LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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A NEW STALEMATE IN THE EURO AREA: ITALY'S RISKY POSITION

An assessment after the European Council and the Euro Summit meetings

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1. On June 28-29, European leaders were summoned to Brussels for two long-awaited meetings of the European Council and the Euro Summit. Most of the public attention in Europe was focused on the migratory issues and on the heated negotiations within the European Council, while the Euro Summit, although expected to take resolute steps towards reforming the euro area, flew mostly under the radar. A concise final *communiqué* raised the impression that the leaders had held over the discussion on the future of the euro area and deferred all the important decisions to the meeting planned for the end of this year. In fact, the final Euro Summit Statement is highly significant since it marks a bitter setback for anybody feeling the urgency to strengthen the rules and institutions that preside over the European Economic and Monetary Union (EMU). It is also a source of very serious concerns from the perspective of specific Italian interests.

Despite the fairly positive appreciation made by fourteen Franco-German economists,[1] the outcome may have negatively surprised those who were aware of the French-German institutional position expressed just days before the Summit. On that occasion, French President Emmanuel Macron and German Chancellor Angela Merkel issued the "Meseberg Declaration," which largely supported the ambitious proposals made by the European Commission at the end of 2017 and a number of issues raised by Macron several times after his election. This Declaration also proposed controversial solutions for the new division of labor between the European Stability Mechanism,

[1] Cf. A. Bénassy-Quéré, M.K. Brunnermeier, H. Enderlein, E. Farhi, M. Fratzscher, C. Fuest, P.-O. Gourinchas, P. Martin, J. Pisani-Ferry, H. Rey, I. Schnabel, N. Veron, B. Weder di Mauro, J. Zettelmeyer, "Next steps after the Euro Summmit" *Voxeu.org*, 10 July 2018.

as a possible new European Monetary Fund, and the European Commission. However, generally speaking, it intended to lend new political weight and responsibility to the euro-area institutions and to its system of economic governance.

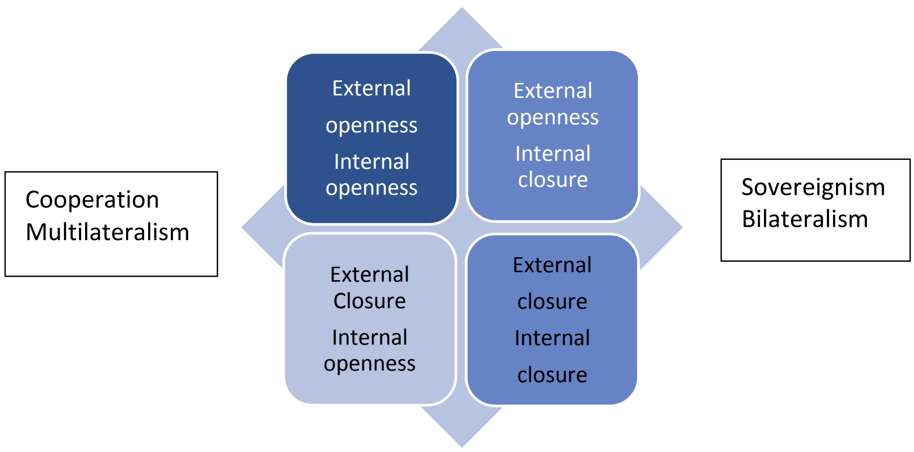
While not much of the Meseberg Declaration was left in the Euro Summit *communiqué*, the euro-area leaders agreed on a number of decision and projects pointing to a regress of cooperative solutions and of fiscal integration between member states. Needless to say, the return of market discipline – i.e. giving a free hand to financial market pressure as a form of hands-off coordination of national fiscal policies – affects Italy's fragile financial position more than any other country.

We had anticipated – in a Policy Brief published just before the Euro Summit (http://sep.luiss.it/brief/2018/07/04/carlo-bastasin-and-marcello-messori-isolation-or-convergence-italy-its-way-european) - that Italy was risking isolation and that the Italian government should have aimed, first and foremost, at bringing home funds supporting stabilization, investments and structural convergence. However, we must acknowledge that, for Italy, the Euro Summit outcome was even more disappointing than we had expected.

2. A brief description of the spirit prevailing among the European Union (EU) leaders - either cooperative or non-cooperative – in the negotiations on migration at the European Council can help to understand the attitudes that emerged at the following Euro Summit.

One way to analyze the political dynamics in progress is with a simple chart describing the combination of the two alternatives on the table (see Fig. 1): opening/closing the EU's external borders, and opening/closing the EU's internal borders. Figure 1 shows that, on the left side, internal openness coincides with a spirit of multilateral cooperation while, on the right side, closing internal borders implies sovereignism and bilateralism. The spirit of multilateral cooperation would be maximized, if it was compatible with external openness (the north-west solution); however, the implementation of this spirit tends to require external closure (the south-west solution). Conversely, the spirit of bilateral sovereignism would be maximized by external closure (the south-east solution), whereas the north-east solution can hardly be conceived as an actual equilibrium, even if it was somewhat cherished by France.

Figure 1: Migration rules



Judging from the European Council's outcome, a unanimous consensus was reached to favor the external closure of the EU borders, halting primary migration; different views emerged, instead, about keeping the internal borders open or closing them to migrants' secondary movements.
Normally, moving away from the Community method to an intergovernmental negotiation among the 27 countries leads to a setting in which member states privileging closure tend to prevail either in bilateral or in multilateral negotiations. It suffices that one single country closes its national borders to trigger a domino effect on its neighboring countries. The same "contagion" rarely happens in the opposite case - that is, when one country unilaterally decides to open its national borders.
The new unprecedented strategy of "intergovernmental bilateralism" allowed by the European Council's Conclusions and inaugurated by Chancellor Merkel after the meeting confirms the myopia of non-cooperative partners such as the Visegrád Group or Italy and the related fragility of bilateral solutions. Some of those nationalist leaders publicly declined the proposal for bilateral coordination with Germany; others denied, at home, to have singularly reached an agreement with the German Chancellor. However, the clearest example of the "bilateral flaws" was the announced negotiations between German Interior Minister Horst Seehofer and his Italian counterpart, Matteo Salvini. The two vocal Eurosceptic ministers share the same inclination for closing national borders; however, during their preliminary bilateral negotiations on the repartition of migrants, they understood that the threat of closing the national borders was ineffective because the two countries do not share a common border. Seehofer and Salvini thus realized that they needed to involve a third country (Austria) and possibly many others (Slovenia, Hungary, France, etc.). Eventually, and maybe inevitably, they will end up bringing the negotiating field back to the EU level.

3. It would be redundant to stress that the 'compromise' reached by the European Council on the subject of migrants does not solve any of the issues that – rightly or wrongly – Italy had brought to the European meeting. It is sufficient to recall that, besides a few verbal concessions and the modest financial support for Africa (500 million euros, which have already been allocated and overpaid – 20% – by Italy itself), not even a marginal change to the Dublin Regulation was introduced and no cogent commitment was made by the other EU member states to assume responsibility for the refugees entering Italy's maritime borders. On the contrary, the reached solution represented a step backwards in relation to previous agreements, since the decision to "collect" and "filter" these migrants became a voluntary action substituting the previous forced – even if unachieved – national quotas. The consequent lack of cooperation weakens the Italian position and dramatizes a situation that, although currently not an unmanageable problem, may one day become an emergency. The extreme positions of both the Visegrád Group and the Italian government may struggle to form any consensus among the partners because they raise serious concerns about the protection of human rights and the acceptance of refugees in conformity with international law.
Here it is important to stress that the 'compromise' reached by the European Council on migration had an impact, however indirectly, on Chancellor Merkel's political strength in Germany and in the EMU. As already noted, taking advantage of the part of the document that recommends a launch

of cooperation among member states on the reallocation of refugees to the EU specific countries that initially register them, Merkel gave up a multilateral European approach and activated bilateral agreements. In this way, the Chancellor prevented the German Interior minister from imposing a unilateral closure of national borders that would have cancelled the Schengen Agreement and brought about the fall of the German grand coalition government. However, this also took a toll on Merkel's reputation in front of the European institutions and other pro-European leaders, thus weakening her international leadership in the midst of the tensions between the United States and the euro area (Germany in particular) on trade and regulation.

This lack of leadership also explains the difficulty in reaching an agreement, within the EU and the euro area, on the "interpretation" of the recent events and on a consequent shared set of necessary reforms. The lack of a common "narrative" results in an openly non-cooperative spirit that causes significant problems for the economic issues of the euro area too. This not only stresses that the migration problem is a crucial challenge per se, but also emphasizes the current European weaknesses.

In the remaining part of this Policy Brief we would like to show that these weaknesses risk bringing the euro area back to the situation that characterized the start of the Greek crisis (end of 2009-beginning of 2010) and the years of maximum institutional and political uncertainty in a number of euro-area countries (end of 2014 – spring of 2017). These two periods implied a long stalemate in terms of economic governance and institutional setting that affected the sustainability of the euro area.

4. As a consequence of the stalemate, at the beginning of 2017 the euro area remained fragile in at least three aspects: (i) although recessions had been overcome, national economies were still on divergent paths so that they were unable to satisfy a minimum degree of homogeneity;[2] (ii) the European financial channels did not play a positive role in risk reduction because the national banking sectors had evolved even more fragmented than before; (iii) finally, buffeted by the crisis, the drive toward political integration had withered in almost every country. It took a new political combination to break the stalemate and to deal with these negative aspects. This came with the election of the new French president, Emmanuel Macron, in May 2017. Macron won the election presenting himself as the standard bearer of the European relaunch and of political integration at the euro-area level. A few months later, in September 2017, the re-election of Chancellor Merkel opened a new phase when the political cycles of the two largest economies were finally aligned.

Not incidentally, at the end of 2017, the European Commission was able to put on the table a number of ambitious proposals that were promptly welcomed in Paris and Berlin. Among others, the European Commission supported the institution of an already mentioned European Monetary Fund (EMF) integrated in the EU legislative framework and built on the basis of the European Stability Mechanism. According to the proposal, the EMF would have been able to play the role of crisis manager by financially assisting stressed countries. It would have also provided for a common backstop for the Single Resolution Fund. The nomination of a European Finance Minister

[2] The efficient functioning of the euro area does not require that each of the member states converges towards a unique model - that is, "one size does not fit all". Nevertheless, it requires that each of the member states meet competitive and social cohesion standards above a given threshold.

– and vice-president of the EU Commission – was also considered as a further step to improve coordination between national fiscal policies.

The European Commission also suggested integrating the Treaty on Stability, Coordination and Convergence in the EU legal framework, taking into account the appropriate flexibility allowed in the Stability and Growth Pact. Finally, new instruments for a euro-area budget were intended to grant more stability to this area, to provide a system of incentives supporting investment, and to encourage and finance reforms of inefficient national institutions. These initiatives were aimed at bringing more structural convergence across the euro area. The use of common resources to asymmetrically support the more fragile economies would have been a form of solidarity.

Unfortunately, in the first half of 2018 there was no progress in the implementation of the roadmap suggested by the European Commission. The unexpected slowness in the construction of the new German government, the growing strain between Merkel's Christian Democratic Union (CDU) and Seehofer's Christian Social Union (CSU), which was mainly due to a right-wing positioning at the imminent Bavarian elections (fall 2018), and the increased institutional and political risk determined by the result of the Italian elections (March 2018) weakened the alliance between Merkel and Macron and made the alignment of the political cycles of the EMU's two largest member states less effective. As a result, this situation enfeebled Merkel's leadership in the EMU's northern and eastern countries, as well as Macron's leadership in the EMU's southern countries (Italy included).

5. The weakness in the Franco-German political leadership and the consequent lack of general political consensus in the euro area emerged dramatically, after the Meseberg Declaration, in the course of the Eurogroup meeting preceding the Euro Summit. In that occasion a number of northern countries, led by the Netherlands, staunchly opposed any form of risk mutualization through a euro-area budget, likely spurred by their contrariety to the Meseberg Declaration's proposals for fiscal harmonization. Italy itself opposed the other proposals intended to improve the degree of risk-reduction in order to pave the way for risk sharing.

A clear indication of the rifts is seen in the letter that the president of the Eurogroup, Mario Centeno, sent to the president of the European Council and Euro Summit, Donald Tusk (http://www.consilium.europa.eu/media/35798/2018-06-25-letter-president-centeno-to-president-tusk.pdf). The content of this letter was intended to summarize the results of the Eurogroup meeting and to offer a technical platform for the recommendations to be possibly taken by the heads of state and government during the Euro Summit. It limits the scope of the Euro Summit meeting to three points: (a) designing a new roadmap for the banking union; (b) fixing some points for the reform of the ESM; and (c) indicating the possible instruments to allow for a convergence process between EMU member states.

With regard to the banking union, the Eurogroup is commited to the principle of the "appropriate sequence" between risk-reduction and risk-sharing, as unanimously approved by the Eurogroup itself in 2016. This means that risk-sharing intervenes only after risks have been clearly reduced at the national levels. In order to ensure this sequence, six indicators are listed (capital ratio, leverage ratio, liquidity coverage ratio, net stable funding ratio, NPLs ratio, MREL ratio). It is also considered that "views on the usefulness of additional indicators, especially on sovereign exposures, differ substantially". According to the Eurogroup, an agreement on all the indicators "would pave the way for ESM providing the backstop facility for the SRF [Single Resolution Fund]." The consensus thus suggests postponing the creation of this common backstop until the end of 2024, under the condition that sufficient progress in risk reduction is verified. On the other hand, the crucial missing element for the completion of the banking union, that is, the European Deposit Insurance System (EDIS), can be examined only under severe constraints: "adhering to all elements of the 2016 roadmap in the appropriate sequence, after the European Council meeting this June, the work on a roadmap for beginning political discussions on EDIS could start…"

With regards to the ESM and the process of convergence, the Eurogroup letter acknowledges that the reform of this mechanism would strengthen the EMU. The letter also asserts the need for changes in ESM governance in order to allow for a swifter management of various crisis events. However, it does not take into account the possible contradiction between this latter aim and the preventive national approval of any costly ESM intervention that is required by the constitutional law of some member states. Moreover, it emphasizes that, even after a possible reform, conditionality would remain an underlying principle of the ESM Treaty and the ESM interventions. Consequently, enhanced precautionary tools would still have to come with a proper and formal commitment by the assisted member state to be compliant with European rules. Finally, the letter adds that, according to some EMU member states, ESM assistance should also come without triggering a "full program," whereas, according to others, ESM responsibility would have to go beyond crisis management (even if in formal cooperation with the European Commission) and to involve an ex ante possibility of public debt restructuring.

6. Together with the possible introduction of a euro-area budget, public debt sustainability of highly indebted member states and the related monitoring activity to be attributed to ESM are the most sensitive issues of Centeno's letter. This letter does not offer a shared view on all these controversial issues: it confines itself to suggesting the initial steps needed to prepare an ex ante and discretionary mechanism of public debt restructuring and to postponing the launch of the euro-area budget.

With regard to the sustainability of public debt, the letter states that the Eurogroup "may work for the introduction of single-limb CACs for new issuances to prevent holdouts." This move would ease the approval of a restructuring process on the whole stock of a national public debt instead of on specific portions of this same stock. According to the single-limb CAC, it would be sufficient to reach the qualified majority for the whole set of bondholders, even if a qualified minority of a specific subset of bondholders expressed a dissenting view. It is thus not surprising that "some members express[ed] concern for the market impact of this approach." The letter adds that this dissenting position did not hinder the Eurogroup's commitment to prepare a proposal before the end of 2018. However, this proposal still does not imply that private sector involvement in the restructuring of a national public debt (bail-in) will be either automatically triggered by a country's access to the European aid program or discretionarily and ex ante decided by the new EMF.

Concerning the euro-area budget, Centeno's letter stresses that the Eurogroup was unable to express a shared position: "differences of views remain on the need for and possible features of a Eurozone budget for competitiveness, convergence and stabilization in EMU". This lack of consensus made the Eurogroup appeal to the heads of state and government for a decision. In this respect, the letter states: "subject to guidance from the leaders, the Eurogroup stands ready to discuss the recent proposals on a possible euro area budget […], including on the basis of the legal architecture proposed by the Commission for its investment stabilization function within the Multiannual Financial Framework. A European unemployment insurance fund for episodes of severe economic crises, could also be considered." Centeno adds that, "as regards funding, several options are explored. Moral hazard issues raised by some members need to be taken into account."

The final Euro Summit Statement, reproduced below, follows the content of Centeno's letter:

> "[…] The EuroSummit today agreed on the following:
>
> 1. The agreement in the Council on the Banking package should allow the co-legislators to adopt it before the end of the year while preserving the overall balance. Adhering to all elements of the 2016 roadmap in the appropriate sequence, work should start on a roadmap for beginning political negotiations on the European Deposit Insurance Scheme.
> 2. The ESM will provide the common backstop to the Single Resolution Fund (SRF) and be strengthened working on the basis of all elements of an ESM reform as set out in the letter of the Eurogroup President. The Eurogroup will prepare the terms of reference of the common backstop and agree on a term sheet for the further development of the ESM by December 2018.
> 3. The Eurogroup will further discuss all the items mentioned in the letter by the Eurogroup President.
> 4. The EuroSummit will come back to these issues in December 2018".

This Statement demonstrates our interpretation: the working and the decisions of the Euro Summit were strongly influenced by the letter of the president of the Eurogroup.

7. The June 29 Euro Summit did not show any real progress regarding euro area economic governance because it did not generate any effective results concerning the two aspects that can serve as success indicators of an intergovernmental European meeting: (a) actual agreement on initiatives that could be immediately implemented through resolutions by the EU Council, the Eurogroup and/or the European Parliament; (b) binding time-schedules for the remaining decisions that need to be made both prior to and after the 2019 European elections.

As regards point (a), there is only one aspect that can become operative in the short-term: the so-called "banking package," mentioned in the Euro Summit Statement (see above), which had been already discussed and essentially – although not formally – approved by Ecofin last June. In that Ecofin meeting, the "package" was the subject of intense debate between Italy and the other member states since it proposes measures for reducing banking risks (capital requirements, asset-liability composition, etc.) but not for sharing risks. The final Euro Summit Statement clearly reiterated that the "first risk reduction and then risk sharing" scheme is still the appropriate sequence. This sequence not only guarantees a swift and definitive approval of the "banking package" but also indefinitely postpones the construction of a European Deposit Insurance Scheme (EDIS) for deposit amounts not exceeding 100,000 euros; and, as already emphasized, this scheme is essential to complete the Banking Union and is crucial for strengthening the Italian banking sector.

As regards point (b), there is an initiative that appears to be positive: the attribution to the European Stability Mechanism (ESM) of the task of providing a common backstop to the Single Resolution Fund. In fact, still in December 2017, the European Commission included this initiative as part of point (a) so that the common backstop would have had to become operative in the short term. Now the decision, taken by the Euro Summit to place the common backstop in point (b), implies that its implementation period was extended. Moreover, in this last respect, the Euro Summit did not set a cogent operative deadline. The activation of the backstop raises complex governance problems, since it is caught between the need for immediate financial interventions (the integration of the SRF must be achieved in the course of a weekend in the event of bank resolutions exceeding the maximum amount of bail-in and the available amount of SRF) and the related preventive approval of each intervention on the part of various national parliaments of the member states. Hence, the Euro Summit asked the Eurogroup to decide on the technical features of the common backstop together with the ESM reform and it committed the Eurogroup to make its first proposals concerning the ESM by the end of 2018. It follows that the backstop's entry into force is subordinate to the launch of the new ESM at an imprecise date in the future.
The lack of progress in economic governance does not imply that the final Euro Summit Statement is ineffective concerning Italy's problems. As the quotation at the end of point 6 shows, the Euro Summit made a commitment to discuss "all" the issues of Centeno's letter at the meeting of December 2018; and, as already mentioned, that letter also refers to the possible expansion of the ESM's tasks to the detriment of those of the European Commission. If the new ESM/EMF did not just manage real or financial crises but also carried out ex ante fiscal controls, it would acquire the power to evaluate the sustainability of the member states' public debt, especially – but not only – in the event of an application for a European assistance program. The consequent risk, although not immediate, is that financial operators would take the new ESM assignment as a surreptitious introduction of an almost automatic mechanism for restructuring the public debt of the EMU countries in difficulty. And, due to its abnormal public debt/GDP ratio and its low growth rate, Italy would be the first candidate on the list.

8. Our previous analysis shows that the euro area risks falling into a new stalemate characterized by a lack of political leadership and the predominant recourse to market discipline to settle the economic problems of its different member states. In this last respect, an important signal came from the absence in the letter of the Eurogroup president, as well as in the final Euro Summit Statement, of any reference to the integration in the EU legal framework of the Fiscal Compact. Giving superior legal status to the Treaty on Stability, Coordination and Governance was one of the main objectives of the communications issued by the EU Commission in December 2017. The sudden disappearance of the fiscal framework was probably a tactical move, given the controversies it might have triggered in several member states. However, it had strategic implications too. Weakening the role of EU institutions in enforcing European rules at the national level leaves room for mechanical settlements based on market discipline that tend to amplify instability. This distortionary effect could be strengthened by the introduction of an ex ante mechanism for restructuring public debt, which might have the same destabilizing impact as that triggered by the 2010 Deauville agreement between Angela Merkel and the then French president, Nicolas Sarkozy.

In this possible EMU framework, Italy's position becomes extremely fragile.[3] The Italian agenda cannot pursue EMU's political integration because it privileges national sovereignty; and it can neither pursue risk-reduction as a premise for risk-sharing because the reduction of Italy's main economic and institutional risks has been placed on the backburner (see fn. 3). However, Italy is not at a complete dead end. The commitment made by the final Statement to discuss "all" the points of the letter from the president of the Eurogroup maintains Macron's proposal of a euro-zone budget in the Euro Summit agenda. This issue was not explicitly discussed by the leaders at the end of June, but it would be wise for Italy to urge rapid progress in this direction. In our already quoted Policy Brief (see point 1 above), we suggest that the new Italian government should endorse the creation of financial funds designed to support economic convergence. A euro-area budget is a necessary condition for approaching this scenario; and the implementation of this condition should be eased if Italy and other fragile countries were ready to launch the required reforms.

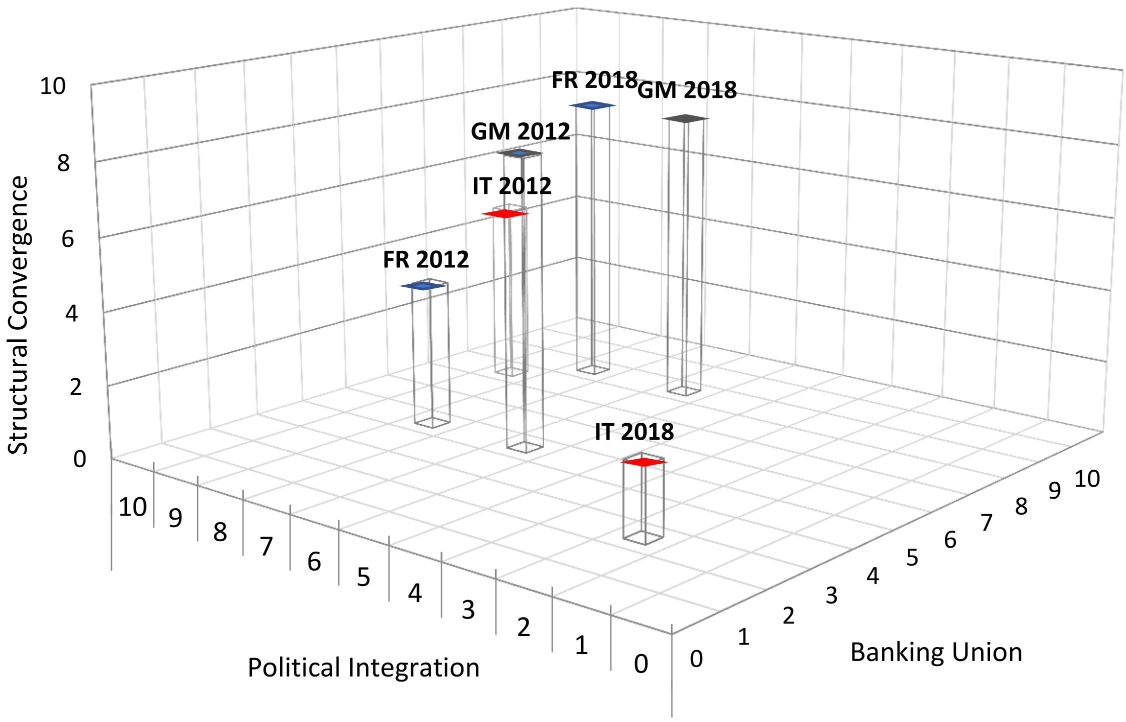
The new Italian government lost the opportunity to follow this path before and during the Euro Summit and the European Council meeting. Let us refer to a chart, admittedly based on extreme qualitative simplifications (see Fig. 2), which examines three possible political options to be followed by the main countries in the euro area at the peak of the European crisis: Germany (GM), France (FR), and Italy (IT). Figure 2 shows that Macron's France is moving ahead of Germany in terms of political integration and required reforms, while Italy is following the opposite direction, repealing reforms to improve competitiveness and embracing sovereignism. It is no surprise that Macron is currently seen as the primary antagonist of the new Italian leaders. The main revelation of Figure 2 seems to be Italy's isolation from its two traditional partners.

9. The Euro Summit was a turnaround in the policy orientation adopted so far in the ex-ante monitoring and in the crisis management of the euro area. This turnaround can have a number of negative implications in the near future. In concluding this Policy Brief, we wish to stress three points.

First, without enhancing the centralization of fiscal control it is not strictly necessary to upgrade the institutions presiding over the controlling operations. Consequently, it is not indispensable to give a European status and a full responsibility to the European Stability Mechanism, turning it into an accountable and transparent European Monetary Fund.

[3] Let us add that the Italian position is furtherly weakened by its ambiguous position towards public debt adjustments. Point 14 of the 28 June European Council's Conclusions states that all the members of this Council endorsed "the integrated country-specific recommendations as discussed by the [EU] Council, thus allowing the conclusion of the 2018 European Semester". Even if largely unnoticed, this is equivalent to state that Italy agreed to make an adjustment equal to 0.3% of its GDP with respect to 2017 and an adjustment equal to 0.6% of its GDP in 2019. On the other hand, following public statements of the Italian minister of the Economy and – *a fortiori* – of the two Deputy-prime ministers contradicted the commitment taken by the Italian prime Minister at the European Council.

Figure 2: Political logics



Secondly, if the creation of the EMF is indefinitely postponed, the institutional reason for a euro-area budget may look much less cogent.

Thirdly, without its own budget the euro area will unlikely be able to raise its own resources and distribute them asymmetrically according to the principles of stabilization, growth, convergence, or simply a spirit of solidarity.

Given these risks, the reasonable reaction of the most fragile EMU member states should have been to contribute to the removal of the factors that are weakening European political leadership and pushing the 'core' member states to privilege the institutional stalemate and the recourse to market discipline. Unfortunately, the last meetings of the Eurogroup, the European Council and the Euro Summit showed that the opposite is happening.