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EU SUMMIT PREVIEW: EUROZONE REFORM TALKS, NO DECISIONS YET

Berenberg Macro Flash

Leaders of Eurozone countries may offer us a first glimpse into the future of the Eurozone when they convene on the second day of the EU summit (22-23 March) in Brussels to discuss ideas for long-term reforms. First decisions on the completion of the Banking Union and a beefed up rescue fund are scheduled for the next summit in June. It is quite likely, however, that they may be pushed to a later meeting this year (September). Decisions on a Eurozone budget and further initiatives towards common funds will follow even later. The slow coalition building process in Germany and the strong showing of radical parties in Italy's election have slowed down (Germany) and may even put at stake (Italy) the more ambitious goals. However, many policy makers want to use the current political window of opportunity for major Eurozone reform. Ahead of the European parliamentary election in May/June 2019, that window will likely close at the end of this year. Therefore, the most likely outcome of this week's and the next summit is incremental progress.

EMF AND BANKING UNION FIRST

The discussions on long-term reforms for the Eurozone will centre around proposals where "convergence of views is the greatest" as European Council President Donald Tusk stressed at the last meeting in December 2017. These include completing the Banking Union and the transformation of the European Stability Mechanism (ESM) into a European Monetary Fund (EMF). Eurozone leaders widely agree on a fully-fledged rescue fund as it would free the Europeans from IMF involvement, and thus US, Chinese and Russian meddling in times of crisis. It would also relieve the ECB of its current role in ESM programmes. The current intergovernmental status and, therefore, the veto power of parliaments of the four big countries (Germany, France, Italy and Spain) would be preserved.

Completing the Banking Union is more controversial. By and large, proponents of risk reduction are at odds with fans of more risk sharing. Solidifying the banking sector by gradually establishing a European wide deposit protection scheme (EDIS) enjoys broad support among those countries that experienced banking crises such as Italy and Spain. France regards it as necessary for the financial stability of a currency union and to weaken the sovereign-bank nexus that was crucial in propagating shocks between countries and those countries' banks, and vice versa. Countries including Germany that are wary of pooling depositors' money have so far slowed down the process and will make sure that EDIS will be introduced only very slowly and with strict conditionality attached. Such conditionality could include setting a maximum NPL ratio for a country's banking sector before that country is permitted to participate in the EDIS. The new pro-European German coalition deal with a new finance minister of the centre-left SPD, Olaf Scholz, does not change the game here. Reluctance towards proposals for Eurozone integration is widespread in Berlin, and the CDU/CSU-SPD deal is vague on this matter.

EUROZONE BUDGET HAS TO WAIT

Leaders will also intensify deliberations about a separate Eurozone budgetary capacity to finance investments and serve as a buffer against external shocks. This is a contentious issue. France and other countries think such a Eurozone budget is more than overdue and an essential requirement to prevent another euro crisis having the same severe and disproportionate (asymmetric) effects – similar to the EDIS. Germany, the Netherlands and the fiscally more conservative countries stress the importance of fiscal prudence at a national level and question the need of – and fear moral hazard from – a Eurozone budget. At this stage, a budgetary capacity does not top the EU's priority list, so proposals in this direction will have to wait a little more.

OUR TAKE: LESS IS MORE

Yes, the election of the staunchly pro-European Emmanuel Macron as French president and a newly elected German government committed to Europe as ever provides a splendid opportunity to reform the EU27 and the Eurozone. Above-trend growth, low inflation and strong employment gains are helping. And public support for the EU has also rebounded. But any proposals to reform the Eurozone (and the EU27) should only be proceeded if they 1) improve efficiency, 2) provide incentives to pursue sensible policies, 3) safeguard against systemic risks and/or 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. According to this, we support a genuine EMF, regard the completion of the Banking Union as desirable in the long-term, but not essential, and are very wary about further permanent transfers. We are very much in favour of an Independent Fiscal Council (IFC) that would not make policy recommendations, but would assess whether current policies as well as potential policy changes would enable a country to comply with the fiscal rules. It would give Eurozone members a positive incentive to strive for compliance to the fiscal rules. The European Fiscal Board established in late 2016 should morph into such an IFC. For more on European reforms, see Reforming Europe: which ideas make sense?.

TIMELINE LIKELY POSTPONED AGAIN

This week's European Council meeting will largely be about talks of Eurozone reforms. During the next summit in June, Eurozone leaders may take the first decisions on the EMF and the completion of the Banking Union. Since Germany and France missed their self-imposed target to come up with joint proposals by this week's summit after German coalition talks absorbed too much time, the talks this week could be less concrete than decisions makers hoped for at the last meeting in December 2017. The inconclusive result of the Italian election two weeks ago in which radical anti-establishment parties won a majority of votes will also make it harder to stick to the timeline. This could also push the time when decisions are taken further into the future. However, we still expect progress this year: Eurozone leaders are well aware that the window of opportunity to make the Eurozone's institutional setting fit(ter) for the next crisis is closing as the political apparatus starts getting busy with the campaigning ahead of the European parliamentary election in May/June 2019.

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