

1.2. EUROZONE REFORM: LACK OF PROGRESS LEAVES BLOC ILL-PREPARED FOR NEXT DOWNTURN

by Philipp Heimberger

It is very possible that a recession will hit the Eurozone within the next three years. If a downturn were to start, the bloc could be in big trouble. The ECB would have little room to cut further to support the economy, bond markets could sell off prompting a liquidity crisis, national governments have little room for manoeuvre in fiscal policy, and a sufficient counter-cyclical response at the EU level looks highly unlikely.

First, the ECB has announced that it will keep interest rates at zero at least until mid-2019 to further support the eurozone economy; although this is a sensible decision, it does imply that monetary policy-makers are unlikely to have much room to cut rates when the next recession hits. Technically, it would be possible for the ECB to experiment further with negative interest rates and other tools; however, the experience of political conflicts surrounding monetary policy measures over recent years (above all the ECB's Quantitative Easing programme) suggests that one should not expect eurozone member countries unanimously to accept extensions of the ECB's usage of 'unconventional' monetary policy tools. Hence, major political tensions among member countries may be expected during the next downturn. The conclusion to be drawn from these political economy considerations is that it remains unclear whether the single currency will hold together in its current form during the next recession.

Second, the eurozone remains fragile to speculative sell-offs on the government bond markets that could lead to self-reinforcing liquidity crises. The turbulence in Italy has recently brought this issue sharply back into focus. The continued fragility is due to the incompleteness of the euro area's institutional framework: individual member countries are prone to experiencing speculation against their government bonds, because they de facto have no control over the currency in which they issue debt. Hence, in principle there is an urgent need to create a eurozone safe asset that can be credibly backed by the ECB. However, despite a variety of reform proposals, the question remains politically controversial. In principle, there are even proposals on the table to create a eurozone-wide safe asset without full joint liability; and such proposals might be easier to accept for member countries in the eurozone core. However, it is still very unclear whether a political compromise on future institutional reforms of the eurozone can be reached, which would allow for the creation of a safe asset backed by the ECB to end the possibility of self-fulfilling debt crises.

Third, at the national level the room for policy manoeuvre remains constrained; this is especially true of the southern eurozone countries hit hardest by the last crisis. Importantly, the legacy of the crisis dynamics over the last 10 years has resulted in high public debt levels (very significantly so in some eurozone countries). European policy-makers have focused on fiscal consolidation, and by doing so have failed to allow for a proper recovery in large parts of the eurozone; this has led to a debt-deflationary spiral and further increases in public debt. In a number of eurozone countries, the banking sector has not recovered and remains fragile. Given that the European Banking Union remains incomplete, governments might again find it difficult to stabilise their banking sector over the course of the next crisis. As policy-makers have so far not managed to break the banking-sovereign nexus by

introducing institutional reforms, further 'doom loops' between banking-sector stress and panic-driven government debt crises in individual countries could lead to eurozone-wide contagion.

Finally, the experience with fiscal policy coordination problems in recent years suggests that the restrictions of the EU's fiscal regulation framework will make it difficult to engineer an appropriate anti-cyclical fiscal policy response to counteract the next crisis. In this context, the crucial question is whether current reform discussions about implementing a common eurozone budget that would allow automatic stabilisers to be used to channel funds to stressed regions of the bloc will actually lead to substantial improvements in the eurozone architecture, or whether fiscal rules will at least be changed to allow more discretionary policy space in individual member countries.

In sum, if even a rather mild recession were to hit the eurozone within the next three years, the resilience of the single currency in its present form would again be put to the test.