Why the eurozone needs a minister of finance and economic reform

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Abstract The Economic and Monetary Union remains incomplete and vulnerable. The current economic and political climate offers a window of opportunity to further deepen this Union in 2018. Completing the banking union and creating a roadmap for a capital markets union are both essential. One of the missing building blocks is a minister of finance and economic reform for the eurozone. This minister should have the powers and democratic legitimacy to better enforce the rules on budgetary and macroeconomic discipline. He or she should also be responsible for managing a budget line for the eurozone that can act as a countercyclical buffer when monetary policy and national fiscal policy are insufficient. This budget line, together with the European Structural Investment Funds, should also act as an instrument for enforcing and supporting structural economic reforms aimed at making the national economies more resilient to external shocks.
Keywords Minister of finance and economic reform | Eurozone | Budget | Structural economic reform | Risk sharing | Risk reduction

Introduction

Already in 1970, Pierre Werner, charged with the development of a blueprint for an Economic and Monetary Union (EMU), had argued that this union entails the need for a 'centre of decision for economic policy, to exercise independently, essential features of the whole of the public budgets, and in particular variations in their volume, the size of balances and the methods of financing or utilising them' (Werner 1970, 12). Werner realised that this implied a political union. Because such a transfer of sovereignty was politically unacceptable at the time, the Delors report (Delors 1989) stopped short of creating this kind of 'centre of decision for economic policy' and established only an independent monetary authority: it substituted the economic pillar with a set of budgetary rules, the Stability and Growth Pact. To strengthen fiscal rules, this pact was reformed several times, notably during the crisis: by the adoption of the 'Two-Pack' and the Treaty on Stability, Coordination and Governance. And under EU President Herman Van Rompuy, it was supplemented with rules governing other dimensions of economic policy: the Macroeconomic Imbalance Procedure (the 'Six-Pack'). In 2010 the Eurozone Semester was introduced. Based on the rules and procedures contained in the Six-Pack, it is the annual cycle of coordination and surveillance of EU economic policies.

Since then, many have pleaded for the creation of a minister of finance for the eurozone. They include Chancellor Merkel, President Macron, former European Central Bank (ECB) President Jean Claude Trichet (2011) and Governor of the Banque de France François Villeroy (Villeroy de Galhau 2016). The mandate of this minister should also include the coordination and promotion of economic reform in the eurozone member states so that they can accommodate better to the constraints imposed by sharing a common currency.

1 The first regulation of the Two-Pack improves and harmonises the budgetary procedures in the euro-area countries. It also imposes additional surveillance and reporting obligations on countries with excessive deficits. For member states subject to the Excessive Deficit Procedure (EDP), this same regulation requires monitoring that goes beyond what is provided for under the Stability and Growth Pact. The second regulation is only applicable to euro-area countries which request financial assistance from the European emergency funds or which face serious financial stability problems that could have negative contagion effects on other euro-area countries or the eurozone as a whole. The approach being followed for programme countries receiving assistance from the European emergency funds is largely institutionalised, including the provision of technical assistance for the implementation of the adjustment programme.

2 Most important and most binding are the four legislative texts of the Six-Pack that concern public finances. They take over and improve on the principles of the Stability and Growth Pact. The decision-making procedure has also been modified. Minimum quality requirements regarding the national budgetary frameworks of the member states apply. Two of the other regulations deal with the new Macroeconomic Imbalance Procedure. This is the most important instrument for dealing with these fundamental problems. The regulation on the prevention and correction of macroeconomic imbalances applies to all EU member states, but a distinction is made between the euro-area countries and the others. The second regulation, which concerns sanctions, applies only to euro-area countries.
Rules are no substitute for a minister of finance and economic reform

In their enforcement of the budgetary rules, the Commission and Council have never failed to disappoint. France, for instance, has had a public deficit exceeding 3% of GDP for each of the last 10 years. Moreover, between the introduction of the euro and 2017, it increased its debt-to-GDP ratio from 60% to 96%. Italy was allowed to join the euro with a debt-to-GDP level almost double the 60% norm, and since then the country has further increased it to 133%.

The nominal unit labour costs (ULCs) in the eurozone have increasingly diverged since 1999. Even if the new member states and programme members are left out of consideration, one sees that there has been no systemic convergence. During the first decade of the EMU, Germany improved its ULCs by 14% relative to the eurozone average, while in France and Italy ULCs deteriorated by 14% and 23%, respectively. The German unemployment rate has decreased since 2009, with the country now enjoying full employment (less than 4% of the active population are unemployed). Meanwhile, unemployment has consistently remained at a high level in France, and in Italy it has even increased steadily. And yet the divergence in ULCs has decreased only slightly (Matthes and Iara 2017, 12). Other indicators, such as GDP per capita, current account balances and unemployment rates, also point to rising macroeconomic imbalances and a lack of real convergence (Fig. 1).

Therefore, rules alone cannot be a substitute for an enhanced economic policy debate within the euro area, one that focuses on growth, financial stability and public finance sustainability. This is where a eurozone minister of finance and economic reform could step in. Current EMU governance does not really allow for such a debate: most of the proceedings of the Eurogroup of the 19 euro-area finance ministers are confidential; they do not nurture national economic policy debate within the member states. The Council's yearly adoption of the 'country specific recommendations' proposed by the Commission tends to be a formal step. A eurozone finance minister could embody and drive such a debate. Furthermore, as ECB President Mario Draghi has stressed many times (Draghi 2015), institutions may, under certain conditions, be more effective than rules. Taking the ECB as an example, he shows how institutions with a commonly agreed mandate and executive powers (monetary policy, Single Supervision Mechanism) can be more effective and flexible without undermining their credibility, as long as they focus on their mandate. The cornerstones here are the commonly agreed mandate and the powers that would be given to a eurozone minister of finance. Without this mandate and powers, this position would merely add another administrative layer.

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3 The author's own calculations based on European Commission data (European Commission 2017). I used the standard deviation of ULCs compared to the average for the euro area.

4 However, Jürgen Matthes and Anna Iara (2017) point to the positive impact of structural labour market reform on wage flexibility.
Can the EMU be completed without a minister of finance and economic reform?

A major constraint for agreeing on a ‘centre for decision on economic policy’ is the need for democratic legitimacy. It took the US 200 years to centralise economic and budget powers in Washington. In the EU the current trend seems to be in the opposite direction: towards more sovereignty for the individual member states (Brexit is an example where a (small) majority of the population prefers more sovereignty over integration) and decidedly not in the direction of a federal Europe or a political union. As a consequence, several ideas for completing the EMU without a eurozone minister of finance have been developed.

The IMF has shown that in the US it is the financial and capital market union, and not the central budget, that acts as the shock absorber (Butzen et al. 2014). Thus there is less need for central budgetary powers. It remains therefore of utmost importance that the euro area should complete the banking union by adopting a backstop to the Single Resolution Fund, moving forward towards a single deposit guarantee scheme and making solid progress on the capital markets union initiative.

The creation of the European Stability Mechanism (ESM) and the launch of the banking union under the pressure of the crisis are sometimes also considered sufficient to address the shortcomings of the Maastricht Treaty. Although there is no doubt that the EMU is now more resilient than before the financial and euro crisis, one should recall that the banking union remains incomplete and that the ESM is a crisis instrument and does not provide for ex ante macroeconomic stabilisation.
It has been argued that market forces will impose sufficient discipline and that the introduction of Collective Action Clauses in newly issued government bonds and a clear commitment to not bailing out countries in distress will lead to budgetary discipline being imposed by bond markets. However, the experience of the euro crisis shows that markets and rating agencies tend to underestimate budgetary derailments at first and then to exaggerate them. This leads to a sudden financing stop, as happened in April 2012.

As recently underlined by the IMF in its staff report on Article 4 and euro-area policies, “unresolved legacy problems are holding back a stronger medium term outlook for the [euro area]” (IMF 2017). Public debt reduces the ability of highly indebted countries to cope with a downturn or higher financing costs, and there is a risk of persistent divergences which over the years may undermine the basis of the EU project.

A minister of finance and economic reform for the eurozone

The economic case for deepening the EMU is overwhelming, but political support is missing. This is mainly due to a lack of understanding between Germany and France. Germany—like other northern member states, including the Netherlands, Finland and Estonia—stresses the need to adhere to the rules agreed upon and to implement structural economic reforms, as was done under the Schroeder government. Moreover, it expects all adjustment to come from the deficit countries. The northern countries also make a strong case for sound banks, which would be better capitalised and less exposed to national government debt and would solve any insolvency problems via bail-in by shareholders and bondholders. In theory, this could make a monetary union function without risk sharing or solidarity, except for certain extreme cases of serious asymmetric shocks.

On the other hand, France and other southern member states, such as Italy, plead for symmetric adjustment. And while acknowledging the importance of fiscal rules, they criticise Germany and the Netherlands for their record high current account surpluses. They see the EMU as a project of solidarity and risk sharing. Indeed, the theory on Optimal Currency Areas (Geeroms et al. 2014) states that in the absence of sufficient economic flexibility and risk sharing via financial and capital markets, there is a need for solidarity through a sufficiently large common budget. The northern countries are concerned that such solidarity would lead to a permanent transfer to the southern member states and even take away the latter countries’ incentive to reform their economies. The examples of north–south transfers in Belgium and Italy and the west–east transfers in Germany—all of which have failed to stimulate convergence—are used as evidence that a ‘transfer union’ would not be effective.

These differences in economic principles and the absence of mutual trust need to be overcome by adopting the principle that effective enforcement of the rules is needed before instruments of risk sharing and solidarity can be created.
The eurozone minister of finance and economic reform would have the following five functions:

1. The first is to independently exercise essential features of ‘the whole of the public budgets’ (Werner 1970, 12). This means preventing unsustainable debt-to-GDP levels. This is not to say, however, that the structure of the budget—revenues and spending—should be decided by this ‘centre of decision’ or a eurozone minister. Rather, it should remain a national responsibility, in accordance with the principle of subsidiarity. The minister of finance and economic reform should also decide independently on the optimal fiscal stance for the eurozone as a whole, thereby complementing the ECB’s monetary policy. The word ‘independently’ is key. The independent character of this function makes it different from the role played by the toothless European Fiscal Board, which is thoroughly reliant on the Commission.

2. The minister would monitor other parameters of macroeconomic policy and propose reforms where needed. The current framework of the Macroeconomic Imbalance Procedure is sufficient. It only needs to be enforced better and more symmetrically.

3. The eurozone finance minister would be in charge of the existing crisis mechanism, the ESM. The current intergovernmental agreement on which the ESM is based should be changed and then incorporated in the Treaty on the Functioning of the European Union (TFEU) to make it a community instrument. The idea of turning it into a European Monetary Fund is inspired by a lack of trust in the Commission and by the political argument that it is difficult to ratify a treaty change. However, the Commission, with a special role for the minister of finance and economic reform, should be in charge of the European Monetary System or European Monetary Fund. And a simplified treaty change would suffice to incorporate the ESM in the TFEU.

4. Managing a budget for the eurozone would be another role played by the finance minister. The European Monetary System (or European Monetary Fund) can never be a complete substitute for a eurozone budget. It is an ex post instrument aimed at ensuring financial stability based on compliance with strict conditions (Thirion 2017). A budget for the eurozone would come into action earlier since it is not based on requests by crisis-hit member states and offers hedging against extreme asymmetric shocks. Four parameters of this budget need to be defined:

   a. How large would this eurozone budget line be? It can be small. The automatic stabilisers are sufficiently large, if the member states achieve their Medium Term Objective of 0% of GDP. A centralised budget should only provide insurance against very large asymmetric shocks. Estimates of the size of the budget range from 2% to 3% of GDP.

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5 Some member states with high debt-to-GDP levels and a high budgetary burden related to their ageing population have a higher Medium Term Objective.
b. Where would the revenue for this budget come from? The euro-area budget requires its own stable resources. A number of possibilities are listed in the Monti Report (European Commission 2016). Another idea would be a uniform tax on banks. The banking union implies the complete harmonisation of all parameters of the financial industry (banking sector), except taxes. Harmonising taxes on the banks’ profits would constitute a fourth pillar of the banking union and contribute to levelling the playing field for banks in the EMU. It would be a stable source of financing and one covering the EMU alone. The IMF proposal of a Financial Activities Tax (IMF 2010) can be a source of inspiration and at the same time be a good substitute for the ill-designed Financial Transaction Tax project.

c. How would this budget be spent? It should be spent on public goods relevant to the eurozone. Most public goods for the eurozone are also public goods for the EU27, but providing them requires a reform of the EU budget. The most relevant functions of a euro-area budget would be economic stabilisation and economic reform. Several formulas have been proposed for the former. These include a scheme to compensate for a part of unemployment benefits (Lellouch and Sode 2014) and an investment scheme for regions or member states suffering from asymmetric shocks (Thirion 2017, 17–19). However, the latter function of stimulating national economic reform to make an economy more resilient and to better meet the conditions of a currency union is crucial, as is finding political agreement between northern and southern member states.

d. Is borrowing capacity needed? Borrowing capacity is necessary and would generate the safe assets that the eurozone very much needs. The euro area is the only monetary union without safe assets. At present there is only nationally issued debt, which is actually a subordinated debt that cannot be considered risk free (De Grauwe 2011). In the context of the Basel reforms, such safe assets would facilitate the debate on the prudential treatment of sovereigns in banking regulation (to apply non-zero risk weights to holdings of national public debt). Conversely, launching this debate without a safe asset would put the financial stability of the euro area at risk by increasing the possibility of a sudden stop in sovereign financing.

5. In the long run, the minister would take on the role of representing the eurozone in contexts outside the euro area, for example at the IMF, Basel Committees and meetings of the G20 ministers of finance. The current fragmented representation of euro-area member states, many of which have historical constituencies with economies outside the euro area, is an anachronism. Germany and France could pave the way for such a move.

The instruments at the disposal of the euro-area minister of finance and economic reform should include the following:
• **The budget for the eurozone**: This has already been discussed.

• **The authority to rate sovereign debt for the purpose of enforcing budgetary and other macroeconomic rules**: If the eurozone finance minister were to be limited to the sanctions provided for in the Six-Pack, there is no reason to think that he or she would be more successful at enforcing these rules than the Commission and the Council have been. Therefore, the minister needs other instruments, and those based on the market would be most effective. One idea that could be explored is the following. The eurozone does not need to rely on ratings given by private third parties (moreover, companies from the US and the UK have a near monopoly on rating agencies). The ECB and the Commission are better equipped than private rating agencies to assess the sustainability of the public debt. They can provide the technical expertise to enable the minister of finance and economic reform to attach a high risk weight where the debt-to-GDP ratio is considered to have become too high. He or she would create ‘red bonds’ (Delpla and von Weizsäcker 2010). These bonds would be subject to higher risk and to the possibility that the ECB might not accept them as collateral. This would lead to higher spreads, thereby de facto creating a financial sanction via the markets. To preserve its independence, the ECB would only provide data and technical expertise to the Commission. The minister would be solely responsible for deciding the rating.

• **The ability to influence the use of EU structural investment funds**: One of these, the Cohesion Fund, was created to help member states improve the competitiveness of their economies so that they could converge in real terms before joining the euro. However, it is not clear that this objective has ever been reached (Butzen et al. 2006). The eurozone finance minister should have a say in the allocation of the five European Structural and Investment Funds. In this way he or she could encourage and support structural economic reforms and focus them on real convergence. The EU should link these funds more closely to achieving specific output targets such as those indicated by the scoreboard of the Macroeconomic Imbalance Procedure: unemployment rate, ULCs and so on.

On the institutional side, the eurozone minister of finance and economic reform should

• be appointed by the heads of state or government (as is the president of the ECB);
• remain in office for a minimum of five years, a period that would not be renewable (so as to assure the minister’s independence);
• combine the functions of chair of the Eurogroup and member of the European Commission (for the sake of simplicity and credibility); and
• have the Directorate General for Economic and Financial Affairs (DG ECFIN) and other Commission services at its disposal as treasury planning office.

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6 All sovereign bonds would be considered ‘red bonds’, as Delpla and von Weizsäcker use the term, if they are issued to finance the part of the deficit exceeding a certain threshold, where this threshold corresponds to the nominal government deficit that is accepted by the eurozone minister plus interest charges and the repayment of all outstanding debt.
Conclusion

As mentioned above, trust has to be renewed between the eurozone member states. The neglect of the Stability and Growth Pact, the experience with the bailout of Greece, the lack of economic reform and the bending of the no-bailout rules for banks in Italy have all eroded this trust. Therefore, structural economic reforms to bring the EMU closer to being an ‘Optimal Currency Area’, the prevention of unsustainable public and private debt, and stable banks are needed to reduce risk and are prerequisites to risk-sharing mechanisms being accepted. Risk reduction and risk sharing need to move ahead hand in hand.

One can only hope that the basis for sound mutual understanding will be restored. For all other matters, the political environment should be in place. There is a window of opportunity after the French elections of May 2017 and the German elections in September 2017. The first signs are promising. The idea of a eurozone budget and minister of finance was proposed by Chancellor Merkel during a recent press conference with French President Macron (Macron and Merkel 2017). Former Minister of Finance Schäuble has long been in favour of both. It has to be seen what the German position will be under a coalition of the Christian Democratic Union of Germany (Christlich Demokratische Union Deutschlands), the Christian Social Union in Bavaria (Christlich-Soziale Union in Bayern) and the Free Democratic Party (Freie Demokratische Partei). Perhaps the proposals above should, in the first stage, exclude the acquisition of borrowing capacity by the euro area as this ‘smells’ like eurobonds. One should also move gradually and hope that the improved economic environment creates momentum for the deepening of the EMU.

As Werner suggested almost a half-century ago, the main hurdle to establishing the economic pillar of the EMU is democratic legitimacy. He pointed to the need for a political union. If we have to wait for a political union before deciding the final steps for completing the EMU, it could be too late. There is a risk that the euro will not survive the next economic or financial crisis.

It is remarkable that the question of the democratic legitimacy of fiscal (budget) policy is not raised when it comes to monetary policy. Since the 1970s independent central banks, accountable to the respective national parliaments, have been created throughout the world. They are considered to have been successful in stabilising prices. On the other hand, the age of central banks that were dependent on politics is considered to have been a period of macroeconomic misconduct and inflation and to have culminated in the stagflation of the seventies. The ECB is among the most independent central banks of the world—indeed, without this independence, Germany would have refused to adopt the euro.

I have argued before that the fiscal stabilisation function of the eurozone is of the same nature as its monetary policy and should therefore be decided by an independent minister of finance (Geeroms 2014). But for the minister’s other functions, such as defining the goals for economic reform and establishing the path to convergence and
competitiveness, the issue of democratic legitimacy is real. The European and national parliaments need to be closely involved. A eurozone chamber should be created at the European Parliament. Werner was correct in holding that social partners and other relevant groups in society should play an important advisory role.

Some will say that the current economic rebound being enjoyed by the EU, notably within the euro area, will reduce the appetite for reform. But one should rather see this recovery as an opportunity to move forward at both the national and EU levels on structural reforms, public finance sustainability and reinforcement of the EMU.

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