://www.reuters.com/article/us-germany-defense-gabriel-idUSKBN1611LD. Accessed 24 April 2017.

Summers, L. (2017). Hurting Mexico will boost China and backfire on Donald Trump. *Financial Times*, 24 March.https://www.ft.com/content/122b8051-9847-3a62-ba31-d94c5cdf9a06. Accessed 13 April 2017.

The Economist. (2017). China faces resistance to a cherished theme of its foreign policy. *The Economist*, 4 May. http://www.economist.com/news/china/21721678-silk-routes-are-not-always-appealing-they-sound-china-faces-resistance-cherished-theme. Accessed 8 May 2017.

The White House. (2017). President Trump leads a roundtable discussion with United States and German business leaders. *YouTube.com*, 17 March. https://www.youtube.com/watch?v=luIJDNyXAek. Accessed 24 April 2017.

Trump, D. [realDonaldTrump] (2017). Why would I call China a currency manipulator when they are working with us on the North Korean problem? We will see what happens! *Twitter*, 16 April. https://twitter.com/realDonaldTrump/status/853583417916755968. Accessed 2 May 2017.

US House of Representatives: Ways and Means Committee. (2015). *Ryan floor statement: Enacting TPA is critical for our economy.* 18 June. Washington, DC. https://www.youtube.com/watch?v=3coXDiyNyRU. Accessed 24 April 2017.

Valero, J. (2017). EU and Mercosur 'committed' to reach deal by end of year. *EURACTIV.com*, 21 April. https://www.euractiv.com/section/economy-jobs/news/eu-and-mercosur-committed-to-reach-deal-by-end-of-year/. Accessed 24 April 2017.

Vinocur, N. (2017). Trump handed Merkel 'outrageous' NATO bill: Report. *Politico EU*, 26 March. http://www.politico.eu/article/donald-trump-handed-angela-merkel-outrageous-nato-bill-report/. Accessed 24 April 2017.

Webber, J. (2017). Mexico eyes duty-free corn deals to counter Trump. *Financial Times*, 26 March. https://www.ft.com/content/850a886c-108c-11e7-b030-768954394623. Accessed 13 April 2017.

WTO. (2017). Trade recovery expected in 2017 and 2018, amid policy uncertainty. 12 April. https://www.wto.org/english/news_e/pres17_e/pr791_e.htm. Accessed 24 April 2017.

Nathan Shepura *is a Political Adviser for the European People's Party, focusing primarily on transatlantic relations and EU trade. He studied European and Middle East Studies at the Johns Hopkins School of Advanced International Studies (Bologna/Washington, DC), graduating with an MA in 2015. He began working at the EPP in 2016.*

EUROPEAN VIEW (2017) 16:153–162
DOI 10.1007/s12290-017-0427-9

ARTICLE

China's interests in Central and Eastern Europe: enter the dragon

Bogdan Góralczyk

Published online: 2 May 2017

Abstract China first became an active and visible player in Central and Eastern Europe (CEE) in the 1950s, when it worked together with the region to stop a possible Soviet invasion of Poland in October 1956. This strong relationship was later dismantled due to the Sino-Soviet split and the volatile domestic situation in China (the Great Leap Forward and the Cultural Revolution). It is only since 2012 that China has become active in the region again, now as an emerging global power with a strategy and new investment initiatives in play: first the 16 + 1 framework and now the Belt and Road Initiative as well. Does China consider the CEE countries to be its new playground, or test area, within the EU? Or does it instead see the region as a gatekeeper that can help it get a foot in the door to the West? China has a vision, a pragmatic approach and political will, but the implementation of this vision has been weak. While several existing mechanisms offer new potential, they have so far only been partially exploited, due to the different business mentalities of both sides, as well as many other obstacles. China

B. Góralczyk (✉)
Centre for Europe, University of Warsaw, Al. Niepodległości 22, 02-653 Warsaw, Poland
e-mail: b.goralczyk@uw.edu.pl

is opening up opportunities for CEE, but the latter must be better prepared for China's new activities.

Keywords EU | China | Central and Eastern Europe | One Belt One Road | Asian Infrastructure and Investment Bank | Foreign direct investment | Geopolitics

Introduction

For a long time China followed a formula and strategy of keeping a low profile, usually identified by the famous motto 'tao guang yang hui' (conceal your capabilities and avoid the limelight), as dictated by the reform visionary Deng Xiaoping and known as the 'Constitution of 28 Chinese Characters'. However, since late 2012, under the current leadership of the ever-stronger, charismatic President Xi Jinping, this strategy has been abrogated. What we now have instead is growing assertiveness and external engagement under the current (fifth) generation of the Chinese leadership (Lam 2015, 270; Shambaugh 2016, 169). Under this active and assertive political leadership and imaginative new strategy, the People's Republic of China (PRC) is more and more frequently returning to its rich traditions and the civilisation of the Middle Kingdom, which dates back to ancient times.[1]

This change is visible in many ways, for example, in Xi Jinping's strongly promoted slogans of the 'Chinese Dream' and the 'Great Rejuvenation of the Chinese Nation', that is, in the internal strategy of the current leadership, which includes a new development model—*Zhongguo moshi* (Chinese model). This change reflects a kind of fault line. China intends to move from quantity to quality and to place emphasis on sustainable growth, a large domestic market, innovation and a green economy. This represents a move away from the previous philosophy of putting growth above everything, no matter what the social or environmental cost (Zheng 2016). This new model is frequently mixed with another important idea—that of a peaceful reunification with Taiwan. Recently, under another strategy, that of 'Two Centenary Goals' (Xi 2014, 325), this domestic blueprint has frequently been combined in Chinese discourse with the new Chinese geostrategic project known as *Yi dai, yilu*—the One Belt, One Road (OBOR) Initiative. Unfortunately, it seems little attention has been paid to either of these strategies in the West, despite the fact that the OBOR umbrella offers a proposal that is more or less in line with the once famous ideas of the 'fathers of geostrategy'. (The groundbreaking concepts *Heartland* and *Rimland* were formulated by John Mackinder and Nicholas Spykman, respectively.)

This new direction taken by the Chinese leadership constitutes both a great opportunity and a big challenge for the Western world, starting with the current hegemon, the US. President Donald Trump's administration needs to respond to the 'hundred-year marathon' (Pillsbury 2016): China would like to implement its OBOR vision before 1

[1] Details on this can be found in Yan (2011) and Zheng (2016).

October 2049, that is, the centenary of the proclamation of the PRC (Xi 2014, 60). Nor should Europe remain indifferent, as both the Silk Road Economic Belt on land and the Twenty-First Century Maritime Silk Road are strategies which target the West, and Europe above all (Xi 2014, 322; Liu 2016, Preface).

In this way, some of the countries of Central and Eastern Europe (CEE)—which, as members of the Communist political bloc, were close to the PRC in the 1950s—are currently being seen, for the first time ever, as important partners for China. This article aims to analyse the current state of affairs in the relationship between CEE and the PRC, and draws conclusions that are important for the EU, and particularly CEE.

The 16 + 1 framework

Prior to the implementation of the well-known OBOR Initiative, the Chinese government had put in place another framework of cooperation, known as 16 + 1. The idea was first announced in 2011 in Budapest and was put forward by then Prime Minister Wen Jiabao when he visited Warsaw in April 2012. Thereafter the 16 member states of the CEE region[2] were in constant cooperation with China. Under the then promoted concept of 'Going Global', Wen Jiabao proposed the 'Twelve Measures Strategy' for mutual engagement. Not only was an annual summit set up and a special secretariat for the 16 + 1 created, but a mixed architecture of financial cooperation, infrastructural construction, cultural and educational exchanges, and economic and investment measures were also proposed to strengthen ties between China and the CEE region (Huang and Liu 2016b, 122, 123; Simurina 2014, 1). Furthermore, regular communication and institutionalisation through the secretariat were crucial.

Despite this grandiose project, few of the above-mentioned 'steps' were implemented. However, both sides introduced what was probably the most important measure under the new strategy, that is, an annual summit meeting at the level of prime ministers (after Warsaw, summits took place in Bucharest, Belgrade, Suzhou and Riga).The above-mentioned secretariat was also established, in Beijing, with Liu Haixing acting as general secretary.

However, the 'flagship' piece of this cooperation, the 350 km high-speed Chinese rail route connecting Belgrade and Budapest, announced at the third summit in Belgrade in November 2014 (Cooperation between China and Central and Eastern European Countries 2014), has not yet been implemented. This is due to obstacles (a 'lack of transparency'), mainly on the Hungarian side, created by the European Commission. The most recent update on this matter was given on 21 February 2017 (*Railway Pro* 2017).

[2] The three Baltic states: Lithuania, Latvia and Estonia; the four Visegrád countries: Poland, the Czech Republic, Hungary and Slovakia; plus Albania, Bulgaria, Romania and all the post-Yugoslavian states: Croatia, Serbia, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Montenegro and Slovenia.

Therefore, the whole project is still far from being finally resolved, even though the current Hungarian cabinet of Prime Minister Viktor Orbán is eager to cooperate with China under his unique 'Openness towards the East' (*keletinyitás*) strategy (*Hvg.hu* 2015).

There seem to be so many obstacles—cultural, mental, technical and bureaucratic—to the relationship with China that Hungarian Foreign Minister Péter Szijártó has even confessed that, 'the Openness towards the East strategy has not been implemented' (*NSZ Népszava* 2016). According to him, cooperation with China is hindered by three major factors: the low price of oil, the unpredictability of and poor security situation in some of the Central Asian republics, and 'blackmail' by the EU, which is 'punishing those who disagree with the European way of thinking' (*NSZ Népszava* 2016). His opinion is more or less shared by one of the leading Chinese experts on the subject, Liu Zuokui: 'China and Europe face an array of difficulties and challenges. The regulation limit, the technological barrier and the lack of mutual trust between China and Europe have made it difficult for China to build the "Belt and Road" in Europe' (Liu 2016, Preface).

OBOR

The announcement of the OBOR Initiative and strategy was obviously another major positive step forward for China–CEE cooperation. According to China, this cooperation is of enormous value,[3] especially with the involvement of the centrally located Poland (between Russia and Germany).

The OBOR Initiative is a geostrategic proposal that is being implemented from the top down by China's State Council, the Ministries of Commerce and Foreign Affairs, and the National Development and Reform Commission, but also via local governments, state-owned enterprises and some of the few private businesses in China (e.g. Sany Group). After the announcement of the initiative, China created many Silk Road research centres and working groups to give some intellectual substance to the idea. These are strongly supported not only by the government, but also by companies and banks, which are collaborating to prepare feasibility studies for the implementation of OBOR projects.

OBOR is supplementary to and being implemented simultaneously with the 16 + 1 framework. This was confirmed by the unprecedented visits of Xi Jinping himself to Belarus in April 2015, Prague in March 2016, and Belgrade and Warsaw in June 2016. These visits were accompanied by an intensive 'charm offensive' by the Chinese media and think tanks, which highlighted the benefits of OBOR for the EU.

[3] According to Prime Minister Li Keqiang, the proposed investment in OBOR could total as much as $1.4 trillion (Sanwal 2016).

Despite this, the EU has been slow to respond to the initiative, and OBOR has been largely ignored by the European policy community. Furthermore, the EU's response was perceived by China as tepid to non-existent due to the lack of a proper understanding of the Chinese vision and the lack of a unified and common strategy with regard to China, as if Brussels has simply 'turned away' (Pavlićievič 2015). Thus China has evaluated the EU's response to OBOR as 'lukewarm' (Casarini 2015).

Difficult implementation in CEE

On 16 January 2016, China formally opened the Asian Infrastructure Investment Bank, together with a special OBOR fund to support the implementation of the announced strategy. The PRC openly expressed its hope that cooperation will facilitate the transfer of advanced technology from the EU to China.

Under both 16 + 1 and the OBOR umbrella China has mainly focused on economic cooperation with the Visegrád countries; there has been less focus on the Western Balkans due to the security concerns there (Huang and Liu 2016a, 3–8). China's investment projects span the region and include a nuclear energy plant, transportation infrastructure, sea ports and innovation centres (Chen and Yang 2016).

In effect, China is already the second trade partner, after Germany, to all the Visegrád countries. Until 2015 some 80% of all Chinese foreign direct investment (FDI) in the CEE region went to Hungary (Huang and Liu 2016a, 167). This situation changed in 2015 when China increased its FDI in Poland. However, it is difficult to estimate how much Chinese investment there has been in Poland as only limited data was available in the Polish media at the end of 2016. According to this data, Chinese companies are prepared to invest exorbitant amounts in alternative energy sources, mining companies, electrical power lines and power stations, among other projects. It is worth mentioning that prior to these types of investment China had already invested in two major initiatives in Poland. One was a successful investment in a steel works and industrial heavy machinery company in Stalowa Wola; the other is the Rolling Bearing Factory in Kraśnik, which has been in Chinese hands since 2015—currently it is too early to say whether or not this has been a success. In yet another example of Chinese investment, the China Overseas Engineering Group (COVEC) undertook the construction of a highway connecting Warsaw with Łódź. The project was a failure, however, and was sharply criticised by the Polish media (Cienski 2011).

Observing Chinese activities in Poland, one can detect a certain pattern, which is probably universal in CEE. In parallel to 'classic' infrastructure investments (new roads, highways, high-speed trains and electricity), the Chinese are most eager to get hold of innovative industries and are fighting for ownership of new trademarks. Instead of greenfield initiatives,[4] fusions and mergers are a priority. This pattern can be detected

[4] A greenfield investment is a form of FDI where a parent company builds its operations in a foreign country from the ground up.

across the CEE region. For instance, in Romania there is only one major greenfield investment—a brick factory in Constanca (valued at $12–$15 million) (Huang and Liu 2016b, 125).

However, the debate in which the 16 + 1 and OBOR are framed in terms of the threat they pose to European unity should be treated as exaggerated (Pavlićievíć 2016). If both trade and investments are taken into consideration, the picture is clear. Currently some 90% of all bilateral EU–China trade still takes place within the bigger EU markets (Huang and Liu 2016b, 166). Western Europe, or more properly the biggest European states—Germany, the UK, France and Italy—are major Chinese trade and investment partners.[5]

Among the CEE countries, only Poland is seen by China as an important partner. This assessment has been confirmed by one of the most important Chinese think tanks, the Institute of European Studies at the Chinese Academy of Social Sciences, in its recent series of studies on the subject (Chen and Yang 2016; Huang and Liu 2016a, b). In these studies Poland is openly described as the most important partner in the region (Chen and Yang 2016, 132), and also a prospective partner from the economic and innovation points of view (Chen and Yang 2016, 92, 96). Thus, in Chinese eyes it is the potential of a country and not necessarily the political will, as shown by Hungary under Mr Orbán, that matters.

However, the political decision-making process counts, and can disrupt emerging projects, for instance the decision made by Polish Defence Minister Antoni Macierewicz not to allow the Chinese to buy a property belonging to the Polish Army for the development of a new investment zone and communication hub in the town of Łódź. Thus this territorial Silk Road initiative was, at least partially, blown up locally, as the Chinese investors have (temporarily, at least) left the city, which had previously been declared a 'communication hub' for OBOR (*Polska Newsweek* 2017).

In response, the Chinese side has once again shown a very pragmatic approach. When obstacles were detected on the Polish governmental side and the agreements from Xi Jinping's Warsaw visit were not properly implemented, the Chinese turned to the Polish local authorities, which were mainly held by the opposition to the current government, and signed new agreements with them. Thus, a communication (mainly rail) hub is being created, not in Łódź as was initially intended, but in the nearby city of Kutno.

Conclusion

It has been obvious from the very beginning that Chinese policy regarding CEE is of a strategic and long-term nature (National Development and Reform Commission et al.

[5] The best source in this respect is the data provided by Baker McKenzie (2016a and 2016b).

2015). This intent was openly declared by Wang Yiwei (2015, 15), one of the leading experts on OBOR: 'Those who have Europe, have the world'. China now wants to be an active participant in globalisation and is directing its new Silk Roads towards Europe. Since the initial Going Global format in the early years of this century, Chinese involvement has gradually and progressively been supplemented, first by the 16 + 1 framework in 2012, and since 2013–14 by OBOR and the Asian Infrastructure Investment Bank.[6]

However, so far the response of the CEE countries to the Chinese strategy and initiatives has been lukewarm. Liu Zuokui is honest when he writes that the implementation of both 16 + 1 and OBOR 'faces an array of difficulties and challenges' (Liu 2016, Preface). Both sides have encountered a series of obstacles: a discrepancy between official declarations and reality, different business cultures and mentalities, and constraints on China from EU rules and regulations. From the EU perspective there have additionally been issues with mutual market access, intellectual property rights and human rights.

The Chinese intent is clear: OBOR aims to relieve China of some of its overcapacity in manufacturing and capital. According to the Chinese, OBOR offers a mutually beneficial (win–win) situation. China is eager to provide much-needed infrastructural investments and FDI in the CEE countries. However, we in the EU, and in the CEE region in particular, do not really know what to do with OBOR: we are undecided and politically split on it. We do not know how to react: is China's offer an opportunity, a challenge or a threat? Some kind of deeper consideration of our attitude is necessary. Therefore, for now, the implementation of the proposed projects and ideas is weak, due partly to unpreparedness on the European side, but also to the differing business mentalities and a lack of trust.

China is pressing and is already visible both in the EU and in particular in CEE. The real problem is that the countries of the CEE region have never come together to form a single political community. What they need to do is to find common ground for a joint approach to China. This approach must include one important area currently overlooked by CEE governments and firms, that is, the cultural aspect of relations with China.

China will continue to fervently promote 16 + 1 and OBOR. However, the CEE countries are hesitant about committing to these strategies. Public opinion is strongly divided, as are many experts and politicians. If we in CEE and the EU want to make proper use of the new initiatives in the win–win manner that the Chinese are so strongly promoting, what is needed is some kind of unification effort, if not a common strategy. Unfortunately, this is not currently visible on the horizon, as no one seems to be ready to work it out, either in the EU or in CEE.

[6] Poland was the only CEE country to be a founding member of the bank. Hungary joined recently and Romania is now applying for membership.

References

Baker McKenzie. (2016a). *Bird's eye view: Comparing Chinese investment in North America and Europe*. June. http://www.bakermckenzie.com/en/insight/publications/2016/06/birds-eye-view/. Accessed 15 March 2017.

Baker Mckenzie. (2016b). *Chinese FDI hits USD40 billion in 2015 for Europe and North America*. 10 March. http://www.bakermckenzie.com/en/newsroom/2016/03/chinese-fdi-hits-usd40-billion/. Accessed 15 March 2017.

Casarini, N. (2015). Is Europe to benefit from China's Belt and Road Initiative? In *IAI working papers 15/40.* October. http://www.iai.it/sites/default/files/iaiwp1540.pdf. Accessed 15 March 2017.

Chen, X., & Yang, C. (eds.). (2016). *Zhongguo—DongOu jingji hezuo jingzhan baogao* [The report on China–CEE economic and trade cooperation]. Beijing: Zhongguo Shehui Kexue Chubanshe.

Cienski, J. (2011). China group sees collapse of Poland ambitions. *Financial Times*, https://www.ft.com/content/d17dda5a-96b7-11e0-baca-00144feab49a. Accessed 15 March 2017.

Cooperation between China and Central and Eastern European Countries. (2014). http://www.china-ceec.org/eng/ldrhw_1/2014bergld/. Accessed 26 February 2017.

Cooperation between China and Central and Eastern European Countries. (n. d.). Website. http://www.china-ceec.org/eng/. Accessed 15 March 2017.

Huang, P., & Liu, Z. (eds.). (2016a). *China–CEEC cooperation and the 'Belt and Road Initiative'*. Beijing: China Social Science Press.

Huang, P., & Liu, Z. (eds.). (2016b). *Stakeholders in China–CEEC cooperation*. Beijing: China Social Science Press.

Hvg.hu. (2015). Orbán: A Bank of China Budapesttel új Selyem utat épít [Orbán: A Bank of China and Budapest builds a Silk Road]. 2 October. http://hvg.hu/cimke/keleti_nyit%C3%A1s. Accessed 26 February 2017.

Lam, W. Wo-Lap (2015). *Chinese politics in the era of Xi Jinping*. London: Routledge.

Liu, Z. (2016). *Europe and the 'Belt and Road Initiative': Responses and risks*. Beijing: China Social Science Press.

National Development and Reform Commission, Ministry of Foreign Affairs, & Ministry of Commerce of the People's Republic of China. (2015). *Vision and actions on jointly building Silk Road Economic Belt and 21st-Century Maritime Silk Road.* Xinhua, 28 March. http://en.ndrc.gov.cn/newsrelease/201503/t20150330_669367.html. Accessed 15 March 2017.

NSZ Népszava. (2016). Népszava-információ. Szijártó vállomása: Nem jött be a keleti-nyitás" [Szijjártó recognises: 'Eastern Strategy was not fulfilled']. 25 February. http://nepszava.hu/cikk/1086639-szijjarto-vallomasa-nem-jott-be-a-keleti-nyitas. Accessed 26 February 2017.

Pavlićievič, D. (2015). China, the EU and One Belt, One Road Initiative. *China Brief, 15*(15). https://jamestown.org/program/china-the-eu-and-one-belt-one-road-strategy/. Accessed 15 March 2017.

Pavlićievič, D. (2016). China in Central and Eastern Europe: 4 myths. *The Diplomat*, 16 June. http://thediplomat.com/2016/06/china-in-central-and-eastern-europe-4-myths/. Accessed 15 March 2017.

Pillsbury, M. (2016). *The hundred-year marathon. China's secret strategy to replace America as the global superpower*. New York: St Martin's Griffin.

Polska Newsweek. (2017). Chińczycy nie zainwestują w Łodzi, bo według Macierewicza chcą 'zlikwidować niepodległość Polski' [The Chinese will not invest in Łódź, as, according to Macierewicz they 'want to liquidate Polish independence']. 5 January. http://www.newsweek.pl/polska/chinczycy-nie-zainwestuja-w-lodzi-bo-chca-zlikwidowac-niepodleglosc-polski,artykuly,403075,1.html. Accessed 27 February 2017.

Railway Pro. (2017). EU inquiry into Budapest–Belgrade high-speed railway project. 21 February. http://www.railwaypro.com/wp/eu-inquiry-budapest-belgrade-high-speed-railway-project/. Accessed 26 February 2017.

Sanwal, M. (2016). *China's One-Road-One Belt Initiative: A new model of global governance*. Institute for Defence Studies and Analyses, IDSA Comment. 29 September. http://www.idsa.in/idsacomments/china-one-road-one-belt-initiative_msanwal_290916. Accessed 15 March 2017.

Shambaugh, D. (2016). *China's future?*. Cambridge: Polity.

Simurina, J. (2014). *China's approach to the CEE-16.* Europe China Research and Advice Network, Short Term Policy Brief 85. January. http://eeas.europa.eu/archives/docs/china/docs/division_ecran/ecran_is107_paper_85_chinas_approach_to_the_cee-16_jurica_simurina_en.pdf. Accessed 10 April 2017.

Wang, Y. (2015). *The Belt and Road Initiative. What will China offer the world in its rise*. Beijing: New World Press.

Xi, J. (2014). *The governance of China*. Beijing: Foreign Languages Press.

Yan, X. (2011). *Ancient Chinese thought, modern Chinese power*. Princeton and Oxford: Princeton University Press.

Zheng, Y. (2016). *Zhongguo moshi: jingyan yu tiaozhan* [Chinese model: Experience and strategy]. Beijing: Zhongxin Chuban Jituan.

Bogdan Góralczyk *is a political scientist and Sinologist, a former ambassador to several Asian states, and currently Professor and Director of the Centre for Europe, University of Warsaw. He is a prolific writer on China, and East- and South-East Asia.*

EUROPEAN VIEW (2017) 16:163–165
DOI 10.1007/s12290-017-0434-x

SATIRICAL REVIEW

Poking fun at the high and mighty

Roland Freudenstein

Published online: 22 June 2017

Making fun of the powerful, and thereby sending a powerful message, has been part and parcel of human society since at least Roman times. In the Middle Ages, court jesters, besides entertaining the diverse monarchs, could also make fun of them, and in some cases, provided strategic advice too. They were often the only ones allowed to give the bad news that no one else dared to deliver. After France lost a naval battle against the English in 1340, Philippe VI's jester told him that 'English sailors don't even have the guts to jump into the water like our brave French' (Wikipedia 2017).

In modern times, making fun of those in power by impersonating them has become an increasingly perfected art. Charlie Chaplin's *The Great Dictator* is an early example of this, at least when it comes to motion pictures. Very much in tune with the sentimentality of those days, however, Chaplin's Hitler converts to the good side at the end of the film.

No such sentimentality has survived in the post-millennial West. Happy endings do not fit into the acerbic world of satirical impersonation today. Instead, what makes a

R. Freudenstein (✉)
Wilfried Martens Centre for European Studies, Rue du Commerce 20, 1000 Brussels, Belgium
e-mail: rf@martenscentre.eu

successful YouTube clip that pokes fun at a modern dictator is, above all, a staccato succession of allusions to history, culture and clichés, together with accented English. An extremely successful example is Slovene Internet comedian Klemen Slakonja's impersonation of Vladimir Putin in 'Putin, Putout' (YouTube 2016b).

But democratic leaders can also be worthy objects of satire, as British comedian Tracey Ullmann showed in her portrayal of Angela Merkel in the legendary 'Sexbomb Cardiff' piece (YouTube 2016a). In this sketch Ullman masterfully plays on British clichés about Germany as well as on Germanness itself—not to mention other features of the EU and its various nations. 'Merkel's' facial expressions, body language and accent are practically perfect here, so Ullman's fame is well-deserved.

Of course, the ultimate satirical impersonation of famous and powerful people is done by themselves. Barack Obama made fun of his opponents as well as of himself at several White House correspondents' dinners. In 2016, his last year as president, he outdid himself with a clip about his job search after leaving the White House (YouTube 2016c).

In 2017, comedians and actors across the world can agree that the election of Donald Trump as the forty-fifth president of the US is a divine gift to their trade. Arguably the best impersonation of Trump so far was produced by Alec Baldwin on Saturday Night Live (YouTube 2017b). Some even argue that after Baldwin began his act, Donald Trump started to sound increasingly like this parody (YouTube 2017c). Memes such as 'America First' (most prominently pronounced during the historically short and decidedly ominous inauguration speech on 21 January 2017) spawned a whole series of viral responses from Europe, beginning with 'Netherlands second' (YouTube 2017d), and shortly followed by the Martens Centre's own version for the whole of Europe: in a way 'Europe second' (YouTube 2017a). Most of the other European spinoffs, from Denmark, Germany, Slovenia and other countries, came later. This seems to be a good year for jesters.

References

Wikipedia. (2017). Jester. https://en.wikipedia.org/wiki/Jester. Accessed 6 April 2017.

YouTube. (2016a). Angela Merkel double Tracey Ullman GB sexbomb Cardiff comedy. *Deutsche Männer*, 26 January. https://www.youtube.com/watch?v=UyhYMWtorPM. Accessed 6 April 2017.

YouTube. (2016b). Klemen Slakonja as Vladimir Putin—Putin, Putout/#TheMockingbirdMan/Путин. *Klemen Slakonja*, 27 February. https://www.youtube.com/watch?v=t-wFKNy0MZQ. Accessed 6 April 2017.

YouTube. (2016c). Obama reveals his ‘retirement plans’. *CBSN*, 30 April. https://www.youtube.com/watch?v=St9AoQZr3-k. Accessed 6 April 2017.

YouTube. (2017a). A comprehensive guide to show Mr. Trump what Europe is about. *Martens Centre*, 7 February. https://www.youtube.com/watch?v=Voj2DBP3CaA. Accessed 6 April 2017.

YouTube. (2017b). Oval Office cold open—SNL. *Saturday Night Live*, 5 February. https://www.youtube.com/watch?v=pZOF9q5fzfs. Accessed 6 April 2017.

YouTube. (2017c). President Trump meets with his cabinet. *The White House*, 13 March. https://www.youtube.com/watch?v=DH7GikYhXFU. Accessed 6 April 2017.

YouTube. (2017d). The Netherlands welcomes Trump in his own words. *Vpro zondag met lubach*, 23 January. https://www.youtube.com/watch?v=ELD2AwFN9Nc. Accessed 6 April 2017.

Roland Freudenstein *is Policy Director at the Wilfried Martens Centre for European Studies.*

EUROPEAN VIEW (2017) 16:167
DOI 10.1007/s12290-017-0438-6

EXECUTIVE SUMMARY

Good or bad neighbours: the main European security challenge

Salome Samadashvili

The Western liberal order is coming under threat from political systems with no regard to universal values. Spillover effects from outside the EU are having their effects on the Union itself. In the absence of the West making a case for the universality of such values and a clear willingness to defend such values, the West risks losing this ideological battle. Only by the geographic expansion of such values, through actions such as EU-led state-building, can these values be protected in the Union's Eastern and Southern neighbourhood. This paper argues for the necessity for the EU to prioritise its role as a 'stabiliser' and security actor in its immediate neighbourhood.

Salome Samadashvili *is a former visiting fellow at the Wilfried Martens Centre for European Studies and a former ambassador of Georgia.*

Springer

EUROPEAN VIEW (2017) 16:169
DOI 10.1007/s12290-017-0439-5

EXECUTIVE SUMMARY

The Russian economy IN FOCUS: recovery is further away than some might think

Vladimir Milov

This working paper looks at recent trends in the Russian economy after more than two years of recession. It analyses the fundamental reasons for the current economic crisis and argues against some of the mainstream views on 'the end of the recession' and the role of Western financial sanctions. The paper follows up the author's publication *Russia's downfall: the worst economic crisis since the collapse of the USSR* (published in December 2015).


The Russian Economy
IN FOCUS
Executive summary
Introduction

Vladimir Milov *is Chairman of the Democratic Choice Party in Russia and Director of the Institute of Energy Policy. He is the former Deputy Minister of Energy of Russia.*

EUROPEAN VIEW (2017) 16:171
DOI 10.1007/s12290-017-0436-8

EXECUTIVE SUMMARY

Security policy IN FOCUS: the case for a postmodern EU defence architecture

Federico Ottavio Reho

It is widely believed that Britain's decision to leave the EU and Donald Trump's election to the White House have strengthened both the case for and the possibility of an ambitious EU defence policy, perhaps even of an EU army. This short paper argues that, contrary to widespread fears, the EU can become a powerful security and defence policy player without adopting the hierarchical structures of traditional states and while maintaining decentralised defence responsibilities and a pluralist institutional framework. Two relevant historical examples—the Holy Roman Empire and the Hanseatic League—are presented to draw general lessons on how the EU could accomplish this, thus becoming an effective 'postmodern' power.

Federico Ottavio Reho *is a research officer at the Wilfried Martens Centre for European Studies interested in the political and economic history of modern Europe.*

EUROPEAN VIEW (2017) 16:173
DOI 10.1007/s12290-017-0435-9

EXECUTIVE SUMMARY

Brexit. Brexit?

János Martonyi

This policy brief, written on the eve of Article 50's triggering, deals with the legal framework and political constraints of the Brexit negotiations. It assesses the reversibility of Brexit, the likely duration and possible outcomes of the negotiations, the legal options for the transition period, and the probable impact of Brexit on the EU27 in general and Central Europe in particular. It concludes that the new partnership between the UK and the EU27 will have to go beyond even the most comprehensive free-trade agreement and it should also include finance, energy and external economic policies, as well as covering foreign policy, security and defence.

János Martonyi *is a former Hungarian minister for foreign affairs and a member of the Executive Board of the Wilfried Martens Centre for European Studies.*

EUROPEAN VIEW (2017) 16:175
DOI 10.1007/s12290-017-0437-7

EXECUTIVE SUMMARY

Kremlin propaganda IN FOCUS: how the EU has become an enemy in the eyes of Russia

Kristina Potapova

The EU's increasing attention to the phenomenon of information warfare has not gone far enough to properly investigate how the Kremlin's propaganda machine operates in Russia itself. The Kremlin uses internal propaganda both to maintain legitimacy and as a defence mechanism against the outside world. This paper scrutinises the Kremlin's propaganda and its popular narratives about the EU in order to understand how Russia's media presents the EU and why less than a quarter of the population has a positive opinion of it.

Kristina Potapova *is a former team member at the Wilfried Martens Centre for European Studies, interested in Russia's Information Warfare and EU relations with Russia.*

EUROPEAN VIEW (2017) 16:177
DOI 10.1007/s12290-017-0443-9

EXECUTIVE SUMMARY

A new transatlantic agenda IN FOCUS: challenges and opportunities in the Trump era

Roland Freudenstein · Craig Kennedy

External threats to Europe and, to a lesser extent, America are intensifying. Rather than unifying the West, these challenges have provoked internal divisions within the transatlantic community that are greater than ever before. These divisions are most prominent in relation to security and foreign policy. The current crisis in the transatlantic relations should be used to rethink how this partnership is constructed and operates so that we can have a more sustainable relationship characterised by more equitable burden sharing and stronger mutual respect.

Roland Freudenstein *is Policy Director at the Wilfried Martens Centre for European Studies.*

Craig Kennedy *is Senior Fellow at the Hudson Institute.*

EUROPEAN VIEW (2017) 16:179
DOI 10.1007/s12290-017-0444-8

EXECUTIVE SUMMARY

We need to talk about the EU—European political advertising in the post-truth era

Konrad Niklewicz

The long economic crisis and the subsequent immigration crisis have frustrated millions of citizens and angered them against the elites—and, unfortunately, against the EU. The rise of online media has triggered a chain reaction and the revolution in communication is transforming the way our democracies work. This paper focuses on the communication challenge the EU is facing. The EU institutions need to take up the gauntlet and start defending the European project. At the occasion of the sixtieth anniversary of the Treaty of Rome, there cannot be a better opportunity to reconnect with citizens.

Konrad Nicklewicz *is the managing director of the Civic Institute and was a Martens Centre Visiting Fellow in 2017.*

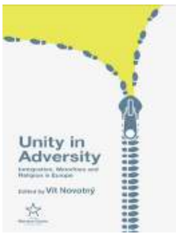
EUROPEAN VIEW (2017) 16:181
DOI 10.1007/s12290-017-0445-7

EXECUTIVE SUMMARY

Unity in adversity–immigration, minorities and religion in Europe

Vít Novotný

Despite the EU's official motto 'United in Diversity', the bloc is experiencing a profound crisis in which diversity is threatening to dispel unity. A variety of factors are behind this strife, including terrorism, the uncertain position of religion in public life, the unclear situation of minority groups (including autochthonous minorities and the Roma), radical Islamism, insufficient integration of immigrants and a loss of personal status and identity due to globalisation. There is a need to promote a concept of state which allows different religious and secular opinions to thrive.



Vít Novotný *is Senior Research Officer at the Wilfried Martens Centre for European Studies.*

The *European View* is the policy journal of the Wilfried Martens Centre for European Studies, the political foundation of the European People's Party. It is an intellectual platform that enables politicians, opinion makers and academics to tackle contemporary themes of European politics, focusing on one specific topic in each issue. What makes the *European View* unique is its hybrid nature—its capacity to involve both esteemed academics and experts on the one hand, and high-level politicians and decision makers on the other. Former prime ministers and ministers are regular contributors to the *European View*.

Michael G. Arghyrou
Assia Bensalah Alaoui
Juan E. Castañeda
Roland Freudenstein
Bogdan Góralczyk
Anna Iara
Miguel Marín Cózar
Jürgen Matthes
Juha-Pekka Nurvala
Nicola Pedde
Federico Ottavio Reho
Nathan Shepura
Ivan Štefanec
Loredana Teodorescu
Juhana Vartiainen
Michael Wohlgemuth

Wilfried Martens Centre for European Studies

Springer