PISM | POLSKI INSTYTUT SPRAW MIĘDZYNARODOWYCH
THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

BULLETIN

No. 69 (522), 28 June 2013 © PISM

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EMU 2.0: On Standby Mode

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The June European Council summit did not produce any significant progress in constructing the "genuine economic and monetary union" called for by the president of the European Council, despite previous commitments. The relative calm on the bond market has given politicians breathing space ahead of the September elections to the German Bundestag. Yet, bleak macroeconomic data and the unstable political situation in the southern euro area are reminders that the bloc's problems are far from resolved. Poland should take advantage of the hiatus to build political support for what will be a hot autumn discussion.

The European Central Bank's September 2012 announcement of so called Outright Monetary Transactions, an intervention programme for use on the secondary bond market, considerably eased the political pressure on the euro area and has heralded a sustained period of calm. Today, the EU institutions are publicising the enlargement of the euro area in January 2014, presenting Latvia's accession as a sign of confidence in the euro. They also highlight that with the entry into force of the so called two-pack measures at the end of May, further coordination and discipline is being brought to euro-area fiscal governance.

Yet, the economic situation in the EU remains bleak. Inflation is dangerously low, unemployment is at a record high—excepting Germany and a handful of other EU members—and the prospects for the southern eurozone members to enjoy sustained improvement remain questionable. The pace of structural reforms in Cyprus, Greece, Italy, Portugal and Spain is unsatisfactory and will take years if not decades to gain traction. Above all, the eurozone economy has yet to signal a recovery: the Purchasing Managers' Index figures are still far below 50, indicating shrinking output. The calm in the euro area is thus nothing more than a pause ahead of Germany's September election.

Towards a Genuine Economic and Monetary Union. The relative calm is reflected in the slowdown of moves to "complete" EMU. In June 2012, Permanent President of the European Council Herman Van Rompuy announced the transformation of the Economic and Monetary Union into a "genuine" one. The debate picked up speed with the Commission's "Blueprint for a Deep and Genuine EMU" adopted on 28 November 2012, and the 5 December 2012 release of the document "Towards a Genuine EMU" from the presidents of the Commission, Parliament, European Council and European Central Bank. Since then, however, the proposals have become less ambitious and the time between them longer. The high unemployment rate among young people in Southern Europe has instead become a focus of voter attention for a Berlin reluctant to commit to any permanent fiscal transfer mechanisms during the electoral campaign. As a result, two major mechanisms—the banking union and the convergence and competitiveness instrument (CCI)—have become bogged down.

The banking union was the flagship project of EMU 2.0, aiming to break the vicious circle between sovereigns and banks. The concept has continued to be debated in the last couple of months, with agreement on the Single Supervisory Mechanism and recently, certain progress achieved on the rules for bank recovery and resolution. Yet, certain key elements have lagged. This relates especially to the common bank resolution fund. It would potentially lead to large fiscal transfers between eurozone members, a bone of contention in Germany. A joint Franco–German paper from 30 May did not bring any significant progress on this issue.

Aspects of the Convergence and Competitiveness Instrument, meanwhile, were presented in the Commission communication of 20 March 2013. This proposes "contractual agreements" between an individual Member State and the EU, combined with a solidarity mechanism (i.e., financial incentives). These agreements will be used to implement

the country-specific recommendations contained in the Commission's European Semester evaluations or in order to implement recommendations within the Macroeconomic Imbalance Procedure. Yet, Member States have failed to address key questions, such as whether only eurozone countries will be eligible or whether it will also include those willing to join the common currency. This is important because it will define the group of financial contributors to CCI. Besides the unresolved financing issue, there is a question about when the CCI would be triggered. It is also unclear to what extent an interested Member State (or indeed the other members of the European Council) may define its domestic reform agenda. And inevitably there is a question about how the relevant national parliament could be involved in negotiations. The European Council Summit of 27–28 June has focused on other more urgent issues, such as completing negotiations on the Multiannual Financial Framework 2014–2020.

Poland's Perspective. For Poland, the crucial issue is how those non-eurozone members willing to join the common currency will participate in these mechanisms. The Polish government would have something to gain from the resources included in the CCI, not least since it still needs to complete relevant domestic reforms. If the new CCI instrument is based on a separate eurozone budget, however, it might just as easily lead to the further fragmentation of the EU. In the case of a Banking Union, meanwhile, the most important question pertains to uncontrolled cross-border financial flows. After all, 60% of the Polish banking sector belongs to large banking groups based on it being a euro member candidate. If these banks are hit by the financial crisis, they may be tempted to withdraw assets from their subsidiaries in Poland. Thus the country has an interest in strict controls that apply throughout the EU.

More than this, of course, Poland has a clear interest in seeing that these mechanisms function effectively, since its capacity to influence the domestic affairs of eurozone members is very limited. Experience shows that the European Commission is reluctant to discipline the eurozone's fiscal laggards. The fiscal recommendations issued in the framework of the European semester, for instance, gave France, Spain, Slovenia, the Netherlands and Portugal more time to adjust their deficit levels. But there is another problem with the effectiveness of the EU tools: the debate on the structural reform process is often simplified to austerity vs. anti-austerity and ignores the larger regulatory and social context. Without liberating it from this narrow perspective, the design of the EMU architecture will simply be too imperfect.

These problems are intensified by the sheer quantity of eurozone measures, something which both diminishes their effectiveness and makes it harder for Poland to join the bloc. The relative calm of the current period has given time for taking stock of the situation, and it is clear that the EU has undertaken numerous economic-coordination reforms, including the introduction of the European Semester, the six-pack, two-pack, Euro-plus Pact and the Treaty on Stability, Coordination and Governance of the Economic and Monetary Union (or fiscal compact). The regulation concerning the new EU Multiannual Financial Framework 2014–2020 will also include a macroeconomic conditionality mechanism permitting the possible suspension of certain payments in case a country falls short of proper macroeconomic policy. This instrument may generate a strong discipline effect, even stronger than the CCI incentive. It all raises questions about the duplication of measures.

Conclusions and Recommendations. If Poland's overriding strategic goal is to make the new projects in the euro area accessible for non-eurozone states, and thereby ensure their effectiveness and coherence, it has been quite successful so far. The provisions of the 2012 fiscal compact, for instance, guarantee it access to euro area summits. Yet, in the longer term, Poland may encounter greater difficulties if it pursues its economic and political interests from outside the euro area. There are still questions about how well the Polish economy would perform in the euro area, and neither the situation in the euro area nor national politics in Poland is favourable for creating a clear and viable path to the euro. Sooner or later this dilemma will have to be resolved.

Strengthening the fundamentals of its economic competitiveness should thus be at the top of Poland's agenda, otherwise the entry to the eurozone may be a poison pill. Thus, the Council's recent draft economic recommendations in the framework of the European Semester should be analysed and implemented with great attention. Moreover, Poland's plan for reforming several areas that influence the economy, such as education, the labour market, better regulation, industrial policy and others, should be achieved independently of even the European Semester. Without thorough reforms, joining the euro would not only be an uphill task, it would considerably reduce Poland's political influence.

In the meantime, EMU 2.0 will have to wait until the results of the German elections. But the relative calm it already is providing gives Warsaw an opportunity to secure broader support from the other Member States. In the EMU 2.0 talks, Poland should underline the broader context of structural reforms, going far beyond the shallow austerity vs. anti-austerity debate. It should include a pro-growth focus, especially on SMEs, which produce a large part of the EU's GDP and which are a key growth engine in Poland (they produce 71% of GDP). That is why Poland should underline that not only is planning of the EMU architecture important but also its successful implementation. Poland should also insist on making existing mechanisms more effective so they operate fully without exceptions before new ones are introduced. This solution requires increasing the role of the European Commission as a guardian of the new rules. Poland should also oppose creating mechanisms that duplicate existing ones.