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COMPLETING THE ECONOMIC AND MONETARY UNION

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Notre Europe – Jacques Delors Institute presents the synthesis of a debate on the topic "Completing the Economic and Monetary Union" held at the annual meeting of its European Steering Committee on 30 November 2013.

Taking their cue from an introductory address by **Daniela Schwarzer**, director of the Department of European Integration at the SWP (German Institute for International and Security Affairs), and by **Pedro Solbes**, president of FRIDE (Foundation for International Relations and Foreign Dialogue) and a former European commissioner, participants debated the main steps required to complete the Economic and Monetary Union (EMU).

The discussion began with an **overview of the euro area's situation today** (1), and went on to focus on some of the issues of primary importance in strengthening the EMU: **completing the banking union in order to break the vicious circle between the banking crises and sovereign debt crises**, and resolving the current problem of the fragmentation of the financial markets (2); **strengthening the fiscal union by adopting solidarity and mutual insurance mechanisms** (3); and **endowing the EMU with the legal bases necessary for those steps to be taken** (4). Lastly, participants pointed out that above the issues associated with strengthening the EMU, **member states need to cope with the economic and social consequences of the current crisis** (5).

1. 2013: the situation is calmer but the EMU is still incomplete

The members of the European Steering Committee (ESC) of *Notre Europe – Jacques Delors Institute* (NE-JDI) launched the debate on the EMU by pointing out that the crisis in the euro area has entered on a new, calmer phase in 2013. Two main factors have contributed to this change of climate in the EU.

On the one hand, the belief has taken hold that the euro is going to survive this crisis; and this, thanks largely to the action taken by the European Central Bank (ECB). Indeed the ECB adopted in late 2012, the "Outright monetary transactions" programme, an unlimited sovereign debt buy-back programme. These purchases are subject to the strict condition that countries wishing to take advantage of the scheme must submit to the conditionality of a European stability mechanism (ESM) macroeconomic adjustment programme or precautionary programme. Now, the programme may never have been activated but it has clearly had a positive impact on the financial markets. We should also remember what Mario Draghi said back in July 2012: "We will do whatever it takes to save the euro" – a remark designed to reassure the markets.

On the other hand, the European institutions have adopted a more flexible attitude over the implementation of the rules governing the Stability and growth pact in order to achieve a better balance between fiscal consolidation and support for growth. This has translated into the granting of one or two additional years for certain member states in the Excessive deficit procedure – including France, Spain and Portugal – to return below the ceiling setting the public deficit at 3% of GDP.

Is this calmer situation totally positive? Not necessarily. In this new context the sense of urgency has been lost and so progress in strengthening the EMU's architecture has slowed down. The German election, which took place last September, and the European elections this coming May are also being used to justify member states' current inertia. This inertia is a particular source of concern because, despite the progress made in the past few years, especially in the fields of fiscal and macro-economic surveillance as well as in the setting up of mechanisms for resolving sovereign debt crises, the EMU is still incomplete.

In the steps yet to be taken to complete the EMU, there are two dangers to be avoided: seeking to go too far or to do things too well, and submitting unclear proposals or lumping too many things together. This, because as the report of the Padoa-Schioppa group stresses, in order to complete the EMU "the single currency requires as much fiscal federalism as necessary for its appropriate functioning, but as little as possible", following a pragmatic approach based on subsidiarity. This is the only way that convinced pro-Europeans will be able to persuade the decision-makers and those citizens who are not so pro-European. If the pro-Europeans try to go too far or to do too much, the risk of failure will be all the greater. Also, it is necessary for proposals to be crystal clear because it will be impossible to make any progress at all if we do not know what we want to achieve.

In the light of all this, what are the priorities for strengthening the EMU today? The issue at the top of the political agenda is the establishment of a banking union. In the current context it is indeed of primary importance for the euro area's economies to complete the banking union, and this, for three main reasons. Firstly, a banking union is crucial in order to break the vicious circle between banking crises and sovereign debt crises. Secondly, it will make it possible to avoid the taxpayer having to pay in order to bail out banks in the future. And lastly, a banking union will make it possible to rebuild confidence in Europe's banking system and thus help to resolve the problem of the fragmentation of its financial markets – a fragmentation that makes it difficult for small and medium enterprises to gain access to funding in the euro area's peripheral countries today.

While the EMU's future necessarily entails the completion of the banking union, however, it must not stop there. The second issue is that of an economic and fiscal union, and it includes three key issues: contracts for structural reforms (which are currently on the political agenda); a cyclical stabilisation mechanism; and a potential debt mutualisation mechanism.

Moreover, the ongoing reinforcement of the EMU asks for new legal bases and, in this context, member states need to consider the need for a revision of the EU treaties or, alternatively, engage into a new treaty at the euro area level.

Lastly, beyond the reinforcement of EMU's architecture, the euro area's member states need to cope with the consequences of the current crisis on the economic (weak growth), social (growing social divergences among euro area countries) and political (rising populism and euro-scepticism) levels.

2. Completing the banking union

The first pillar of the banking union – the Single supervisory mechanism (SSM) – was adopted in the autumn and it will be in place before the end of 2014. The crucial thing now is to move rapidly towards the second pillar, namely the implementation of a Single resolution mechanism (SRM). In this connection, differences of opinion exist among euro area member states over certain issues, in particular over the financing of the single resolution fund. While the basic idea is that this fund should be financed by contributions from the banking industry, the problem lies in the fact that it would take about ten years to implement such a fund. Thus the question arising is this: What would the member states' response be if a need for recapitalisation were to arise in the meantime? There is of course the ESM, which is now able to recapitalise banks directly; but it can intervene only after the participation of shareholders, creditors and national resources. This means that the link pegging banking crises to sovereign debt crises is not going be broken in the short or medium term. If there is ever any need for major recapitalisation as identified in the "Asset quality review" conducted by the ECB ahead of the SSM's implementation, public finances will inevitably be destabilised in certain member states.

It was pointed out that one of the messages formulated by the Glienicker group is that in order to restore credibility to the "no bail-out" principle that the Germans treasure so dearly, it is necessary to work on the banking union. The "no bail-out" principle will not be credible until the member states succeed in cutting the link between public finances and the stability of the banking system.

Once this second pillar is in place, we may hope that the third pillar, namely a common deposit guarantee scheme, will also attract the support of the member states, even though this issue is not on the agenda today and the new coalition pact in Germany rules it out as an objective for the euro area. With single supervisory and resolution mechanisms in place, a common deposit guarantee will however become of secondary importance because it would only kick in in the event of the banking system's collapse.

3. What kind of fiscal union for the euro area?

The fiscal union issue is multifaceted. The idea of endowing the euro area with its own budget, distinct from that of the EU 28, is currently being mooted in certain circles. Yet, rather than talking about a euro area budget, it might be wiser to talk about the concrete tools that the euro area needs. Clarification is necessary in this regard.

Thus it is crucial to present clear and cogently argued proposals – a contention that applies on several different registers. Firstly, where fiscal instruments are concerned, it is necessary to separate the different dimensions: the budget has a simple solidarity dimension in terms of permanent transfers, but it can also have an insurance dimension designed to protect member states against excessive variations in the business cycle, and in that case the kind of transfers that can take place will be short-term and not one-way. Secondly, the debt mutualisation issue includes very different proposals, such as "Blue bonds / Red bonds" – which are a permanent solution – or the European debt redemption fund – a temporary solution designed to mutualise the excessive debt of euro area countries. Besides, the ESM is already a kind of debt mutualisation mechanism. It is necessary to submit specific proposals because it will be impossible to make any progress if we do not know what we want to achieve or why we want these tools.

So there are three dimensions of the fiscal union that need to be debated:

1. The implementation of contracts for structural reforms accompanied by a financial aid tool;
2. The creation of a cyclical stabilisation mechanism;
3. The adoption of a mechanism to protect euro area countries from self-fulfilling solvency crises and to make it possible for countries to finance their debt at a reasonable cost.

3.1. From competitiveness contracts towards a "super-cohesion fund"

The idea of creating a tool for encouraging structural reforms in the euro area has been on the political agenda since late 2012. Thus there has been an important change in the way the euro area is run: the stress is shifting from the fiscal balance to structural reforms. This idea is based on the clear need for structural reforms in numerous countries in the euro area in order to restore member states' competitiveness. Yet it is going to take time for those structural reforms to have any real impact on competitiveness and on growth; thus structural reforms come at a cost in the short term while only producing results in the medium to longer term.

In this debate on structural reforms, it is necessary first and foremost to clarify two issues. First of all, it is necessary for the member states to be aware of the fact that structural reforms are primarily in the interest of the countries that have to implement them. If a country needs to reform its justice system, its administration or its tax system, it is not because it is in Europe's interest for it to do so. It is not a favour that the country is doing to the Commission but a favour that the country is doing to itself. By the same token, it is counterproductive for national governments that these reforms should be perceived as having been imposed by Brussels (the recent example of France with regard to the reform of the French pension system is one such instance: orders must not be imparted from Brussels). Thus these contracts must not translate into "soft Memorandums of Understanding", otherwise Europe will continue to be perceived as the entity that forces member states to implement reforms. That is not the right position for Europe to adopt: what member states need is not a Europe that forces them to do things so much as a Europe that offers them support, and that is the rationale that must underpin these contracts.

The rationale of bilateral contracts is justified because it makes it possible to target each country's priorities better. While the same fiscal rules – in particular the same 3%-of-GDP threshold for public deficits – are enforced on all of the member states, structural reforms need to be tailored from one country to the next in order to better respond to each country's individual problems.

The idea of accompanying these contracts with financial aid is, of course, very welcome; its guidelines, however, have yet to be clarified. First of all, we need to clarify exactly which countries can aspire to this financial aid. While there is no point in all EU member states attempting to move forward together, it has yet to be decided whether it is preferable to restrict the contracts and the financial aid to countries already in the euro area or whether candidate countries should also be included in the mechanism. This, because there is today a mistrust of countries outside the euro area regarding the possibility of creating a new financial tool designed solely for countries in the euro area. Also, regardless of the group of countries involved, we need to bear clearly in mind that aid of this kind could only have an impact on countries of the size of Greece, Portugal or Ireland. It would only have a very limited impact on countries the size of Spain, France or Italy.

The question of this aid fund's resources – should they be based on existing structural funds or on new *ad hoc* funding via an own resource or national contributions? – and spending has yet to be addressed. Where spending is concerned, we should focus first of all on clarifying its nature: is it a mechanism for encouraging structural reforms, the way it was initially presented, or would it not be useful, not to say necessary, to have a solidarity mechanism designed to support the implementation of reforms in those countries being choked by sovereign over-indebtedness? This second option would facilitate convergence within the euro area in addition to being of major political value and to fuelling confidence in the euro area. It would also be a matter of moving forward in the direction proposed by Jacques Delors when he suggested setting up a "super-cohesion fund" in the euro area designed to close the competitiveness gap between the member states. And it is also important to stress that while certain reforms do indeed come at an initial cost and only bear results in the medium term (for instance, labour market reform), other reforms (for example, justice or civil service reform) come at a limited cost and can in fact lead to savings in public-sector expenditure.

It is also necessary to envisage extending the objectives around which this solidarity can be organised. Should the stress be laid solely on structural reforms, or should we include also social expenditure and investment (in education and R&D, for instance), or spending relating to infrastructures and to the energy transition?

3.2. Putting the adoption of a cyclical stabilisation mechanism on Europe's agenda

The Padoa-Schioppa group's report and the Glienicker group's declaration both dwell on the need to endow the EMU with a cyclical stabilisation mechanism in order to minimise the impact of cyclical differences within the euro area. Unlike the structural reform support tool discussed above, this cannot be construed in any way as a solidarity mechanism, but rather as a mutual insurance system that must not translate into either permanent or one-way transfers.

The question that needs to be asked is what shape this mechanism should take, the two main proposals in the debate being that of a system based on the output gap (countries' net contributions / payments would be determined by the gap between their individual output and the average output figure) and that of a common unemployment insurance scheme.

There are difficulties inherent in both proposals. On the one hand, it is difficult to measure the output gap, and on the other, it would be complicated in administrative terms to set up a common unemployment insurance scheme at the euro area level. Yet these difficulties are not impossible to overcome and they should not form a barrier hindering the implementation of a cyclical stabilisation mechanism of one kind or another in the euro area. It was pointed out that the advantage of common unemployment insurance scheme – the implementation of which would require the agreement of the social partners – is that it would be a political trump card because the EU would be perceived as adopting measures designed to protect its citizens in times of difficulty.

While this idea has attracted the support of certain political players such as László Andor, the commissioner for employment, social affairs and inclusion, or as French finance and economy minister Pierre

Moscovici, it is not yet on EU's agenda because it lacks political support at the highest level. This issue must become a priority in strengthening the EMU and thus it must be given pride of place on the European political agenda.

3.3. How to cope with euro area countries' vulnerability to self-fulfilling solvency crises?

The crisis has highlighted the need to strengthen fiscal discipline in the euro area, and this has been achieved through the adoption of new measures included in the "Six-Pack" and "Two-Pack" legislative packages as well as through the signing of the Fiscal compact. Yet compliance with fiscal rules may prove insufficient to prevent sovereign debt crises in the future, particularly as long as member states continue to have to bear the burden of a past debt which, for many countries in the euro area, is way above the agreed threshhold of a debt-to-GDP ratio standing at below 60%.

Moreover, while the cost of servicing the public debt has dropped considerably since the start of the crisis for some countries (for instance, for Germany and France), other countries are having to cope with debt servicing costs that are currently far too high, which only makes their budgetary situation even more fragile. We are not going to return to the pre-crisis scenario in which there was no distinction between the countries, of course, but the current differences are spawning divergences which are dangerous for the euro area as a whole.

In view of this, it is necessary to establish a kind of "federalism by exception" in the euro area, resting on a fair balance between responsibility and solidarity, in order both to ensure that member states have reasonable debt financing costs and to protect member countries against self-fulfilling solvency crises. What we mean by "federalism by exception" is that in a normal situation, when there is no sovereign debt crisis, it is the governments that lead the dance; but when a country encounters difficulty in financing its debt on the markets, it must be able to finance that debt through common bonds in order to ensure that it can finance its debt at a reasonable cost. In return, it is necessary for it to accept a transfer of fiscal sovereignty to the European level: sovereignty ends when solvency ends. Naturally, it is crucial that this federalism by exception should be properly understood and not be perceived by the man in the street as implying that "when the going is good it is thanks to the member states, but when the going is bad it is Brussels' fault".

4. A revision of the existing treaties, or a new treaty at the euro area level?

Back in 2012 Angela Merkel called for the forging of a political Europe. It was part of the response to the crisis. Today, now that the situation has calmed down, the thirst for a sweeping debate on political Europe appears to have been quenched.

Yet the question we still need to answer is whether it is possible to strengthen the EMU in the context of the treaties currently in force. It seems unlikely. Besides, since the start of the crisis, member states have had to resort to intergovernmental treaties to take certain steps forward (the treaty setting up the ESM and the Fiscal compact) in addition to a simplified revision of the treaty (Article 136, which is the legal basis for the creation of the ESM).

If the member states decide to endow the EMU with its own fiscal capacity, whether it be in the context of the bank resolution mechanism or of the setting up new solidarity or mutual insurance mechanisms, the legal basis offered by the present treaties will prove to be insufficient. Yet in the light of the Lisbon treaty experience, engaging in a revision of the treaties at the EU28 level would unquestionably turn out to be a long and difficult exercise and its result would be uncertain (in particular bearing in mind the referenda that would have to be held in certain countries). This context seems to favour the idea of a new founding treaty for the euro area, an argument embraced also by the members of the Glienicker group.

5. Imparting a fresh boost to growth and reducing the differences within the EU

The crisis has had a seriously negative impact on growth rates in the member states, and in all probability also on their potential growth for the next few years. In view of several member states' difficulty in returning to growth, we need to ask ourselves whether the current policy mix is in fact the right one. Certain European economies' weak growth and lack of competitiveness are issues of fundamental importance for the euro area's future. Structural reforms are necessary, but they may not be sufficient to address the problem. We need to do more, at the EU level, to rebalance austerity and growth.

In this context, completing the single market appears to be of primary importance, for two main reasons. On the one hand, it is a lever for stimulating growth in Europe. On the other, the single market plays an important role within the euro area: it is necessary to complete the single market for the real exchange rate mechanism among member states to function better, and that in turn will make the euro area more resilient to crises. For these two reasons it is necessary to pursue the completion of the single market by moving further and more rapidly forward, while respecting the balance between economic freedoms and social rights defended by Jacques Delors and outlined in the Monti Report.

Beyond its economic consequences, this crisis has also had serious social consequences that have translated into growing divergence among the member states. When we compare the situation within the euro area with that in the rest of the EU, we can see that the unemployment rates are on the whole far higher in the euro area, and above all, that the divergence among the countries is far more substantive. This polarisation within the euro zone is a source of concern and the member states have to come up with a solution to compensate for it.

In this context, the cohesion policy, which is the primary tool for convergence, must be renewed in order to address the current challenges more effectively. Also, greater attention must be paid to an innovative tool which may only have been implemented on a minor scale but which is a factor in European social policy, namely the European "youth guarantee" designed to combat unemployment among young people. This is a basis on which more work needs to be done.

In conclusion, Europe's decision-makers need to address the dual challenge of coming up with a response to the economic, social and political consequences of the crisis, while at the same time strengthening the architecture of the EMU in order to minimise the euro area's vulnerability to future crises. Progress has been made in both areas, but a great deal remains to be done.

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