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Is Renewed EU Optimism Justified?

In the mid-1990s, it is alleged, British Prime Minister John Major asked Russian President Boris Yeltsin to describe the state of the Russian economy in one word. “Good,” Yeltsin responded. Seeking greater detail, Major asked Yeltsin to describe it in two words. “Not good,” Yeltsin replied.

This apocryphal tale could equally well describe the European Union in 2018, perhaps substituting Donald Trump for Major and Jean-Claude Juncker for Yeltsin, though one might question whether Trump possesses the intellectual curiosity to ask the question or whether Juncker has the candor to answer it. The good news is that the economy is growing again, by 2.3% in 2017 and an anticipated 2.1% in 2018. Unemployment, that most corrosive of social maladies, is falling. The EU, including now even Italy, has put the worst of its banking problems behind it. Tier 1 capital is 14%, up from just nine per cent as recently as 2012, and behemoths like Deutsche Bank are downsizing to better meet the needs of the 21st century. The Single Supervisory Mechanism, intended to prevent similar banking problems from recurring, is making significant progress – something that will become easier with Brexit, more on which below. Asylum applications in the EU28 fell by 55% in the third quarter of 2017 compared with the same quarter in 2016. They are down to levels comparable to those of 2014, just prior to the refugee crisis.

While Brexit-related uncertainty is likely to seriously damage the British economy, the process amounts to little more than a sideshow for the rest of the EU. If anything, the troubled course of Brexit negotiations has strengthened solidarity among other EU member states and served as a caution to additional countries – can you say Poland? – that otherwise might have pondered going down that road.

The other good political news is that far-right populist parties suffered decisive defeats in last year’s Dutch and French elections. Stronger economic growth solidified support for centrist politicians and parties, while dynamic new candidates such as Emmanuel Macron successfully projected an image of hope and competence. Elsewhere, political trends were more mixed. In Germany, the stridently anti-Muslim *Alternative für Deutschland* achieved disturbingly large electoral gains, while in Austria the far-right Freedom Party became a partner in the newly formed governing coalition. That said, it is clear that any new German government will be pro-European. And as a condition for the formation of the Austrian government, President Alexander Van der Bellen required all members, including the Freedom Party, to affirm their commitment to the European Union and its *acquis communautaire*.

But there is also a long list of entries in the “not good” column. The refugee problem remains fundamentally unsolved. The conditions in Syria and Afghanistan causing refugees to flee remain unattended, and Europe’s protection from the flow depends on the willingness of Turkey’s President Recep Erdogan, not the most reliable of partners, to bottle them up. Agreement on how to share the burden of refugee settlement, whether according to the Dublin mechanism or some other formula, is no closer now than at the height of the crisis. This disagreement could result in a serious rupture were Erdogan to open the floodgates. In any case, relying on Erdogan to house asylum seekers in camps is a strategy that reflective Europeans should see as morally reprehensible. One way or another, 2018 is likely to be the year when the refugee problem returns to the forefront.

On the macroeconomic front, Europe’s continued success depends on factors fundamentally beyond its control. President Trump could start a trade war or, worse, a shooting war with North Korea. Chinese growth could slow. Financial markets could react negatively to the Fed’s campaign to normalize interest rates. The risks to European growth are, as forecasters like to say, on the downside.

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A final negative is the unresolved eurozone conundrum. The euro's institutional architecture remains incomplete, and there is no agreement on how to complete it. President Macron's vision is a dedicated eurozone budget to support the maintenance of investment through transfers to countries experiencing temporary increases in unemployment. This budget would be overseen by a eurozone finance minister accountable to members of the European Parliament representing euro area countries. This eurozone budget, finance minister and assembly would all function separately from larger EU structures.

Martin Schulz notwithstanding, Macron's vision is anathema to most German leaders, for whom it smacks of the dreaded "transfer union." They reject the idea of a eurozone budget, oppose the appointment of a European finance minister and argue that what member states need is more fiscal discipline, not fiscal flexibility. Accordingly, they advocate transforming the European Stability Mechanism (ESM), the emergency agency created at the height of the euro crisis, into a European Monetary Fund (EMF) which would be responsible for enforcing Europe's fiscal rules and whose lending would be subject to the strictest conditionality, including the requirement that troubled countries reschedule or restructure their debts. The EMF would take decisions by supermajority vote while still preserving for its large shareholders, notably Germany, de facto veto power.

Finally, there is the roadmap for eurozone reform issued by the European Commission last December. This, unsurprisingly, takes an all-of-the-above approach. The Commission proposes to transform the ESM into an EMF authorized to lend to member states, but not obviously subject to the strict conditionality insisted on by Germany. The Commission proposes creating a European finance minister (more precisely, a European Minister of Economy and Finance) à la Macron, but under its proposal this official would serve simultaneously as vice president of the Commission and chair of the Eurogroup of finance ministers. To simulate the functions of a dedicated eurozone budget without raising German hackles, it would establish a cosmetically named "stabilization tool" to provide temporary transfers, but only to troubled countries otherwise following sound policies. This would be funded through a combination of the existing EU budget and the resources, both capital and borrowings, of the EMF.

The Commission also proposes to formally integrate the Fiscal Compact, adopted in 2012 to strengthen budgetary rigor, with the latest version of the Stability and Growth Pact, which was reformed to enhance fiscal flexibility. Not for the first time is the Commission speaking out of both sides of its mouth, seeking to appeal simultaneously to Germany and France and, more generally, to Northern and Southern Europe.

This is, to summarize the situation dispassionately, a god-awful mess. There is no agreement on whether the eurozone needs more or less fiscal flexibility, no agreement on the desirability of a dedicated eurozone budget and no agreement on whether to proceed within existing EU structures or outside them. The Commission is seeking to preserve its position at the center of the European project, while the member states, disillusioned by its machinations, are looking for ways to circumvent it. For a brief period last spring, there was hope that Macron and Angela Merkel might agree on a set of reform proposals and move the euro area in the direction of completing its common economic and political house. The German election, by weakening Merkel's hand, put paid to these prospects, or so it is said. The reality, of course, is that the French and German positions were always far apart, rendering any such agreement unlikely.

Thus, 2018 will be another year of much talk but little actual progress on institutional reform. If all goes well, the European economy will continue to grow. But if something interrupts that growth, the euro area will find that it still lacks the institutions needed to smoothly absorb the consequences, and in particular their uneven impact. Another crisis could then finally serve as the catalyst for meaningful reform. We just do not know when this will occur, in 2018 or some subsequent year.