Where is the Eurozone heading?

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It is now almost two years ago since Mario Draghi famously stated that the ECB would do whatever it takes to preserve the euro. Also, two years have passed since the intention to set up a European banking union was made public. This may be a good time to look back on what has been achieved since then and to discuss where the single currency union is heading. In short, we argue that the ECB has played a very important role in restoring financial stability which, in combination with reduced fiscal tightening, has paved the way for gradually improving confidence among households and companies. At the same time, however, the institutional flaws that made the Eurozone crisis so severe have not been fully addressed and it doesn't look like this is going to happen anywhere in the near future. Also, although current account imbalances have been reduced significantly, this has come at huge social and political costs in the periphery. Consequently, despite the fact that confidence indicators are showing clear signs of progress, we highlight that the current recovery remains very fragile and remain highly skeptical to the idea that the Eurozone has now all the instruments in place to fight the next crisis.

Almost exactly two years ago European policymakers came up with a fairly short document stating their willingness to establish a European banking union. Although far from impressive, that statement was important in the sense that it was probably a necessary condition for the ECB to announce its successful OMT program of (conditional) sovereign bond purchases a few weeks later. Indeed, both the ECB's SMP bond buying program in May 2010 and the ECB's implementation of the three year refinancing operations (LTRO) for the commercial banking sector in December 2011, have also been introduced after important political breakthroughs (the introduction of the EFSF and Fiscal Compact respectively). Draghi's pledge to "do whatever it takes" largely restored financial stability. Moreover, in combination with last year's adoption of more flexible public deficit targets, this has significantly improved economic confidence. However, the current setup of the single currency union is still flawed and further integration is needed to deal with future crises. Firstly, important steps have been taken to supervise the European banking sector and to break the vicious feedback loops between banks and governments. However, it cannot be ignored that the plans for a recapitalization fund of only 55bn euro (0.6% of Eurozone GDP) show a clear lack of ambition to go much further. Secondly, there is close to no progress with regards to the introduction of fiscal transfer mechanisms between Eurozone member states. That is problematic when both labor mobility and wage flexibility remain insufficient. Also, talks about collective debt issuance on a Eurozone level (eurobonds) seemed to have completely stalled. Thirdly, the absence of a good functioning political union and the lack of democratic legitimacy remains a true concern. The latest European election results have made it painfully clear that natural progress in this respect is far from self-evident. Finally, economic imbalances within the Eurozone have corrected to an important extent over the last few years. But the burden of the adjustment has almost entirely fallen on the deficit countries in the Eurozone periphery. The surplus countries, notably Germany, should have played a far bigger role in the adjustment process through more investment and less saving. Instead, adjustment has come at the cost of unsustainably high unemployment and deflation in the periphery. With unemployment set to stay high in the foreseeable future, this threatens to further undermine political integration. The upshot is that, although the ECB action of two years ago has proven very successful, integration attempts in the form of a banking union, fiscal union and political union remain far too modest and insufficient to successfully confront the future.