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Eurozone Quest for Sustainability:

The Central European Perspective

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CONTENTS

ARTICLES

functions of institutions and the preservation of financial stability." It can also threaten confidence in the European financial markets and financial players, which in turn could bring unintended consequences for economic growth. From political and economic points of view, such a situation could no longer be accepted. Therefore, politicians and economists, having been accused of doing nothing by European taxpayers bearing the huge costs of numerous rescue packages granted to failing banks, had to find a solution.

REVIEWS

PAWEŁ TOKARSKI

The Challenge of Eurozone Reforms in a Time of Uncertain Economic Prospects

The autumn 2014 brings widespread fear that the crisis in the eurozone may reescalate. A truism is to say that its main drawbacks have not been solved. The problems with the banking sector in the EU are far from solved and the need to clean up bank balance sheets. The necessary process of private sector deleveraging will continue to have an adverse effect on economic activity. The public finances of several eurozone economies are in poor condition. In three out of four of the largest eurozone economies, the general government gross debt-to-GDP ratio is increasing. Several Member States still face considerable structural challenges and the sustainability of economic models will have to be reconsidered, not only in countries such as Greece, Cyprus, Spain, Italy or France but also in Finland. After Standard & Poor's stripped Finland of its triple "A" rating in October 2014, the only members of this exclusive club in the eurozone remained Germany and Luxembourg.

The lack of growth and cuts in public spending have resulted in a difficult social situation in several southern eurozone members. On the other hand, the picture is not one-sided. Countries such as Spain, Portugal, and especially Ireland, that applied difficult austerity measures have started showing positive effects of the reforms.[1] The light at the end of the tunnel also can be seen in Greece, although the scale of challenges it is facing is still enormous and there are fears the country may backtrack on the reforms

1 European Commission, "Market Reforms at Work in Italy, Spain, Portugal and Greece," *European Economy*, May 2014; see also the reviews of economic adjustment programmes and post-programme surveillance reports for these countries prepared by the EC's DG Ecofin, available at ec.europa.eu/economy_finance/assistance_eu_ms/index_en.htm.

when it exits the financial assistance package from the European Union and International Monetary Fund.

The EU economies are also exposed to external risks: the war in eastern Ukraine, EU–Russia economic relations, the fragility of the BRIC(S) economies, and expansion of the Islamic State in the Middle East are not creating a friendly environment for the eurozone recovery. Several indicators portray worsening confidence in the European economies. For example, the Economic Sentiment Indicator, managed by the European Commission (EC), shows a decrease in economic sentiment in both the EU and the eurozone itself, influenced mostly by the opinions of consumers and those in the retail trade sector.[2] The Markit Eurozone PMI® Composite Output Index published on 3 October shows slowing growth in the eurozone. This indicator fell to 52.0, a 10-month low in September 2014.[3] It is difficult to say how long this trend is likely to continue. As a result, growth forecasts were revised downwards. The OECD in September 2014 in its Interim Economic Assessment cut its own growth projections for the eurozone for 2014 and 2015 to 0.8% and 1.1%, respectively.[4] Similarly, the International Monetary Fund (IMF) in its World Economic Outlook from early October 2014 did the same. The IMF experts are more optimistic concerning economic growth prospects in the eurozone in 2015. They assume that the EU-19 output will grow by 1.3% compared to 2014.[5] It is likely that these forecasts will be revised downwards. The slower-than-predicted economic recovery will further weaken the fragile political landscapes of the southern eurozone members. The first confidence test for international investors will be the much anticipated parliamentary elections in Greece, very likely to take place in 2015 and which probably will be won by eurosceptic party SYRIZA. An increase in the eurosceptic movement is also expected in France, where Marine Le Pen is likely to win the first round of the presidential vote in 2017.

Mounting economic and social challenges in several eurozone countries have a direct influence on the new EU institutional cycle. The sound victory

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2 European Commission, "Business and Consumer Survey Results," Business and Consumer Surveys, Economic and Financial Affairs, Brussels, September 2014, ec.europa.eu/economy_finance/db_indicators/surveys/index_en.htm.

3 Markit, "Eurozone growth wanes as downturns in France and Italy continue," Markit Eurozone Composite PMI®-final data news release, 3 October 2014, markiteconomics.com.

4 OECD, "Interim Economic Assessment," 15 September 2014.

5 International Monetary Fund, "World Economic Outlook: Legacies, Clouds, Uncertainties," Washington D.C., October 2014.

of Matteo Renzi in the May 2014 election and Italian presidency of the EU Council gave a large boost to the anti-austerity camp led by Paris and Rome. Its demands include more flexibility in the Stability and Growth Pact rules concerning the general government deficit deadline; exclusion of pro-growth investments from the deficit calculation; a looser monetary policy by the European Central Bank (ECB); a new, large EU investment programme; more public investment in Germany to support growth in the eurozone; and, more EU intervention in national job markets. Many of these demands are supported by top European and U.S. economists, including Nobel Prize winners.[6] These voices are counterbalanced by Berlin's firm stance that eurozone governments should implement promised structural reforms and continue fiscal consolidation. After Manuel Valls' first official visit to Berlin on 22 September 2014, the French prime minister has little doubt that there will be concessions from German Chancellor Angela Merkel, who declared that the Stability and Growth Pact has enough room for flexibility and that Germany will support the EC in its judgment of whether to extend the deficit deadline for France.[7] The European Commission and the Member States will be forced to square the circle: keep eurozone fiscal rules credible without pushing France too much, which is in the midst of a difficult internal political situation.[8] The necessity of structural reform of the southern eurozone states is a common narrative in public discussions in Germany. There are many voices concerned that looser monetary policy and expansion of the ECB balance sheet would be a risky experiment with potential negative side effects and may not necessarily result in supporting economic growth but rather discourage the implementation of structural reforms in those countries.[9] These views also are shared by some other northern eurozone countries.[10]

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6 "La politique de l'Allemagne aggrave la crise," *Le Monde*, 22 August 2014; P. Krugman, "Europanic 2.0," *The Conscience of Liberal*, 11 October 2014, http://krugman.blogs.nytimes.com/2014/10/11/europanic-2-0/; J. Stiglitz, "Deutschland wird einen hohen Preis zahlen," *Handelsblatt*, 7 October 2014.

7 "Merkel empfängt Valls in Berlin. Herausforderungen gemeinsam bewältigen," 22 September 2014, bundesregierung.de.

8 "Le casse-tête des procédures budgétaires européennes," *Le Monde*, 14 October 2014.

9 J. Stark, "What Is Driving ECB Monetary Policy?," *World Economic Forum*, 6 October 2014, forumblog.org/2014/10/ecb-eurozone-monetary-policy-structural-reform; see also: H.W. Sinn, "Merkel Has a Duty to Stop Draghi's Illegal Fiscal Meddling," *Financial Times,* 1 October 2014.

10 A. van Riemsdijk, "Dutch Central Bank Warns ECB over Policy Risks," *The Wall Street Journal,* 7 October 2014.

The record low yields on the eurozone government bonds of southern members have given some breathing space to discuss the present state and future of economic integration in the EU. This is the effect of what ECB President Mario Draghi declared, saying within its mandate "the ECB is ready to do whatever it takes to preserve the euro."[11] However, there are signs that the volatility could return to the bond markets. Therefore, it is high time to reconsider the current model of EU economic integration and to discuss possible next steps. In recent months, several proposals concerning the possibility of eurozone reconstruction have been put forward by the Glienicker Gruppe and Eiffel Group, and more recently a federal vision was delivered by Notre Europe.[12] In December 2012, European Council President Herman van Rompuy, in cooperation with the three other presidents (of the EC, ECB, and European Parliament) published a plan for the further integration of the eurozone.[13] The roadmap was based on the "Blueprint of the European Commission" published a couple of days earlier. The EC judged that deeper economic and fiscal integration will require amendments to EU treaties. However, it seems that this plan could be risky due to the political situation in the largest eurozone members. The electoral calendar in France and Germany gives the impression that it is difficult to expect any substantial EU treaty amendments during the current institutional cycle in Brussels. Any significant EU treaty changes would trigger a referendum in France, which would most certainly lead to a "no" vote due to the extremely low confidence in President François Hollande among French society. Therefore, it looks reasonable to expect that for more significant Economic and Monetary Union (EMU) reforms one will have to wait until there is a new resident at Elyseé, though not until the elections in May 2017. Berlin seems also reluctant to open a difficult institutional dossier before Germany's federal elections in the second half of 2017, despite pressure from the United Kingdom.

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[11] Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London, 26 July 2012, www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html.

[12] Glienicker Gruppe, "Towards a Euro Union," www.glienickergruppe.de/english.html; Groupe Eiffel Europe, "Pour une communauté politique de l'euro," www.groupe-eiffel.eu/pour-une-communaute-politique-de-leuro; Y. Bertoncini, A. Vitorino, "Réformer la 'gouvernance' européenne. Pour une fédération d'états nations. Plus légitime et plus efficace," Notre Europe, September 2014, www.notre-europe.eu/media/reformergouvernanceue-bertoncini-vitorino-ne-ijd-sept14.pdf?pdf=ok.

[13] H. van Rompuy, "Towards a Genuine Economic and Monetary Union," 5 December 2012.

There might have been an impression that the Central and Eastern European (CEE) members have not been sufficiently heard in this debate over possible reforms of the eurozone. The CEE Member States not only have experts on the EMU but also the full right to actively take part in the EU-wide debate about the future shape of it. The recent proposal by Poland's minister of finance, Mateusz Szczurek, to create an EU-wide fund to support investment, which he relayed in Brussels in September 2014, is a good example of how to influence the discussion over the future of EMU.[14] This investment instrument, according to the proposal, would be based on the European Stability Mechanism's architecture, so it would not put an additional burden on national public finances. The member countries would have to contribute with paid-in capital and guarantees. Although the proposal is for now rather unlikely to have broader support, it was quoted by some of the most influential media in the EU.[15] Another initiative worth mentioning is the letter "Central Europe for the new EU agenda," issued after Reflection Group meetings organised by Demos Europa and the Central European Policy Institute. The letter put a strong emphasis on deepening of the internal market, which is missing in the current discussions about the future directions of the economic integration of the EU.[16] However, a strong voice from the CEE on eurozone reforms, comparable to the Glienicker Gruppe's declaration, is still lacking.

The appointment of Donald Tusk, the now former prime minister of Poland, to the post of Permanent President of the European Council offers the opportunity for eurozone and non-eurozone countries to reconcile their interests. However, the European Council presidency is a post that requires a concrete vision of European integration, a vision which can be supported not only by experts from national central banks and finance ministries but also first and foremost from civil society representatives, think tanks and academia. It is obvious that research institutions in the CEE still have a long path to traverse to start enjoying the position and influence of their Western

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14 M. Szczurek, "'Quantifying the macroeconomic impact of the European fund for investments', an analytical note to accompany Minister Mateusz Szczurek's keynote address Bruegel Institute's 2014 Annual Meeting," 5 September 2014, www.bruegel.org/nc/blog/detail/article/1428-quantifying-the-macroeconomic-impact-of-the-european-fund-for-investments.

15 H. Foy, "Poland Calls for €700bn EU Spending Round," *Financial Times*, 11 September 2014; "Investir pour maintenir la paix en Europe," *Les Echos*, 1 October 2014.

16 Demos Europa, Central European Policy Institute, "Central Europe for the new EU agenda," 22 September 2014, demoseuropa.eu.

European counterparts. However, this is changing, and more and more CEE experts and institutions have become involved in the dialogue and common project with the most prestigious of their kind in the world. The participation of the Polish Institute of International Affairs (PISM) in the consortium of the "7th Framework Project: Macro-Risk Assessment and Stabilisation Policies with New Early Warning Signals (RASTANEWS)" is a very good opportunity to continue quality and policy-oriented research in cooperation with leading academic institutions and think tanks. This scientific consortium has already issued several deliverables on EU and eurozone economic governance, mapping its blind spots and suggesting possible changes.[17] PISM is directly involved in research on EU/eurozone governance reforms and eurozone enlargement.[18]

This special issue of the *Polish Quarterly of International Affairs*, focused on the EU Economic and Monetary Union, gives another chance to give voice to experts with a CEE perspective and who are specialised in research on these subjects. In this volume, there is not the intention to present any large, comprehensive vision of eurozone reconstruction. Instead, a more general proposal will be delivered at the end of the RASTANEWS project, taking into account the research conducted under all of the Work Packages. Therefore, the authors here enjoyed the liberty to concentrate on areas of specialisation and the opportunity to deliver their own assessments of recent changes in the EMU's architecture and functioning.

In This Issue

This volume contains seven contributions by experts from Belgium, Germany, Hungary, Poland, and Slovakia, all of whom write from a Central and Eastern European perspective or analyse EMU issues that are crucial from the perspective of the region. As a result, the thematic scope of the articles is wide, but there is a strong common denominator. Several contributions overlap with analyses of similar issues from different research angles. **Oliver**

[17] F. Bruni, "Bringing Money Back to the Real Economy," ISPI, Milan, 2013, www.ispionline.it/it/pubblicazione/bringing-money-back-real-economy; F. Passarelli, A. Villafranca, "Eurozone Flaws: Uncovering the Holes in the Cheese," ISPI, Milan, 2013, www.ispionline.it/ sites/default/files/pubblicazioni/passarelli_villafranca_t4_0.pdf.

[18] A. Gostyńska, P. Tokarski, P. Toporowski, D. Wnukowski (eds.), *Eurozone Enlargement in Times of Crisis: Challenges for the V4 Countries*, Polish Institute of International Affairs, Warsaw, 2014; *Membership in the Reforming Euro Area: a Central-Eastern European Perspective*, PISM Report, Warsaw, August 2013.

Kovács, research fellow at ICEG European Center, analyses one of the most important challenges for the CEE countries, which is eurozone accession, focusing on the case of Hungary. He delivers an extensive analysis of the macroeconomic situation in the country, though without limiting himself to this perspective. He gives some interesting comments on global governance challenges and underlines that the quality of national governance plays a key role in ensuring the long-term economic sustainability of a country. In his analysis, Kovács puts strong emphasis on sufficient preparation for eurozone membership.

Jolanta Zombirt, professor at Jagiellonian University in Kraków, is known in Poland for her original research and critical approach towards EU economic governance, especially concerning the financial sector.[19] In her article, she focuses on one of the most recent and frequently elaborated subjects in the last couple of months: the EU banking union. She claims that the entire project has been watered down due to different political pressures. As a result, there are significant doubts about its sustainability. Zombirt states that supervision based on national resolution authorities may prove difficult or effective. What's more, there is still a strong and unspecified national component, namely the role of the EU Council, which will be involved in bank resolution decision-making. Zombirt also raises the very important question of the insufficient size of the Single Resolution Fund, which will gradually be built up from Member State contributions over eight years and the lack of a common system of deposit guaranties. As a result, according to Zombirt, the entire system of bank supervision, restructurisation and resolution is "slightly more than just a demonstration, with the aim to calm down European citizens."

Endre Domonkos, professor at Budapest Business School, continues the topic in a different context by presenting in detail the Hungarian position towards the banking union in the context of eurozone accession. The Hungarian objections are similar to the other CEE countries that are not participating in the third stage of the EMU. These concerns refer to especially the equal treatment of countries outside the eurozone in decision-making, home-host relations, and the competitive position of domestic credit institutions on the

[19] J. Zombirt has authored various publications, including the most comprehensive textbook in Polish on EU economic integration, with a special emphasis on the EU single market. See: J. Zombirt, *Mechanizmy rynku wewnętrznego Unii Europejskiej*, Difin, Warszawa, 2011.

EU single market. Therefore, the decision to take part or not in the Single Supervisory Mechanism will be far from easy. Without surprise, Domonkos dispels hopes for Hungary's possible eurozone accession in the near future.

Those who know that participation in the EMU's third stage brings with it not only concrete political and economic benefits but also common financial liabilities will definitely find interest in reading the contribution by **Jozef Stískala**, an expert from Slovakia working in the financial sector. He reminds the reader that "the currency union stands and falls on the flows of payments," so a problem on the interbank market can endanger the sustainability of the common currency. Stískala analyses the decentralised structure of the Eurosystem in comparison to the Federal Reserve and puts an emphasis on the importance of uninterrupted capital flows in the TARGET 2 system as a key factor for the future of the single currency.

Some issues of EU economic governance are literally absent in the public discussions in the CEE countries. One of them is macroeconomic conditionality in cohesion policy. Therefore, the current issue of the *Polish Quarterly of International Affairs* includes a contribution by a leading expert on EU economic governance, **Stijn Verhelst**, the author of numerous publications on the subject.[20] His article analyses the final compromise on macroeconomic conditionality in cohesion policy adopted in the new package under the EU Multiannual Financial Framework 2014–2020. The issue concerns linking the spending of five EU structural and investment funds with the conduct of the required macroeconomic policy. For instance, when a Member State fails to take action to address macroeconomic imbalances, the EC, after approval by the Council, can suspend part of the EU's commitments or payments to a Member State. Therefore, the issue is of key importance for economic policymakers in the CEE, as Member States from the region receive a substantial amount of cohesion funding. Verhelst, in his article, questions to what extent macroeconomic conditionality, after amendments introduced by the European Parliament, is relevant to the new EU Multiannual Financial Framework 2014–2020. The article is an insightful contribution to the general discussion of how to give economic governance

[20] Among others: S. Verhelst, *A Eurozone Subcommittee in the European Parliament: High Hopes, Low Results?*, Policy Brief No. 31, Egmont–Royal Institute for International Relations, July 2014; S. Verhelst, "Macro-Economic Conditionalities in Cohesion Policy," European Parliament, December 2012; S. Verhelst, *The Reform of European Economic Governance: Towards a Sustainable Monetary Union?*, Egmont–Royal Institute for International Relations, June 2011.