IMPROVING ECONOMIC POLICY

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Future of EMU

Testimony to the Swedish Parliament’s – Committee on Finance

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Where are we?

- EMU overcame severe crisis and is back to substantial growth
- Major measures were taken:
  - National reforms, substantial clean-up in banking system
  - ESM & OMT
  - Single rule book, BRRD, SSM, SRB, SRF
  - Troika structure for assistance programmes
- However major fragilities remaining
  - High public debts, significant weaknesses in structural fundamentals crucial for growth
  - Large current account surpluses as a sign of imbalanced euro area
  - Incomplete banking union that keeps banking-country/sovereign doom loop alive
  - No tools to deal with the zero-lower bound problem of monetary policy
  - A failing European Semester – fiscal and structural surveillance weak

What remains to be done – the necessary

- Finish banking union
  - EDIS pillar is important for trust in EMU deposits, making reliance on ECB liquidity less probable
- Yet EDIS very controversial
  - Full European coverage difficult if major bank policies remain national, e.g. insolvency laws
  - Significant transition problem due to existing NPL differences, missing MREL, and large exposure to national sovereign debts
  - National opposition due to usual vested interests
- Gradual EDIS introduction could be one solution to this problem but resistance to EDIS proposals of EC hardly changed
- Towards a model with nationally differentiated fees but fully centralised insurance (Schnabl, Véron 2018)
  - Acknowledges country differences
  - Phase in due overcome legacy
- But fragmentation of funding costs will remain in any reinsurance model, no unified banking market (Wolff 2016)

What remains to be done - necessary

- Addressing the still deep national problems when they have cross-border relevance.
- More investments in Germany would support rebalancing of euro area and improve conditions for growth
- Getting fiscal houses in order and building fiscal buffers now that recovery is strong – fiscal stabilisation policy is a national responsibility → can one create stronger mechanism of fiscal enforcement?
- Re-focussing the EU budget on the future and EU public goods is fundamental for political cohesiveness of Europe. Only if we have many programmes that unite us positively will we be able to stay united in crisis periods

The desirable

- Can the EA fiscal framework be strengthened to permit better coordination of national fiscal policies when monetary policy is at zero lower bound?
  - Legal mandate
  - Political feasibility

  → Create full time euro group president to strengthen political voice of the center (Wolff 2017)
- Can one create a fiscal insurance to help countries cope with large country-specific shocks? A European unemployment **re-**insurance? What kind of ex-ante eligibility criteria?

Desirable clarification on programmes

- “Troika” construction has been intransparent, opaque and unaccountable (Pisani-Ferry, Sapir, Wolff 2013)
- Too many red lines by various institutions, overlap too limited, resulting conditionality sub-optimal (Henning 2017).
- Better to put entire financial assistance with programme conditionality in the hands of one institution, the ESM. ESM to be accountable to Eurogroup and ensure formal reporting requirement to European Parliament
- IMF could only be involved as second voice for DSO at start of programme.

Dangerous if we don’t get balance right

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- The fundamental fragility of the euro area is result of 19 separate sovereign debt markets that can lead to nominal losses for investors if
  - pure liquidity run (multiple equilibrium in bond market)
  - Genuine solvency problem
- Current way to deal with this: unanimous political decision whether or not country is solvent.
  - If solvent, ESM (and possibly OMT) programme with conditionality.
  - If non-solvent, debt restructuring necessary
- De facto, significant grey area. Ultimately, a political judgment call.
- To my mind, current institutional set-up gets the balance right: risk premia are visible in bond markets but are contained. No-bail-out clause keeps its credibility and disciplining effect but is seen as a very last resort.
- Automatic debt restructuring highly destabilising and would require a major quid-pro-quo such as a sizeable EA borrowing capacity – the EA is ready for neither.
- Technical solutions to the safe asset issue are fudges that ultimately won’t work.

A few comments on the note of 8 finance ministers

- Can EMU future be decided by EU27? Formally only if EU law involved. For intergovernmental initiatives, consultation should be ensured in my view, see also Pisani-Ferry, Sapir, Wolff (2012).
- Positive to see single market and free trade being pushed.
- Ideas on banking union as start of negotiating position
- ESM ideas: probably realistic to stay in intergovernmental model. But system would be stronger if more robust decision making such as for IMF programmes.

Concluding slide

- To really overcome the relative fragility of the euro area, further economic, political and institutional convergence necessary.
- This remains a political project for some in Europe. If they succeed, it will have major implications for all those outside the euro area.
- Rogers (2017), the former PermRep of UK, emphasized in his Oxford speech that euro area political convergence was one of the factors for Cameron’s political choices of referendum.
- How can a continent be organised in a fair way with different levels of integration?

References

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