Completing the Euro

A road map towards fiscal union in Europe

Report of the “Tommaso Padoa-Schioppa Group”

The „Tommaso Padoa-Schioppa Group“

- Under the patronage of Jacques Delors and Helmut Schmidt
  - In honour of Notre Europe’s former President
- Members of the Group
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  - Peter Bofinger
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Background: European social contract at risk

- Break-up of the euro area is a real possibility
  - Risk of monetary, economic, and political disintegration
- Four key pillars of European social contract are at risk
  - Competitive markets: risk of renationalization, protectionism
  - Monetary stability: risk of return to national currencies, bank-runs, monetization of debt
  - Equitable distribution of gains in economic welfare: inequalities on the rise (within and across countries), unemployment
  - Growth performance: costs of crisis, costs of disintegration, excessive austerity

Guiding principles of the Group

- There is an urgent need for a credible long-term plan
- Return to national currencies simply not an option
  - Excessive economic and political costs
- A pragmatic approach is needed
  - Taking into account political and legal constraints
  - EMU is incomplete: correct dysfunctionalites - not more, not less
  - „As much political and economic union as necessary, but as little as possible“
  - No European „super-state“ needed
  - Tommaso Padoa-Schioppa: A „post-Westphalian“ model

Main points of the report

- Lessons from the crisis: 3 main challenges
  - Primacy of real interest effect over real exchange rate effect
  - Self-fulfilling solvency crises
  - Banking paradox: financial markets are European, supervision is national; nexus between national banks and national sovereigns
- 4 key proposals of the group
  - Foster Single Market to strenghten real exchange rate channel
  - Cyclical stabilization insurance fund (no permanent transfers)
  - European Debt Agency: ensure access to bond markets, but in exchange for a stepwise transfer of sovereignty („sovereignty ends when solvency ends“).
  - Banking Union: euro-area supervisor and deposit insurance

Root causes of the current crisis (I)

- EMU is not an Optimum Currency Area (OCA)
  - Structural and cyclical divergences are very large
- The „one size fits none“ problem of the ECB
  - ECB targets euro-area average data, i.e. a virtual business cycle
  - Pro-cyclical effect: high growth countries face low real interest rates, low growth countries face high real interest rates
  - Cyclical divergences are accentuated
  - ECB runs right monetary policy for a country that does not exist
- Three possible solutions to the problem
  - Real exchange rate effect
  - Use national economic policies more effectively
  - Rebalancing through redistribution

Root causes of the current crisis (II)

- Self-fulfilling fiscal crises
  - Liquidity crises can‘t be solved domestically
  - Over-reaction in markets can lead to a „bad equilibrium“
    - Deflation
    - High interest rates
    - Rising deficit and debt levels
    - Banking crisis
  - Contagion can transport fiscal crises across the euro-area
- EMU not prepared to deal with this challenge
  - Only ex-ante coordination
  - But even countries that didn‘t show fiscal misbehavior faced self-fulfilling fiscal crises (Spain, Ireland)

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How to deal with heterogeneities in the euro-area

- There are two types of divergences
  - Structural – originating in different historical models, institutions
  - Cyclical – to a large extent specific to EMU
- How to deal with cyclical divergences?
  - The main challenge is not an „asymmetric exogenous shock“, but an „asymmetric endogenous shock“ (pro-cyclical ECB effect)
  - Before EMU, there was a strong belief that the real exchange rate channel would automatically correct asymmetric endogenous shocks. This did not happen.
  - Two solutions
    - Foster exchange rate channel through a deepening of the Single Market
    - Develop cyclical stabilization insurance fund

Proposal 1: Completing the Single Market

- Markets in the euro-area are not sufficiently integrated
  - Monetary integtration did not trigger an automatic deepening of economic integration
- Further steps are needed
  - Single market for services (only 20% cross border)
  - Intra EMU labor mobility
    - Portability of pension rights
    - Recognition of professional qualifications
    - Cooperation across employment agencies
  - Domestic reforms facilitating price and wage adjustments
- There is a strong nexus between the proper functioning of the Single market and proper functioning of the euro

Proposal 2: A Cylical Adjustment Insurance Fund

- Cyclical divergences are temporary
  - But temporary doesn‘t imply „short“
  - Persistent cylical deviations during the first decade of EMU
- Objetive: facilitate internal devaluations
  - Countries pay into the fund in good times (signficantly better than the euro-area average)
  - Countries can draw funds in bad times (significantly worse than the euro-area average)
  - Should not be activated in case of a symmetric downturn
- Outside the EU budget
  - If rightly devised no permanent transfer, balances should be zero

How to deal with structural divergences?

- This is a political and economic challenge
  - Harmful, as they prevent the emergence of an OCA
  - But not as harmful as cyclical divergences for the functioning of the euro
- Decisions on alleviating them should be political
  - EU Budget
  - Involvement of EP
  - Mechanisms could be transfers, but not only
  - Consider different corporate income taxes in euro-area
- Open issue: link between EMU and structural divergences
  - Has EMU led to concentration effects?
  - The crisis might accentuate structural divergences

How to deal with fiscal challenges

- 2 models to ensure fiscal discipline in fiscal federations
  - Hierarchical incentive system (rules, top-down, sticks & carrots)
  - Market system (no bailout, no monetization, defaults possible)
- EMU originally a market-based system, today transformed
  - Risk of self-fulfilling solvency crises underestimated pre-crisis
  - No-bailout has lost its original power, no longer credible
  - No hierarchical elements in place
  - Incentives on an ad-hoc basis
- Combination of market and hierarchy systems needed
  - Normal system: market based
  - But: sovereignty ends when solvency ends

Proposal 3: A European Debt Agency (I)

- Assistance against conditionality
  - Easy financing access for small amounts, but then stepwise transfer of sovereignty for larger amounts
- Possible design of EDA
  - Jointly and severally guaranteed
  - In normal times, all euro-area members issue 10% of GDP through the EDA, all countries pay the same rate on that share
  - Discount window: In a short-term crisis, up to 10% on top largely unconditional (only ex-ante conditionality)
  - Tranches > 20%/GDP would imply stepwise transfers of sovereignty to the EDA
  - 20-30% = MoU, 30-40% full programme, 40-60% joint decision
  - > 60%, EDA would obtain full veto over national budgets

Proposal 3: A European Debt Agency (II)

- EDA headed by a Euro-Area Finance Minister
- Legitimacy largely derived from national parliaments
  - But EP involvement possible
  - Joint committee: 34 representatives from NP, 17 from EP
  - Exact set-up to be worked out
- Legal basis: New Intergovernmental Treaty
  - But involvement of existing EU institutions to the largest possible extent
  - Could at a later stage be integrated into normal EU framework

Proposal 4: A Euro-Area Banking Union

- Fully integrated banking supervision
  - Institution responsible for microprudential supervision with investigation powers
- Built within the ECB or closely related to ECB
  - Article 127(6) TFEU
- Deposit insurance scheme
  - Responsible for negotiating resolution path
  - Possibility to agree on ex-ante burden sharing
  - Pay-ins from national budgets needed

Conclusion

- Complete EMU
- Proposals are long-term, but urgent
- Proposals are pragmatic - possible compromise solutions
- Proposals are not „à la carte“!
  - Everything has to come as a package
- Much can be done within existing framework
  - Single Market
  - Banking Union
- Credible longer-term roadmap now neded
- Ultimately: recognize that economic policies are matter of common concern