On the Future of EMU:

Targeted reforms instead of more fiscal integration

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1. Introduction and key results

According to a dominant narrative, the recent crisis has allegedly shown that EMU is not sustainable without fiscal risk sharing. We identify two major hazards associated with this view.

1. If further fiscal integration should prove politically elusive, trust in EMU governance could unduly erode despite major recent achievements.
2. The debate on further fiscal integration could distract from additional reforms needed to prevent financial cycles in the future.

We argue that

- The recent crisis was exceptional, because several extraordinary factors contributed to its severity that are unlikely to repeat: the one-off interest rate decrease at the onset of EMU, the ensuing large credit boom, the severe global financial crisis, the German labor market reforms, and a large globalization shock emanating mainly from China and the eastern enlargement of the EU.
- The legacy of the crisis has been severe, particularly in terms of high unemployment and weak investment. We consider these problems temporary, as they mainly relate to the deleveraging process after an immense debt crisis.
- Reforms already implemented and yet to be taken can prevent excessive financial cycles so that future crises in the euro area will be less severe in the longer term, once the current debt burdens will have been reduced.
- In terms of regulatory and adjustment capacities, the optimality characteristics of EMU have substantially improved in the course of the recent crisis, indeed much more than conventionally recognised.

2. Policy recommendations

We deem a **limited set of reforms** (mostly focusing on the financial sector) to be necessary and sufficient to render EMU sustainable.

The temporary legacy problems of the crisis should be tackled with temporary tools instead of creating permanent instruments or even institutions for the euro area. The unconventional policy of the ECB, the EFSI (that needs to be made more effective though) are useful tools in the meantime that have to be withdrawn again when times become normal. Moreover, the problem of high private debts and non-performing loans needs to be tackled decisively by means of tougher directions given by the SSM, bad bank resolution schemes and further reforms of private insolvency regimes.

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Containing the damaging impacts of future crises should be the key objective. To achieve this, some further reforms are required, notably to prevent excessive financial cycles and unsustainable private debt increases:

- **Better macroprudential and macroeconomic supervision**: It is key that the SSM can overrule national supervisors: this changes their incentives and makes supervision more effective. Together with the new Macroeconomic Surveillance in the EU, much better instruments are now available to rein in financial cycles. They have to be actively used.
- **Make the banking system sounder:** Apart from CRR/CRD-IV and the banking union (SSM, SRM, SRBF, bail-in instrument), further measures are required in banking regulation: the active use of (anti-cyclical) capital buffers, ensuring that bail-in-able capital is largely held outside the banking sector, and making sure that banks are not too big to fail.
- **Preventing systemic risks in shadow banking:** As risk migrate from the banking system to the shadow banking system, financial supervision has to be broadened. In the short term, measures need to focus on more transparency and stress tests for relevant entities, and a general leverage ratio is needed for high leverage activities. In the medium term a new central supervision authority needs to be created in the euro area to cover the whole financial market.
- **Facilitate counter-cyclical fiscal policies in recessions:** The ESM and the OMT can be powerful tools to facilitate counter-cyclical national fiscal policies also for debt-laden governments, provided the countries adhere to the SGP rules. The conditionality principle on which they are based must not be weakened.
- **Ensure counter-cyclical national fiscal policy in a boom:** In economic (and financial) booms, fiscal policy needs to be counter-cyclical. This has proved to be difficult for political economy reasons. To foster counter-cyclicality by a rules-based framework, we propose to analyse whether the inclusion of a measure of the financial cycle in the calculation of the structural deficit could contribute be useful.
- **Phasing out preferential treatment of euro area sovereign bonds**: It is necessary to gradually introduce exposure limits and adequate risk-weights *for new issuances* in the near future. Moreover, the Single Supervisory Mechanism (SSM) should induce banks with an excessive holding of (domestic) sovereign debt to sell part of the portfolio to the ECB in the course of the current QE program.

The **optimality properties of EMU** are better and have been improved more than is often perceived. A reformed EMU will be better able to deal with "standard" downturns:

- **Less heterogeneity and divergence among EMU countries:** Structural reforms labour and product markets particularly in distressed countries have reduced heterogeneity within EMU in a very important dimension. This is highly relevant because heterogeneity renders EMU susceptible to asymmetric shocks.
- **Country-specific macroprudential measures** are able and needed to mitigate the real interest rate effect: The one-size-does-not-fit-all problem of the single monetary policy and the resulting real interest rate effect are key problems any monetary union. However, macroprudential policy tools can and should be used in a country-specific way to address this problem and to prevent new excessive financial cycles. Arguments questioning the effectiveness of macroprudential policies can be considerably qualified. Particularly, borrower-based tools (such as loan-to-value ratios for loans) prove to be effective in curbing excessive credit booms. Moreover, such instruments can be applied to all domestic transactions so that they cannot be circumvented by shadow banks or foreign loan suppliers. The SSM urgently needs access to these instruments in order to make sure that they are applied in case of need on the national level.
- **Adjustment capacities** of EMU countries to idiosyncratic shocks are better than recognised and have improved significantly.

- **Downward wage rigidities are considerably lower than often thought and have been further reduced** by structural reforms and especially reforms of wage bargaining systems. Regarding wage rigidities, recent research based on micro-level evidence questions the extent of downward wage rigidities in southern euro area countries (Verdugo, 2016). Even before the crisis, the share of full time workers experiencing negative annual (log) nominal wage changes was at around a third in Spain, Italy, and Portugal. This ratio increased considerably in and after the Great Recession in Spain and Portugal. The reaction of wages to changes in unemployment is found to be similar than in the US
- **Short-term labour mobility appears to have increased to US levels during the crisis**: Short-term labour mobility proved to be much higher in the euro area during the recent crisis than expected, because migration outflows from stressed euro area countries increased considerably. Also due to this important adjustment valve, the short term adjustment capacity of labor markets to demand shocks via migration has been estimated to come close to US levels. The further removal of impediments to labour mobility is still required, however.
- **Financial risk sharing has also been somewhat better but its improvement is key to make EMU sustainable.** Financial risk sharing, a key adjustment mechanism to idiosyncratic shocks, largely broke down when it was needed during the recent crisis. This was largely due to outflows of short term and debt-based assets. On the contrary, the share of intra euro area equity and longer-term financing has increased considerably since the start of EMU and also since the crisis. Nevertheless, financial risk sharing capacities need to improve further in EMU - but without leading to significant systemic risks. The banking union and especially the bail-in instrument are important achievements in this respect. On top of this, further reforms are required: The capital markets union agenda needs a clear roadmap in order to foster the quantity and quality of financial integration in the euro area. In addition, regulatory incentives are needed for more diversification among asset classes and investors, more equity (instead of debt) financing, and for more long-term (instead of short term) investments.

3. Conclusions

Overall, the reform pressures of the recent crisis have significantly improved the structural functioning of EMU. In this respect, the OCA endogeneity hypothesis of EMU has eventually proved correct. On this basis, and with the additional reforms suggested here, it is far from evident that EMU is not sustainable without further fiscal integration. The prospect of fiscal integration in EMU thus needs to be discussed as a political choice, not an economic necessity.