CENTRE FOR EUROPEAN REFORM

Insight

Macron's plans for the euro

by Charles Grant

23 February 2018

Decision-makers in Paris sense a golden opportunity to reform the eurozone. They are optimistic that, notwithstanding political uncertainty in Germany, some key reforms can begin this year.

When Emmanuel Macron was François Hollande's economic adviser, and later his minister for economy, he had strong views on the reforms required for the eurozone to flourish. He called for elements of a transfer union, risk-sharing and demand management at eurozone level.

He has not changed his mind and believes that the time is propitious for reform: eurozone economies are growing nicely; no major country (Italy excepted) faces an election in the near future; he retains his aura of success; and Angela Merkel remains a sympathetic and (at least for now) fairly authoritative figure in Berlin.

Assuming that Germany has a government soon, the French hope for a Franco-German letter in March. That would lead to the Euro Group (the eurozone finance ministers) drawing up a roadmap for reform in June. Stage one would involve the completion of the banking union and get underway this year. Later stages, requiring more time, would deal with the transformation of the European Stability Mechanism (ESM), a bail-out fund, into a European Monetary Fund (EMF), the establishment of a eurozone budget and institutional reforms such as the creation of a eurozone finance minister. Several French officials compare this roadmap to the 1989 'Delors Plan' with its three-stage progression to economic and monetary union.

Evidently, none of this can happen without the accord of Germany, which has very different views on the economics of the euro. Backed by countries like Austria, Finland and the Netherlands, Germany opposes the mutualisation of eurozone sovereign debts and any kind of transfer union. It wants stricter compliance with budgetary rules and argues that countries should not be bailed out unless holders of their sovereign bonds take losses; then markets would be a more effective constraint on profligate sovereigns.

Policy-makers in Paris are not naïve about what the Germans will sign up to. They like the rather 'French' tone of the Christian Democrat-Social Democrat coalition agreement, which calls for an EMF "anchored in EU law" and holds out the prospect of "a future investment budget for the eurozone". But they know that German hostility to French and Keynesian thinking on the eurozone is undiminished. Intellectually, Germany's leaders do not accept that their policies have been erroneous over the past ten years. The coalition agreement does not signal that the German public has suddenly becoming more 'European' and sympathetic to eurozone-wide demand management through fiscal policy.

Yet there is real optimism in Paris about the prospects for eurozone reform. Officials know that Macron's reforms within France are earning respect in Germany; Merkel and her colleagues think they need to give him something. If the grand coalition takes office, the presence of Social Democrats in the government, and in particular, in the finance ministry, would be good news for Macron, since they are somewhat sympathetic to his thinking. Wolfgang Schäuble, the Christian Democrat finance minister until September, was implacably opposed to French ideas. Nevertheless France knows that it cannot ask for too much, too quickly, and will not push for a transfer union or 'eurobonds' (the mutualisation of debt) in the foreseeable future.

The French hope for an agreement to complete the banking union this year. They want the ESM to be able to provide liquidity to the eurozone's under-powered Single Resolution Fund (which helps to resolve banks in difficulty) – thus achieving 'a bigger backstop'. The French think the Germans will agree, as long as they retain a veto over the use of the ESM.

Paris also thinks Berlin will accept an EU-wide deposit insurance scheme. But Germany and its allies say their price is 'risk-reduction', meaning steps to reduce banks' non-performing loans (a particular problem in Italy), as well as the piles of sovereign bonds that some banks (notably those in Italy) hold without setting aside capital.

The French, like the Italians, oppose paying such a price, believing that the German prescriptions could destabilise many banks and thus the markets. The French also argue that rules curbing banks' holdings of their own sovereign's debt could prevent the ECB stepping in to save the euro in a crisis, as it did when it lent to banks in Italy and other troubled countries so that they could buy their governments' bonds. Some leading French economists (though fewer officials) argue that the corollary of reducing bank holdings of their own sovereign's bonds should be the creation of a 'European safe asset'.

The European Systemic Risk Board has proposed a scheme for safe assets. Existing sovereign bonds could be bought up by the ESM, then repackaged into two sets of security – 'senior' bonds, with a high credit rating, and 'junior' bonds, which would pay higher yields to investors, who would have to bear the risk of losses. Thus banks would have access to a safe asset, with the risk spread across different countries. But the Italians resist this idea, since the country's banks would have to hold lower-yielding safe bonds rather than Italian debt, which might damage their profitability. And, unless a very large proportion of Italy's debt were included in the safe asset scheme, it could find itself having to pay more to borrow.

Also this year, the French want progress on the EU's planned capital markets union. This would help to spread risk across the eurozone, since investment in securities tends to be more cross-border than bank lending. A capital markets union would also help channel investment funds from surplus countries like Germany to targets that need capital, such as the digital single market, green projects and SMEs. The French think that Bundesbank president Jens Weidmann will be supportive.

On the longer-term issues, the French are far apart from Germany on the design of the European Monetary Fund that would emerge from the ESM. They dislike the German idea that it should lend to sovereigns in return for bond-holders being made to take losses, believing that this would spook the markets.

France sees the EMF as playing a different role to that of the eurozone budget. The former would lend to countries that needed bailing out, or ex ante to help prevent a crisis. Some of the French are less keen on the German idea of an EMF than their idea of a eurozone budget, fearing that the former could become a vehicle for the imposition of Germanic austerity. But they are open to the EMF playing a bigger role in bail-outs than the current ESM. They think it should replace the IMF's role in crisis management in the eurozone, notably in designing programmes.

The budget, by contrast, would give money rather than lend. Some senior French officials think Macron has overdone his plan for a eurozone budget, since it has provoked German fears of a transfer union. To reassure the Germans, officials stress that the eurozone budget should not be a transfer mechanism or redistributive. It should provide common goods at federal level, with all countries contributing and benefiting. But the French know that Germany will not agree to the budget without a lot of persuading.

Merkel and other German leaders have accepted the concept of a 'eurozone investment capacity', to boost economic convergence and to promote innovation; it is harder for them to accept a budget that also stabilises macro-economic shocks, that is to say provides hand-outs to help prevent or resolve a crisis. Seeing national reform as the answer to many economic problems, the Germans are not convinced of the need for EU-level stabilisation instruments.

The French Trésor has concocted a formula for financing the budget, via a contribution from corporate taxes; thus countries in difficulty would pay less into the budget. The budget could also be funded via debt issuance. One top official says the budget should be 1 per cent of eurozone GDP – big enough to make a difference (Macron has said "several per cent"). Germany opposes the idea of bond issuance at eurozone level – and at least for now, is unlikely to accept anything other than a small eurozone budget.

The French know that their idea of a eurozone finance minister – merging the roles carried out by the president of the Euro Group and the commissioner for the eurozone – is unpopular in many places, and not only in Berlin. So they describe the institutional aspects of eurozone reform, including a formation of the European Parliament to hold that minister to account, as the "end of the process". There is a philosophical difference: Macron sees the need for accountability at eurozone level, but Germany focuses on the Bundestag (the lower chamber of the German parliament). French officials expect a compromise involving both national and EU-level accountability.

The French have a generally favourable view of the Juncker Commission because they think that, compared to its predecessor, it is more political, willing to listen to the member-states, 'balanced' on trade questions, reluctant to legislate and concerned about better regulation. "Juncker has more political sense," says a French official.

And on eurozone governance, France is closer to the Commission's *communautaire* thinking than Berlin's inter-governmentalism. Some French officials dislike German ideas for excluding the Commission from budgetary surveillance, via an enhanced role for the ESM or the future EMF (although the coalition agreement talks of embedding the EMF in EU treaties, a senior German official sees little chance of the Bundestag allowing Brussels institutions to run that body). However, the French do not like the Commission's idea that it should manage a new eurozone budget; EU processes are too slow to allow a rapid response in a crisis, they think.

Bridging the gap between Paris and Berlin will be extremely hard. In an effort to help, 14 eminent French and German economists recently proposed a series of incremental reforms on eurozone governance. They seek to balance a moderate return to the Maastricht treaty's no-bail out principle, and the possibility of restructuring debt, with modest elements of risk-sharing and transfers. But this report has not gone down well with officials in Paris. In particular, the argument that in bail-outs, holders of sovereign bonds should lose money simply shows, say officials, that "academic economists don't get markets". They fear that talk of write-offs would turn a liquidity problem into a solvency problem.

The report does not say enough about a eurozone budget to keep Macron's team happy. Furthermore, the proposal to replace the 3 per cent of GDP fiscal rule with a new metric based on the quantity of debt and its relation to nominal GDP would not work, they say; though an attractive idea, now is the wrong time to reopen the debates around the stability and growth pact – and risk scaring the Germans. Nor do officials enthuse about the suggestion for new bonds to be issued as eurozone safe assets – they worry that the Germans and Italians, and perhaps the financial markets, would be opposed.

Macron's officials are aware that the bigger changes they hope for, on the eurozone budget and new institutions, must await the European Parliament and Commission that will take office in 2019. They understand that a Franco-German bargain will not suffice to bring along the entire eurozone. Macron will also need a sympathetic Commission, which is why the European elections matter.

Like Merkel, Macron dislikes the *Spitzenkandidaten* system, whereby the candidate nominated by the largest party group in the European Parliament becomes Commission president. It is a system that may encourage politicians who are not of the highest rank to put their names forward. In fact Macron has a good relationship with the winner of the 2014 contest, Commission President Jean-Claude Juncker. But a second round of *Spitzenkandidaten* would probably ensure another victory for the centre-right European People's Party (EPP).

Macron has plans for a new centrist force in the Parliament, building on the ALDE liberal group and taking in parties like Ciudadanos in Spain, the Democratic Party in Italy, D66 in the Netherlands and many other MEPs who currently sit with the EPP or the Socialists. However, given the support of the Parliament, the Commission and the main European political parties for *Spitzenkandidaten*, Macron knows that he may have to accept the system. He may hope that it could be modified so that the candidate who gains the most votes from MEPs wins, rather than the candidate of the party with the most MEPs.

Although Macron's self-confidence is limitless, he will be hard pressed to bend the Brussels institutions and the 18 other euro governments to his will on eurozone reform. It may not help that he and Merkel are likely to lead competing camps in the European elections. But if he can deploy his considerable charm and powers of persuasion on the Germans, he will achieve some reform.

Charles Grant is director of the Centre for European Reform.