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EMU: The Way Forward

The crisis in the euro-area, triggered by the financial crisis but fuelled by the macroeconomic imbalances that have emerged since the establishment of the single currency, has shown **the fundamental deficiency** of a design where the monetary policy is integrated while the stabilisation instruments remain at the national level. The euro-area has already adopted **significant reforms** with a view to addressing this deficiency.

First, **a safety net** was created, the so-called « European Stability Mechanism » (ESM), to provide access to finance in case of acute market-financing difficulty. It is an important addition to the European policy architecture but it does not provide support to countries still benefitting from market access[1]. The fact that the ESM can bring support only at a very late stage is reinforced by two features of the mechanism. First, its intergovernmental nature implies that some national parliaments have de facto a veto right on aid disbursements to partner countries, which means that a level of uncertainty remains. Second, the conditionality attached to ESM support appears so severe that national governments do not ask for help until in desperate need. So the ESM has no opportunity to intervene when problems are emerging.

The second significant response was **a very sizeable provisioning of liquidity** by the European Central Bank. This helped to finance banks in the south of Europe, many of which were and some still are shut out of the market. Abundant ECB liquidity has prevented a major banking crisis and has reduced funding tensions. The ECB has contributed to financial stability – which is of course a major achievement – but it could not substitute for the absence of fiscal stabilisation.

Third, **a new macroeconomic imbalance procedure** was established to detect the development of macroeconomic vulnerabilities early on and exert pressure on Member States to correct them. The so-called **« European semester »** allows the Commission to propose and the Council to adopt « country-specific recommendations ». These two innovations move in the right direction: Member States receive guidance on growth-enhancing structural reforms before they are discussed by national parliaments. But their impact is still limited, notably because they lack appropriate democratic legitimacy due to the modest involvement of the European Parliament and of the national parliaments.

Fourth, **the reform of the « Stability and Growth Pact »** and **the agreement on the « Fiscal Compact »** were intended to reinforce the fiscal framework in order to prevent the building up of large fiscal imbalances in the future. The introduction of **the reverse qualified majority** for decisions under both the excessive deficit procedure and the macroeconomic imbalance procedure was supposed to increase the quasi-automaticity of the sanctions. But, of course, if the Commission does not dare to propose sanctions when a big country is concerned, the effectiveness of the system is reduced.

The fifth - and in my view most significant - response was the establishment of **the Banking Union** in order to break the vicious circle connecting banks and sovereigns. A well functioning banking union will allow credit markets to act as stabilisers. However, *"it is not certain that the credit channel by itself can provide enough stabilization"*[2]. Moreover, the third pillar of the banking union – the joint deposit guarantee – is still missing. This third pillar would prevent disruptive capital outflows ; as long as it is missing, the only possible response in case of capital flight from a country, as it was evident during the Cyprus crisis, is the reintroduction of capital controls, which violates a basic principle not only of the EMU but of the EU itself.

Even if the banking union was completed with the third pillar, would these five responses be sufficient to provide the needed stabilisation? My answer is : No. In full agreement with the Four Presidents' Report of December 2012[3], I firmly believe that further steps for the euro-area integration need to be taken. Ultimately, a monetary union that is supposed to be stable and irreversible must be also an economic union.

A preliminary remark: when one speaks about « economic union », almost everybody thinks of an improvement of the coordination of economic policies going in some cases to the adoption of common policies as well as the setting up of legal and budgetary instruments making this better coordination possible. This institutional dimension is of course essential but we should not lose sight of the other dimension, what I would call the structural dimension. An economic union is first of all a single market that should be truly integrated and completed. The two dimensions are equally important ; if one is missing, we have no true economic union.

Now there is a paradox that is rarely recognised but that Mario Monti has well underlined : several euro-area members, including the biggest, are lagging behind in comparison with countries which do not participate in EMU. According to this experienced observer, *« countries like the United Kingdom, Denmark, Sweden (…) are more compliant with the rules of the single market, the competition and the state aids (…) than most euro-area countries »*[4]. We should put an end to this paradox. The euro-area countries, to begin with Germany and France, should be the first to encourage the effective achievement of a single market for electricity, rail transport or insurance. They should be the first to comply without restriction with the rules of the single market. They should be the first because a single market is a structural component of a monetary union.

This is especially true when the challenge is to build a « Capital Markets Union ». Granted, a single capital market could be useful for the whole European Union, but it is absolutely critical in a monetary union : conducting a single monetary policy in an area with broadly varying financial practices is difficult and sometimes dangerous. Therefore, *« financial integration of the countries in EMU must receive top priority in a process that the rest of the European Union may then subsequently join »*[5].

I come now to the institutional dimension. Even if the recent improvements I have mentioned go in the right direction, they are not sufficient. The experience of other monetary unions shows that, even if the degree of centralisation of fiscal instruments and the modalities of financial solidarity may be very different, the survival of a monetary union requires some form of common budget or, in the more prudent words of Herman Van Rompuy, some form of **« fiscal capacity »**[6]. Such mechanism could have three aims : first, to help Member States to implement necessary **structural reforms** which might generate costs before benefits (this was the original idea of Chancellor Merkel taken over by Herman Van Rompuy) ; second, to provide a temporary but significant transfer of resources in case of asymetric shocks, thereby reducing the financial and social cost of the adjustment for the countries concerned ; third, to be an instrument to counteract **severe recessions** in the area as a whole. The first aim was rejected by several governments who claim that they have already implemented important reforms and do not see why they should contribute to finance the reforms of others. The third aim appears for the moment too ambitious as it would require a bigger budget to be effective for the whole euro-area. Therefore I will focus on the second aim.

The creation of a shock absorbing mechanism is all the more necessary because **other corrective mechanisms play less in EMU** than in the US : despite some recent progress, **labour mobility** is much lower in Europe ; in stress time, **capital movements** can provoke a rapid fragmentation of financial markets, thus aggravating the difficulties of the countries hit by an asymetric shock ; **structural rigidities** can slow or even prevent the adjustment through prices. In this context, a fiscal capacity for the euro-area in view of helping to absorb asymetric shocks appears fully justified as far as it respects some principles. I insist on three of these principles :

1) This mechanism for helping to address country-specific shocks should be structured in such a way that it does not lead to permanent unidirectional transfers between countries. Over time, each country, as it moves along its economic cycle, would in turn be a net recipient or a net contributor of the scheme. This is what Guntram Wolff calls the principle of **distributional neutrality** : no net transfer in the long run[7]. If such a mechanism would have existed since the introduction of the euro, it would have benefited the countries in the North of the euro-area in the early years of the century and it would have benefited the countries in the South after 2009.

2) The existence of such a mechanism should not encourage countries to postpone the necessary reforms to address national structural weaknesses. To the contrary, it is important to ensure that any future asymetric shock does not stem from non-cooperative structural policies. Therefore I suggest that the implementation of the **country-specific recommendations** issued by the Council in the framework of the « European semester » should be a prior condition to benefit from the mechanism.

3) The mechanism should not be redundant with the European Stability Mechanism (ESM) which has been established, as I said, to manage an acute crisis when a country loses access to capital markets. The function of the fiscal capacity should be to improve the **economic resilience** of countries in order to prevent such acute crises. Therefore, it should make ESM interventions much rarer.

Of course three important questions must be solved: What would trigger the intervention of the euro-area budget in favour of a specific country ? What would be the amount of the intervention ? And how would this budget be funded ?

Should the intervention of the euro-area budget be automatic or based on discretion ? Ideally, discretion would seem preferable to address specific shocks in a targeted way. However, discretion implies a strong decision-making center that would be able to take decisions quickly and that would be fully accountable to a democratic watchdog. Such an institutional setting does not yet exist; it would require important Treaty changes which do not seem feasible in the near future. Therefore, I think that we have to look for some kind of automatic stabilisers which would enter into motion according to clear *ex ante* rules. We could think of several indicators which could be used to trigger the intervention of the euro-area budget: a decline in **GDP** significantly sharper than the average of the euro-area ; an increase of the **rate of unemployment** (or of the rate of unemployment for less than 12 months in order to capture the most cyclical component of unemployment[8]) significantly stronger than the evolution for the whole euro-area ; an enlargement of the **output gap** significantly bigger than the evolution for the whole euro-area; a significant deviation of the **interest rate on sovereign bonds** from the average interest rate. Each indicator has its advantages and its drawbacks; some, like the output gap, cannot be observed or estimated accurately in real time and are often revised substantially over time[9]. Several indicators could be used in combination. What is certain is that we must reason in terms of differences in evolution, not in absolute level.

What would be the amount of the intervention ? The amount should be high enough to provide a real relief to the country in shock by easing its borrowing requirements and making its fiscal policy less procyclical. However, the amount should not be too high to ensure that the intervention does not create any incentive to artificially prolong the duration of the negative evolution at its origin. This means that the intervention of the euro-area budget should always be **temporary** and its amount should be **smaller** than the actual cost of the negative evolution for the national budget. For example, the euro-area budget could pay 70% of the additional expenditures in unemployment benefits for 12 months. So the country concerned would have no incentive to increase the number of unemployed who actually receive benefits or the income replacement rate level (i.e. the percentage of the past earnings replaced by the unemployment benefit) as 30% of the additional cost would still be at its charge. On the other hand, the intervention of the euro-area budget would help the country in shock to maintain unemployment benefits as this type of expenditure is an important automatic stabilizer that attenuates the economic impact of cyclical shocks. The multiplier effect of unemployment benefits is very large since it primarily targets low-income households facing cash shortfalls.

A third important question is **how the euro-area budget should be funded**. Revenues could come from national budgets or from a specific EMU tax. Again, in an ideal world, I would suggest that the second option would be preferable. Taking into account the purpose of the mechanism, I would think that a small percentage on corporate profits would be an appropriate own ressource for the euro-area budget. As a first approximation, by using AMECO data on corporate earnings, we find that the average corporate tax rate that would have generated 0,6% of GDP in income during 2002-2010 is 4,2%. But this would require a prior harmonisation of the tax base and we know that, despite the excellent work already done by the Commission, we are still far from an agreement on such an harmonisation. In their joint document, Ministers S. Gabriel and E. Macron suggest that this own resource might also be the tax on financial transactions. A Commission proposal is currently under discussion but only between 11 Member States. To transform it into an own resource for the euro-area would require an enlargement to all EMU members which should unanimously agree on the modalities of this new tax; what is far from achieved with 11 would be much more difficult with 19 and would be a very lenghty process. Therefore, in the meantime, I see no other solution than to fund the budget with national contributions. According to some estimates[10], this budget should amount to 1% of the euro-area GDP, i.e. some 100 billions, in order to be able to play its shock-absorbing role but I think that it could be

smaller provided that it would have a borrowing capacity constrained with a strict structural balanced budget rule (i.e. over the cycle)[11].

In summary, the creation of a fiscal capacity is of major importance for the good functioning of EMU. Fiscal support is needed to address severe shocks and alleviate the financial and social cost of adjustment. The very existence of such a mechanism would send a strong signal which would reduce the *ex ante* likelihood that a Member State will be affected by self-fulfilling prophecies. It would strenghten the euro-area substantially.

Agreeing on *ex ante* rules and contributions for an automatic support system would require only a relatively limited degree of further political integration. Article 352 of the Treaty allows the adoption of measures in areas where the Treaty currently does not explicitly provide all necessary powers to reach the Treaty objectives ; it could therefore possibly be a suitable Treaty base.

Of course, at a later stage, a more ambitious fiscal union would be desirable. But we know that the European integration can only move forward step by step. The step I suggest today is not the end of the road but it would be a significant move in the right direction.

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References:

[1] See J. Pisani-Ferry, E. Vihriälä and G. Wolff : « Options for a Euro-Area Fiscal Capacity », *Bruegel Policy Contribution*, January 2013.
[2] *Ibid.*, p. 3.
[3] H. Van Rompuy, in close collaboration with J.-M. Barroso, J.-C. Juncker and M. Draghi : *« Towards a Genuine Economic and Monetary Union »*, 5 December 2012.
[4] M. Monti : « Gouvernance économique : questions ouvertes », in *L'Euro, les investisseurs et la gouvernance*, Notre Europe, 2011, p. 66.
[5] A. Brender, F. Pisani and D. Gros : « Building a Capital Markets Union…or designing a financial system for the euro area ? », *CEPS Commentary*, 2 June 2015.
[6] H. Van Rompuy and al. : *op. cit*. It is interesting to note that a group of eleven German economists – the Glienicker Group – stated that *« the monetary union cannot be permanently stable without a controlled transfer mechanism (…) to cushion the fiscal consequences of a dramatic economic downturn »*, Die Zeit, 17 October 2013. See also the joint document of the German and French ministers for Economy, S. Gabriel and E. Macron : *« un budget commun à l'échelle de la zone euro (…) est la condition de l'efficacité de notre union monétaire »*, Le Soir, 4 June 2015.
[7] G. Wolff : *« A Budget for Europe's Monetary Union »*, Bruegel Policy Contribution, December 2012, p. 6.
[8] See Chart 4 : Cyclical nature of unemployment by benefit duration period, in *Trésor-Economics*, n° 132, June 2014, p. 5.
[9] See G. Wolff : *« potential output is a concept that is appealing in theory but controversial in practice »*, *ibid.*, p. 10.
[10] G. Wolff : *Ibid.*, p. 11.
[11] The Glienicker Group proposes *« to finance the euro-budget through a membership fee, in the amount of about 0.5 per cent of the gross domestic product »*, Die Zeit, 17 October 2013.

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