Completing Economic and Monetary Union

Forum hosted by the OeNB in Vienna on November 24 and 25, 2016

Compiled by Andreas Breitenfellner, Carmencita Nader-Uher and Teresa Messner[1]

The EMU Forum 2016 brought together academics, experts and policymakers to debate about the political economy of the euro area. The resilience of Economic and Monetary Union (EMU) hinges on its capability to reduce and distribute risks among its member countries. Aiming at long-term convergence, the deepening of EMU implies ex ante coordination and swift crisis management by strong institutions. Drawing on the Five Presidents' Report on "Completing Europe's Economic and Monetary Union,"[2] the forum explored ways to bolster the single currency by promoting economic, financial, fiscal and political union. Organized by the OeNB together with the Euro50 Group and the Vienna Institute for International Economic Studies (wiiw), the event built on last year's workshop "Toward a Genuine Economic and Monetary Union."

EMU deepening between ambition and realism (keynote speeches)

In his opening remarks, OeNB Governor *Ewald Nowotny* noted that since last year's Workshop "Toward a Genuine EMU" the circumstances have changed dramatically. Brexit has revealed a paradox: It points to weaknesses of current EU arrangements, the improvement of which would require "more Europe." But at the same time, Nowotny remarked, Brexit is strengthening those populist and Eurosceptic political forces that object to any deeper integration. He stressed that policymakers should never stop explaining that moving forward toward a more stable, prosperous and fair EMU is in the very best interest of all European citizens. Nowotny cautioned against accepting a potential growth rate as low as 1½% as a given, as this would imply accepting a situation of permanently high unemployment. This would seriously threaten social cohesion. A step in the right direction is the Investment Plan for Europe ("Juncker Plan"), which is broadly operating as scheduled. But in addition, Europe would need initiatives to foster a strong and deep European capital market. This includes the creation of European assets that can attract international investors, such as the "European Safe Bonds" proposed by Princeton economist Markus Brunnermeier.

Peter Praet, Member of the Executive Board of the ECB, stated that the shallow and bank-centric financial integration in the euro area has been impeding the shock absorption function of the financial sector, thus amplifying negative shocks during the last crisis. It is important to reduce such procyclicality of the financial sector despite the current "integration fatigue." Praet noted that the incompleteness of the banking union has been hindering the effectiveness of monetary policy, which is not well-suited to address asymmetric shocks for a heterogeneous group of countries, even less so when predominantly nationally owned banks lack the necessary liquidity. While the euro area has supranational regulatory and supervisory institutions, risk-sharing remains limited to the national level. In order to complete banking union, supervisory responsibilities and related activities need to be shared

[1] *This summary report has been compiled on the basis of notes taken by Christian Belabed, Andrea Hofer, Paul Ramskogler, Thomas Scheiber, Maria Silgoner and the three mentioned authors.*

[2] *Juncker, J.-C., D. Tusk, J. Dijsselbloem, M. Draghi, M. Schulz. 2015. Completing Europe's Economic and Monetary Union. Brussels, European Commission.*

and streamlined across countries. A positive sign against the partial re-nationalization that occurred during the crisis would be if banks transformed subsidiaries into branches. Since the capacity to absorb shocks increases when resources and risks are pooled across countries, a system-wide approach would require a European Deposit Insurance Scheme (EDI) as well as a common fiscal backstop within the Singe Resolution Mechanism (SRM).

Klaus Regling, Managing Director of the European Stability Mechanism (ESM), emphasized that EMU has always been a political and economic project. He stressed that "the euro is worth defending." Experts and policymakers should communicate the economic benefits of a single currency: open markets, lower transaction costs, transparent prices, increased trade, productivity and growth, as well as a centralized monetary policy that balances the interests of all Member States. After the global financial crisis, EMU was successfully shielded against the sovereign debt crisis by national efforts, and many new institutions have been created: (1) the ESM as a lender of last resort to sovereigns; (2) the Single Supervisory Mechanism (SSM), the Single Resolution Board (SRB) and the Single Resolution Fund (SRF) as integral parts of banking union. Europe has become stronger and two out of three euro area citizens support the single currency. Regling mentioned the still-existing lack of risk-sharing between the euro area countries and thus strongly advocated the completion of banking union and capital markets union and the creation of a centrally managed unemployment fund. The more channels are used for risk-sharing, the more resilient EMU will become.

Outside views on EMU reform (policy panel)

The panel's chair, Michael Landesmann (wiiw), urged that, given the crucial phase EMU and EU have entered, the discussion on their future should go beyond technical aspects.

Iain Begg (European Institute, London School of Economics) stated that the EU's Achilles heel is the implementation of and compliance with the rules set on a European level. Moreover, he criticized the Excessive Imbalance Procedure's asymmetric approach to current account imbalances, as it only allows current account deficits of up to 4% of GDP but current account surpluses of up to 6%. Begg argued that the EU should focus more on solidarity instead of stability, which requires a more expansionary fiscal policy for the euro area as a whole, also on the part of large surplus countries such as Germany.

He was followed by *Hanna Gronkiewicz-Waltz*, the mayor of Warsaw, who stated that the EU was facing serious challenges ahead. According to her, however, the Polish population is currently not in favor of further integration. Ten years ago, Poland might have joined the euro area but today the mood has changed. Moreover, members of the younger generation doubt they will be better off than the generations before them. Worse, they participate less in the democratic process than the older generation, which will bias election results against deeper integration for years to come.

Aneta Krstevska, chief economist of the National Bank of the Republic of Macedonia, put her focus on the economic and financial integration of the Western Balkan countries with the EU. According to public opinion surveys, the Western Balkan countries are still mostly in favor of joining the EU, considering the economic benefits of integration. The candidate countries have already established strong economic and financial linkages to the EU, and economic circumstances are improving constantly. However, on their way to EU accession these countries still face a variety of challenges in implementing structural reforms and improving economic performance. In this regard, cooperation and support by the EU institutions remain valuable.

Ambassador *Wolfgang Petritsch*, President of the Austrian Marshall Plan Foundation and former UN High Representative for Bosnia-Herzegovina, observed that, in an unfortunate turn of events, the "Europeanization" of the Balkans evident in the 1990s has now given way to a "Balkanization" of Europe. The widespread "euroization" or unilateral adoption of the euro causes many problems. If Europe wants to become a global player it is vital to keep focused on the candidate countries of the Western Balkans.

György Surányi, former governor of Magyar Nemzeti Bank, argued that the constantly recurring breaches of the Maastricht Treaty are a sign that the rules are inadequate. Current fiscal rules, with their strong emphasis on cyclically adjusted fiscal balances, would eventually lead to the disappearance of public debt. "Do we really think that this would be desirable or possible?" he remarked. The external imbalances of Member States are not being tackled in a serious manner; the lack of effective demand in Europe calls for more activist economic policy. Pre-in Member States such as Hungary are reluctant to rush into the euro area as long as fiscal union and political union remain incomplete. Yet, only if they apply now can they effectively participate in shaping the future of EMU.

Economic union: convergence in the euro area – a pious wish? (session 1)

The session's chair, *Kurt Pribil*, Executive Director at the OeNB, illustrated the divergence tendencies in the euro area: In the first years of EMU, Germany had recorded low growth and high unemployment but recovered as a result of reforms and rising demand from emerging markets. Spain, on the other hand, had initially benefited from capital inflows causing a housing boom, but was seriously hit by the crisis as capital was repatriated (to Germany) and today is only about to reach pre-crisis GDP levels. Taken together, the first 15 years of monetary integration did not bring about the desired catching-up of poor to rich countries.

According to *Anna auf dem Brinke*, research fellow at the Jacques Delors Institute, Berlin, the track record of EMU has been mixed: Economic convergence in the run-up years toward monetary unification was followed by years of divergence that cumulated in the financial crisis. But the euro area needs cyclical convergence to reduce imbalances, and real convergence for social cohesion, she stated. This requires investment, structural reforms and stronger institutions. A promising area of reforms would be the completion of the European single market for services, the fastest growing and most employment-intensive sector. Investment in childcare, education and training has the potential for integrating outsiders into the labor market and enhancing equity and efficiency. Survey data has revealed that public support for reforms hinges on how informed the public is.

Fabian Zuleeg, Chief Executive, European Policy Centre, investigated the question whether divergence has the power to tear the EU apart. He claimed that convergence is a decisive factor for the euro area, because it has implications for the accumulation of imbalances and for long-term prospects and thus for investment, growth, jobs, the banking system and public finances. Economically, we can deal with divergence, but politically we cannot, Zuleeg stated. The Five Presidents' Report offers valuable suggestions, but the intentions to actually implement the reforms are limited. First steps like the establishment of the European Fund for Strategic Investment (EFSI) have not been truly effective since the EFSI benefits countries that have sufficient fiscal space anyway. As an alternative, Zuleeg proposed, we should implement a golden rule for public and social investment. Developing a European fiscal capacity would be key to overcoming limitations of fiscal space. It also might help solving the political economy problem of vanishing trust.

Heiner Flassbeck, editor of Makroskop and former chief economist of UNCTAD, focused on current account imbalances within the euro area in the run-up to the crisis that were mainly caused by unequal wage developments in northern and southern Europe. He was particularly critical of German wage restraint. Since the crisis, however, this situation has changed drastically and, with the exception of France, all member countries of the euro area now have positive external balances. He criticized the asymmetrical approach in the macroeconomic imbalance procedure (MIP), which favors surpluses over deficits, implying the false assumption that economic growth could be fostered through exports alone. At the same time, restrictions imposed on fiscal policy prevent a revitalization of economic activity. In terms of accounting identities, EMU is faced with an unusual situation: all domestic sectors of the economy – households, firms and to some extent even governments have become or are becoming net savers. This has given rise to unusual situations, such as the one in Italy: a country having a current account surplus only because of a sustained period of recession resulting from contractionary fiscal policies. In Flassbeck's opinion, only the government sector can solve the problem of low economic growth, especially since monetary policy transmission via lowering interest rates is no longer working, even though the ECB is trying to convince the corporate sector to assume a debtor role again, rather than a creditor role.

Financial union: a tool for risk-sharing in EMU? (session 2)

The session's chair, *Philip Reading*, Director of the OeNB's Department for Financial Stability and the Supervision of Less Significant Institutions, addressed the importance of identifying and preventing macrofinancial risks, which requires the swift implementation of macroprudential measures and mechanisms.

Daniela Gabor, associate professor at UWE Bristol, argued that the "Lamfalussy approach" of the pre-crisis EMU era had aimed at a market-based financial system, which was more efficient than bank-based systems but also inherently instable. Already Lamfalussy had acknowledged that a liquid and transparent government debt market plays a central role in a financial union. This was illustrated by the sovereign debt crises, which brought about a fragmentation of the banking sector just as collateral for repo transactions (i.e. sovereign bonds) was being rated differently across euro area countries. With the crisis, the creation of banking union marked a shift toward federalization. Capital markets union (CMU), however, implies a new market approach toward simple, transparent and standardised (STS) securitizations. Since market-based finance is collateral-intensive, markets that circulate collateral need adequate regulation. Gabor advocated fiscal risk-sharing and an institutional framework to ensure that all euro sovereigns supply safe assets.

Nicolas Véron, senior fellow at Bruegel, Brussels, stated that one has to accept the current political preference of private over public risk-sharing as a basic working assumption; i.e. banking union and CMU are prioritized over fiscal union.

Although it is still incomplete, banking union has borne some fruit: the shared supervision is already quite powerful. To strengthen banking union, however, it is necessary to improve crisis management instruments. With regard to the diabolic loop between banks and sovereigns, he favored maintaining the fiction of credit risk-free sovereign debt in the euro area instead of introducing risk weights, but he added that the exposure of banks to government bonds needs to be limited. However, bank resolution and a euro area-wide deposit insurance scheme are still in their infancy, he argued. Véron called for a single rulebook for bank insolvency instruments and more profound crisis management instruments and resources, including a fiscal backstop.

Stephan Bruckbauer, Chief Economist of UniCredit Bank Austria, considered financial union as crucial for risk-sharing. The regulation of financial markets has effectively helped to decrease risk exposure, however, the decision-making processes lack transparency and are thus hard to understand. Despite some re-convergence of corporate interest rates, the heterogeneity of the euro area banking and financial markets remains the main challenge for financial union. In particular, Bruckbauer noted different behaviors in the housing, corporate and state sectors across member countries. Furthermore, European institutions, such as the SSM need further streamlining, and more transparency needs to be guaranteed to avoid "regulatory overkill." A European deposit insurance scheme might enhance financial integration, he added. Lastly, for a financial union to function, deeper fiscal integration is required.

Fiscal union: toward a treasury for the euro area? (session 3)

The session's chair, *Peter Mooslechner*, Executive Director at the OeNB, stated that fiscal union affects both public risk reduction and risk-sharing.

Pasquale D'Apice, European Commission, focused on comparing the EU budget and the U.S. budget, using average data for the years 2007 to 2013. However, unlike the EU, the U.S.A. rests on a fully fledged fiscal and political union. There is a direct fiscal relationship between U.S. citizens and their federal government, which covers more than half of total public spending. In the EU virtually all of the comparable expenditures are made by Member States. Cross-border EU budget flows amount to around 0.25% of the EU's GDP, i.e. only one-sixth of those recorded in the U.S. in normal times, but they have a higher redistributive power. The allocation of the EU budget is heterogeneous across countries and progressive, supporting catching-up regions.

Jürgen Matthes, Cologne Institute for Economic Research, questioned the narrative according to which the crisis brought to the fore that EMU sustainability hinges on more fiscal integration. According to him, the causes that made the sovereign debt crisis so severe were exceptional and non-repetitive. Also, significant demand-side weaknesses were only temporary and ad hoc measures are sufficient to address them (e.g. ECB policy and EFSI). Many reforms at EMU and country level have addressed the key roots of the crisis and have improved the functioning of EMU – a fact that is often underappreciated. He suggested a fiscal macroeconomic stabilization mechanism in order to improve the capacity for counter-cyclical fiscal policy, but said that this might prove unnecessary if the measures that have already been adopted are fully implemented and further necessary steps are taken.

Eulalia Rubio, Jacques Delors Institute, diagnosed major shortcomings in EMU's fiscal framework in terms of future crisis responses and fiscal stabilization measures at both the aggregate and the national level. She highlighted the need for a deeper reform in the long term, guided by criteria such as consistency, political feasibility, pragmatism and appropriate sequencing. She elaborated on potential design principles for a fiscal risk-sharing mechanism and on her reform idea of an EMU stabilization function based on the EFSI. The advantages Rubio sees in such an EFSI-based stabilization function are its significant fire power and possible allocation to high-quality projects.

Political union: a European dream? (policy panel)

The final policy panel was chaired by *Doris Ritzberger-Grünwald*, Director of the OeNB's Economic Analysis and Research Department.

Ulrike Rabmer-Koller, President of the European Association of Craft, Small and Medium-sized Enterprises (UEAPME), called for politically realistic steps instead of a fully fledged political union, such as the introduction of National Productivity Boards as recommended by the European Council. Such steps could be complemented by productivity partnerships of social partners and initiatives to close the gaps in investment and skills. Rabmer-Koller advocated more flexibility with respect to the Stability and Growth Pact in exchange for reforms, e.g. of pension systems, as well as efficient European automatic stabilizers provided that moral hazard is excluded. In her opinion, unfeasible dreams should not be used as an excuse for national governments and social partners to do nothing.

Gabriele Bischoff, President of the Workers' Group in the European Economic and Social Committee, emphasized that EMU does not only need to rest on an economic and political pillar, but also on a social pillar. She pointed out that it has been the social erosion of the middle class in Europe, in particular, that has given rise to xenophobic nationalism. She suggested focusing on reforms within the existing treaty framework, such as a golden rule for investment or a European unemployment insurance scheme. Democratic legitimacy could be built on existing political institutions such as the Macroeconomic Dialogue, the Committee of the Regions and national parliaments. Job security and higher wages could reinstall confidence that Europe can shape globalization.

Paul Lindquist, European Committee of the Regions' Commission for Economic Policy, acknowledged that EMU has achieved a lot in terms of travel cost savings, growth, jobs, social fairness and stability. Nevertheless, increasing regional disparities have to be addressed by appropriate cohesion policies. Local and regional governments can provide the necessary expertise; they account for more than half of public investment and may apply the necessary ownership for reforms. Lindquist went on to say that populism is a reaction to overpromises and underdeliveries but does not offer solutions. Politicians should tell the truth, i.e. that a well-managed EMU with a fiscal capacity could help to better absorb crises.

Heinz Zourek, former Director General for Taxation and Customs Union of the European Commission, pointed to the lack of knowledge about the meaning of political union. Establishing a euro area treasury or a finance ministry are, in his view, two different things with regard to both the expenditure and revenue side. However, on taxation he noted that every Member State is now on its own, which is contributing to the erosion of political support for EMU. Instead of scapegoating

Brussels, national politicians need to explain that joint forces facilitate solving urgent problems even without a full-fledged political union.

In his closing remarks, *Edmond Alphandéry*, Chairman of the Euro50 Group and former finance minister of France, stated that despite the blow Brexit has delivered to the European Union, the EU remains attractive to Balkan countries. The values of the EU are more important than ever: democracy, diversity and freedom. He reminded the audience of the EU's origins, quoting Robert Schuman's acclamation, "Never again war in Europe!". He also alluded to the Monnet Method and stated that whenever a problem arises at the European level one has to find a solution at the European level. Currently, this applies to security issues with conflicts in neighboring regions and risk concerning relations between Europe and the U.S.A., since the latter is threatening to fall into isolationism. Pooling defense expenditures would also help to reduce German current account surpluses. On the euro area, he noted that even if the crisis has not been solved in an ideal manner, the euro is more solid than some believe. In conclusion, he insisted on two further reform steps: a European deposit insurance scheme and sovereign bankruptcy rules.