

SWP Research Paper

Paweł Tokarski

Divergence and Diversity in the Euro Area

The Case of Germany, France and Italy



Stiftung Wissenschaft und Politik
German Institute for
International and Security Affairs

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Previous analyses of economic differences in the euro area have mostly focused on specific groups of countries, such as southern Europe versus northern Europe or central versus peripheral Europe. This study takes a different approach to the issue of convergence by looking at the three largest economies in the euro area: Germany, France and Italy.

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Divergence and Diversity in the Euro Area. The Case of Germany, France and Italy

When the European Union introduced a common currency, this was based on the assumption that there would be increasing economic convergence of the participating states. These expectations were not met. Instead of gradually converging, the economic performance of euro area countries has noticeably diverged. The most considerable problem arising from this divergence is that it leads to social differences and to discrepancies in political interests regarding economic and monetary integration. Thus, in the long term, the existing integration model within the euro area might be called into question.

Previous analyses of economic differences in the euro area have mostly focused on specific groups of countries, such as southern Europe versus northern Europe or central versus peripheral Europe. This study takes a different approach to the issue of convergence by looking at the three largest economies in the euro area: Germany, France and Italy. There are good reasons for focusing on these countries when analysing euro area stability. Together they account for almost 65 percent of the euro area's Gross Domestic Product (GDP) and are home to around 210 million of the EU-19's 341 million citizens. All three are among the most important economies in the world. They are also the only euro area countries that belong to the G7 and G20 formats. Furthermore, the stability of Germany, France and Italy is essential for the euro area. A massive financial assistance package for any one of these countries, even if unimaginable for Germany or France, would exceed the capacities of the European Stability Mechanism (ESM). Finally, the main challenge for the euro area is the sustainability of the economic models of the three largest economies. Italy's economic and social problems (risks in the banking sector, excessive public debt, unemployment, regional differences) constitute a systemic risk for the currency area. Similarly, France has to implement comprehensive structural reforms. Meanwhile, the stability of the euro area depends heavily on the sustainability of the German economic model. Today, the Federal Republic of Germany functions as a stabiliser for the euro area, whereas in the late 1990s it

was still referred to as the “sick man of Europe” and was regarded as a risk for monetary integration.

This study’s central focus is the unequal development of the three states. The intention is not to clarify whether or not sustained convergence within the monetary union could be promoted, and how, but rather how to deal with limited convergence. The research aims to answer key questions about the future of the euro area. How did the significant differences in economic performance between the three countries come about? Where do divergence processes show themselves most clearly? Could a return to national currencies support the necessary structural reforms and convergence? And what conclusions can be drawn from the economic performance of the three countries regarding current debates on euro area reform? This study will outline existing concepts of convergence before considering the economic systems of the three states in all their diversity. Thereafter, it will examine various options for consolidating euro area stability.

The reasons behind the divergence cannot be adequately assessed without analysing the structural problems of the euro area members, whose economic models are very heterogeneous. Differences include, for example, the role of the state, the quality of institutions and economic structures. They are responsible for the fact that membership of a common currency area has not brought about the hoped-for convergence. Instead, the financial and euro crises have further exacerbated the differences. This is evident in both nominal and real convergence indicators, which measure the economic and social divergence of the three largest euro area countries. The most significant differences are in competitiveness, current account balances, public debt and the labour market. A comparison of the real per-capita GDP growth rates of the twelve founding members of the euro area since 1999 shows that Italy’s deviation is greater than average. The economic models of Germany, France and Italy differ to such an extent that it is impossible to pursue a sustainable convergence path. Reforms in the euro area must therefore focus on how to stabilise the single currency under the conditions of limited convergence between its largest economies.

Everything suggests that there is no simple solution to further stabilising the euro area. Neither returning to national currencies nor federalising the euro area are a way out. Convergence and structural change will heavily depend on independent factors such as a positive economic environment, as well as a

favourable political situation in the largest euro area members. In particular, stabilising the euro area requires continuing the structural changes at member state level. The efficiency of state institutions must be improved; as recent research shows, this has a major influence on real convergence. The largest euro states should be monitored more intensively and from the long-term perspective within the framework of the European Semester – their importance for the stability of monetary union and the difficulties associated with structural changes implies this. It is also essential to keep monetary policy clearly involved in the stabilisation process and to increasingly share risks, including the joint debt issuance. The ESM should be strengthened, especially in its role as backstop of the banking union. This also means increasing the ESM’s lending capacity. Ultimately, the euro cannot exist without the support of public opinion; social integration therefore needs to be further strengthened in the euro area.

The Sheer Diversity of Economic Models Causing the Lack of Convergence

Convergence and Diversity in the Monetary Union

Convergence in the EU context means the alignment of individual member states' economic performances. Sustainable convergence means that economically weaker countries move towards the level of stronger economies.¹ The term divergence describes the opposite: a drifting apart of states' economic performances. There are different types of convergence that can be measured by specific indicators. Nominal convergence describes harmonisation by nominal variables such as inflation, interest rates, budget deficit or public debt. This has been a condition for entry into the euro area since the beginning of monetary union. Real convergence, on the other hand, is measured in terms of how much a country's general standard of living, working conditions, economic institutions and structures change for the better in comparison with better positioned countries.² This study analyses the main aspects of real and nominal convergence using concrete examples relating to competitiveness, public finances, income levels and the labour market. There is a special focus on the role, efficiency and particularities of national institutions.

The wish to promote convergence has always played a central role in the historical development of mon-

etary integration. As long ago as 1974, the Council of the European Communities made it clear that the project of economic and monetary union could not be tackled as long as convergence in member states' economic policies could not be achieved and maintained.³ The 1989 Delors Report, named after the then-President of the European Commission, argued that a monetary union without sufficient convergence of national economic policies would not survive in the long term and could harm the Community.⁴

The current EU Treaties contain references to real and nominal convergence. Article 3 TEU sets out the objective of promoting the well-being of member states and the "economic, social and territorial cohesion" between them. Article 121 para 3 TFEU provides that the Council shall monitor economic developments in each member state and in the Union in order to "ensure closer coordination of economic policies and sustained convergence of the economic performances of the Member States". The only concrete definition of convergence provided by EU law is in Article 140 para 1 TFEU, which specifies the nominal convergence criteria for candidate countries for monetary union.⁵ However, exceptions have already

¹ Juan Luiz Diaz del Hoyo, Ettore Dorrucci, Frigyes Ferdinand Heinz and Sona Muzikarova, *Real Convergence in the Eurozone: A Long-Term Perspective*, ECB Occasional Paper Series, no. 203 (Frankfurt: European Central Bank [ECB], December 2017), 10.

² Robert Anderton, Ray Barrell and Jan Willem in 't Veld, "Macroeconomic Convergence in Europe: Achievements and Prospects", in *Economic Convergence and Monetary Union in Europe*, ed. Ray Barrell, 2ff. (London: SAGE Publications, 1991).

³ Council of the European Communities, Council Decision of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community, Brussels, 18 February 1974 (74/120/EEC), <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:31974D0120&from=EN> (accessed 3 July 2018).

⁴ Committee for the Study of Economic and Monetary Union, *Report on Economic Monetary Union in the European Community* ["Delors Report"] (Luxembourg, 12 April 1989), 28.

⁵ Article 140 contains four convergence criteria: stable prices, stable public finances, stable participation in the

been made in practice. Italy, for example, was accepted as a member of the monetary union even though it failed the sovereign debt criterion. It was generally assumed that membership of the single currency zone would give a strong impetus to national economic reforms because the countries concerned could no longer rely on the exchange rate adjustment instrument.⁶ However, this expectation has not been fulfilled. Instead, a substantial number of the monetary union members have neglected urgently needed structural reforms since the introduction of the euro.

The main challenge to the smooth functioning of monetary union is the diversity of its member states.

Convergence plays a key role in the functioning of monetary union. Sustainable convergence could bring the euro area closer to being an optimal currency area, which would strengthen its stability. This could be achieved, inter alia, by promoting worker mobility and fiscal transfers.⁷ The convergence of per capita incomes within the monetary union also plays a major role. It is not only an important objective of economic integration, but also contributes to the overall cohesion of the euro area.⁸

There are no studies that show what degree of convergence would be necessary for the monetary union system and how much divergence it can withstand. In general, however, it is clear that divergent economic performance by states can undermine the stability of the economic area in two ways. First, the excessive public debt of individual economies poses an increased risk to the entire monetary union. In such cases, the ECB or the ESM can assist by alleviating the pressure of financial markets on the countries

concerned. However, this requires a convergence of political interests at the euro level, as other countries must agree to bear the costs and risks of financial assistance. Second, a lack of sufficient political integration and convergence of interests can pose a risk to the stability of the currency area. Different economic performances lead to different social situations; in turn, this results in differing political objectives for European integration.⁹ As a consequence, the social aspects of economic divergence have increasingly come to the fore since the beginning of the euro crisis. If the political objectives of the largest economies diverge significantly and become increasingly difficult to reconcile, this could lead to the disintegration of monetary union.

The EU-19 format brings together economies of different sizes, following different economic models and at different stages of economic development. The common monetary policy and strict fiscal policy therefore complicate overall economic policy. Some countries in the currency area found it easier to cope with the consequences of the global financial crisis and the euro crisis, while others are still struggling with the economic, financial, political and social consequences. The wide range and scale of these problems are particularly evident in the case of the three largest euro area economies.

The main challenge to the smooth functioning of monetary union is member state diversity. They differ in their traditions, institutions and patterns of economic thought and action. The fact that their economic institutions, such as the labour market, are not equally efficient and flexible contributed directly to the difference in individual countries' economic performance during the crisis. Such particularities are difficult to bring together under a common umbrella of a single currency, uniform fiscal rules and uniform monetary policy. Another important factor is that while monetary policy is regulated centrally by the ECB, economic policy is still the responsibility of member states. There are certain fiscal rules to which all states must adhere, but it is still up to national institutions to shape economic policies. Differences in the quality of state and economic institutions as well as in economic and social models are therefore consti-

exchange rate mechanism of the European Monetary System for at least two years, and stable long-term interest rate levels. Exact figures can be found in Protocol 13 of 7 December 1992 on convergence criteria.

⁶ See, e.g., Marco Buti and Andre Sapir, *Economic Policy in EMU* (Oxford: Clarendon Press, 1998).

⁷ Diaz del Hoyo et al., *Real Convergence in the Eurozone* (see note 1), 14ff.

⁸ Jeffrey Franks, Bergljot Barkbu, Rodolphe Blavy, William Oman and Hanni Schoelermann, *Economic Convergence in the Eurozone: Coming Together or Drifting Apart?* IMF Working Paper, WP/18/10 (Washington, D.C.: International Monetary Fund [IMF], 2018), 7f.

⁹ Peter Becker, "Die soziale Dimension fortentwickeln", in *Die Zukunft der Eurozone. Wie wir den Euro retten und Europa zusammenhalten*, ed. Alexander Schellinger and Philip Steinberg, 173–188 (176) (Bielefeld: Transcript, 2016).

tutive for the differences in member states' economic development.

Fundamental Differences in Economic Models

The economic models of EU countries differ in the way their product and labour markets function, in their welfare and education systems, politics, culture and even underlying ideology.¹⁰ Large economies, which are often complex, cannot always be assigned a universal classification. The three economic models are indeed classified differently. Germany and France are often referred to as belonging to the continental model, Italy to the Mediterranean model.¹¹ Sometimes Germany and France are also categorised as “northwestern continental”.¹²

Within the monetary union, there are further categories. One group consists of Germany, the Netherlands, Austria, Belgium and Finland. They pursue an export-orientated growth model and are referred to as Coordinated Market Economies (CME). Such market economies prefer to coordinate their relations with other economic actors rather than rely on pure market forces. The southern European countries are Mediterranean Market Economies (MME): Spain, Portugal, Greece and Italy.¹³ These countries have a limited institutional capacity to coordinate wages and implement long-term growth strategies. Before joining the Monetary Union, they used periodic devaluations of their respective currencies as an instrument to increase their competitiveness.¹⁴

In this typology, the French model is situated in between CME and MME, although it has more simi-

larities with the Southern European variant.¹⁵ Italy's economic model also has some specific features, in particular the importance of correlations between central and regional institutions (regional capitalism).¹⁶ The economic models of the CME euro states are said to be more adaptable to changing external conditions because their growth strategies are “externally” orientated, and because they have pronounced cultures of internal cooperation. This is particularly important in the face of strong external shocks such as the global financial crisis. The type of economic model therefore plays a crucial role in a country's economic development. With monetary integration, the Euro area member states lost a constitutive component of their options for steering economic policy. This particularly affected those economies whose competitive strategy was based on periodically devaluing their own currency within the framework of an autonomous monetary policy.

The overview of the three major economies in Table 1 (p. 10) shows their considerable differences: in territorial design, the role of the state and its relationship to the economy, but also in economic philosophy and the objectives of economic policy. The characteristics of the Italian model are difficult to capture in some categories, but in most cases it can be located between the German and French systems. Moreover, the Italian South represents a different model than the North, where industrial production and services play a much more important role.

The three countries also differ in the dominant schools of economic thought. Germany's Ordoliberalism and France's neo-Keynesian orientation, in particular, are often in opposition. German and French economic thinking differs, among other things, in terms of the prevailing rules, the government's freedom to borrow, the role of monetary policy and inflation, and freedom of trade and competition.¹⁷ The most important factors in German economic thinking are personal responsibility, the disciplinary function of the financial markets, low inflation, stable finances and the independence of the central

10 See, e.g., B. Steven Rosefielde, *Comparative Economic Systems. Culture, Wealth, and Power in the 21st Century* (Malden, Mass.: Blackwell, 2002); Bruno Amable, *The Diversity of Modern Capitalism* (Oxford and New York: Oxford University Press, 2003); Beáta Farkas, *Models of Capitalism in the European Union. Post-crisis Perspectives* (Basingstoke: Palgrave Macmillan, 2016).

11 Amable, *The Diversity of Modern Capitalism* (see note 10), 92.

12 Farkas, *Models of Capitalism in the European Union* (see note 10), 146–70.

13 Peter A. Hall and David Soskice, *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (Oxford: Oxford Scholarship Online, 2003).

14 Peter A. Hall, “Varieties of Capitalism in Light of the Euro Crisis”, *Journal of European Public Policy* 25, no. 1 (2018): 7–30 (11ff.).

15 Ibid.

16 Carlo Trigilia and Luigi Burrone, “Italy: Rise, Decline and Restructuring of a Regionalized Capitalism”, *Economy and Society* 38, no. 4 (2009): 630–53.

17 See Markus K. Brunnermeier, Harold James and Jean-Pierre Landau, *The Euro and the Battle of Ideas* (Princeton University Press, 2016; Kindle edition), 1236–1496.

Table 1

The Economic Models of Germany, France and Italy

	Germany	France	Italy
Type of state	federalism	centralised unitary state	regional unitary state
Model of capitalism	“managed capitalism”	state capitalism	dysfunctional state capitalism, regionalised capitalism
State/economy relations	state as guarantor of free competition, state as regulator	state as driver, government control	state oriented towards patronage and subsidies
Dominant economic philosophy	Ordoliberalism	(Neo-)Keynesianism	elements of both, dominated by (Neo-)Keynesianism
Growth model	export-based	based on domestic demand	mixed
Orientation of economic policy	supply policy	demand policy	demand policy
Priorities of economic policy	price stability, economic growth, employment, balance	economic growth, employment	economic growth, employment

Author’s presentation based on: Sinah Schnells, *Deutschland und Frankreich im Krisenmanagement der Eurozone. Kompromisse trotz unterschiedlicher Präferenzen?* (Freie Universität Berlin, 2016), 45; Markus K. Brunnermeier, Harold James and Jean-Pierre Landau, *The Euro and the Battle of Ideas* (Princeton, NJ: Princeton University Press, 2016); Vincent Della Sala, “The Italian Model of Capitalism: On the Road between Globalization and Europeanization?”, *Journal of European Public Policy* 11, no. 6 (2004): 1041–57; Carlo Trigilia and Luigi Burrone, “Italy: Rise, Decline and Restructuring of a Regionalized Capitalism”, *Economy and Society* 38, no. 4 (2009): 630–53.

bank.¹⁸ Italian economic thinking, in turn, has been strongly influenced by both Germany and France. The Italian and French economies are similar in their demand-led, Keynes-inspired economic policies.¹⁹ Such deviations in interests and theoretical approaches make it difficult for euro area members to agree on a common direction in economic policy. This increases the divergence of economic policies, which are mainly the responsibility of member states.

¹⁸ Franz-Josef Meiers, *Germany’s Role in the Euro Crisis. Berlin’s Quest for a More Perfect Monetary Union* (Cham: Springer 2015), 11–15.

¹⁹ Bruno Amable, Elvire Guillaud and Stefano Palombarini, *L’économie politique de néolibéralisme, le cas de la France et de l’Italie* (Paris: Éditions Rue d’Ulm/Presses de l’École normale supérieure, 2012).

The Role of the State and Social Dialogue

An important feature in which the three major economies differ is the role of the state. The inequalities in this area are relevant to both the emergence of divergences and the necessary adjustment mechanisms.

In France, the state plays an especially important role. Compared to Germany and Italy, the country has a very long tradition of state centralisation, which originated with King Louis XIV (1638–1715). The Italian experience with statehood, on the other hand, is less continuous. Until the foundation of the Kingdom in 1861, Italy was really only a geographical concept. Despite the country’s regional diversity, the unitary-state model was chosen to build a compact nation state. This marked the beginning of the conflict between the central government and the regions,

which manifests itself particularly strongly in southern Italy. An important feature that distinguishes Italy from Germany and France is the North-South divide in economic development.

The differences in the role of the state are evident, for example, in public expenditure as a share of GDP. A historically evolved feature of the French economic model is the high level of government spending in relation to general economic output. According to the OECD, in 2017 France's government expenditure ratio was 56.4 percent of GDP and was the highest of all OECD countries. In Italy, this indicator is lower than for France, at 48.7 percent, but the strong intervention of the state clearly distinguishes both from the German model, where the level of government spending relative to GDP is only 43.9 percent.²⁰ France is an active shareholder of the largest companies. This is problematic in so far as the government shares responsibility for the companies' financial situation, as well as their protection against foreign takeover.²¹

As the example of the Nordic countries shows, a stronger role of the state in the economy and high tax burdens do not necessarily lead to lower economic performance. However, the Nordic economic models have specific characteristics such as efficient state institutions, a business-friendly environment, high competitiveness through innovation, low product market regulation, efficient social protection, a high degree of media freedom, low corruption, effective collective bargaining and high-quality education with broad access. In the absence of these characteristics, however, a high level of government spending has considerable negative consequences. First, the risk of misallocation of resources increases as the state intervenes in the allocation process and the latter is no longer guided by market mechanisms. Second, it multiplies the social groups that engage in "rent-seeking", leading to the politicisation of transfers. Where the state exercises a stronger redistributive role, there are, as a rule, large numbers of domestic actors who are not interested in the status quo changing.

Political institutions should above all preserve the stability of a country and at the same time be able

to initiate reforms. In Italy, political instability – reflected in frequent changes of government – is a major obstacle to coherent economic policies. Constant changes of government stand in the way of long-term strategies, such as those required to develop southern Italy. Italy has a tradition of technocratic government (*governo tecnico*) to compensate for the inability of political parties to form stable coalitions. Such governments usually take on the difficult task of implementing reforms that are unpopular in society.²² Although political cycles in France are much more stable than in Italy, internal party conflicts often block reforms. To surmount such situations, the Paris Government can use the legal instrument of the decree or Article 49.3 of the French Constitution. The latter allows the government to force a bill through parliament unless parliament votes a no confidence measure in the government. This procedure was used several times between 2015 and 2017 to implement labour market reforms. The German political system is currently in a state of flux because the country's political scene is becoming increasingly fragmented; this makes it more difficult to form government coalitions.

Another important factor is the ability of the most important actors in the economy, including trade unions, to influence economic policy. France has one of the lowest rates of union membership in the OECD (7.9 percent in 2015) and yet the highest percentage of workers covered by collective agreements (98.5 percent in 2014). This means that French unions negotiate not only for their own members, but for the sector as a whole, making them much more powerful than unions in Germany. There the proportion of trade union members is significantly higher than in France – in 2015 it stood at 17.6 percent – without this being reflected in greater influence. As can be observed in negotiations, French trade unions are more politicised than German ones. In Italy, the role of trade unions is yet more complex. At 35.7 percent (2015), the proportion of members is considerably higher again than in Germany. However, the influence of Italian trade unions varies from sector to

20 Organisation for Economic Co-operation and Development (OECD), *General Government Spending* (indicator), 2018, doi: 10.1787/a31cbf4d-en (accessed 26 April 2018).

21 Michael Stothard, "France: The Politics of State Ownership", *Financial Times*, 13 November 2016.

22 Examples of such (short-lived) governments are the ones headed by Lamberto Dini (1995/96), Carlo Azeglio Ciampi (1993/94) or Mario Monti (2011 – 2013), see Elisa Cencig, *Italy's Economy in the Eurozone Crisis and Monti's Reform Agenda*, Working Paper FG 1, 2012/05 (Berlin: Stiftung Wissenschaft und Politik, September 2012), 31.

sector and region to region. In addition, Italy has a large number of small enterprises with few workers and a high level of irregular employment.

The Efficiency of Public Institutions

There is a positive correlation between the economic institutions of a state and its economic performance. The quality of institutions is sometimes presented as decisive for the success or failure of entire nations.²³ More recent analyses have also shown that institutions are an important factor in explaining the economic divergence between members of the monetary union.²⁴ There is evidence of a direct link between institutions and public debt on the one hand and economic growth on the other.²⁵ Moreover, the research in institutional economics demonstrates that the fundamental prerequisite for better economic policy is to reform the social and political institutions that shape it.

The institutional perspective must therefore be taken into account in explaining the euro crisis. The “northern” economies of Europe, including Germany, had more institutional capacity than the “southern” ones to pursue export-orientated growth strategies. Such strategies require coordination between producers, coordinated wage bargaining and cooperation in vocational training with a focus on skills and innovation promotion.²⁶

The efficiency of state institutions and state regulation has a direct impact on a country’s economic ac-

tivity. It is a prerequisite for innovation and productivity. The World Bank’s “Doing Business” analyses show this correlation.²⁷ They identify legal obstacles in Italy, for example, which are reflected in a low recovery rate and high insolvency costs. In addition, these hurdles have a negative impact on current efforts to restructure the country’s banking sector, which is suffering from non-performing loans. Regional data, on the other hand, show that there are significant differences in the efficiency of public institutions between the north and the south of Italy.²⁸

Economic Structures: Differences and Connections

One of the main characteristics of the euro area is a high level of economic-structures differentiation at the national level: some are demand-led, others supply-led.²⁹ At present, the three largest economies in the euro area show marked differences.³⁰

An open economy has some advantages for a country’s competitiveness and convergence towards more efficient economies. It expands the markets for domestic companies and exposes them to international competition. An economy’s success in international competition depends directly on the quality of government institutions and regulatory practices, on productivity, infrastructure and human capital.³¹ The

23 Daron Acemoglu and James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty* (London, 2012). Douglass North, among others, has analysed the role of institutions in the economy. He emphasises the importance of obstacles, such as ideologies and cultural norms, to the formation of efficient institutions, Douglass C. North, *Institutions, Institutional Change and Economic Performance. Political Economy of Institutions and Decisions* (Cambridge, 1990), 3–10.

24 “Real Convergence in the Euro Area: Evidence, Theory and Policy Implications”, *ECB Economic Bulletin*, no. 5 (2015): 30–45; Elias Papaioannou, “EZ Original Sin? Nominal Rather than Institutional Convergence”, *VOX CEPR’s Policy Portal*, 7 September 2015, <https://voxeu.org/article/nominal-rather-institutional-convergence-ez> (accessed 3 July 2018).

25 Klaus Masuch, Edmund Moshhammer and Beatrice Pierluigi, *Institutions, Public Debt and Growth in Europe*, ECB Working Paper Series, no. 1963 (Frankfurt, September 2016).

26 Hall, “Varieties of Capitalism in Light of the Euro Crisis” (see note 14).

27 The World Bank, *Doing Business 2018. Reforming to Create Jobs* (Washington, D.C., 2018), <http://www.doingbusiness.org/> (accessed 7 June 2018).

28 See, e.g., Annamaria Nifo and Gaetano Vecchione, “Measuring Institutional Quality in Italy”, *Rivista economica del Mezzogiorno* 1/2 (2015): 157–82.

29 Alison Johnston and Aidan Regan, “European Monetary Integration and the Incompatibility of National Varieties of Capitalism”, *Journal of Common Market Studies* 54, no. 2 (2016): 318–36.

30 In Germany, industry has a high share of GDP (30.1 percent) and agriculture a low share (0.6 percent). In France, on the other hand, industry accounts for only 19.4 percent of GDP and agriculture for 1.6 percent. In Italy, these figures are 24 percent and 2.1 percent respectively. See Central Intelligence Agency (CIA), *World Factbook. GDP – Composition, by Sector of Origin*, <https://www.cia.gov/library/publications/the-world-factbook/fields/2012.html> (accessed 3 July 2018).

31 World Economic Forum, *The Case for Trade and Competitiveness. Global Agenda Councils on Competitiveness and Trade and FDI* (Geneva, September 2015), http://www3.weforum.org/docs/WEF_GAC_Competitiveness_2105.pdf (accessed 3 July 2018).

German economy has a higher degree of openness than the Italian or French economies. It is strongly geared to exports, which accounted for 46 percent of German GDP in 2016.³² That year, Germany generated the largest trade surplus worldwide. There are now also many competitive companies in Italy that are successfully expanding in foreign markets. However, the level of Italian exports to GDP is significantly lower (30 percent).

The economies of the three countries being examined here are closely connected. There are more interdependencies between the French and German economies than between each of the two and the Italian economy. How mutual economic relations have developed also has to do with the extent to which the three countries cooperated politically after the Second World War. France and Germany worked closely together, which led to a strong economic exchange and mutual dependencies between the two economies. For both France and Italy, the German economy carries enormous weight,³³ achieving a significant surplus in bilateral trade.³⁴ All three countries are also important sources and targets of reciprocal direct investment. Although their financial sectors are dominated by domestic institutions, they are still strongly interconnected.³⁵ In December 2017, German banks held financial claims against France amounting to approximately €180 billion and the liabilities of Italian banks to German ones totalled €67 billion.³⁶ This is an important link between the three economies; it is also a potential channel of risk transmission.

32 OECD, *Trade in Goods and Services* [database], <http://dx.doi.org/10.1787/0fe445d9-en> (accessed 4 April 2019).

33 The Observatory of Economic Complexity (OEC), *France* [database], <http://atlas.media.mit.edu/en/profile/country/fra/> (accessed 16 December 2017).

34 With France about €35 billion, with Italy about €9.5 billion. Federal Statistical Office, *Foreign Trade. Ranking of Germany's Trading Partners in Foreign Trade 2017* (Wiesbaden, 24 October 2018).

35 ECB, *Report on Financial Structures* (Frankfurt, October 2017), 15.

36 Deutsche Bundesbank, *Balance of Payments Statistics January 2018*, Statistical Supplement 3 to the Monthly Report, 62, <https://www.bundesbank.de/en/publications/statistics/statistical-supplements/balance-of-payments-statistics--january-2018-708854> (accessed 8 February 2019).

Convergence or Divergence in the Monetary Union?

The respective economic models and the efficiency of the national economic institutions have a direct influence on the economic performance of the three largest euro states. At the start of monetary union, the economic and political situation in Europe was quite different from what it is today. Following the implementation of Stage Three of Economic and Monetary Union in 1999, Italy and France experienced stronger GDP growth dynamics than Germany. The Federal Republic was regarded as the “sick man of the euro”, and there were fears that its economic problems might have a negative impact on the stability of the single currency.

Until 2005, economic cycles in Germany, France and Italy were relatively similar; thereafter growth slowed significantly in Italy. In the years of the global financial crisis starting in 2007 and during the euro area crisis, all three economies experienced a deep recession. That the decline in France was comparatively weaker is due to distinct features of the French economic model and the lower importance of foreign trade for the country. The Italian economy, on the other hand, was severely affected by the crisis, which was exacerbated by its subsequent budget consolidation. That Italy’s GDP has risen noticeably since 2015 is mainly due to the growth of the global economy and the ECB’s accommodative monetary policy.

The next part of this study will examine the varied economic performance of the three countries with a special focus on the functioning of economic institutions. Nominal convergence will be mainly analysed in the context of competitiveness and public finances. The aim is to clarify why the three economies have developed so differently. Real convergence will be measured on the basis of income development and the labour market situation.

Competitiveness

The Real Effective Exchange Rate (REER) is one of the most important indicators of the competitiveness of an economy. It provides information on the price trends of goods produced in that country in relation to its main trading partners.³⁷ The loss of competitiveness vis-à-vis trading partners caused by inflation differentials is generally considered one of the main reasons for the weak economic performance of certain euro area countries. Higher inflation in one of the member states can make exports from that country more expensive than exports from the others, while imported products simultaneously become cheaper than domestic products. This mechanism is known as the appreciation of the real effective exchange rate. If, on the other hand, the development of the REER is negative, the domestic economy will become more competitive compared to that of its trading partners.

Graph 1 (p. 15) shows how the REER developed between 1999 and 2016 in the three major euro area countries and in the euro area as a whole. It is evident that Italy’s membership of the monetary union has had a negative impact on its exports because the high REER has reduced the external competitiveness of its economy. Even though the price competitiveness of France and Italy improved after 2010, Germany’s real effective exchange rate remains well below that of the other two countries. The German economy has remained much more competitive because it has been able to keep its labour costs low. Graph 2 shows

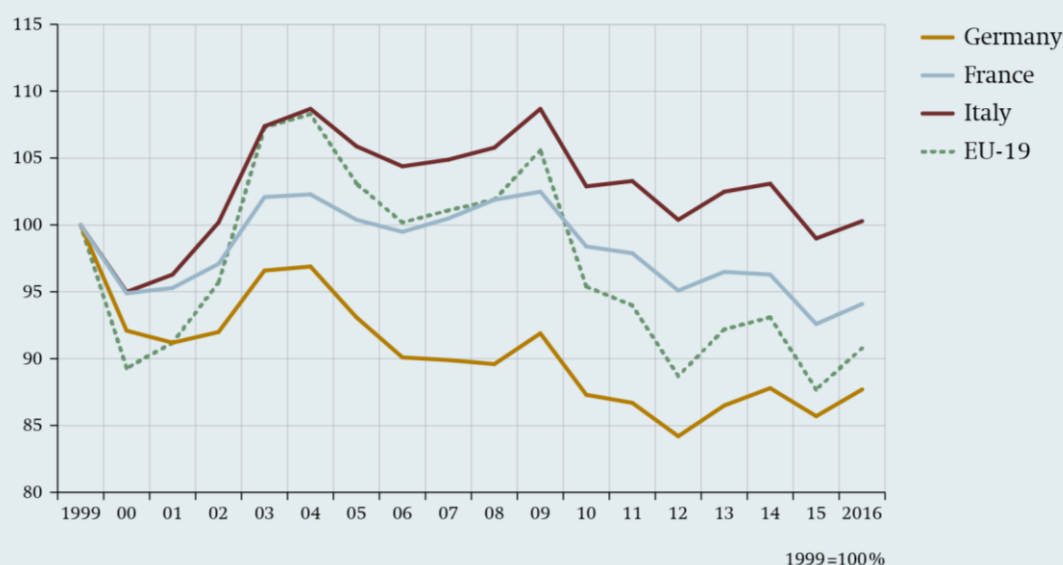
³⁷ The real effective exchange rate refers to the nominal effective exchange rate, which is usually deflated by relative price or cost ratios. However, the REER does not cover factors related to non-price competitiveness, such as product quality or the reputation of a manufacturer. The REER indicator measures both nominal and real convergence.

Graph 1

Real Effective Exchange Rate (REER) of Germany, France and Italy, 1999–2016

GDP deflator, 91 trading partners

Figures in percent



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Source: UNCTAD.

the development of this factor in Germany, France and Italy from 1999 to 2017. Clearly the trend differs between the three countries. After 2001, labour costs developed very differently in France and Italy compared to Germany. The euro crisis did not bring about any significant convergence; although labour costs have now also fallen in France and Italy, the same trend has applied to Germany. The most important explanation for Germany's differing values is the way the German labour market institutions function. Its labour market is based on flexible contracts and reciprocal agreements between trade unions and employers' organisations. These instruments have made it possible to decentralise wage bargaining and shift it to the enterprise and industry level.³⁸

As a "northern" economy with strong institutions, Germany thus enjoys a considerable competitive advantage, which leads to the accumulation of current

account surpluses. This is mainly due to wage restraint, but also to other factors that ensure an optimal product range for imports from the BRICS countries (Brazil, Russia, India, China, and South Africa) or ensure cost efficiency by using supply chains towards economies with low labour costs. The dynamics of relative prices reflect not only changes in labour costs and other production factors, but also growth in productivity and quality improvements. Qualitative improvements were similar in the three large euro states. Low productivity, however, was a significant challenge of the Italian economy.

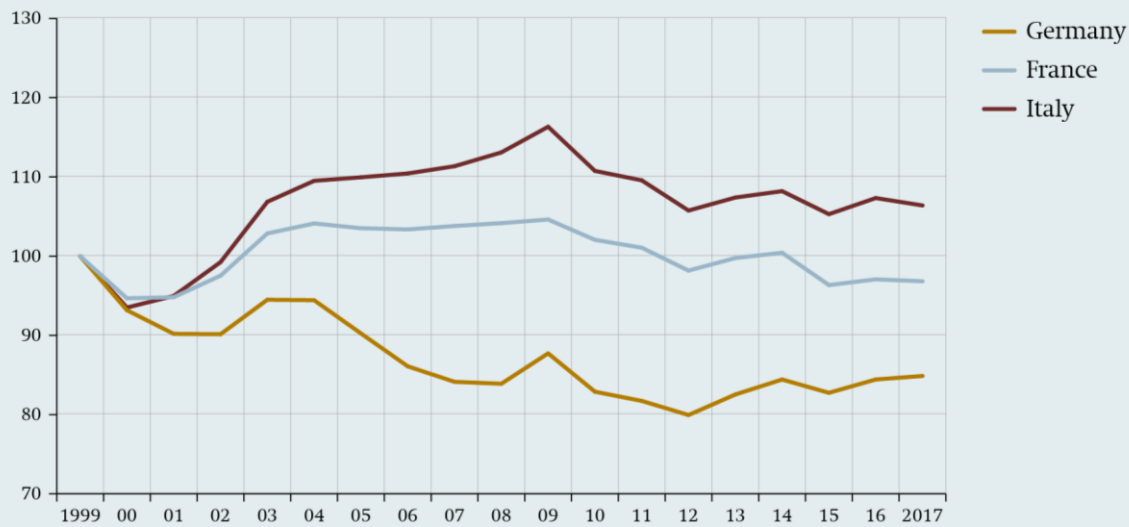
The current account balances of France, Germany and Italy have also increasingly diverged since the beginning of the monetary union. The current account balance reveals the specific features of the French economy. It is mainly based on domestic consumption, is strongly driven by government expenditure and its external competitiveness is low. The core of the current account is the trade balance. One of the most controversial topics in debates on imbalances in the euro area is Germany's massive trade surplus. Although most of this is achieved with countries out-

³⁸ Matteo Bugamelli, Silvia Fabiani, Stefano Federico, Alberto Felettigh, Claire Giordano and Andrea Linarello, *Back on Track? A Macro-micro Narrative of Italian Exports*, *Matteri di Economia e Finanza*, no. 399 (Rome: Banca d'Italia, October 2017), 35ff.

Graph 2

Relative labour costs in Germany, France and Italy, 1999–2017 (1999 = 100%)

Figures in percent



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Source: OECD.

side the monetary union,³⁹ in 2017 Germany also generated significant surpluses in trade with France (€41.4 billion) and Italy (€10 billion).⁴⁰ In France, it is often argued that the German surplus is at the expense of the other euro countries.⁴¹ Germany's trade balance surplus is interpreted in different ways, but in any case results from several internal and external factors. One explanation lies in the basic determinants of import and export, such as the productivity of the German economy and the quality of its products. Another interpretation is that in the event of a surplus of national savings over national investments – as in Germany – the savings flow abroad as capital exports and promote the import of German products there.⁴²

³⁹ Federal Statistical Office, *Foreign Trade* (see note 34).

⁴⁰ Ibid.

⁴¹ Elisabeth Behrmann, "France's Macron Says German Trade Surplus Harmful to EU Economy", *Bloomberg*, 17 April 2017, <https://www.bloomberg.com/news/articles/2017-04-16/france-s-macron-says-german-trade-surplus-harmful-to-eu-economy> (accessed 4 July 2018).

⁴² Jan Prieue, *Understanding Germany's Current Account Surplus*, Paper Presented to the FMM Annual Conference (Berlin, 2017); Robert Kollmann, Marco Ratto, Werner Roeger, Jan

According to yet another interpretation, Germany's low REER and low domestic demand are responsible for the surplus. The latter, it is argued, poses a threat to the euro area, as other countries will not be able to keep up due to the German price advantage.

There is also a risk for Germany itself. As mentioned above, Germany exports a great deal of capital, making it an important creditor state. Moreover, an export-driven current account balance containing massive surpluses should be considered as a warning signal because it often reflects economic problems. These may be structural weaknesses requiring changes in economic and social policies, such as low domestic demand, demographic ageing, high labour taxation, insufficient investment or low wages. In general, the

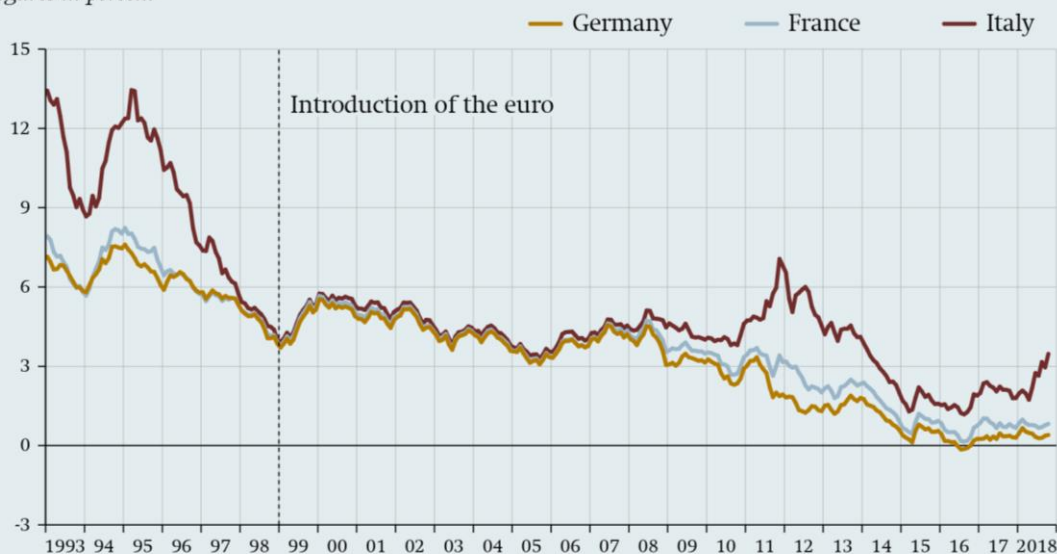
in 't Veld and Lukas Vogel, *What Drives the German Current Account? And How Does It Affect Other EU Member States?* Economic Papers 516 (Brussels: European Commission, April 2014); Mathilde le Moigne and Xavier Ragot, "France et Allemagne: une histoire du désajustement européen", *Revue de l'OFCE*, 142 (2015/16): 177–231; Philip Steinberg, "Global Imbalances – Coordinating with Different Script Books", in *Ordo-liberalism: A German Oddity?* ed. Thorsten Beck and Hans-Helmut Kotz, 167–180 (168) (London: VoxEU, CEPR Press, 2017).

Graph 3

Evolution of yields on ten-year government bonds in Germany, France and Italy

January 1993–October 2018

Figures in percent



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Source: OECD.

German trade surplus is due to both structural and economic policy factors – and it should be tackled. Possible solutions on the German side include strengthening domestic demand through wage increases and a more expansionary fiscal policy.⁴³ However, these methods would not necessarily increase internal consumption or imports from other euro area countries, including France or Italy. Higher wages can also lead to higher savings. To achieve more convergence, structural adjustments in the other euro area countries will also have to be pursued.

Public Finances

One of the most important factors exposing the divergence between the large euro area countries

⁴³ Heribert Dieter, *Stubbornly Germany First: Options for Reducing the World's Largest Current Account Surplus*, SWP Comment 48/2018 (Berlin: Stiftung Wissenschaft und Politik, November 2018); Jan Prieve, *A Time Bomb for the Euro? Understanding Germany's Current Account Surplus*, IMK Studies no. 59 (Düsseldorf: Hans-Böckler-Stiftung, 2018), 28.

is the state of public finances. There is a close link between the problems of persistent negative current account balances discussed above and excessive public sector debt. The latter leads to a negative net foreign asset position and increases a country's dependence on foreign capital to finance its domestic economy. The budget deficit and the ratio of sovereign debt to GDP are among the most important criteria for nominal convergence when a country wants to join the euro area.

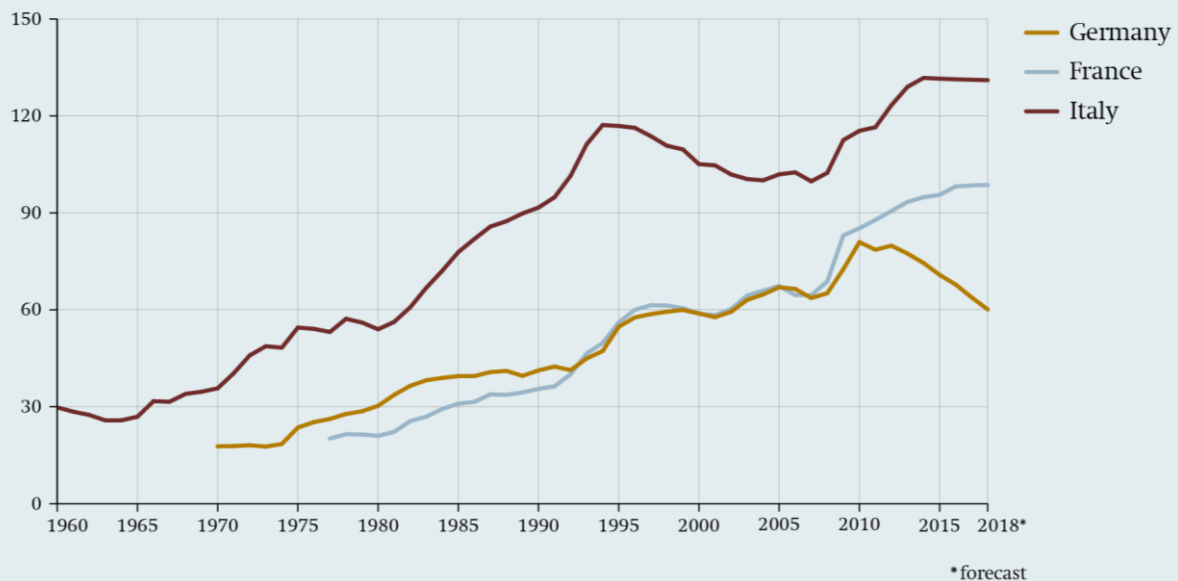
As Graph 3 shows, France, Germany and Italy recorded similar debt financing costs almost throughout the entire first decade of monetary union. This came to an end with the outbreak of the global financial crisis and the Euro area crisis. The German and French yield curves on one side and the Italian on the other side started to diverge significantly. German and French government bonds were also priced differently by the investors. The interest rates of the German government bonds served as a benchmark to assess the trends in financing costs of the other EU-19 countries.

Italian public finances are a special case. After the onset of the global financial crisis, the country was particularly hard hit by the increase of interest rates

Graph 4

Public debt of Germany, France and Italy, 1960–2018

Figures in percent of GDP



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Source: OECD.

of its government bonds. Its present level of public debt is alarmingly high. However, the problem of growing public debt predates the crisis in the monetary union. In Italy, government debt began to rise gradually as early as the mid-1960s. This was justified by the fight against inflation and the attempt to stabilise the lira within the framework of the European Monetary System. However, the origins of Italy's debt problem are much more complex. They can also be explained by the economic differences between the north and south of the country and by the behaviour of its national institutions. In southern Italy, large and persistent deficits arose, which were not counteracted for political reasons. Regional governments there caused massive overspending without internalising the costs of growing national debt.⁴⁴ Neither the centre-right nor the centre-left governments in Rome

⁴⁴ Luciano Mauro, Cesare Buiatti and Gaetano Carmeci, *The Origins of the Sovereign Debt of Italy: A Common Pool Issue?*, CRENoS Working Paper 12/2012 (Cagliari and Sassari: Centro Ricerche Economiche Nord Sud [CRENoS], May 2012), <http://crenos.unica.it/crenos/sites/default/files/WP12-12.pdf> (accessed 4 July 2018).

during the 2000s were able to push through the reforms needed to reduce debt and improve the country's competitiveness and cohesion. Since the escalation of the euro area crisis in 2010, the problem has become even more acute. In the summer of 2011, Italy was on the verge of insolvency. The reason was not only the high public debt, but also the distrust of international investors, which was fuelled by a conflict between then Prime Minister Silvio Berlusconi and Finance Minister Giulio Tremonti. The Securities Markets Programme, a bond purchasing programme of the European Central Bank for the secondary market, probably saved the country from insolvency. The ECB is currently the only institution able to stabilise the country's debt market. In mid-2018, the announcement of additional public spending by the Conte government led to a substantial rise in interest rates on Italian government bonds, raising questions about the sustainability of the country's public finances. In 2018 the public debt was close to 133 percent of GDP and the Italian debt market was far from stable.

France also has significant problems in stabilising its public finances, but the difficulties are somewhat different. The high level of government spending – with France topping all other OECD countries – re-

mains at the heart of national budget problems. According to the IMF, what caused the country's large budget deficits were the rapid growth in social, wage and municipal spending during the global financial crisis.⁴⁵ France also has the highest private sector debt within the euro area (households and non-financial corporations). Private debt accounts for almost 130 percent of GDP, and is rising. Potentially, this is a significant risk transmission channel for the country's entire economy as well as its public finances.⁴⁶

In Germany, the trend in public finances is completely different from France and Italy. During the euro crisis, the country benefited from significantly lower borrowing costs. This factor has helped to balance the federal budget since 2014. The level of government gross debt fell from 81 percent of GDP in 2010 to 60.9 percent in 2018. According to some calculations, the total savings that Germany achieved between 2010 and 2015 through the low interest rates on government bonds add up to almost €100 billion.⁴⁷

Another problem with public finances is that they are linked to the banking sector. There is a link between taxpayers and banks for as long as the banks are restructured and capitalised with public money. Contrary to media coverage, state aids to the banking sector in Germany during the crisis years were much greater than in France or Italy. During the period 2010–2017, government debt resulting from support to financial institutions was between 5 and 10 percent of GDP, while Italy and France had almost no such debt at all.⁴⁸ Due to the increasing spreads on government bonds, the governments of the southern euro countries were unable to provide any significant assistance to the banking sector. Germany, on the other hand, was able to help its banks thanks to low

spreads on government bonds, which ensured low financing costs for industry and helped finance foreign demand.⁴⁹ In Italy, the sustainability of public finances is further undermined by the difficult situation within the banking sector. The third largest economy in the euro area has still a very high proportion of non-performing loans (NPLs). In the second quarter of 2018, NPLs in Italy accounted for 9.9 percent of total loans. In Germany, on the other hand, this share is only 1.5 percent, and in France 3.1 percent.⁵⁰ Non-performing loans are loans whose repayment is either heavily in arrears or very unlikely. In such cases, the bank must make a value adjustment to the loan with additional capital, thereby either reducing its profit or increasing its loss. A high number of non-performing loans can therefore cause considerable difficulties for banks.

Excessive public debt is a major burden on Italy's budget. In times of unfavourable economic conditions, there is no room for manoeuvre in fiscal policy to stimulate the economy. The cost of servicing the debt also increases the pressure on other expenditures in the budget. According to OECD figures, debt service costs in Italy amounted to 4.8 percent of nominal GDP in 2014.⁵¹ They thus exceeded the country's public spending on education, which, according to UNESCO, amounted to only 4.1 percent of GDP in the same year.⁵²

The fiscal policy framework of the monetary union is a central theme for Paris, Rome and Berlin. Because the three countries differ in their economic performance, they also pursue different political priorities with regard to the EU. The European Commission is calling for budget deficits to be reduced at a predetermined pace. This prompts France and Italy to focus their efforts on making financial supervision in the euro area more flexible. For example, Paris has pro-

45 IMF, *France*, IMF Country Report no. 17/288 (Washington, D.C., September 2017), 6.

46 Banque de France, *Non-financial Sector Debt Ratios – International Comparisons. Second Quarter 2017* (14 November 2017).

47 *Germany's Benefit from the Greek Crisis*, ed. Leibniz-Institut für Wirtschaftsforschung Halle (IWH), IWH Online 7/2015 (Halle [Saale], 2015), http://www.iwh-halle.de/fileadmin/user_upload/publications/iwh_online/io_2015-07.pdf (accessed 4 July 2018).

48 European Commission, *Eurostat Supplementary Table for Reporting Government Interventions to Support Financial Institutions*, Background Note (April 2018), <https://ec.europa.eu/eurostat/documents/1015035/8441002/Background-note-on-gov-interventions-Apr-2018.pdf/54c5e531-688b-427b-80a1-46e471f3a54b> (accessed 22 November 2018).

49 Marcello Minenna, *The Incomplete Currency. The Future of the Euro and Solutions for the Eurozone* (Chichester: Wiley, 2016), 302f.

50 IMF, *Financial Soundness Indicators (FSIs)* [database], <http://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA> (accessed 26 November 2018).

51 *OECD Economic Outlook*, Volume 2018, Issue 1: Preliminary version (Paris: OECD Publishing, 2018, Statistical Annex, table 35, p. 45, http://dx.doi.org/10.1787/eco_outlook-v2018-1-en (accessed 30 November 2018).

52 UNESCO, "Expenditure on education as % of GDP (from government sources)", <http://data.uis.unesco.org/index.aspx?queryid=181> (accessed 22 November 2018).

posed excluding investment or defence expenditure from the deficit calculation, which would loosen the EU framework.

Of the three countries, Germany has the largest fiscal room for manoeuvre, but its fiscal policy remains extremely rigid as it aims at balanced budgets. Opportunities to secure sustainable economic growth in Germany are therefore not being properly utilised. Its growth potential could be increased through investment in infrastructure, digital networks, better childcare, and increased integration of refugees and lower taxation of labour.⁵³ On the other hand, the high indebtedness of some countries severely exacerbates the divergence problem in the euro area. Excessive public debt slows down the economy in several ways, for example by crowding out private and public investment, or triggering speculation about a country's possible insolvency. All this leads to macroeconomic uncertainty, which is particularly strong in Italy.

Income Development

Real convergence, measured by per capita income, reflects how the population's prosperity develops and is therefore closely linked to changes in social conditions. Analyses of the situation prior to the creation of Economic and Monetary Union show that real convergence between the current euro area countries has gradually declined since the early 1980s.⁵⁴ It was expected that monetary union would strengthen convergence between members. This has not been achieved, however. In fact, there has been a strong process of divergence between the first members of the euro area since the introduction of the single currency. As the data show, the three major economies have developed differently in this respect. Graph 5 (p. 21) shows that Italy's GDP level per capita in 2018 was on a similar level as in 1999. The country's performance is worse than that of Greece and other euro area members who received financial assistance

during the crisis. In 2019, Italy is expected to reach a symbolic GDP growth rate of around 0.2 percent. This will complicate the process of returning GDP per capita to the pre-crisis levels of 2007. According to IMF forecasts, this should be achieved by 2027. Furthermore, there are also large differences in per capita income in Italy along the north-south axis.

France has had a much better growth momentum since 1999. However, it must be remembered that the French population has grown faster than other countries', so that its GDP per capita is proportionally lower. France has not been able to translate the additional labour supply into growth. Real GDP per capita has risen less in France than in some euro area countries that have experienced economic difficulties, such as Finland and Spain.

The Labour Market Situation

The economic performance and GDP per capita of individual countries often depend heavily on the quality of their public institutions.⁵⁵ This is particularly evident in Italy: the inefficiency of its public sector has a negative impact on the country's competitiveness. One of the most important areas of divergence between the three economies is the labour market, especially its flexibility. There are major problems in the way the Italian labour market institutions function. Italy ranks 116th on the Global Competitiveness Index in terms of labour market efficiency.⁵⁶ This measures the ease with which workers are hired and dismissed, and collective bargaining takes place. Germany and France ranked significantly higher: 14th and 56th, respectively. There is general agreement that countries whose labour and product markets have more rigid structures have been more affected by the crisis than those with more flexible markets. Existing divergences were thus encouraged.⁵⁷

Both France and Italy face the problem of structural unemployment. The situation in both countries has deteriorated as a result of the euro crisis. From 2011

53 IMF, *Germany*, IMF Country Report no. 17/192 (Washington, D.C., July 2017), 10f.

54 Bergljot Barkbu, Barry Eichengreen and Ashoka Mody, "The Euro's Twin Challenges: Experience and Lessons", in *The Political and Economic Dynamics of the Eurozone Crisis*, ed. James A. Caporaso and Martin Rhodes, 48–78 (57–62) (Oxford and New York: Oxford University Press, 2016).

55 Diaz del Hoyo et al., *Real Convergence in the Eurozone* (see note 1).

56 World Economic Forum, *The Global Competitiveness Report, 2017–2018 Edition* (Geneva, September 2017), <https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018> (accessed 4 July 2018).

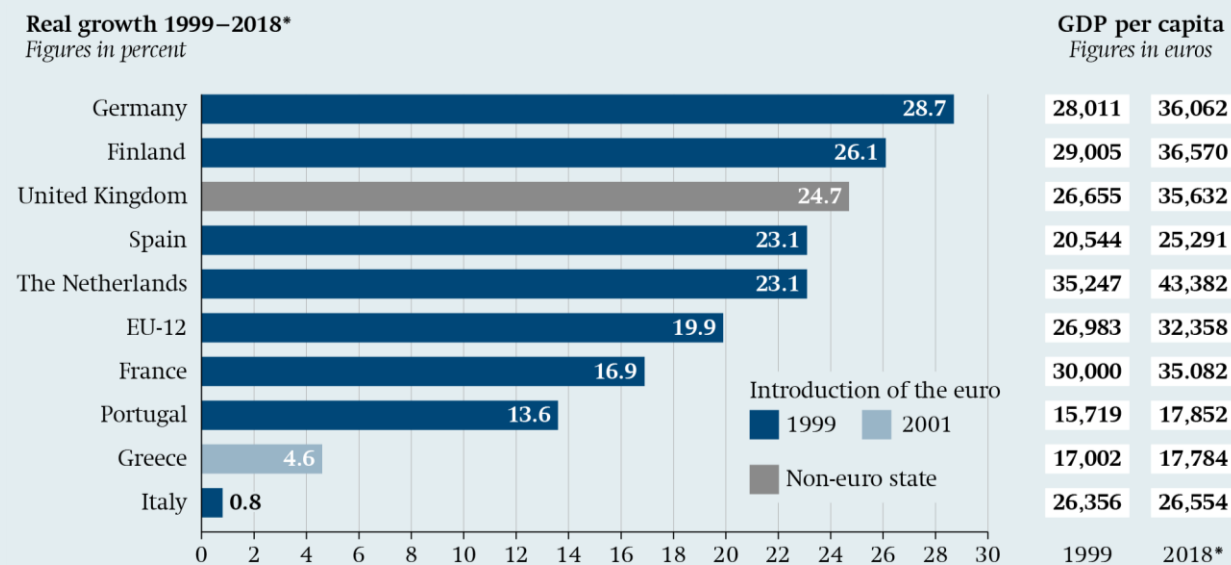
57 ECB, "Real Convergence in the Eurozone" (see note 24), 34.

Graph 5

GDP per capita in selected countries

Real growth 1999–2018*

Figures in percent



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*forecast

Source: OECD.

to 2014, unemployment in Italy rose from around 8 percent to over 12 percent. As of 2015, the situation gradually began to improve again, due to a change in economic conditions and some reforms of the Italian labour market (Jobs Act). However, the labour market is still a cause for concern. This is particularly true with respect to certain statistical values. For instance, the female employment rate in Italy is the third lowest of all OECD countries (ahead of Turkey and Mexico).⁵⁸ It is also striking that the costs of the crisis on the labour market are disproportionately borne by the younger population.⁵⁹ Youth unemployment level in Italy is at almost 33 percent, one of the highest rates in Europe. In most cases, younger workers only have temporary contracts. However, the division of the labour market into temporary and permanent jobs is also a problem for the other large euro area countries. In 2017, almost 17 percent of employees in France were employed in temporary work – significantly

more than in Italy (15.4 percent) and Germany (12.8 percent). In all three countries the share is thus above the OECD average of 11.2 percent.⁶⁰ Among OECD members, France has not only the lowest rate of change from temporary to permanent contracts, but also the highest rate of under- and over-qualified workers in the workforce.⁶¹ This indicates institutional problems in the labour market linked to deficits in the education system and in vocational qualifications.

In Italy, the north-south divide must be taken into account for the labour market as well. In 2018, unemployment in Sicily was 21.5 percent, more than three times as high as in Lombardy (6 percent).⁶² For Italy as a whole, in 2017 the proportion of 15–29 year olds who were Not in Education, Employment, or Training (NEET) was 25.11 percent.⁶³ This is not

⁶⁰ OECD (2019), *Temporary Employment (indicator)*, doi: 10.1787/75589b8a-en (accessed 16 April 2019).

⁶¹ Ibid.

⁶² ISTAT, *Unemployment Rate – Regional Level*, <http://dati.istat.it/Index.aspx?QueryId=20744&lang=en> (accessed 17 April 2019).

⁶³ OECD (2018), *Youth Not in Employment, Education or Training (NEET) (indicator)*, doi: 10.1787/72d1033a-en (accessed 16 April 2019).

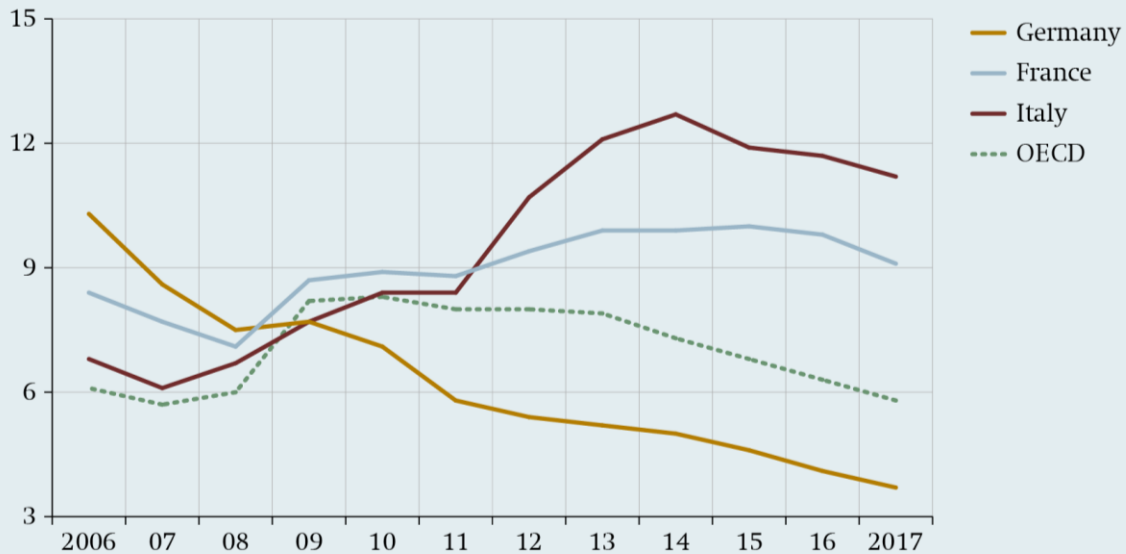
⁵⁸ OECD, *OECD Economic Surveys: Italy 2017* (Paris: OECD Publishing, 2017), 19.

⁵⁹ IMF, *Italy 2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for Italy*, IMF Country Report no. 17/237 (Washington, D.C., July 2017).

Graph 6

Unemployment rates in Germany, France and Italy, 2005–2017 (%)**Persons aged 15 and over**

Figures in percent



© 2018 Stiftung Wissenschaft und Politik (SWP)

Source: OECD.

only the highest rate within the monetary union, but also one of the highest among OECD economies. In Italy, youth unemployment closely correlates with the rate of early school leavers, which is particularly high in the south. The euro crisis has made young people's lack of prospects even worse; some scholars consider it a "lost generation".⁶⁴

In Germany differences persist between east and west, which are reflected in unemployment statistics, real GDP per capita and the location of the largest companies. But neither Germany nor France has such serious regional differences as Italy. In France, the most vulnerable groups on the labour market are young low-skilled workers and immigrants from outside the EU.⁶⁵ The situation in Germany is quite different from that of France and Italy. In the initial

phase of monetary union, Germany had to contend with even greater problems on the labour market than the other two countries. From 2004 to 2007, unemployment was higher in the largest EU economy than in Italy or France (see Graph 6). Not until 2009 did Germany's rate fall below Italy's (7.7 percent), to 7.6 percent.⁶⁶ The labour-market and social reforms implemented by Germany between 2003 and 2005 are one of the main reasons for its rising labour force participation and falling unemployment.⁶⁷ Unemployment has remained at its lowest level since reunification. In the coming years, however, Germany will face several challenges, such as integration of immigrants into the labour market.

In summary, comparing the three largest euro economies reveals a growing divergence in competitiveness, public finances and their social conditions. These differences in economic performance have

⁶⁴ Ulrich Glassmann, "Eine verlorene Generation? Ursachen der Jugendarbeitslosigkeit in Italien", in *Italien zwischen Krise und Aufbruch. Reformen und Reformversuche der Regierung Renzi*, ed. Alexander Grasse, Markus Grimm and Jan Labitzke, 343–61 (Wiesbaden: Springer 2018).

⁶⁵ IMF, *France*, September 2017 (see note 45), 7th ed.

⁶⁶ Eurostat, *Unemployment by Sex and Age*, (last update: 2 July 2018), http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=une_rt_a&lang=en (accessed 3 July 2018).

⁶⁷ IMF, *Germany*, July 2017 (see note 53).

various causes. Some can be attributed to monetary integration, which has eliminated the instrument of flexible exchange rates at the national level. However, the main reasons lie in the structural characteristics of the three economies. Persistent differences in inflation and labour market performance have contributed to the existing chasm in competitiveness, which is reflected in the respective current account balances. A closer look reveals complex structural problems in labour markets and wide regional disparities, particularly in Italy. In theory, internal deflation is necessary to improve the country's competitiveness. However, deflation would hamper growth. It is difficult to imagine that such a process would be socially and politically acceptable for Italy. Despite all this, the extent of economic divergence between the three economies is so significant that a sustainable convergence path for the monetary union cannot be achieved in the foreseeable future.

The Future of the Euro Area with Limited Convergence

The need for convergence continues to play an important role in discussions at various levels on the future of monetary union. The ECB's expansive monetary policy largely contributed to the last phase of positive economic climate. In October 2018, net purchases of government bonds were reduced to €15 billion per month and discontinued at the end of the year. If the expected slowdown in economic growth occurs, France, Germany and Italy could again drift further apart in their economic performance. The structural differences between the economic models of the three countries are unlikely to narrow significantly in the foreseeable future. Therefore, economic divergence is likely to persist for a long time and remain one of the major challenges for European economic integration.⁶⁸

Two questions are particularly important in this context. First, might withdrawing from the monetary union or splitting it into two currency areas be a better alternative to retaining the current composition of the euro area? Would convergence between Europe's largest economies be strengthened if national currencies were reintroduced? Second, in which direction should the entire economic and monetary integration process move? In the medium term, monetary union is not expected to transform into a federal or quasi-federal system. What path should be taken to better prepare a euro area with limited convergence for the next crisis, taking into account the different interests of the three largest countries?

⁶⁸ Farkas, *Models of Capitalism in the European Union* (see note 10), 498 – 505.

Convergence through Disintegration or Fragmentation of the Monetary Union?

Withdrawal from Monetary Union

Since the outbreak of the euro area crisis, there have been regular discussions as to whether a return to the national currency in some states could help improve their economic situation and increase convergence.⁶⁹ Of the three countries discussed here, speculation about Italy's withdrawal from the euro is particularly frequent.⁷⁰ There are several factors that could speak in favour of such a step. A national currency with a flexible exchange rate can help to mitigate external shocks and increase the price competitiveness of a state's economy. In addition, national monetary policy can be better coordinated with national fiscal policy, allowing a country to respond to macroeconomic imbalances with a consistent policy mix.

However, there are many arguments that contradict the assumption that the reintroduction of national currencies would improve convergence between countries. Three overriding aspects speak against an optimistic interpretation of a euro withdrawal: the behaviour of the population, the likely depreciation of the new currency, and the lack of a regulated withdrawal procedure.

First, while a return to the national currency would restore national control over monetary policy, the first reports of the country in question leaving the euro should be expected to lead to a "bank run", i.e. inhabitants would try en masse to withdraw their

⁶⁹ See, e.g., Joseph Stiglitz, "The Problem with Europe Is the Euro", *The Guardian*, 10 August 2016.

⁷⁰ See, e.g., "Hans-Werner Sinn rechnet mit Euro-Austritt Italiens", *Die Welt*, 17 October 2016; Silvia Ognibene, "Italy's Northern League Chief Attacks Euro, Says Preparing Exit", *Reuters*, 7 February 2018.

deposits as quickly as possible. This would paralyse the financial sector. Such a scenario is particularly likely in Italy, where there is little confidence in the banking system. To prevent a run on the banks, capital controls would have to be introduced to prevent capital from flowing abroad. This in turn would prevent the country from fully participating in the EU internal market, which would be extremely damaging to the economy and fatal to many businesses.

The depreciation of a new currency would mean bankruptcy for many private companies in Italy.

The second set of counterarguments is related to the depreciation of the new currency. Such depreciation would be initiated almost automatically if investors lacked confidence in the new currency. On the one hand, the depreciation would mean bankruptcy for a large number of private companies in the country, because the companies' assets would be converted into the new currency, whereas liabilities to foreign companies would still have to be paid in euros. On the other hand, investors who have invested in public debt would be severely damaged by the withdrawal of the country from the euro. A special feature of Italy's public debt is that only a relatively small proportion of public debt is held by non-residents: 33.3 percent in August 2018.⁷¹ Italy thus has the lowest share of government bonds held by non-residents among all euro countries.⁷² Domestic investors would be paid back their debts in the new currency, which would have a much lower value against the euro. Even more serious would be state insolvency, in which case the debts would not be repaid at all. The country would therefore be confronted with serious financial problems as a result of its withdrawal from the euro. Another argument in the context of currency devaluation is the related price increase for imported goods. This would increase inflation, and government bond yields would rise. Debt repayment in euros would

therefore be a major problem for the budget of the country concerned. For example, the French central bank estimates additional debt servicing costs of €30 billion if a new French currency depreciated.⁷³

An unresolved issue is how the depreciation of the new currency would affect exchange rates. In the case of France, the new national currency would lose its value only against a few countries, including Germany, Ireland, the Netherlands and Luxembourg, following a withdrawal from the euro. Because these countries account for only about 45 percent of France's exports, more than half of its exports would be less competitive than before.⁷⁴ Additionally, countries such as Italy could go into severe recession or even insolvency after leaving the currency area or after its disintegration. This, in turn, would have a very negative effect on exports, such as France's, due to reduced demand. An additional factor is the political will of the government. Currency depreciation might well appear to be a more attractive measure for increasing the competitiveness of a country's economy, rather than painful and protracted structural reforms. The latter are usually associated with enormous political costs. As long as there is no strong external pressure and the instrument of devaluation is available, the government concerned would probably avoid reform efforts. A "temporary" exit from monetary union is therefore not a viable way to restore convergence. Moreover, it is unlikely that either the country's population or the rest of the euro area would accept the country adopting the single currency again at a later date.

Another problem in the event of withdrawal from the single currency is the country's financial liabilities to the Eurosystem. For Italy, these total about €482.8 billion, as shown by the latest TARGET 2 data. For France, the problem would be considerably smaller, since TARGET 2 liabilities of the French central bank "only" amount to €19.8 billion. The most exposed central bank in the Eurosystem is the Bundesbank. Its TARGET 2 claims amounted to €872.7

71 49 percent in March 2008. See "Quanto debito pubblico è detenuto all'estero? Il termometro della fiducia?" *Il Sole 24 Ore* (online), 2 November 2018, https://www.infodata.ilsole24ore.com/2018/11/02/quanto-debito-pubblico-detenuto-allestero-termometro-della-fiducia/?refresh_ce=1 (accessed 22 November 2018).

72 In Germany and France, the share is around 60 percent. Bruegel, *Bruegel Database of Sovereign Bond Holdings* (see note 71).

73 François Villeroy de Galhau, "L'euro, notre force dans un monde incertain", *Le Figaro*, 6 February 2017.

74 Michel Aglietta et al, "Sortie de l'euro et compétitivité française", *CEPII, le Blog* (online), 21 March 2017, <http://www.cepii.fr/BLOG/bi/post.asp?IDcommuniqué=508> (accessed 4 July 2018).

billion at the end of February 2019.⁷⁵ Should Italy decide to withdraw from monetary union, it would never be able to pay its liabilities. This is again due to the fact that a withdrawal would devalue its new currency whereas its debt would continue to be payable in euro.

A disintegration of the euro area or the withdrawal of individual states would also signal the beginning of serious legal disputes, as there is currently no orderly legal procedure for this. Legal chaos and economic uncertainty would result. The creation of a new currency for a euro member state would be a gigantic logistical operation that would require at least three years of intensive preparations. In addition, the withdrawal of a large euro economy would probably trigger a domino effect that could lead to the disintegration of the monetary union. The belief in the irreversibility of the euro area would be destroyed, and confidence in the euro currency would also suffer.

It can be concluded that withdrawals from the euro area would have a negative impact on convergence. The disintegration of the monetary area would have negative consequences for political integration in Europe. None of the countries examined would benefit from withdrawing from the monetary union either. Although the national government in question would have regained monetary control, this advantage would be outweighed by the negative economic, social and institutional consequences of a return to its own currency.

Splitting the Euro Area into Two Currency Areas

An alternative idea for strengthening the competitiveness of the southern states is to divide the euro area into two currency areas. This is based on the frequently voiced assessment that the euro area consists of “North” and “South” blocks, and argues that the EU-19 should be split into these two sections.⁷⁶ His-

⁷⁵ European Central Bank, Statistical Data Warehouse, *Target Balances*, Stand: Oktober 2018, <http://sdw.ecb.europa.eu/reports.do?node=1000004859> (accessed 17 April 2019).

⁷⁶ See, e.g., Fritz W. Scharpf, “Südeuro. Zur Lösung der europäischen Finanzkrise braucht es zwei verschiedene Eurozonen”, *Internationale Politik und Gesellschaft* (online), 4 December 2017, <http://www.ipg-journal.de/rubriken/europaeische-integration/artikel/suedeuro-2449/>; Mark Blyth and Simon Tilford, “How the Eurozone Might Split. Could

torical experience also shows that it is possible to break up a currency area into two or more zones. One example is the division of Czechoslovakia in 1993. However, it is debatable whether such an option could work as intended for the euro. There are too many economic, political and legal obstacles that need to be surmounted in too short a time. As already mentioned, a split in the euro would destroy the most important foundation of monetary union, namely the principle of the irreversibility of the single currency. This could intensify speculation about the sustainability of sovereign debt of some euro members. Moreover, the EU Treaties would have to be amended to lay down the new rules, which in some countries would require referendums. Another problem is the aforementioned liabilities in the Eurosystem.

It has often been suggested that members of the southern euro area should leave the monetary union.⁷⁷ From an economic point of view, however, an exit would be much easier for the strong economies of the North.⁷⁸ This is due to their competitiveness, the extremely low probability that their currencies would depreciate, the stability of their banking systems, and their institutional strength. All these factors would make it possible to smoothly organise such a complex operation as the creation of a new currency. However, this currency would tend to appreciate in the stronger economies, which would be detrimental to their international competitiveness and thus to exports. For countries that base their economic model on exports, such as Germany, this is not an attractive option.

There is no question that Germany and Italy would find themselves in different currency systems if the split were to occur. However, it is unclear which camp France would be in. Membership in the southern euro would mean that the country would have to assume greater responsibility for Italy’s and Greece’s public debt and banking problems. However, participating

Germany Become a Reluctant Hegemon?”, *Foreign Affairs*, 11 January 2018, <https://www.foreignaffairs.com/articles/europe/2018-01-11/how-eurozone-might-split> (both accessed 4 July 2018).

⁷⁷ See Blyth and Tilford, “How the Eurozone Might Split” (see note 76).

⁷⁸ Ernest Pytlarczyk and Stefan Kawalec, *Kontrolowana dekompozycja strefy euro aby uratować Unię Unię Europejską i jednolity rynek* [Controlled dissolution of the eurozone to save the European Union and the internal market] (Warsaw: Capital Strategy, 2012).

in the northern euro would also be difficult for the French economy, since deficit rules could be interpreted more strictly and other members could better control labour costs. If three separate monetary areas were created, this would also have negative consequences for the integrity of the EU internal market.

Stabilising Monetary Union with Limited Convergence

A dismantling of the monetary union – whether controlled or uncontrolled – would pose major economic and political problems. Therefore the key question remains how the different national economies, with their different institutions and economic performances, can coexist under the umbrella of the single currency. Consideration should be given to how the stability of the monetary union could be improved when convergence processes are limited. Moreover, the debate on possible solutions to the euro crisis is strongly focused on the euro area rules. The search for new convergence criteria or a reform of the Stability and Growth Pact is the wrong way to go about this. Sufficient economic benchmarks have already been defined in the economic policy management system of the currency area. Examples are the “EU 2020 Strategy” and the macroeconomic imbalance procedure. However, implementation poses many problems in both cases, relating to the way some economies function within the rigid framework of monetary union. In this context, crucial questions arise regarding the capacity for reform of the largest economies, including fiscal transfers, sanctions mechanisms and financial markets, as well as further risk-sharing, power centralisation in the monetary union, and societal support for the euro project. All these issues are interconnected.

Transforming Economic Models

The analysis in the previous sections has shown that most of the economic problems in the euro area are structural in nature. Italy and France in particular need to adapt their economic models to changing global and regional competition. Italy faces the greatest challenges in this transformation. Because the country lacks the possibility of increasing its competitiveness via the exchange rate, it has only one option: permanent strict budgetary discipline and structural reforms. Both paths seem to be difficult to

follow for political reasons. Italy’s structural problems are not easily solved due to institutional weaknesses and the political elite’s disinterest.⁷⁹ A certain level of financial resources is also needed to implement structural reforms and reduce institutional shortcomings. But, due to strict budgetary discipline and substantial debt servicing costs, Rome lacks the money.

The literature on the diversity of capitalism concludes that existing economic models are subject to constant change. This transformation is demonstrably market-oriented – a development that can be observed in France and Italy in fields such as the labour market, social protection and product market regulation since the late 1980s.⁸⁰ The question remains as to how to steer this change in the desired direction and to increase the chances of success for reforms.

The first and most important prerequisite for structural reforms and thus for encouraging convergence is macroeconomic stability and a positive macroeconomic environment. The more favourable the economic outlook, the lower the political cost of national reform. However, favourable economic conditions are independent of the political cycle. Furthermore, even when favourable, economic conditions often discourage political decision makers from making unpopular decisions. In times of economic slowdown, the fiscal space is often limited. Structural rigidities, especially in the labour and product markets, then deepen the recession and make recovery more difficult.

Experience shows that successful reform programmes are based on several preconditions that are difficult to reconcile. An extensive analysis of the main elements necessary for successful structural reform was presented by the OECD in 2009. They are a strong electoral mandate; effective communication between the political sphere and society; solid research behind the reform targets; sufficient time; strong government cohesion; effective political leadership; good conditions for the policy area to

⁷⁹ Andrea Lorenzo Capussela, *The Political Economy of Italy’s Decline* (Oxford: Oxford University Press, 2018).

⁸⁰ Amable, Guillaud and Palombarini, *L’économie politique du néolibéralisme* (see note 19), 2061–2214.

be reformed; and perseverance.⁸¹ It is very hard to achieve several of these factors simultaneously.

Economic reforms are much easier to implement in small euro area member states as opposed to large ones. This is due to the territorial and economic complexity of the respective economies. It is therefore not especially helpful to use the example of successful reforms in Ireland or Latvia for large countries. Moreover, the reforms in these two cases have had serious social consequences, which are still felt today. In contrast, the German Hartz reforms are often cited as a possible model in the debates on economic reforms in France and Italy. Both countries compiled legislative packages to liberalise their labour markets. In Italy, the Jobs Act was adopted in 2015, in France the Loi Macron (2015), Loi El Khomri (2016) and Loi Pénicaud (2017) were adopted. However, the desired results of these reforms are unlikely to materialise unless the labour market institutions are renewed, and lessons are drawn from the negative side effects of the German labour market reforms (such as a division of the labour market into two; and increase in precarious employment). Recent IMF research suggests that a special fiscal package should be implemented to mitigate the negative social impact of reforms.⁸² However, this is problematic in countries struggling with excessive public debt, as is the case in Italy and France.

The European Semester has turned into a kind of bureaucratic routine.

How, then, can national reforms be accelerated using the instruments available within the economic governance of the monetary area? First of all, it should be acknowledged that these resources only have a limited impact on the economic policies of the largest member states.

The “European Semester”, the most important instrument of economic policy coordination, has turned into a kind of bureaucratic routine. The European Commission presents each member state with country-specific recommendations (CSRs), which are then endorsed by the European Councils and then adopted

⁸¹ William Tompson and Robert Price, *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries* (Paris: OECD, 2009).

⁸² Angana Banerji et al., *Labor and Product Market Reforms in Advanced Economies: Fiscal Costs, Gains, and Support*, IMF Staff Discussion Note (Washington, D.C.: IMF, March 2017).

by the EU finance ministers. However, the CSRs do not trigger much public debate about the macroeconomic situation or the state of national reforms. Since 2013, most of the country-specific recommendations related to Macroeconomic Imbalance Procedure have not been sufficiently implemented.⁸³ To strengthen ownership, member states have set up various bodies to monitor economic reforms (National Fiscal Councils and National Productivity Boards). The decentralisation of this assessment is a positive catalyst for reform. However, it remains a challenge to limit tasks appropriately at each level, and to carry out checks and balances without unduly complicating economic governance.⁸⁴ Besides, the largest EU economies should be subject to stricter surveillance, given their systemic importance for the euro area. The reality is rather different. There have been several instances where the Commission has put more pressure on smaller member states than on the larger ones. The experience of the European Semester also shows that the institutions of large member states are inward-looking and have little interest in accepting external advice concerning structural reforms.⁸⁵

Reform capability of the largest euro countries remains uncertain – especially in Italy.

However, it is questionable whether transfers of funds to implement reforms would be a sufficient incentive for the largest euro states. Germany, France and Italy are the largest net contributors to the EU budget. Cash transfers would only adjust their net position; they would not be significant for the macroeconomic situation. Moreover, Italy’s institutional weakness makes it difficult for it to draw on EU -

⁸³ European Parliament, Economic Governance Support Unit (EGOV), *At a Glance. Implementation of Country Specific Recommendations under the MIP*, March 2019.

⁸⁴ Cinzia Alcidi and Daniel Gross, *How to Further Strengthen the European Semester* (Brussels: Centre for European Policy Studies [CEPS], November 2017); Adriaan Schout and Christian Schwieter, “National Fiscal Councils, the European Fiscal Board and National Productivity Boards: New EMU Independent Bodies without Much Prospect”, in Margriet Drent et al., *Clingendael State of the Union 2018: Towards Better European Integration*, Clingendael Report (The Hague, January 2018).

⁸⁵ Alcidi and Gross, *How to Further Strengthen the European Semester* (see note 84), 5.

funds. At end of 2016 the country had the largest proportion of unabsorbed EU funds from the 2007–2013 multiannual financial framework.⁸⁶ If a member state is unable to pursue a proper economic policy, this usually has to do with a lack of ownership – and this cannot be “bought” with EU funds or imposed from Brussels.

Sanctions are another economic policy instrument. This instrument was strengthened during the euro area crisis for use against individual member states in the event of inadmissible national policies. However, it is difficult to envisage the largest euro area countries being subject to financial sanctions. Such punitive measures could also have counterproductive effects and strengthen Euro-sceptic movements. Both the European Commission and the ministers in the EU Economic and Financial Affairs Council (ECOFIN) are aware of the negative political consequences of sanctions against the largest over indebted countries.

Another way to create incentives for reform is through pressure from the financial markets. During the crisis, interest rates on government bonds from France, Italy and other countries rose. This was an important warning signal from the financial markets; it showed that investors were increasingly distrustful of the economic prospects of these countries. However, this kind of pressure should not be overestimated. The negative reactions of rating agencies and investors came too late to avert the crisis. In addition, at some stages of the crisis, the agencies over-reacted, thus contributing – along with some chaotic investor behaviour – to the escalation of the situation. To date, during the euro crisis, the financial markets have been characterised by irrational and short-term thinking. Their actions service the need for quick profits. Furthermore, the ECB’s expansionary monetary policy helped to lower government bond yields, which limited the “corrective” role of the financial markets. However, the pressure on Italian government bonds in 2018 and 2019 played an important role in limiting the deficit plans of the Conte Government.

Whether the largest euro countries can indeed reform therefore remains unclear. There are pessimistic predictions, especially for Italy. Institutional blockades, interest groups orientated towards the status quo and the fiscal policy of Giuseppe Conte’s

government, in office since June 2018 (tax cuts and higher government spending) give little cause for optimism. The two coalition partners, the Lega and the Five-Star Movement, have announced some reforms to the justice system and the fight against corruption. In the first months of its term, however, the government focused on fulfilling populist election promises, including special benefits for the poorest sections of the population and the cancellation of earlier pension reforms. The projections of general government deficit in April 2019 raised the public deficit to 2.4 percent of GDP, significantly higher than agreed with the European Commission in December 2018 (2.04 percent). The ensuing conflict between Rome and Brussels revealed the ineffectiveness of the EU and euro area institutions and their dependence on the disciplining effects of financial markets.⁸⁷ If the Conte government continues to relax fiscal policy, Italy’s financial stability will deteriorate and the country will experience further political shocks.

France’s economy continues to face significant challenges, and Macron’s reforms should be assessed cautiously.

The case of France is different. President Emmanuel Macron has been more successful with reforms than his predecessors, benefiting from favourable economic conditions. But two years after his election, there was growing resistance from various social groups, while support for the president is declining. Union protests against planned labour market reforms contributed to the sluggish growth of the French economy in mid-2018. In the autumn of that year, there were violent protests by the “yellow vests”, including blockades of motorways and petrol stations. These events will also have a negative impact on economic activity. France’s economy continues to face significant challenges, and Macron’s reforms should be assessed cautiously. Despite their clear objective of curbing expenditure, and favourable economic conditions, France’s public debt rose to almost 100 percent of GDP at the end of 2018.⁸⁸

⁸⁷ Pawel Tokarski, *Italien als Belastungsprobe für den Euroraum. Grenzen wirtschaftspolitischer Steuerung der EU-19*, SWP Comments 52/2018 (Berlin: Stiftung Wissenschaft und Politik, September 2018).

⁸⁸ Eurostat, *General Government Gross Debt – Quarterly Data* (accessed 25 April 2019), <https://ec.europa.eu/eurostat/tgm/>

⁸⁶ OECD, *OECD Economic Surveys: Italy 2019* (Paris: OECD Publishing, 2019), 140, <https://doi.org/10.1787/369ec0f2-en>.

Even further-reaching reforms of public finances are therefore not to be expected. In the coming years, Germany will also be confronted with the need to review the sustainability of its economic model. An attempt to partially revise the Hartz reforms could worsen the country's competitiveness. This would probably lead to a convergence of economic performance vis-à-vis France and Italy, but could at the same time call into question euro area sustainability.

According to current forecasts, economic growth will develop differently in the three countries, and will be heavily influenced by their demographic situations. The current trends show strong divergences in demographic outlook between the countries. In Germany the long term scenario is not very optimistic. According to the latest assessment by the Global Aging Report, between 2018 and 2070 Germany will have to face one of the highest increases of pension contributions of all EU countries (measured in terms of GDP).⁸⁹ In France, the long-term demographic situation is expected to be significantly better than in Germany and Italy, according to projections of its working-age population between 2018 and 2070.⁹⁰

How Much Centralisation of Power Should There Be in Monetary Union?

For some time now, there has been discussion as to whether economic policy in the currency area should be further centralised to promote convergence between member states. This issue particularly concerns the largest euro area countries. They tend to prefer intergovernmental contacts, whereas EU institutions tend to use them mainly when they see an opportunity for self-advancement. A key area of conflict has long been the implementation of the Stability and Growth Pact. The largest member states of the EU, France and Germany, diluted the rules of the Pact in 2005. Often, it is the larger euro area countries facing problems

table.do?tab=table&init=1&language=en&pcode=teina230&plugin=1.

⁸⁹ European Commission, Directorate-General for Economic and Financial Affairs, *The 2018 Ageing Report Economic and Budgetary Projections for the 28 EU Member States (2018–2070)*, Institutional Paper 079 (Brussels, 2018), 66, https://ec.europa.eu/info/sites/info/files/economy-finance/ip079_en.pdf (accessed 15 April 2019).

⁹⁰ François Villeroy de Galhau, *Economic Adjustments in Europe: The Case of France* (GIC/SUERG/Deutsche Bundesbank Conference, Frankfurt, 8–9 February 2018).

complying with budgetary rules that openly criticise the European Commission. This especially applies to France, where high-ranking politicians like to protest loudly against Brussels' reprimands.⁹¹ Similar dissent can frequently be heard from politicians in Rome.⁹²

The intergovernmental trend has further intensified as a result of the euro crisis. During the crisis, the heads of state or government or the finance ministers of the largest member states played a key role in many situations. The debate on further centralisation of economic governance has long focused on the idea of creating the post of a euro area finance minister with the aim of addressing the biggest institutional challenge to monetary union: the lack of a strong political centre. However, member states have very different ideas and imperatives on this issue. France would use the euro area finance minister as an administrator of the EU transfer mechanisms. This is the main discrepancy with Germany, which sees the key task of such a minister as improving budgetary discipline in the euro area. Quite apart from that, however, it is difficult to imagine the member states agreeing to transfer decisive powers to the finance minister, such as those for blocking national budgets.

It would do more harm than good to create a position without definite competencies. The post-holder would be a perfect target for national populist and EU-sceptical politicians, and would probably be used as a scapegoat for economic failures at the national level. A better option would be to strengthen the collegial leadership of the euro area. In the evolution of monetary union, there is an example of how economic policy interests can be efficiently reconciled at the supranational level: monetary policy, which is decided by the Governing Council of the ECB. Although budgetary policy decisions (such as pension reforms) have much stronger political and social consequences than monetary policy decisions, monetary policy is also a sensitive area.

In order to strengthen collegial economic governance, the Eurogroup could develop into a kind of Economic Council, drawing on the experience of the ECB Governing Council. This Economic Council would have a permanent Presidency with a longer term and a six-member Executive Board (as is the

⁹¹ "Hollande: 'La Commission n'a pas à nous dicter ce que nous avons à faire'", *Le Point*, 29 May 2013.

⁹² Francesco Guarascio, "'Stop Attacking EU Commission on Fiscal Policy', Juncker Tells Renzi", *Reuters*, 7 November 2016.

case with the ECB, and would be independent of national elections. An interesting element of the ECB's decision-making process is that the size of the respective euro economies is reflected in the weighting of votes.⁹³ Germany, France and Italy benefit from the unwritten rule that gives them a permanent presence on the ECB Executive Board.⁹⁴

However, one should be aware of the limitations of centralised decision-making. It is doubtful whether this would fulfil the promise of efficient decision-making and increased convergence. Examples such as Ireland, Portugal or Finland show that the success of reforms depends above all on the extent to which the political classes assume responsibility at the national level. The efficiency of national institutions also plays a significant role.

It is the interplay between the EU level and national policy that primarily causes problems for monetary union. The asymmetry of political cycles at both levels makes political manoeuvres more difficult. Furthermore, the electoral calendar of the member states influences the European agenda. The succession of elections, especially in the large countries, reduces the scope for planning and implementing more complex political projects. The most recent example were the 2017 elections to the German Bundestag, which were followed by a lengthy government-forming process. As a result, political attention was severely restricted in the run-up to the upcoming European elections in 2019. The elections to state parliaments in Germany also have a significant impact on the formulation and implementation of the agenda at the EU level.

If the potential for political centralisation in the monetary union is limited, and yet its three largest economies have systemic importance, then Germany, France and Italy should strengthen their economic policy cooperation. Despite all the differences in European policy objectives, it is still the Franco-German tandem that sets the political tone for integration in the euro area. Together with Italy, a kind of

triumvirate has emerged that has already met twice, first in June 2016 in Berlin in response to the Brexit referendum, then in August 2016 on the Italian island of Ventotene. The current government in Rome is founded on a majority that is in opposition to the current EU set-up and is not an easy partner for Berlin and Paris. However, maintaining a dialogue is both possible and desirable on such issues as the labour market, judicial reform and the fight against corruption. If a trilateral intergovernmental exchange of heads of state and economic and finance ministers is established, this could also create a platform for consultations about structural reforms at the national level, and for exerting the requisite peer pressure. However, the leaders of the two coalition parties in Rome would first have to acknowledge that their confrontational stance towards the European Commission and other members of the euro area creates a high risk to the stability of their own country.

Further Risk-Sharing with Stronger Conditionality

Some of the structural problems that the three states suffer from are deeply rooted in their economic systems. It is difficult to imagine that these obstacles could be overcome in a few years. A political commitment to adhere to the euro can only be maintained in the medium term if a process of risk-sharing also takes place. In this context, strengthening conditionality is the best means for creating incentives for reforms at national level. The experience of the crisis shows that member states prefer measures that involve the lowest political costs for themselves. The stability network of the Monetary Union has been significantly strengthened since the beginning of the euro crisis,⁹⁵ but there is a broad consensus that the euro area is not prepared for another crisis of comparable magnitude. It is therefore necessary to clarify what concrete steps can be taken to make the euro area more resilient to internal and external shocks.

⁹³ See "Rotation of voting rights in the Governing Council" [of the ECB], *European Central Bank* (online), <https://www.ecb.europa.eu/ecb/orga/decisions/govc/html/votingrights.en.html> (accessed 5 February 2017).

⁹⁴ Paweł Tokarski, *Die Europäische Zentralbank als politischer Akteur in der Eurokrise. Mandat, Stellung und Handeln der EZB in einer unvollständigen Währungsunion*, SWP Research Paper 14/2016 (Berlin: Stiftung Wissenschaft und Politik, July 2016).

⁹⁵ The relevant elements mainly include the European Stability Mechanism established in 2012, the ECB's Outright Monetary Transactions and the banking union.

The fundamental question: fiscal integration or risk-sharing through the banking sector?

Two fundamental positions dominate the current debate on further euro stabilisation. One side argues in favour of fiscal integration, which would be achieved through inter-state transfers, thereby undertaking greater risk-sharing. The other side prefers decentralised fiscal responsibility and risk-sharing through the banking sector.⁹⁶ According to the first stance, it is the transfer mechanisms within the monetary union that should primarily be strengthened. President Macron has proposed creating a budget of several percentage points of EU-19 GDP for the euro area.⁹⁷ A Franco-German position paper in mid-November 2018 proposed a much less ambitious instrument: a budget line within the multiannual financial framework 2021–2027.⁹⁸ Furthermore, the stabilisation function of this mechanism has been blocked by the group of Northern Euro area states led by Holland.

Italy supported the idea of a euro stabilisation mechanism, but focused on another instrument: the creation of an unemployment insurance system for the entire monetary union.⁹⁹ Its main purpose would be to mitigate the impact of severe economic shocks on employment. The US experience with a similar

mechanism suggests that this step could help to strengthen convergence in the single currency area.¹⁰⁰ However, since national labour market institutions in the euro area have different levels of efficiency, it is uncertain how such an instrument would work.

Another widely debated idea in the field of fiscal integration concerns partial debt mutualisation. The basic idea is to reduce the financing costs of those member states which are struggling with excessive debt levels. In practice, this means transferring the refinancing costs and the associated risk from one group of monetary union members to another. Joint issuing of debt securities would be the best way to underpin member states' commitment to the monetary union project. It would ensure that members view monetary union as irreversible. The European Commission had already put forward the idea of such stability bonds in 2011, but the creditor countries in the currency area rejected them. The more recent proposals are about creating "a European safe asset" supported by government bonds. This asset would have different degrees of seniority, which would mean a certain risk for the buyers.¹⁰¹

There are two major obstacles to debt mutualisation. First, risks are transferred to all participating members. Second, it would mean a loss of sovereignty for nation states if they were subjected to stricter fiscal control in order to limit moral hazard. However, it would be possible to combine participation in a partial common debt issuance programme with strict conditionality. Participation in the issuing of debt securities could be reviewed annually by the Eurogroup, taking into account whether appropriate economic policies are being pursued at national level. An alternative idea would be to reduce the debt burden of some EU-19 member states by freezing their gov-

96 Martin Sandbu, "Banking Union v Fiscal Union, Part 2", *Financial Times*, 15 December 2017; Anne-Laure Delatte, Clemens Fuest, Daniel Gros, Friedrich Heinemann, Martin Kocher and Roberto Tamborini, *The Future of Eurozone Fiscal Governance*, EconPol Policy Report, 1/2017 (Munich: European Network of Economic and Fiscal Policy Research [EconPol Europe]; June 2017).

97 See, e.g., "Emmanuel Macron: le grand entretien", *Le Point*, 30 August 2017; *Initiative pour l'Europe – Discours d'Emmanuel Macron pour une Europe souveraine, unie, démocratique*, 26 September 2017, <http://www.elysee.fr/declarations/article/initiative-pour-l-europe-discours-d-emmanuel-macron-pour-une-europe-souveraine-unie-democratique/> (accessed 2 October 2017).

98 *Proposal on the Architecture of a Eurozone Budget within the Framework of the European Union* [Non-Paper], 16 November 2018, <https://www.consilium.europa.eu/media/37011/proposal-on-the-architecture-of-a-eurozone-budget.pdf> (accessed 23 November 2018).

99 Italian Ministry of the Economy and Finance, *European Unemployment Benefit Scheme*, August 2016, http://www.mef.gov.it/inevidenza/documenti/Unemployment_benefit_scheme_rev_2016.pdf (accessed 4 July 2018).

100 Sebastian Dullien, *Eine Arbeitslosenversicherung für die Eurozone. Ein Vorschlag zur Stabilisierung divergierender Wirtschaftsentwicklungen in der Europäischen Währungsunion*, SWP-Studie 1/2008 (Berlin: Stiftung Wissenschaft und Politik, February 2008).

101 Markus K. Brunnermeier et al., *ESBies: Safety in the Tranches*, Frankfurt a.M., European Systemic Risk Board (ESRB), September 2016 (Working Paper Series, Nr. 21); Agnès Bénassy-Quéré et al., *Reconciling Risk-sharing with Market Discipline: A Constructive Approach to Eurozone Reform*, Policy Insight no. 91 (London: Centre for Economic Policy Research, January 2018); ESRB, *Sovereign Bond-Backed Securities: A Feasibility Study* (Frankfurt, January 2018), vol. 1: *Main Findings*.

ernment bonds.¹⁰² However, this would lead to indirect government financing by the ECB. In any case, the different economic performances of the euro countries and the divergent development of interest rates on government bonds could at some point lead to a partial common debt issuance.

Another option that was under discussion for stabilising the monetary union is to transform the European Stability Mechanism into a European Monetary Fund (EMF). Such a fund could be used to plan and implement financial assistance packages, which would allow it to be more firmly anchored in the EU institutional system than the current ESM. It is questionable, however, whether this intergovernmental instrument would (as called for by Germany) be more objective than the European Commission when assessing the budgetary policies of selected countries. The ESM is not in itself a means of increasing convergence. It was set up as a rescue mechanism and is based on the financial risk-sharing of all 19 member countries. The ESM is currently one of the most important risk-sharing channels in the euro area. At the euro summit in June 2018, it was decided that the ESM should assume the role of backstop for the Single Resolution Fund.¹⁰³ A common backstop would reduce the risk of contagion in the banking sector and the likelihood of risks being transferred from one country to another. In addition, the activation of an ESM programme requires the approval of a number of national parliaments, including the Bundestag. This process takes time. Crisis experience shows that the more time it takes to agree a package, the more costly it becomes. The Eurogroup decision of 4 December 2018 on the ESM precautionary credit line is a step in the right direction for at least two reasons.¹⁰⁴ First, the ESM would be used for financial support at an early stage. Second, the establishment of ex-ante conditions can serve as an incentive for member states to pursue sound economic policies in the framework of the European Semester. However, one should also be

aware of the financial limitations of the mechanism. At the beginning of 2018, the ESM credit capacity was up to €410 billion.¹⁰⁵ This would not be sufficient for creating a comprehensive financial assistance programme for just one of the three largest members of the euro area. Thus, an increase in the volume of ESM lending should be seriously considered. In the opposite case, the ECB will continue to be the only institution capable of assisting the largest member states in case of difficulties in servicing their own debts.

The second view in the debate on euro stabilisation is, as mentioned, decentralised fiscal policy. This position argues against the claim that fiscal integration, including tax transfers, is necessary for the euro to survive. The arguments favouring a fiscal union, it maintains, were based on a misinterpretation of how existing currency areas function, and especially the nature of risk-sharing. The example of the USA shows that risk-sharing takes place largely via the financial markets and not via fiscal channels.¹⁰⁶ The sustainability of the euro area therefore does not depend on a central budget, but on the strength of the financial market institutions and the completion of the flagship banking union project.¹⁰⁷

Non-performing loans remain the biggest challenge facing the European banking sector.

This particularly applies to the development of the third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS). Even countries from the north of the monetary union, such as Finland, are now seeing more and more advantages from the common deposit guarantee system.¹⁰⁸ The large volume of non-performing loans in the banking sector, especially in Italy, remains the biggest challenge

102 Marcello Minenna, “Why ESBies Won’t Solve the Eurozone’s Problem”, *Financial Times*, 25 April 2017.

103 “Statement of the Euro Summit”, 29 June 2018, <https://www.consilium.europa.eu/de/press/press-releases/2018/06/29/20180629-euro-summit-statement/> (accessed 4 December 2018).

104 “Eurogroup Report to Leaders on EMU Deepening”, 4 December 2018, <https://www.consilium.europa.eu/de/press/press-releases/2018/12/04/eurogroup-report-to-leaders-on-emu-deepening/>.

105 ESM, “What Is the ESM’s Lending Capacity?”, <https://www.esm.europa.eu/content/what-esm%E2%80%99s-lending-capacity> (accessed 23 November 2018).

106 Martin Sandbu, “Europe’s Fiscal Union Envy Is Misguided”, *Financial Times*, 20 July 2015.

107 Erik Jones, “Financial Markets Matter More Than Fiscal Institutions for the Success of the Euro”, *The International Spectator* 51, no. 4 (2016): 29–39.

108 Raine Tiessalo, “Nordea’s Move Into Bank Union Raises Stakes on Deposit Insurance”, *Bloomberg*, 4 December 2017, <https://www.bloomberg.com/news/articles/2017-12-04/nordea-s-move-into-bank-union-raises-stakes-on-deposit-insurance> (accessed 3 July 2018).

facing the European banking sector. On the positive side, this issue remains high on the EU's political agenda.¹⁰⁹ Yet the process of reducing non-performing loans takes time, as does continuously improving economic conditions in the single currency area as well as the efficiency of national institutions. Conditions could be attached to it, pooling risks in the banking sector through EDIS. At the start of the process, EDIS could cover 30 percent of the losses of the relevant national insurance system, as proposed by the Commission.¹¹⁰ The percentage of mutualisation could be linked to appropriate benchmarks, analogous to risk elimination in the banking sector. An annual assessment that offers incentives to reduce non-performing loans in the banking sector is conceivable. A similar conditionality has been attached to the ESM providing a backstop to the Single Resolution Fund. It should be remembered that the smooth functioning of the banking union and the elimination of links between banks and states require a profound change in the business model of the Italian banking sector, which relies strongly on individual investors. The liquidation of the insolvent banks Veneto Banca and Banca Popolare di Vicenza in 2017 was secured by the state for fear of losses for small investors and was subject to national insolvency law.

Another important issue is the possible introduction of rules on the debt restructuring of euro area member states. A Bundesbank report has proposed that the ESM should play a leading role in any debt restructuring process. It also calls for the creation of an automatic mechanism to extend the maturity of

government bonds, and for changes to the standardised terms and conditions of government bonds issued by euro area member states to facilitate debt restructuring.¹¹¹ This could lead to the private sector assuming part of the cost of financial support. But there is a risk that entering into a financial assistance programme might increase market volatility rather than alleviate an already tense situation.¹¹² Moreover, this solution would contribute to increased market pressure in some economies, as investors would have to take into account an increased risk of default. This could affect Italy in particular, where, as mentioned above, most of the public debt is held by domestic creditors.

Given the complexity and political sensitivity of further risk-sharing, the ECB is expected to continue playing the crucial role in stabilising the monetary union if risks in the euro area increase further. ECB President Mario Draghi committed himself to this role in a speech in July 2012. The ECB's Outright Monetary Transactions (OMT) programme includes robust requirements for the implementation of reforms. However, monetary policy also has its limitations. The balance sheet of the Eurosystem stood at over 40 percent of euro area GDP in April 2019, significantly higher than the US Federal Bank's (19 percent). The question is whether the stabilisation objective of monetary union will always be compatible with the ECB's main objective, price stability. Another option would be to redefine how inflation is assessed. The current quantitative target of below but close to 2 percent was set in 1998 and 2003 by the Governing Council of the ECB – which could change it. The problem of how to determine an optimal inflation target and the best possible monetary policy is increasingly being discussed in academia. The ECB is trying to prepare the public for this debate as well.¹¹³

109 In July 2017, the Council adopted special resolutions on non-performing loans. It called on the Commission to prepare legislative proposals to develop secondary markets for NPLs or to review the efficiency of national insolvency systems for loans. Council of the European Union, "Banking sector: Council presents action plan to reduce non-performing loans", *European Union. News*, 11 July 2017, https://europa.eu/newsroom/content/bankensektor-rat-stellt-aktionsplan-zum-abbau-notleidender-kredite-vor_en (accessed 4 July 2018). The following measures have been proposed: strengthening banking supervision, reforming insolvency and debt collection arrangements, developing secondary markets for non-performing loans, and restructuring the banking system.

110 European Commission, *Communication to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on Completing the Banking Union* (Brussels, 11 October 2017).

111 Bundesbank, "Starting points for dealing with sovereign debt crises in the eurozone", *Monthly Bulletin* (July 2016), 43–64.

112 Lucas Guttenberg, *Looking for the Silver Bullet. A Comprehensive Guide to the Debate on ESM Reform* (Berlin: Jacques Delors Institute, 4 December 2017), 11f.

113 See ECB, "The Future of Monetary Policy Frameworks". Lecture by Vítor Constâncio, Vice-President of the European Central Bank at the Instituto Superior de Economia e Gestão, (Lisbone, 25 May 2017).

Social Support for the Euro Project

Public support for the common euro rarely plays a role in the analyses of the stability of Economic and Monetary Union. However, the attitude of the population is likely to be crucial for the future of monetary integration. The social problems that have worsened in some countries during the crisis will continue to have a negative impact on national policies. It is difficult to predict how governments that are formed or influenced by populist parties will behave. This creates a political risk which also increases uncertainty about the future of the euro. Public support for monetary union is highest in high-income countries. Countries that have experienced high growth since the introduction of the euro have also tended to see increasing support for the single currency.¹¹⁴ In this respect, the stability of the euro area requires social aspects of economic and monetary union to be taken into account. The extent to which the euro is supported by the population is directly related to these factors, which in turn are related to the real convergence of the economies within the currency area.

Low support for the euro is a particular problem in Italy. At the beginning of Economic and Monetary Union, there was still a great deal of support: back in the early 2000s, Italians were among the most enthusiastic supporters of the euro and of European integration in general. The population was convinced that the euro and the European institutions were more efficient and more democratic than their national counterparts.¹¹⁵ Subsequently, euro scepticism gradually increased in Italy, mainly due to poor implementation of the currency introduction in 2002.¹¹⁶ Table 2 (p. 36) shows how public support for the euro has developed in Germany, France, Italy and the EU-28 as a whole since the beginning of the crisis. The most important reason for the current lack of euro approval in Italy is its tense economic and social

situation, especially high unemployment.¹¹⁷ Public debate in the country often argues that the euro and the inability to devalue have destroyed Italy's competitiveness.¹¹⁸ Simultaneously, there is a direct link between unemployment and support for anti-system and EU-critical parties.¹¹⁹ Nevertheless, in all three countries the number of euro supporters is greater than that of opponents. The pro camp is particularly large in Germany. In Italy, too, support for the euro is once again increasing, because — despite everything — the economic situation is improving. Overall, though, the number of supporters in Italy is still one of the lowest of all euro area countries, which represents a risk factor for the monetary union.

There is a danger that the euro will once again be made a scapegoat for economic problems as soon as the economy weakens. It is therefore important to further develop the social pillar of economic integration in the euro area. Significant progress has already been made in this area, while the need for genuine convergence in the euro area has been increasingly discussed. Examples are the Joint Employment Report or the inclusion (in 2014) of social indicators in the Alert Mechanism Report. The debate on reforms of the monetary union focuses strongly on the integration of financial markets, the banking union or the European Monetary Fund. These issues seem very abstract to ordinary citizens who do not see a direct link between their situation and the regulation of financial institutions. The fact that the social dimension of monetary integration has gained in importance in recent years could counteract this detachment. In 2017, it was announced that a new pillar of social rights would be created in the euro area, relating to 20 non-binding social principles. The aim is to promote convergence in the fields of em-

114 IMF, *Eurozone Policies, Selected Issues*, 25 July 2017, IMF Country Report no. 17/236 (Washington, D.C., 2017), 5.

115 Thomas Risse, "The Euro between National and European Identity", *Journal of European Public Policy* 10, no. 4 (2003): 487–505 (497).

116 At the time, retailers and restaurants used the currency exchange to raise prices — a move that the right-wing populist Lega Nord used as an argument against the euro.

117 Felix Roth, Lars Jonung and Felicitas Nowak-Lehmann, "Public Support for the Euro", *VOX CEPR's Policy Portal*, 11 November 2016, <https://voxeu.org/article/public-support-euro> (accessed 4 July 2018); Philip Giurlando, *Eurozone Politics. Perception and Reality in Italy, the UK, and Germany* (London and New York, 2016).

118 See Gavin Jones, "Out of Pocket, Italians Fall Out of Love with the Euro", *Reuters*, 8 February 2017, <http://www.reuters.com/article/us-eurozone-italy-exit-analysis-idUSKBN15N0JJ> (accessed 3 July 2018).

119 See Yann Algan et al., "The European Trust Crisis and the Rise of Populism", *VOX CEPR's Policy Portal*, 12 December 2017, <https://voxeu.org/article/european-trust-crisis-and-rise-populism> (accessed 4 July 2018).

Table 2

Public support for the euro, 2010–2018 (%)

	Nov. 2010	Nov. 2011	Nov. 2012	Nov. 2013	Nov. 2014	Nov. 2015	Nov. 2016	Nov. 2017	Nov. 2018
Italy	68	57	57	53	54	55	53	59	63
France	69	63	69	63	67	67	68	71	72
Germany	67	66	69	71	73	73	81	80	81
EU-28	58	53	53	53	56	56	58	61	62

Source: European Commission, Public Opinion.

ployment. The euro area needs a concrete flagship programme focusing on the labour market – the most important issue for citizens. Fragmentation and the incompatibility of national social systems are the main obstacles if social policy is to be developed at EU level. Unemployment benefits, for example, are granted for different periods and depend on the level of wages.¹²⁰ An option would be to introduce an instrument such as the German short-time working allowance, which could contribute to the stimulation and flexibility of the labour market.

120 Peter Becker, *Europas soziale Dimension. Die Suche nach der Balance zwischen europäischer Solidarität und nationaler Zuständigkeit*, SWP-Studie, SWP Research Paper 21/2015 (Berlin: Stiftung Wissenschaft und Politik, November 2015), 27ff.

Conclusions

- France, Italy and Germany differ considerably from each other in terms of state participation in the economy, their national growth models and the efficiency of their state institutions. The economic divergence between the three countries is largely the result of their economic models, which have evolved over decades and which react differently to the conditions of the monetary union and to economic fluctuations. There are major structural problems in Italy and France, both of which face a lack of competitiveness and excessive debt.
- Italy suffers from institutional weaknesses, public debt, risks in the banking sector, a tense social situation and polarisation between the north and south of the country. The problems are so serious that they pose a risk to the stability of the monetary union as a whole. This risk has increased significantly since the formation in Rome of a government coalition of the Lega and the Five-Star Movement. Nevertheless, political contacts between all the largest economies of the euro area should be strengthened, especially in the area of economic policy. It is important to involve the Italian government in a constructive dialogue at ministerial and state level as soon as the political leadership in Rome realises that its policy of confrontation with Brussels brings more costs than benefits.
- The German economic model is successful, especially in comparison to the French and Italian models. The greatest challenge facing Germany is to successfully secure its own growth potential for the future. In order to deal with this, Germany should use its fiscal and economic leeway to increase public investment and wages. At the same time, structural reforms should be implemented in France and Italy in order to increase the competitiveness of both countries. The negative demographics in Italy and Germany must also be dealt with.
- Limited convergence cannot be addressed either by increased federalisation of the euro area or by dismantling European integration. In theory, the Italian and French economies could be more competitive outside the euro area. However, for both countries the economic and social costs of leaving the euro would be enormous. The consequence would be the depreciation of their new national currencies against the euro. This could lead to state insolvency. Withdrawing from the euro area or its general disintegration are not reasonable options. It should be remembered that an exit scenario would not necessarily be the result of a conscious political decision, but could result from an uncontrollable, self-reinforcing process. All three major euro area countries should better inform their citizens about the economic, social and political consequences of the disintegration of the currency block.
- There is no simple solution for strengthening the stability of a monetary union with limited convergence. The discussion in the euro area should not be based on the model of a federal state and derive from it the need for a euro finance minister or its own budget. The euro area is a sui generis construction. Due to the strong intergovernmental tendencies within it, further centralisation of power (such as with a finance minister) is likely to bring more disadvantages than advantages. Instead, consideration should be given to strengthening collegial economic governance at European level, along the lines of the Governing Council of the ECB. Further stabilisation of the monetary union also requires greater institutional efficiency at the national level, and more ownership of national reforms within the framework of the European Semester.
- The current economic governance instruments have limited efficiency. This should be taken into account in the discussion on economic policy reform in the euro area. It is also worth considering strengthening macroeconomic surveillance of the largest economies on a permanent basis, as they have a systemic significance for the monetary union as a whole. Germany, France and Italy should also intensify their trilateral intergovernmental cooperation on economic policy issues. However, differences in electoral cycles at the national level and the increasing fragmentation of the party systems represent a major obstacle

to efficient political cooperation between Berlin, Paris and Rome.

- There may be a need for additional risk-sharing paths in the monetary union. The banking union should be progressively completed through the introduction of the common deposit-guarantee scheme. A partial issuing of euro bonds should also be considered. New risk-sharing channels should be linked to conditionality: how well a country performs in reforms within the framework of the European Semester should be the decisive factor.
- The most promising reform element is to extend the tasks of the ESM. Within the euro area, there seems to be a general consensus for taking action in this area. The future development of the ESM into a European Monetary Fund must be accompanied by an adequate lending capacity and more automatism in granting financial assistance.
- It is nevertheless important to be aware of the limitations placed on the instruments of economic governance in the euro area. Financial sanctions or financial transfers cannot replace national ownership of reforms.
- Stabilisation of the euro area must not overlook the social aspect, even though social policy will remain the responsibility of member states for the foreseeable future, and even though social systems within the EU-19 are very heterogeneous. In particular, it is important to strengthen public support for the euro. The social pillar of the euro area has gained momentum in recent months. Consideration should be given to creating a showcase project, for instance a European short-time allowance.
- In the context of limited convergence and a lack of stabilisation mechanisms in the euro area, the ECB may again be forced to play a decisive role in stabilising the currency area. This particularly applies to how the situation develops in Italy. But the monetary union model based on monetary stabilisation is not sustainable.
- In the ongoing debate on euro area reforms, the internal challenges of its three largest economies should be given greater attention. If divergence increases significantly, their willingness to share risk would be correspondingly reduced. This would jeopardise the whole euro project. The future of European economic integration will therefore depend on the success or failure of national economic policies in France, Germany and Italy.

Abbreviations

AMR	Alert Mechanism Report
CME	Coordinated Market Economies
CSR	Country Specific Recommendations
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EDIS	European Deposit Insurance Scheme
EDP	Excessive Deficit Procedure
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
EU-19	Eurozone with 19 Member States
EU-28	European Union with 28 Member States
G7	Group of the seven major advanced economies
G20	Group of the twenty most important industrialised and emerging economies
GDP	Gross Domestic Product
IMF	International Monetary Fund
MIP	Macroeconomic Imbalance Procedure
MME	Mediterranean Market Economies
NEET	Not in Education, Employment or Training
NPLs	Non-Performing Loans
OECD	Organisation for Economic Cooperation and Development
OMT	Outright Monetary Transactions (ECB Bond Purchasing Programme)
REER	Real Effective Exchange Rate
SGP	Stability and Growth Pact
TARGET	Trans-European Automated Real-time Gross Settlement Express Transfer System
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
UNESCO	United Nations Educational, Scientific and Cultural Organization

