Workshop
Toward a Genuine Economic and Monetary Union

September 10 and 11, 2015, Vienna

Paper Abstracts

Paper Session 1

EMU Governance

Reforming the Architecture of EMU: Ensuring Stability in Europe

Jakob de Haan (DNB), Jeroen Hessel & Niels Gilbert

This paper analyses the reforms in the architecture of EMU since the eruption of the euro crisis in 2010. We describe major weaknesses in the original set-up of EMU, such as lack of fiscal discipline, diverging financial cycles and competitiveness positions, and a lack of crisis instruments. These weaknesses appeared against the background of a strong increase in financial integration and financial imbalances since the Maastricht treaty was signed. European policymakers have addressed all weaknesses in the EMU architecture in some way or the other, which is a major achievement. Yet, the effectiveness of the new framework will crucially depend on strict implementation. We discuss whether in the longer run the current balance between policy coordination and risk sharing can be improved upon.

Monetary Union and Fiscal and Macroeconomic Governance

Marek Dabrowski (CASE)

The paper analyzes three questions related to the EU/EMU integration infrastructure: (i) interrelation between monetary and fiscal integration; (ii) interrelation between monetary integration and closer coordination of macroeconomic policies and (iii) fiscal discipline vs. fiscal solidarity. On the first issue, we suggest that rationale of further fiscal and political integration should be guided by the cost-benefit analysis based on the theory of fiscal federalism rather than OCA theory. On the second issue, we express conceptual and practical doubts regarding the way in which the Macroeconomic Imbalance Procedure has been designed and operated. On the third issue, we believe returning to the market discipline (based on credible danger of sovereign default) supplemented by clear and consistently enforced fiscal rules will have a key importance for long-term sustainability of a monetary union in Europe and avoiding dysfunctional fiscal federalism.

Paper Session 2

Economic Union

Macroeconomic Imbalances and Institutional Reforms in the EMU

Stefan Ederer (WIFO)

The paper summarizes the channels and mechanisms which led to the emergence of macroeconomic imbalances in the EMU before and after the financial and economic crisis of 2008/09. It focuses on the role of the specific institutional settings of the EMU in these developments and outlines the key reforms which are necessary to eliminate the imbalances and prevent them from re-emerging. We argue that the particular architecture of the EMU was not appropriate to prevent a divergence of unit labour costs between member states, which was the main factor behind the emergence of macroeconomic imbalances. We therefore conclude that a coordinated policy to realign unit labour costs is a necessary precondition for the elimination of these imbalances.

Quantitative Easing with Bite: A Proposal for Conditional Overt Monetary Financing of Public Investment

Andrew Watt (IMK)

To address the on-going crisis in the euro area it is proposed to introduce a scheme of conditional, overt monetary financing of public investment (COMFOPI). The inadequate response of monetary and fiscal policy is shown to explain the weak performance of the euro area compared with other advanced countries since the crisis. The measures currently on the table, including the Juncker Plan and quantitative easing QE, are unlikely to bring about the needed substantial improvement in economic growth, while putting growth on a sustainable footing. Advantages and dangers of monetary financing of fiscal policy are discussed in the light of the recent literature. COMFOPI is a form of QE in which bonds newly issued by the European Investment Bank are purchased, on secondary markets, by the ECB, and the financial resources are made available to national governments to finance investment projects. The scheme is explicitly time-limited by being made subject to a price-stability criterion ("conditional"). The provision of central bank money leads directly to higher spending in the economy ("overt"), unlike with QE which relies on indirect channels. A number of ways to operationalize the scheme are discussed.

Paper Session 3

Financial Union

Opting into the Banking Union before Euro Adoption

Plamen Iossifov (IMF)

In the aftermath of the crisis, the European Union embarked on reforms aimed at harmonizing regulatory and supervisory regimes, with the view of improving the functioning of the single market for financial services. Euro area countries took a step further by forming a Banking Union that centralizes bank supervision and resolution powers and puts in place common backstops. The banking union is open to non-euro area EU countries before they adopt the euro. We analyze the early opt-in decision, by assessing the pros and cons of opting into the Banking Union through the prism of country policy preferences and economic characteristics. We find that while the opt-in decision depends on country-specific circumstances, there is a gap between the potential downsides of ceding regulatory powers to supranational bodies and the benefits from common backstops and say-in in union-wide financial policies. This largely stems from lack of equal (or fully equivalent) treatment of euro area and non-euro area members. Efforts to narrow this gap are needed to make opt-in more attractive. For some countries, the upside from boosting credibility and quality of national supervision and strengthening weak national backstops may prove decisive.

(When) Should a Non-Euro Country Join the Banking Union?

Ansgar Belke, Anna Dobrzańska, Daniel Gros & **Paweł Smaga** (NBP, WSE)

We analyze the benefits and costs of a non-euro country opting-in to the banking union. The decision to opt-in depends on the comparison between the assessment of the banking union attractiveness and the robustness of national safety net. The benefits of opting-in are still only potential and uncertain, while costs are more tangible. Due to treaty constraints non-euro countries in the banking union will not be on equal footing with euro zone members. Analysis presented in the paper points out that reducing the weaknesses of the banking union and thus providing incentives for opting-in is not probable in the short term, mainly due to political constraints. Until a fully-fledged banking union is established it may be an optimal for a non-euro country to join the banking union upon euro adoption. Assessing first experiences with the functioning of the banking union will be crucial for non-euro countries when deciding whether to opt-in.

Paper Session 4
Fiscal Union

Market-Preserving Fiscal Federalism in the European Monetary Union

Ad van Riet (ECB)

Responding to the euro crisis, European leaders have put in place an enhanced economic and financial governance framework for the eurozone, including the main pillars of a banking union, while they have initiated work on a capital markets union. This should more effectively secure sound national macroeconomic and fiscal policies, a healthy financial sector and the stability of the euro. This paper poses the question whether the status quo of half-way political integration is sufficient to safeguard the integrity of the eurozone. National governments still have considerable leeway to circumvent the 'hard' budget constraint and the strong market competition implied by the eurozone's 'holy trinity' (one market, one currency and one monetary policy). For example, they might target captive sovereign debt markets or take protectionist measures. This economic nationalism would entrench the crisis-related fragmentation of the single market and frustrate the efficient functioning of the monetary union. A higher level of market-preserving fiscal federalism could prevent member countries from encroaching on markets and foster sustainable economic convergence towards an optimal currency area.

Sustainable Tax Policy Beyond the Tax Ratio for the EU as Core Element of a "Fiscal Union"

Margit Schratzenstaller (WIFO)

The European debt and financial crisis triggered a debate on the lacking components of the European Union and Economic and Monetary Union integration architecture. Meanwhile several new integration measures have been adopted. In broader conceptual terms, it is worth to ask the question which integration steps can make the single currency more resilient to potential adverse shocks (of various kinds) in future and which, on the contrary, make it more vulnerable. The purpose of this essay is to analyze the newly established mechanisms of fiscal and macroeconomic governance and contribute to the debate on their further reforms. It will concentrate on the following three issues i) Interrelation between monetary and fiscal integration, ii) Interrelation between monetary integration and closer coordination and iii) Fiscal discipline vs. fiscal solidarity. The results of the analysis show that monetary integration needs not necessarily be accompanied by fiscal and deeper political integration or even by trade and market integration and that in some cases integration has been limited to the adoption of a common currency standard and has not been followed by fiscal and political integration. Furthermore the analysis demonstrates that the Eurozone is unique in its focus on monitoring and surveillance of internal current account imbalances, IIP and real exchange rates, compared to federal states and monetary unions of sovereign states.

Paper Session 5 Automatic Stabilizers

A Feasible Unemployment-Based Shock Absorber for the Euro Area

Andrea Brandolini, **Francesca Carta** (BdI), Francesco D'Amuri

This paper contributes to the debate on the design of a centralized fiscal tool absorbing country-specific negative shocks in the euro area. Based on theoretical insights, it identifies the broad characteristics that a shock absorber based on unemployment should have in order to be incentive-compatible and politically feasible. It then derives empirically the combination of activation thresholds, experience rating, eligibility criteria, and benefit generosity which define the systems offering the highest stabilization for given levels of redistribution, accounting for the large variation in benefit take-up rates across European countries. The analysis suggests that the shock absorber should: i) give rise to macro cross-national transfers, mimicking those that would be generated by a notional euro-wide unemployment benefit scheme of minimal coverage and generosity; ii) be activated by a trigger; and iii) feature partial experience rating. The simulation results, confirmed by robustness checks, show that even systems that do not redistribute resources between countries can have a non-negligible stabilization impact in the medium run. Low benefit take-up rates in Southern Europe substantially reduce the stabilization properties and the size of the scheme.

An Unemployment Insurance Scheme for the Euro Area? A Comparison of Different Alternatives using Micro Data

Mathias Dolls (ZEW), Clemens Fuest, Dirk Neumann & Andreas Peichl

We analyse different alternatives how a common unemployment insurance system for the euro area (EA) could be designed and assess their effectiveness to act as an insurance device in the presence of asymmetric macroeconomic shocks. Running counterfactual simulations based on micro data for the period 2000-13, we highlight and quantify the trade-o¤ between automatic stabilization effects and the degree of cross-country transfers. In the baseline, we focus on a non-contingent scheme covering short-term unemployment and find that it would have absorbed a significant fraction of the unemployment shock in the recent crisis. However, 5 member states of the EA18 would have been either a permanent net contributor or net recipient. Our results suggest that claw-back mechanisms and contingent benefits could limit the degree of cross-country redistribution, but might reduce desired insurance effects. We also discuss moral hazard issues at the level of individuals, the administration and economic policy.

Paper Session 6

Wage Policy

The Trinity of Wage Setting in the European Monetary Union – A Policy Proposal

Martin Gächter, **Paul Ramskogler** & Aleksandra Riedl (OeNB)

Diverging labor cost developments are often regarded as being responsible for the large current account imbalances in the Euro area (EA) in the onset of the global financial crisis. Moreover, in a recent paper, Gächter and Riedl (2014) show that wage growth differentials across member countries of the Economic and Monetary Union (EMU) have impacted negatively on the co-movement of business cycles – the most widely used meta-criterion for an optimum currency area. This clearly indicates that a lack of trans-European considerations in wages setting can lead to the rise of dangerous divergences within a currency union. Against this background, the paper develops a wage-setting benchmark that has the capacity to (i) correct for external imbalances while (ii) maintaining price stability and (iii) keeping the economy in internal equilibrium. The proposed wage rule can be easily applied and may serve as an anchor for the macroeconomic dialogue in the Economic and Monetary Union. In order to demonstrate the potentially beneficial effects of this rule we present some simulations to show how current accounts and labor costs would have developed in the EA if the rule had served as a benchmark already in the run up to the crisis.

The Effects of Institutional Instability in Collective Bargaining: A Long-Term Analysis of Changing Collective Bargaining Actors and Structures

Bernd Brandl (Univ. Durham) & Christian Lyhne Ibsen

Previous studies on collective bargaining have focused on the effects of different institutional structures of coordination of bargaining on economic performance. Almost no attention has been paid to the effects of institutional change itself or the effects of institutional instability which is caused by a sequence of changes. In this paper we argue that institutional stability is of major importance for the efficacy of collective bargaining as it provides the necessary basis for trust amongst bargaining actors. Thus it is hypothesized that institutional change is associated with at least temporary negative effects on economic performance. The hypotheses are tested on the basis of yearly data from 1965 to 2010 of 33 countries. The underlying causal mechanism between institutional change, mutual trust, and macro-economic performance is discussed in detail through two case studies of institutional changes in the United Kingdom and Sweden.

Paper Session 7

Capital Market Union

Monetary Union with a Single Currency and Imperfect Credit Market Integration

Vincent Bignon, **Régis Breton**, Mariana Rojas Breu (BdF)

With the Euro Area context in mind, we show that currency arrangements impact on credit available through default incentives. To this end we build a symmetric two-country model with money and imperfect credit market integration. Differences in credit market integration are captured by variations in the cost for banks to grant credit for cross-border purchases. We show that for high enough levels of this cost, currency integration may magnify default incentives, leading to more stringent credit rationing and lower welfare than in a regime of two currencies. The integration of credit markets restores the optimality of the currency union.

Does a Currency Union Need a Capital Market Union?

Joseba Martinez and Thomas Philippon (New York University)

We study financial linkages and risk sharing in the context of the Eurozone crisis. We consider four types of currency unions: a currency union with (potentially) segmented markets; a banking union; a capital market union; and a currency union with complete financial markets. We then analyze how these economies respond to deleveraging shocks and to technology shocks. We find that a banking union is enough to deal with public and private deleveraging shocks, but a capital market union is necessary to approximate the complete market allocation when there are shocks that affect productivity or the terms of trade.

Paper Session 8

Debt Management

A New Start for the Eurozone: Dealing with Debt

Giancarlo Corsetti, Lars P. Feld, Philip R. Lane, Lucrezia Reichlin, Hélène Rey, Dimitri Vayanos, Beatrice Weder di Mauro (CEPR)

The Eurozone architecture is unfinished business in many respects. This report focuses on three issues because they are important and they can be addressed without a fully-fledged fiscal federation or changes to the Treaty. The components of our proposal are: (1.) A one-time debt stock operation to rapidly reduce sovereign debt, particularly in the highly indebted peripheral countries. We offer a menu of options, one of which is a debt buyback through the commitment of future revenues, which could include seigniorage, VAT or a wealth (transfer) tax. This does not involve any redistribution across members of the currency union, but it would not be sufficient to eliminate the overhang. Therefore, we discuss a number of other choices, including a European solidarity tax with some limited redistribution across countries and 'debt-equity' exchange with GDP-indexed bonds. (2.) A strengthened sovereign lending framework for the ESM, which both creates strong market-based incentives to avoid excessive debt levels in the future and makes future debt restructuring – should it become necessary – less painful than is currently the case. (3.) A set of regulatory changes that discourage and limit the exposure of banks to sovereign debt, particularly that of their own sovereign. This should be complemented by the creation of a European synthetic bond that does not require mutualisation, but would constitute a safe asset and could facilitate unconventional monetary policies by the ECB.

Conditional Eurobonds and Eurozone Reforms

John Muellbauer (Nuffield College)

This paper proposes that all new euro area sovereign borrowing be in the form of jointly guaranteed Eurobonds. To avoid classic moral hazard problems and to insure the guarantors against default, each country would pay a risk premium conditional on economic fundamentals to a joint debt management agency. This suggests that these bonds be called 'Euro-insurance-bonds'. While the sovereign debt markets have taken increasing account of the economic fundamentals, the signal to noise ratio has been weakened by huge market volatility, so undercutting incentives for appropriate reforms and obscuring economic realities for voters. This paper uses an econometric model to show that competitiveness, public and private debt to GDP, and the fall-out from housing market crises are the most relevant economic fundamentals. Formula-based risk spreads based on these fundamentals would provide clear incentives for governments to be more oriented towards economic reforms to promote long-run growth than mere fiscal contraction. Putting more weight on incentives that come from risk spreads, than on fiscal centralization and the associated heavy bureaucratic procedures, would promote the principle of subsidiarity to which member states subscribe. The paper compares Euro-insurance-bonds incorporating these risk spreads with other policy proposals.

Paper Session 9

Public Investment

Implementing the Golden Rule for Public Investment in Europe

Achim Truger (HS Berlin)

Most parts of the Euro area have seen seven years of deep economic crisis. Public investment which should have stabilized the economies and kept up their long-term growth potential has instead dramatically shrunk in the crisis-ridden countries of the periphery. Therefore the calls for a more expansionary fiscal stance, above all for a boost to public – or publically supported – investment have become louder, with the Investment for Europe Plan (Juncker-Plan) as the most prominent official policy reaction. In this study the Golden Rule of public investment is proposed as one important element of the necessary institutional reform. The rule is widely accepted in the traditional public finance literature and would allow financing (net) public investment by government deficits thus promoting integrational fairness as well as economic growth. Hence, the purpose of the study is to state the case for such a Golden Rule and to present a concrete proposal for its introduction in the EU.

In Sickness and in Health: Protecting and Supporting Public Investment in Europe

Francesca Barbiero and **Zsolt Darvas** (Bruegel)

The long-term decline in gross public investment in European Union countries mirrors the trend in other advanced economies, but recent developments have been different: public investment has increased elsewhere, but in the EU it has declined and even collapsed in the most vulnerable countries, exaggerating the output fall. The provisions in the EU fiscal framework to support public investment are very weak. The recently inserted 'investment clause' is almost no help. In the short term, exclusion of national co-funding of EU-supported investments from the fiscal indicators considered in the Stability and Growth Pact would be sensible. In the medium term, the EU fiscal framework should be extended with an asymmetric 'golden rule' to further protect public investment in bad times, while limiting adverse incentives in good times. During a downturn, a European investment program is needed and the European Semester should encourage greater investment by member states with healthy public finances and low public investment rates. Reform and harmonization of budgeting, accounting, transparency and project assessment is also needed to improve the quality of public investment.

Paper Session 10

Fiscal Capacity

The Economic Rationale of an EMU Fiscal Capacity

Paolo Pasimeni (EC)

This paper presents an analysis of the EMU conditions that determined its prolonged period of low growth and high unemployment. It argues that the EMU architecture was in itself a source of major asymmetries, which were amplified by the shock originated by the global financial crisis. The system was and still is deprived of the key instruments to cope with them. The paper then explains why a common fiscal capacity was needed and how it would be designed. In order to avoid an inherent deflationary bias and periodic falls in aggregate demand, and keep the system operating close to full-employment, a countercyclical instrument of demand management should be in place. This would take the form of a common fiscal capacity, where net contributions are linked to the relative external balance positions.

Making Sense of the Fiscal Union: a Budget for the Eurozone?

Agnès Bénassy-Quéré (PSE)

Beyond the banking union, the case for a fiscal union in the euro area has been raised as a useful complement to monetary union. The main motivation for a fiscal union is to help Member States to compensate for the lack of an independent monetary policy at the national level when facing a specific shock. According to the theory of optimum currency areas, countries in a monetary union need to rely on alternative adjustment devices, namely price and wage flexibility, capital and labor mobility, or a federal budget. The latter can have direct stabilizing impact in case of asymmetric shocks (e.g. sustaining disposable income in crisis countries). However, the question is whether a small federal budget can have a significant impact on macroeconomic stabilization. We argue that it may be the case if the budget is well targeted or if it is used to back other stabilization mechanisms such as the banking union or labor mobility.