Session 4: EMU Diversity and Sustainability: From The Maastricht Treaty To The Fiscal Compact

EMU Sustainability: the Role of Structural Reforms
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ABSTRACT: EMU’s governance framework was incomplete at its inception. Its institutional fragilities allowed for the building up of competitiveness and fiscal disequilibria in some Member States during its first ten years and left the Eurozone unprepared to cope with the sovereign debt crisis. While some of those weaknesses have been addressed in response to the crisis EMU’s governance framework remains incomplete to date and therefore vulnerable to adverse market and political-economy pressures. This paper argues that EMU – or at least the membership of individual countries – will not be sustainable without national adjustment capacity and willingness to implement economic reforms. Those reforms are also a pre-condition for promoting sustainable growth and hence a credible crisis exit strategy. Although EMU’s resilience could still be guaranteed through other mechanisms in the absence of sufficient national adjustment capacity, notably a banking union with an orderly state bankruptcy regime, even if feasible it would mean a rather different model of European integration.

KEYWORDS: EMU governance, economic, fiscal, financial and political integration, sustainable growth

JEL classification: E42, E61, E65.

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1 Background paper prepared for the Conference in Honour of Mike Artis, EUI, Economics Department and Robert Schuman Centre of Advanced Studies, Florence, 17 June 2016. We would like to thank, without implicating, seminar participants in Oxford (ESC, St Antony’s) and London (LSE and King’s College), and in particular Paul De Grauwe, Erik Jones, Kalypso Nicolaïdis and Waltraud Schelkle, for valuable comments and discussions.
1. Introduction

At Maastricht, Economic and Monetary Union (EMU) membership was made conditional on the fulfilment of entry criteria that would test whether (or show to those opposing EMU or too large an EMU, that) there was a ‘sufficient’ prior convergence of preferences with regard to both inflation and budgetary and fiscal discipline. As in the case of the creation of the European Monetary System (EMS) before, a number of institutional questions remained open in order to allow for the establishment of a timescale for the creation of EMU. Moreover, besides the need to allow for the establishment of a timescale to implement EMU, its Maastricht blueprint could not have been complete for a variety of reasons, notably the idiosyncrasy of the European construct, which had no parallel in previous experiences. To be sure, that incompleteness had been pointed out at the time by academics (Giavazzi and Wyplosz, 2016), policy makers and politicians but member states could only agree on the lowest common denominator, hoping for preferences to converge (Torres, 2009). Open questions primarily concerned how to enforce the convergence/stability (entry) criteria once countries had joined EMU and how to further coordinate budgetary and various other policies in order to guarantee EMU’s sustainability.

The fiscal (entry) criteria were complemented in 1997 by the establishment of the Stability and Growth Pact (SGP) with regard to the post-entry period. They did not however address institutional and economic gaps in the criteria identified by some economists for an optimum currency area (OCA). Still, endogenous developments could have improved matters over time (see Corsetti, 2010, De Grauwe and Mongelli, 2008, and Torres, 2009).

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2 Jones et al. (2015) argue that the incompleteness of EMU was both a cause of the euro crisis and a characteristic pattern of the policy responses to the crisis.

3 Traditional OCA theory states that the condition for a country to surrender its monetary autonomy and join a monetary union is that the (microeconomic) efficiency gains must outweigh the macroeconomic costs of participation. These factors are dependent on the characteristics of the country in question. OCA theory has tended to focus on the stabilization policies (the macroeconomic costs) of a monetary union, namely the loss of the exchange rate as an adjustment mechanism. For an analysis of the role played by OCA theory in the process of European monetary integration, see Krugman (1993), Mongelli (2008), Mongelli (2010) and Eichengreen (2014). For a critical appraisal (namely on the unreliable role of the exchange rate or of labour mobility as adjustment mechanisms) as part of the more recent transatlantic debate on EMU as a non-OCA, see Schelkle (2016).
Unlike in the case of a common of monetary policy, where national central banks had been made independent as EMU qualifying criteria, there was no parallel establishment at the national level of enhanced fiscal rules or national institutional fiscal arrangements in future Eurozone member countries. As a result, the monitoring of fiscal policies and debt accumulation was not effective: the SGP did not function satisfactorily as a fiscal disciplinary device, as its legalistic approach failed when the European Commission faced national arguments of “special circumstances” (Giavazzi and Wyplosz, 2016). No Eurozone institutional mechanisms were put in place for a systematic detection and correction of private sector imbalances, because those imbalances would be subject to – and thought to be taken care of by – creditor discipline. As Giavazzi and Wyplosz (2016) note, the European Central Bank (ECB) had frequently expressed frustration with governments that were not fiscally disciplined and with financial markets that did not price public debts accordingly but its warnings went ignored. In addition, creditors allowed private imbalances and debts in some cases to reach unsustainable levels.

In 2000, at the Lisbon European Council Member states also committed to an economic reform agenda. Under the heading of the Lisbon Strategy (2000–2010), common EU objectives and benchmarks were established for member state performance, which were to be gauged against agreed targets. The Lisbon Strategy was above all driven by international competitiveness concerns and the objective to make the internal market deliver economic results (growth and employment; sustainable development) in a globalized world economy, rather than by monetary union requirements. Of course, to the extent that structural reforms and economic liberalization promote price and wage flexibility, the Lisbon economic agenda would also contribute to a better functioning of the monetary union.

The way the Lisbon strategy and its successor, the Europe 2020 Strategy, were set up was conducive to preference convergence within a gradual, learning process, and reflects a perceived need for creating ownership of reforms at the national level, through

4 Barta and Schelkle (2016) address this lack of support from markets (rating agencies) in disciplining budgetary policies during EMU first decade. Eijffinger et al. (2015) argue that markets had behaved in a rational manner, taking the no bailout clause as unreliable from EMU’s inception. Risk weights on sovereign debts of euro members were also set at zero by the official sector.
a process of slow-moving convergence of preferences on institutions (Bongardt and Torres 2013b). The implementation of their commitments came to hinge on soft coordination rather than being effected through the Community method. Given that instruments remained a national competence, the convergence of preferences relied on member states’ willingness and capacity of putting best practice and mutual learning to good use. Enforcement relied on public and peer pressure, exerted via benchmarking and ranking of member states’ performance (Bongardt and Torres, 2012). Yet, by and large public opinion in member states failed to take ownership of reforms and exert pressure with a view to institutional modernization, and peer pressure was largely ineffectual and official ranking abandoned.

The remainder of this paper is organised as follows. The next section shows how EMU incompleteness allowed for the building up of macroeconomic imbalances throughout its first decade. Section 3 examines how the crisis brought to the forefront additional demands on the economic union part of an incomplete EMU. Section 4 focuses on the need for and importance of creating ownership of reforms at the national level. Section 5 argues the case for a sustainable growth strategy with structural reforms at the national level as a pre-condition for a credible exit strategy and a durable recovery. Section 6 operationalizes that strategy. Section 7 concludes.

2. EMU’s first decade: the building up of macroeconomic imbalances

Despite a rather successful first decade by many accounts, EMU’s incompleteness – rooted in an incomplete institutional model beyond monetary policy – implied persistent institutional fragilities and allowed for building up (financial, fiscal and competitiveness) disequilibria. The lack of national reforms in some member states also contributed to growing intra-EMU macroeconomic imbalances.\(^5\)

In the EU, the increase in economic integration to a monetary union had brought about a qualitative change, in which different member state conceptions of the mixed economy (with its different state-market relations), when in contradiction with additional

\(^5\) Most EU countries had failed to internalize the established common objectives of fiscal (SGP) and economic and social governance (the Lisbon and Europe 2020 Strategies).
monetary union requisites on the economic side, became no longer sustainable. Albeit to different degrees, member states - especially those which were to experience severe problems later on in the sovereign debt crisis – failed (some of them significantly) to internalize what living in a monetary union meant, let alone to internalize the challenges posed by globalization, and delayed long-due reforms. Any proposed remedies – as it were, even more so under time pressure – would necessarily be more ‘intrusive’ in member state affairs. After all, a country’s permanence in EMU requires the compliance with those commitments it made under constrained decentralization, needed to sustain EMU.

The combination of the absence of market pressure during EMU’s first decade – when financial markets failed to differentiate between the sustainability of public debt and external imbalances among participants – and non-binding and not enforceable commitments in the case of the Lisbon Strategy and binding but not enforceable rules in the case of the SGP contributed to the procrastination of some of those (economic and institutional) reforms. The same holds true for the announced objectives (various times voted in national and European elections) to which various governments and political parties had subscribed and which were poorly implemented. It is therefore hardly surprising that economic policy coordination, effected through the Lisbon Strategy and the SGP, failed to deliver during EMU’s first decade.

The combination of those two factors – the lack of national reforms in some member states, in conjunction with the incapacity of financial markets to distinguish between Eurozone sovereigns – paved the way for increasing intra-EMU macroeconomic imbalances. Apart from its weak enforcement, the Lisbon Strategy also lacked any specific EMU dimension to address the increased interdependencies between members of a monetary union.6

3. The crises and additional demands on economic union

3.1 Towards a ‘genuine EMU’?

6 With the launch of EMU’s second phase in 1994, the nature of European integration changed, as developments in any member state could have a much greater impact on the others (Mongelli et al., 2016). The crises have been illustrative in this regard.
EMU’s incompleteness in the economic union part left its (financial, fiscal and economic) governance institutions unable to encompass increasing policy interdependence, let alone capable of dealing with the cumulative effects of the financial and sovereign debt crises.\(^7\) EMU institutions, already affected by the 2008–9 global financial crisis, were unable to deal with the sovereign debt crisis that began in 2010.\(^8\)

Although the EU moved towards increased coordinated financial supervision in response to the 2008/9 global financial crisis, it was insufficient. However, in the sovereign debt crisis the large negative spillovers, originating in the economic part of the union where there had been insufficient financial, fiscal and economic policy coordination and domestic adjustments to prevent macroeconomic instability and imbalances, affected the monetary side (Torres, 2015). They came to put at risk even the survival of the monetary union. The sovereign debt crisis thereby added urgency to the completion of the economic union side of EMU. Member States responded by seeking to address the causes of the crisis, namely banking sector fragilities, budgetary disequilibria and competitiveness differentials between member states. In order to curb spillovers into the monetary sphere, in particular in the Eurozone, it was most urgent to break the feedback loop between weak banks and over-indebted sovereigns.

The advances in economic governance were triggered in the crisis through successive steps, prompted by the need to ensure the survival of EMU in the light of market pressure. Different measures meant to strengthen fiscal discipline and economic coordination have come to address some of EMU’s fragilities since 2010 as a result. These responses, together with the creation of the European Stability Mechanism (ESM) as a permanent rescue fund, new arrangements for financial regulation and supervision and better tools for macro-prudential supervision, arguably reduce the risk of future crises and strengthen the capacity of crisis management.\(^9\) However, and although those

\(^7\) As Bini-Smaghi (2016) points out, Eurozone governance combines a centralization of competences in policy areas such as monetary policy and now banking supervision (the responsibility of the ECB) and competition policy, state aid and external trade (the responsibility of the European Commission) with a form of “constrained” decentralization in other areas, such as fiscal and structural policies.

\(^8\) There were neither financial backstops for stressed sovereigns or strained banks nor for countering sudden stops in financial flows (Mongelli et al., 2016).

\(^9\) A brief summary of the measures taken since 2010 to strengthen EMU’s resilience is presented in Juncker et al. (2015a). See also Mongelli et al. (2016) and the European Commission Fact Sheet on “The EU’s
incremental steps add up over time and foster further integration, a “complete EMU” seems always beyond reach (Jones et al., 2015; Pisani-Ferry, 2016).

The various versions of the EU Presidents’ Reports (Van Rompuy et al. 2012; Juncker et al. 2015a and 2015b) seek remedy for the fact that the functioning of an economic and monetary union, as compared to a stand-alone economic union, makes additional demands on the economic side (notably on labour, product and financial markets with regard to flexibility and coordination requirements), which were previously unaccounted for. To make EMU sustainable they advocate the necessity to respond to the Eurozone crisis by completing its economic union part. That means creating a ‘genuine EMU’ (GEMU) with a banking union, an integrated budgetary framework, an integrated economic policy framework and enhanced democratic legitimacy and accountability of EMU governance.

Thus far the process of creating new institutions and mechanisms has displayed significant political and institutional resilience to the crisis. Nevertheless, efforts to create a ‘genuine EMU’ have only made limited progress. Considering GEMU’s three economic strands, fiscal integration did not progress much since 2011 although financial integration (banking union) advanced substantially (to what can be denominated a half banking union). As far as enhanced democratic legitimacy and accountability of EMU governance is concerned, the institutional steps taken during the crisis appear not to be significant. However, a non-negligible informal bottom-up process of political integration is occurring through the substantially increased politicisation of multi-level governance (Torres 2015). Among GEMU’s four strands, it was the integrated economic policy framework that has progressed the least during the crisis (Mongelli et al., 2015; Bongardt and Torres, 2016); it is also still far from the level required to sustain EMU.

The various Presidents’ reports recognize that policy adjustment in the Eurozone cannot rely on macroeconomic policies alone. Economic integration would have to be pursued along the lines of creating stronger incentives for structural reforms in low-

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10 Still, governments and citizens were not mobilized around a new impetus for European integration in the midst of the crisis, which in turn raises the question of the longer-term political sustainability of both EMU and the European Union project (see Jones and Torres 2015).
productivity countries. This would help the Eurozone better meet the economic requirements of a currency union by improving the overall stability of EMU to macroeconomic shocks. However, the proposal of creating incentives for promoting structural reforms for member states, such as a system of national reform contracts to be signed with EU institutions in exchange for financial support (Van Rompuy et al. 2012), seems not to have gathered the necessary political support across member states and was abandoned.

Against the background of an integrated economic coordination framework which barely advanced, held back by member state competences, the Five Presidents’ report (Juncker et al. 2015b) proposes building on the Euro Plus Pact, with its EMU dimension and focus on interdependencies, rather than on the EU-wide Europe 2020 Strategy. More specifically, they suggest strengthening national reform efforts through competitiveness authorities at the national level and, in a second phase, by moving to a legal base for commitments. This innovation looks like an attempt to increase ownership and the effectiveness of reforms at national levels.11

3.2 Urgent institutional challenges to be addressed

A growing consensus has emerged on the causes of the crisis (Baldwin et al., 2015) and also on the fragilities that have to be corrected. It is summarized in Baldwin and Giavazzi (2016) and includes: completing the missing one-and-a-half pillars of the currently incomplete banking union; breaking the feedback loop between banks and their overindebted sovereigns; securing Eurozone-wide risk sharing for dealing with Europe-wide shocks and coordinating fiscal policy / national fiscal policies while reinforcing discipline at the national level; some sort of sovereign debt restructuring mechanism for the Eurozone in order to redistribute the burden of legacy debt (“cleaning up the legacy debt problem”); and advancing structural reforms to push the Eurozone more towards an OCA.

11 The proposal of such a legal base in the second phase suggests that the five presidents have little faith in the delivery of national structural reform through non-binding coordination (Begg et al. 2015). Sapir and Wolff (2015) propose the establishment of a European Competitiveness Council composed of national competitiveness councils and the creation of a Euro System of Fiscal Policy to oversee fiscal debt sustainability and an adequate area-wide fiscal position.
As yet, there is no consensus on the specifics of the additional demands on economic union with respect to macroeconomic stabilization, notably whether fiscal policy needs to be centralised (De Grauwe and Ji, 2016a and 2016b; Tabellini, 2016) or not (Eichengreen and Wyplosz, 2016, Gros, 2016). There is also some controversy on the role of the ECB as a lender of last resort.\textsuperscript{12} The legacy debt problem seems to be the most important political obstacle that stands in the way of most of the other necessary corrections. There are various proposals for a limited set of measures to be implemented as fast as possible without any need for deepening political or even economic integration for which there is little appetite today.\textsuperscript{13} However, all of these proposals encompass the creation of some fiscal space at the level of the Eurozone and some sort of (more or less limited) programme of debt consolidation/restructuring. A second important political obstacle, stressed by Sapir (2016), is the resistance to creating Eurozone-wide risk sharing for Europe-wide shocks (which begs increased fiscal integration) for fear that structural weaknesses in some countries, in particular in the functioning of labour markets, may lead to structural rather than temporary fiscal transfers.

Today it has become more or less consensual that the one fundamental ingredient for a sustainable monetary union is banking union (Baldwin and Giavazzi, 2016; Eichengreen and Wyplosz, 2016; Gros, 2016; Gros and Belke, 2016). However, the question is whether such a banking union can materialise without a fiscal backstop requiring a significant move towards a fiscal union.

Member states have resisted the centralization of competences on the economic side of EMU and it is uncertain whether this will change any time in the future. It nevertheless remains urgent to address those challenges and make the necessary institutional changes. Independently of those necessary changes, however, it is the adjustment capacity and the willingness to implement economic reforms at the member-state level that is crucial for a better functioning monetary union and for promoting sustainable growth and hence a credible crisis exit strategy.

\textsuperscript{12} See De Grauwe (2013), Eichengreen (2014) and Torres (2013) and Feld et al. (2016) for a discussion.

\textsuperscript{13} Corsetti et al. (2016) put forward a mechanism to redistribute the burden of legacy debt over time and only to a minimal extent across countries, not requiring debt mutualisation or a joint debt guarantee.
4. Beyond institutional reform: the need to create ownership of reforms

Regardless of the completion of a banking union and progress towards fiscal integration and other necessary changes, any attempts at moving the Euro area closer to an OCA, or to at least transform it into a sustainable currency area (SCA), require reforms in areas where competencies have remained national.\textsuperscript{14} For the time being, this is therefore only possible through structural reform and adjustment capacity at the member state level.

Throughout the sovereign debt crisis market pressure surfaced as an additional source of pressure for increasing lagging member states’ reform efforts. In addition, conditionality made an appearance through the access to funds for those countries that were cut off from capital markets for their financing needs. To a certain extent, this has been a game changer for softly coordinated economic reforms.\textsuperscript{15} The new crisis-enacted mechanisms and the conditionality-linked availability of funds have started to positively affect the implementation of structural reforms. In fact, there has been an acceleration of structural reforms in laggard countries – including Greece, at least until 2014 – as a result of market and peer pressure and of formal and informal conditionality (Schmieding and Schulz 2014; OECD 2015).

The relevance of economic reforms rises in a context where fiscal policy is also constrained by the need to ensure a proper adjustment of the budgetary imbalance, which is due to the need for an enduring correction of the budgetary imbalance. This is because structural reform can increase the credibility of the adjustment programme whereby a more gradual fiscal adjustment can be achieved (Bini-Smaghi 2016). As Draghi (2016) emphasizes, even supporting demand is not just a question of the budget balance, but also of its composition, especially the tax burden and the share of public investment – that is, fiscal policy is used as a microeconomic policy tool in that it can enhance growth even when public finances require consolidation.

Without efforts by member states to create ownership of reforms, there may however be a political backlash.

\textsuperscript{14} For a discussion of the concept of SCA in contrast to OCA, see Torres (2009).

\textsuperscript{15} Arguably, by buying time for reform the ECB also alleviates market pressure on member states.
As Gros (2015) and Gros and Belke (2016) show for the case of Puerto Rico, even a ‘genuine’ economic and monetary union (with a well-functioning banking union) like the US cannot prevent regional failures. The case of Puerto Rico in the US bears many similarities with the case of Greece in the Eurozone. Both delayed over-due reforms and arrived at the brink of bankruptcy. The only difference is that in the case of Puerto Rico there seems to be little criticism of the US dollar for the failure and of the US government for lack of solidarity (Puerto Rico is left to the mercy of the markets). However, Puerto Rico, member of a financially integrated monetary union, did not put the monetary union at risk. It did not receive any help from the US either, and entered into default (see Gros 2015). In the case of Greece, Eurozone partners paid the country’s debts to the IMF (which were over due) and to the ECB.

The case of Greece has illustrated that, without increased sovereignty sharing, the new governance framework still remains vulnerable to adverse market and political-economy pressures. So far Cyprus, Ireland, Portugal and Spain seem not to have succumbed to the Greek disaster, although the jury is still out also for these countries as well as for other member states, notably Italy and France. Therefore, even if macroeconomic stability was to substantially improve, the as yet incomplete recasting of the governance of EMU leaves it at risk without structural reforms.

One might ask what the implications were if a member state opted for not honouring its ‘constrained’ commitments to sufficiently reform and modernize its economy and society to be part of a dynamic economic and monetary union. That member state should assume the responsibility for its choice of following a different economic model and do so without putting at risk the Eurozone’s common good of monetary and financial stability and of other Eurozone members’ budgetary sustainability. That would imply leaving the Eurozone, but Euro exit is not foreseen in the Treaties; they allow for voluntary exit from the EU but not for Euro exit alone. The question then becomes whether there is any alternative to make EMU function regardless of a lack of member state progress on economic reform. It is possible but requires a monetary union that is no obstacle to an orderly restructuring of the sovereign debt of one of its members (see Philippon 2015 for a more complete proposal). It amounts to a credible non-bailout regime. There is also the possibility of a drastic form of banking
union à la Buiter (2015), which makes it possible to rescue the banks without rescuing the sovereign. The EU would thereby move towards US practice. In the above scenarios member states would be free to choose whether or not to comply with reform commitments. They alone would suffer the dire consequences (lower living standards and, most likely, a more unfair type of society) of their political choices (Giavazzi 2015; Phelps 2015).

In fact, the lack of ownership of economic reform by the national government in Greece has proven disastrous for the country and has carried a high cost for the other members of the Union (Bongardt and Torres, 2016). In the end Greece, or for that matter any other EU member state, has the choice between addressing structural reforms in order to move on to sustainable growth (and, therefore, to a fairer model of society) or be prepared to continuously deteriorate living standards and internal social cohesion and quality of life vis-à-vis its partners.

5. A Durable Exit from the Crisis: Sustainable Growth

Apart from EMU resilience, structural reforms are also important for higher potential growth (Draghi 2015 and 2016) and hence for dealing with legacy costs and with exit from the crisis. Still, whereas appropriate structural reforms are growth enhancing in the long run, they often fail to bring about immediate benefits (IMF 2015), while causing frictions at a high political cost when they collide with entrenched interest groups or affect vulnerable social groups. The common objectives put down in the Europe 2020 Strategy have, with the sovereign debt crisis, come to encompass increasingly salient political and distributional issues, not only in but also between member states. The enforcement, under market and peer pressure and conditionality, of objectives to which the member states already committed risks being perceived as intrusive as competencies have remained national.16

If one is concerned with long-term sustainability, a sustainable growth strategy with structural reforms at the national level is a pre-condition for a credible exit strategy

16 This is especially complicated when conditionality in adjustment countries coincides with EU institution building (Nicolaïdis and Watson 2016).
and a durable recovery. According to the ECB (2015), the smooth functioning of EMU warrants growth that is sustainable in the long run, which implies that any economic recovery from the crisis needs to be durable. Sustainable (not only economically but also environmentally) growth thereby offers both a crisis exit strategy and adds to the wider benefits from EU integration. As we suggested elsewhere (Begg et al. 2015), EMU can be sustained both in the more immediate crisis context and in the long run as part of a political sustainable integration project, which envisages high-quality growth and respects longer-term budgetary challenges.

Even on purely economic grounds, economic growth will not be sustainable – and any recovery not durable - unless environmental damages and resource depletion and long-term, inter-generational effects are internalized; nor would it be politically sustainable. Any general call for growth (‘whatever kind of growth’), and one which makes do with sustained rather than sustainable growth, ignores the economic case for environmental protection and with it environmental constraints on growth, let alone the EU’s commitment to a model of development with quality, sustainable growth and a moral obligation (towards the less well off and future generations) of dealing with climate change.18

The need for long-term sustainable growth for EMU sustainability first of all begs the question whether it is possible to promote sustainable growth within the crisis context given a one-fits-all monetary policy and budgetary constraints. As for monetary policy, it can smoothen cyclical shocks but it is unable to solve structural problems. The European Central Bank, to which the conduct of monetary policy has been delegated in the EU, has consistently stressed the importance of structural reform for EMU’s smooth functioning (see for instance ECB 2015).19 ECB actions (just like a more expansionary fiscal policy stance in the Eurozone) can only buy time for member states to address their structural

17 Sustainable development has been an objective of the EU for about three decades (the concept goes back to the so-called Brundtland report, World Commission on Environment and Development 1987). The 2009 Lisbon Treaty goes further, committing the EU to a high level of protection and improvement of the quality of the environment in the management of the single market (Art.3 (3) TEU).

18 In this respect, see the encyclical letter on the environment by Pope Francis (2015) and Stern (2015).

19 See Torres (2013) for an explanation of this ‘invasion of other policy domains’ by the ECB: it became a guardian of EMU given that the EU’s political system per se seemed incapable of providing timely and consistent solutions.
problems; they cannot solve them. Structural reforms are therefore a precondition for generating sustainable growth and for putting countries on a higher potential growth trajectory (ECB, 2015; Draghi, 2016).

As for budgetary constraints, one should note that a fiscal stimulus (even if feasible) is a crude instrument. As such it is unlikely to result per se in quality growth, unless it deals with the causes of competitiveness problems. Incentives for growth can be provided not only through the level but also and perhaps more importantly the composition of expenditure and incentives on the revenue side, notably taxation (Giavazzi and Wyplosz 2016; and Begg et al. 2015; Bongardt and Torres, 2016; Draghi, 2016).

6. Operationalizing Sustainable Growth

It is probably fair to say that the more immediate concerns with economic results somewhat eclipsed long-term sustainability concerns and their implications for future growth in the EU policy discussion (Bongardt and Torres 2013a). This was more the case after the crisis, when many economists and politicians proposed fiscal expansions, which risked perpetuating unsustainable consumption and production patterns. In our view, the need to stimulate domestic demand in surplus countries – which is not irrespective of the composition of expenditure and taxation, rather the opposite – goes hand-in-hand with the need to implement structural reforms in order to reduce built-up disequilibria in deficit countries. Structural reforms that modernize the economy are a precondition for a shift to sustainable growth.

The overall European objective of transforming its economy into a low-carbon green economy produces important economic benefits in the long run, but rather obviously the cost-benefit balance depends on how well it is implemented in the shorter term (Bongardt and Torres 2013b). Apart from the adequacy of policies and instruments, it will also be much conditioned by the characteristics of the EU Energy Union that is being created. In the crisis context, public opinion in Europe has been concerned first and foremost with dealing with the effects of the immediate economic crisis, although longer-term environmental concerns have for long and consistently been among European
citizens’ priorities. It is important to communicate that such a dichotomy is unfounded since addressing both can be mutually reinforcing with regard to economic and political resilience of the European project.

With regard to the political sustainability of structural reforms, sequencing ought to be a relevant concern: those reforms that are growth enhancing in the short run should be prioritized, and private investment encouraged in ways compatible with fiscal constraints. This will avoid that structural reform and austerity do not mingle in such a way that it may push countries into problems they did not have. As for sustainable growth, appropriate taxation and tighter regulation to promote green investments are a case in point (Pisani-Ferry 2014). The use of fiscal instruments opens up the perspective of promoting sustainable growth by shifting taxation onto inefficiencies (like pollution), away from taxing productive factors (such as labour). Taxes carry a double dividend, in that they provide receipts for the state and discourage inefficient behaviour. The abolition of incentive-distorting inefficient subsidies (negative taxes), like the ones on coal (IEA 2014), likewise reduces government expenditure and improves the state of the environment by lowering carbon emissions. Economic instruments (like taxes and transferable emission licences) have dynamic efficiency properties, promoting innovation, and provide least cost abatement of pollution; as such they are very much in tune with the Europe 2020 goals of (green) growth. In addition, regulation (market rules) can be used to foster private green investments without incurring fiscal expenditure. Demanding EU harmonized environmental regulation can provide a push for EU green innovation and cost-efficiency. For that it needs to be perceived as part of a sustainable growth strategy rather than as constituting red tape. The circular economy package is a case in point where demanding EU regulation can promote growth and employment.

20 Environmental protection and combatting climate change reflect European citizens’ values and priorities, as Eurobarometer surveys (http://ec.europa.eu/public_opinion/archives/eb/eb82/eb82_first_en.pdf) have consistently indicated.

21 We thank Paul De Grauwe for calling our attention to this point.

22 EU level fiscal instruments require unanimity in the Council of the EU. While member states can impose taxes or cut subsidies at the national level they will be reluctant to do so if that implies competitiveness disadvantages in the internal market.

23 EU environmental regulation provides for minimum standards with a view to avoiding a race to the bottom in member state regulation standards. Conversely, demanding EU harmonized environmental regulation can be used as an instrument to foster EU green innovation and cost-efficiency.
creation (EEA, 2015). Its success will be indicative for the EU’s resolve in implementing sustainable growth. The same can be said for the Commission’s European Fund for Strategic Investment, where much will depend on whether it will be oriented towards long-term sustainable growth.

**Conclusion**

This paper focuses on the need for national reforms. Their importance in the monetary union context derives on the one hand from market requisites for pushing EMU towards a sustainable currency area and on the other hand from institutional modernization being a pre-condition for promoting growth and hence a credible exit strategy from the crisis.

While ECB actions have been buying time they are no substitutes for either the EU completing the economic side of EMU or for member states to enact economic reforms. Monetary policy can smoothen cyclical shocks but it is unable to solve structural problems. It is member states that need to implement long-due structural reforms. In fact, ECB actions, with all their positive effects, even have the (negative) side effect to alleviate pressures for reform. Experience has shown the difficulties in implementing economic reforms without external pressure.

Furthermore, the relevance of economic reforms rises in a context where fiscal policy is also constrained by the need to ensure fiscal consolidation, as structural reform can increase the credibility of the adjustment programme whereby a more gradual fiscal adjustment can be achieved. Fiscal policy can also be used as a microeconomic policy tool in that, if properly employed, it can enhance (sustainable) growth even when public finances require consolidation.

It is true that structural reform has become also more politically charged. The reason is that economic reform became entangled with austerity in the public debate, particularly so in countries that underwent (or are still undergoing) adjustment programmes and did not use structural reforms to achieve a more gradual fiscal

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24 The circular economy package, aimed at making the European economy more resource-efficient by increasing recycling levels and tightening the rules on incineration and landfill, was withdrawn by the Juncker Commission in December 2014 amidst wide-ranging concerns and protests, among which EU environment ministers, MEPs, NGOs.
adjustment (clearly the case of Greece). What this increased politicization highlights is the need for creating ownership of reforms. Ownership of reforms can contribute to more sustainable and high quality growth that in turn also reduces the need for austerity. Without economic modernization countries will not prosper in an economic environment in which competitiveness factors changed significantly notably due to globalization, let alone be able to deal with crisis legacy costs.

Ownership and implementation of structural reforms are hence a precondition for generating sustainable growth and for putting countries on a higher potential growth trajectory. It will also increase the acceptance of economic reforms against the background of wider benefits from EU integration.

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