



The future of economic and monetary union in Europe

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Outline

- 1. Maastricht assignment:** *What has been achieved?*
- 2. Since the Great Recession:** *What went wrong and what has been done to fix it?*
- 3. Looking ahead:** *How could a sustainable institutional architecture for EMU look like?*

EMU provides clear benefits, but has potential costs

Key benefits of EMU

- Elimination of exchange rate risks in relation to its main trade partners
- Reduction of transaction and information costs
- Lower long-term interest rates due to a credible framework for fiscal and monetary policy
- Trade and financial market integration

Potential costs of EMU

- Differences in business cycles can lead to "sub-optimal" interest rate in a national context
- Competitiveness problems can no longer be solved through nominal exchange rate adjustments
- Insufficient wage and price flexibility to adjust to changes in competitiveness and or shocks could lead to protracted economic losses

- The higher the heterogeneity, the higher the costs
- A sufficient degree of convergence is needed (ex-ante or ex-post?)
- But what means "sufficient"?

Divided views on EMU's future

The pessimists' view: EMU will fail!

Possible explanations:

- Free-riding in fiscal policy (*Eichengreen, 1995*)
- Weak central bank (*Gormley and de Haan, 1996*) and weak currency (*Cohen, 1998*)
- 'A currency without a state' (*Padoa-Schioppa, 2004*)
- Ill-designed convergence criteria (*Buiter et al., 2013*)
- Lack of democratic legitimacy (*Mayone, 1998*)
- Dominance of large Member States (*Moravcsik, 1998*)

The optimists' view: EMU will become a success (*'endogenous OCA'*)

Possible explanations:

- Increased trade integration (*Frankel and Rose, 1998*)
- New impetus for structural reforms due to increased competition (*Calmfors, 1998*)
- Increasing foreign direct investment (*Darvas and Szapary, 2008*)
- Monetary and political stability leading to reduced risk premium in interest rates on government bonds (*Wagner, 2014*)

Major successes in the first 10 years of EMU

Monetary	<ul style="list-style-type: none">• Well-anchored long-run inflation expectations close to the ECB's definition of price stability• Euro established itself as the world's second international currency
Fiscal	<ul style="list-style-type: none">• Sound fiscal positions, supporting macroeconomic stability
Economic	<ul style="list-style-type: none">• Fostered economic and market integration (notably via the Single Market)• Greater synchronisation of business cycles• Significant catching-up process• Improved resilience against adverse external developments
Financial	<ul style="list-style-type: none">• Stronger financial (notably bond) market integration

Source: European Commission (2008): EMU@10. Successes and challenges after ten years of Economic and Monetary Union, European Economy, 2.

Major challenges identified

Fiscal

- Build-up of large fiscal imbalances in some countries

Economic

- Potential growth too low
- Substantial and lasting differences across countries in terms of inflation and unit labour costs
- Catching-up process supported by capital misallocation

Financial

- Financial markets may have underestimated sovereigns' risk

Political

- Lack of a clear international strategy and the absence of a strong voice in international fora implies costs for the euro-area in an increasingly globalised world
- Overall support for the euro but lack of legitimacy and euro as scapegoat

Source: European Commission (2008): EMU@10. Successes and challenges after ten years of Economic and Monetary Union, European Economy, 2.

Europe had to cope with two crises

- ***Global financial crisis (in 2008-09)***
 - US subprime mortgage crisis
 - Failing market discipline (risk premia too low)
 - Excessive risk-taking in the banking sector
- ***Euro area sovereign debt crisis (in 2010)***
 - Unsustainable budget deficits and debt
 - Excessive macroeconomic imbalances
 - Several countries lost market access
 - Euro area's viability in danger

Design flaws in EMU's institutional architecture

Fiscal

- Fiscal framework was weakly enforced, focused too little on debt, did not prevent pro-cyclical fiscal policies

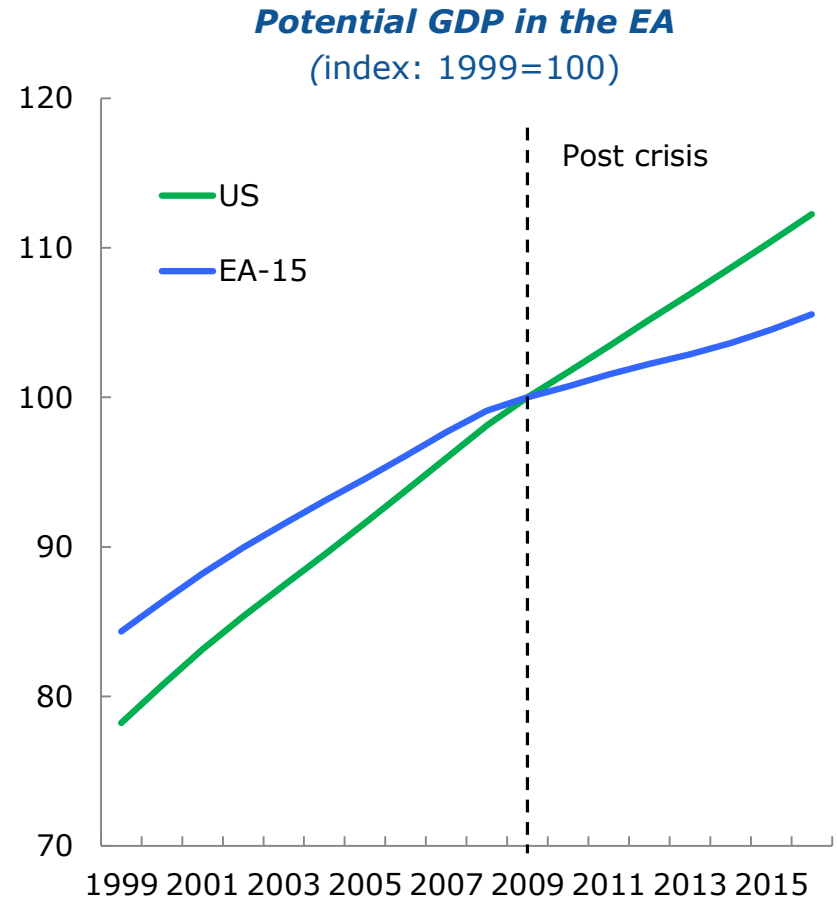
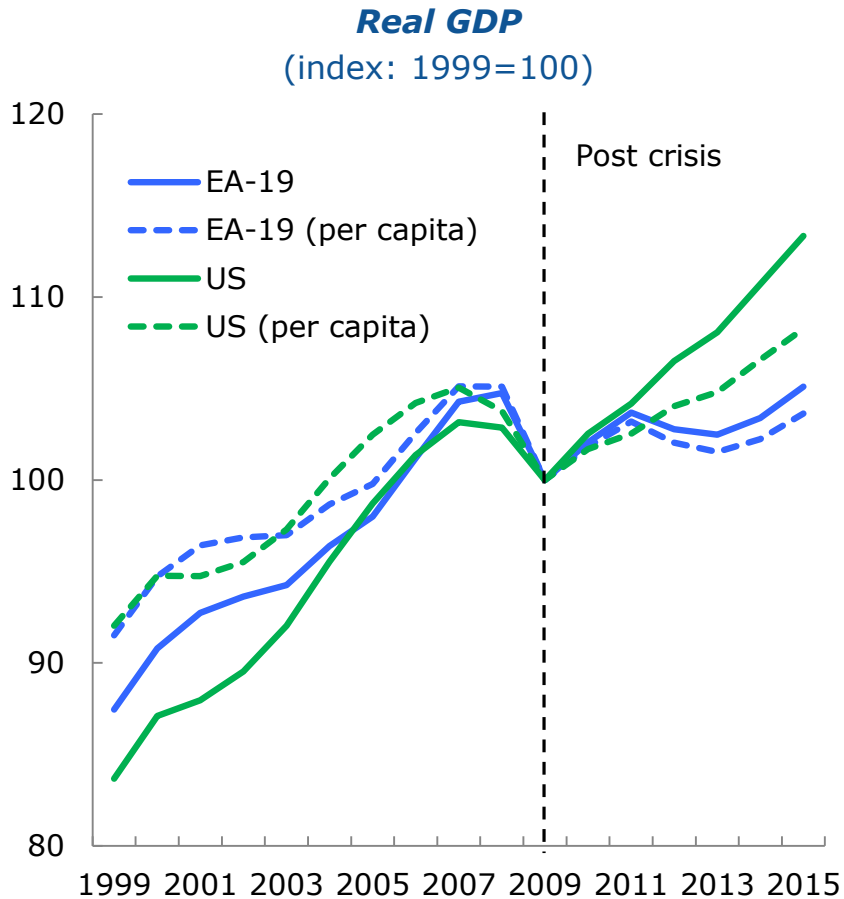
Economic

- Lack of tools to prevent macroeconomic imbalances
- No mechanism/instruments to foster structural reforms

Financial

- Lack of a sovereign-debt crisis management mechanism
- No integrated European supervisory and regulatory architecture for financial institutions
- Doom loop between banks and sovereigns: High bank dependency/little diversified sources of finance

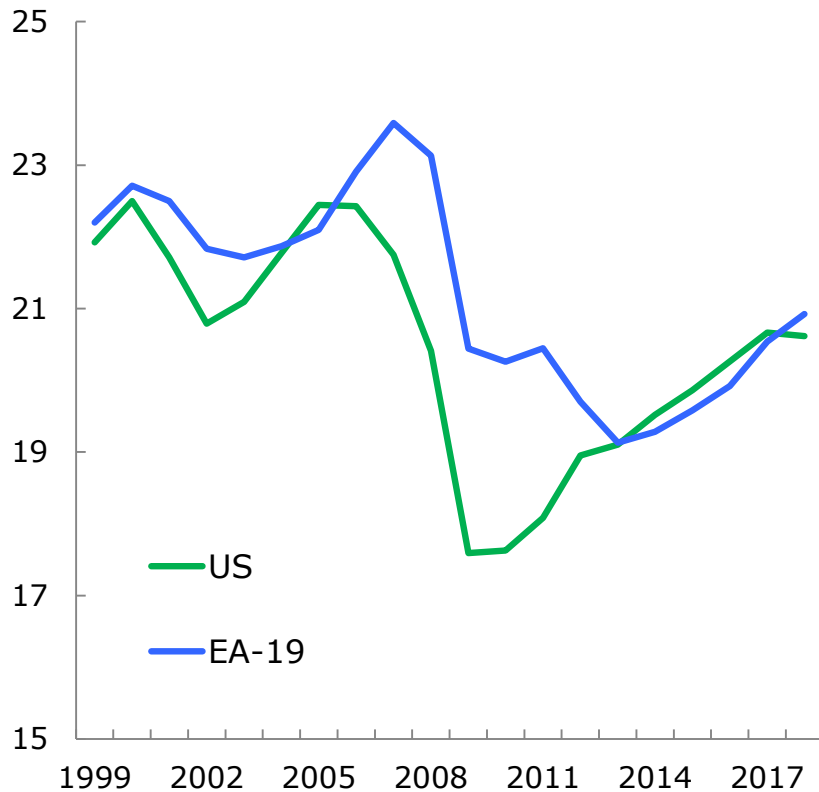
Great Recession revealed sizeable growth differences between EA and US



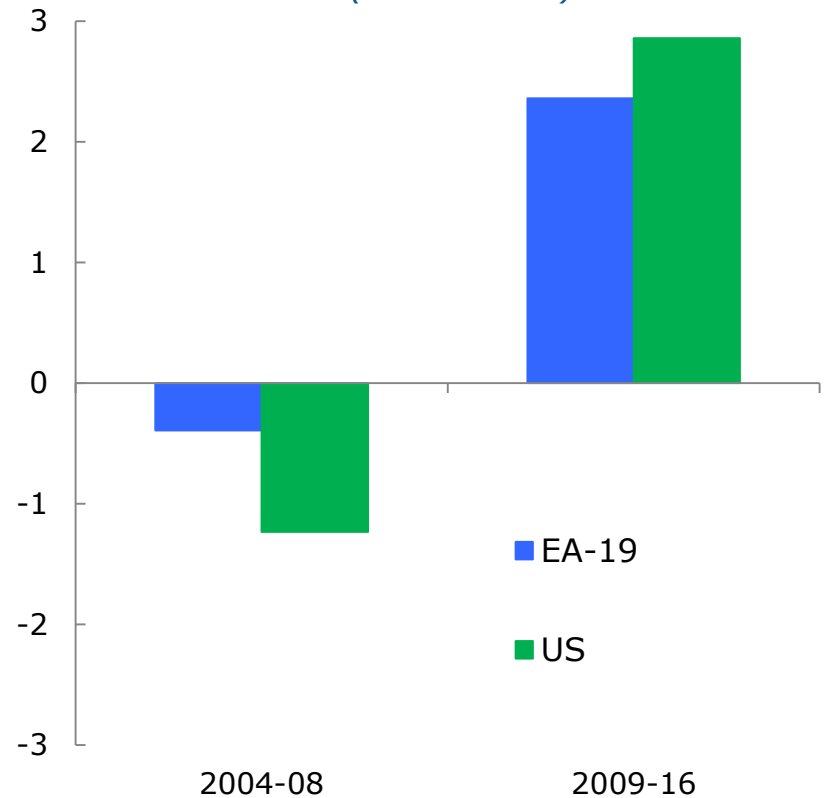
Source: Own calculations based on Ameco, Spring forecast 2016.

Strong deterioration in investment and fiscal positions in both the EA and the US

*Investment to potential output ratio
(in %)*



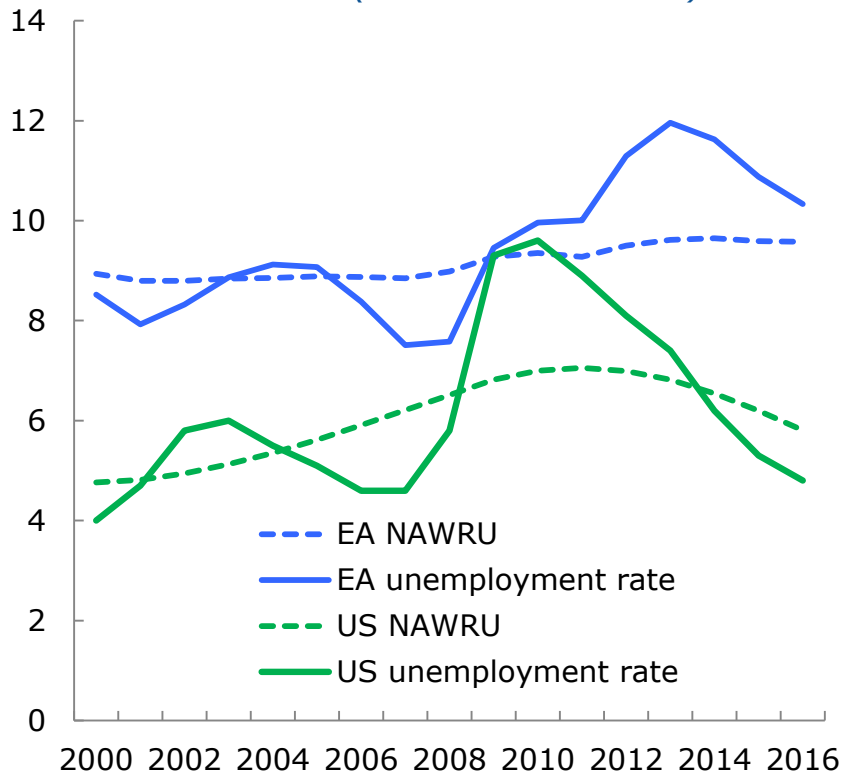
*Change in structural balances
(in % of GDP)*



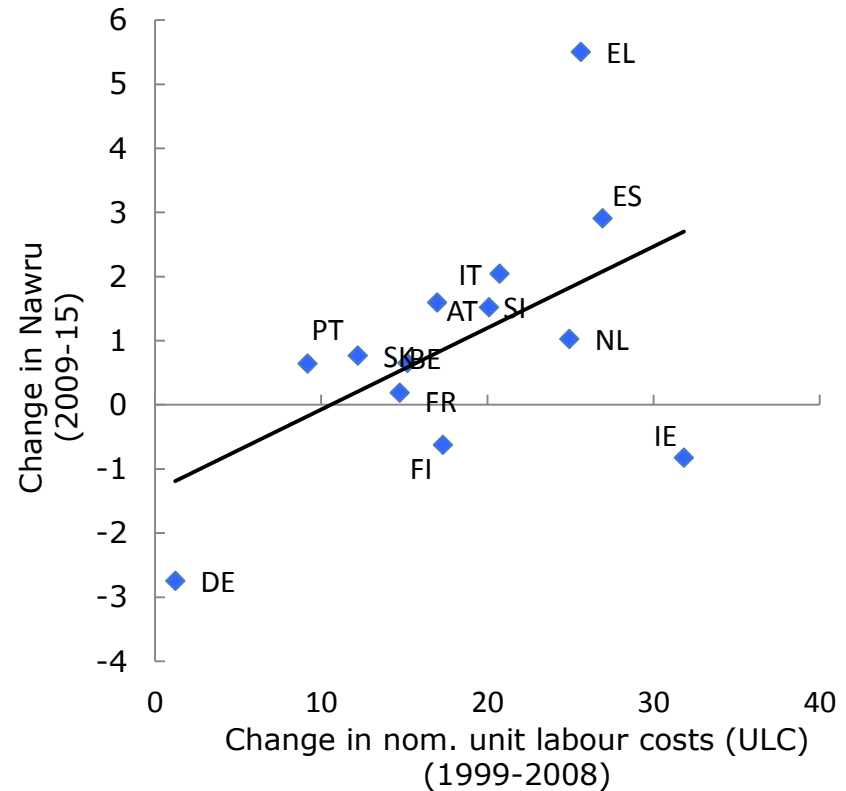
Source: Own calculations based on IMF World Economic Outlook, October 2015.

Slower adjustment in the EA mainly due to: (1) More rigid labour and product markets

Unemployment rate (in %) and NAWRU (in % of labour force)



Changes in ULC and unemployment rate

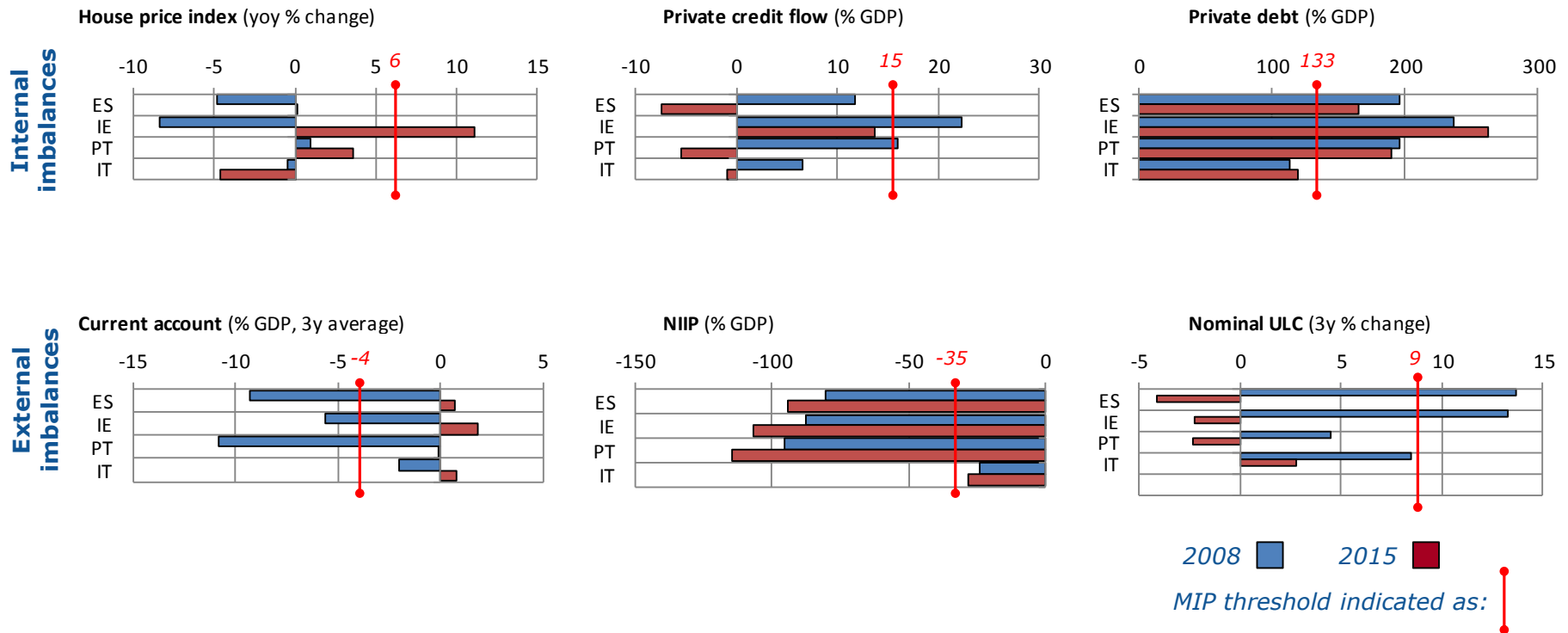


Note: LHS: Euro area corresponds to EA-12, RHS: Increases (decreases) in the NAWRU/ULC over the time period indicated are recorded with a positive (negative) sign.

Source: DG-ECFIN calculations, Spring forecast 2016.

(2) Build-up of large macroeconomic imbalances in vulnerable countries

Selected MIP scoreboard indicators 2008 versus 2015

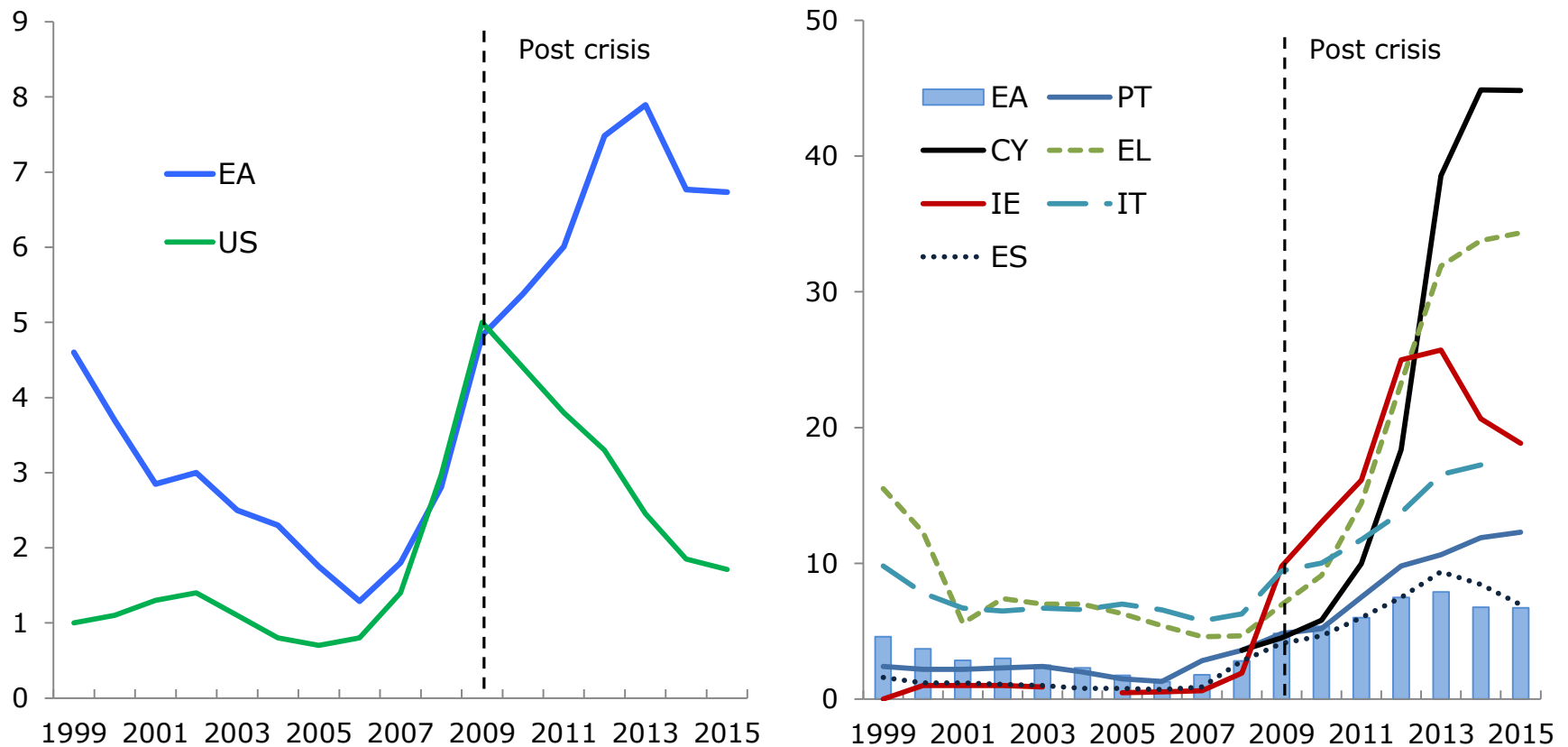


Note: Data for private debt and private credit flow are only available until 2014.

Source: Eurostat.

(3) Slower fixing of the banking system and more bank-centric economy

Bank non-performing loans to gross loans (in %)



Source: World Bank World Development Indicators.

Far-reaching changes in the EA institutional framework since the crisis

Policy area	General objective	Elements in greater detail
Fiscal	<i>Stronger surveillance and enforcement</i>	<p><i>Stronger preventive arm of the SGP</i></p> <ul style="list-style-type: none"> • Introduction of an expenditure rule (6-P) and balanced budget rule (TSCG) • Possibility of imposing sanctions (6-P) • Surveillance of draft budgetary plans by Commission (2-P)
		<p><i>Stronger corrective arm of the SGP</i></p> <ul style="list-style-type: none"> • Introduction of a numerical debt benchmark (6-P) • Earlier and more gradual sanctions (6-P) • More automaticity in decision-making via new voting scheme (TSCG)
Economic	<i>New surveillance</i>	<ul style="list-style-type: none"> • Prevention and correction of macroeconomic imbalances via the introduction of the Macroeconomic Imbalance Procedure (MIP) (6-P)
Financial	<i>New crisis resolution mechanism</i>	<ul style="list-style-type: none"> • European Stability Mechanism (ESM) • OMT programme by the European Central Bank (ECB)
	<i>New supervision and resolution</i>	<p><i>New Banking Union:</i></p> <ul style="list-style-type: none"> • Single Supervisory Mechanism (SSM) • Single Resolution Board (ERB) and Single Resolution Fund (SRB) • Under construction: Common deposit insurance scheme

Note: Key reforms steps taken in the area of fiscal and macroeconomic policies are shown in italics in brackets, namely 6-Pack (6-P), Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG), 2-Pack (2-P).

Much stronger risk reduction and risk sharing in the US than in the EA

		Elements in the US	Reached in EMU?
Risk Reduction		<ul style="list-style-type: none"> Effective no bail-out clause (e.g. Puerto Rico, California, 1840s) 	Red
		<ul style="list-style-type: none"> Strict enforcement of fiscal rules (sharp fiscal adjustment can be required) 	Red
Risk Sharing	Private	<ul style="list-style-type: none"> Significant private risk-sharing (via foreign financial markets, including through foreign capital markets) 	Red
	Public	<ul style="list-style-type: none"> Full Banking Union: little contagion of sovereign debt stress to bank balance sheets 	Orange
		<ul style="list-style-type: none"> Significant fiscal stabilisation/redistribution 	Red

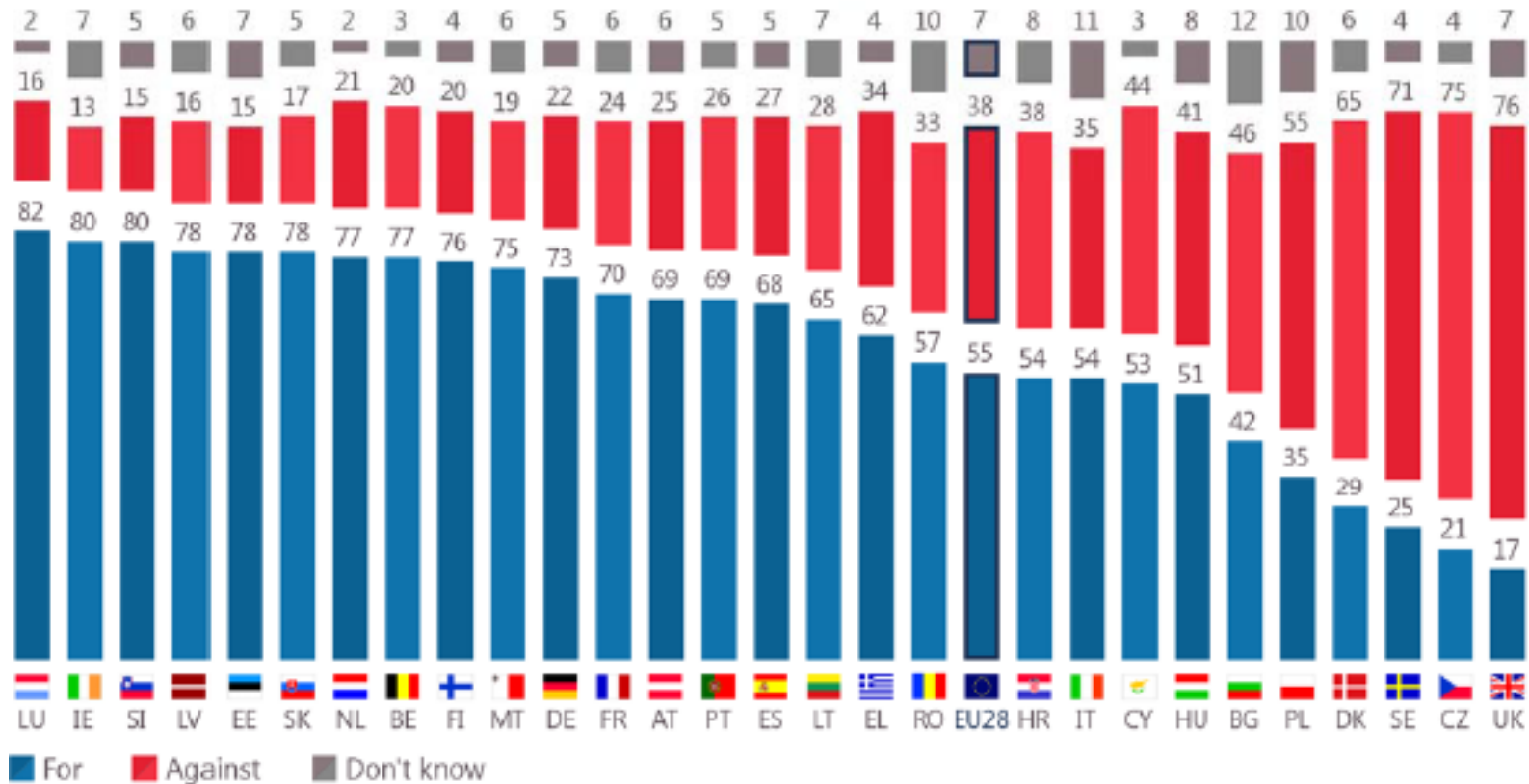
→ EMU is a monetary union "sui generis"

Note: Green / orange / red stand for 'fulfilled' / 'partly fulfilled' / 'not fulfilled'.

Competing views on EMU's future

	Maastricht+	EU Federalists	Hybrid
Fiscal	<ul style="list-style-type: none"> Decentralised and rule-based fiscal policy Credible SGP (incl. enforcement of rules) 	<ul style="list-style-type: none"> Introduce sizeable public risk sharing (notably via fiscal stabilisation tool) Possibility of a veto to block national budgets 	<ul style="list-style-type: none"> Improvements in application of the SGP with a focus on simplicity, predictability and consistency
Economic	<ul style="list-style-type: none"> MS implement structural reforms to create competitive economic structures 	<ul style="list-style-type: none"> Pooled decision over elements of national policies 	<ul style="list-style-type: none"> "Significant and sustained progress towards similar resilient economies" as a condition for access to a shock absorption capacity
Financial	<ul style="list-style-type: none"> No further private risk-sharing Automatic sovereign debt restructuring in the event of EMU support End of risk-free status for sovereign debt 	<ul style="list-style-type: none"> Emphasis on private risk-sharing (notably via full Banking and Capital Markets Union) 	<ul style="list-style-type: none"> Emphasis on private risk-sharing (notably via full Banking and Capital Markets Union)
Political		<ul style="list-style-type: none"> EA Parliament created EP co-legislator for all elements to complete EMU EA treasury 	<ul style="list-style-type: none"> New EA chamber of EP Joint representation of EA at IMF

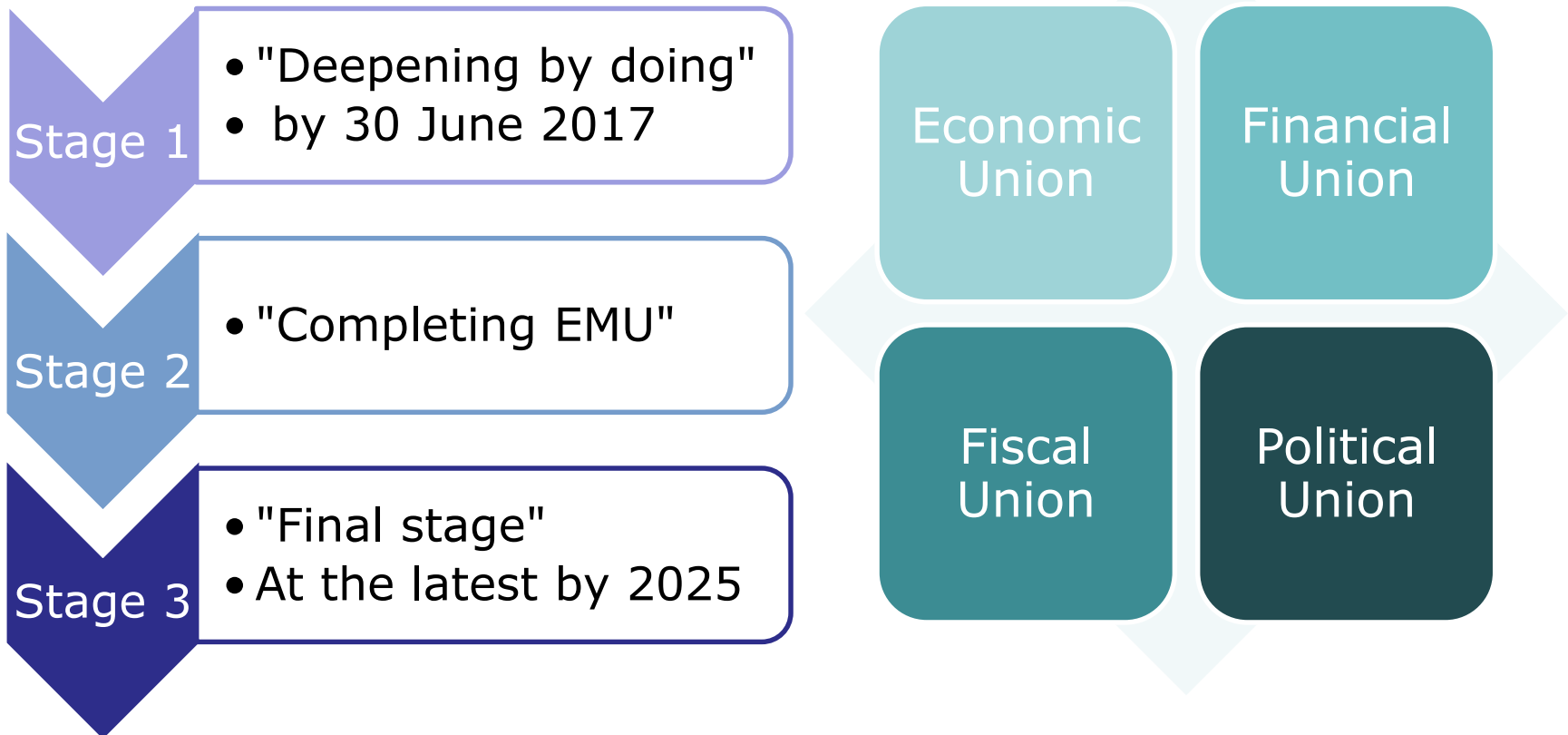
The single currency still receives EU citizens' support



Note: Eurobarometer question: What is your opinion on the following statement. Please tell me whether you are for or against it. A European economic and monetary union with one single currency, the euro?

Source: Standard Eurobarometer, 85, May 2016.

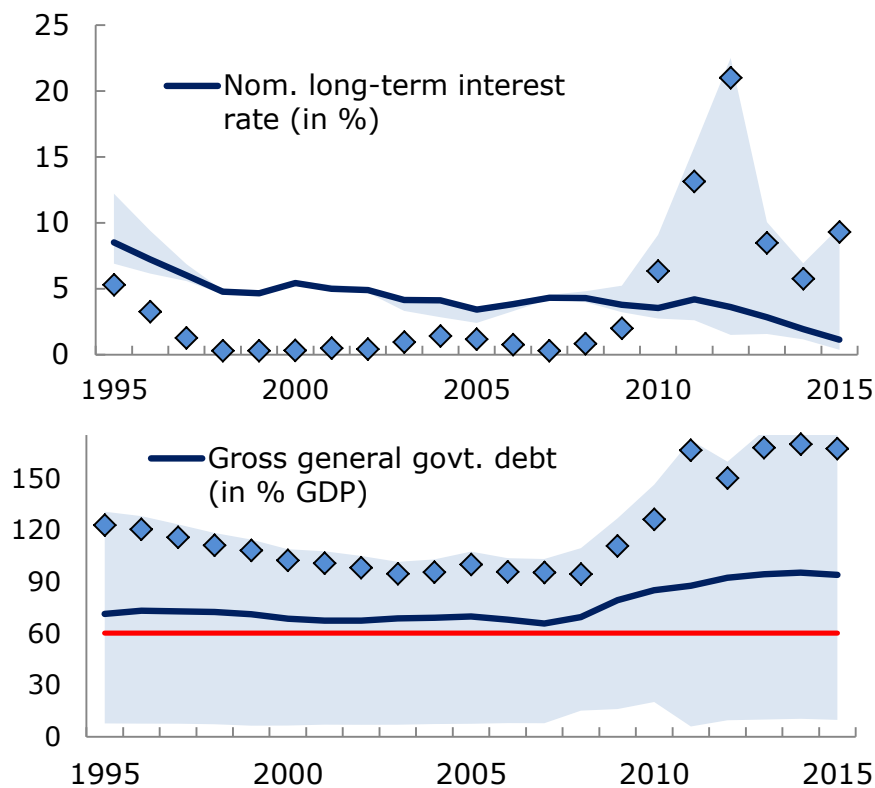
A concrete and comprehensive reform proposal: 5 Presidents' Report: 3 stages, 4 unions



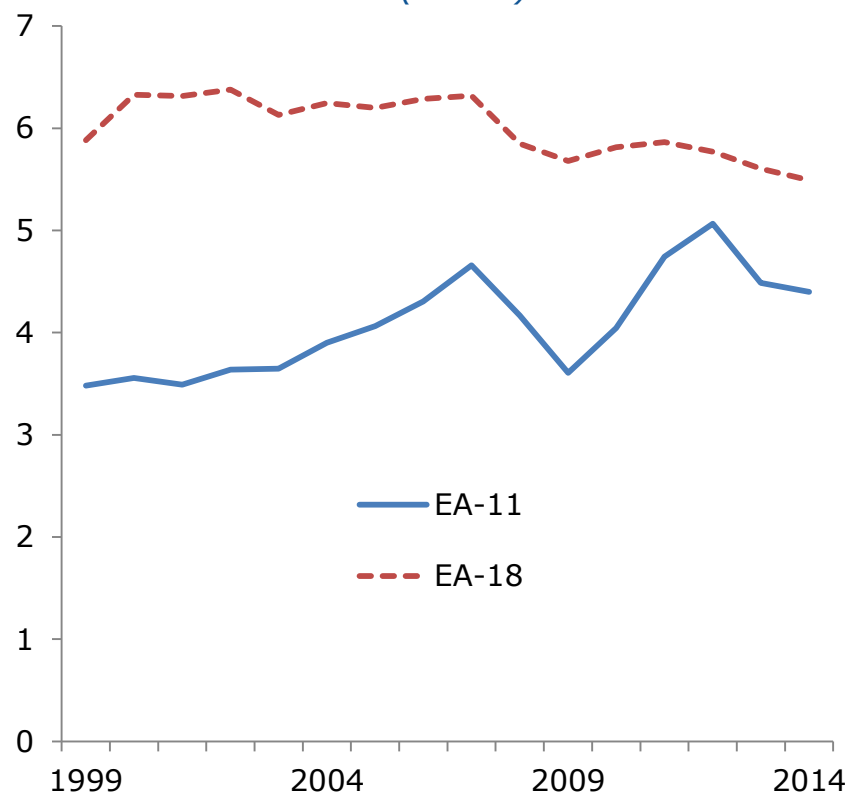
Economic Union: What is at stake?

No sustainable convergence process in EMU

Nominal convergence
(1995 – 2015)



Dispersion GDP per capita
(in PPS)



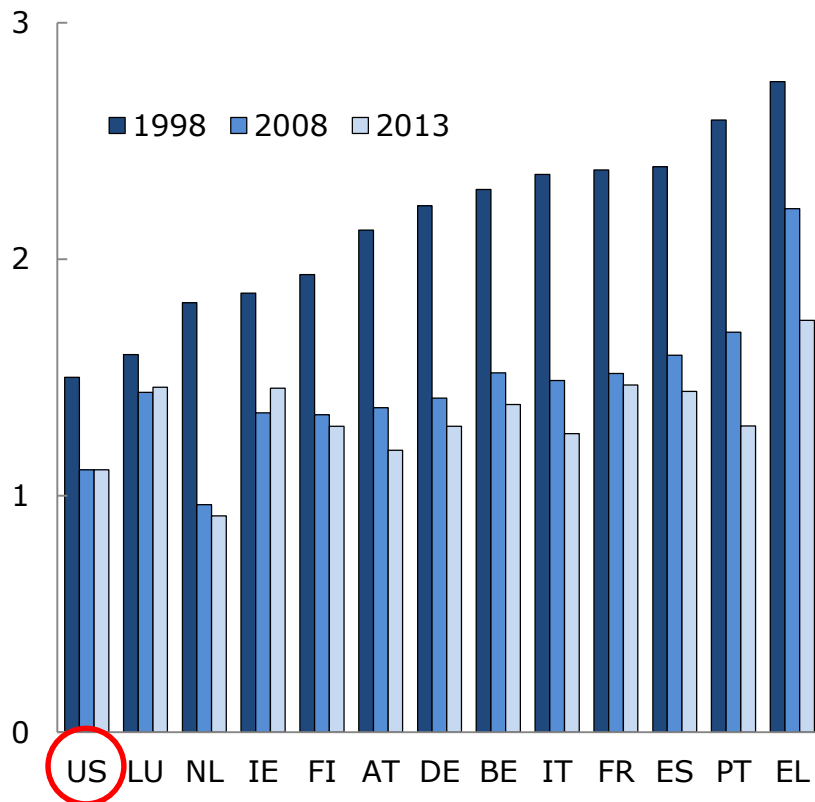
Note: Blue shaded areas show the distribution of the observed indicators (from max to min) across EA Member States. The dark blue lines display EA-12 averages. Blue diamonds show the maximum value. Red line shows the Maastricht target for debt (60% of GDP). *Source:* European Commission forecast April 2016.

Note: Dispersion measured by the standard deviation. EA-11 consist of the founding members of the euro area plus Greece. Luxembourg excluded.

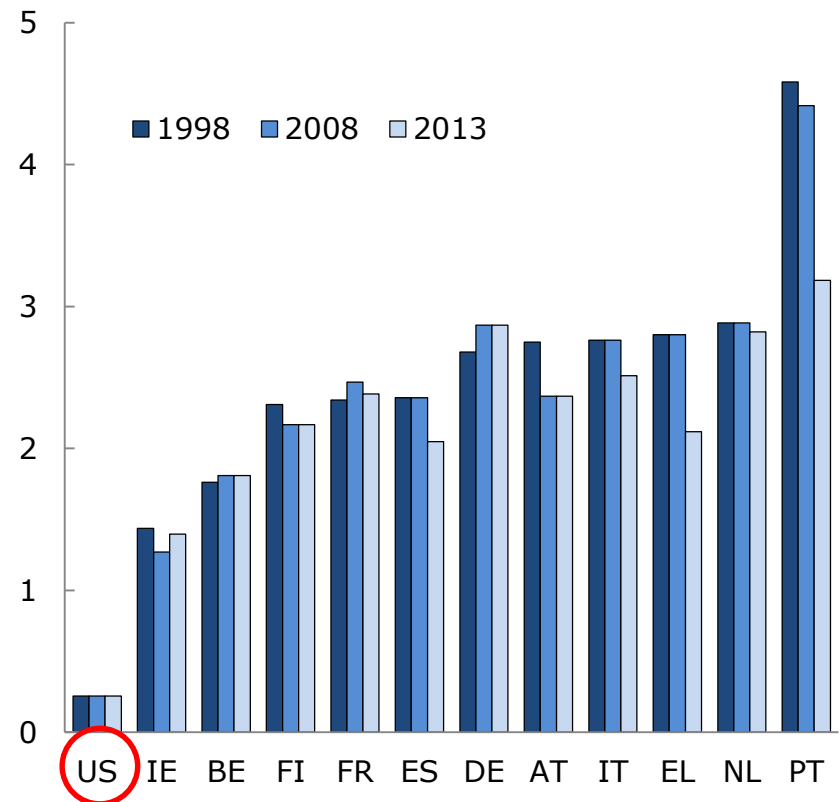
Source: Eurostat. Only available until 2014.

Insufficient convergence towards resilient economic structures

Product market regulation



Employment protection legislation



Note: The graph shows OECD indicators measuring the degree of product and labour market regulation (the latter refers to individual and collective dismissals). Indicators range on a scale from 0 (least restrictions) to 6 (most restrictions). Latest data available 2013.

Source: OECD.

Economic Union: Key policy proposal: Strengthen economic resilience

- **Why?** Increase the capacity of an economy to withstand an economic shock and, if a shock does hit, swiftly adjust to it
- **How?**
 - Agree on a set of high-level standards, mainly in the area of labour, product and financial markets
 - Provide incentives for reforms by granting those countries access to a shock absorption mechanism who made "significant and sustained progress" in implementing reforms
 - Create productivity councils at the national level
- **Key challenges** (to be dealt with by expert group)?
 - Which standards?
 - Sound governance framework?
 - Key role for the Single Market?

Fiscal Union: What is at stake?

Pro-cyclical policies and weak compliance with rules

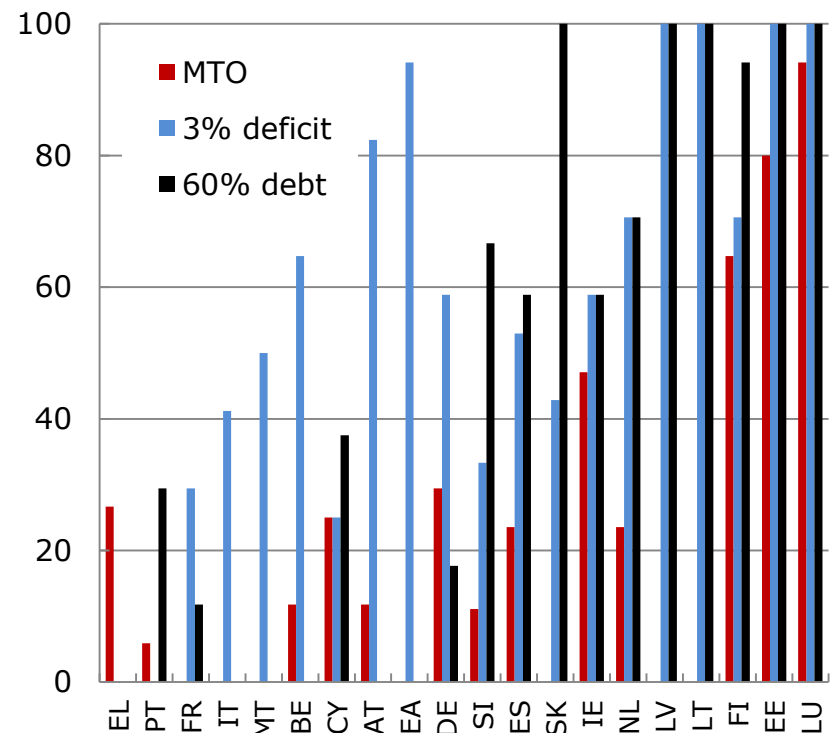
**Fiscal adjustment during boom/
recession periods**
(in % of GDP since EMU membership)

	Boom	Recession
IE	-8.4	4.1
EL	-11.1	7.9
ES	-1.5	-0.7
FR	-0.8	-0.4
CY	-8.0	3.5
SI	-0.2	-1.5
EA-19	0.8	-0.4

Note: Fiscal adjustment represents the aggregated change in the general govt. headline balances during a boom (recession) period, measured by a positive (negative) output gap. Negative (positive) values imply a deterioration (improvement) of the fiscal headline balance.

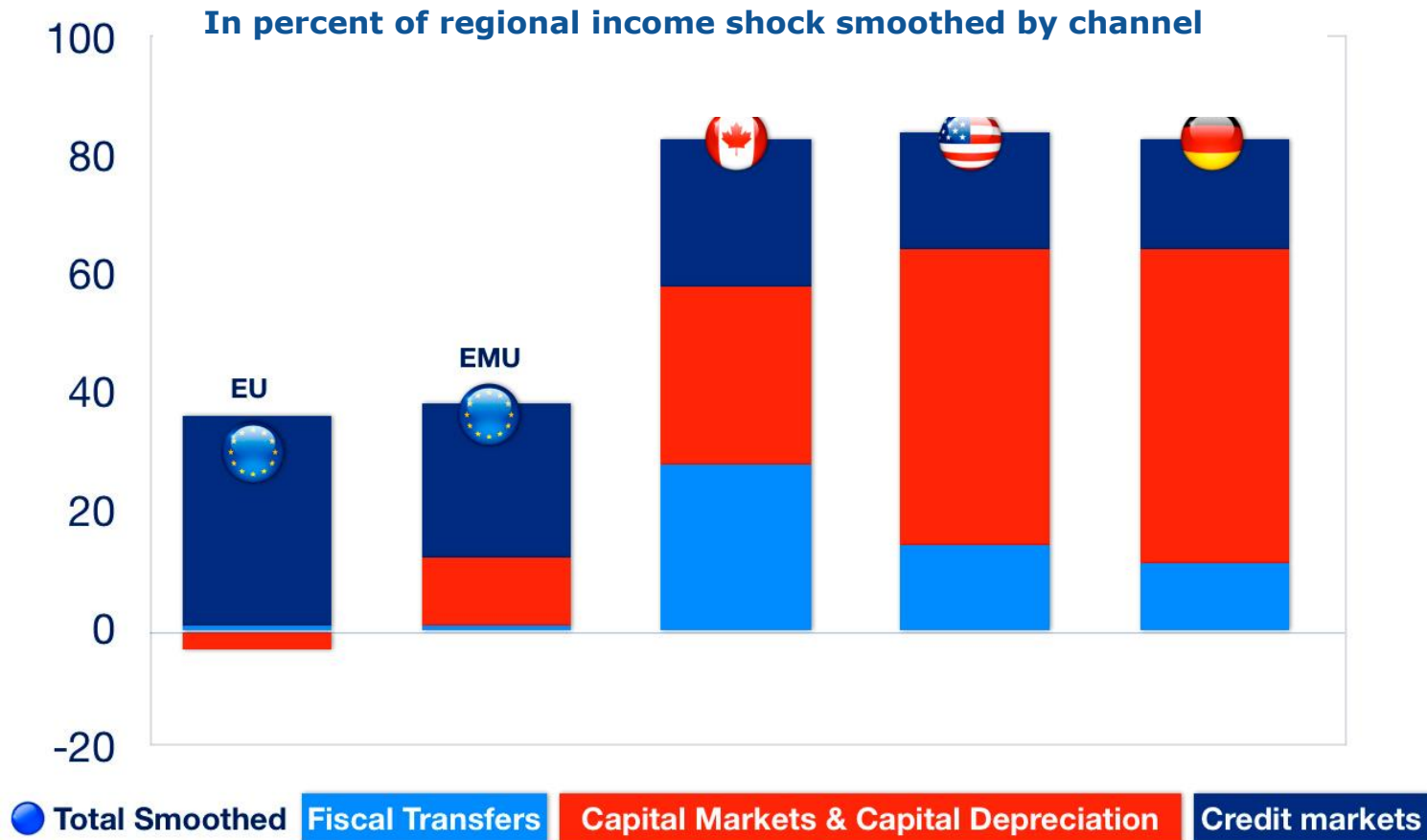
Source: Ameco, spring 2016 forecast.

Meeting fiscal reference values
(in percent of years since EMU membership)



Reading example: LU reached the fiscal reference values of the preventive arm of the Stability and Growth Pact (SGP) (the so-called medium-term objective (MTO)) in around 95% of the years and the corrective arm of the SGP (consisting of the 3% deficit and 60% debt values) in all years since EMU membership. *Source:* Ameco spring 2016.

Low insurance against income shocks in EMU



Source: Allard et al. (2013): Toward a fiscal union for the Euro Area, IMF Working Paper, SDN/13/09, September.

Fiscal Union: Key policy proposal

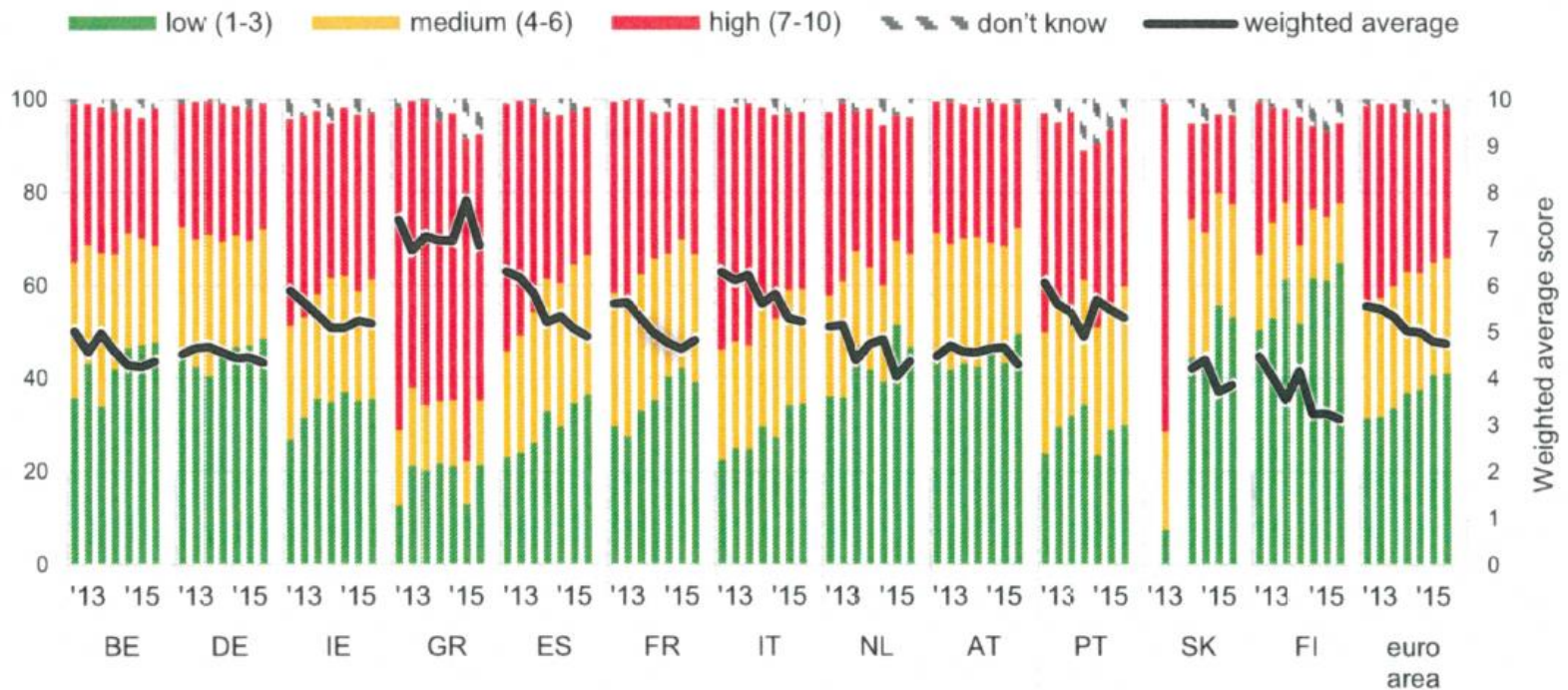
Creation of a fiscal capacity

- **Why?** Stabilise large country-specific shocks and/or common shocks?
- **How?** Different concepts floating in public and among pundits (not mutually exclusive)
 - Unemployment (re-)insurance mechanism
 - Investment capacity
 - Shock absorption capacity
- **Key challenges?** No permanent transfers, beware moral hazard, respect subsidiarity principle, what degree of automaticity?

Financial Union: What is at stake?

Importance of access to finance by SMEs

Survey question: How important is the access to finance perceived by SMEs in the following countries in the past six months



Source: ECB (2016): Survey on the Access to Finance of Enterprises (SAFE) in the euro area. October 2015 to March 2016.

Financial Union: Key policy proposals

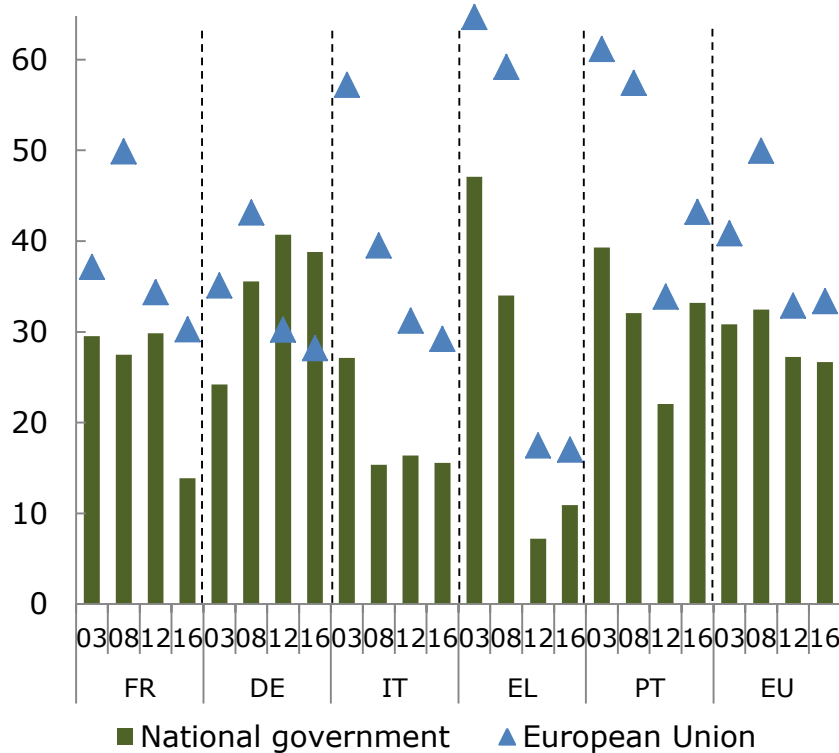
Complete Banking Union, launch Capital Markets Union

- **Why?**
 - European Single deposit insurance could be conceived as re-insurance system at the EU level for the national deposit guarantee schemes
 - Ensure more diversified sources of finance
 - Remove negative feedback loop between sovereign and bank risks
- **How?** Implement the outstanding regulation in the area of Banking Union and draft/implement a regulation for the Capital Markets Union
- **Key challenges?** Avoid moral hazard, public risk sharing

Political Union: What is at stake?

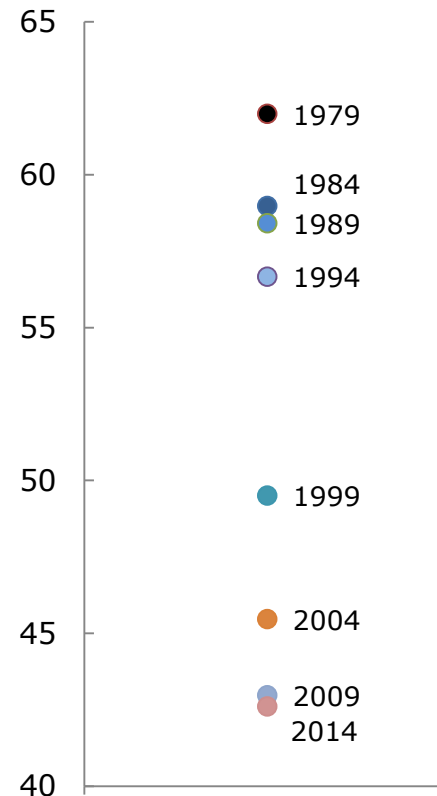
Trust in EU still higher than in national governments

Trust in national governments and the European Union
(% of respondents who 'tend to trust')



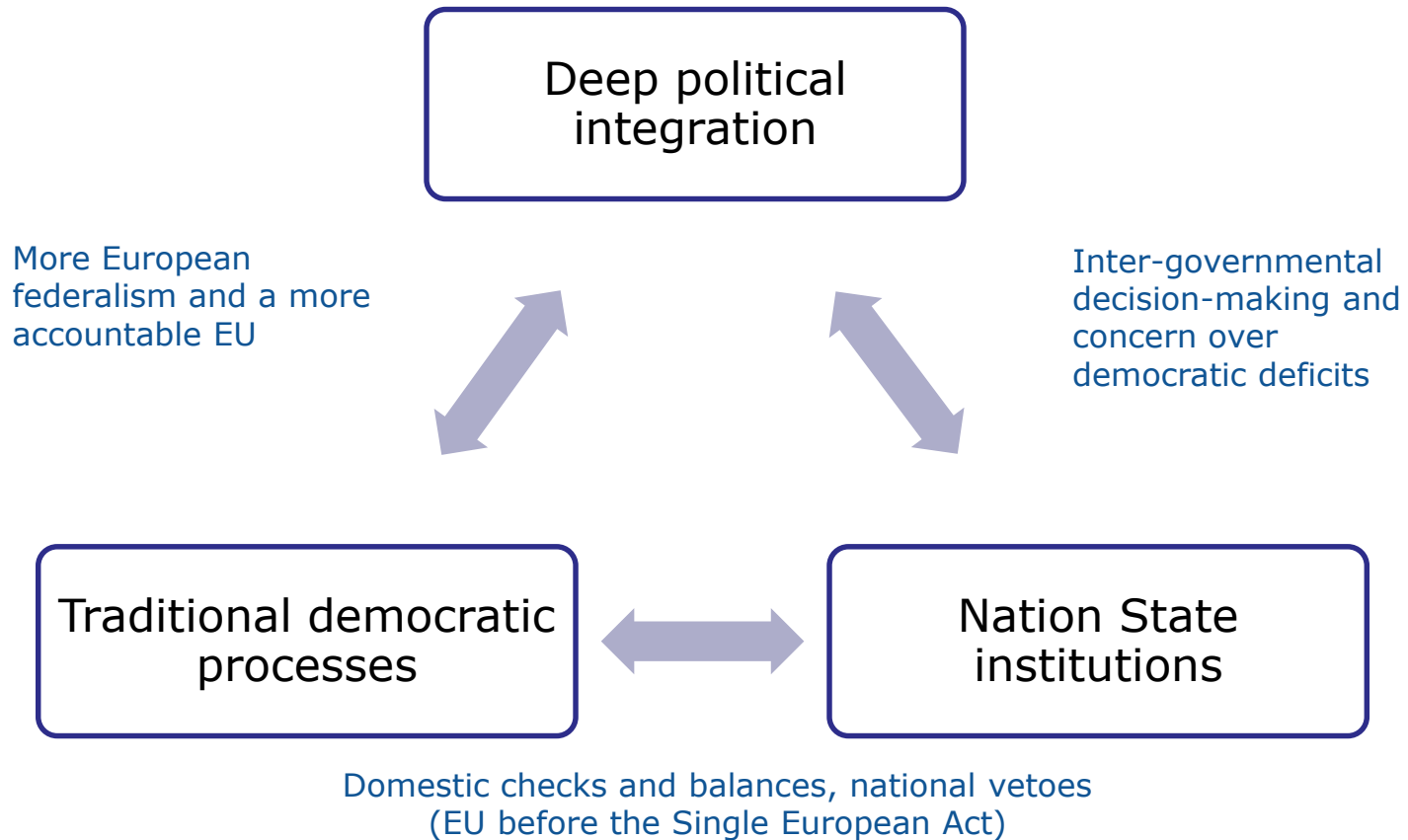
Source: Eurobarometer question: Do you tend to trust the national government (green bars), the European Union (blue triangles)? "EU" refers to the average value for the EU. Time periods covered 2003, 2008, 2012 and 2016.

Voter turnout in elections for the European Parliament
(in % of total electorate)



Source: European Parliament.

Inconsistent trinity: political integration



Political Union: Key policy proposal

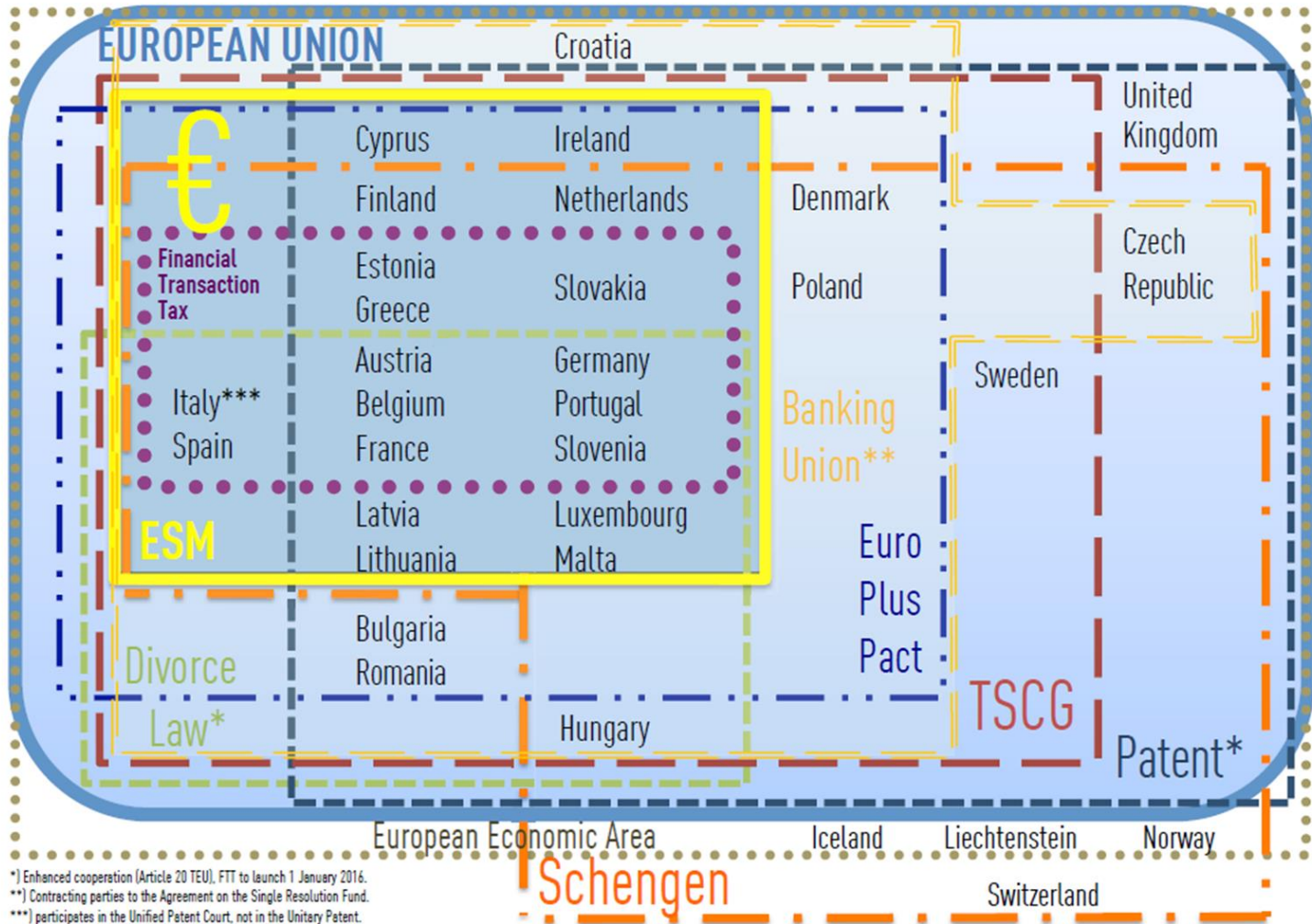
Enhance democratic accountability

- **Why?** Address the democratic deficit
- **How?**
 - Enhanced role of national and European Parliaments (e.g. more systematic appearances of Commissioners in national Parliaments; plenary debate on the AGS)
 - Consolidate external representation of the Euro Area
 - Integrate inter-governmental arrangements into EU law framework (ESM; TSCG; EuroPlus Pact; Single Resolution Fund)
 - Strengthening of Eurogroup
 - Set up a Euro Area treasury accountable at European level
- **Key challenges?** Ensure effectiveness of new procedures

From multi-speed to multi-tier Europe?

- The European Union started as a one-speed project, but developed into a complex multi-speed project contributing to conceptual confusion
- Various factors will continue to drive increased differentiation
 - Crisis-induced strengthening of EMU governance
 - Tendency towards intergovernmentalism
 - Increased heterogeneity of EU
- Transition towards multi-tier Europe?

A highly differentiated European reality



*) Enhanced cooperation (Article 20 TEU), FTT to launch 1 January 2016.
 **) Contracting parties to the Agreement on the Single Resolution Fund.
 ***) participates in the Unified Patent Court, not in the Unitary Patent.

Conclusion

- ***Recovery under way, but not yet out of the woods***
 - Recovery: moderate, fragile and uneven
 - Crises' legacies, long-term trends and new shocks (Brexit)
- ***Euro has overcome existential crisis***
 - Comprehensive crises' response
 - But buffers against new crisis have not been sufficiently built up
- ***Completing EMU remains important***
 - Competing views on EMU's future
 - Building trust is key
 - Five-Presidents' Report offers promising reform ideas