

Eurozone Reform - a View from China

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As China and the EU are each other's largest sources of import and major export markets,¹ Beijing keeps a watchful eye on the economic stability of the Euro area. The latest push for eurozone reform by Germany and France once again caught the attention of political observers.² After long negotiations, Berlin and Paris agreed to establish a common eurozone budget starting in 2021. This goal is a key element of the so-called "Meseberg Declaration", published by both governments on the 19th of June 2018. However, this fiscal policy plan faced two immediate hurdles: It had to give way to migrant and refugee issues at the summit of the European Council on the 28th / 29th of June 2018 and other eurozone members raised doubts over it. So, what substance and prospects does the budget proposal have and what are the implications for China?

The path to the deepest reform after the crisis

The break-out and the rapid contagion of the sovereign debt crisis in Southern Europe illustrated that monetary integration with separate fiscal policies has been the main institutional flaw of the eurozone. So the current plan to build a common eurozone budget seems fit for making another sovereign debt crisis less likely. Such a reform would be much more effective than turning the European Stability Mechanism (ESM) into a European monetary fund, as proposed by the European Commission on the 6th of December 2017,³ since such a fund would still heavily rely on loans. However, the drawing up of an intergovernmental eurozone budget would not be

sufficient as only a common treasury could investigate state budgets and provide fiscal transfers to troubled states that suffer from sudden shocks.

The eurozone is a single currency area which means it does not only need economic convergence of member states to reduce the probability of asymmetric shocks, but also absorbing measures to confront them when they occur, according to the traditional theory on Optimum Currency Areas (OCA).⁴ For the absorption of asymmetric shocks, a common eurozone budget would provide an effective tool as special and targeted fiscal investment could flow into the states or regions under shock. Yet without having a financial equalisation scheme between the budgets of member states, asymmetric shocks would be inevitable in the long-term.

Additionally, the Banking Union improves the convergence between member states because it provides their banking systems with a supranational supervision and resolution under the same scheme. As for the European Deposit Insurance Scheme (EDIS), which is the missing element of the Banking Union, the European Commission on the 11th of October 2017 released a Communication suggesting measures to reduce non-performing loans in an attempt to counter concerns of net-donor member states about moral hazard.⁵

However, the Single Resolution System which has already come into force in 2016, has its own limits with the fund only amounting to 55 billion euro⁶, when for example dealing with the liabilities of Italian banks, which according to estimations amount to hundreds of billion euro.

Main challenges ahead

Once Germany and France announced their common eurozone budget plan, doubts arose inside and outside the euro area. The northern states, for example The Netherlands, worry that the common budget will become a transfer system to the benefit of southern states at the cost of the more frugal ones. The southern states have welcomed the Franco-German proposal, but worry the plan would impose supervision on their national budgets. Non-eurozone member states such as Hungary fear being geopolitically marginalised as a consequence of a deeper eurozone integration. So in the mid-term, political controversies between members of the euro area and those still being in the waiting room might prove to be the greatest challenge ahead. These internal disputes also present a challenge for the Chinese Europe policy, because they extend the uncertainty of whether the EU's ongoing integration is feasible or not. Some voices even argued that the EU was disintegrating after the BREXIT referendum⁷. Progress on eurozone reform would send an explicit, positive signal about the EU's political capability. Despite the potential for common ground within the eurozone, even Germany and France still have to sort out political differences - most importantly the amount of the budget. France suggests to allocate hundreds of billion euros, while Germany wants to limit its volume to tens of billion euros. France and the European Commission also proposed a financial minister for the eurozone, but did not receive support from Germany. The only agreement lies in the time line for the budget to begin in 2021.

However, both disagreements on asylum policy and a no-deal-Brexit pose the risk of delaying the eurozone's reform another time, with the proposed time line in 2021 coming closer. At last, detailed negotiations would be another challenge, considering the difficulties in the ongoing talks on the fine print of the plan to turn the ESM into a backstop for banks.⁸

Furthermore, upcoming debates on the budget's amount, capital source, state distribution as well as its budget management might well be exhausting to negotiate.

Prospect of the common eurozone budget plan

Germany was once the strongest opponent of fiscal integration, as proposed by then French Minister of Economy Emmanuel Macron several years ago.. Even the most recent EMU roadmap set out by the Juncker Commission in December 2017 is less ambitious and does not include a common eurozone budget, mostly because of the German government's objection.⁹

With France and Germany now driving the agenda, a political settlement in principle has been reached. It is now the best time for Paris and Berlin to push ahead. The bailouts of defaulted eurozone states ,which have so far been implemented, already paved the way towards establishing a more harmonised euro governance system - whether in the form of debt relief, renegotiation of lending terms, or new loans to repay existing ones. To prevent future bailouts, the common budget could be helpful by providing member states with the possibility for a prompt reaction. Having a coordinated fiscal policy in place would avoid a rapid contagion of another national budgetary crisis. This would be in the interest of every EU member and Chinese investments.

Some may argue that the European Central Bank has already mitigated the risk of contagion, rendering a deeper fiscal integration unnecessary. Most notably, the ECB has launched its Outright Monetary Transactions (OMT), under which the ECB makes purchases ("outright transactions") of bonds in secondary, sovereign bond markets, and initiated a super easy monetary policy. . However, the ECB's -measures during the debt crisis are still controversial

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as the so-called Quantitative Easing (QE) policy helped indebted states at the price of increasing the risk of overheating the economies in northern states. In November 2017, the German ‘Wise Men’ - an advisory council to the government - expressed such a warning. Eventually, the proposed fiscal measures discussed above would mitigate side effects of injecting money into markets.

Implications for China

Reforms leading to the deepening of the eurozone will enhance the international role of the euro.¹⁰ The international monetary system with a strong euro would be more stable than the current system, which is dominated by the US Dollar, leading to financial shocks in emerging markets due to their one-sided currency dependence when performing monetary adjustments. China needs a stable international monetary system, as well as a diversified international payment system to which, a substantial eurozone reform could make a great contribution. Furthermore, a bigger presence of the Euro as a medium of exchange would benefit China’s increasing international financial transactions and enable the internationalisation of the Renminbi. As a matter of fact, the debt crisis in the eurozone has reinforced the dominance of the USD in the international monetary system. What is more, a strong euro could be a better alternative for Chinese investment to diversify its magnificent foreign currency reserve. Financing the US’s public debt neither meets the Chinese portfolio strategy, nor is it appreciated by the US administration. China has already invested a lot in the economies of the eurozone. A strong euro would increase the value of these investments even more.

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Endnotes:

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2. Xinhua. “Merkel, Macron agree on major EU reforms”, in: *China Daily*, 20 June 2018.
3. see ZEI Monitor 2017. “A Strong Union Built on a Strong EMU”, retrieved from <https://www.zei.uni-bonn.de/research/governance-and-regulation/economic-and-monetary-union>.
4. Paul Krugman. *Revenge of the Optimum Currency Area*. Nber Macroeconomics Annual , 2013, 27 (1):439-448.
5. see ZEI Monitor 2017. “A Strong Union Built on a Strong EMU”, retrieved from <https://www.zei.uni-bonn.de/research/governance-and-regulation/economic-and-monetary-union>.
6.) Luo Ning. *The banking union: a certain result with indelible dissensions*. *Shanghai Securities News*, 9 Jan 2016.
7. Shao Yu. *EU disintegration and Euro collapse in 2017 with 30% possibility*. *Speech in the New Mogan Meeting in China*, 25 September 2016.
8. Jim Brunsten. *The winding path of eurozone reform*. *Financial Times*, 3 September 2018.
9. European Commission. *Commission sets out Roadmap for deepening Europe’s Economic and Monetary Union*. Brussels : Press release, 6 Dec. 2017. IP/17/5005.
10. Jean-Claude Juncker. *State of the Union 2018: the hour of European Sovereignty*. Brussels : European Commission, 12 September 2018.

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