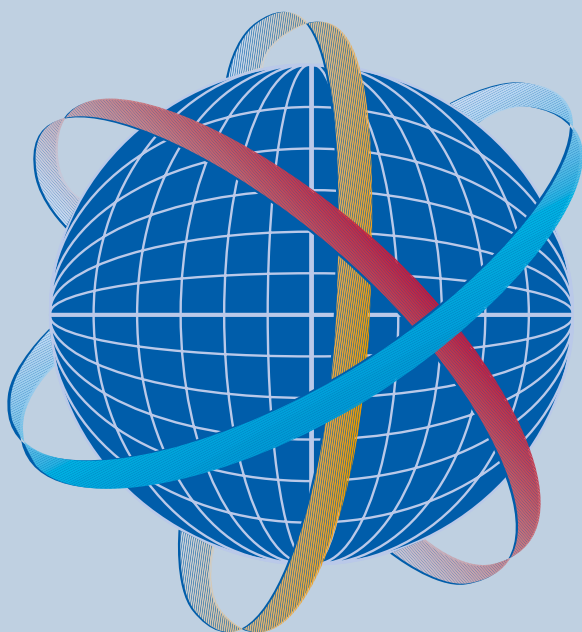




45th ECONOMICS CONFERENCE 2018

Economic and Monetary Union –
Deepening and Convergence

Conference organized by the
Oesterreichische Nationalbank (OeNB) and the
Austrian Federal Economic Chamber (WKO)



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Editorial

This volume brings together the papers presented at the 45th Economics Conference: Economic and Monetary Union (EMU) – Deepening and Convergence. The conference, which was one of the events marking the start of Austria's second EU presidency, was organized by the Austrian Federal Economic Chamber (WKÖ) and the Oesterreichische Nationalbank (OeNB) and took place on July 5 and 6, 2018, on the premises of Raiffeisenlandesbank Linz, Upper Austria.

EMU and the euro are great achievements of the European project. Yet, the future of Europe also depends on its economic strength and on the commitment of all EU Member States to deeper integration. Hence the need to use the current favorable economic times to deepen the EMU so that future global challenges can be addressed successfully. In this respect, the conference aimed at contributing to a dialog among high-ranking experts from academia, politics, trade and industry to foster mutual understanding of Europe's future prospects on the one hand and Austria's role in this process on the other.

Opening Remarks

In his opening remarks, *Heinrich Schaller*, Chief Executive Officer of Raiffeisenlandesbank Oberösterreich, stressed the importance of a certain level of understanding and compromise to solve problems without getting too many emotions involved. *Ewald Nowotny*, Governor of the Oesterreichische Nationalbank, recalled that the institutional set-up of EMU has been substantially transformed as a result of lessons drawn from the crisis, and that the creation of the SSM (Single Supervisory Mechanism) has added an entirely new dimension to future euro area accession pro-

cesses. But there is an ongoing need to use good times to make our economies more resilient by building fiscal buffers and implementing further economic reforms to strengthen the foundations of EMU. We have to make sure that the benefits of EMU reach all EU citizens. During Austria's EU Presidency, we will strive to help meet these challenges. *Christoph Leitl*, President of EUROCHAMBRES, the Association of European Chambers of Commerce and Industry and Honorary President of WKÖ, started his introduction by underlining his personal connection to his hometown Linz and by reminiscing on his time as a student of professor Nowotny. Looking ahead, Leitl stressed the need of ensuring fair regulation, fair taxation and fair trade in the real economy in keeping with the principle of proportionality. In other words, big companies should have to pay more tax and smaller companies should have to pay less tax. Banks should be able to spend more time to serve their customers and less on having to meet regulatory demands. Fair trade is essential with respect to the uncertainty resulting from US trade policies. We have to support free trade and we need a strong Europe to accomplish this. In addition, we have a responsibility to many other parts of the world. We have to raise awareness about what is happening in the world and prepare for any incoming challenges with appropriate responses.

Keynote Lectures: Deepening EMU – Political Integration and Economic Convergence

Jens Weidmann, President of the Deutsche Bundesbank, opened the keynote lectures: He explained EMU by using the famous Linzertorte as an illustrative symbol. Given the range of recipes for Linzertorte that have existed since the 17th

century, every bakery will have to pick “the right one” – but it won't be able to change the basic ingredients. For EMU, these basic ingredients include price stability and a stable financial system, for which the Treaty on European Union provides an ideal framework. The fact that the long period of stability during the great moderation was suddenly ended by a global financial crisis showed that EMU was vulnerable to adverse shocks. With the creation of the banking union, structural weaknesses of EMU have been remedied. A monetary union needs competitive and resilient economies. In EMU, the single monetary policy has been successful in ensuring price stability. Fiscal policies have been less successful; however, in 2018, all Member States remained under the 3% deficit ceiling, aided by low interest rates. Further fiscal efforts are still necessary, as are more far-reaching structural reforms. In regards to further risk sharing, Weidmann argued for prioritizing risk reduction through reducing NPLs and the sovereign-bank nexus over risk sharing to avoid moral hazard. In terms of instruments providing value added for Europe, he also argued in favor of strengthening the ESM and setting aside a euro area budget for investment, whereas the stabilization function should continue to be fulfilled at a national level. He closed his lecture by remarking that, unfortunately, there is no single correct recipe for Linzertorte. This is what makes Linzertorte unique. According to Popper, all that is needed is the willingness to have a discussion. Conferences like this can help us find solutions together.

Yves Mersch, member of the Executive Board of the ECB, spoke of a “constructive bubble”. If we look back, the Werner Report already argued for economic policy coordination and the

Delors Report for a fiscal dimension to support EMU. However, the Political Union Conference did not develop meaningful results; as a consequence, the EU is suffering because of these shortcomings. The only alternative is internal devaluation, which has created social resistance. The cost of a breakup of EMU is devastatingly high, so the only option is to continue to deepen EMU. The focus should be put on three areas: pursuing structural reforms, reducing risks in the financial sector and strengthening the EMU architecture. As the risk of adverse shocks persists, it is important to increase resilience. A sound and coordinated fiscal policy reduces the danger of spillovers. At this moment, we are still at the announcement stage and have not yet reached the implementation stage. We still need to enhance ownership of the instruments we have installed. Fiscal adjustment is necessary, especially in highly indebted countries. For Mersch, the main challenge is being able to cope with a severe area-wide recession. Any fiscal capacity has to be accompanied by responsibility and governance to avoid moral hazard. He further mentioned the banking union, which has translated some of the key lessons drawn from the crisis into a framework. Whether all of the reforms were necessary, only time will tell. He also mentioned the common backstop EDIS (European Deposit Insurance Scheme), which might not even have to be used in a way similar to the OMT program. That is the beauty of such backstops: If private risk sharing is in place, little public risk sharing is needed. Still, economic shocks can never be fully eliminated. To quote Jaques Delors, Europe is like a bicycle: it moves forward, if it stops, it falls over.

Panel 1: Stocktaking Convergence in EMU and CESEE

Peter Mooslechner, Executive Director of the Oesterreichische Nationalbank, chaired Panel 1, which dealt with the more specific issue of convergence and CESEE. When talking about convergence, we should be clear what kind of convergence we are referring to, as there are many different types, such as income, nominal, real, price, or sigma convergence and many more. The Treaty even uses the term cohesion instead. The current assessment and understanding of the issue is driven by expectations, which have been too high with regard to convergence. EMU is complicated and does not automatically lead to convergence. The benefits of convergence measures have become less clear. There is a need for stocktaking and analysis. Have our expectations been correct, how have they developed, where do we stand today and why? This panel features two distinguished speakers, Sylvie Goulard and Michael Landesmann.

Sylvie Goulard, Second Deputy Governor at the Banque de France, stressed that EU convergence is the cornerstone of the European social contract. It started in 1957, when the Treaty of Rome defined the constant improvement of living and working conditions of Europeans as the main objective. It also elaborated that the Union was to promote the wellbeing of its people in a competitive social market economy, aiming at full employment and social progress. The EU shall promote economic, social and territorial cohesion and solidarity among Member States. The Commission's roadmap of December 2017 stated that one lesson learned from the crisis is that achieving convergence and building robust economic structures is crucial for the prosperity of the Union. The notions of conver-

gence and integration are at the heart of the EU. When we talk about the future of EMU, people are interested in specific results, especially in increasing GDP per capita.

It is a pity that the EU's Macroeconomic Imbalance Procedure has apparently failed to deliver. The idea was to look more closely at macro coordination, seriously consider spillovers when taking policy decisions at a national level, and to make efforts to tackle imbalances afterwards. However, recommendations have not been adhered to and implementation is rather weak. That is quite worrying. So what comes next? The EU's objectives are higher employment and growth in all Member States. To achieve this, we need to improve the rules of enforcement, as the current legal framework is not strong enough. Rejecting the calls that have been to do away with rules, Goulard stressed that we need rules, otherwise we will move backwards. Not only do we need rules, but we also need to respect them and share the ensuing risks. What remains is a fundamental policymaking problem: "We are privileged, as we are not the ones who are affected by our speeches. We ask for flexibility from the more deprived."

Michael Landesmann, professor of economics at Johannes Kepler University Linz and at the Vienna Institute for International Economic Studies (wiiw) focused on the situation of the CESEE countries and on the importance of institutional convergence. The prospering economies around Austria have been very successful in terms of convergence. They have been able to catch up due to FDI-led industrialization; disciplinary measures would not do. Still, income catching-up continues to lag behind. Emphasizing the issue of external imbalances and the resulting implications regarding instability, Landes-

mann stressed that building strong export sectors is an uneven process. There are persistently low export capacities in some groups of countries. Referring to the economics of geography, trends should be reinforced over time. Values added create the conditions for new trade. The power of business should be harnessed to counteract export gaps. We are already integrated, but which factors will drive convergence in the future?

In the ensuing discussion Goulard suggested that we should look more carefully at demographic factors. We prefer labor mobility, free movement of persons, but it can be hard to find the right balance, as some countries see their young people moving abroad. She also referred to difficulties due to Brexit and the movement of talents. Our society is based on solidarity between generations, but have we taken the young generation seriously? In the south of Europe, young people have been waiting for solutions for ten years. There is not really a better place to live than Europe. For policymaking to remain convincing, "the social market economy" must be kept up. Last but not least, Landesmann referred to the very problematic effects of differences in age and skill, which lead to divergence in successful countries.

What is the main reason for the lack of enforcement? Is it a fear of centralization? Where is the European counterpart to Amazon, Ali Baba etc.? Goulard suggested that we should accelerate innovation and implement initiatives against disruption. We do not have those giants. We cannot control the speed on a highway if we leave it up to the drivers. We need a stronger political commitment or stick to a neutral approach, but mixing the two does not work. Landesmann detected a lack of enforcement. He further stressed that

we cannot take convergence for granted within a country, so there is no reason to expect it within the EU, either. We have to aim for a macroeconomic policy scenario, which allows for sustainable growth. Finally, Goulard stressed that it is essential to fight the rise of nationalism, otherwise we will not get far. We should not forget that we are the luckiest generation in the history of Europe and that the U.S. helped us. We have to return to a more rational approach, exchange views and find solutions.

Panel 2: Social Cohesion – The Role of Labor Mobility

Kurt Pribil, Executive Director of the Oesterreichische Nationalbank, chaired panel 2 with a focus on social cohesion, in particular the role of the labor market, labor mobility and migration in the Union. According to standard economic theory, migration entails benefits for the native population. The economic argument to support this claim is as follows: Labor increases, which in turn increases profits; the increase in profits leads to more investment, which boosts demand for labor. The result is a clear improvement in total welfare. However, the social and political consequences of open national borders sometimes suggest the opposite. There may be hostility towards large-scale immigration as a way of protesting against job losses, depressed wages and growing inequality. Economic welfare does not always seem to be congruent with social wellbeing.

Thomas Liebig, Senior Migration Specialist at the OECD, started by stating that the debate on migration produces two main positions – the heartless and the headless. Economic welfare will not always be the same as social welfare. As the Treaty of Lisbon states, the Union shall promote economic, social and

territorial cohesion, and solidarity among Member States. He pointed out that labor mobility as part of the single market is one of the major achievements of the EU. Free mobility has been a key driving force for changes in migration flows in Europe. OECD studies show that free mobility has been a non-negligible shock absorber. He argued that the increase in labor mobility in Europe is inter alia a consequence of the EU enlargements of 2004 and 2007, which greatly increased the scope of free labor mobility within the EU/EFTA and the euro area. One in twelve people living in Austria comes from another EU country. Intra-EU migrants predominantly work low- and medium-skilled jobs. Intra-European mobility only started growing disproportionately once labor market disparities had reached a certain level. In fact, these disparities have grown as a result of the crisis in Europe. Free labor mobility has alleviated asymmetric shocks in Europe. In this respect, intra-EU migration has been a contributing factor in lowering regional unemployment disparities in the EU.

Angela Pfister, Economic Expert, Austrian Trade Union Federation (ÖGB), began her speech with the following question: “Is labor migration a win-win situation for all?” One of the driving factors for migration still is the large wage gap between Western and Eastern European countries. She emphasized that since the enlargement of the EU in 2004, a considerable catch-up process concerning wage development in CESEE countries was observable, but on average, wages in CESEE countries are significantly lower than in Austria, resulting in problems on the labor market and challenges for social cohesion in the EU in the near future. She concluded that a coordinated economic, social and

labor market policy combined with increased public spending would be necessary to solve the problems mentioned.

Klaus F. Zimmermann, President of Global Labor Organization (GLO) and professor at Maastricht University, stressed that social cohesion and labor mobility act as an indicator of solidarity and mobility within the EU. Free labor markets have been at the core of EU economic integration policies since the beginning. The main fact is that labor mobility promotes optimal resource allocation and balanced adjustments to asymmetric shocks. Migrants can even reduce native unemployment if they complement, not substitute, native workers in the production of goods and services. He pointed out that labor markets that are well-integrated and more flexible would increase the resilience of EMU, similarly to deeper financial market integration.

Panel 3: EMU Deepening from Today's Perspective

Gertrude Tumpel-Gugerell, former member of the ECB Executive Board, chaired the third panel of the conference, which provided an overview about the politically critical discussion on the deepening of EMU.

Christian Keuschnigg, Professor of economics at the University of St. Gallen, examined analogies to the current discussion on Brexit. Is the euro irreversible? While there is an established and lengthy mechanism to prepare for accession to the euro area, there is no equivalent procedure for an exit. He stated that in the end, euro area countries must reduce the large imbalances in all scenarios, within or outside the euro area. Furthermore, he emphasized that Member States should view and accept each other as partners and in honesty, and take responsibility for their own actions to counteract imbalances.

Ulrike Rabmer-Koller, President of the European Association of Craft, Small and Medium-sized Enterprises (UEAPME), welcomed all efforts to complete the capital market union, but identified serious challenges for SMEs in Europe related to the debate on a reform of EMU. The main challenge is the restricted access to capital markets, as 95% of SMEs depend on bank finance. Therefore, she advocated for a completion of the banking union and emphasized the importance of reviewing banking regulations before taking further steps to deepen the EMU. We are facing four challenges: a lack of finance, public investment, structural reform and economic stability.

Thomas Wieser, former President of the Eurogroup Working Group, former chair of the Economic Finance Committee (EFC), said that political developments in Italy and Germany have slowed down a deepening of EMU. We are facing severe political problems in the Union, such as populism and nationalism. Most of the loopholes of the Maastricht Treaty have been filled, the banking union and ESM, for instance, have been successes. The five adjustment programs have been successful as well. In terms of fiscal policy, Wieser said the EU budget rules are difficult to implement and he questioned the need for an EU budget. Most of the work will have to be done by national governments with pro-growth policies. Nevertheless, many challenges will have to be overcome in order to complete EMU in any way and to prevent another crisis in the future. Therefore, it is a necessity to take further steps to strengthen EMU and enable it to be stable and resistant to crises in the future.

Dinner Speech: Deepening EMU – Political Integration and Economic Convergence

In his dinner speech, *Boris Vujcic* referred to the similarity between the Habsburg Empire and the EU. In both cases, various regions coexisted or coexist, united by supranational bodies and policies. Economic divergence has always been a breeding ground for destructive forces, especially during difficult economic times. In the EU, we have experienced a rise in populism and nationalism after the crisis. The EU has to deal with these issues and take them seriously. Furthermore, convergence should not be taken for granted. Convergence depends on structural issues more than on monetary and fiscal policies. There were strong investment inflows before the crisis, but this will not be the case in the future. Therefore, CESEE countries will have to develop new growth models. Fiscal policy can only create limited growth and is far from being the ideal instrument. The percentage of elderly people is growing and the population of working age is shrinking. We have to fight on so many fronts. The agenda for reforms is widely supported. Should we act on all of them? Do we understand them all? Probably not.

Keynote lecture: Deepening EMU – Political Integration and Economic Convergence

Marco Buti, Director-General of the DG for Economic and Financial Affairs of the European Commission presented the steps he considers necessary for preparing the EU to withstand a potential next crisis. His three key messages were as follows: First, Buti warned that the EU is not ready to withstand the next crisis, although several important

institutional reforms have been implemented and banks are more resilient now than they were before the crisis. Among other things, the following action is key to improve the functioning of financial markets: complete the banking union, progress toward the capital markets union, establish a central fiscal capacity to deal with large shocks with asymmetric implications and arrive at an agreement to launch a genuine European safe asset. Second, Buti stressed that the EU and its Member States need political leadership to create a common narrative and to overcome the approach of implementing reforms mainly as “ultima ratio”. The EU should use the current favorable conditions to prepare for the next downturn instead of waiting for the next crisis to implement reforms. Buti also mentioned that, due to the current political environment, it is no longer possible to trust politicians’ commitment to preserve the European project, as it has been the case in the past. Third, Buti talked about the false dichotomy between risk reduction and risk sharing. While the EU does need risk reduction and risk sharing to happen in parallel, it is necessary to recognize the progress that has been made in reducing risks in Europe and that risk sharing helps further reduce risk. The Commission proposal for a European Investment Stabilisation Function represents a means to share and reduce risk.

Panel 4: Financial Convergence, Resilience and Supervision

Franz Rudorfer, Managing Director of the Austrian Federal Economic Chamber, opened the panel by stating that new regulations introduced in the aftermath of the financial crisis had made banks more resilient and definitely safer. Nevertheless, the industry is struggling with contradictory regulations, overlapping

requirements and national gold-plating potentially jeopardizing the level playing field.

Florian Hagenauer, member of the Management Board of Oberbank, stressed that the main factors contributing to the impressive development of Oberbank over the last decade included an efficient management structure and a profit-oriented strategy. The focus lies on developing the customer base, on facilitating growth by entering new markets (Germany, Czech Republic, Slovakia and Hungary) and on opening new branches. In this respect, the human factor is a key aspect of their strategy. *Hagenauer* mentioned that the amount of red tape and related bureaucracy due to increased regulation makes life harder for banks, but that Oberbank tries to anticipate what will be the regulators’ requirements. The regulatory measures are often difficult to implement and hard to explain to customers. Oberbank is following a conservative risk approach and does not have to follow every trend in banking; just being “boring” can be the secret to success.

Hannes Mösenbacher, Chief Risk Officer at Raiffeisen Bank International AG, stressed that regulation is necessary. At the same time, he pointed out that there are too many players involved who are competing against each other, such as the ECB, EBA and EC. Especially banks like Raiffeisen that are active in many countries would benefit greatly from a single rulebook. Competition is something to be welcomed, but having a competitive edge due to unequal regulation is unfair, especially with regard to new competitors like Fintechs. A new aspect which nobody covered so far is the “trade war” between the U.S. and Europe and the potential sanctions.

According to *Marco Valli*, Head of Macro Research and Chief Eurozone Economist at UniCredit Bank AG,

cross-border banks need to be more resilient and better able to smoothen the economic cycle than banks that are not cross-border. Especially in the absence of a common fiscal tool for cyclical stabilization, they need to be able to lend if needed. However, regulatory treatment of cross-border banks is inconsistent. First, constraints on free movement of capital strongly discourages cross-border activity within a banking group. Second, the one-size-fits-all treatment of NPLs is compromising the level playing field due to differences in national jurisdictions. All of these constraints pose a risk to the functioning of the transmission mechanism of monetary policy in the euro area. The ultimate aim should be to have the banking union considered as a single jurisdiction from a prudential perspective. Although it is clear that this would take time, it is important to acknowledge that actions such as the ring-fencing of liquidity and capital, which might be seen as an optimal solution from a national point of view, are self-defeating at the aggregate level.

Panel 5: Convergence of Production, Investment and the Reduction of Imbalances

Ralf Kronberger, Director of the Austrian Federal Economic Chamber, started the panel by recalling the academic debate about whether the EU was ready for adopting a single currency or not – between those advocating that a single currency should be the crowning of a lengthy process of convergence among its prospective members, and those who considered a single currency feasible even against the backdrop of diverging economic indicators. Following the introduction of the euro, some economic variables have been showing a mixed picture, some even diverging in regard to per capita income between

1999 and 2014 in four countries of the euro area. During the period after the crisis, the institutional development of the EU took important steps forward. However, the Macroeconomic Imbalance Procedure (MIP) shows some weaknesses with regard to the interpretation of the existence of macroeconomic imbalances since there is no agreed upon definition of what represents a harming imbalance.

Marco Buti emphasized that the convergence before the 2008 crisis was not sustainable, especially not for the euro area countries. During the first ten years of the euro, the peripheral countries and the core structurally diverged. Possible reasons could be the misallocation of capital, as the core countries invested more in tradable goods whereas the periphery invested in non-tradable goods. This led to differences in growth due to productivity divergence, fed the political debate after the crisis, and increased disparity in social and political preferences.

According to *Wilhelm Molterer*, Managing Director of the European Fund for Strategic Investments (EFSI), convergence is the cornerstone of the EU and the driving force for making the EU stronger. EFSI is the central pillar of European Commission President Juncker’s investment plan for Europe, aimed at supporting investment through supporting private public partnerships (PPPs) and through helping to build high-quality institutions and an investment-friendly environment. Technically, EFSI is an EU budget guarantee that provides the EIB Group with first-loss protection, thus enabling it to provide financing amounting to EUR 500 billion in investments from 2015 to 2020. Support of SMEs, sustainable investments and digitalization are given priority. PPPs need to close the financing gap and should promote investments;

however, some hurdles such as the low quality of institutions and the lack of efficiency on capital markets need to be removed.

As a representative of the industry, *Robert Ottel*, Member of the Management Board and CFO of voestalpine AG, remarked that the investments of voestalpine are longterm decisions driven by the attractiveness of the region and by innovation. In his opinion, CESEE is no longer as attractive and competitive as it used to be. The decisive long-term factor that encouraged voestalpine to invest in Austria was the availability of a skilled labor force as well as the secure business environment. In general, EU Member States have to compete for investment. Low labor costs are no longer a relevant factor, because they are converging. Tax and subsidy regimes can change in the medium to long run; therefore, they are important but not decisive factors. Demographic developments and the availability of skilled labor are the only long-term production factors.

Session on Banking and Capital Markets Union – Financial Regulation and SME Financing

Andreas Ittner, Vice Governor of the Oesterreichische Nationalbank, opened the panel by underlining that banks still play an important role in funding the real economy. Nevertheless, the banks' balance sheet structure shifted towards mortgage lending while funding for nonfinancial corporations decreased. This development is driven by supply and demand. Ittner then asked how financial regulation would affect banks' lending to small and medium sized enterprises (SMEs). Higher capital requirements do not have an immediate impact on the amount of credit given, but they affect the cost of funding for banks. In the short run, higher capital

requirements can affect credit growth; in Austria, however, this was not the case. The financial crisis triggered the strongest decline in bank lending to SMEs. Initiatives envisaged by the European Commission's action plan on building a markets union (CMU) will reduce SMEs' reliance on bank lending, but Ittner cautioned against the belief that bank lending for SMEs will be substituted completely by CMU.

Danièle Nouy, Chair of the Supervisory Board of the European Central Bank, stated in her keynote lecture "Financing the economy – SMEs, banks and capital markets" that the core task for banks is to finance the real economy. What is the real economy? In fact, huge companies like Apple or General Motors do not represent the real economy; instead, SMEs are the backbone of the real economy. However, SMEs are generally limited in their choice of funding sources and must therefore rely heavily on banks. Regulators will react to this structural disadvantage for SMEs and envisage a separate treatment for SMEs in the Basel framework. The next step to diversify funding sources for SMEs is the completion and implementation of the capital market union – although there is still a long way to go. With a truly European integrated market, SMEs could tap into funding sources across borders.

According to *Andreas Treichl*, Chair of the Division 'Bank and Insurance' of the Austrian Federal Economic Chamber and CEO of the Erste Bank Group, banking regulation in EMU is a very complex stand-alone system. Compared to the U.S., European financial regulation is more democratic but also more bureaucratic. The EU is lacking a capital market culture; the only countries having one would be the UK (which is leaving) and Switzerland (which is outside the EU). In Austria and Germany, the prevailing

attitude can be summed up as "saving is good, investment is bad". In his view, the CMU cannot be built by implementing instruments; it requires a change of culture. For Treichl, one of the most urgent steps that EU governments must take is to complete the third pillar of the banking union, i.e. EDIS. Europe is falling behind in the field of digitalization and artificial intelligence due to a lack of competition in the high-tech industry. To this end, politicians need to stop seeing investors as speculators. He suggested allowing banks to give 1% to 2% of their risk weighted assets (RWA) to SMEs in the form of unsecured credit, depending on the NPL ratio. Treichl concluded his speech by stating, "In Europe, we hate to make mistakes – but this is our greatest mistake".

Heinrich Schaller, CEO of Raiffeisenlandesbank Oberösterreich and former CEO of the Vienna Stock Exchange, stressed the importance of bank lending as a financing source for SMEs in Europe. Banks in Europe did a good job supporting SMEs with funding. During the crisis, banks were de facto the only funding source for SMEs in Austria. However, the ratio of bank lending vs. capital financing for SMEs is too high. This can only change if the mentality of EU citizens changes (as mentioned already by Treichl) and if the regulatory framework stops deterring banks from engaging in equity financing and from selling equity instruments. In general, the regulatory environment in the EU is too complicated and banks face too many requirements from too many institutions.

Othmar Karas, Member of the European Parliament, underlined the difference in cultures as well as the different political and economic frameworks and banking sectors/systems in the U.S.

and Europe. The European economic system is financed through credit whereas the economic system in the U.S. is financed through capital. Even though the world needs global rules, European regulators should act as Europeans. In a political-historical outline, he explained that the compromise achieved in Maastricht was also about linking the EU Member States together to prevent them from returning to the nationalistic way of thinking of the past. *Karas* considers the banking and capital market unions to be essential projects to create financial stability as well as growth and jobs in Europe. The challenges of globalization, digitalization and Brexit are exacerbated by the daunting fact that the euro is still the only currency in the world which is not yet backed by a common budgetary, fiscal, economic and tax policy. In addition to strengthening the financial union, efforts to establish an economic and fiscal union while ensuring democratic accountability, effective governance and convergence must continue. The euro's rescue fund, the ESM, has to gradually develop into a fully-fledged European Monetary Fund, firmly anchored in EU Community Law.

Governor Nowotny closed the conference by thanking the organizers, speakers and participants for the inspiring event. We had serious and realistic discussions which can help to deliver practical progress. Hopefully, the conference was able to contribute to finding solutions for a successful deepening of and convergence in EMU.

Majken Corti
Ingrid Ettl
Sylvia Gloggnitzer
Christiane Kment
Franz Nauschnigg



Opening Remarks

Financial regulation

After 2008 we had the impression that the EU was exposed to a high degree of public pressure. It was challenged to quickly adapt the legal framework for participants in the financial market since they were, at least in part, responsible for the financial crisis as levels of regulation had hitherto been too weak and insufficient.

It was also clear to financial institutions that new rules were needed which would ensure a stable and functioning financial market. And, of course, it should not be the taxpayer having to pay when banks that are “too big to fail” experience difficulties. However, what then happened was the creation of the most complex and thus most expensive legal framework that Europe has ever seen.

Banks are not complaining about the new regulations, even if they are sometimes difficult to accept. The problem in this respect is that the banks’ core business suffers as a result:

- Instead of banks using their core competencies for their day-to-day business, these are devoted to complying with legal and political requirements.
- The costs associated with complying with these requirements and developing new structures and systems are exorbitant.
- In most cases, the time periods that are provided to comply with these regulations are much too short.
- The requirements often change in the middle of the implementation process.
- The instructions provided for the implementation of new measures are often too imprecise and vague.
- The institutions (European Banking Association – EBA, ECB, European Commission, national authorities) often do not coordinate with one another or their instructions diverge.
- Systemic or national particularities are often not taken into account.

Small and medium-sized enterprise financing

Bank lending continues to represent the most important source of financing for small and medium-sized enterprises (SMEs) and is often based on a long-term relationship between a bank and its customers. Banks with a regional and local focus can adapt ideally to the specific financing needs of SMEs. Banks possess expertise in the evaluation of credit risk from SMEs and can create their appraisal based on a company’s credit history. Focusing on the customer is the most effective way to secure and improve access to financing for SMEs.

Due to this intensive relationship between SMEs and banks, the deliberations of the Basel Committee on increasing levels of equity backing for SME financing are not well-founded. This is also because, most importantly, SMEs form the backbone of the European economy, which is why access to finance should not be made more difficult for them.

Nevertheless, it is important to diversify financing options for SMEs in order to allow them to access a broad range of options. However, there are still many obstacles for SMEs if they wish to take advantage of market-based and other more innovative forms of financing. The availability of financial information on SMEs is key to successfully accessing the capital market. Investors must be in a position to assess the profitability of, and risk appetite associated with, their investment, irrespective of whether these are banks, institutional investors or small investors.

A note on forms of financing: bank loans represent companies’ borrowed capital. If a company is listed on a stock exchange, it receives equity. This means that the money lender is a co-owner of the company and is exposed to a significantly higher level of risk than a creditor, since if the company is liquidated external

creditors have priority. A stock exchange listing is considered the 'high-end' of equity financing. Securitisations could offer an opportunity to increase the level of credit granted by banks to SMEs.

One option made possible by a stock exchange listing and which is associated with lower costs are what are known as 'baskets': SMEs from a certain sector or region are grouped together or combined in a basket to be assessed jointly. However, it should be verified whether this form of financing is deemed to be useful or viable, or whether other financing options can be developed via the capital market for SMEs. If the associated costs mean that it is not practicable to have a company listed on a stock

exchange due to numerous information rules and required adjustments across all structural situations, crowdfunding, peer-to-peer loans, employee participation programmes or business angels may represent an appropriate solution.

The use of new and innovative technologies could also open up new financing options for SMEs. It is important to expand SMEs' expertise across complementary market-based sources of financing and to enable them to understand the costs, benefits and the associated risks of these often complex forms of external financing. It is entirely reasonable to create a capital market culture in which entrepreneurs are prepared to consider capital market-related solutions.



Ewald Nowotny

Governor
Oesterreichische Nationalbank



Opening Remarks

Ladies and Gentlemen,

It is a great pleasure to welcome you here in Linz to today's and tomorrow's conference hosted by the Oesterreichische Nationalbank in cooperation with the Austrian Federal Economic Chamber (WKÖ). My special thanks go to Raiffeisenlandesbank Oberösterreich for making this great conference venue available to us and to Land Oberösterreich for their hospitality and tonight's dinner invitation to the Linz castle.

In coming to Linz – a town with which I am personally closely connected – this year, we follow a tradition. In 2006, when Austria last held the EU presidency, we also started the economic policy discussion with a conference here in Linz, the capital of Austria's industrial heartland.

We also follow a long-standing tradition by inviting prominent speakers from Austria and from abroad, and I want to thank all the renowned experts that have accepted our invitation very much. Moreover, it was important for us to bring together speakers from academia and political decisionmakers, as well as representatives from the industry and small and medium-sized enterprises (SMEs). Last but not least, we continue the tradition of having speakers representing the various sides of the Austrian system of social partnership. Let us not forget that the different social partners' joint effort had been crucial for the positive outcome of the referendum that established Austria's membership in the EU. In a similar vein, it is important today to establish broad-based consensus vis-à-vis the EU in general and especially with regard to economic policy. In my view, this also means strengthening, not weakening, the consensus-building role of Austria's system of social partnership.

I very much hope that this conference will contribute to strengthening

the role of rational dialogue and of mutual understanding with regard to Europe's future economic perspectives and Austria's contribution in this respect.

The title of our conference, "Economic and Monetary Union – Deepening and Convergence," implies that Economic and Monetary Union, or EMU for short, is not yet perfect. However, while there is clearly room for improvement, let us not forget that both EMU and the euro are major achievements.

EMU has anchored price stability and fueled cross-border trade and financial integration. In 2017, the European economy grew at its fastest pace in ten years, and for the first time since 2007, all Member States saw their economies expand. In 2018, GDP growth is expected to remain strong, based on strong private consumption as well as increased investment and exports, and unemployment rates are receding toward pre-crisis levels. Robust growth helps both further reduce government deficit and debt levels and improve labor market conditions.

"The wind is back in Europe's sails. But we will go nowhere unless we catch that wind," as President Juncker said in his 2017 State of the Union address. We can use the current good times to make our economies more resilient. This means building fiscal buffers and implementing further economic reforms to strengthen the foundations of our Economic and Monetary Union. We have already made great strides in making its architecture more robust, but it is still not complete. More work lies ahead to ensure that the benefits of EMU reach all EU citizens.

The date of this year's Economics Conference was not chosen randomly. The beginning of July coincides with the start of the Austrian EU presidency in the second half of 2018. After 1998 and 2006, this is now the third time

that Austria holds the Presidency of the Council of the European Union. This time, the Presidency faces major challenges, including

- the Brexit negotiations with the U.K.,
- the debates on the multi-annual financial framework,
- progress in completing banking union,
- the implementation of the European Security and Migration Agenda,
- the fight against terrorism, and
- the debate on the future of the European Union.

The Austrian EU Presidency takes place at a politically sensitive time as the European Parliament's legislative period ends in 2019. Important dossiers have to be finalized before the European elections in spring 2019.

For the European Union as a whole, the euro is a symbol of a peaceful Europe, a keystone of economic integration and political unity. For the world, the euro has become a major player in the international monetary system and the second most important global currency.

The single currency rests on a common monetary policy, where the Governing Council of the ECB can and must only target the euro area aggregate when making monetary policy decisions. In mid-2012, Mario Draghi's statement that the ECB is ready to do "whatever it takes to preserve the euro" within its mandate undoubtedly re-established confidence in sovereign bonds. Moreover, in response to the crisis, the EU laid the foundation for a banking union by establishing the Single Supervisory Mechanism at the ECB, which is a main pillar of banking union.

During the global financial crisis starting in 2008, EMU was seriously put to the test. As an emergency response, a number of instruments were proposed and adopted. In this context, the debate on deepening EMU gained

momentum, with a view to ensuring that Europe is better prepared to withstand future shocks.

The Five Presidents' Report "Completing Europe's Economic and Monetary Union" published in June 2015 by the Presidents of the European Commission, the European Parliament, the European Central Bank, the European Council, and the Eurogroup laid down a roadmap to deepen EMU in two stages and complete it by 2025 at the latest. The proposals rest on four pillars: first, an economic union that promotes convergence, prosperity and social cohesion; second, a financial union that integrates banking and capital markets regulation; third, a fiscal union that guarantees sound public households; and fourth, a political union that strengthens democratic accountability, legitimacy and institution building.

In the meantime, the European Commission has published a great number of papers and proposals to advance the different fields covered in the Five Presidents' Report. We all know that this is hard work and that other topics may overshadow economic policy discussions, as was the case at the last European Council summit. In any case, the Euro Summit on June 29 agreed that the banking package will be adopted before the end of the year, and the ESM will provide the common backstop to the Single Resolution Fund.

If we take a medium-term view, the EU and EMU have achieved substantial progress in important fields – progress that may have been considered utopian just ten years ago. I just want to mention the establishment of the Single Supervisory Mechanism in the context of the European banking union and the creation and highly successful work of the European Stability Mechanism. In my view, this may be seen as reason for cautious optimism with regard to the

next steps of the evolution of European economic and monetary policy. The capital markets union initiative launched in 2014 is a case in point. Its aim is to provide businesses with a greater choice of funding at lower costs, offer new opportunities for private investors, and make the financial system more resilient. By encouraging households and companies to invest, a capital markets union mainly enables SMEs to access market financing in the European Union across national borders. Hence, the capital markets union fosters cross-border private financial risk sharing. In the EU, SMEs account for a share of over 90% of all businesses, which patently illustrates the potential of the capital markets union initiative to promote sustainable growth. Only 3,000 of the 20 million SMEs in Europe are listed on a stock exchange. This is about to change, as rules have been proposed that make it easier for SMEs to tap into a wide range of funding at all stages of their development, and I fully trust the initiative and energy of my friend Christoph Leitl, President of Eurochambers and co-initiator of this conference, to achieve progress in this field.

Let us not forget that all EU countries, except two with an opt-out, should one day adopt the euro. However, compared with the situation before the crisis, the setting in which euro area enlargement is taking place has changed profoundly. Lessons drawn from the crisis have substantially transformed the institutional set-up of EMU itself. In particular, the creation of the SSM has added an entirely new dimension to future euro area accession processes.

At the same time, experience from the crisis has sharpened policy makers' views, both in the current euro area countries and in the non-euro area Member States, on what it takes for an individual country to participate smoothly in a monetary union.



In a nutshell, we are facing twin challenges in the EU today – namely, that of deepening monetary union for the euro area countries, and that of achieving convergence to allow for a smooth integration into monetary union of those EU Member States not yet part of the euro area.

At today's and tomorrow's conference, renowned experts and policy makers will provide us with new insights and help us understand where we stand right now in terms of EMU deepening and convergence. Let us take this opportunity to discuss what the major risks and needs for action are. During Austria's EU Presidency, we will strive to help master these challenges.

I am very much looking forward to stimulating presentations and fruitful discussions, and I wish you an interesting and pleasant stay in Linz.

Christoph Leitl

President
EUROCHAMBRES – The Association of European Chambers of Commerce and Industry
Honorary President
WKÖ



Keynote Lecture 1: Deepening EMU – Political Integration and Economic Convergence

Dear Governor Nowotny,
Dear Mr Schaller,
Excellencies, Ladies and Gentlemen,

It is a real honor and pleasure for me to be here with you at the start of the Austrian EU Presidency. A very warm welcome to our keynote speakers, panelists and all our distinguished participants and guests. We are very happy to have you here today to discuss the future of the euro area and, more general, the economic future of Europe.

First, I would like to thank our partner, Oesterreichische Nationalbank, for the excellent cooperation during the preparation of this event. Governor Nowotny and I took the initiative for this conference. Archetype was a similar very successful event organized by both organizations in 2006 during the last Austrian EU Presidency at the same venue. In addition, many thanks to Raiffeisenlandesbank Oberösterreich for hosting the conference as well as to Land Oberösterreich for the evening reception at Linz castle.

Europe's economic stability, resilience to crises and competitiveness must be a priority. Strengthening the single currency, curbing speculation and creating new institutions to help countries coping with problematic situations is part of Europe's economic and security architecture. An Economic and Monetary Union (EMU) that is more stable, resilient to crises, and competitive must be coupled with better economic governance and accelerated convergence through a strict and consistent approach to implement structural reforms across Member States. An extensive transfer of powers can only be envisaged if sufficient economic and social convergence among Member States and their regions is achieved.

Europe still suffers from a lack of implementation and enforcement of necessary reforms. The European Semester is therefore of crucial importance for guiding Member States when drafting and implementing structural reforms. This is the basis for investment, growth, and employment as well as for sustainable financing of the European Union.

Let me address the following main points:

1. The EMU should be inclusive and based on strong, shared values, as it will help to strengthen the EU. Despite the euro area being perceived as unsustainable, the euro enjoys continuous support – 70 percent over the past ten years. In contrast, in Member States outside the euro area, support for the euro declined over the same period from 56 percent to 37 percent. It is a clear sign that people within and outside the EMU perceive the euro differently. The main challenge for the future of the EMU is its incomplete institutional character, as it suffers from the lack of a political entity behind it as well as from different perceptions of the euro depending on whether a country is in or out of EMU. Nevertheless, the euro is still “the only existent common language” in a union characterized by linguistic variety.
2. A strong EMU requires strong, responsible, and decisive leadership and actions, starting with the Stability and Growth Pact and fiscal buffers, but also via the whole European Semester process. The EU's stability, resilience, and convergence is directly proportionate to the condition within the EMU and affects the well-being of our societies.
3. Despite our society's continuous support for the European project,

there is no doubt that we need to work harder on restoring our citizens' trust and confidence. Hence, we need to strengthen the economic and financial stability of all Member States. We need to finally recognize the potential of our cooperation and complete great projects such as the banking union and the single market. In addition, we should develop the European Stability Mechanism (ESM) into a European monetary fund, improve economic cooperation, and further enhance the EU's growth potential; and finally, despite all the current challenges, we have to pursue an ambitious trade agenda.

4. Speaking about stability, planning security and trade: There are exceptional situations where European companies that operate across borders need support while facing external shocks. Such a European crisis or buffer fund could take the form of an export guarantee for a certain transition period. It could act as a measure of last resort, and only be applicable once all other remedies, including national ones, have been exhausted. It should only be applicable for companies acting in good faith and for events constituting force majeure.
5. For an entrepreneur, taxation always plays an important role. In addition, a tax revolution is currently taking place. With regards to ongoing tax proposals and reforms, entrepreneurs that are operating cross border need clear and easily administrable tax provisions. The proposed destination principle would, however, lead to high additional costs and considerable administrative burdens and would increase legal uncertainty for all companies and, in par-

ticular, SMEs (small and medium-sized enterprises) which suffer from informational disadvantages.

From an investment point of view, there is strong interest to push companies towards the stock markets. However, investing in SMEs or financing business activity via equity is not necessarily tax friendly: in many countries, there are no or little tax incentives and the bias regarding tax debt persists.

Regarding digitalization, temporary measures are not sufficient means to tackle the problems of the taxation of the digital economy; a long-term and comprehensive solution is needed. The proposed digital tax would most likely increase the tax burden and compliance costs for businesses. It would not contribute significantly to creating a level playing field or to increasing the competitiveness of EU digital companies.

We all understand that taxes need to be paid as we depend on them, be it in provision of public services or pension schemes, but we are calling for a consultative approach and a fair share of taxation being borne by all social actors.

6. In order to be fit for running all these projects and make them happen, we need a post-2020 multi-annual financial framework that can actually respond to these needs. We need a budget focusing on education, innovation, competitiveness, flexibility, and R&D, as these are the factors that will help to improve Europe's productivity in the medium- and long-term. Structural reforms are key to improving the resilience and perspectives of growth for each Member State and the EU as a whole. Well-targeted budgetary resources can help to

change a Member State from being euro reluctant to euro willing.

7. We need to work on strengthening the euro area by preserving the EU's unity, as it is not the time for a re-emergence of divisions. We need a credible scale up-Europe with the EMU featuring humanity and

flexibility, as it is not only economically and politically indispensable, but it is our responsibility towards current and future generations because the EU, it is you, it is me, it is us.

I wish you interesting discussions and a pleasant stay in Linz.



Keynote Lecture 2: Towards a More Stable Monetary Union – What Is the Right Recipe?

Dear Ewald,
Ladies and gentlemen,
It is always a great pleasure for me to visit Austria.

One year ago, almost to the day, I was in Vienna to talk about the future of the monetary union. Back then, the key issue was how to ensure that the union is permanently preserved as a union of stability. Today, we are still dealing with this issue. In fact, it concerns us now more than ever. The meeting of the EU's heads of state or government last week marked yet another milestone on this journey.

As Austria has just taken over the presidency of the Council of the EU, it plays a key role in moderating the reform process. In that sense, we are in exactly the right place to discuss the way forward for the economic and monetary union.

I am particularly pleased to be here in Linz. Since it is my first visit, I am looking forward to tasting Linzer Torte, the nutty jam-filled cake named after the town.

The first recorded recipes for Linzer Torte date from the 17th century. It is therefore believed to be the oldest known cake recipe in the world. And from the outset, there wasn't just one recipe, but a range of variants with slight differences in ingredients and ways of preparing it.

Thus, there is one problem that every baker has to solve: which is the "right" recipe?

When we talk at this conference about the future of economic and monetary union, we are in a somewhat similar position. There are a large number of proposals on the table concerning the future design of the euro area. All proposals share the ambition to make the monetary union more stable and more

resilient. But it is an open question which of the recommendations are appropriate to this end.

Allow me to approach this question in three stages. I will set out with the basic ingredients for a stable union. As you will see, these are largely not in dispute. Then I will turn to the institutional framework which, one might say, resembles the fundamentals of baking. Finally, I will discuss some recent reform proposals – or specific baking instructions, if you like.

1 Basic ingredients

Turning to the basic ingredients, you won't be surprised that, as a central banker, my considerations start from monetary policy geared to price stability.

The European treaties provide us with an ideal framework for this: the Eurosystem is equipped with wide-ranging independence and has a clear mandate with price stability as its primary objective. And that has paid off. With an inflation rate of 1.7% on an average of the past 20 years, price developments have broadly been in line with our definition of price stability. The promise of a stable currency has thus been kept.

But the success of monetary policy also depends on conditions which it cannot create on its own. In particular, it is dependent on a stable financial system.

After the "Great Inflation" of the 1970s, advanced economies experienced a long period of remarkable economic stability that came to be known as the "Great Moderation". Academics were still debating the specific role of monetary policy in bringing about this period of economic calm when the global financial crisis ended it.

Important lessons have been drawn from the crisis. The regulation of banks,

insurers and financial markets has been strengthened. And, along with the reform of traditional supervision, macroprudential policy has been established as a new policy field. It can be deployed against regional and sectoral pockets of exuberance in case they are suspected of posing a systemic risk.

As the sovereign debt crisis has painfully reminded us, such risks can also arise from unsound public finances.

In a monetary union, the risk of excessive debt is greater than in countries which have their own currency. Saying that, I do not so much mean the lack of the option to service government debt simply by printing money. For a central bank committed to price stability, that is a complete non-starter anyway – whether in a monetary union or not.

Something else is more important: in a monetary union, the incentive to run up debt is greater because the negative consequences are smaller. For instance, interest rates may not rise as much in response to fiscal profligacy. In order to prevent such behaviour, the member states agreed on joint fiscal rules. But rules can only be of help where there is a will to observe them.

In retrospect, ever since the euro was introduced, there has not been a single year in which all countries have kept their new borrowing below the ceiling of 3% of GDP. The Commission projects that this will be achieved this year for the first time. That would be good news indeed, but it is no cause for jubilation, as the Stability and Growth Pact calls for more to be achieved in two respects.

First, the 3% mark is not a benchmark, but a ceiling. Fiscal policy should be focused on the medium-term objective,

which requires that member states have a structurally close-to-balance budget.

Consequently, we have to consider the economic environment when assessing fiscal policy. And the underlying conditions have improved remarkably in recent years: the robust economic upturn means higher revenues from taxes or social security contributions and lower outlays for unemployment benefits.

Moreover, government interest spending has fallen thanks to low interest rates. According to Bundesbank calculations, this has generated savings of approximately one trillion euros in the euro area over nine years.¹

In times such as these, fiscal policy should not be satisfied with merely adhering to the 3% threshold: it should be aiming for the zero mark or surpluses. That would give governments the leeway they need to take fiscal measures in the future, when economies may enter another downturn.

It would also help to reduce the overall debt burden, which – and that is my second point – is much too high in some countries. As things currently stand, just 7 out of 19 euro area member states meet the debt ceiling of 60% of GDP. For the euro area as a whole, debt stood at 87% of GDP last year. And these figures do not account for implicit future burdens in connection with demographic change. When considering such implicit debt, public finances in most countries – and certainly including Germany – face demanding challenges.

Elevated debt levels must not become permanent, also because persistent breaches harm the binding effect of the common fiscal rules. Benjamin Franklin already warned us that it is easier to prevent bad habits than to break them.

Moreover, high levels of government debt limit the fiscal room for manoeuvre. They make it difficult to channel government spending towards investment, weaken resilience and thereby raise uncertainty, which is very likely to dampen economic growth in the long term.

And this brings us to the last basic ingredient for a stable monetary union: competitive economies which are resilient enough to withstand or recover from adverse shocks.

Unlike countries with their own currency, euro area member states cannot resort to the instruments of monetary policy and exchange rate flexibility when they face country-specific shocks. And the single monetary policy looks only at the euro area as a whole. It can respond to the specific situation of individual member states only in so far as they affect euro area aggregates.

In the wake of the crisis we witnessed that some countries bounced back quite quickly from the economic slump, while in others growth remained low and unemployment stayed high for a long time. If the monetary union is to function free of tensions, member countries have to improve the underlying structures so that their economies become – or remain – competitive and resilient.

One element, for instance, is that easier market entry for new enterprises – and easier market exit for failing firms – can unlock the innovative potential of companies. Both would facilitate what the great Austrian economist Joseph Schumpeter called “creative destruction”, which he described as a

process that “incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one.”

OECD research suggests that policy-induced exit barriers matter for productivity growth, because unproductive firms that do not exit the market lock workers into unproductive jobs.² According to OECD estimates, reducing barriers to restructuring could, for instance, add more than 2 percentage points to productivity growth within laggard firms in Italy.³

Beyond pro-competitive regulations for product markets, there is a wide range of possible policies for enhancing resilience, including such diverse areas as the quality of institutions, political stability, infrastructure and labour market reforms.⁴

2 Fundamentals of baking: an act of balancing

We have identified four basic ingredients for a stable union: monetary policy geared towards price stability, a sound financial system, healthy public finances, and resilient economies.

Four basic ingredients are also needed for shortcrust pastry, the base of the Linzer Torte: flour, sugar, eggs, and butter.

One secret of the pastry is the right level of gluten. It provides the dough with stability and elasticity, and it forms when proteins in the flour build a network of chains. This happens by adding liquid to the flour and kneading the mixture. However, the gluten content must be limited in order to produce a

¹ Deutsche Bundesbank. 2017. *The development of government interest expenditure in Germany and other euro-area countries. In: Monthly Report. July 2017. 33–67.*

² McGowan, M. A. and D. Andrews. 2016. *Insolvency Regimes And Productivity Growth: A Framework For Analysis. OECD Economics Department Working Papers 1309.*

³ McGowan, M. A., D. Andrews and V. Millot. 2016. *Insolvency Regimes, Technology Diffusion and Productivity Growth: Evidence from Firms in OECD Countries. OECD Economics Department Working Papers 1425.*

⁴ In particular, a Bundesbank study has argued that greater wage flexibility would probably have helped overcome the crisis and safeguard employment in some euro area countries. See Deutsche Bundesbank. 2016. *Wage dynamics amid high euro-area unemployment. In: Monthly Report. December 2016. 33–55.*

tender short pastry. Too much gluten makes the dough tough. Therefore, it is important to refrain from kneading too much.

A similar act of balancing is required for a stable monetary union, when we frame the basic ingredients within a crisis-proof institutional set-up to provide the right incentives for responsible behaviour. The particular architecture of monetary union doesn't make things any easier. In the euro area one single monetary policy co-exists with 19 autonomous fiscal and economic policies.

The autonomy reflects and enables the diversity of member states in terms of their economic and social structures, which is an expression of our societies' distinct preferences and identities. In my view, such great variety is an asset and contributes to Europe's richness. It is not by chance that the official motto of the European Union is "in varietate concordia" – united in diversity.

But the asymmetric construction also makes the monetary union vulnerable.

The original recipe as enshrined in the Maastricht Treaty focussed on a no-bailout clause that would unleash the disciplining power of financial markets. This framework did not prevent the crisis, nor did it provide any mechanisms or tools to overcome it.

Since the crisis, however, the design of the union has already been adapted in some important aspects. The establishment of the ESM as a permanent rescue facility and the creation of the banking union remedied design weaknesses that were either ignored or overlooked when monetary union was founded.

However, the euro area is not yet permanently crisis-proof. And that's why there is a broad consensus that further institutional reforms are needed.

The proposals that are currently under discussion differ on one point in

particular, namely on the extent to which risks should be shared. Some place their faith in greater joint liability, while others would like to strengthen individual responsibility.

However, the true challenge consists in striking a balance between actions and liability. That means the decision-making power and responsibility for the effects of the decision have to be placed on the same level. Responsible decisions are taken only if the decision-makers also bear the consequences. Why, for example, should a government refrain from risky policies if, at the end of the day, the community has to pay the bill?

In the 2010 sequel to the classic movie "Wall Street" the fictional character Gordon Gekko, played by Michael Douglas, explains the problem more eloquently than I ever could: "Moral hazard is when somebody takes your money and is not responsible for it."

Rebalancing actions and liability by no means rules out a greater sharing of risks. In order to maintain the balance, however, the relevant powers would have to be transferred along with the risks to the European level.

Having said that, I can identify very few member states that display a willingness to forgo national competences. Quite the opposite: over the past few weeks it has again become apparent that those who may call the loudest for greater risk sharing explicitly insist on their national sovereignty in fiscal policy matters.

And that highlights the current dilemma: demanding greater solidarity of the community and, at the same time, rejecting any transfer of competences to the community does not match up. The saying "You can't have your cake and eat it too" also applies to this trade-off between national sovereignty and risk sharing.

3 A closer look at some instructions

At last week's Euro Summit in Brussels, the heads of state or government identified the need for further discussion in many areas with regard to the framework underpinning the EMU. This has prompted a great deal of criticism and calls for faster decisions. But I am in favour of putting thoroughness before speed. Further debate ought to take priority over preconceptions or hasty decisions.

Nevertheless, the governments confirmed that further reductions in risks are necessary before the banking union can be completed by introducing the European Deposit Insurance Scheme (EDIS).

The Bundesbank has long recommended that risks which banks incurred under national responsibility should not be retroactively mutualised through the EDIS. To a casual observer the proper sequencing has always been a matter of common sense. In the end, when you have just crashed your car, it's too late to take out insurance with comprehensive coverage.

Obviously, reducing risks requires addressing the legacy of non-performing loans on banks' balance sheets. But we cannot stop there. Going forward, more needs to be done to rein in future risks by severing the sovereign-bank nexus. It is crucial that we abandon the preferential treatment of sovereign debt in banking regulation. If this matter is not resolved, further steps towards completing the banking union would imply a significant increase in fiscal risk sharing.

In the coming months, discussions will also focus on possible new fiscal tools.

At this point, allow me a general word of caution. We need to be mindful of public debt: higher budget deficits today mean higher taxes tomorrow.

Given the burden of government debt in the euro area, the creation of additional possibilities for borrowing is precisely what we should not be aiming for. Instead, we should start by considering the specific tasks that are to be performed at the European level and the value added that these tasks are supposed to create.

As I set out earlier, the promotion of competitiveness and convergence is an important objective. A euro area budget designed for this purpose could be a welcome advancement and refinement of the existing European structural and investment funds.

That does not necessarily mean an increase of the overall size of fiscal transfers. Instead, it would be desirable for this to be part of a fundamental reform of the EU budget as a whole, with the focus resting squarely on designing and efficiently carrying out projects that can deliver added value for Europe.

As far as new European stabilisation facilities are concerned, we have to keep in mind that a lot of the declared stabilisation objectives can be achieved in a much less complex national form within the existing framework.

In the event of a recession, member states with sound finances can themselves take fiscal countermeasures. There is nothing in the European fiscal rules that stands in the way of such action. And if a crisis threatens to overwhelm a member state financially, the ESM is on hand to grant aid on condition that reforms are carried out.

I believe there is considerable promise in strengthening the ESM. However, it is important to preserve the principle of solidarity in connection with joint agreements, and not to weaken it by granting largely unconditional access to the programmes.

Finally, further progress towards a capital markets union would foster

private risk sharing within Europe and, in this way, facilitate macroeconomic adjustment following asymmetric shocks. After all, we should bear in mind that in federations like the USA and Canada, economic risks are primarily shared through private channels. By comparison, fiscal policy takes a back seat, as only 10% to 25% of risks are shared in this way.⁵

The Bundesbank is therefore explicitly backing the project of the European capital markets union. I am sure that this will be one of the key projects as we move ahead.

Conclusion

A permanently stable economic and monetary union will benefit all of us. It will create the basis for a stable currency and robust economic growth, thus ultimately safeguarding our prosperity in Europe.

It would be wonderful if there were a single and straightforward recipe for eliminating EMU's shortcomings. But, I am afraid, there is no such thing as the "right" recipe. Instead, I have stressed that any viable reform must entail a rebalancing of actions and liability.

In a similar vein, what makes the Linzer Torte so distinguishable is the combination of the typical lattice of dough and the layer of jam beneath. Nevertheless, the recipe can be adapted to different tastes. Our Austrian hosts may forgive those who choose raspberry jam for their cakes. I, for my part, prefer the traditional Linzer Torte with redcurrant jam.

When it comes to preferences, however, it is essential that voices from all over Europe are heard in the debate on the future of EMU. And that is exactly why conferences like this one are so important.

Karl Popper, another great Austrian thinker, went even further when he wrote: "All that is needed is a readiness to learn from one's partner in the discussion, which includes a genuine wish to understand what he intends to say. If this readiness is there, the discussion will be more fruitful the more the partners' backgrounds differ. Thus the value of a discussion depends largely upon the variety of the competing views. Had there been no Tower of Babel, we should invent it."

Thank you for your attention.



⁵ Allard, C., P. K. Brooks, J. C. Bluedorn, F. Bornhorst, K. Christopherson, F. Ohnsorge, T. Poghosyan and an IMF staff team. v2013. *Toward a Fiscal Union for the Euro Area. IMF Staff Discussion Note 13/09.*

Yves Mersch

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Keynote Lecture 3: Deepening EMU – Political Integration and Economic Convergence

Ladies and Gentlemen,
We could have known better.

The discussions on the first meaningful blueprint for a European monetary union already highlighted challenges that we have not yet fully overcome. The plan to establish a single currency by 1980, drawn up in 1970 by a committee of experts chaired by the then Luxembourg Prime Minister Pierre Werner, referred to the need for economic policy coordination amid insufficient economic convergence and the absence of fiscal transfers which would require a political union. Later proposals, including the Maastricht Treaty of 1992, failed to sufficiently tackle the inherent tensions of a currency without a state. Although Europe has recovered from the most severe financial and economic crisis in a century, which threatened the very functioning of our democracies, it is still suffering from these shortcomings.

As the euro is a shared currency, euro area countries with low productivity growth cannot resort to exchange rate depreciation [currency devaluation]; and the more dynamic countries, whose currencies would normally appreciate, end up with stubbornly low inflation rates. The only way out is through internal devaluation, which entails lower wage costs and higher productivity, but this encounters social resistance and fosters populism. Recent political propositions in Italy were kept in check only by market pressures and the sanity of established institutions – national and European alike.

But recognizing the design flaws of the currency union cannot mean calling the whole project into question. Too much financial, political and social capital has been invested, and the cost of a break-up would be prohibitively

high, with devastating economic, social and political consequences.

The only viable option is to continue the deepening of our Economic and Monetary Union (EMU) through political and economic convergence. Both channels are indispensable for EMU.

Today, I will focus on three areas in which it is vital to make progress. First, we have to more actively pursue fiscal and structural reforms. Second, we need to further reduce risks and fragmentation in the financial sector. And third, we must decisively strengthen the institutional architecture of EMU to weather the challenges of today and tomorrow.

Notwithstanding robust economic expansion, the euro area remains vulnerable to adverse shocks. The risk of an external shock, albeit symmetrical at its origin, has come to the fore lately, as we witness a global environment marked by heightened uncertainty, retrenchment behind national borders, and pressure on the multilateral system.

Fiscal policies and structural reforms

All euro area countries first and foremost need to increase their resilience. Strengthening macroeconomic resilience is particularly important in the euro area. In the face of asymmetric shocks beyond the control of national authorities, costs are more likely to be transmitted across borders within monetary union in view of the strong trade and financial linkages. Even in the face of a common shock, different degrees of resilience among countries will make the transmission of the single monetary policy more challenging. Still, monetary policy cannot act to compensate for national deficiencies.

It is therefore of vital importance to develop the flexible labor and product

markets that reduce the chance of crises and allow for quicker recoveries by enabling the factors of production to move more quickly between sectors.¹ Research from the IMF, the OECD and the ECB demonstrates that well-sequenced and packaged reforms in these areas can increase potential growth and resilience. In parallel, further work to reinforce the soundness and effectiveness of domestic institutions will be critical.^{2,3}

On the fiscal side, it is imperative that Member States use the ongoing expansion to build up fiscal buffers and reduce debt levels, while those with fiscal space ought to address their public investment gaps. Lower debt and higher buffers increase resilience when a shock hits. By complying with the rules, including the requirement for low debt levels, states undergoing a downturn are more likely to retain financial market confidence in their solvency. They also increase their ability to recover from the shock. Sizeable buffers create the fiscal space to mitigate downturns, which minimizes output losses and thus strengthens the underlying capacity of a country to pay off the national debt.

It is ultimately up to national governments to pursue sound economic and fiscal policies. But given the spillovers these policies can create, they are also a common concern for the union.

In this light, there is a need for greater ownership of the tools we already have, notably the Stability and Growth Pact (SGP) and the macroeconomic imbalance procedure (MIP). The fact that euro area aggregate debt and deficit levels are now lower in the euro area than in

any other major economy demonstrates that our common fiscal rules are having some effect. Yet further structural fiscal adjustment is necessary, particularly in the countries with the highest debt levels. And while the MIP has proven very effective in identifying reform needs, implementation has been sluggish.

In parallel, additional instruments could be developed at the euro area level. Proposals here essentially come in two flavors. Either they focus on supporting convergence by directly strengthening allocative efficiency, thus moving beyond the existing structural and cohesion funds in the EU budget. Or they focus on stabilization at the euro area level. Although I will not elaborate on this today, there are also proposals that blend the two approaches, for example by supporting investment in downturns.

On the convergence side, the European Commission, for example, suggests supporting structural reforms through the EU budget. In principle, such a tool could contribute to reform implementation by way of positive incentives. However, for that to work effectively, the Commission proposal needs to be significantly strengthened in three ways.

First, reforms should be selected on the basis of their implications for macroeconomic prospects. Second, the funding should be distributed on the basis of a quality assessment rather than in proportion to a country's entitlement to a "slice of the pie". To strengthen such an assessment, the funds themselves should be linked to the packaging of reforms, reforms with short-term fiscal costs or the funding of flanking policies.⁴ Pension

reforms would be a suitable example, since they can come with short-term fiscal costs⁵. Third, proper and powerful clawback mechanisms should be built in so that the funds could be recuperated if reforms are reversed. While the Commission mentions such a mechanism, the identification of reversals is left overly vague.

Both the Commission and the recent Franco-German paper also foresee additional instruments for macroeconomic stabilization. Two design elements are essential for the effectiveness of such an instrument. First, a central fiscal capacity should be designed to increase the euro area's ability to counter severe area-wide recessions, thereby supporting monetary policy. Second, any fiscal capacity should come with appropriate incentives for sound fiscal and economic policymaking.

On both counts, the proposals made so far fall short. They fall short in terms of their effectiveness, as they are limited in size and seem to focus on asymmetric rather than symmetric shocks, although existing Treaty provisions already allow for financial assistance to a Member State threatened with severe difficulties caused by exceptional occurrences beyond its control.⁶ Moreover, the proposals do not sufficiently counteract moral hazard. The Franco-German proposals did not mention any mechanisms to this effect.

Similarly, reliance on an unemployment trigger – as foreseen by the Commission – would not enable policymakers to distinguish between "bad luck" and "bad policies". Indeed, it might potentially reward policy-induced increases in unemployment.

These examples illustrate that any introduction of a central fiscal capacity

should be coupled with an overhaul of the economic and fiscal governance framework. Moreover, agreement would be more likely to be reached if proposals did not repackage tax proposals of questionable value which have been rejected in the past.

Reducing risks and fragmentation in the financial sector

Let me now turn to the second set of challenges faced by the euro area: risks in the financial sector.

However, I would first like to recall what has been achieved in making the euro area's financial sector more resilient. With the establishment of the banking union, Europe has translated some of the key lessons of the crisis into a more solid framework.

The banking union rests on three pillars, two of which are already fully developed and one on which political agreement is under way. Under the first pillar of the banking union, the euro area's largest banks are supervised by the ECB on the basis of a single rulebook that harmonizes banking legislation and regulation. The Single Supervisory Mechanism (SSM) not only seeks to ensure a uniform approach to prudential supervision in the euro area in line with the highest international standards, it also fosters a level playing field that promotes financial integration in Europe.

The second pillar establishes a banking resolution framework for significant institutions aimed at minimizing the involvement of public funds in bank failures. The Single Resolution Mechanism (SRM) is a logical complement to the system of single supervision in the euro area: large banks are

¹ Sondermann, D. 2018. *Towards more resilient economies*. In: *Journal of Policy Modelling* 40(1). 97117.

² Dellis, K., D. Sondermann and I. Vansteenkiste. 2017. *Determinants of FDI inflows in advanced economies: Does the quality of economic structures matter?* In: *Working Paper Series* 2066. ECB.

³ Masuch, K., E. Mooshammer and B. Pierluigi. 2016. *Institutions and Growth in Europe*. CEPS Working Paper, April 2016.

⁴ Duval, R. 2008. *Is there a role for macroeconomic policy in fostering structural reforms? Panel evidence from OECD countries over the past two decades*. In: *European Journal of Political Economy*. 24(2). 491–502.

⁵ European Central Bank. 2015. *The short-term fiscal implications of structural reforms*. In: *Economic Bulletin* 7. 52–70.

⁶ "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned. [...] Article 122.2, Treaty on the Functioning of the European Union.

not only supervised at the Union level, their failure is also addressed centrally. The SRM is a leap forward, as banks can now fail without disrupting the entire financial system. Moreover, the smooth functioning of the SRM is supported through the establishment of a Single Resolution Fund (SRF), which ensures that the financial industry, as a whole, finances the stabilization of the financial system by pooling contributions. But a solvency and liquidity backstop for the SRF, docked at the European Stability Mechanism (ESM), needs to be established.

The steps that have been taken on the supervisory and resolution side should, in turn, pave the way for political discussions on a European deposit insurance scheme (EDIS). And they should make this discussion easier, as they significantly reduce the likelihood of EDIS ever needing to be used. The key contribution of EDIS is, in fact, that it will instill confidence in the financial system as a whole without probably ever being used.⁷ That is the beauty of such backstops.

This, however, only holds if the discussions on EDIS remain fully incentive-compatible. In other words, EDIS should in no way water down the standards on MREL and TLAC or other risk reduction measures, such as moves to reduce the pile of sour loans and prevent the build-up of new ones. But if these conditions are in place, any residual resistance to EDIS is based on a misunderstanding of its nature as an insurance mechanism.

The banking union, and its enhanced regulatory and supervisory framework, has brought about significant progress in reducing overall risk. The Common Equity Tier 1 ratios of significant banks have increased from 9.7% in 2008 to over 14% today. Leverage ratios have risen from 3.7% to 5.8%. And banks have much more stable liquidity and funding. Further risk reduction is under way as we speak.⁸

We should not dwell on our achievements, however. The euro area's financial sector remains vulnerable to legacy issues.⁹ Moreover, to accelerate further risk sharing, milestones are necessary to ensure progress in areas of key importance for the optimal functioning of banking union.

For example, focused steps need to be taken towards harmonizing and improving certain elements of national insolvency frameworks, including the alignment of the conditions under which a bank is deemed to be failing or likely to fail and the conditions for liquidation under the national laws for credit institutions. Progress is also necessary on the aforementioned sour loans, or non-performing loans – NPLs – as we call them, in particular swift implementation of the ECOFIN action plan. Finally, we need to use the single rulebook to further reduce fragmentation, removing opportunities for regulatory arbitrage, harmonizing supervisory powers, and making sure that large cross-border investment firms with risks akin to those of credit institutions are supervised like banks at the European level.

All of these policy goals are commensurate with a more efficient operation of the SSM.

In addition, there remains a need for banks to be able to plan ahead and obtain liquidity, even if they are deemed to be failing or likely to fail or if a resolution process has been activated. The provision of central bank liquidity – be it through monetary policy credit operations or emergency liquidity assistance – should however by no means be automatically assumed in resolution planning. Resolution financing is foremost a government task, now complemented by the rules and procedures applied by the Single Resolution Board and the national resolution authorities within the framework of the SRM. Central banks provide liquidity, not solvency support. And funding gaps that cannot be addressed by the industry or through the SRF should be filled, ultimately, by or on behalf of Member States or intergovernmental institutions.

Strengthening the institutional architecture of Economic and Monetary Union

The elements mentioned so far can be mutually reinforcing. In the fiscal and economic realms, common instruments can bolster convergence, thus providing a shield against bad equilibria and economic scarring in crises. And pursuing the right policies helps to create the policy space to address shocks in the first place. In the financial realm, backstops reduce risk across the system by containing market panics when a crisis hits. And a strong resolution framework ensures that very little public risk-sharing is actually needed when a crisis hits, as the costs are primarily born by the private sector.

Nevertheless, it is a fact of economic life that the risk of significant downside economic shocks can never be fully eliminated. This is why an effective crisis management framework remains indispensable. There is thus merit in strengthening the role of the ESM in managing crises, provided that governance arrangements are duly reviewed with a view to integrating them into the federal set-up of the EU. Should the ESM remain outside the EU legal order as an intergovernmental body, any future discussion of the tasks that could be conferred on the ESM in the field of economic governance must respect the existing competences conferred on the EU and its institutions under EU law.

Market incentives that appropriately support prudent fiscal policies and reduce risks on bank balance sheets may usefully support the implementation of the existing rules-based framework. To reinforce the credibility of the no bailout clause, and better anticipate debt sustainability problems, the ESM needs to be able to distinguish early on between liquidity and solvency problems.¹⁰ More clarity in our policy frameworks would allow us to pick up the can at an early stage rather than kicking it down the road.

Similarly, to definitively break the bank-sovereign nexus, we have to continue to reflect on regulatory instruments to curb the excessive accumulation of sovereign risks on bank balance sheets without triggering market disruptions. In that sense, ensuring the adequate regulatory treatment of sovereign risk and facilitating orderly debt restructurings are two sides of the same coin, reflecting the reality that public debt is no longer risk-free. Still, we have to be mindful that Europe might be walking this path alone.

⁷ Carmassi, J. et al. 2018. *Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?* Occasional Paper Series 208. ECB.

⁸ Draghi, M. 2018. *Risk reducing and risk sharing in the euro area*. Speech at the European University Institute, Florence, 11 May 2018.

⁹ Andrews, D. and F. Petroulakis. 2017. *Breaking the shackles: zombie firms, weak banks and depressed restructuring in Europe*. OECD working papers 1433.

¹⁰ Mersch, Y. 2016. *Reflections on the feasibility of a sovereign debt restructuring mechanism in the euro area*. ESCB Legal Conference 2016.



At the same time, we should be aware that market-imposed discipline often comes suddenly, creates cliff-edge effects and can have negative consequences for financial stability. For this reason, the recent Franco-German proposal to introduce single-limb collective action clauses and moves to align the roles of the ESM and the IMF in debt restructuring negotiations are sensible first steps towards building a more predictable framework for the orderly resolution of debt crises.¹¹

Let me now turn to my final point, which is that institutional arrangements and democratic control need to evolve in lock-step with progress in the economic, fiscal and financial unions to meet the test of constitutionality.

As European policies assume a stronger role over time, confusion over the assignment of responsibilities and accountability arrangements threatens efficiency and legitimacy. But greater control at EU level is important for two reasons. First, it would be a true reflection of a functioning democracy where sovereignty either has been fully transferred to EU level (in the case of monetary policy, for example) or it involves both national and EU levels (as with prudential policies, for instance). And

second, liability and control need to be aligned – he who pays the piper calls the tune. When taxpayers' money is involved at European level, a European control function is called for.

Economic and Monetary Union is unique in this regard. The distinction between the euro area and the EU means that it is more difficult to fully tailor accountability to euro area tasks. In particular, the European Parliament does not sit in euro area composition when discussing euro area matters, even though it would be common sense for it to do so.

Accountability and sovereignty also need to be proportionate in areas that are not exclusively dealt with at EU or euro area level but are areas of shared competence. This holds true for the ESM and for fiscal policies, where the situation is somewhat more complex and blurred.

The ESM, for example, was created on the basis of intergovernmental arrangements and for tasks where the EU only has a coordination role, and where the European Parliament is not yet a counterpart in terms of accountability. So we need to strike a balance. On the one hand, accountability should be assigned to national parliaments for decisions that are fully in the hands of national authorities. On the other hand, the ESM needs to be equipped with swift and credible decision-making procedures. This will never be fully possible in an intergovernmental setting that is hampered by national vetoes and operates outside the constitutional safeguards of the *acquis*. Against this backdrop, the ESM should be turned into a body that is governed by EU law and is accountable to the European Parliament. This would ensure that the

ESM is better placed to act in the sole interest of the euro area and thus in line with its functional mandate of ensuring the stability of Economic and Monetary Union as a whole.

A similar logic must be applied in any further discussions regarding a euro area fiscal capacity, the possible centralization of EU investment schemes or the powers that a European finance minister might have.

Fiscal instruments need to be complemented by institutional arrangements and democratic control at the corresponding level. If a euro area budget is established, it should be part of an ongoing debate on a euro area finance ministry and a euro area composition of the European Parliament, as well as its role on both the revenue and expenditure side.

While the creation of new umbrella funds, such as the InvestEU Programme, may pursue laudable public policy objectives, we should avoid undermining established Union methods. Indeed, we should not succumb to the appeal of

relying on secondary legislation in areas where primary law is unambiguous.

Concluding remarks

As we take further steps to complete EMU, we should keep in mind two principles that are at the heart of effective policy in a democratic society: namely, the effective alignment of liability and control, and the discharge of democratic control or accountability at the level at which policy decisions are taken. Upholding these two principles is a necessary condition in the continuing efforts to foster economic convergence and further integration in the euro area. Given the experience of the past 20 years, there can be no doubt that the progress achieved so far has laid the groundwork for further steps to be taken for a “currency beyond a state” – a fact that the early intellectual architects of Monetary Union were already aware of. In other words, to quote the then Commission President Jacques Delors: “Europe is like a bicycle. It has to move forward. If it stops, it will fall over”.

¹¹ Benassy-Quere, A. et al. 2018. *Reconciling Risk Sharing with Market Discipline*. CEPR Policy Insight 91. Centre for Economic Policy Research.

Panel 1

Stocktaking: Convergence in EMU and CESEE



Convergence in EMU and CESEE: Where Do We Stand Twenty and Thirty Years after Departure?¹

Interestingly enough and not much noted, the Treaty on European Union (TEU) doesn't talk about convergence but of cohesion, using cohesion in a very broad sense – including social cohesion, solidarity and even territorial cohesion. Annexed to the Treaty are the famous well-known convergence criteria and there is also the Protocol on economic and social cohesion, which deals specifically with cohesion financing. Against this background it comes as no surprise that even in a rather narrow economic sense the term convergence can mean many different things, and that its meaning has changed considerably over time.

Twenty years after the establishment of the European Central Bank and almost thirty years after the fall of the “iron curtain” a serious “stocktaking” regarding convergence seems not only necessary but also possible, covering both monetary union and the development of the CESEE region over the last decades. When talking about the concept and the underlying economic development and its assessment, a first important step would be to clarify what type of convergence one has in mind.

“Babylon” or Do we know what are we talking about?

From both perspectives – EMU and CESEE – convergence is a very difficult term to be used in an analytical or policy context. In many cases the debate starts from very different starting points with regard to the prior (and often unre-

vealed) understanding of what is meant by convergence and, at the same time, with regard to the real importance of convergence in the context of (European) integration. As Krastev (2018) has shown, this diversity can in particular be explained by the specific situation in Europe after the opening-up of Eastern Europe and by the specific focus on differences in standards of living created thereby.

Even from a rather narrow economic point of view, convergence is used – to give a few examples only – with the meaning of (i) income convergence, (ii) nominal convergence, (iii) real convergence, (iv) price convergence, (v) beta convergence (= catching-up), (vi) sigma convergence (= variation; e.g. in GDP per capita) and in many other meanings – even very prominently in the sense of business cycle synchronization.

But when the EU Treaty speaks of “cohesion” it does so less about business cycle synchronization but mostly about income convergence, social fairness and even solidarity, addressing social and distributional objectives mainly. The wording used regarding cohesion in Article 3 TEU and in the Protocol on economic and social cohesion is as follows:

“The Union shall promote economic, social and territorial cohesion, and solidarity among Member States...” and “Stating their belief that progress towards Economic and Monetary Union will contribute to the economic growth of all Member States... the European Investment Bank should continue to devote the majority of its resources to the

¹ Special thanks go to Christiane Kment for excellent research input for this paper.

promotion of economic and social cohesion...

In fact, income convergence between the original euro area countries was high and increasing before the introduction of the euro (not least because of the so-called “Maastricht effect”). After the introduction of the euro convergence stagnated, and it has become markedly divergent since the crisis of 2008/2009. Euro area countries which joined EMU some time after its start show a better performance, mainly because they experienced some fundamental catching-up process in parallel. Related to this, convergence of regions is another important and often neglected aspect of convergence. Due to OECD figures, regional GDP per capita disparities have declined over time in the majority of EU countries and there is convergence both at the country and regional level (OECD, 2018). As expected, business cycle synchronization has accelerated significantly since the introduction of the euro, with synchronization across European countries increasing by 50% after 1999 and at an even more pronounced rate in the euro area countries. (Campos et al., 2017)

But there are many more perspectives to look at when trying to understand the many facets of convergence. Convergence in the EU and euro area is widely understood as the approximation of poorer Member States to richer ones in terms of “economic and social performance,” most commonly measured by GDP per capita. In the growth literature the rationale behind “convergence” is the expected tendency for countries to grow faster the lower their GDP per capita at the starting point is. Such “real convergence” (i.e. narrowing differences in terms of per capita GDP, relative endowments of productive factor prices) is what neo-classical growth theory predicts (Buti and Turrini, 2015).

Beta convergence measures the process of catching-up and the tendency for low-income countries or regions to grow faster than high-income ones. Catching-up is characterized by a negative relationship between the growth rate of GDP per capita (in purchasing parity terms) and the initial level of GDP per capita. In fact, there is a clear pattern of catching-up in the EU, with low-income regions having grown faster, on average, than high-income ones.

Different from that, sigma convergence is captured by a lower dispersion of the income distribution, typically measured as the coefficient of variation of GDP per capita. If the cross-sectional dispersion falls over time, there is sigma convergence for economies in the sample. There has been convergence among regions in Europe in the past decade, although convergence has since somewhat stalled because of the crisis. Last but not least, while the single market contributed to rising price convergence between countries, price dispersion within countries remains significantly higher than in the U.S.A. (OECD, 2018). At the same time, there was a global trend to “divergence” observable in parallel, the only significant exceptions in Europe being the Visegrad and Western Balkan countries. Even in the U.S.A. there is divergence of per capita incomes between states observable since the 1990s. In contrast, states converged in GDP per capita before the 1990s, and the gap between poor and rich narrowed as a trend (Ganong and Shoag, 2016).

Overall, there was a process of upward convergence ahead of the crisis 2008/2009, which then reversed into divergence because of the crisis, followed by a return to convergence, at least partly, very recently. But more importantly, Buti and Turrini (2015) argue that euro area convergence has never really stopped but just changed its nature,

such that the current face of convergence is different from that of the past. They characterize today’s convergence as neither nominal nor real; convergence nowadays is now predominantly “structural” in their view.

At the same time, structural convergence presents a necessary basis for renewed real convergence. The first decade of EMU showed that structural convergence is not automatically a by-product of nominal and real convergence achieved, as had been expected. Today, many structural reforms implemented during and because of the crisis may be responsible for higher potential convergence in terms of structural convergence. This is underlined by most recent data pointing to an acceleration of growth and employment in most euro area countries in the periphery as well. The easing of bond market tensions, the reduced fragmentation of financial markets and fewer fiscal austerity needs in (previously) distressed countries can be seen as contributing factors to these developments.

But whether these developments will be sufficient in a sustainable sense can be questioned because of underlying special determinants: (i) Much of the structural convergence observed is linked to the contraction in the non-tradable sector in periphery countries. More ambitious reforms and supportive policy frameworks are still needed to improve competitiveness in export markets. (ii) There is a possible trade-off between export-driven growth strategy and price competitiveness gains. (iii) To achieve sustainable convergence will only be possible with building a credible institutional framework and with creating a corresponding climate of social trust and an investment friendly business climate.

Doubtful evidence, lost recipes?

With the benefit of hindsight – and obviously very much complicated by the recent experience since the crisis started in 2008/2009 – the policy measures and recipes for successful convergence have become less clear. This is in particular true compared to the textbook-based view and advice dominant at the beginning of these convergence processes (European Council, 1989; Emerson et al., 1992; Barro et al., 1992; Sala-i-Martin, 1996). Even the importance of areas contributing to convergence, ranging from fiscal developments and business synchronization to governance and institution building has become more difficult to rank compared to past experience. To a large extent this increased “policy uncertainty” or “recipe uncertainty” regarding convergence is related to the significant changes in the institutional design of the EU because of the crisis, for example concerning banking supervision or the fiscal framework.

Against this background, there is an obvious need for stocktaking on the empirical convergence evidence, as well as for a qualified analytical assessment of the effectiveness of convergence recipes. However, the analytical sequence in dealing with European convergence issues has to be structured along three crucial questions:

- What were the convergence expectations and objectives at the beginning of EMU and at the opening-up of CESEE?
- Where do we stand today compared to these starting points and what has been achieved?
- What are the convergence perspectives for the medium-term future and what are the related policy challenges and needs?

From a European integration point of view, a first policy priority should be to make convergence towards more resilient economic structures more binding. This could be achieved or at least fostered by politically agreeing on a set of common high-level standards that could be defined in EU legislation – including inter alia sovereignty over policies of common concern as well as a strengthening of decision-making at euro area level. This will either need to involve further harmonization in some areas or finding better country-specific solutions in others. In this context it is undisputed that the famous Copenhagen criteria of 1993 – enshrined in European law since the Amsterdam treaty of 1997 – still constitute the basic political, economic and legislative criteria of membership in the European Union. At the same time it is necessary to accept also that the situation has changed and developed further over the last 25 years and that, as a consequence, a much broader set of criteria is held relevant for assessing progress toward convergence today – and even the focus within the spectrum of relevant issues might have shifted.

This becomes visible for example when comparing past and recent convergence reports, which are still the most encompassing analytical instrument in assessing progress toward convergence and in identifying further convergence needs. All seven EU Member States under review in the recent 2018 convergence reports have made progress with regard to compliance with – traditional – convergence criteria. But there is no country fulfilling all obligations laid down in the Treaty, including legal convergence criteria and, in particular, institutional requests. As sustainable convergence is now seen as the overriding condition for successful adoption of the euro, countries which want to

adopt the euro should be able to demonstrate the sustainability of their convergence process as early as when they consider applying for ERM II membership. The treatment of Bulgaria in its 2018 attempt to join ERM II is a telling example in this respect, putting sustainability as well as banking union into the centre (Council of the European Union, 2018). No doubt, to achieve good grades in an evaluation regarding sustainability has become more complicated over time and today refers to a much broader set of issues and criteria than at the time of the Maastricht treaty, mainly because of the crisis experience of the last decade.

An indispensable prerequisite for sustainable convergence nowadays is macroeconomic stability, understood in a very broad sense. It's no longer the fulfilment of certain quantitative single criteria alone which counts, the assessment depends on a certain track record and the proven robustness of successful policies also. In this sense, the European fiscal framework has been reformed in order to incentivize the improvement of fiscal positions in good times and to reinforce convergence towards a sustainable debt level. Most of the countries under review have made progress in addressing macroeconomic imbalances in their economy, with the newly introduced macroeconomic imbalances procedure (MIP) as an explicit recognition of the importance of this aspect from a forward-looking sustainability-oriented perspective. In addition, countries must have well-functioning product and labor markets, which is essential for coping with macroeconomic shocks. Moreover, appropriate macroprudential policies need to be in place to prevent especially the build-up of macrofinancial imbalances, such as excessive asset price increases or credit boom-bust cycles. Last but not least, for convergence to be

sustainable, an encompassing sound and functioning institutional framework must be in place, with banking supervision and sound financial structures as a central challenge stemming from the crisis experience.

Successful “Deepening of EMU” demands much more than (simple) structural reforms...

Structural reforms will play a crucial role in successful EMU deepening in all countries. But there is no one-size fits all policy framework. The optimal set of structural policies for an economy depends on many idiosyncratic factors, ranging from its historical record and its appropriate institutional setup to its level of development and/or geographical location. In any case, reforms must go beyond simple flexibility-enhancing measures, towards targeted productivity-enhancing instruments. In reality, the success of reforms depends very much on the design, timing and sequencing of the reform process. Even if cross-border spillovers justify the involvement of the EU in structural reforms of Member States, reform ownership at the national level based on broad social consensus is essential for effectiveness.

Perhaps the most recent and important consequence from the actual crisis experience in this respect is an appropriate framework for banking supervision and the resolution of financial institutions, in view of the establishment of European banking union and the Single Supervisory Mechanism (SSM). In addition, greater convergence of capital market regimes would enhance cross-border capital flows by removing undue differences in regulatory practices and by improving consistent enforcement, as it is addressed in the capital markets union initiative of the European Commission.

At the German-French Head of State's meeting at Schloss Meseberg

near Berlin on June 19, 2018, French President Macron and German Chancellor Merkel agreed on a number of important elements set to shape the future of Europe. Concerning EMU, they are committed to promote competition and stabilization, with the ESM, banking union and capital markets union as well as a common euro area budget seen as key steps of a roadmap for deepening EMU. It has to be seen to what an extent this agreement will lead to a focused and broadly accepted strategy towards more encompassing convergence policies in European political reality.

This leads to the fundamental question, namely why it is at all important to fight divergence and to create convergence. Some “realists” think countries “should simply live their divergence” but they forget that this is and will be followed by a divergence of national political cycles. Today's political reality shows that this is a breeding ground for populism, which in the end endangers European integration, EMU and economic development.

Although for the CESEE region relative growth performance always has to be understood as a combination of convergence and catching-up, the Central and Eastern European EU Member States have enjoyed robust growth over the past couple of years, and this trend has even strengthened recently. With annual growth rates close to or even above 4%, their economic convergence with Western Europe gained momentum in 2017.

Convergence in terms of per capita GDP levels in CESEE is a long-term process. Overall, per capita GDP levels in the CESEE economies have been approximating those of the ‘old’ EU Member States. However, the pace of convergence, which was quite rapid before the outbreak of the global financial

crisis, has since slowed. This slowdown has been particularly visible in the more developed EU CESEE countries. Forward looking simulations show (Zuk et al., 2018) that by 2026 no country in the region will have caught up with average EU-28 levels. Per capita GDP in the Czech Republic will exceed 90% of the EU-28 level, whereas in Poland and Hungary it will not reach 80%. For most of the CESEE region, a halving of the current gap to the EU-28 in terms of average per capita GDP will take almost 25 years.

Challenges for future convergence in CESEE reside in an adverse impact of population ageing, institutional quality, innovative production, reinvigoration of investment and ensuring its sustainability and weak productivity growth. In general, the transformation of Central and Eastern European economies from centrally planned towards open market economies has been inherently inter-linked with their integration into the EU. The desire to join the EU worked as a major force for economic reform, in particular over the first decade after the opening-up of Eastern Europe. This not only improved the efficiency of resource allocation but also made EU membership a plausible political outcome, a mood which seems to have deteriorated more recently. However, the positive climate that rapid growth and convergence created has hidden deeply seated problems of weak institutions and slow social progress, while substantial capital inflows led to resource misallocation in the economy. The speed, sustainability, and equity of future convergence will depend on further renewed efforts.

After a good start, euro area economies have not converged as envisaged

In the first years of its existence, the euro contributed noticeably to economic convergence in the euro area (European Commission, 2008), against a favorable global background called “The Great Moderation” by Ben Bernanke (2004). With the benefit of hindsight, it looks like that part of the convergence gains achieved over this period were due to less frequent and less pronounced country-specific shocks. However, these smooth developments were masking the build-up of unsustainable imbalances and mispricing of sovereign risk. As a result, the economic convergence achieved early in the euro’s existence was reversed during the crisis period until the overall economic recovery stopped and has since partly reversed this tendency (Franks et al., 2018).

If one looks more closely into some of the several dimensions of convergence the picture that emerges is at least somewhat mixed:

- Nominal convergence of inflation and interest rates largely took place in the run-up to the establishment of the euro, then temporarily reversed and has since been re-established, although at (or because of?) a historically unusual low level of inflation and interest rates.
- Real convergence has been a rare phenomenon among the original euro member countries (European Central Bank, 2015). In particular, GDP growth and productivity growth have not reduced income disparities between richer and poorer

countries, while there was some convergence of unemployment rates.

- There has been significant convergence among those countries who joined the euro later on.
- The synchronization of the timing of business cycles has improved, but the amplitude of those cycles has diverged because of asymmetric shocks and specific national developments.
- The synchronization of financial cycles diverged during the pre-crisis boom, but has since been re-established. Also regarding financial cycles the amplitude again has become more uneven (Cesa-Bianchi, 2015; Praet, 2014).
- Last but not least, it is interesting to note that German cycles have become more delinked from the rest of the euro area. Significant capital flows, build-up imbalances, emerging systemic risk as well as resource misallocation and therefore productivity divergence and divergence in competitiveness in parts of EMU contributed to this development.

An additional important issue, which became very prominent not least because of the crisis experience and politically driven disintegration tendencies, is how to tackle the core-periphery issue. Campos and Macchiarelli (2018) try to overcome the simplistic core-periphery perspective and propose a new framework to identify sets of European countries. They show the recent emergence of three clusters: a set of six core countries (Austria, Belgium, Germany, France, Italy and the Netherlands), a mixed set of (intermediate) countries (Greece, Denmark, Sweden, Spain and the UK) and a set of deep-rooted periphery countries (Finland, Ireland, Norway, Portugal and Switzerland) – clusters which seem to reflect the crisis experience as well as the political and economic integration status (or integra-

tion willingness?) of European countries. In the same vein Demertzis et al. (2018) propose a hybrid “European integration by differentiation” governance framework for the EU, consisting of a “bare-bones EU base” and a “top-up Europe of clubs.”

Integration: A story of (high) expectations and (deep) disappointments

The current assessment and understanding of convergence seems to be driven very much by expectations. Expectations of “dis-equilibria” are nowadays very prominent and impactful in many economic areas, especially in financial markets. They are characterized by a high degree of instability and they are the source of all kinds of uncertainty as well as “disappointments” by economic agents. It seems that there is a very similar type of problem regarding EU, EMU and CESEE integration. As expectations were very high – perhaps unreasonably high and far reaching – at the start of EMU and at the opening-up of Eastern Europe, the substantial progress achieved since then tends to be experienced negatively by the people, because these expectations – in some cases even wide-ranging political promises – were not (and could not be) completely met.

- Regarding EMU, the theory-based expectation that monetary integration will automatically lead to quick and complete cross-country convergence turned out to be more complicated in reality – and in any case to take much longer as envisaged.
- Regarding CESEE, the expectation that catching-up to Western GDP-per-capita levels will be a quick, smooth and common process for the region did not materialize.

EMU was expected to foster greater macroeconomic stability, prosperity and convergence. It succeeded in estab-

lishing a credible monetary policy framework and deepened financial integration, but governments failed to exercise sufficiently coordinated fiscal policies and to agree on a joint implementation of targeted and adequate institutional reforms. In the wake of the financial crisis 2008/2009, the euro area crisis has severely tested the stability of the euro area and uncovered dangerous tendencies of economic divergence, but monetary policy has been successful in retaining the existing integration status and a sustained convergence of inflation towards the inflation target avoiding deflation (IMF, 2017; OECD, 2018).

In the light of the debate at the start of EMU this crisis experience came as a surprise, as the discussion at that time mainly focused on convergence. The Maastricht criteria essentially singled out nominal convergence (such as convergence in interest rates and inflation rates). The objective was not only to create a single currency but also a stable currency. It was expected that a single currency would give strong incentives to carry out structural reforms to compensate for the loss of monetary policy as a national stabilization tool (Buti and Turrini, 2015; Banerji et al., 2015).

U.S. economists, for different reasons and based on rather different arguments, pointed to the risks of this undertaking. For example, Krugman (1993) concluded that "...EMU will not be a bad thing, but ... the combination of 1992 and EMU will tend to produce some new stabilization problems at the regional level." Martin Feldstein (1992) went even further: "... the European Community should abandon its plans for monetary union."

Is it still the case and valid that EU integration – in its different forms – can be seen as a convergence engine? In fact, the European Union has been the

modern world's greatest "convergence machine" since its foundation more than 60 years ago (The World Bank, 2017), propelling poorer new Member States to become middle- to high-income economies and to delivering to its citizens some of the highest living standards and lowest levels of income inequality in the world against the background of completely devastated economies and societies after WW II. Today, however, at a markedly higher income level, Europe is increasingly recognizing that convergence is not automatic.

Contrary to its nominal policy focus in preparation for EMU, the academic debate – based on optimal currency area theory – has emphasized the extent also to which real convergence was sufficiently advanced to make the economies of the countries in EMU sufficiently synchronized. Within monetary union, the lost mechanism of exchange rate adjustments created the need for another (set of) adjustment mechanism(s) to deal with asymmetric shocks – and the need to introduce common structural improvements to the integration region.

Another optimal currency area theory-based integration aspect is the role of risk-sharing mechanisms. Given the still existing lack of fiscal risk sharing in EMU, this role has been more or less explicitly delegated to financial markets solely. This is one reason also why the EU's capital markets union initiative – launched in 2014 – is so important to provide businesses with a greater choice of funding, to offer new opportunities for private investors across Member States, thereby making the entire financial system more resilient (Buti and Turrini, 2015). In a similar way, EU enlargement was surrounded by the debate on the possible tensions between nominal and real convergence and the related difficulties encountered by

accession countries in respecting Maastricht criteria because of their catching-up properties (the famous Balassa-Samuelson effect).

Instead of conclusions: Four core questions to concentrate on

Instead of drawing curtailed conclusions on the complex question of convergence let me end by simply stating four questions which would need more detailed analysis to make progress regarding a better understanding of this difficult topic:

In what areas is convergence most needed for a well-functioning EMU?

Euro area member states differ significantly in economic structure. Broad consensus about socioeconomic convergence seems necessary to guarantee the stability of the euro area, but not in all its dimensions to the same degree. Any binding rule has to take note of the principle of subsidiarity. The crisis experience has revealed that exaggerated convergence demand puts the whole euro area to test and can/will create unwanted side effects and even larger imbalances. How to identify the appropriate degree of convergence is perhaps the most urgent requirement to be addressed (auf dem Brinke et al., 2015).

What role for convergence in the social field?

Better-integrated and more flexible labor markets as well as deeper financial market integration are widely seen as the basic prerequisites to increase the resilience of EMU. But how much socioeconomic convergence and/or minimum standards are really necessary and reliable without putting the integration process at stake? Given existing European cultural diver-

sity it seems neither possible nor meaningful to make Europe similar to the U.S.A. or any other specific role model.

How to achieve convergence: laws, carrots or sticks?

Common sustainable economic policies are in the best interest of all euro area member states. No question, cautious coordination of national policies is necessary in an integration context, as national policies in the end influence the functioning of the entire area. Up to now, limited implementation of the commonly agreed policies turned out to be an increasing political weakness of the integration efforts in an enlarging EU. A common understanding of collective challenges and a greater readiness to agree on common objectives would enable all countries to converge faster and produce a better outcome. Incentive-based enforcement mechanisms to complement the already extended framework of existing rules – as suggested, for example, in the Five Presidents' Report (see in particular European Commission, 2016) – would be a positive way to achieve more agreeable convergence standards.

What do we know about all the other factors influencing our readiness to live convergence?

Much more research efforts and understanding is definitely needed on all the prospective many other factors, which obviously not only have an impact on convergence but seem to have risen markedly in their influence on and relevance for people's acceptance of integration and convergence – such as globalization, technical progress or migration to name three recently very prominent factors only.

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Convergence and Shared Prosperity Have Always Been at the Heart of European Objectives

The European project has laid the foundations of a closer union among the people of Europe since the very beginning and, still today, remains resolved to ensure the economic and social progress of all.

The preamble of the Treaty of Rome (1957) says that the establishment of the European Union was intended to “strengthen the unity of [European] economies and to ensure their harmonious development by reducing the differences existing between the various regions and by mitigating the backwardness of the less favored regions” and to “direct their efforts to the essential purpose of constantly improving the living and working conditions of their peoples”.

The improvement of the well-being of the European Union’s people is one of the first aims of the European Union (Article 3 of the Treaty on European Union – TEU¹). The means to achieve this goal are clearly described in Article 119 of the Treaty on the Functioning of the European Union (TFEU), in particular “the adoption of an economic policy which is based on the close coor-

dination of Member States’ economic policies” and “without prejudice to the objective of maintaining price stability, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition”².

More recently, the European Commission’s roadmap published in December 2017 pointed out that “one of the lessons learned from the crisis is that achieving convergence and building robust economic structures is crucial for the prosperity of the Union and, in particular, for the smooth functioning of the single currency”. [...] “The notions of convergence and integration are at the heart of the Economic Union. To achieve sustainable prosperity, Member States need to continue to focus on the necessary reforms to modernize their economies, make them more resilient to possible shocks and improve their growth prospects”. [...] “Going forward, the Union framework should continue to support a process of reforms for real convergence across the EU, both within the euro area and for countries on their way to joining the euro.”

¹ Article 3 TEU: 1. The Union's aim is to promote peace, its values and the well-being of its peoples. 2. The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, in which the free movement of persons is ensured in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime.

² Article 119 TFEU: 1. For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition. Concurrently with the foregoing, and as provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition.

Convergence is multifold

Convergence of per capita income levels³ is not a prerequisite for a functioning monetary union per se. The convergence of economic structures is not required for a successful monetary union either.

However, countries need sufficiently flexible labor and product markets to adjust to shocks. If not, a heavier adjustment burden falls on the quantities (employment and output) – something we painfully felt during the crisis. This does not mean having identical product and labor markets but ensuring that factors can move to their most efficient use and be reallocated quickly. And, in any case, convergence and improvement of the living conditions is a decisive element for ownership of European citizens.

Real convergence is important for political cohesion within monetary union. It can help ensure that gains from monetary union are shared among Member States and thereby foster social cohesion. Divergences may fuel frustration and lead to resentment and political instability. During preparation of the

Economic and Monetary union (EMU), nominal convergence criteria (e.g. inflation) took center stage.

General progress but high heterogeneity remains, especially after the 2008 crisis

The inspiring idea behind EU and EMU was that the removal of barriers would produce capital flows towards catching-up economies, thereby boosting investment and economic growth. Hence, it was expected, not only that all European countries would grow but that less favored countries would benefit from the impetus coming from the most favored ones. Looking at the figures, and starting at the introduction of the euro, all countries have indeed experienced growth in GDP per capita. In addition, some degree of real convergence has definitely taken place in the most recent EU Member States.

In particular, Lithuania, Estonia, Latvia, Romania and Slovakia have achieved the largest degree of convergence among EU countries so far (top of the top-left quadrant in chart 1),

followed by other countries in the Central and Eastern Europe region⁴. While they were among the poorest countries in 1999, they cumulated growth points that allowed them to achieve substantial GDP per capita gains relative to the EU average.

More problematically, in contrast with initial expectations that the euro would act as a catalyst of faster real convergence, little convergence, if any, has taken place over the period 2000–2017 among the older Members States (EU-12). In fact, a stocktaking exercise may appear quite bleak: low-income early euro adopters (e. g. Spain, Greece) have increased their income gap with the average, which means that not only they are still below the European average, as they were in 1999, but their relative income gap has deteriorated (bottom-left quadrant in chart 1). Italy, initially a higher-income country (above EU-12 average), has registered the highest relative fall in GDP per capita (lowest part of the bottom-right quadrant in chart 1, i.e. the relative fall in the level of GDP per capita was much stronger than in any other EU Member States).

Of course, the global financial crisis explains a lot: before the crisis, there was faster growth in Spain or in Greece than in the rest of the euro area but this catching-up process rapidly reversed after the crisis (with a recession or at best a stagnation). The persistent under-performance of growth in some euro area countries limited the performance of the whole area. Transfers arising from the EU budget (cohesion funds, struc-



tural funds and the common agricultural policy) also contributed to the increased prosperity of some Member States.

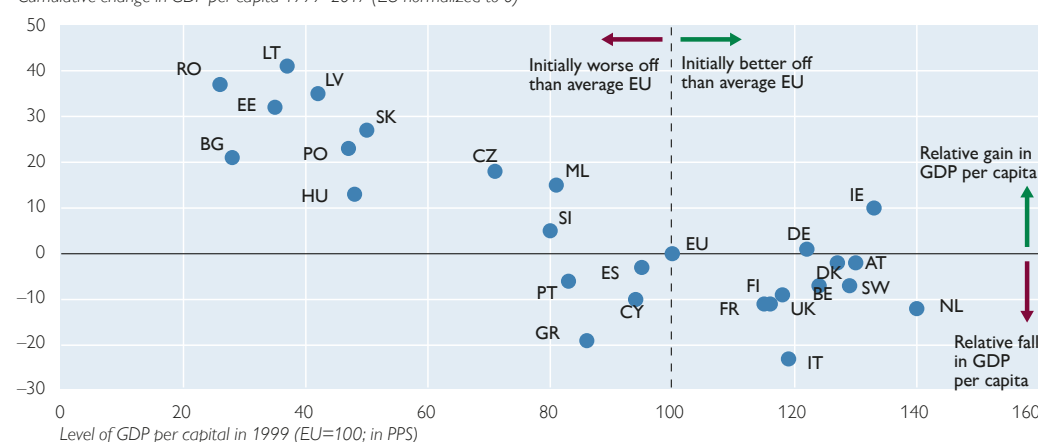
The crisis hit an uncompleted European Union

We knew a complete EMU implied more integration. This situation was not unanticipated. Ever since the early steps of EMU, many have warned that it was at risk of being suboptimal and unbalanced. In the 1970s, the Werner report advocated an autonomous budget, a decisional center for economic policy, accountable to a parliament elected by popular vote and the coordination of social partners. The 1989 Delors report required proper convergence before entering EMU, rules to control national budgets and common resources to increase transfers – a topic that carried no taboo at the time. Between 1994 and 1999 the structural and cohesion funds of the EU were doubled to reach almost a third of the total EU budget. The 1993 White Paper on Growth, Competitiveness, and Employment advocated

Chart 1

EU Convergence: where do we stand now ?

Cumulative change in GDP per capita 1999–2017 (EU normalized to 0)



Source: ECB.

³ “Real convergence” is then defined as real GDP per capita of lower income economies catching up with those of higher income economies on a durable basis.

⁴ Some evidence for the positive effect of EU membership on relatively low-income countries, largely thanks to a greater degree of economic integration, can be found in a number of economic papers. E.g. Crespo Cuaresma, J., D. Ritzberger-Grünwald and M.A. Silgoner. 2008. Growth convergence and EU membership. In: *Applied Economics* 40(5). 643–656. One cannot ignore that an additional factor lies, more simply, in the “natural” catching-up of these economies, i.e. their greater scope for accumulation of capital, labor shifting out of the agricultural sector, and productivity gains.

a sweeping program of infrastructure of Europe-wide interest based on a European funding.

After the strong catching-up of the 2000s, the crisis both stopped and differentiated the growth of new Members States – especially those whose initial standard of living was low – and created the beginning of divergence among the core countries. An explanatory factor lies in the widening of macro-

economic imbalances among European economies.

Urgent actions were taken to weather the crisis

Several measures were taken to deal with the financial crisis: a monetary policy response (decrease in policy interest rates, non-standard measures, etc.), macro-prudential measures, new regulations, new tools (the Single Rulebook), new

Chart 2

Emergency responses to the crisis

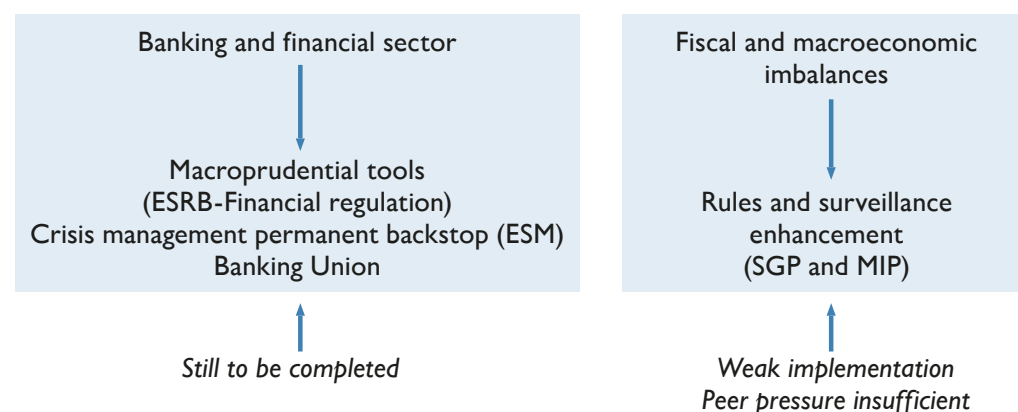
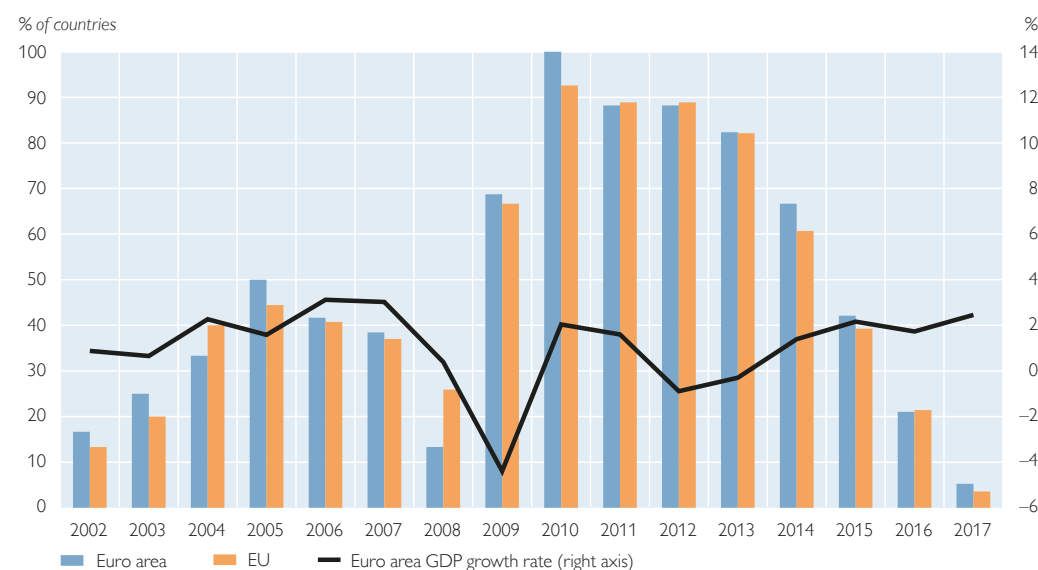


Chart 3

Stability and Growth Pact: Countries in Excessive Deficit Procedure



Source: Eurostat.

institutions (like the European Stability Mechanism – ESM), etc. The banking union both protects financial stability and deepens financial integration in the EU. It is a considerable step forward compared with the pre-crisis situation but needs to be completed. Steps were also taken to change the rules. As a response to the absence of policy tools to prevent the build-up of macroeconomic imbalances prior to 2008, the Macroeconomic Imbalance Procedure (MIP) was created within the European Semester six-pack in 2012.

Some sort of fiscal convergence appeared over time. In 2017 there is only one country left in Excessive Deficit Procedure (EDP) (see chart 3). However, this instrument failed to avoid procyclical policies during the crisis. Besides, the correction of macroeconomic imbalances is slow and insufficient. The current system based on peer pressure, asymmetric incentives, and possible – but never applied – sanctions does not lead to reform implementation (see chart 4).

What next? Avenues for improvement

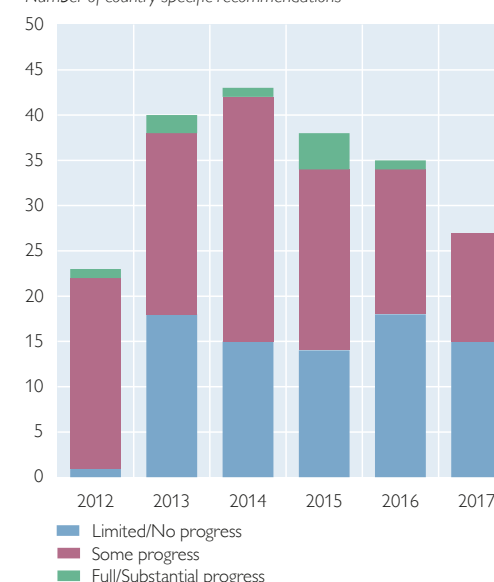
Within the current framework, there are multiple layers of rules but no proper mechanism for enforcement when rules are not respected. One suggestion might be to apply the rule of law. The Court of Justice is at least partly excluded from having the role of judicial control (Art 126 (10) TFEU on budgetary discipline). Without enforcement procedures, the single market would certainly not be what it is.

A way was found to compensate the lack of legal enforcement with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed in 2012 as an intergovernmental tool which has been transposed into national constitutions.

Chart 4

Macroeconomic Imbalance Procedure

Number of country specific recommendations



Source: Eurostat.

A budget not in line with a country's European commitments could thus be invalidated by the national supervisory authorities (Constitutional Court most often). Unfortunately, the requirements related to macroeconomic imbalances, which are key for convergence, are not part of this intergovernmental treaty. Although the Commission is supposed to enforce them, they were neglected.

Boost potential growth

National structural reforms are needed to boost employment and growth in all Member States and they will have even more impact if they take into account the objectives set for the entire union in a collective and coordinated way.

These reforms should favor policies with cross-country effects that can enhance rebalancing within the EU and the euro area. They should also foster real sustainable convergence between European economies, in particular by improving labor and capital mobility, improving education and labor

skills and stimulating investment and innovation.

Create the right conditions for investment and innovation: finance the real economy

On this particular issue, a "financing union for investment and innovation", which would better channel money towards innovation such as digital or energy transition technologies, is a promising option. The aim of such a financing union is to better steer the 400 billion EUR savings surplus in the EU towards productive investment, in particular by shoring up equity, which is key for an innovation economy and for boosting potential growth. This union should bring together existing initiatives, and as a priority, the Capital Markets Union, but also the banking union and the Juncker investment plan.

Conclusions

Reforms can be very painful in the short-run but they do pay off in the longer run. Of course, one has to be wary of reforms made under the pressure of markets and are to a certain extent countercyclical (GR, IT). Yet, looking at the last two decades, we have proof that sound economic structures have benefited the countries that implemented reforms. We know that structural reforms boost growth and create employment.

Sharing a common currency is about sharing risks. It means sharing a vision, an endeavor, a destiny, and about building a bold and lasting relationship. This is about delivering on a pledge, as Helmut Kohl did when he promised his mother her grandson would not die in a war between European states. The denial of rules and risk-taking generates mistrust – it does not foster convergence.



Panel 2

Social Cohesion – The Role of Labor Mobility



Introductory Statement: Social Cohesion – The Role of Labor Mobility

Ladies and Gentlemen,
welcome to our session. We have a burning issue on our agenda: labor mobility and migration and social cohesion – it is a hot topic because it evokes emotions and also fear in people. However, polls suggest that a lot of people overestimate how many migrants are actually living in their societies. A few people even say the debate on migration is characterized by two polarized positions: the heartless and the headless. But maybe both are wrong. Our discussion, I hope will shed some light on this matter.

Standard economic theory says that migration benefits the native population. The economic argument is the following: the quantity of labor increases and this will increase profits; the increase in profits leads to more investment, which will increase demand for labor; the result is a clear improvement in total welfare.

However, the social and political consequences of open national borders sometimes suggest the opposite. There may be hostility to large-scale immigration resulting from a protest against job losses, depressed wages, and growing inequality. Economic welfare not always seems to be the same as social wellbeing.

Therefore, the crux of the matter is the social impact of migration. The risk is a loss of social cohesion. According to the British economic historian Lord Robert Skidelsky, large-scale immigration can weaken bonds of solidarity.

Of course, these are just some ideas about a very complex and important issue that we are going to discuss today. And I now have the great pleasure to introduce our panel:

A very warm welcome to Angela Pfister, who is a trade specialist at the Austrian Trade Union Federation (ÖGB). She works at the economics department of the ÖGB, where she is responsible for European economic policy and trade

policy issues. She holds a master's degree of Commercial Sciences and International Business Administration from the Vienna University of Economics and Business. Before joining the Austrian Trade Union in 1997, Ms. Pfister worked for the Department of European Integration at the Federal Chancellery.

A warm welcome to Klaus F. Zimmermann who is president of the Global Labor Organization (GLO), Co-director of the Centre for Population, Development and Labour Economics at UNU – MERIT in Maastricht, and Editor-in-Chief of the Journal of Population Economics. He is honorary professor at Maastricht University, the Free University of Berlin, and the Renmin University of China in Beijing, and research fellow of various renowned research institutions. In his research, Mr. Zimmermann works in the areas of labor economics, migration and development.

Last but not least, a warm welcome to Thomas Liebig who is a senior migration specialist in the International Migration Division of the OECD's Directorate for Employment, Labour and Social Affairs in Paris. He holds a doctorate and a master's degree in Economics from the University of St. Gallen, a master's degree of International Affairs, and a CEMS Master in International Business Management. Mr. Liebig's research focuses on the integration of immigrants and their children, on the analysis of migration trends and on the economic impact of migration.

The very interesting and lively debate clearly showed that there are two distinct sides to this very pressing issue. Many questions remain open. Is migration simply about economics? Can we ignore social and cultural pressure? Whether we see it in economic or social terms, I think we can all agree that – whatever level of migration – integration is essential.



Migration: A Win-Win Situation?

1 Challenges in Central and Eastern European countries of the EU

Central and Eastern Europe has a globally unique role due to decades of emigration to predominantly Western Europe. The population in Central and Eastern European countries (CEECs) stagnated or fell (e.g. in Bulgaria and Romania dramatically). Latest EU population projections show that this is likely to continue in the coming decades (see table 1). Emigration from countries such as Bulgaria and Romania is expected to continue and is likely to increase, especially among younger age groups. One consequence of the continuing emigration will be a shrinking and aging population in the EU-CEECs, with few exceptions such as Slovenia and Czech Republic. At the same time, several EU-CEECs have become host countries for migrants, especially from Ukraine and other countries in the East. In contrast to the demographic development in many EU-CEECs, the population is increasing in Western EU countries, such as in

Table 1
Demographic trends in the EU

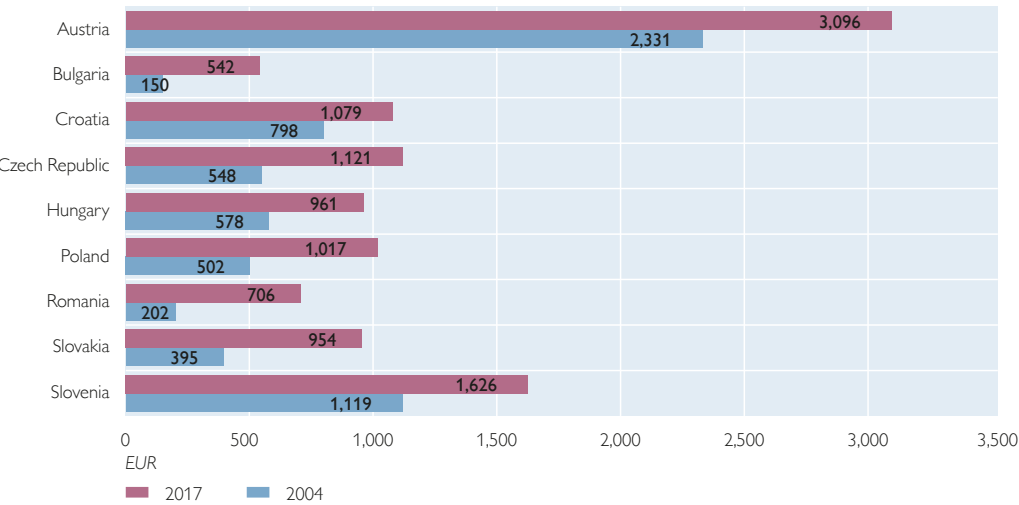
| | Population 2015 | Projected population 2050 |
|----------------|-----------------|---------------------------|
| | million | |
| Austria | 8.6 | 10.5 |
| Bulgaria | 7.2 | 5.4 |
| Croatia | 4.2 | 3.3 |
| Czech Republic | 10.5 | 11.1 |
| EU-28 | 506.3 | 539.8 |
| Hungary | 9.9 | 8.6 |
| Romania | 19.9 | 16.2 |
| Slovakia | 5.4 | 4.7 |
| Slovenia | 2.1 | 2.0 |

Source: IASA - International Institute for Applied Systems Analysis.

Austria, where the population could increase to over 10 million by 2050.

One of the driving factors for migration is still the large wage gap between Western and Eastern European countries. In general, the EU-CEECs are catching up but the wage gap is still huge which can be seen by comparing wages in the EU-CEECs to Austria in 2004 and 2017 (see chart 1). Considering holiday and Christmas allowances, Austrian workers earn approximately

Chart 1
Monthly average wages in Austria and EU-CEECs 2004 and 2017

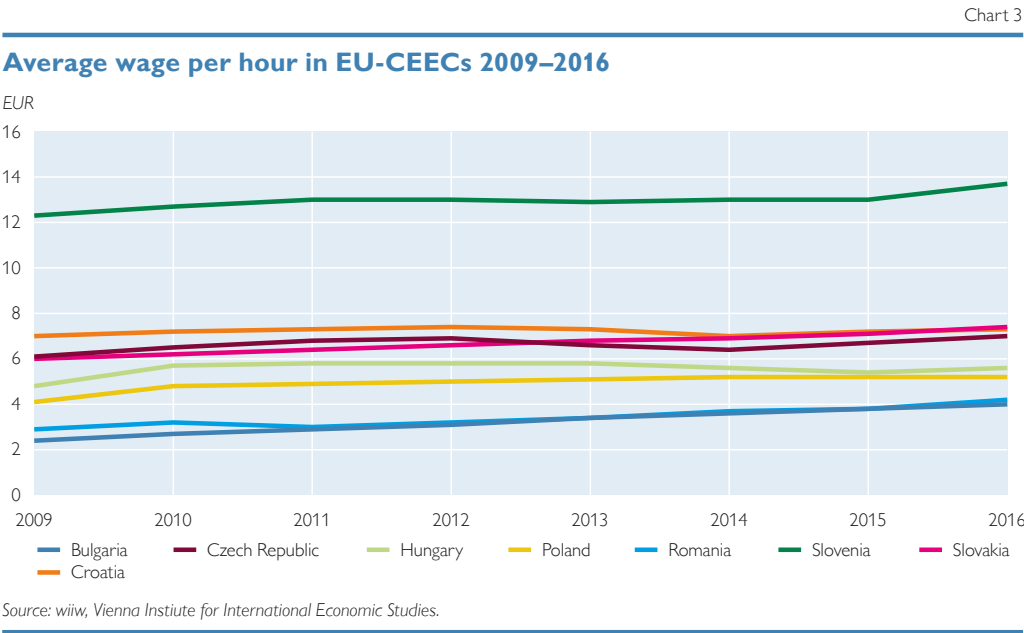
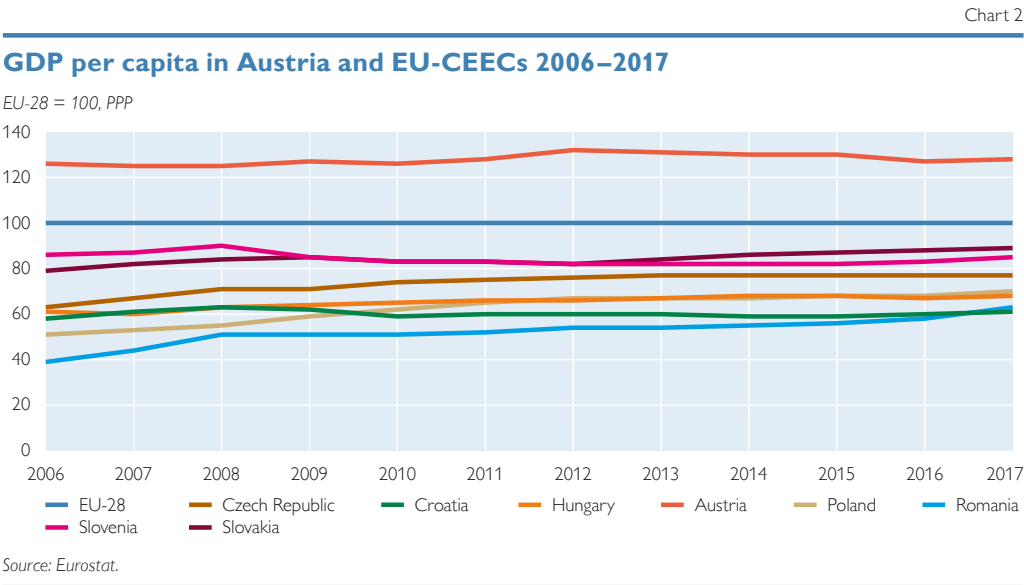


Source: WIFO Economic Data Service.
Note: Christmas and holiday allowances are included.

three times as much as workers in EU-CEECs. The exception is Slovenia where wages already account for more than 50% of Austrian wages. In Austria, workers from Bulgaria and Romania can earn four to five times more than at home.

The gap between EU-CEECs and western EU countries is also proven by the development of GDP per capita and hourly wages (see chart 2 and 3). Both are significantly lower in EU-CEECs

than in Austria. Apart from Romania and Bulgaria, wages increased by more than 10% between 2009 and 2016, which corresponds to a wage growth of less than 2 % per year (Astrov et al., 2018). The European Trade Union Confederation (ETUC) shows that the wage convergence between Eastern and Western Europe in the EU has even stopped since 2008. After some years of catching-up the crisis has reverted



this trend (ETUC, 2017). ETUC points out that wage gaps persist between Central European and peripheral countries even though productivity rates and cost of living get closer because of the single market and the effects the single currency spreads all over the EU.

Austria's social policy is characterized by a diverse and coordinated network of social benefits. This well-developed network has proven particularly successful in overcoming the still noticeable effects of the economic and financial crisis 2008. In contrast to Austria and especially to the Nordic countries the welfare state and social security systems are poorly developed in EU-CEECs (Astrov et al., 2018). The maximum duration of unemployment benefits in EU-CEECs is considerably shorter than in Austria and unemployment benefits and other state subsidies are much lower or non-existent. For example, after 13 months of unemployment only in Austria and in Croatia unemployment benefits are paid (see table 2). Therefore unemployed people

are urged to take up employment, no matter what the conditions are (e.g. low paid jobs that are very inadequate for livelihoods). Current welfare schemes are failing to tackle poverty and inequalities.

A look at the institutional framework of labor markets in CEECs shows that collective agreement mechanisms in those countries are much weaker than in Austria or in other EU Member States (see table 3). Furthermore, in the course of the economic crisis in some of these countries steps have been taken towards further restrictions of collective bargaining at national and sectoral level. This is especially true for Romania and Slovenia. According to Astrov et al. (2018), the weakening of the bargaining power of workers has led to a less dynamic wage development. Overall, the important macro-economic stabilization functions of labor market institutions are lacking which would be particularly important in view of specific problems of emigration, productivity growth, (over)aging

Table 2

Income from state aid for one-person households in relation to net income for average earners before job loss

| | Unemployment assistance | | | | | | Unemployment assistance, housing allowance & social assistance | | | | | |
|----------------|--------------------------|------|----------|------|-----------|------|--|------|----------|------|-----------|------|
| | Duration of unemployment | | | | | | Duration of unemployment | | | | | |
| | 2 months | | 7 months | | 13 months | | 2 months | | 7 months | | 13 months | |
| | 2008 | 2016 | 2008 | 2016 | 2008 | 2016 | 2008 | 2016 | 2008 | 2016 | 2008 | 2016 |
| % | | | | | | | | | | | | |
| Austria | 55 | 55 | 55 | 55 | 51 | 51 | 55 | 55 | 55 | 55 | 51 | 51 |
| Bulgaria | 47 | 77 | 47 | 77 | 6 | 0 | 47 | 77 | 47 | 77 | 15 | 10 |
| Croatia | – | 75 | – | 37 | – | 37 | – | 75 | – | 37 | – | 37 |
| Czech Republic | 50 | 65 | 0 | 0 | 0 | 0 | 53 | 72 | 30 | 37 | 30 | 37 |
| Germany | 60 | 59 | 60 | 59 | 26 | 17 | 60 | 59 | 60 | 59 | 44 | 30 |
| Hungary | 59 | 45 | 31 | 0 | 0 | 0 | 59 | 45 | 33 | 12 | 24 | 12 |
| Poland | 29 | 30 | 29 | 24 | 0 | 0 | 45 | 46 | 45 | 41 | 24 | 23 |
| Romania | 43 | 31 | 43 | 31 | 0 | 0 | 43 | 31 | 43 | 31 | 8 | 7 |
| Slovakia | 65 | 65 | 0 | 0 | 0 | 0 | 65 | 65 | 19 | 17 | 19 | 17 |
| Slovenia | 64 | 66 | 64 | 66 | 0 | 0 | 64 | 66 | 64 | 66 | 33 | 35 |

Source: wiw, Vienna Institute for International Economic Studies.

Table 3

Coverage rate of collective agreements

| | 2000 | 2008 | 2013 |
|----------------|------|------|------|
| Austria | 98 | 98 | 98 |
| Bulgaria | 40 | 35 | 29 |
| Croatia | – | 60 | 53 |
| Czech Republic | 48 | 50 | 47 |
| France | 98 | 98 | 98 |
| Germany | 68 | 61 | 58 |
| Great Britain | 36 | 34 | 30 |
| Greece | 90 | 88 | 59 |
| Hungary | 37 | 37 | 23 |
| Italy | 80 | 80 | 80 |
| Poland | 25 | 16 | 15 |
| Portugal | 79 | 84 | 72 |
| Romania | 98 | 98 | 35 |
| Slovakia | 51 | 40 | 25 |
| Slovenia | 100 | 92 | 65 |
| Spain | 85 | 81 | 80 |

Source: wiiv, Vienna Institute for International Economic Studies.

of the population and the strong dependence on foreign demand. Cazes et al. (2017) describe the role of collective bargaining in free-market economies well. They reach the conclusion that collective bargaining can make labor markets function more efficiently by correcting market failures and leads to a better management of labor market challenges arising from globalization, technological change, and workforce ageing.

2 Open issues for EU-CEECs

First, emigration eased certainly the tensions in the labor market in CEECs where unemployment was high. However, emigration further aggravates the population decline. In the long run the lack of qualified workers might slow down economic development and might have a negative impact on investment. Second, not an insignificant part of the GDP of the EU-CEECs flows as profit to foreign investors which is not compensated by public spending. And finally, export industries are historically mainly upstream of Western European production. This could limit

an upgrade to higher added value activities (Astrov et al., 2018).

Therefore policy action should focus on a coordinated economic and social policy including:

- Actions to increase the supply of skilled labor possessing the skills required by employers (including policies directed towards retention of skilled workers in the country, return of young people who have completed their education abroad and as well as return of migrants already working abroad).
- Measures targeted at industry consisting of various tools and financed by various sources of funding, ranging from stimulating domestic and foreign investment to state funding and public-private partnerships. This is an important prerequisite for restructuring the economy towards new high-tech industries with high value added.
- Strengthening of social security systems which guarantee equal access to adequate social protection and to the full range of support measures (including adequate unemployment benefits) for a re-entry into the labor market, also including self-employed.
- Undertaking steady pro-wage policies supporting free and autonomous collective bargaining in a context of social dialogue.
- At European level a budgetary reform providing the EU with greater financial leeway.

3 Challenges in the host countries

In general, macroeconomic developments have been comparatively favorable in terms of GDP growth and unemployment in Austria. While figures on growth are good and the unemployment rate is dropping, problems in the labor market remain. Still, record levels of unemployment and social dumping are major challenges in Austria. Fast

increasing labor supply has been the main reason for rising unemployment during the recent years. This strong increase in labor supply is due to different forms of migration apart from changes in early retirement regime.

The opening of the labor market and the associated free movement of people and services have led to a sharp rise in the number of workers from CEECs that started to work in Austria (Chaloupek 2016). Overall, employment has increased in Austria, but at the same time the number of domestic workers has decreased and unemployment has increased (see table 4).

The construction sector is particularly affected. The posting of workers from other EU Member States has so far increased significantly (Hofstadler et al., 2016). Wage and social dumping are widespread and causing severe problems. Results of the construction audits done by the Construction Worker Holiday and Severance Fund (CWSH; Bauarbeiter-Urlaubs- und Abfertigungskasse, BUAK) give a good overview regarding the compliance with payment regulations in Austria. During the first half-year of 2017 3075 construction sites were audited by CWSH inspectors. 3365 domestic companies and 12.371 workers of these companies were checked. 40 companies and 115 workers with suspected cases of underpayment were reported (which constitutes 1.2% of companies and 0.9% of workers). During the same period 816 posting companies and 3706 workers of these companies were audited. In 360 companies and for 1518 workers suspected cases of underpayment were reported (adding up to 44.1% of all companies and 41.0% of all workers).

In addition, macroeconomic implications of wage and social dumping must be considered. In Austria unemployment increased and income is lost. Tax and social security contribution losses alone

Table 4

Development of employment 2008–2014

| | Austria | | Vienna | |
|-----------------------|---------|-----|---------|-----|
| | | % | | % |
| employed nationals | –36,894 | 0.0 | –21,327 | 0.0 |
| employed foreigners | 151,666 | 0.3 | 46,147 | 0.3 |
| from EU Member States | 145,873 | 0.8 | 43,100 | 0.9 |
| of which | | | | |
| Hungary | 43,913 | 2.1 | 8,882 | 2.5 |
| Slovakia | 16,300 | 1.8 | 5,937 | 2.1 |
| Slovenia | 9,373 | 1.6 | 662,0 | 1.8 |
| Romania | 17,629 | 1.2 | 5,102 | 1.3 |
| Bulgaria | 4,282 | 1.6 | 2,329 | 1.7 |
| Poland | 15,294 | 1.0 | 8,280 | 1.0 |
| Germany | 16,616 | 0.2 | 5,546 | 0.4 |

Source: Main Association of Austrian Social Security Institutions.

amount to more than 2.5 billion euros (Schneider, 2014).

4 Open issues for host countries

Labor market regulations are crucial to avoid unfair competition. In Austria a new law against wage and social dumping would help to combat remuneration below collective agreement level. However, further improvements of Austrian laws and above all the directive concerning the posting of workers and the enforcement directive are urgent. Recent changes related to the directive on posting the workers are welcome but still do not solve the problems in Austria. The criticism from the population regarding cross-border mobility of workers is on the rise due to ongoing and systemic wage dumping. People expect the EU to finally develop instruments and implement measures for fair competition. As first steps, this requires immediately:

1. The enforcement of the principle of “equal pay for equal work on the same place of work” faces still some challenges which cannot be solved in the country of work performance. Posted workers are not registered with the social insurance

institution in the host country on the first day of their activity by the posting company. According to the posting directive posted workers remain in the social security system of their home country for 18 months which is a discrimination of affected posted worker and is leading to unfair competition. At least the higher wage while being posted, should be used to calculate the social security contribution.

2. Still further improvement in enforcement is needed, that is easier enforcement of penalties abroad, improved cooperation between foreign authorities and combating of bogus firms already in their country of origin.
3. The establishment of a mandatory minimum employment period before workers can be posted (e.g. three months) would be of significance.

This could reduce the widespread practice of employing workers in a Member State exclusively with the intention of posting them to another Member State.

And finally, there are several other open issues apart from labor market regulations to be addressed. Since the population in Austria will be sharply growing there will be an increasing demand for housing. The required infrastructure in growing areas – mainly Vienna and large cities – is in many cases not yet available. Decisions on infrastructure are outstanding (new homes and workplaces, mobility with future technology, energy and water supply, etc.). There is still no satisfactory solution to various budgetary issues e.g. setting a process of budgetary reform providing the EU with greater financial leeway or related to financial compensation (agricultural regions against urban areas).

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Social Cohesion and Labor Mobility

Social cohesion and labor mobility both have the same objective and do not need to be in conflict. They are about cooperating among individuals and societies in order to survive and prosper. Social cohesion can benefit from labor mobility: Labor mobility is economically beneficial for migrants and natives. Attitudes towards migrants are more friendly if they come and work. Migrants are more accepted if they are many. The wellbeing of natives is higher with more migrants present.

1 What can central banks learn from migration economists?

Central banks are concerned about labor markets since these markets determine wages and labor mobility. Wages are a decisive driving factor of inflation, which is the major objective of central bank policies. Labor mobility can accommodate inflation pressures across regions and countries through relative wage adjustments. In a currency union like the euro area, labor mobility can take part of the flexibility role freely mobile exchange rates would otherwise play. Labor mobility in itself fosters the optimal allocation of resources and hence contributes to economic prosperity. Therefore, free labor markets have been at the core of European Union (EU) economic integration policies since the beginning.

However, labor mobility like the market economy in general comes with adjustments, which may be painful or at least create fears since the ultimate consequences are often unknown. Migration is then seen as a threat, people are “pushed” to move and those coming may cause expectations about forthcoming trouble among the natives. This may damage the identity of societies and communities and destroy social cohesion, the ability, and readiness of the individuals to collaborate with each other to perform and to develop. Such a potential damage of social cohesion could negatively affect economic performance and leave the economic benefits of mobility undetermined.

So is there a trade-off between social cohesion and labor mobility that

endangers societies? My contribution to this debate is an optimistic view that is based on four observations: (i) Labor mobility is economically beneficial for migrants and natives, it is not a zero-sum game. (ii) Attitudes towards migrants are more friendly if they come and work. (iii) Migrants are more accepted if they are many. (iv) The wellbeing of natives is higher with more migrants present.

2 The good and the bad sides of labor mobility

Are social cohesion and labor mobility enemies or friends? Societies with a strong social cohesion may also create a larger loyalty, a lower readiness to leave and hence are less mobile. A solid societal basis, however, could also encourage a more risky behavior, such as mobility. Migration in any case enforces adjustments in sending and receiving societies, but also create potentials for the economy and societal development. Labor mobility is about cooperating in societies or between societies in order to survive and prosper. In sum, there is no need to be enemies, since both social cohesion and labor mobility have the same objective.

The good sides: Labor mobility does not only support the optimal allocation of resources, but also leads to balanced adjustments across regions and countries in response to asymmetric shocks. It responds to temporary scarcity and accommodates shared long-term needs. As a flexibility instrument, it is important for the euro area. On a political level, migration is also an indicator of

solidarity as the debate about refugees in Europe since 2015 shows.

The bad sides: The change associated with labor mobility implies pressures and potential failure. Where should one go and what is expected to be there? Who are those migrants coming? Can migrants perform or do they end in unemployment and misery and do welfare shopping? Do migrants take jobs away from the natives and depress their wages? Are refugees just a burden on receiving societies?

Although there are facts about those concerns, they are often ignored or dominated by negative perceptions.

3 Empirical evidence: Economic migration is indeed beneficial

Labor migration does not cause an economic threat. A large body of research has documented that labor mobility has had beneficial effects for the receiving countries (Constant and Zimmermann, 2013; Zimmermann, 2014, 2016; Blau and Mackie, 2016). In a large ‘natural’ experience, this was also documented for the recent process of EU east enlargement (Kahanec and Zimmermann, 2009, 2016). Migration can indeed absorb a significant part of asymmetric shocks. Europe has become much more flexible in recent years, also fostered by EU east enlargement (Jauer, Liebig, Martin, and Puhani, 2018).

Labor migrants are economically successful, do not take jobs away or depress wages, but stimulate the economy and are needed in the long-term. Migrants can even reduce native unemployment if they are complements and not substitutes to native workers in the production of goods and services. As a consequence, more employed migrants may cause a larger labor demand for natives. Besides public fears, the risk of welfare migration is also low (Giulietti and Wahba, 2013).

Labor migration improves economic balance, creates more equality and hence can support social cohesion. Kahanec and Zimmermann (2009b) report that OECD countries with a larger share of foreign labor are more equal. Kahanec and Zimmermann (2014) further document that in particular skilled migration will improve equality under standard empirical conditions. Labor mobility may create pressure to adjust, but also ensures that one is not left behind but moves up to better jobs (Foged and Peri, 2016). Social tensions are smaller and attitudes towards migrants are more open if mobility is connected to jobs (Bauer, Lofstrom and Zimmermann, 2000).

4 How mobility can support social cohesion

Migration can support social cohesion if it is labor mobility, since migrants have jobs, pay taxes and are good for the economy. A consequence of this observation could be that a significant immigration channel should connect mobility to the availability and accessibility of jobs. This points to the labor market as a natural filter for migrant workers and towards explicit labor immigration laws. It also suggests that asylum seekers and refugees should have access to work as early as possible, and independent of the likelihood of their long-term stay in the receiving country.

Also size plays an important role: Migrants are more accepted if there are many! Countries or regions with no or few migrants or refugees exhibit often the largest resistance or negative attitude against them. A recent study by Esipova, Ray, Pugliese and Tsubutashvili (2015) documents this conjecture forcefully. Based on interviews with over 183,000 adults across more than 140 countries between 2012 and 2014 surveyed in Gallup’s World Poll they find (p. 14):

“Countries where migrants constitute 10 per cent or more of the population are the most likely to have an opinion about immigration levels, and they are more likely to be positive (a combined 51% favor keeping levels the same or increasing them) than negative (43% favor decreasing levels). One explanation for this could be that in countries with higher percentages of migrants, the population has a greater chance to interact with migrants and this might promote greater acceptance.” This implies a better chance for social cohesion when migrants are more frequent and interact stronger with the native population.

A number of empirical studies have further found evidence that the wellbeing of natives is higher with more migrants and with more diverse migrants present

(see e.g. for German data Akay, Constant and Giulietti, 2014 and Akay, Constant, Giulietti and Guzi, 2017). Even if the exact source of the additional utility is unknown to the natives, this has the potential to strengthen social cohesion. Akay, Constant and Giulietti (2014) have studied the subjective well-being effect of changes in the spatial concentration of immigrants to identify a stable positive effect on the well-being of German natives. This finding is positively associated with a successful labor market assimilation of the migrants. Furthermore, Akay, Constant, Giulietti and Guzi (2017) found a positive effect of ethnic diversity on the well-being of German natives, an effect that is stronger for immigrant groups that are culturally and economically closer to Germany.

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Panel 3

EMU Deepening from Today's Perspective

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Is the Euro Irreversible?

Brexit happened. Given large accumulated imbalances, the restrictions of membership in the Economic and Monetary Union (EMU) create much larger problems for some troubled Member States. However, the accumulated imbalances must be resolved in any case, inside or outside the euro area. Fundamentally, the decision about an exit is a tradeoff between shock therapy and gradualism. In addition, exit might lead to forced default on a large scale. No such debt forgiveness seems possible within EMU. To avoid a bias towards exit, the euro area would need sovereign bankruptcy procedures with debt relief in line with a country's debt capacity, coupled with an economic restructuring plan.

When adopting the euro, countries must give up their own monetary policy, and exchange rates among Member States are irrevocably fixed. The heterogeneity of Member States in the euro area is huge. The EZB must make decisions conditional on the average state of the euro area economy but an average Member State does not exist. In consequence, common monetary policy is never right for each individual country. Interest rates are too low for Germany, but too high in some crisis countries who must accept deflation to regain competitiveness. The external euro exchange rate is too high for poorer countries with stagnant growth, and too low for Germany.

Key adjustment mechanisms are lost and are seemingly difficult to replace by corrections on other fronts. If adjustment does not happen, recessions tend to be much harsher and booms more exaggerated, and Member States tend to build up large imbalances over time. Member States need low sovereign debt to allow for more fiscal space and powerful fiscal stabilizers. They need a robust banking sector with larger equity capital to become a robust shock absorber, rather than a source of contagion for the real economy, the government or other countries. Member States need more flexible labor market institutions to keep wages at their level of productivity, to absorb more short-run fluctuations, and prevent accumulating external imbalances. Apart from high labor market

flexibility for internal adjustment, economic theory mentions additional preconditions for a successful 'optimum' currency area: substantial fiscal insurance; high labor mobility; and high capital market integration. However, there is little fiscal equalization and insurance in the euro area. Labor mobility is low and yet meets popular resistance. Capital markets have defragmented to some extent since the start of the crisis in 2008.

Is the euro irreversible? Brexit happened. For no compelling economic reasons. Membership in the euro area involves a much greater loss of autonomy than EU membership. The irony is that the EZB must conduct a common monetary policy, but cannot implement the structural reforms that are necessary for more internal flexibility. However, such flexibility is a precondition for common monetary policy to be successful. If national governments are not able to implement required reform and large imbalances accumulate, the euro becomes a straitjacket that creates much more compelling and tempting economic reasons for an exit than the UK ever had in leaving the EU. Given the large unresolved imbalances both in the weak and strong parts of the euro area, one might expect that the likelihood of a euro area exit in the next severe recession is larger than the probability of a Brexit before it actually happened.

While there is an established and lengthy mechanism to prepare entry to the euro area, there is no equivalent

procedure for an exit. How are imbalances resolved upon an exit? What are the rules and obligations? Must one expect massive default? How does it affect economic performance in the short- and long-run? In the absence of a systematic investigation of euro area exit, how could policy makers make an informed decision when sudden economic shocks and unforeseen events forces them to decide? How could the population form a popular opinion about the value of euro area membership if it knows little if anything about the alternatives? The lack of an exit procedure and the lack of investigation a priori is likely to lead to very chaotic events when the 'accident' happens. In all likelihood, an unprepared and chaotic exit would be much more costly and could impose unduly large economic costs.

What would actually happen if a country choses to exit the euro area? Clearly, there are huge practical difficulties that are not at all symmetric to entry procedures for joining the euro. The biggest challenge would be to avoid that market participants start to anticipate an exit. The Greek experience showed that this could trigger massive capital flight, involving bank-runs as well, which would multiply the economic costs for a country that chooses to exit. A large devaluation of the new currency would mean a large reduction in financial wealth relative to other countries. Even unsubstantiated rumors might lead domestic and foreign investors and depositors to panic and quickly move money out of the country, to convert it into safe currencies. By way of contrast, a strong country such as Germany would probably experience huge capital inflows in anticipation of a large appreciation of the Deutsche Mark, allowing investors and depositors to reap large windfall gains.

If an exit were to take market participants by surprise, and if bank

holidays and capital controls could prevent large capital movements prior to an exit, the distribution of losses would be rather different. The consequences could nevertheless be very large. They would differ substantially across countries, depending on the nature of imbalances that have built up prior to the event. Three cases can illustrate the argument. Consider Italy: productivity is stagnant and wage costs are too high relative to the euro area average. The banking sector is fraught with a large amount of non-performing loans. Government debt is excessive. The country ran up large TARGET2 liabilities. Imbalances are huge. One must expect a sharp correction upon an exit. The new Lira would have to depreciate substantially to regain price competitiveness. With a depreciation, the real value of foreign debt of the private and public sector in EUR and US-Dollar would suddenly explode, causing massive default. Italy could probably not pay back its TARGET2 liabilities. The government would be unable to service foreign-owned sovereign debt. Given cross border integration of banks and capital markets, the losses would spread all over Europe. Many unprofitable firms would have to close down and unemployment would shoot up. Given the inability of the over-indebted government to intervene, the central bank would need to initiate a massive one-time expansion of money supply to recapitalize banks. An inflationary shock would further deflate the value of debt in national currency and reduce real incomes. After a very severe short-run financial crisis of one to two years with a large output loss and unemployment, the country would probably start to grow fast to catch up and bring back unemployment from excessive levels.

A German exit scenario would be entirely different. Consequences would be quite dramatic as well since Germany

also runs large imbalances towards the euro area, including unit labor costs substantially below average and huge trade and current account surpluses. Institutions and government finances are strong. The largest effects would be in the export sector. A large appreciation of the Deutsche Mark would strengthen Germany's purchasing power and allow the country to reap large gains from trade that the euro has prevented. One might expect the shock to be considerably larger than the Swiss Franken shock with a 20% appreciation that Switzerland had to digest. By substantially impairing export demand, unemployment would rise again and growth would come to a halt with negative consequences for public budgets. Another shock would be large windfall losses due to a substantial depreciation of German wealth invested abroad. Up to now, German foreign financial wealth is denominated mostly in EUR and US-Dollar. Even if foreigners could fully repay these liabilities in EUR or US-Dollar, the real value in Deutsche Mark would fall substantially resulting in a large onetime loss. It seems also inconceivable that Germany's large TARGET2 claims could be settled in full.

A third illustrative case is Austria. In isolation, one would expect only minor disruptions. For Austria, the euro is about right. Imbalances relative to the euro area are small. Its own institutions and public finances are reasonably robust. There are no obvious reasons that Austria or other European countries could not fulfill their financial obligations after an exit. Historically, there were examples of exiting a common currency without much friction, such as Czech Republic and Slovakia. Given the absence of large imbalances, such separations can happen relatively smoothly. An important difference is, however, that Austria is part of a big heterogeneous currency

area. While an Italian or German exit would remove the extreme poles and make the rest of the Eurozone more homogeneous, an Austrian exit would diminish the center and leave the extremes, making the remaining euro area even more conflict ridden.

Where does that leave the debate? One must again consider the trilemma that governed the euro area crisis: government finances paralyzed by too much fiscal debt; a weak and excessively leveraged banking sector; and competitiveness problems, trade imbalances and international indebtedness due to the inability to replicate real exchange rate movements by internal price flexibility (internal instead of external devaluation or appreciation). Another problem is that a country can no longer condition its monetary policy on the state of its own business cycle, which tends to magnify fluctuations and make booms and recessions more severe and costly. A first conclusion is that the economic problems that might lead to a euro area exit do not simply disappear after an exit. Government debt would have still to be reduced to allow fiscal stabilizers to work and to retain fiscal space in the event of a severe recession or crisis. Second, a weak and highly leveraged banking sector is a problem within and outside the euro area, leaving no alternative but regulatory and institutional reform. Third, competitiveness problems and sustained trade imbalances require a price correction in any case. Internal devaluation by real wage moderation or external exchange rate depreciation are just two alternative ways to achieve such a correction. In both cases, a country gets poorer relative to the rest of the world. Sustainable increases in long-run per capita income are only possible with sustained increases in productivity and wages growing in line with it.

In the end, euro area countries must reduce the large imbalances in all scenarios, within or outside the euro area. The ultimate trade-off is between shock therapy versus gradualism. Leaving the euro area is a shock therapy creating crisis in the short-run with the promise of faster recovery thereafter. Institutional reform within the euro area is a prolonged gradual process, avoiding severe short-run disruptions in exchange for stretching out the adjustment problems over a longer period. It then takes much more time to recover fully from the crisis. Following a gradual reform path within the euro area would be in cooperation with the other Member States, thereby improving the prospects of a cooperative Europe that is able to create and cultivate common goods to the benefit of all. Gradualism would also have the added advantage of more intergenerational fairness by stretching the costs more evenly across present and future generations instead of concentrating all pain on current generations to the benefit of future ones. On the negative side of gradualism weighs the risk of lacking reform commitment, where negative political developments in the future could undo much of the achievements until then.

For a country with large imbalances, exit from the euro area would be a very risky undertaking at the expense of current voters and do not in itself solve the economic problems that led to this decision. However, a country could substantially benefit if an exit, on a massive scale, leads to default on claims of other Member States whereas continued EMU participation does not allow for such debt forgiveness. Such a scenario would involve a huge one-time redistribution from creditor to debtor nations. Future recovery after an exit would then be much easier since the country would start with a much lower debt overhang.

Such an asymmetry in debt resolution within and outside EMU creates a bias towards exit.

To avoid such a bias in favor of exit by large debtor countries, it is important to apply the market principle with orderly sovereign default procedures within the euro area. When a private sector firm goes bankrupt, control goes from management to creditors who must agree on a debt cut and a restructuring plan so that the company can recover and pay back at least a substantial part of its debt. Largely the same applies in the banking union under the new guidelines for resolution and restructuring of troubled banks. The principle also applies to the mission of the European Stability Mechanism (ESM) or IMF and involves three steps when giving new credit to illiquid sovereigns. First, calculate the debt capacity of the country and work out a 'restructuring plan'. Second, impose a haircut on existing creditors so that repayment of the remaining debt becomes credible with regard to the calculated debt capacity. Third, give new credit only in tranches against achieving milestones of the agreed reform plan. The purpose of the restructuring program, associated with a substantial loss in autonomous policymaking, is to maximize the country's debt capacity and thereby to reduce the losses of the creditors. An important element of this mechanism is, however, to apply the right debt haircut to free the country of an excessive debt overhang. Failure to do so delays insolvency rather than fostering recovery and new growth, as illustrated many times in the private sector. Today, other Member States and the ECB hold a large part of sovereign debt of crisis countries. By not being willing to apply the market principle to insolvent countries, these institutions do not only risk delayed and even more costly sovereign bankruptcy but also create a bias towards euro area exit.



Ulrike Rabmer-Koller

President

European Association of Craft, Small and Medium-Sized Enterprises (UEAPME)



Deepening of the Economic and Monetary Union from the Perspective of SMEs

As President of the European Association of Craft, Small and Medium-Sized Enterprises (SMEs) UEAPME, but also as owner of a SME, which is active at international level, I am well aware about the challenges monetary union is facing and we follow closely the ongoing debate, which is also crucial for our 23 million SMEs in Europe.

What I would like to do in my introduction is to explain the main challenges of small enterprises in Europe related to the ongoing debate about monetary union. What do SMEs need and which progress they can realistically expect from the next reform steps?

The challenges, I would like to touch are:

- the ongoing problems SMEs have – at least in some countries – with access to finance
- deficits in public investment, especially in IT infrastructure, qualification as well as research and innovation
- missing structural reforms to increase the competitiveness in Europe
- economic and social stability in case of external shocks in order to avoid a dramatic decrease of domestic demand

Let me start with access to finance. Due to the structure of the European economy, which is dominated by micro and small enterprises, the overwhelming majority of our SMEs depends on debt financing, if they need access to external finance. I am not denying the importance of capital markets and UEAPME fully supports the efforts made to create a European Capital Markets Union, but we have to be aware that more than 95% of our companies will not be able to benefit from it. The majority of SMEs is depending and will depend on bank finance.

Therefore, completing the banking union and improving the capacity of

banks to lend to SMEs is crucial for the ability of SMEs to invest, to grow, and to create jobs. This is why UEAPME supports the completion of the banking union. However, we are aware that this will only happen, if it goes hand in hand with risk reduction in the banking system. We understand that some Member States want to avoid a future deposit guarantee scheme, which pays in the first round for failures in the past. This is why UEAPME agrees with the efforts made to reduce the amount of non-performing loans. Another important project in this context is the review of banking regulations, where we need a continuation of the SME supporting factor and more proportionality as regards to obligations for smaller local banks, which play an important role in financing local SMEs in many countries.

As regards public investments, one has to be aware that small enterprises depend more on a well-functioning infrastructure and on skilled labor supply than multinationals. This means, an increase of public investments in modern IT, transport and energy infrastructure as well as in qualification systems providing the needed skills is crucial to support economic growth and job creation in Europe's SME sector. Therefore, UEAPME asks to apply the Stability and Growth Pact in a way that is does not only focus on the quantity of public spending, but also to its contribution to future growth. The same is true for the revenue system: tax avoidance and fraud as well as a too strong dependence on labor related taxes reduce the potential for growth and employment. This is why the composition of public revenues should also be analyzed. For the same reasons, UEAPME fully agrees with the request to increase public investments or to cut taxes on

wages in those countries having budgetary leeway for it.

My third point tackles the deficits in the implementation of needed structural reforms. Not only business organizations but also the European Commission regularly complains about the lack of implementation of needed and agreed structural reforms in many Member States. Delays in modernizing products, services, and labor markets are reducing the growth potential of Europe's economy and the competitiveness of our companies.

Therefore, UEAPME supports the intention of the current proposal of the European Commission to increase the technical and financial support to Member States to implement priority reforms. However, this must avoid moral hazard and must not encourage governments to delay reforms until they get financial support. Furthermore, if the implementation of needed reforms creates costs for front loading, such costs should be treated favorably in the framework of the European Semester.

My last point is the adequate reaction on external shocks, which may easily result in an economic downturn or even a recession in affected Member States. SMEs – acting to a large extent at local level – suffer more from crisis in a certain region than larger enterprises. It is therefore in our interest to avoid economic or social disruption created by such a shock. However, it has to be clear that the main instrument to buffer such shocks are sustainable public finances, allowing the full functioning of automatic stabilizers and the implementation of structural reforms to increase the resilience of national economies. Therefore, UEAPME shows some hesitation towards a financial stabilization function and has always argued

that if such an instrument will be introduced, it has to be strictly conditional on the implementation of reforms and it has to exclude moral hazard.

Furthermore, if such a stabilization instrument were provided, we would have preferred a kind of “rainy day fund” to an investment stabilization function. Hence, a rainy day fund provides more leeway for discretionary measures, adapted to the concrete needs of a country and more possibilities for conditionality compared to a rule base investment support.

With these four policy areas I have demonstrated that SMEs in Europe want to see progress in deepening the Economic and Monetary Union and why smaller companies would benefit from it. However, I am convinced that we also need realistic expectations. There is neither the need to change the European treaties nor the need to wait for a political union to realize the needed step forwards.

I am even more hesitant as regards the European Stability Mechanism or a potential European monetary fund and I do not expect that now the time has come to move from intergovernmental solutions to a community solution in the framework of the current treaty. As long as there is no further progress in risk reduction and economic convergence, it will be difficult to convince all Member States to hand over such competences to European institutions.

Let me finish by stating that at least the next steps, which UEAPME is expecting in the interest of our SMEs, can be done without such changes. Therefore, I would like to invite policymakers to take the necessary steps now and not use unfeasible reform wishes for a deeper Economic and Monetary Union as an excuse for doing nothing.





Deepening the Economic and Monetary Union from Today's Perspective

I present some considerations for completing the set-up of the Euro. They are framed against the present topical political debates, and how I assess the feasibility of a set of solutions. The envisaged outcome should largely complete banking union, and have a few further reform steps that only partially satisfy the ambitions of some Member States, but may go beyond what others see as desirable or necessary at this stage.

1 Incrementalism or Grand Design?

At the time of the negotiations for the Maastricht Treaty it was clear to participants that the final agreed text was not the final configuration of Economic and Monetary Union (EMU). Two strands of discussion at the time are worth recalling:

- The sequencing debate: prominent especially in Germany, where there was a lively debate on the “crowning theory” (Krönungstheorie). Its central theorem was that political union had to precede EMU.
- Progress through crisis: in analogy to Schuman (“not built all at once (and) will be forged through crisis”).

Historical developments have shown that progress through smaller steps has indeed been the politically plausible and achievable mode of deepening European integration.

Living with imperfection, or incompleteness, has advantages and drawbacks too. Experimentation in small steps avoids large mistakes that cannot be rectified. Each step of integration can be assimilated into the political culture of Member States for longer periods before the next step commences. Conversely, the incomplete architecture of the European project increases risks

of instability, and even fears of reversal in troubled times.

Completing EMU has stress tested the economic and political resilience of Member States over the last ten years. Whilst the different stages of the crisis post-2008 were not necessarily causally related to EMU they brought out the fault lines of design and practice.

2 “Firewalls”

The absence of instruments for addressing balance of payments crisis in the Maastricht Treaty rested on the assumption that within a monetary union there could per definition no longer be such crisis, and also on the no bailout provisions of the Treaty. Their absence was one of the reasons why it took Europe so much longer to resolutely address the effects of the financial crisis. The euro area now has the European Stability Mechanism (ESM) with a paid in capital of 80 billion EUR, which can provide adjustment loans against conditionality of up to 500 billion EUR.

The founding of the ESM in turn led to what was presumably the game changer in our crisis approach. It enabled the ECB to announce the Outright Monetary Transactions (OMT) and thus transcend the monetary financing prohibition.

There is an ongoing discussion of turning the ESM into a European monetary fund. There are few specific thoughts and suggestions on what precisely should be achieved. An important aspect in this debate is what effects this would have on the future role of the IMF in Europe, and the future wider relationship between Europe and the IMF. Changes in the role of the European Commission (EC) could have wider ramifications, and need to be carefully addressed.

3 Banking Union

Progress has been significant: we have made large steps towards Banking Union since 2012. There is a single supervisor (Single Supervisory Mechanism – SSM) for banks under the umbrella of the ECB in Frankfurt. It has ensured that the playing field is becoming more level than it was. We have a single resolution authority (Single Resolution Board – SRB) which is funded by the European banking system. Regulatory reforms have made the banking system more robust and resilient.

The next steps will be a political agreement on deposit insurance which I expect to come about this year. The debate of the last years has shown that this will only happen in conjunction with a number of so-called risk reduction measures. Importantly, there is a good chance that there will be exposure limits for sovereign bonds in bank balance sheets, and a convergence process for national insolvency frameworks and practices. Quantified targets values for national NPL ratios and their reduction are likely.

This will not be implemented in one step. I would expect a process of moving from one step to the next step of integration of deposit insurance schemes that are dependent on progress in fulfilling the quantifiable parameters as described above. We can therefore expect fairly lengthy transition periods.

The principle underlying this negotiating package is the following: if risks are to be shared among Member States (or economic actors) then the factors that lead to such shared (contingent) liabilities need to be controlled either jointly (inter-governmental approach) or through a joint institution (community method).

Extending the approach of common supervision to insurance and securities markets would be a desirable further step, but the legal framework and fierce

opposition by some Member States make this improbable for the nearer future. Extending the remit of the SSM to other areas such as money laundering would also be desirable.

In the longer run I consider a treaty-based separation of monetary policy and banking supervision in the best interest of both. This requires treaty change.

4 Fiscal Union

A fiscal union can be described as one that combines joint resources with joint disciplines, and has the appropriate democratic legitimacy. Few dispute the fact that a monetary union needs a fiscal framework in order to ensure that negative spillovers are containable, and so that joint policies yield the appropriate benefits.

Moving towards a fiscal union can come in many forms. Attitudes towards these political choices are usually informed by approaches towards the political legitimization of such policies. A useful categorization is whether national fiscal policies are

- regulated through institutions,
- by common rules,
- or through market discipline.

Again, we see the choice between political union (joint institutions that are democratically legitimized) and a common approach that rests on a mix of national sovereignty and mutually agreed rules that are surveilled by a central institution (like the Commission) or regulated through market discipline. The latter has not worked that well in practice.

Providing the euro area not only with rules but also with a common budget, or fiscal capacity, has been widely debated over many decades. Suggestions range from a small investment budget, to a small budget that should stimulate economic reforms, right up to large joint budgets that are capable of macro-economically significant countercyclical

policies. A useful question in this debate is which problem one is trying to fix: issues of regional cohesion, lack of public investment, problems of asymmetric shocks, or making sure that “others” (i.e. everybody else) have the “correct” fiscal stance.

An argument often made in favor of a joint fiscal capacity is that macroeconomic stabilization in the euro area would improve the effectiveness of monetary policy. This would then exclude fiscal mechanisms that are not correlated to the business cycle, such as structural support capacities.

The feasibility of such joint fiscal capacities differs according to the extent to which the fiscal sovereignty of national parliaments is affected.

Budgets analogous to the EU budget, i. e. financed by transfers of national governments that are calculated according to an agreed set of rules avoid constitutionally difficult questions. The main issue is who decides on spending algorithms.

More difficult are those joint budgets that are financed by joint policies. Suggestions abound, ranging from joint financing of unemployment insurance schemes to financing through joint tax policies.

The present situation is characterized by the following parameters:

- an EU budget that is in form and substance disassociated from the euro area
- fiscal rules that are incomprehensible to most,
- their application in practice has led to mistrust and discord among Member States and between Member States and the Commission
- and increasingly divergent levels of debt among Member States.

In this situation, large changes to the present set-up of the euro area are unlikely. A plausible outcome of this year’s political negotiations would be

an agreement on a small fiscal capacity that is financed by transfers, and focuses on common public goods.

A simplification of the stability and growth pact (SGP) would be highly desirable. An intelligent step in the right direction could be to focus on larger fiscal errors, and stop focusing on the values behind the comma. Using cyclically adjusted values is economically intelligent, but practically challenging. Forecasting potential output based on current values is not a useful basis for fiscal decisions. A promising approach would be to focus on an expenditure rule, giving the debt rule a more prominent role, and focus on the medium-term budgetary approach of governments instead of adjusting (in extreme cases) requirements several times a year.

Using nominal values, as it was done up to 2005 is economically not sensible. This would only work if one gives an institution, obviously the Commission, a certain degree of discretion to evaluate the cyclical component of budgetary developments and to make recommendations accordingly. This takes away some of the quasi-automaticity of the present framework, and requires increased trust in the judgement and recommendations of the Commission, higher than some Member States have at present.

I am skeptical if governments will have the strategic foresight to agree to such changes in the short run. They are more necessary and pressing than they realize. Whilst there has been some progress in fiscal consolidation the balance between stabilization policies and sustainability concerns has not been a great success. Some Member States with elevated debt levels have increased debt levels even further. Credibility in the system has been undermined through continuous fine-tuning of rules with only partial de

facto compliance. Mistrust in this areas spills over into other areas.

5 Economic Union

The euro was not conceived as an isolated monetary experiment, but as the monetary complement to a fully functioning internal market of the European Union. This is not the occasion to treat in depth the question of how well the internal market functions, or which further integration steps are required. Suffice to say that there are still significant obstacles to reaping the full benefits of European integration in this area. Examples are markets for energy and other utilities, services and even some professions. The better such markets function the better the benefits of the euro can be realized. And vice versa.

Developments in the first ten years of EMU brought about wide divergences in real unit labor costs, mostly in countries that had not had a long history of shadowing the Deutschmark through hard currency policies. Strong institutions and processes help in aligning wage, price and productivity developments and thus limit negative spill-overs, and thus external disequilibria within the euro area. This is of course a symmetric issue of adjustment requirements within the euro area.

6 Democratic Accountability

The question of democratic accountability is often raised, usually in the sense of some perceived democratic deficit. Accountability and legitimacy need to rest where the constitution positions them. In the context of the policies of EMU there are reporting requirements of the ECB to the Council and the European Parliament (EP), as well as hearings in front of the EP.

There have been repeated complaints about the lack of democratic accountability of decisions taken in the

Eurogroup, such as on country adjustment programmes. Such decisions are taken on an intergovernmental basis, based on the constitutional domestic requirements of the Member States represented there. As such there can be no deficit.

An issue in the context of political transparency and involvement seems to be the issue that the economic policies of the euro area are discussed in the Eurogroup in Brussels. And that is often where they stay. A considerably deeper involvement and information of national policy actors would seem to be necessary in order to improve the understanding, acceptance and legitimacy of the policies that are joint policies. This could largely be the task of the President of the Eurogroup. Given that this is a job that is exercised in parallel to that of a national finance minister this will not happen. Making the job full-time and Brussels-based would make this possible. His or her interactions would need to include regular and intensive consultations with national parliaments.

7 Summary and Outlook

Progress in deepening EMU has been significant over the last years. Banking union and other measures have led to a significant strengthening of the euro area. For 2018 I would expect political decisions on completing banking union, quite possibly decisions on a small budget for the euro area, and hopefully some progress on making the fiscal framework more practical and politically legitimate. Whilst not representing a completed and final monetary union these steps are important ones towards this goal. Steps that require major treaty changes will not be taken, also because they would lead to a rebalancing of core constitutional powers between national parliaments and the central institutions of EMU.





Dinner Speech: Deepening EMU – Political Integration and Economic Convergence

Dear Ladies and Gentleman,
Allow me first of all to thank Oesterreichische Nationalbank and the Austrian Federal Economic Chamber for organizing this excellent conference and giving me the opportunity to share my thoughts at this event and in this beautiful surroundings.

We all know that Europe has gone a long way in terms of monetary and economic integration and that the path to the point where we stand today was not an easy one. From a perspective of a person who was deeply involved in Croatia's negotiation process towards the EU membership, bringing so many countries under one "roof" is an achievement in itself. But, as we have discussed today, formidable challenges still lie ahead if we want to achieve deeper integration and boost economic convergence.

Being here in Austria tonight, it is only natural to think about Habsburg Empire as one example of a challenging nature of integration and convergence processes. Vienna Institute for International Economic Studies recently argued that some similarities exist between the Habsburg Empire and the EU, both representing complex state structures, involving various nations and autonomous regional authorities. However, the Habsburg Empire was characterized by the very low "strength" of the convergence process. According to the authors of the study, reduction of the income gap by half was supposed to happen over the period of 238 years – apparently a too long period from that particular union's perspective. This is not to say that economic divergence was solely responsible for what happened, but protracted economic hardship provides a breeding ground for destructive ideas. Same can be witnessed in today's post-crisis European landscape.

In the last couple of years, convergence processes in the EU were not in the focus of policy makers as most EU countries have been preoccupied with more serious issues – financial sector crisis and sovereign debt crisis. Rightfully so, as these were threatening the very existence of the euro area and possibly even the EU. While we are still not entirely out of the woods, great progress was achieved in these areas. Government deficits were substantially reduced and in most of the EU Member States public debt has been put on a downward path. Even more importantly, we now have the mechanisms in place that better equip us to deal with the next crisis. The Stability and Growth Pact was strengthened, ESM was established, creating the first serious European financial firepower, and the SSM and the SRM, the first two pillars of the banking union, are now in place.

However, with the negative effects of the financial crisis being gradually overcome, focus of policy makers has turned back towards one of EU's main policy objectives – economic and institutional convergence of its Member States.

Central and Eastern European countries have made large progress since the 1990s and in many countries transition towards market based economies is now largely completed. Nonetheless, their economic convergence is far from over and it was severely shaken by the recent economic crisis. Since the onset of the crisis positive income convergence trends were first reversed in many of the countries in the region and, when convergence reappeared, its pace was significantly slower than at the beginning of 2000s. At the current pace of convergence, some countries in the region would need many decades to come closer to Austrian or German levels of income.

These trends clearly show us that further convergence of standards of living is not a sure thing, and should not be taken for granted. The CEE countries will have to find new and more flexible drivers to support the relaunch of the catching-up process and to build more efficient and productive economic systems in the years to come.

So, the question arises what policy tools are available to lift potential growth and convergence?

In the pre-crisis period the growth in CEE countries was to a large extent based on strong investment growth supported by huge inflow of foreign capital. In post-crisis period net foreign direct investment inflows fell in most countries of the region and, while we can expect a rebound of capital investment growth in CEE countries, I am quite certain that growth rates that we have witnessed in 2000s, will not be seen again in the near future.

Fiscal policy might give some impetus to growth but only to a very limited extent. Most countries still have no or very limited fiscal space. Although large progress has been made to stabilize public finances after surge of deficits in the wake of global crisis, in some countries debt ratios are still above prudent levels and most countries have not yet reached their medium-term objectives. In order to increase public investment without making strong pressure on public finances the key will be to use EU funds more efficiently and effectively which in some countries, like my own, is still far from optimal.

On top of the mentioned challenges, CEE countries are also facing very unfavorable demographic trends. The share of the elderly population in total population is increasing while the share of the working age population is declining, resulting in a significant rise in the old-age dependency ratio. These unfavorable

demographic trends are in some countries further aggravated by strong migration outflows (of mostly young and relatively educated labor force) which, in turn, puts a pressure on domestic wage growth and might weigh negatively on countries' cost competitiveness. This might not only work as a drag on real and potential output growth but might also create additional pressure on the fiscal positions. As pension system reforms have been rolled back in many countries, improvement in current fiscal positions are hiding higher fiscal pressures in the years to come.

With these constraints in place, the key of lifting potential growth will be to increase the efficiency with which factors of production are used, that is total factor productivity (TFP). We know that in the long run, when it comes to rising living standards, it is all about productivity. Much has been said about TFP growth in the context of the discussions on the slowdown in productivity growth, or discussions of convergence in Europe. For us, policy makers, understanding the determinants of TFP growth, is the key, as this gives us the channel to act through. There is an increasing number of theoretical and empirical papers linking both the development and the adoption of technologies to the quality of institutions defined in a very broad way. And data seem to be supportive of the link – there is a strong positive relationship between quality of institutions on one side, and growth on the other. This is why labor and product market liberalization, or business friendly environments and quality of institutions in general are so important in communication with government and broader public.

Moreover, as I mentioned earlier, catch-up growth in CEE countries in pre-crisis period relied largely on importing foreign capital which resulted in transfer of knowledge and know-how

via massive amounts of foreign direct investment. But with these inflows subsiding, it seems that more domestic innovation and investment in non-material assets will be required to maintain growth and to avoid the middle-income trap. And for this, increasing level of human capital will be crucial.

But, when it comes to the quality of institutions or human capital, there has been only modest convergence of the CEE. If quality of institutions is proxied by World Bank's Worldwide Governance Indicator there has been hardly any convergence of the CEE region towards Germany (notable exceptions are the Baltic countries where we have seen positive developments also in the aftermath of global financial crisis). Very similar conclusion can be drawn when looking at the human capital quality – not only that CEE countries lag substantially behind the EU countries that achieve the best results in PISA tests in Math and Science, but the developments over time are also not encouraging as in many countries the results actually worsened, rather than improved during the last decade.

On one hand, such developments are worrisome, but, on the other, they provide the opportunity to streamline reforms and make substantial gains from these same reforms. European Commission estimated that structural reforms that would close only half the gap with best performers in different areas (market competition and regulation, R&D expenditure, skill structure, tax structure, labor market participation, unemployment benefit 'generosity' and active labor market policies) could have significant macroeconomic effects. The level of GDP in 10 years after the reform would be around 7% higher in the CEE countries and around 12% after 20 years compared to the "no reform" scenario, and effects on employment

are of similar magnitude. The OECD, or the IMF, also point to significant benefits of structural reforms in terms of TFP improvements. Notwithstanding the uncertainty around these estimates, welfare advances would most probably be substantial.

But the question is how to get structural reforms right? There are in general two dimensions of structural reforms. First, and in principle the easier ones, are the reforms that bring us closer to the efficiency frontier. That said, it is possible that easy productivity gains from sectoral reallocation and imports of foreign technology have to a large extent been exhausted. The second are the reforms that expand the efficiency frontier with many different policies to follow: research and innovation policy and strategy, product market reforms, competition policy, labor market reforms, public finance and taxation (including social security system), human capital development, etc. Can we, and should we, act on all, or most of these different fronts simultaneously? Probably yes. Do we as economists and policymakers truly understand all the synergies, complementarities and marginal effects of different reforms? Do we understand political economy of moving individually or in parallel on all these fronts? Probably not.

Another question is what should we use as a benchmark of good practices? We could, and in my opinion should, go beyond EU best performers and look at other, better, countries. Namely, what is also worrisome is that not only convergence within EU has slowed down, but also EU as a whole started to lag behind U.S.A., and this trend of divergence started long before the recent crisis. Europe's convergence process towards U.S.A. actually stopped in the mid-1990s and in the early 2000s U.S. productivity growth re-accelerated and the U.S.-EU gap widened indicating

structural and institutional weaknesses that need to be addressed. So should the goal for CEE countries be to converge towards EU style labor, product and financial markets, or maybe towards more efficient ones? Converging towards the structures that are themselves underperforming might not be a good choice.

For example, integration of CEE banking markets with the West European ones, through entry of banks into the CEE region at an early stage of the transition, was certainly beneficial in bringing better technology and banking culture, as well as facilitating the capital transfer. However, today, when it is clear that bank-based financial systems are inferior to more diversified ones, the goal should probably be to turn towards developing more efficient structures.

At the same time, we need to keep in mind the political economy dimension of the process. We need to ensure broad support for the reform agenda especially since there might be some short-term costs of certain reforms. However, according to the EBRD data, not only the difference between shares of people who support and those who oppose market economy in the CEE region is only half of that in Germany, but it actually declined over the last ten years. Moreover, the same applies to the support of democracy as a political system. This is where policy design of inclusiveness, policy transparency and communication will play a tremendously important role.

So, the bottom line is that hard work awaits us and that there are no guarantees

that levels of income in CEE countries are going to converge towards those of the developed Western economies. However, it is our job to dare to introduce reforms even if we are not entirely sure about the appropriate timing and the scale of their effects, as these are often not under our direct control and are notoriously hard to predict. But if history teaches us anything, and if we follow the best practices from around the world, then the path we have to follow becomes much clearer. And the closest thing to a recipe for reducing probability of being caught in middle income trap (of low growth and slow or no convergence) would be to dare to reform. Be it the education system with an aim to increase the quality of human capital, more advanced research and innovation, further liberalizing product and labor markets controls, reform of justice or public administrations systems, or any other thing that is proven to enhance the business environment in the country. And clearly, not everything we do will always get full support from the broad public, especially in the case of structural reforms with long-term gains and short-term costs, but, believe me, boldness is often rewarded beyond our expectations.

Let me end here by saying that exhibits of Schlossmuseum Linz warn us that the course of natural and societal development is indeed a long, winding and hard to follow road, but also allows us to be optimistic about our future prospects. We only need to make sure that the convergence process this time takes somewhat less than 238 years. Thank you!

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Marco Buti

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Keynote Lecture: Deepening EMU – Political Integration and Economic Convergence

Dear colleagues,

First thank you very much, this is a great privilege to be here. I would like to thank the organizers for giving me the opportunity to discuss with you the challenges ahead to reignite economic convergence and political integration. In that respect, I would like to depart from a purely institutional view and provide you with my personal views of where we stand and what remains to be achieved to ensure that the EU is best prepared to withstand a potential next crisis. As a disclaimer, and to paraphrase Alan Greenspan famous dictum, I have to warn you that if I turn out to be particularly controversial or innovative, you have probably misunderstood what I said.

As you all know, it has been eleven years since the first tremors in financial markets that gave rise to the crisis where felt. Lehmann Brothers fell ten years ago. During that period, many institutional reforms have been pursued in the EU. Still, much remains to be done and I would thus like to focus on three key messages:

- First one, in light of the progress made, are we ready to withstand the next crisis, whenever it will come? Here, the answer at this stage is “no”.
- Second, we have so far, at the national and European level, operated under the “ultima ratio” principle, making reforms only when we had our shoulders against the wall. Counting on the ultima ratio for the next crisis would be extremely risky.
- Third, a narrow approach to risk reduction is bound to fail. More specifically, without the right pre-conditions, measures that seek to reduce the risk of bailout would actually increase the risk. More generally, the dichotomy, which has prevailed since 2016 between

“risk sharing” and “risk reduction” will have to be overcome if we are to make decisive progress towards a better functioning EMU.

I will now elaborate on these three key messages.

Progress on EMU architecture made, but not enough

As I mentioned, the institutional reforms that we have made throughout the crisis clearly reinforce the EU. I think that we have put in place a number of mechanisms that allow responding to extreme circumstances. Most prominently, the European Stability Mechanism (ESM) goes a long way in strengthening the institutional architecture of EMU. Also, compared to the pre-crisis period, banks are definitely better capitalized and have stronger balance sheets. In that respect, we have achieved substantial progresses in the establishment of a banking union, a project which was initiated in June 2012, at a time when market pressure was heavy on heads of state and governments. Still, I would say that we are only halfway through. A number of bricks are still missing to complete the architecture and dwindling “political capital” at the EU and at the national level could put further progress at risk.

The banking union rests on three pillars. The first pillar is the Single Supervisory Mechanism, which is now fully operational. The second pillar, the Single Resolution Mechanism, will be completed once the backstop to the Single Resolution Fund (SRF) is established. On the other hand, the third pillar, the European Deposit Insurance Scheme (EDIS), is still ahead of us.

On the backstop of the SRF, we have now a clear commitment at the political level. It is the clearest achievement of the Euro Summit of 29th June

2018. While Leaders have decided that the backstop would be operated by the ESM, the actual implementation now has to address two challenges:

First, the activation of the backstop has to be operational. By its very nature, the related funds need to be made available very quickly, usually over a weekend. This is particularly critical as resolution authorities have to be able to factor the backstop in their decision-making. Putting intricate conditions to its use would risk making the whole instrument unhelpful in case of crisis. The need to ensure parliaments' involvement, which is considered in a number of countries, has to be addressed without compromising effectiveness.

The second point is that having the ESM providing the backstop for the SRF will likely require a change in the ESM Treaty. As this is an intergovernmental agreement, such change will need to be ratified according to national practices in all signatory countries. While there is an agreement, codified in the Euro Summit, that the backstop should be with the ESM, some countries may be tempted to introduce additional elements that are more controversial through their national ratification procedure. Overall, we need to avoid the risk that this derails the adoption process of the SRF backstop. Delivering what the Euro Summit decided in June will thus require political will and tactical prowess.

Regarding EDIS, I see the fact that it was mentioned by Leaders as a positive step. I think it is one of the concrete results of the Meseberg declaration by France and Germany. However, we need to be realistic. Given the divergences of views, concrete steps in that respect are not for tomorrow, probably not even for the day after tomorrow. Still, the fact that there is an agreement means that with the right preconditions,

the political discussion can start in earnest.

Overall, proceeding on the backstop and on EDIS is important because otherwise we risk having here the reverse of the "no taxation without representation" motto. Unless we make progress, we would have "representation", in the sense that there is mutual control over the instruments, but we would not have "taxation" meaning that the right resources to have a complete banking union would be lacking.

In the financial area, we have also to proceed speedily and effectively on capital markets union (CMU). There are at least two important reasons why this is crucial at the current juncture and also in the medium term. The first one is that, in order to boost productivity, we need the type of long-term investments that banks, especially in the current circumstances, are unlikely to finance. The European Fund for Strategic Investments (EFSI) contributes to bridge that gap. Going further, we need to make much stronger use of capital markets and CMU is a key enabling factor in that respect. The second reason for the importance of the CMU is actually more euro area specific and is related to the remaining imbalances in the EMU. Internal imbalances, which have played a critical role in the unfolding of the crisis, have not been fully resolved. They imply excess savings in some parts of the Union that have to be reallocated to other parts. Having a CMU would allow to do so via equity rather than via debt which would reduce the risk of sudden stop and of adjustment. In my view, it would also lessen the political tensions linked to imbalances within the euro area.

A third element that we are still missing is a central fiscal capacity. The opportunity of setting up such an instrument is controversial. Although it

is mentioned in the letter of the Eurogroup's President to Leaders, there is no agreement on this. Personally, I believe that a central fiscal capacity is needed, not for ordinary shocks that stem from cyclical fluctuations but in the case of large shocks. In the event of a large asymmetric shock, whether it is asymmetric per se or has a common origin for Member States but asymmetric implications across countries, even if countries have created the necessary room for maneuver at the country level, a pure national response is not enough to withstand the shock. In such circumstances, having a central fiscal capacity is critical to deal with the consequences of the shock in an effective manner.

In parallel, it is important that countries use the current favorable economic circumstances to improve their resilience. This implies creating budgetary room for maneuver at the national level to ensure that automatic stabilizers can play freely in case of a crisis. It also means proceeding with economic reforms. Since the crisis abated, we have seen a slowdown of reform in the EU. To support countries in their effort, the EU has put forward a reform support programme. This tool, which goes hand-in-hand with the surveillance as part of the European Semester, and notably the implementation of the Macroeconomic Imbalances Procedure, provides positive incentives for reforms. In its proposal for the next Multiannual Financial Framework, the Commission proposes to allocate EUR 25 billion to such incentives, including EUR 2 billion specifically earmarked to support the convergence of non-euro area Member States and EUR 1 billion for technical assistance.

Overcoming the curse of the "ultima ratio"

The second point that I would like to make is that Europe has been operating for too long under the "ultima ratio principle". The fact that we could only agree collectively on reforms with our back against the wall shows that Europe is still lacking a common narrative. We still have not developed a common understanding of what we want the EU to achieve. Incidentally, we also lack a common narrative on the origin and the meaning of the crisis, with important implications for the legacy of the crisis itself. Having a common narrative cannot be devolved to technocrats, whatever their quality. This is not possible and it cannot work.

Borrowing the analogy with technology that was used yesterday by another speaker, I would say that the role of bureaucrats is to help a country move to the "policy frontier". We have the institutions and the savoir-faire necessary to achieve that. However, what we cannot do alone is push the frontier. This takes politicians and political leadership and it cannot be delegated to the technocratic level. Waiting for the next crisis and expecting that reform progress could only be made, once again, under hardship would be wrong for both economic and political reasons:

From an economic point of view, what experience has taught us over the past decade is that deferred action is always costlier. The case of Greece, which has finally emerged out of the financial assistance programme, demonstrates this sufficiently clearly.

Besides this economic reasoning, there is also a compelling political argument. Throughout the crisis, one

could count on the idea that under pressure, governments in the EU made the right choices. Certain specific decisions could have been taken better, faster, but at the end of the day, there was unequivocal political determination in order to safeguard the euro and the integrity of the euro area. Market observers and investors often neglected or downplayed this common will during the crisis and they were wrong. In each case, the political capital needed was put on the table to save the European project. Today, such political capital is depleted, even in a number of core countries. As a consequence, as the debate on the functioning of the Schengen area shows, one cannot take for granted that the same determination and efforts towards a collective solution would be shown. For this reason, we have to try to build a common narrative now to exploit the economically more comfortable times and not wait for the next crisis.

Risk reduction versus risk sharing: a false dichotomy

My third point is that without proper sequencing and the right preconditions, reforms to reduce risk, especially in the banking sector or for sovereigns, may actually lead to more risks rather than less. Indeed, risk reducers and risk sharers in their pure form are their own worst enemies. More specifically, reviewing the regulatory treatment of sovereign exposures or having some form of sovereign debt restructuring mechanism, although they are aimed at avoiding bailout, could very well backfire.

Those who only put the emphasis on risk sharing neglect the fact that the political capital to implement such measures is limited. This capital can only be extended by taking measures to actually reduce risk. This is indeed

what is being done regarding nonperforming loans in the EU. In conjunction with the ongoing economic recovery, recent reforms at the EU and national level are putting nonperforming loans on a downward path in every Member State. Asset quality remains very much deteriorated in a number of countries but progress is recorded in all.

At the same time, I would like to insist that developing risk sharing mechanisms across Member States will actually help reduce risks. As an example, I would like to remind of the Commission proposal for a European Investment Stabilisation Fund (EISF). The proposal is to provide EUR 30 billion in loans, with some concessionary interest rate reduction, for countries affected by a very large shock. Clearly, this instrument belongs to the risk sharing sphere. However, it also has an element of risk reduction in the sense that it reduces the likelihood that the country eventually has to apply for a financial assistance programme. In that respect, the experience from the crisis tells us that being submitted to a programme is difficult but that creditor countries also face politically difficult situations. Having to present a programme for a third country to parliament in a context where pro-European parties are weakened, is never easy. Developing the EISF should thus be considered not only as a risk sharing but also as a risk reducing proposal. The same type of reasoning could be applied to the backstop of the SRF and to EDIS. Both will help develop a pan-European mobility of capital and enhance private risk sharing. This will in turn reduce the pressure for public intervention in case of large losses and the related fiscal risks.

These two examples show that the dichotomy between risk sharing and risk reduction can sometimes be fallacious.

Although this dividing line has become well-established in policy discussions at the EU level, one needs to question it in a more profound way. As I just mentioned, from an economic point of view, a strict distinction is analytically doubtful. Politically, this is even more problematic. Indeed, relying on such a simplistic opposition crystallizes the division between creditors and debtors, between those who care about “responsibility” and those who care about “solidarity”. Eventually, this puts countries in two separate buckets, which threatens the sense of common purpose, which is critical to reach a true compromise. Introducing such a political divide tears the “veil of ignorance” that is necessary to agree on fair reforms.

Overcoming the discrepancy would allow to make progress on further reforms to avoid financial instability. I already mentioned two of them: the fiscal capacity and the completion of the banking union. I also think that we also need to have the courage to put on the table the question of a safe asset for Europe. I know it is controversial, notably because it is usually associated with risk mutualisation. However, a proper design can avoid most of the risks usually highlighted. In addition, if you think about the functioning of modern financial systems, some form of safe asset is needed. I think the scarcity and asymmetric supply of such asset impacts negatively on the availability and the cost of finance for the economy. A genuine European safe asset would be a new financial instrument for the common issuance of debt which would reinforce integration and financial stability and help with the completion of the banking union. In times of market stress, it would also contribute to prevent flight to safety and the types of sudden stops in capital flows that have contributed to the crisis.

While work on this issue is not foreseen for the December summit, this will be a “chantier” that will need to be opened in the medium term.

As a conclusion, I would like to remind of the agenda for reforming the EMU both in the short and in the medium term. The next steps in that respect have been clearly set by the Euro Summit of end-June 2018. They include completing the backstop to the SRF in an operational way and strengthening the ESM. The ESM would then be provided with a new term sheet granting it more involvement in crisis management and design of programmes. In the discussions on the developments of the ESM, we have to find the right articulation of the surveillance competence of the European Commission in order not to create confusion and increase intransparency. Along the way, we have to strive to build a common narrative to reinvigorate the sense of a European purpose. This would pave the way for restoring politically the genuine culture of compromise that we seem to have lost over the last few years. In recent negotiations at the EU level, the various actors have nominally found a form of compromise only to go back to their constituency and preach their own position instead of acknowledging the progress and the need to find a stable equilibrium between the various Member States. Only through genuine compromise did we achieve significant progress in the European construction and only through returning to a culture of compromise can we hope to achieve more.

We then have to start discussing the proposals that need to be delivered after the December deadline. This includes notably the EDIS and the fiscal stabilisation. On the latter, the Meseberg declaration by France and Germany is a

useful point for reference. However, the declaration actually contains two proposals for fiscal stabilisation: a French one, which foresees varying contributions to the budget according to the phase of the cycle; and a more German one, which is essentially a reinsurance system for unemployment systems at the national level. I believe that the Commission proposal for a EISF, which is currently on the table for discussion at the Council and at the Parliament, has the potential to actually bridge the gap between the two positions.

Finally, in the medium term, there is scope to explore the potential additional instruments such as a European safe asset. We should also try to assess whether the kind of fiscal rules that we have are indeed the most effective one. I think there is room here to simplify, to make the system overall more transparent, less complex. But at the same time, as I mentioned such reforms should not be thought about in isolation but fully integrated in the broader picture which I tried to outline.



45th ECONOMICS CONFERENCE 2018



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Panel 4

Financial Convergence, Resilience and
Supervision



Introductory Statement: Financial Convergence, Resilience and Supervision

In the aftermath of the financial crisis, a huge amount of new regulation has been introduced. Some call it an “on-slaught”. The goal was to make the financial system more resilient. So after a decade of bank regulation banks are definitely safer and better run as a result.

Both regulators and supervisors and also our industry believe that consequences had to be taken and lessons learned. But we also know that contradictory regulations were passed. Some regulations are working in opposing directions. The industry is struggling with overlapping requirements and national gold plating potentially jeopardizing the level playing field.

Nevertheless, the strengthening of the banking sector can be seen in much higher capital ratios (e.g. common equity tier 1 – CET1), and the large reduction of nonperforming loans (NPLs) is giving proof that the industry has become increasingly resilient.

The panelists, who are representing banks with very different business models, presented in the discussion how their banks managed this challenging environment. Those panelists were:

- Florian Hagenauer, Member of the Management Board of a successful regional bank, Oberbank.
- Hannes Mösenbacher, Chief Risk Officer of Raiffeisen Bank International (RBI), one of the most important banking groups in Central and Eastern Europe.
- Marco Valli, Head of Macro Research and Chief Euro Economist of one of the big European players, UniCredit Group.

The following aspects concerning volatility of markets, fluctuating exchange rates and current global geopolitical developments were discussed: Is the (current) regulation an appropriate tool

to keep the system healthy? What about the risks that are outside the scope of Basel such as political risks? Furthermore, the panelists elaborated the Commission’s proposals for a capital markets union, crowdfunding, sustainable investments, a European deposit insurance scheme (EDIS), the future of the Eurosystem and how financial players can stay resilient within this future framework.

Other foci of discussion were current and future challenges like digitalization (blockchain, fintechs), cybersecurity and cyber risks (the Allianz Risk Barometer 2018 ranks cybercrime second in the top 10 business risks); new competitors and level playing field aspects; the fine line of over-regulation and watering down regulations; whether economic growth and competitiveness are contradictory to regulation; future business models; sustainable finance, financial education and Brexit. Finally, the panelists gave brief core messages to European legislators and supervisors.

Marco Valli (Chief Euro Economist of Unicredit Group) pointed out that overall, the measures implemented so far to strengthen banks’ balance sheets and liquidity positions should provide a good buffer in the event of a shock hitting the economy and financial markets. However, new regulation raises issues when it comes to creating or preserving a level playing field.

Cross-border banking groups in the EU should be preserved and supported, mainly for two reasons. First Marco Valli thinks banks with geographical diversification are generally safer as their assets tend to be more diversified. Hence, cross-country diversification, at least in the EU, should be encouraged. Second, the euro area lacks shock absorbers and the majority of adverse

shocks go unsmoothed due to poor risk-sharing mechanisms.

The impression is that European regulators are discouraging cross-border banking by allowing for national ring fencing of liquidity and loss absorbing capacity while penalizing the prudential treatment of intra-group cross-border exposure. The ultimate aim should be that the banking union is as a single jurisdiction from a prudential perspective. Although it is clear that this would take time, it is important to acknowledge that actions such as ring fencing of liquidity and capital, which might be regarded as optimal from a national perspective, are self-defeating at the aggregate level.

The establishment of a comprehensive EU strategy to address the problem of troubled loans can be fully supported. However, calendar provisioning might not create the right incentives for a proactive approach to managing NPLs. Instead, policymakers should focus on harmonizing the insolvency and pre-insolvency framework at the European level. Shortening the length of judicial procedures would provide secured creditors with more certainty on the recovery of collateral. By facilitating early restructuring or giving a second chance to entrepreneurs, employment and growth would be improved.

Florian Hagenauer (Member of the Management Board of Oberbank) gave a brief statement regarding key success factors for banks during the crisis from the perspective of Oberbank as a regional European player. The first key success factor is a clear and focused strategy as well as a resilient business model, which is consequently pursued. Furthermore, regulatory requirements need to be monitored and anticipated.

Secondly, strategy has to be customer-oriented. The third key success factor is organic growth. The customer base and

business area especially in corporate and SME businesses in Austria, Germany, Czech Republic, Slovakia and Hungary need to be expanded.

Fourthly, a conservative approach to risk and a continuous improvement of the risk management framework and risk management tools are of utmost importance. The fifth factor is investment in people. Excellence in sales and development of a professional management team are equally important. Recruiting, training and preparing the next generation to take charge within a successful organization are big challenges.

The sixth precondition for success from an Oberbank perspective is an efficient operating model based on a strongly centralized back office and a centralized IT even across borders. The last success factor is not to chase after every trend emerging. To sum up, a sound business model and strategy are inevitably for successful banks during times of crisis.

Hannes Mösenbacher (Chief Risk Officer of RBI) emphasized first that RBI is the prototype of a European integrator as the group has been active in 14 Central and Eastern European countries for over 30 years. Today, RBI is making profit in all markets. But not only the bank has benefited, also the countries, companies and people themselves as RBI is a prudent investor with a long-term perspective and thus contributing to the resilience of the markets.

Talking about banking regulation, Hannes Mösenbacher stated that RBI as a bank is traditionally a regulated entity and used to “digest” new requirements. In addition, he highlights the constructive dialogue with the supervisory authorities. However, the complexity of the supervisory architecture is a challenge: RBI group is governed by around forty national and European regulatory and supervisory authorities, some of

them belonging to the Single Supervisory Mechanism, some of them to the European Union, others to third countries. These authorities tend to have different views on the same topic. Therefore, for cross-border banking groups, he stressed that a single set of rules is the only way of how to implement the increasing regulatory pressure. Furthermore, it ensures a level playing field for both, only locally active banks and cross-border banks. Close alignment amongst authorities, e.g. the avoidance of double reporting, would also be key for banks to implement new requirements efficiently.

As regards competition with non-banks, Hannes Mösenbacher stressed the importance of a level playing field regarding regulatory requirements since

traditional banks are becoming more and more like software companies. Finally, at European and national level, “gold plating” of global regulatory standards needs to be avoided to prevent competitive disadvantages for European banks.



Marco Valli

Head of Macro Research, Chief Eurozone Economist
UniCredit Bank AG



The Importance of a Level Playing Field

The crisis has shown how important bank resilience is in preserving credit flows, broader financial stability and, ultimately, aggregate welfare during downturns. The euro area banking sector and its regulators have devoted considerable effort to increasing the system's resilience to shocks. The CET1 ratio of significant institutions doubled from 7% in 2008 to more than 14% by the end of last year, and the NPL ratio has declined significantly. Stress test practices have allowed for a forward-looking assessment of banks' potential capital needs during a severe recession, while the introduction of liquidity ratios has increased the resilience of banks to sudden shocks to liquidity and funding.

Overall, the measures implemented so far to strengthen banks' balance sheets and liquidity positions should provide a good buffer in the event of a shock hitting the economy and financial markets. However, new regulation raises issues when it comes to creating or preserving a level playing field.

When regulation does not favor a level playing field: the case of cross-border banking and calendar provisioning

Banks in Europe play a fundamental role in financing growth. UniCredit – as the second largest corporate lender in Europe – is a key contributor, serving 600,000 SMEs and corporate clients. However, for banks to continue to play their core role of financing the real economy, they need a supportive and clear regulatory environment that gives them sufficient predictability to plan ahead. So far, this has often not been the case.

There are important areas where regulation can be improved with the ultimate goal of creating a level playing field. Two of these areas are firstly the

treatment of cross-border banking and secondly calendar provisioning.

1. Cross-border banking groups in the EU should be preserved and supported, mainly for two reasons. First, banks with geographical diversification are generally safer than local banks, as their assets tend to be more diversified. Hence, cross-country diversification, at least in the EU, should be encouraged. Second, the euro area lacks shock absorbers and the majority of adverse shocks go unsmoothed due to poor risk-sharing mechanisms. In the U.S.A., where shock absorption is much greater than in the euro area, most of the absorption stems from more effective private risk sharing through credit and capital markets, whereas fiscal transfers between states play a smaller role. If the U.S. example were to be followed, improving the scope to counter asymmetric shocks in the euro area would not require a transfer union, but rather well-functioning credit and capital markets in which cross-border banks are important players.

In theory, the introduction of the banking union and the Single Supervisory Mechanism, alongside the fundamental improvements in financial stability through CRR/CRD IV and the European recovery and resolution framework, should contribute to breaking down the barriers to intragroup cross-border capital and liquidity flows. In reality, though, significant obstacles remain.

The impression is that European regulators are discouraging cross-border banking by allowing for national ring-fencing of liquidity and loss absorbing capacity while penalizing the prudential treatment of intra-group cross-border exposure. Cross-border banks should be allowed to move capital and liquidity

freely within their group. Such free flow is crucial because it allows financial institutions to extend credit where it is most needed, thereby ensuring continued funding of the real economy throughout cyclical downturns and thus contributing to the smooth functioning of the transmission mechanism of the ECB's monetary policy. This is currently not happening to a sufficient extent, partly because of the large scope for discretionary measures at the national level, for example when it comes to intragroup exemptions in the risk and leverage frameworks.

The ultimate aim should be to have the banking union considered a single jurisdiction from a prudential perspective. Although it is clear that this would take time, it is important to acknowledge that actions such as the ringfencing of liquidity and capital, which might be regarded as optimal from a national perspective, are self-defeating at the aggregate level.

2. UniCredit has been taking proactive action in tackling the non-performing loans (NPL) issue and fully supports the establishment of a comprehensive EU strategy to address the problem of troubled loans. However, calendar provisioning of NPLs might be overly punitive where the local legal-judicial environment is comparatively less favorable. This could lead to a restriction of bank lending in those countries where structural issues already undermine the competitiveness of the system. In turn, this would imply higher fragmentation. In general, calendar provisioning might not create the right incentives for a proactive approach to managing NPLs. Since the credit recovery time is determined predominantly by the effectiveness of the legal-judicial environment, these measures might provide an incentive for banks to liquidate loans rather

than offering restructuring alternatives to debtors that are in temporary difficulty in order to release the collateral and minimize short-term costs.

Instead, policymakers should focus on harmonizing the insolvency and pre-insolvency framework at the European level. Shortening the length of judicial procedures would provide secured creditors with more certainty on the recovery of collateral. By facilitating early restructuring or giving a second chance to entrepreneurs, employment and growth would be improved.

Capital market union should prioritize equity financing for small and medium-sized enterprises (SMEs)

European SMEs receive about 75% of their funding from banks and the rest from the capital markets, whereas the situation is roughly the opposite in the United States. Therefore, I fully support the capital market union (CMU) initiative as a way to reduce the over-reliance of companies, and especially SMEs, on banks for their financing needs. In Europe, SMEs are undercapitalized and the lack of equity capital relative to other jurisdictions has a number of important drawbacks in terms of innovation, investment and potential growth. Better-capitalized firms would, in turn, ensure that banks could lend more confidently.

This is where the CMU should come more forcefully into play. However, there does not seem to be sufficient emphasis on the need for institutional investors to play a greater role in providing equity financing to SMEs. Currently, insurance companies and pension funds are severely constrained by both EU and national rules that limit their ability to invest in SMEs. For example, direct equity investment represents only around 6% of the total

investment portfolio of insurance companies and this share has decreased over the past ten years.

One of the key underlying factors of this significant reduction in equity holdings has been the conservative capital requirements of Solvency II, including

the punitive treatment of private equity investments, which does not properly reflect the non-volatile nature of unlisted SME investment. If regulators want to channel Europe's large savings pot more effectively into the real economy, this needs to be tackled urgently.

Panel 5

Convergence of Production, Investment and
the Reduction of Imbalances



Introductory Remarks: Convergence of Production, Investment and the Reduction of Imbalances

Today's topic of our session "Convergence of Production, Investment and the Reduction of Imbalances" made me remember the public discourse about the Economic and Monetary Union in the early 1990s. At this time, the Maastricht Treaty was signed and I was still a student of economics. Back then, the academic debate was about whether the European Union was ready for adopting a single currency or not. The „old“ approach to the optimum currency area theory was set against „new approaches“. The first one was very much about what to do if there was a disparity in real economic indicators. Alternative means – other than the exchange rate instruments – of adapting to disparities were needed, i.e. mobility of factors, wage flexibility or fiscal transfers. This was seen as the precondition for introducing a single currency. The new approaches suggested that even though economic indicators diverged one could introduce the single currency and thereafter over time convergence could be observed, i.e. business cycles would be more synchronized (Kronberger, 2010). When I first heard about today's topic it occurred to me that not a lot has changed since then. Which of course is not right. Now we know more about the empirics, be it the development of real economic variables or be it the institutional development of the Economic and Monetary Union.

Having a look at the empirics concerning some specific economic variables the following can be said: Franks et al.

(2018) find a mixed picture regarding the convergence of GDP per capita. Before 1992 (starting with observations in 1960) 12 euro area countries with lower GDP grew faster than their richer counterparts which already had a higher level of GDP (catching up). The authors call this type of convergence beta convergence according to Sala-i-Martin (1996). After the signing of the Maastricht Treaty the convergence of the GDP slowed and came subsequently to a halt. Countries joining the euro area starting from 2007 showed continued convergence. Comparing the 19 euro area countries to the 28 EU Member States, the convergence of the first has been significantly higher in the period from 1993 to 2015.¹

The authors also compute the so-called sigma convergence. It gives information whether the dispersion of GDP per capita decreases over time. For the observed countries it shows a similar behavior as does the beta convergence. Of the 12 euro area countries, in particular Greece, Italy, Portugal and Spain showed divergence with regard to per capita income between 1999 and 2014 (ECB, 2015). Although these four countries obtained sizeable capital inflows they consisted mainly of debt instruments and banking flows and much less of foreign direct investment. Therefore, capital inflows did not trigger real convergence as predicted by theory. Reasons can be found in the quality of institutions and governance, structural rigidities even contributing to the reversal

¹ ECB (2015) shows similar results regarding the two indicators of convergence.

of convergence and a demand driven credit boom. Productivity growth in Greece, Spain and Portugal lagged behind the average of the euro area. Low productivity in the non-tradable and even in the tradable sector were in the end caused by weaknesses in the business environment resulting in a lack of innovation.

The institutional development of the European Union regarding convergence showed some important steps forward in the period after the economic crisis. Many acts regarding financial regulations have been stipulated in the last couple of years, be it Basel III or be it the (not yet complete) European banking union to just mention the most well-known examples. In 2014 the Investment Plan for Europe, the so-called Juncker Plan, has been launched. Much progress has also been seen in the area of fiscal rules. They have been enhanced and put more effective, for instance, by the so called six pack and the two pack. An interesting by-product of the six pack are the two procedures on Macroeconomic Imbalances (MIP) since they point basically to other economic indicators than the ones related to public finances. They were born out of the conclusion, that fiscal imbalances were tied to imbalances in other economic sectors. So far, this conclusion is straight forward and rather undisputable. It is also undisputable that these two Macroeconomic Imbalances Procedures have not received much public attention and they are kept on rather a “low level” in the policy arena. Until now only in-depth reviews have been applied.² “The

EIP (Excessive Imbalances Procedure) has so far never been launched, the reason being that the identification of excessive imbalances was followed by strengthened policy commitments in National Reform Programs followed up by implementation.” (European Commission, 2016a, 54). Nonetheless, Bricogne and Turrini (2017) find that “MIP-related recommendations have a higher chance of being followed up by implementation.”³ Despite no sanctions were triggered by the MIP the implementation of the respective regulation was a success.

Strength and weakness of the MIP is the room for maneuver with regard to the interpretation of the existence of macroeconomic imbalances. The Commission and the Council are not bound to trigger the procedure when thresholds of relevant economic variables are passed (Kronberger, 2017, 520). Since there is not one agreed definition of a harming macroeconomic imbalance among economists and furthermore a big number of relevant economic models yield to different results it can make sense not to stick “stubbornly” to defined quantitative thresholds. A weakness of the MIP could be that the recommendation of policy measures is based on interpretation: Is the interpretation of the harming macroeconomic imbalance correct? Is the recommended policy measure adequate, in the sense that it helps to improve the imbalance?⁴ For instance, the current account balance is used as a relevant indicator for the MIP scoreboard regarding external competitiveness. Using this aggregate

measure, however, does not distinguish between the current account balance vis-à-vis the euro area, the European Union and the rest of the world. This makes a lot of a difference for the interpretation of passing thresholds. In the case of Germany, its current account surplus is also fed significantly by economic exchange with the rest of the world (European Commission, 2016b). As such it cannot be concluded that a harmful imbalance within the European Union or the euro area exists, although a critical threshold of the aggregate indicator of the current account is eventually passed.⁵

In this session Marco Buti, Director General for Economic and Financial Affairs at the European Commission, who holds this post since 2008, will give some insights on the development

of macroeconomic indicators and therefore derived conclusions and policy measures.

Wilhelm Molterer, former Vice Chancellor and Minister of Finance in Austria, who is Managing Director of the European Fund for Strategic Investments (EFSI) since 2015, gives an introduction to the EFSI and explains its importance for activating investment within the European Union, thereby helping to increase productivity.

Robert Ottel looks back to a long-standing career within voestalpine. Since 2005 he is member of the board of voestalpine AG as Chief Financial Officer (CFO). He will give us a picture of what drives a multinational steel company when deciding on important investments and what motives are at present when choosing the investment location.

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² For the year 2018 12 in-depth reviews have been carried out: Bulgaria, Croatia, Cyprus, France, Germany, Ireland, Italy, the Netherlands, Portugal, Slovenia, Spain and Sweden (European Commission, 2018).

³ They compare the progress of countries applying country-specific recommendations who follow the MIP with countries not following MIP.

⁴ For a critical discussion on MIP see for instance Tamborini, (2018). One of his conclusions is that the MIP would be an imperfect replacement for fully federalized fiscal institutions.

⁵ The European Commission is conscious of this fact (European Commission, 2016b) nonetheless it would make sense to adjust the indicator to what is needed to interpret harmful macroeconomic imbalances within the European Union or the euro area.

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Wilhelm Molterer

Managing Director

European Fund for Strategic Investments (EFSI)



EFSI as a Driver towards Convergence

Economic, social and territorial cohesion and convergence are key pillars for the European model. Since the codification of these principles in the Treaty of Rome, they have been drivers and crucial preconditions for a sound economic development, a positive perception of European integration and the political stability of the European Union.

A positive economic perspective and an efficient cohesion policy are no contradiction, but rather go hand in hand. A study by the World Bank entitled “Golden Growth: Restoring the Lustre of the European Model” shows how economic growth and convergence have been inseparable over the last 50 years. It concludes: “Adjustments are needed to restart the European convergence machine in order to improve competitiveness and raise living standards”.

The European Investment Bank (EIB) was founded in 1958 exactly for the purpose of economic and social cohesion. As the bank of the EU, the EIB is tasked to support EU policy priorities: competitiveness, cohesion, and climate protection. It does so by providing finance to eligible projects, including small and medium-sized enterprises (SMEs) as well as midcap companies, infrastructure, innovation and environmental protection.

2014, at the beginning of the current multiannual financial framework (MFF 2014–2020), Europe and its economy were in a difficult situation. As a result of the financial and economic crises growth was severely hit and the perspective for renewed growth was bleak, unemployment was rising, and overall investment was decreasing by –15% compared to pre-crises level, even more in many individual regions. Europe lost competitiveness compared to its main international counterparts. As a matter of fact the positive trend to

close cohesion gaps within the Union stalled, and the gaps started to widen again.

Jean-Claude Juncker therefore launched the “Investment Plan for Europe” to tackle the key challenges: to close the investment and competitiveness gap, to fight the credit crunch via increased risk taking, to attract private capital to finance infrastructure as public resources are limited and to remove investment barriers via structural reforms. The “Investment Plan for Europe” is based on three pillars:

- to create an investment friendly environment via structural reforms and to improve the regulatory conditions for investment;
- to advise on investment opportunities via the European Investment Advisory Hub (EIAH) and the European Investment Project Portal (EIPP);
- to mobilize investments via increased financing provided by the EIB Group, with the guarantee support of the European Fund for Strategic Investments (EFSI).

EFSI is not a separate legal entity providing finance. It is a guarantee facility supported by the EU Budget (EUR 26 billion) and augmented by a contribution from the EIB’s own capital reserves (EUR 7.5 billion). Together, these contributions have enabled the EIB Group to expand rapidly the scale and scope of its financial support for eligible, worthy and economically sustainable investments throughout the entire EU; developing new financial products and intensifying the cooperation with national partners to provide financing for risky projects that could not have been supported before.

Given its impact, EFSI was recently extended until the end of 2020, combined with an increase of the investment target from EUR 315 billion to EUR 500 billion as key challenges remain.

Chart 1

Despite the much improved economic perspective the EU continues to face significant competitiveness and productivity gaps, which have grown in recent years as Europe has been looking inwards. There is comparatively low EU spending on research and development and a huge digital gap which interrelates with low innovation capacity. The risk-taking capacity of commercial banks remains constrained based on stricter regulatory requirements and the frequent need to repair balance sheets and build up capital buffers. Public and budgetary resources remain limited and the capital market in Europe is still underdeveloped which limits alternative sources of long-term financing for willing investors. Nevertheless, competitiveness, cohesion and climate protection need further investments on a significant scale.

There are still clear and persisting investment gaps in Europe. The figures may vary by source but the amount of investment needed to secure Europe's future remains enormous. The EIB's latest figures indicate annual invest-

ment gaps of approximately EUR 160 billion for innovation, EUR 155 billion for energy and energy efficiency (already before the recent increase of EU 2030 targets) and EUR 88 billion for sustainable infrastructure. Overall, this points to an investment gap of more than EUR 400 billion every year till 2030. Investment that would be needed in order to achieve EU policy priorities, prepare for long-term demographical trends and respond to new challenges such as migration.

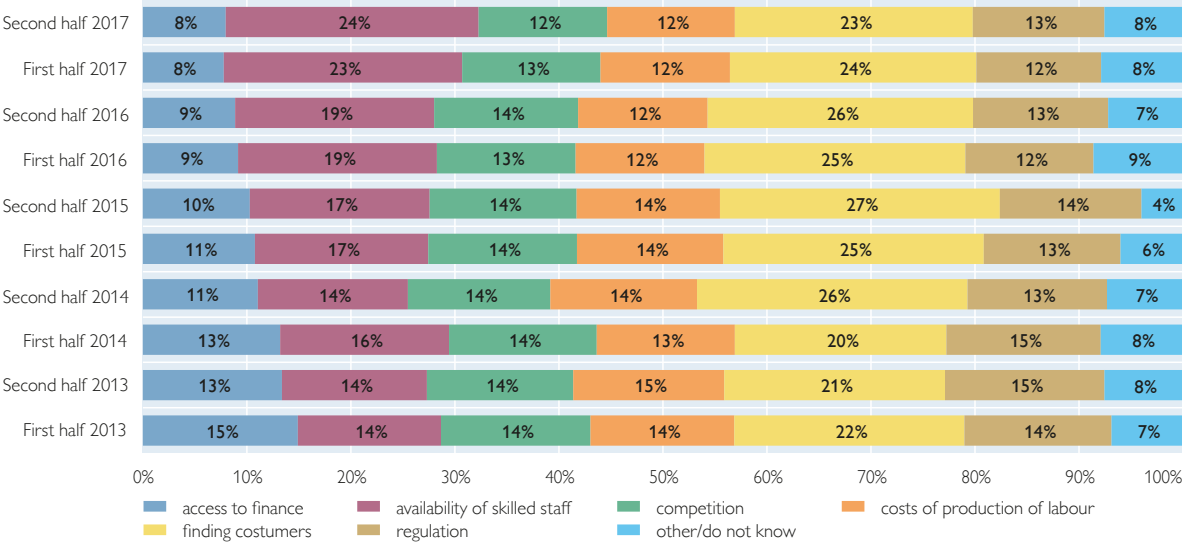
Specifically for SMEs access to finance remains both critical and often sub-optimal, as financial markets still are very fragmented and financing is largely limited to banks. While there has been a welcome improvement of financing conditions of SMEs in many of the larger Member States, many small firms still find it difficult to obtain sufficient finance to prosper and grow. This is especially the case if they are young, innovative, and therefore risky, or if they are based in less developed or cohesion regions.

Specific needs are evident: venture capital, midcap and growth companies, innovative firms and riskier investments in Research & Development as well as equity or quasi equity finance would be needed. Another aspect that has come to the forefront of SMEs' concerns is the availability of skilled staff, which is currently the most important problem cited in ECB SAFE survey. To grow the potential of Europe and its businesses, investment into education has become at least as crucial as direct SME financing.

The Investment Plan for Europe has lived up to its name. Amongst its three pillars EFSI, implemented by the EIB Group, has exceeded its ambitious initial targets and is a story of success:

- EUR 334.8 billion of investment were already incentivized by July 2018.

The most important problems faced by euro area SMEs



Source: ECB Survey on Access to Finance for Enterprises (SAFE).

The EIB Group remains on track to achieve the target of EUR 500 billion by end of 2020.

- EFSI is a market driven instrument without sectoral or geographical quotas. It is encouraging to see that EFSI financing has reached important target areas for growth and the growth potential of the EU: 31% for SMEs, 21% for Research, Development and Innovation (RDI), 21% for energy infrastructure, 19% for digital and transport infrastructure.
- EFSI financing provided by the EIB Group has reached all 28 Member States, proving that it is possible to structure projects that are both worthy and economically sound “bankable” throughout the Union.

There was some criticism of the geographical distribution of EFSI funding on a nominal basis early on, which was both premature and shallow. For a market-driven instrument, the sheer size of the underlying economies is naturally liable to influence the nominal size of intervention, and the speed at which new and unfamiliar instruments are

accepted by project sponsors varies with the specificities of each market. However, after three years of experience and adjusting for the size of the respective economies, it is encouraging that the top 10 countries, which benefited most from investments supported by EFSI relative to their GDP are headed by Greece, Estonia, Lithuania, Bulgaria and Finland, followed by Poland, Spain, Portugal, Latvia and Italy.

The current investment mobilized of EUR 334.8 billion has been achieved with EUR 65.5 billion of financing approved by the EIB Group based on EFSI guarantee. Close to EUR 270 billion of financing will be co-financed by other sources: private and public project promoters, national promotional banks and institutions, partner banks across the EU and many other co-investors – around two-thirds from the private sector.

The EFSI works and is already having a macroeconomic impact. Short-term effects and long-term structural impacts are evidenced by the EC's RHOMOLO model, which has been

Table 1

| Investment gaps remain significant Annual investment gaps through 2030 | | |
|---|-----------------------------|---------|
| | Investment Gap | Range |
| | billion EUR per year, EU-27 | |
| Innovation | 160 | 150–170 |
| R&D | 110 | |
| Broadband and Digitalisation | 50 | |
| Energy ¹ | 155 | 145–165 |
| Generation and grids | 17 | |
| Energy efficiency | 138 | |
| Sustainable infrastructure | 88 | 85-90 |
| Water supply, sanitation, solid waste | 7 | |
| Social and affordable housing | 6 | |
| Education | 8 | |
| Health | 17 | |
| Mobility | 50 | |
| Total | 403 | 380–425 |
| Total in % of the EU-27 GDP (2018) | 3 | |

Quelle: EIB.
¹ Before the increase of the EU 2030 targets agreed in June 2018.

adapted by the EIB to model the results of EFSI. The current stock of EIB financing with EFSI support is already expected to have a positive effect of 1.3% on EU GDP and to create 1.4 million jobs by 2020. This immediate investment effect will gradually give way to a long-term structural impact, which is estimated at 0.9% of GDP and 780,000 jobs by 2037.

The macroeconomic analysis shows another qualitative effect that had been overlooked by the initial criticism focused on nominal financing volumes. The economies of less developed and cohesion regions are typically more labor intensive than those in the most developed Member States. Relative to their nominal amount, investments in these regions have on average a higher imme-

diated impact on jobs, a higher relative impact on the capital stock employed and therefore potential productivity gains, and are expected to lead to a longer lasting structural impact on growth and employment.

The impact on cohesion regions as well as those hardest hit by the economic and financial crisis is therefore expected to be over proportional to the nominal absorption of EFSI financing. Based on these positive results financial instruments will play a bigger role in the next MFF (2021–2027). On the one hand this is to increase the economic impact of budget sources (to do more with less), on the other hand this innovative concept is used to support cohesion and convergence in a more efficient way.



Robert Ottel

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voestalpine AG



Convergence of Production, Investment and the Reduction of Imbalances

Despite all efforts to continuously remove borders, there are still some between the Member States of the EU. From a generalist point of view, further promoting cohesion and getting single economies to converge towards their best performing peers could unleash great economic potential. In this respect, special attention should be paid to the convergence of Central, Eastern and Southeastern European countries not only because they are close to Austria but also because there is still great potential to be reaped for the economic area. In the end, it is the political integration of the Member States which will lead to sustainable economic cohesion. However, there are recently contrary political developments like the Brexit which show that some Member States are refocusing more on national interests than on common targets of the community. This political divergence will inevitably induce an economic drifting apart between Member States, which will directly lead to further economic imbalances.

Why is political integration a crucial factor for investment decisions that industrial companies, like voestalpine, have to take? Why is the opinion of industrial companies about political integration important?

The influence of industrial companies on the economic performance of countries is substantial. The direct and indirect effects of a company's output amount to two to three times higher figures than their actual standalone output. This is the case because the production of these industrial companies simultaneously induces production at suppliers, services and consumption. In addition, investment leads to innovation which is in turn an important driver of productivity. Therefore, it can be stated that investment itself raises

the country's attractiveness for further investment. This in turn enhances the divergent development of the economic performance of countries and regions, since investment and engagement in R&D represent long-term drivers of economic development and sustainable growth.

From an industrial company's point of view, differences between European countries are decisive for choosing a future location. Therefore, Member States defining their economic and political framework conditions are seen to be in competition to each other trying to attract a company's investment. It is not the competitive situation at the moment, which counts for the companies willing to invest. Far more important are the expected future circumstances which need to be considered before investing. The CESEE region for example outperformed other locations by offering labor in the manufacturing sector at comparatively low cost in the past. This was one of the major drivers why industrial companies started to invest in local productions. However, in respect to labor cost the CESEE region is not only competing within Europe but with all world regions. Since convergence between countries is increasing in the long-term the advantages gained by differing wage levels might disappear someday. How long will it take until a high level of convergence in labor cost is finally reached and the advantages disappear?

For an industrial company there are different aspects which are crucial for taking decisions concerning the location of operation or investment. The cost of labor is not the single decision criteria anymore. Investment is bound to a location, has to pay back and can only be evaluated in the long term, which means in a time horizon of about 10-20 years. For this reason long-term decision criteria are weighting most heavily.

The tax environment, financing conditions or the situation concerning subsidies in a country are surely considerable factors for choosing the right location for an investment. Nevertheless, these are economic factors which can easily change for political reasons in the medium or even in the short term. This implicates a certain planning risk for an investment. Such topics will for sure affect the calculation of the investment and, therefore, make it more or less profitable. Finally, they will not be of crucial importance for the investment decision because a change of the current tax, financing or subsidy situation can never be completely excluded.

So, what are the crucial long-term criteria for an investment decision of an industrial company? As stated before it cannot be labor cost or the tax or subsidy situation solely, this would make investing in a country like Austria not favorable. Recent decisions are showing that this is not the case.

First of all, demographics and the educational situation in a country are two of the main aspects when it comes to evaluating the potential of a region. The demographic situation is directly connected to potential demand growth in a country. The presence of sufficient skilled labor is the foremost important production factor; even more in times of value chains getting more complex and interconnected. These parameters are directly affecting the operations and, therefore, the performance of the investment. Moreover, subjects like education have to be assessed in an absolute long-term perspective because implementing desired changes in this context takes an enormous amount of time.

Secondly, companies that are willing to invest are looking for politically stable

surroundings. In this respect, it is not exactly the stability of the government itself that is decisive. An authoritarian leader can create a stable situation within the government, but this is no substantial evidence for the quality of the political decisions that are taken. It is noticeable that the quality of the governments is widely differing between EU Member States. Issues like corruption, a lack of transparency, erratic legal or official restrictions or, more generally, an insecure business environment makes investment unattractive. This is the case because countries having such administrative problems are in need of structural long-term reforms. Moreover, the local government needs to be able to put those reforms into practice and change the business culture and ethics of a country. One can also question whether an authoritarian style of leadership could induce a worsening of transparency and, thus, of business environment. In my opinion, the quality of the government and its general attitude towards the EU are the most important, long-term criteria for an investment decision.

To sum it up, investment by industrial companies is vital to the economic development within the EU. The relevant decision criteria are those which are unlikely to change in the long-term, like administrative structures, governmental quality or the educational system. From the industry's side, countries which engage in installing such stable business surroundings are making a diligent calculation of future investment possible and should be rewarded. Therefore, the crucial, final question is: Which means or measures does the European Union have to support Member States in promoting stable and qualitatively valuable governments?



Session

Banking and Capital Markets Union –
Financial Regulation and SME Financing



Keynote Lecture 1: Financing the Economy – SMEs, Banks and Capital Markets

We banking supervisors like to stress that banks have one core task: financing the real economy. This, however, begs the question: who or what is the “real economy”?

When speaking of the real economy, many people think of large companies – and there are indeed giants out there. Of the 100 largest economic entities in the world, fewer than half are countries; the rest are private companies.

Companies such as General Motors, Apple and BP are huge. They earn vast revenues and are always in the public eye. But, at the same time, they divert attention from something else. And it is this “something else” I will discuss in my speech today.

SMEs and the economy

Let’s start by looking at some numbers. The EU is home to around 45,000 large companies, companies that have more than 250 employees. But it is also home to almost 24 million smaller companies that have fewer than 250 employees. These are the small and medium-sized enterprises, SMEs for short.

99.8% of all companies in the EU are SMEs. They employ 93 million people, accounting for two-thirds of total employment. And they generate almost 60% of value added. And what is true for the EU is true for Austria. The proportions are almost exactly the same.¹

So, when we talk about the real economy, when we talk about jobs and growth, we are in fact talking about SMEs. As the numbers show, it is these

companies that make up the real “real economy”.

If SMEs do not do well, the economy does not do well. And in the aftermath of the crisis, we have seen that SMEs are more vulnerable to changes in the business environment than larger firms. At the same time, they are more reliant on supportive policies. SMEs have comparatively fewer resources to invest in training, for instance. In order to recruit staff with the appropriate skill sets, they therefore depend more heavily on public investment in education. Recent survey results have indeed shown that the main concern for SMEs right now is the availability of skilled labor.²

So, SMEs make up the real economy, and, what’s more, they also have the potential to drive it. Economic growth is driven first and foremost by productivity and innovation. And SMEs could play a major role here. On average, we see that larger firms are still more productive and innovative than SMEs. But there are exceptions. The OECD found, for instance, that here in Austria, SMEs have been more productive than large firms ever since the financial crisis.³

And many SMEs have become leaders in niche sectors. For example, SMEs owned 20% of biotechnology patents in Europe in 2014.⁴ Specialization is important for SMEs as is the ability to create networks to maximize their potential.

But to be productive and innovative, SMEs first need access to finance. Their survival and success depends on it. So let’s take a closer look at this specific aspect of running an SME.

¹ EU Commission, *List of country SME key figures 2017*, https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_de.

² ECB. 2018. *Survey on the access to finance of enterprises (SAFE)*. October 2017–March 2018.

³ OECD. 2017. *Small, Medium, Strong. Trends in SME Performance and Business Conditions*.

⁴ Eurostat. 2014.

SMEs and banks – a challenging relationship

As a general rule, SMEs are limited in their choice of funding sources. Capital markets, for instance, are often closed to them: low volumes and high fixed costs keep them from issuing bonds or stocks.

Thus, SMEs mostly rely on banks to finance themselves. But when dealing with banks, SMEs face a structural disadvantage compared with larger companies. For banks, SMEs are usually opaque as they do not publish detailed financial statements and, in many cases, lack long credit histories.

As banks find it harder to assess the risk on a loan to an SME, the classic problems of asymmetric information arise and translate into higher premiums for the SMEs.

But there is another angle to this problem. Being more opaque than larger firms makes SMEs “dependent borrowers”. Once they have established a relationship with a bank, it becomes very costly for them to switch. Potential new lenders would peg them as riskier than they actually are, regardless of their true financial situation. So SMEs not only depend on banks in general to obtain finance, but they often depend on specific banks.

This gives banks additional power over SMEs. In the language of economics, they are in a position to extract rents at the expense of SMEs.

So, even in normal times SMEs are at a disadvantage when sourcing funding from banks. In times of crisis, this is exacerbated: funding costs for SMEs tend to rise more steeply than those for

larger firms. This happened during the recent financial crisis too.

But why exactly do SMEs suffer more than large firms in a financial crisis? Well, as I said, banks have some power over SMEs, and this might play a role.

There is indeed some evidence for this. A recent study of the euro area confirms that, during the crisis, banks raised interest rates for SMEs by more than they did for larger firms.⁵ Having fewer non-bank funding options, SMEs are likely to be more exposed to pricing externalities related to banking market structures and impairments. Untangling this unequal treatment, the study finds a number of factors that play a role.

First: market power. The greater a bank’s market share, the higher the interest rates it charges on loans to SMEs. Second: funding. Banks with a less stable funding base tend to impose higher interest rates on SMEs. And third: balance sheet strength. Banks with a high share of nonperforming loans (NPLs) also tend to charge higher interest rates for loans to SMEs than for loans to larger firms.

Adding all this up, the tentative conclusion is that banks that are in trouble and need to make up for losses turn to those who cannot easily run away. They turn to dependent borrowers⁶, many of whom are SMEs.

To sum up: SMEs face a structural disadvantage when borrowing from banks. And this disadvantage becomes even more pronounced in a crisis. Given how important SMEs are for the economy, policymakers are rightfully paying attention to this issue.

The role of banking regulation and supervision

First of all, there is banking regulation. In the wake of the financial crisis, policymakers around the world tightened the rules for banks. In particular, banks are now required to hold much more, and far better quality, capital than before. This makes them more resilient and ensures that they can finance the economy throughout an entire cycle.

But some point out that capital requirements influence banks’ lending decisions. They argue that whether a bank will grant a loan to an SME depends, among many other things, on the amount of capital it needs to hold against that loan. Following this logic, the calibration of capital requirements might thus influence lending to SMEs.

As you know, the crisis led to higher capital requirements. Among other things, new capital buffers, such as the capital conservation buffer, were introduced. This triggered some concerns with regard to SMEs. The argument was that the new buffers would oblige banks to hold more capital against loans to SMEs too – even though such loans had not contributed to the crisis. So, the new requirements would overestimate the amount of capital required.

To alleviate these concerns, regulators introduced an SME support factor which reduces the risk weights for SMEs so as to balance out the effect of the new capital conservation buffer.

Regulators will be able to come back to the question of how to treat SMEs when they implement the final elements of the Basel framework, which also envisages separate treatment for SMEs. Finally, the work on evaluating the overall impact of the crisis on lending will also provide additional insight.

So, rulemakers have tailored regulation to ensure that SMEs are not

disadvantaged. And, of course, banking supervision also plays a role in this.

European banking supervision helps to make banks safer and sounder. This in turn makes crises less likely. And when there are fewer crises, SMEs will be less often exposed to disproportionate funding constraints. This is the general message, but we can look a little deeper.

Take nonperforming loans, NPLs for short, as an example. As I already mentioned: in times of crisis, banks with high levels of NPLs tend to charge disproportionately high interest rates on loans to SMEs. This presents another reason for reducing the amount of NPLs on banks’ balance sheets.

That’s why we have issued guidance to banks on how to deal with nonperforming loans. And that’s why we later added guidance on how to provision for loans that become nonperforming in the future. Judging by the data, we are on the right track: from early 2015 to the end of 2017, the amount of NPLs fell from almost 1,000 billion EUR to just over 720 billion EUR. This number is still too high, but progress is visible.

So, tough banking regulation and sound supervision do lend some indirect support to SMEs. But here we are still assuming that banks are the main sources of funding for SMEs. And this brings us to a more fundamental problem which I touched on before: SMEs depend very much on banks, and often on one specific bank. This can weaken their negotiating position and make them vulnerable. The obvious conclusion is that SMEs would benefit from a wider set of funding sources.

Market power – from the banking union to the capital markets union

But a wider set of funding sources could still include banks. The main thrust of the banking union is to prepare the

⁵ Holton, S. and F. McCann. 2017. *Sources of the small firm financing premium: evidence from euro area banks. Working Paper Series 2092. ECB. August.*

⁶ Santos, J. 2011. *Bank Corporate Loan Pricing Following the Subprime Crisis. In: Review of Financial Studies 24(6). 1916–1943.*

ground for a truly European banking market. Such an integrated market would give SMEs the chance to reach across borders and tap banks throughout the euro area for funding. They could diversify their funding sources and become less dependent on individual banks. That said, it is still a long way towards a truly European banking market.

And this is not the only option. Beyond having access to loans from a wider set of European banks, SMEs should have better options for raising funds on capital markets. On this front, the ECB has been a strong supporter of the capital markets union. It is not just banking markets that need to grow together; capital markets should do so as well.

I know of course that the way towards a truly European capital market is as long as the one towards a truly European banking market – it might even be longer. After all, capital markets are very complex and very diverse. This underscores the need for initiatives on many fronts, including initiatives that would also help SMEs. For instance, SMEs might benefit from the new framework on securitization as well as from more harmonized regulation for SME listings on public markets across the EU.

And then, not all SMEs are equal. Newly founded SMEs face even bigger problems. Many start-ups might have the potential to grow into mature SMEs, or even into large firms. But for most of them, funding is still very hard to come by. They are deemed too risky for bank loans, and venture capital is

close to non-existent in most EU countries. So, they have even fewer funding options. A number of fintech activities are now seeking to fill this gap. Peer-to-peer lending platforms, for instance, have expanded significantly in recent years. If policymakers want to support SMEs, they need to ensure that such innovations are supported, but also appropriately regulated.

Conclusion

It might be said that SMEs are the heart and soul of the economy. If they do well, the economy does well. So when it comes to SMEs, small is not only beautiful, it is also important.

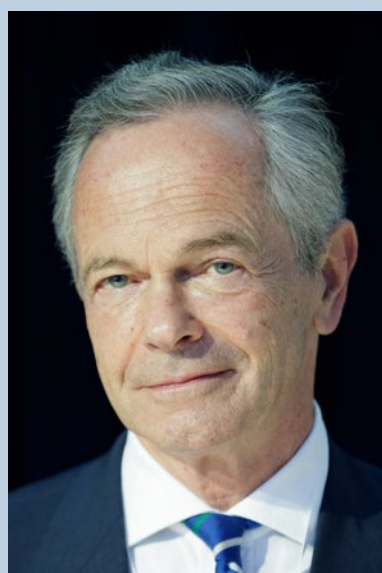
But it is also challenging. When looking for funding, SMEs face a structural disadvantage, which can become even more pronounced in times of crisis. I have discussed how banking regulation and supervision can help alleviate some of the SMEs' funding constraints. But let me be clear: our job is to help banks remain safe and sound, nothing more and nothing less.

Ultimately, the issue of SMEs' access to finance comes down to choice. If SMEs had a wider set of funding sources to choose from, they would be less dependent on banks. The banking union, the capital markets union, and digitalization might help in this regard. At the same time, information asymmetries make it hard for SMEs to diversify their funding sources. These are the levers policymakers need to pull in order to improve access to finance for SMEs. The economy would certainly benefit.



Andreas Treichl

Chair of Division Bank and Insurance, Austrian Federal Economic Chamber
CEO Erste Group Bank



Keynote Lecture 2: Financing the Economy – SMEs, Banks and Capital Markets

Thank you very much for the invitation. I think inviting me in my function [as Chair of the Division Bank and Insurance of the Austrian Federal Economic Chamber] is just a cover; in reality, you invited me because you know how much I love the European Economic and Monetary Union and how much I love European regulators. Let me reveal the reason why I love them so much: It is simply because they are just another perfect example of how Europe actually works and how the EU works. We always start off with a great idea and then we have great politicians who actually make it happen. Then, everybody is happy about what happens in Europe and then we find out that a couple of things do not really work out simply because we forgot to implement them when we started off. And slowly, everything starts to deteriorate even though it is still a great idea but suddenly nobody is happy with it anymore. This is true for the EU, this is true for the European Economic and Monetary Union, this is true for European regulation and, lately and very sadly, this is also true for Schengen.

Maybe, the new era of the European Economic and Monetary Union did not accidentally start or coincide with the beginning of the financial crisis. In this context it is important to state that financial regulation did a really great job in Europe – and I do not mean that cynically, I mean that very seriously. So did regulation in the United States and in most of the Asian countries. Thanks to regulation, the banking system or the financial system of Europe has been substantially better and safer in 2018 compared to 2008. Banks are better capitalized, they are less crisis-prone than they were ten years ago, supervisory systems and

tools are substantially better, as well as resolution mechanisms. Could we therefore actually say: mission accomplished? Well, maybe there are some aspects of that mission accomplished to be found in the United States where the threshold for “regulation light” has just been raised to a balance sheet of USD 250 billion. Maybe there are some aspects of that mission accomplished to be found in Asia, but there is definitely no mission accomplished in Europe. Here, “regulation light” – if it exists at all – ends with a balance sheet of EUR 5 billion. And in order to put a “cool European touch” on it, we will actually lower the threshold for “regulation super-tough” – for the biggest banks – to EUR 100 billion. That is a typically European solution and, in my view, it is simply a compromise between Germany and France. The Germans, representing their banking sector, got proportionality, and the smaller banks loved it. But not all banks in Europe are smaller banks.

So, have we really thought that through? We see what is going on in the United States, and we should not do what is good for Germany, or what is wanted by France but what is good for Europe. The U.S. approach is very different and very typical of the United States: The U.S. regulators said, “We punish the banks, then we repair them, then we make a lot of money repairing them, and then we regulate them such that they can help us to make America great again.” The European approach is: Taxpayers should never ever have to pay again; therefore, we need to control everything banks do 24/7, irrespective of what it costs. Now, I agree with the taxpayers but I definitely do not agree with 24/7 regulation, and I do not agree with all the costs. What are the

reasons for the different approach of Europe? Reason number one is that the European political system is very complex and therefore it is very difficult to change direction. From 2018 to 2028, the problems of the financial system will be completely different from the problems experienced from 2008 to 2018. The second reason is that Europe is the most democratic continent in the world – which I love – but it is also the most bureaucratic continent in the world – which I do not love. Regulators are bureaucrats, and if nobody tells them otherwise they will simply continue to regulate. Reason number three is that the term “bankster” is still somewhere in every regulator’s mind. That might be good for a regulator, but it is not good for regulation; maybe regulation should actually help to identify, locate, punish and eliminate banksters, instead of trying to establish a system that is so good that even banksters cannot do any harm. This is not going to work, and every year that Europe continues on this path will destroy some of the values it has created.

Let’s take a look at the three components of the financial crisis when it hit Europe. The first one was an imported component and came from the United States where, basically, inexperienced institutional investors bought billions of U.S. real estate junk. Had Europe had a well-established capital market culture back then, maybe some of the big shots in European banking would have actually known what they were about to buy and would not have bought it. Now, that is being taken care of by the European capital markets union. So if we are not doing a good job on this one, I see a big problem coming up for us. Let’s not fool ourselves: We do not have a capital market culture in the European Union. The two biggest capital market countries in Europe are

either not in the European Union – Switzerland – or will leave the European Union very soon – UK. Establishing capital markets is not done by changing the legislation for venture capital funds, and it is not done by building a stock exchange for SMEs – that is the last step. The first thing that we need in Europe is a true and honest capital market culture, and this is not only true for Austria, this is also true for Germany. A German Minister of Finance actually believes that saving is good and that investing is bad, because investing is for capitalists. Everybody who produces dividends is valuable for the economy, but he is not somebody we want to deal with. We like the good “deutsche Kaufmann” who saves. The problem is that saving has been the biggest form of speculation on this planet over the last ten years because we all lost money by saving money. So, if we are to establish a capital markets union that can actually call itself a capital market, we will not see any results before 2050 – that is my bet. What do we do until then? How do we help Europe not to continue to fall behind Asia and the U.S.? And what does it all have to do with regulation?

Compared to the total financing of the economy, bank assets are substantially higher in the EU, and particularly in Austria, than they are in the U.S. Stock market capitalization in the EU is substantially lower than it is in the U.S. and Switzerland. In Austria and in CEE, it is practically non-existent. Yes, we do have a stock exchange in Vienna, and we do have a stock exchange in Poland, but we do not have anything in some of the countries, and that is a huge issue for our region. In total, the capital market in the region that many of us have to deal with is completely under-represented. What this actually tells us is another story: It is not only the story

of us having a much lower capital market than the U.S. or the U.K., which of course has enormous effects on pension funds and on the ability of our citizens to invest in our economies. It is also the story of another effect that is, in my view, highly important for European financial regulation: The banking system in Europe is substantially more important for Europe than the banking system is for the U.S. economy. So, whatever we do with regard to regulation in Europe has a substantially higher effect on the ability of our economy to grow than it would be the case in the United States.

What are the other components of the crisis? The first one was the imported component from the U.S. The second component included the homemade crises. Each of the EU countries – Ireland, Spain, Greece, Austria, Romania, Italy, Germany, and so on – had its own form of a crisis: It was real estate lending in different forms, it was foreign currency loans, liquidity problems, undercapitalization, and so on and so forth. In some countries, the EU had to step in in order to help the respective country and the banks to get out of the crisis. In other countries, the EU did not have to step in; rather, the crisis was dealt with locally. And in yet other countries, we did not even have a crisis, like in Poland or the Czech Republic.

The third component of the crisis is the cross-border crisis in the EU and what we generally call the death loop between banks and governments.

What was the role of regulation in these three areas? In area number one: zero. I think regulation had nothing to do with the imported part of the crisis other than the fact that it created parts of the crisis, but that is something we will deal with in the capital markets union. In the second area – the local crises – the EU and regulation played a

hugely important role. The rules that were established back then will substantially reduce the risk of a lending crisis and bank failures in Europe in the future. And for that, regulators deserve the praise for the next 100 years because the system itself would not have made it without regulation. However, the third area – the death loop – cannot be dealt with by regulators. It can only be dealt with seriously by the third pillar of the European monetary union, the so-called European Deposit Insurance Scheme, which is – as you all know – a long shot. That is also not in the hands of regulators, it is in the hands of politicians. And presently, I am sorry to say, they deal with it pretty much in the same way as they deal with migration. It’s a pity, because if we want to make sure that the European banking system becomes a real competitor to the U.S. and Asian banking system at some point in time – which we all hope and wish for – we have got to get work done, and we have got to get work done very soon.

After ten years of European banking union, two out of its three pillars have been established: the SSM and the SRM; the third one, however, has not been established. What is the outlook for the European Economic and Monetary Union? We could ask, “What will it look like ten years from now?” But allow me to formulate it differently, so instead of asking, “What will the European banking union look like in ten years?,” allow me to ask, “What should the European financial system look like in 2028 in order to fulfill its only purpose, which is to help create prosperity for all citizens of the European Union?” Or we find yet another way of formulating: “How and what do we need to do in order to make sure that the European financial system provides European businesses and citizens with an

advantage vis-à-vis the rest of the world in 2028?" This is not a Trump copy of "Europe first," this is much more modest. This is just saying, "Please, let Europe not be second." We all see what is going on in the world. Europe is still the best place to live but we all know that we are falling behind in many areas. What was the contribution of Europe to the digitization of the world? What is the contribution of Europe to artificial intelligence? What will the contribution of Europe be to car battery manufacturing? What is the contribution of Europe to block chain technology? We are very happy to hear that a new payment company headed for the stock exchange in the Netherlands, being valued at EUR 14 billion. We should have companies, high-tech companies that are valued many many hundred billions of euros because big companies also create small companies.

These days, we are also wondering why there are so many European brains in Silicon Valley. Because it is so nice to be in California? European brains are in Silicon Valley because that is where they receive financial support. This is the only reason why they went to Silicon Valley. We should not be happy about small leaps in Berlin, Vienna or Munich; we should have much grander aspirations as Europeans. We should say, "what Silicon Valley can do, Kitzbühel can do too!" Not only skiing, but we could create the same thing. What we need for that, however, are clever forms of financing. Establishing capital markets will take a while, and it is not going to happen overnight. The first thing we now need to do is stop European politicians calling investors speculators. We need to make politicians aware of the fact that their citizens have lost millions, and billions during the last ten years because they helped to create a climate in which everybody

who buys a share has to feel bad. If we do not stop that, it will be over. However, establishing capital markets will take a while, so what do we do in the meantime?

Could we not think about how to shape the financial system of Europe and, in an intermediary step, get the banks involved in creating products that could help establish capital markets? Could we not try to speed up the development of capital markets and a capital market culture dramatically? Could we, bankers and regulators, not just stand together, whereby the bankers actually say, "Dear European regulators, please do everything possible to make us less important. We are presently financing 75 % of the economy and in Austria as well as Central and Eastern Europe we are financing 90 % of the economy. This is unhealthy." I do not want a system like in America where American banks are down to 25 %; but why not try to get to 50:50? Do you know how long that would take and what that would mean for us if we tried to get to 50:50?

You also mentioned start-ups today. We are saying that the European banking system has improved a lot, and that the nonperforming loans ratio (NPL ratio) has come down dramatically even though there are still some countries in which the NPL ratio remains relatively high. But in total, it dropped dramatically in Europe. So why could we not say – now after ten years and after having seen how the banking system has developed: Why do we not let banks with an NPL ratio of less than 5 % lend 1 % of their risk-weighted assets without guaranties, without collateral, to start-ups and social enterprises? And trust the bank managers that they are smart enough and that they have the expertise necessary to decide whom they want to finance? 1 % of our risk-

weighted assets, or maybe – if a bank has an NPL ratio of less than 3 % – we could let them lend 2 % of their risk-weighted assets in unsecured uncollateralized loans to SME start-ups and social enterprises.

By the way, some of the European funds are doing an absolutely great job in helping us to develop exactly that. We are very fortunate to have been working with a European fund that helped us to develop a social banking system in Central and Eastern Europe and the Western Balkans, which we needed desperately. And raising EUR 50 million for something like that is a huge effort. Just imagine: If regulators together with politicians could agree on taking the risk and letting us lend 1 % of our balance sheet, this would not create EUR 50 million, this would create EUR 50 billion. EUR 50 billion to finance start-ups, to build an atmosphere somewhere in Europe, where we could create our own Silicon Valley.

At the same time, we could help the more than 13 million people in the European Union who have no access to banking back on track and back to life. All we need are the guts to make a



mistake. And that is one of the problems that we have in Europe, and that the Americans do not have. We hate to make mistakes but sometimes the biggest mistake is not to try. Thank you very much.



Introductory Remarks: Banking and Capital Markets Union – Financial Regulation and SMEs

Ladies and Gentlemen,
Ten years after the global financial crisis that led to the market exit of three large Austrian banks and a substantial bank rescue package, the Austrian banking system is considered one of the most stable banking systems worldwide. Just last month, the credit rating agency Standard & Poor's raised its Banking Industry Country Risk Assessment (BICRA¹) of Austria's banking sector from group 3 to group 2 (there is no country in group 1). The upgrade reflects material improvements in banking sector stability. Stronger capitalization was a main reason (S&P 2018). Such an upgrade leads to lower funding costs for banks, which benefits banks and borrowers alike.

Having this success story in mind, let me briefly outline why stronger bank capitalization also benefits SME-lending (Small and Medium Enterprise-lending).

The role of capital regulation for bank credit to SMEs

Overall, capital requirements for banks have increased since the global financial crisis. Does this affect lending?

Higher capital requirements affect banks' liability mix and their weighted average cost of funding and thereby the pricing of loans (ECB 2015). This is largely intentional. Regulators aim at shifting the cost of financial crises from the public back to banks; economists call this "the internalization of externalities".

In the short run, higher requirements can lead to lower credit demand due to

higher lending rates. However, the ECB's bank lending survey shows that cost of capital plays a rather modest role in banks' lending decisions (ECB, BLS 2018). Indeed, capital levels are just one of many factors.

One of the most important lessons of the past is that the strongest and most sudden decline in banks' lending to SMEs was triggered by financial instability when the financial crisis unfolded. Capital requirements aim at reducing this risk.

The role of banks in SME financing

Banks play an important role in funding the real economy, but that role has changed over the past 20 years. For example in Austria, the balance sheet structure of Austrian banks shifted towards more mortgage lending, while the share of funding of non-financial corporates in banks' total assets decreased. The following figures show this in detail.

Funding of non-financial corporates amounted to 23% of total unconsolidated assets in 1999 and decreased to 17% in 2017. SME lending is currently at around 6% (no historical data available). In contrast, mortgage lending increased strongly from 5% to 12% of total unconsolidated assets in the same period (OeNB, ECB). Both supply and demand drive these developments.

The demand side mirrors the development of lending to non-financial corporates seen in banks' balance sheets. The share of bank loans in total liabilities of Austrian non-financial corporates

¹ The Banking Industry Country Risk Assessment (BICRA) of Standard & Poor (S&P) classifies national banking sectors on a scale from 'group 1' (lowest-risk banking system) to 'group 10' (highest-risk banking system). It is the starting point for S&P's single bank ratings.

declined from 36% in 1999 to 20% in 2017 (OeNB, financial accounts).

SMEs have three major sources of financing (BACH data as of 2016). Each accounts for about one third of total financing: (1) bank credit (29% of total assets), (2) equity (34% of total assets) and (3) other non-bank sources (38% of total assets; thereof loans from non-financial corporates accounting for the largest share of 23%)². These figures show that SMEs are already diversifying their sources of finance.

Diversification of SME finance supported by European initiatives

Several European initiatives are underway to reduce the reliance of SMEs on bank credit somewhat.

First, the report of the High Level Expert Group on SME and Infrastructure Financing identified a number of possible actions in this regard already in 2011 (EC 2011). These are in particular, action to facilitate credit analysis via public and private databases, the aggregation of business registers, a standardized and more widespread use of credit scoring, and standardized loan-level information on asset-backed securities, or a granular credit risk dataset (so-called AnaCredit).

Second, the Commission's action plan for SMEs³ covers a wide range of initiatives and regulatory measures (e.g. EC 2018). They may be more promising and effective in promoting SME lending, compared with the SME Supporting Factor, which aims at lowering banks' capital requirements for SME loans.⁴ Examples are to promote venture capital and the use of ratings by SMEs, to improve SMEs' access to capital markets

or to explore better enforcement of late payment rules. These measures would in particular strengthen SMEs' creditworthiness and the access of smaller firms to external financing.

Third, the capital markets union (CMU) is often referred to as the spare-wheel for financing. In times of need and when banks do not provide lending, the capital market might step in. Under the CMU, the European Commission aims to develop a more diversified financial system that complements bank financing with deep and developed capital markets (CMU 2018). This should unlock more investment for all companies, especially SMEs.

No complete substitution of bank lending as CMU advances

However, I would like to caution against the belief that bank lending for SMEs would be completely substituted as the CMU advances.

First, we expect banks to be among the major investors in SME bonds in the CMU.

Second, just like with large corporates, access to bank credit is a complement and not a substitute for bond financing.

Third, in Europe and Austria we see a slow shift towards equity financing and issuing bonds by larger corporates. Such additional funding for large corporates provides ancillary capacity in banks to supply credit to SMEs.

Fourth, in banks' rating models the equity level of SMEs is often a key variable. If SMEs can increase their equity through the CMU, we will see an increase of the quality of SME lending

via this channel, which benefits the real economy and financial stability simultaneously.

In that sense, the CMU will not be just a spare wheel, it will serve as another stone reinforcing an ever-stronger foundation for access to funding for SMEs and larger corporates alike.

The future of SME lending from a financial stability perspective

Let us envision the future of SME lending from a financial stability perspective:

Banks will remain important for SME funding. Simultaneously, alternative sources of funding will be increasingly used by SMEs.

Ultimately, a better diversification of external funding for SMEs and the real economy will strengthen the financial system and the real economy.

In turn, the capital markets union is a project that needs to be advanced – from the perspective of SMEs, banks and the public.

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Closing remarks

From a financial stability perspective, developing the capital markets union is an important complement to the banking union. A shift from bank-based to more market-based financing will also contribute to a healthy, stable and resilient banking sector and strengthen the European monetary union. Therefore, deepening the capital markets union is a priority of the Austrian EU Presidency.

² SMEs defined as corporations with a turnover of less than EUR 50 million per year. Latest available data as of 2015 (BACH database).

³ For example, see: Regulatory initiative to promote SME growth markets, https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/securities-markets/sme-listing-public-markets_en#regulatory-initiative-to-promote-sme-growth-markets

⁴ For more details on the SME Supporting Factor, see EBA (2016).



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Building a Stronger Economic and Monetary Union to the Benefit of all European Citizens

A quarter of a century ago, the Treaty of Maastricht became effective and paved the way for our single currency. The euro was born as an accounting currency in 1999 and euro banknotes and coins began to circulate in 2002. Today, the euro is, after the U.S. dollar, the second most important currency in the world and the common means of payment for more than 340 million Europeans in 19 Member States. Sixty countries and territories, representing another 175 million people, have pegged their own currencies directly or indirectly to the euro. After Brexit, an estimated 85 percent of the total GDP of the EU will be generated by the economies of euro area countries¹.

The euro – a success story

Looking back, the euro is on many levels a success story. It has brought immense tangible benefits for people, firms and the euro area countries. Firstly, price stability, which has ensured that our living standards are no longer at the mercy of the high inflation and volatile exchange rates of the 1970s and 1980s. Secondly, the abolition of expensive charges for citizens travelling from one euro country to another or for transferring and withdrawing money in another euro country than at home. Thirdly, cheaper credit for households and businesses and on average enormous savings of time and money for firms, given there are no more exchange-rate risks nor transaction costs for cross-border operations². McKinsey has calculated that in 2010 the euro boosted the wealth in the euro area by no less than EUR 332 billion. With

7.8 percent of its GDP corresponding to EUR 22 billion, the positive effect of the euro for Austria was greater than for any other euro area country in that year³. Regrettably, the euro is not always perceived as such a success, which is partly due to the turbulences caused by the global financial and economic crisis that started in the United States in 2007 to 2008.

This recent crisis has undeniably revealed several weaknesses in the system underpinning the euro. In response, the EU adopted more than 40 pieces of legislation to stabilize markets, restore trust and increase the resilience of the financial sector as a whole. These measures include more stringent capital and liquidity requirements for all of the currently 6,500 banks in the EU, the introduction of the banker's bonus cap, the establishment of the European supervisory authorities (ESAs) as well as the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRB) and strengthened deposit insurance. As so often in the history of European integration, the biggest steps forward were made under duress, at the height of or immediately after a crisis. Also due to the constraints of time, emergency interim measures – such as the establishment of the euro rescue system, the European Stability Mechanism (ESM), or the agreement on the fiscal compact – have been established only on an intergovernmental basis. To increase democratic accountability and control, they still have to be fully incorporated into EU Community Law. As long ago as in 1950, the French Foreign Minister Robert Schuman pointed

¹ European Commission. 2017.

² European Commission. 2017.

³ McKinsey. 2010.

it out well: “Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a *de facto* solidarity.”

The adopted measures have contributed to making the euro stronger than before 2008. Today, unemployment in the EU has fallen to its lowest level in eight years and EU growth is set to remain robust with 2.1 percent in 2018 and with 2 percent in 2019⁴. With Greece successfully concluding the financial assistance programme on 20 August 2018, the last Member State has left the euro’s rescue fund⁵. Clearly, even the most difficult tasks can be managed together in Europe, if only the political will to do so is present.

However, our Economic and Monetary Union (EMU) is not yet completed. We must continue to draw the right lessons from the crisis and address the structural and institutional weaknesses that remain. In fact, there should be no complacency about the necessity to strengthen the euro’s architecture to ensure financial stability, growth and jobs in Austria and Europe. As Vice-President Dombrovskis and Commissioner Moscovici jointly stated, “the euro area does not need only firefighters – it also needs builders and long-term architects”⁶. The challenges of globalisation, digitalisation and Brexit are exacerbated by the daunting fact that the euro is still the only currency in the world which is not yet backed by a common budget, fiscal, economic and tax policy. Yet the ideas for the further development of the EMU that are currently being discussed – including the proposals and ideas put forward by President Juncker, President Macron

and Chancellor Merkel –, are in fact nothing new. They reflect imperatives, which have been acknowledged for many decades to make up an effective economic and monetary policy.

The far-back reaching roots

The underpinnings of the EMU can be traced back at least 60 years when Germany, France, Italy, Belgium, Luxembourg and the Netherlands agreed to implement joint economic policies in 1957. The European Economic Community (EEC) came to life in that year with the signing of the Rome Treaties. Just a little more than a decade later – when Member States found themselves facing ever more frequent monetary turbulences – they instructed the Luxembourgian Prime Minister Pierre Werner to draw up a three-stage plan to establish an Economic and Monetary Union. In his 1970 report, Werner states that: “the economic and monetary union thus appears as a *leaven for the development of political union, which in the long run it cannot do without*”. He argued further that: “the economic and monetary union is an objective realizable in the course of the present decade, provided the political will of the member states to realize this objective (...) is present”⁷.

As we know, it took more than two decades until the aforementioned Treaty of Maastricht became effective and laid the legal foundation for our common currency in 1993. The day after the negotiations on this Treaty were concluded, the then German Chancellor, Helmut Kohl, said: “The way to European unity is irreversible. The member states of the European Community are now bound in such a way that it is impossible for them to split

apart and fall back into the concept of the nation-state, with all of its consequences.” He went on: “The outcome of the Maastricht negotiations has established the path to European economic and monetary union, clearly and once and for all.”⁸

Already at the time of birth of the Maastricht Treaty, Helmut Kohl was convinced that a common currency would inevitably lead to the introduction of a common budgetary, fiscal and economic policy. The euro was never a project for few, but always a project for all Member States. The euro is a political project, designed to pave the way for a political union. Except for Denmark and the United Kingdom, which have an opt-out clause, all EU Member States have committed themselves to introduce the euro once they have met the convergence criteria. All EU citizens – irrespective from which Member State they come from, and irrespective of whether that Member State is in the euro area or not – are affected when it comes to the further development of our EMU.

A complete EMU is a necessary development step for our Union

The euro is much more than just a currency. A complete EMU is not an end in itself, but a vital step in the development process of our Union. The Five Presidents’ Report⁹, published in June 2015, and the recent Reflection Paper by the European Commission¹⁰, have laid out the timetable for deepening the EMU until 2025. The large majority of all the measures necessary to complete the picture are either lying on the table as legislative proposals by the European Commission or are already well advanced in the EU legislative process.

For example, we must complete the banking union as soon as possible. Ten risk-reducing measures for the EU banking sector are close to being adopted. They include the reduction of nonperforming loans, the revision of the macroprudential framework, the reduction of options and national discretions in the application of capital and liquidity requirements, the improvement of the bail-in instrument and the introduction of a binding leverage ratio and net stable funding ratio. There is, on the risk-sharing side, the urgent necessity to complete the third pillar of the banking union with the establishment of a common European Deposit Insurance Scheme (EDIS) as well as the stronger application of the principle of proportionality with the reduction of unnecessary bureaucracy and regulatory burdens for small and non-complex institutions.

In addition, there are over 30 initiatives of the capital markets union (CMU) to strengthen capital markets and investment in the EU. At this stage, over two thirds of them have been implemented. Although we want to create a CMU, this does not mean we have a capital market in Europe. With approximately 70 percent, the biggest part of our real economy is bank-financed and the CMU must therefore be a financing union for our real economy. Measures include, for example, the European investment engine EFSI (European Fund for Strategic Investment) – which to date has mobilised EUR 335 billion of investment in the EU (EUR 3.9 billion in Austria), supported 750.000 jobs and 700.000 small and medium-sized companies and will continue as part of the recent InvestEU initiative¹¹. There

⁴ European Commission. 2018a.

⁵ European Stability Mechanism. 2018. Press Release.

⁶ Dombrovskis, V. and P. Moscovici. 2018.

⁷ Werner, P. 1970.

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⁹ Five Presidents’ Report. 2015.

¹⁰ European Commission. 2017a.

¹¹ European Commission. 2018b. Press Release.

are also new rules for simple and transparent securitisations, the reform of the ESAs, the birth to a private European pension product (PEPP) or the covered bonds, fintech or sustainable finance initiatives.



Besides the strengthening of the financial union, we must continue our work to establish an economic and fiscal union while ensuring democratic accountability, effective governance and convergence. The euro's rescue fund, the European Stability Mechanism (ESM), has to progressively graduate into a fully-fledged European monetary fund firmly anchored in EU community law. We need a budget for the euro that acts as macroeconomic stabilization function, supports structural reforms and gives assistance to those countries which are not yet part of the euro area. Furthermore, we must

strengthen the coordination of our economic policy and move from unanimity to qualified majority voting in certain areas such as in tax matters – since the unanimity voting limits our ability to act. Europe has to be able to take action quicker and more decisively.

The need for joint action and Austria's key role

Until the 2019 European elections, there is still time to achieve considerable progress to strengthen the EMU to the advantage of all European citizens. Since decisive negotiations will take place in the second half of 2018, the Austrian EU Council Presidency has the key responsibility to successfully adopt – together with the European Parliament – as many of the aforementioned initiatives as possible. As the Five Presidents' Report states: *"A complete EMU is not an end in itself. It is a means to create a better and fairer life for all citizens, to prepare the Union for future global challenges and to enable each of its members to prosper."* We must now summon the political will, courage and determination needed to honour that pledge. With favourable economic conditions, the window of opportunity is here but it will not stay open forever. Let us now take advantage of the wind in our sails and address these our common challenges together to the benefit of all European citizens.

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