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SAINT NICOLAS BROUGHT A BAG OF EU PROPOSALS - SOME GIFTS, SOME TWIGS

Berenberg Macro Flash

Saint Nicolas day did not bring any Brexit gifts yesterday, but the European Commission's proposals to reform the eurozone. The proposals cover changes to the eurozone's governance, measures to reduce and share risks, and foster convergence both within and among member states. The proposals mark the official start of the European reform debate that will be a key issue for Europe in 2018. They set the stage for next week's EU summit (14-15 December). The deliberations on the institutional architecture of the eurozone are planned to culminate in another summit in June 2018 when we expect first decisions to be taken.

Expect the EU to seize the window of opportunity – but to stop short of the Commission proposals. The Eurozone is enjoying a robust economic recovery, the political schedule of the upcoming year is unusually light (except for the Italian election), and French President Emmanuel Macron is putting all his power behind a push for more integration. However, the European Commission's proposals overstretch what EU national governments are willing to do. We expect the national governments to water down some of the Commission proposals (especially the proposals that weaken conditionality, or foresee further financial transfers) and reject some of them (more power for the European Commission).

Proposals to improve the economic performance and strengthen the cohesion of the EU and the eurozone should be measured against four criteria: do the proposed institutions and rules 1) improve efficiency, 2) provide incentives for member countries to pursue sensible policies, 3) safeguard against systemic risks and/or 4) provide a buffer against temporary asymmetric shocks? In addition, reforms need to be politically sustainable and economise on the use of scarce political capital to push them through.

In general, many proposals by the European Commission go in the right direction. However, we do not support the European Commission's idea that further integration requires significant further funds. The European Commission suggests that new funds with a "stabilisation function" may be necessary for further integration steps. The European Commission stresses that any new funds should be subject to strict conditionality to minimise moral hazard. In our view, that is a necessary but not sufficient requirement for further funds. Yes, stabilisation funds would be required if borrowing at the national level was limited. But current fiscal rules already allow for sufficient flexibility. The case for new funds, even if subject to strict conditionality, is not as compelling as the European Commission suggests. In our view, the goal should be to use the instruments in place more effectively rather than creating more funds. Within limits, we would support new funds only if they set the right incentives for countries to pursue pro-growth reforms. For a more detailed discussion, see our report on Reforming Europe: which ideas make sense.

The major European Commission proposals and the position of national governments:
1. ESM/EMF: (1) The Commission is proposing to upgrade the European Stability Mechanism (ESM) into a fully-fledged European Monetary Fund (EMF). That the Commission foresees a closer involvement of such future EMF in the management of financial assistance programmes will meet widespread agreement among national governments who want to avoid calling in the IMF in the next crisis. That the EMF is supposed to provide a common backstop for the banking sector may meet some resistance at first, but we expect consensus eventually to build. (2) The European Commission's idea to anchor the ESM in EU law is more controversial. The move would provide the European Commission with tighter control over the ESM/EMF at the expense of national governments which prefer to keep the intergovernmental structure.

2. Eurozone budget: (1) The European Commission wants to discuss a fiscal capacity to support eurozone member states that are undergoing major structural reforms and non-eurozone EU member states that want to join the eurozone. A majority of EU member states may approve that. (2) The European Commission would also like to use the fiscal capacity to counter asymmetric shocks. Especially Germany and the Netherlands will be reluctant to agree to such a fund as they fear unconditional permanent fiscal transfers through the back door. (3) The European Commission wants a eurozone budget within the EU budget. As this could mean that non-eurozone countries could have a veto power on decisions that only cover the eurozone, eurozone leaders may rather push for a eurozone budget entirely separate from the EU budget or no/limited voting powers for non-eurozone member states on eurozone decisions. (4) More importantly, many eurozone countries see little need for a eurozone budget. The eventual compromise will likely be some limited funds to be used for pre-defined, specific purposes with clear conditionality.

3. Economic and finance ministry/minister: (1) The European Commission wants to elevate the commissioner for economic and financial affairs to a super commissioner. The aim is to make the governance more coherent, transparent and accountable. Crucially, the minister would coordinate all EU-wide financial instruments that can be deployed to counter asymmetric shocks. EU leaders may be open to discuss giving more competencies to the Commissioner for economic and financial affairs, but it is unclear how much they will be ready to give. Again Northern eurozone countries will fear a finance minister will focus more on the fiscal stance of the eurozone as a whole and, thereby, downgrade the need for debtor countries to bring their finances into balance. (2) According to the European Commission, the finance minister should also preside over the Eurogroup, oversee the work of the new EMF and represent the EU at meetings of international financial institutions. Critics from the EU member states and the European Commission have expressed concerns about the convolution of these jobs. If the roles of Eurogroup chief and EU commissioner are merged into one, member states would probably insist that such a finance minister is de facto controlled by national governments through the Eurogroup and not just by the European parliament.

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