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Eurozone

Wasting the good times?

The state of play in the Eurozone's quest for further integration

Ideally, the year in which the Eurozone has staged an impressive comeback as global growth driver and, for a change, positive surprise of the year, should have climaxed with further steps towards more integration next week. However, the political impasse in Germany as well as a general fading of a verve to reform do not bode well for next week's European Summit. And beyond. The window of opportunity for further integration seems to be closing again, before it had actually been opened. Below is our take on the current state of play.

This week, the European Commission will present another set of proposals on how to further reform the Eurozone. It will be the prelude to what was supposed to be a crucial month for the development and further integration of the monetary union. According to the initial (and optimistic) roadmap, the European Summit on 14 and 15 December should have marked the peak of a spectacular u-turn for the Eurozone throughout the year. From Nexit and Frexit fears towards further integration in the wake of revived eu(ro)phoria, at least partly initiated by Emmanuel Macron's victory at the French presidential elections.

The German elections gave this new eu(ro)phoria already a cold shower. First, the future of the Eurozone hardly played a role in the parties' election platforms, then the FDP's proposals for an unwinding of the European Stability Mechanism (ESM) and temporary exit facilities made the coalition talks look like a threat for the future of the monetary union and now the collapsed coalition talks simply mean that Germany will not have an official government position at the upcoming summit. As regards German politics, one upside of a possible new grand coalition for the Eurozone could possibly be a more pro-integration oriented government.

Over the last months, or better years, a huge variety of ideas on how to strengthen Eurozone integration has been floating around. The basic idea of all these ideas is to bring the monetary union closer to a political union (preferably without telling anyone). For a long while, opponents of this route simply stepped on the brakes, undermining any reform efforts. This strategy has changed and opponents of further federalism have taken a more constructive stance, proposing their own view of how the Eurozone should look like in the future. In short, this clash of views or cultures can be described as the "federal model" versus the "national plus independent but technical institutions model."

There is an entire ocean out there with proposals on how to reform the Eurozone. In fact, some of these proposals are already as old as the monetary union itself. Currently, the most prominent proposals are currently circulating: a Eurozone finance minister, a fiscal capacity or a Eurozone budget, a European Monetary Fund, Eurobonds, etc.

In the following, we take a look at the most prominent proposals, give a brief assessment and also our view on the political feasibility. For the sake of keeping this note relatively lean, we will exclude banking union. We take a pragmatic not an ideological look at these proposals as deeper integration just for the sake of deeper integration obviously does not make sense.

Probably the best and most likely outcome of the discussion on further Eurozone reforms will be a typical European reflex: create new institutions.

Carsten Brzeski
Chief Economist Germany, Austria
Frankfurt +49 69 27 222 64455
carsten.brzeski@ing-diba.de

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The rationale for more reforms

Strong growth seems to have reduced the appetite for further institutional reforms…

With strong economic growth that has broadened across sectors and countries in the Eurozone, some might wonder why there is a need at all for further reforms and integration. If it ain't broken, don't fix it…Unfortunately, this is a very short-sighted view. Political developments this year have nicely illustrated how quickly the tide can turn. Independence of Catalonia, populist victories at the Italian elections or another shake-up of the Greek bailout package. It is easy to come up with events that could bring back the Eurozone's existential crisis. And as long as the risk of another existential crisis remains bigger than zero, investments and growth in the Eurozone will remain suboptimal.

…but there are compelling economic arguments to go on

Further integration of the Eurozone should not be an end in itself. Neither would a fully-fledged political union automatically hush political nationalism or populism. However, in our view, there are two compelling economic arguments in favour of further integration of the Eurozone: further reduce the break-up risk and reap the full economic benefits of monetary union. In short, avoid the worst and bring out the best.

In the following, we will have a look at the most prominent proposals to further reform the Eurozone, without moving it to a political union, and will group them into the described two categories.

Further reduce the break-up risk

Role of 'lender of last resort" has finally been accepted by ECB…

One of the main reasons why the euro crisis turned into an existential crisis was the lack of a credible lender of last resort for sovereigns. Starting in 2008, the ECB has proven to be a lender of last resort for banks when it provided illiquid financial institutions liquidity support but it only reluctantly took up the role of lender of last resort for sovereigns. Understandably, as the set-up of the monetary union does not foresee this role. In fact, there is no Eurozone sovereign, only national sovereigns. It was the launch of the Securities Markets Programme (SMP) in May 2010, "whatever it takes" and the subsequent OMT, which made the ECB a credible lender of last resort for sovereigns.

…while the ESM has become a credible fire fighter…

Also, the ESM has become another important instrument in reducing the break-up risk. The ESM can provide Eurozone members in need with financial assistance or even fully-fledged bailout packages, practically taking a country off financial markets. In combination with the ECB's OMT programme, an ESM bailout package should also in the future be the most credible way to reduce break-up risks. A combination which comes very close to the idea of Eurobonds, with the advantage that it already has a built-in policy conditionality and control.

Fig 1 Tools to reduce the break-up risk

Options	Advantage	Disadvantage	Likelihood
Eurobonds	Clear step towards political union	Risk of moral hazard Would require central fiscal policies	Close to zero
ESM plus ECB's OMT programme	Credible Implemented swiftly	Conditional on ESM programme	100%
Upfront debt restructuring before ESM bailout	Clear path towards debt sustainability	Speculation Possible contagion Requires completed banking union	80%

Source: ING

...but break-up risk has not disappeared entirely

Looking ahead, the combination of ESM support and the ECB's OMT programme should further reduce the break-up risk in the Eurozone. However, given that ESM support does not come automatically but always as the result of a political process and decision, the risk of a country leaving the Eurozone – either because it doesn't agree to the terms of ESM support or because it doesn't get support – cannot be fully erased. A depoliticised ESM would make a difference.

A more depoliticized ESM in combination with the ECB would be an important step forward

Going forward, an important element of this ESM/ECB combo would be a strict ex ante debt sustainability analysis. Let's not forget that the ECB can only purchase bonds of illiquid but solvent governments, not of illiquid and insolvent governments. Therefore, as already stated now in the ESM Treaty, a country applying for ESM support should first undergo a debt sustainability analysis and "in accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme". This debt sustainability analysis could be more formalised in the ESM Treaty.

Prevention

Good prevention is best answer to break-up risks...

While the above would clearly be reduce the break-up risk in case of new tension, the best way to get rid of break-up risks simply is to ensure that public finances are sustainable. Over the last twenty years, the Eurozone has seen many changes and reforms of its fiscal rules with shifting focus from deficits to debt (and vice versa), long-term objectives and cyclical-adjusted measures. There have been reforms of the monitoring process as well as of the sanction process. There have been new fiscal rules and agreements like the two-pack, six-pack and fiscal compact. All meant to improve fiscal sustainability and control. Clearly no shortage of good intentions and attempts to make public finances sustainable. To throw in yet another proposal for the Eurozone's fiscal framework, more focus on the expenditure side of government finances, possibly excluding unemployment benefits and other one-off expenditure, could make fiscal policies easier to control and fiscal rules easier to implement. A rule that would be simpler and easier to monitor than the current rules.

...and implementation is crucial

The best rule can fail if the institution implementing it is not strong enough. The experience of the last twenty years shows that the complicated fiscal framework and decision-making process between European levels and national levels has regularly led to complications. A move towards a more independent Fiscal Authority could solve this problem.

Fig 2 Tools for prevention

	advantage	disadvantage	Likelihood
Stricter (or different) fiscal rule	Improve debt sustainability	Does not tackle implementation problem	20%
ESM as guardian of fiscal rule	More independent	Still a political process Too much focus on debt sustainability Too little focus on economic stabilisation	80%
Fiscal Authority	Depolitising of process Gradual shift of fiscal policies from national to Eurozone level	How to balance national and Eurozone interests Risk to national sovereignty	60%

Source: ING

All of the above tools would help further reducing the economic break-up risk. They obviously cannot entirely rule out the possibility that due to political considerations countries would eventually try to move towards the exit.

Bringing out the best

How to kick-start growth…

The economic anti-crisis prescription of the last ten years focussed mainly on sustainable public finances and structural reforms. Even though most Eurozone countries are now enjoying a cyclical recovery, the question is whether this recipe is sufficient to bring unemployment levels really back to acceptable levels.

…with more than structural reforms…

Needless to say, structural reforms remain an important factor for future growth. However, there are at least two open issues: how can an economic downswing or recession be dampened and reversed and how can an ongoing economic upswing be enhanced? To tackle recessions or slow recoveries, there could either be a European solution, eg, a Eurozone stability budget, or a national solution through looser fiscal rules.

…balancing between European and national solutions…

As regards the European solution, a Eurozone budget or a dedicated Eurozone part within the EU budget, could either be a temporary or a structural transfer. As regards the national solution, the flexibility in the current fiscal framework in case of recessions would have to be expanded by elements, allowing governments to take advantage of low interest rates to finance infrastructure investments or R&D spending. In this context, the biggest challenge would be to create fiscal rules which ensure debt sustainability and prevent another sovereign crisis from happening, while at the same time leaving enough room for macro-economic stabilisation. Looking beyond the stabilisation effect of fiscal policies, the need for further transfers looks small. Instead, more efficient public finances together structural reforms should be a more fruitful strategy for future growth.

Fig 3 Bringing out the best

	advantages	disadvantages	likelihood
Eurozone budget	Swift implementation Crisis tool	Does not cure structural weaknesses disincentive	40%
Structural reforms	Germans love it	Takes a while before yielding more growth	100%
Money for reforms	Incentive for structural reforms Germans love it as well	Political horse trading Little impact for cyclical stabilisation	80%
Unemployment scheme	Special work scheme subsidies	Difficult to distinguish between temporary and structural solution Requires harmonised unemployment schemes Reduces incentives for labour market reforms	30%
Looser fiscal rules	Already partly tackled in current rules Option to react to unexpected crisis	Political horse trading Who's call is it	50%

Source: ING

Could new institutions do the trick?

A lot has already been achieved…

Given all of the above, a way forward for the Eurozone could look as follows: a depoliticised ESM combined with the ECB's OMT programme would be a credible 'lender of last resort', while at the same time a more technocratic fiscal authority could ensure the right balance between long-term sustainability and short-term stabilisation of fiscal policies.

…but can new institutions do the trick?

German officials, including Wolfgang Schäuble, have argued that the ESM should become bailout-funds, European Monetary Fund and Fiscal Authority in one. Given its

inter-governmental nature, however, the ESM would in our view be overburdened by all of these features. Also, the ESM would probably mingle national and Eurozone interests and would probably also have a tightening bias for fiscal policies, due to the fact that its main focus is on debt sustainability. Instead, we would argue that setting up a real Fiscal Authority or a Eurosystem of national fiscal authorities, in which national fiscal policies are assessed against the fiscal rules and their impact on the economy but also on their impact of the Eurozone as a whole, would make more sense but is highly unlikely at the current juncture, even though the European Treaties already state that there is an obligation for Member States to treat their economic policies, in particular their fiscal policies, as a matter of common concern.

Reality check

Don't expect anything from next week's summit...

Given the small appetite in Eurozone core countries for far-reaching reforms as for example reflected in the recent Dutch coalition agreement, as well as the current impasse in German politics, next week's European Summit will be another standstill. If any at all, progress towards integration will again be small and cumbersome.

...as there is very little appetite for big changes

Looking beyond next week, permanent transfers, even a small unconditional Eurozone budget look like a no-go. Even the idea of a rainy day fund looks unlikely. At best, the focus will again shift to the well-known paradigm of conditional solidarity; or in short "money for reforms". In this regards, a fiscal capacity which offers investments or funding if a country has delivered on structural reforms could be a compromise between France and Germany. It is an idea, the German government already proposed in 2012.

Strengthening the ESM...

As regards the institutional front, the idea of a European Monetary Funds, a beefed-up ESM, which has more analytical capacities to fully replace the IMF in future bailouts and which gets a broader legal basis to conduct upfront debt restructurings, should probably find the broadest support across Eurozone capitals.

...and possibly a move towards a Fiscal Authority look like the most likely options...

Instead of introducing a Eurozone finance minister or other super-commissioners (to eg combine the role of Eurogroup president and Commissioner for Economic and Financial Affairs), particularly the core Eurozone countries could rather take first steps towards an independent fiscal authority. This would also tackle the grown distrust of the German government in the EC (too political).

...making the Eurozone more resistant but not perfect

All in all, it currently looks as if a new crisis is needed to take bold steps towards a fully-fledged monetary union. But maybe this optimal set-up is not even necessary (at least politically not feasible). Obviously, starting a monetary union from scratch would look much differently than the current set-up but with some additional tweaks and only little changes, the monetary union is indeed more sustainable. At least for an economist...ESM for bailouts, ECB as lender of last resort, Banking Union to cut the link between sovereign and banking sector, a Fiscal Authority to depolitise the assessment of fiscal policies and the Juncker Plan et al to support cross-border investment with at the same time further steps towards harmonization of taxes, social security would already be bold steps. However, even though any sub-optimal set-up (as close as it might get to optimal) will always leave a residual risk of break-up or exit (possibly undermining the first pillar: banking and capital market union to work perfectly), hence reducing economic stability and investment prospects.

Research Analyst Contacts

Developed Markets		Title	Telephone	Email
London	Mark Cliffe	Head of Global Markets Research	44 20 7767 6283	mark.cliffe@ing.com
	James Knightley	Chief International Economist	44 20 7767 6614	james.knightley@ing.com
	James Smith	Economist, Developed Markets	44 20 7767 1038	james.smith@ing.com
	Jonas Goltermann	Economist, Developed Markets	44 20 7767 6909	jonas.goltermann@ing.com
	Carlo Cocuzzo	Economist	44 20 7767 5306	carlo.cocuzzo@ing.com
	Chris Turner	Global Head of Strategy and Head of EMEA and LATAM Research	44 20 7767 1610	christopher.turner@ing.com
	Petr Krpata	Chief EMEA FX and IR Strategist	44 20 7767 6561	petr.krpata@ing.com
	Viraj Patel	Foreign Exchange Strategist	44 20 7767 6405	viraj.patel@ing.com
	Padhraic Garvey	Global Head of Debt and Rates Strategy	44 20 7767 8057	padhraic.garvey@ing.com
	Juan Carrion	Head of High Yield Research	44 20 7767 8379	juan.carrion.jr@ing.com
Amsterdam	Maarten Leen	Head of Macro Economics	31 20 563 4406	maarten.leen@ing.nl
	Teunis Brosens	Senior Economist, Eurozone	31 20 563 6167	teunis.brosens@ing.nl
	Bert Colijn	Senior Economist, Eurozone	31 20 563 4926	bert.colijn@ing.nl
	Raoul Leering	Head of International Trade Analysis	31 20 563 4407	raoul.leering@ing.nl
	Joanna Konings	Senior Economist, International Trade Analysis	31 20 576 4366	joanna.konings@ing.nl
	Timme Spakman	Economist, International Trade Analysis	31 20 576 4469	timme.spakman@ing.nl
	Marieke Blom	Chief Economist, Netherlands	31 20 576 0465	marieke.blom@ing.nl
	Dimitry Fleming	Senior Economist, Netherlands	31 20 576 0465	dimitry.fleming@ing.nl
	Jeroen van den Broek	Head of DM Strategy and Research	31 20 563 8959	jeroen.van.den.broek@ingbank.com
	Maureen Schuller	Head of Covered Bond Strategy and Financials Research	31 20 563 8941	maureen.schuller@ingbank.com
	Martin van Vliet	Senior Rates Strategist	31 20 563 8801	martin.van.vliet@ingbank.com
	Benjamin Schroeder	Senior Rates Strategist	31 20 563 8955	benjamin.schroder@ing.nl
	Hamza Khan	Head of Commodities Strategy	31 20 563 8958	hamza.khan@ingbank.com
	Warren Patterson	Commodities Strategist	31 20 563 8921	warren.patterson@ing.nl
	Suvi Platerink Kosonen	Senior Credit Analyst, Banks	31 20 563 8029	suvi.platerink@ingbank.com
	Nadège Tillier	Senior Credit Analyst, Utilities	31 20 563 8967	nadege.tillier@ing.nl
	Hendrik Wiersma	Senior Credit Analyst, TMT	31 20 563 8961	hendrik.wiersma@ing.nl
	Job Veenendaal	Credit Analyst, Consumer Products and Retail	31 20 563 8956	job.veenendaal@ingbank.com
	Marina Le Blanc	Credit Analyst, Insurance	31 20 563 8094	marina.le.blanc@ingbank.com
	Roelof-Jan van den Akker	Head of Technical Analysis	31 20 563 8178	roelof-jan.van.den.akker@ingbank.com
Brussels	Peter Vanden Houte	Chief Economist, Belgium, Eurozone	32 2 547 8009	peter.vandenhoute@ing.be
	Julien Manceaux	Senior Economist, France, Belgium, Switzerland	32 2 547 3350	julien.manceaux@ing.be
	Philippe Ledent	Senior Economist, Belgium, Luxembourg	32 2 547 3161	philippe.ledent@ing.be
	Steven Trypsteen	Economist, Spain, Portugal	32 2 547 3379	steven.trypsteen@ing.be
Frankfurt	Carsten Brzeski	Chief Economist, Germany, Austria	49 69 27 222 64455	c.brzeski@ing-diba.de
	Inga Fechner	Economist, Germany, Austria	49 69 27 222 66131	inga.fechner@ing-diba.de
Milan	Paolo Pizzoli	Senior Economist, EMU, Italy, Greece	39 02 55226 2468	paolo.pizzoli@ing.it

Emerging Markets		Title	Telephone	Email
New York	Gustavo Rangel	Chief Economist, LATAM	1 646 424 6464	gustavo.rangel@ing.com
London	Nicholas Smallwood	Senior Emerging Markets Credit Analyst	44 20 7767 1045	nicholas.smallwood@uk.ing.com
Czech Rep	Jakub Seidler	Chief Economist, Czech Republic	420 257 47 4432	jakub.seidler@ing.cz
Hong Kong	Iris Pang	Economist, Greater China	852 2848 8071	iris.pang@asia.ing.com
Hungary	Péter Virovácz	Senior Economist, Hungary	36 1 235 8757	peter.virovacz@ingbank.com
Philippines	Joey Cuyegkeng	Senior Economist, Philippines	632 479 8855	joey.cuyegkeng@asia.ing.com
Poland	Rafal Benecki	Chief Economist, Poland	48 22 820 4696	rafal.benecki@ingbank.pl
	Piotr Poplawski	Senior Economist, Poland	48 22 820 4078	piotr.poplawski@ingbank.pl
	Jakub Rybacki	Economist, Poland	48 22 820 4608	jakub.rybacki@ingbank.pl
	Karol Pogorzelski	Economist, Poland	48 22 820 4891	karol.pogorzelski@ingbank.pl
Romania	Ciprian Dascalu	Chief Economist, Romania	40 31 406 8990	ciprian.dascalu@ing.ro
Russia	Dmitry Polevoy	Chief Economist, Russia and CIS	7 495 771 7994	dmitry.polevoy@ingbank.com
	Egor Fedorov	Senior Credit Analyst, Russia and CIS	7 495 755 5480	egor.fedorov@ingbank.com
Singapore	Rob Carnell	Chief Economist & Head of Research, Asia-Pacific	65 6232 6020	robert.carnell@asia.ing.com
	Prakash Sakpal	Economist, Asia	65 6232 6181	prakash.sakpal@asia.ing.com
Turkey	Muhammet Mercan	Chief Economist, Turkey	90 212 329 0751	muhammet.mercan@ingbank.com.tr

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Bratislava	**Frankfurt**	**Madrid**	**Paris**	**Sofia**
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Research offices: legal entity/address/*primary securities regulator*

Amsterdam	ING Bank NV, Foppingadreef 7, Amsterdam, Netherlands, 1102BD. *Netherlands Authority for the Financial Markets*
Brussels	ING Belgium SA/NV, Avenue Marnix 24, Brussels, Belgium, B-1000. *Financial Services and Market Authority (FSMA)*
Bucharest	ING Bank NV Amsterdam - Bucharest Branch, 48 Iancu de Hunedoara Bd, 011745, Bucharest 1, Romania. *Financial Supervisory Authority, Romanian National Bank*
Budapest	ING Bank NV Hungary Branch, Dozsa Gyorgy ut 84\B, H - 1068 Budapest, Hungary. *National Bank of Hungary*
Frankfurt	ING-DiBa AG, Theodor-Heuss-Allee 2, 60486 Frankfurt, Germany. *Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)*
Hong Kong	ING Bank NV, Hong Kong Branch, 8/F, Three Pacific Place, 1 Queens' Road East, Hong Kong. *Hong Kong Securities and Futures Commission*
Istanbul	ING Bank AS, ING Bank Headquarters, Resitpasa Mahallesi Eski Buyukdere Cad. No.8, 34467 Sariyer, Istanbul, Turkey. *Capital Markets Board*
London	ING Bank NV London Branch, 8-10 Moorgate, London EC2R 6DA, United Kingdom. *Financial Conduct Authority*
Manila	ING Bank NV Manila Branch, 20/F Tower One, Ayala Triangle, Ayala Avenue, 1226 Makati City, Philippines. *Philippine Securities and Exchange Commission*
Milan	ING Bank NV Milano, Via Arbe, 49, Milano, Italy, 20125. *Commissione Nazionale per le Società e la Borsa*
Moscow	ING Bank (Eurasia) JSC, 36, Krasnoproletarskaya ulitsa, 127473, Moscow, Russia. *The Central Bank of Russia*
New York	ING Financial Markets LLC, 1133 Avenue of the Americas, New York, United States,10036. *Securities and Exchange Commission*
Prague	ING Bank NV, Prague Branch, Českomoravská 2420/15, Prague 9, Czech Republic. *Czech National Bank*
Singapore	ING Bank NV Singapore Branch, 1 Wallich Street, 12-01 Guoco Tower, Singapore 078881. *Monetary Authority of Singapore*
Warsaw	ING Bank Slaski SA, Ul. Pulawska 2, Warsaw, Poland, 02-566. *Polish Financial Supervision Authority*

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