



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 legitimation 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 spillovers, 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.

