EMU reforms: Achievement and challenges

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FMM Summer School 2.8.2019
Programme

1. Introduction
2. A look back: Causes for the euro-zone crisis
3. Pre-2017 reforms of the euro-area
4. Reform debates and progress since 2018
5. Conclusions
Introduction

• Hope 2017: Window of opportunity for reform in Germany and France
• A number of new reform proposals
• But: Delay because of delayed government formation
• Decisions at euro summit in December 2018
• In parallel: Growing conflict with Italian government
THE DIABOLIC SEVEN: CAUSES FOR THE EURO-ZONE CRISIS
The diabolic seven: Causes for the euro-zone crisis

1. Excessive deficits in some countries (Greece!)
2. Problems in the banking sector
3. Doom-loop between sovereigns and banks
4. Self-fulfilling market panics
5. Boom-Bust cycles in the periphery
6. Structural divergence of competitiveness
7. Loss of legitimacy because of dismal economic performance/feeling of political impotence
The crisis causes

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Crisis cause #1: Excessive deficits in some countries

- In some countries (especially Greece) budget deficits were excessive

![Graph showing government budget balance, Greece, % of GDP](image)
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Crisis cause #2: Problems in the banking sector

- Lax regulation and excessive credit growth led to problems in a number of countries
  - During the US subprime crisis (2007-9)
    - Germany, France, Ireland, Belgium, Netherlands
  - Later, during the euro crisis
    - Spain, Greece, Cyprus
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Crisis cause #2: Problems in the banking sector

Gross Government Debt, in % of GDP

- Portugal, Percent of GDP (Excessive Deficit Procedure)
- France, Percent of GDP (Excessive Deficit Procedure)
- Spain, Percent of GDP (Excessive Deficit Procedure)
- Euro Area 18, Percent of GDP
- Germany, Percent of GDP (Excessive Deficit Procedure)
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Crisis cause #3: Doom-loop between banks and sovereigns

- Banks have to write down bond holdings
- Balance sheet problems in banking sector
- Bond prices fall, interest rates rise
- Expectations of expensive bail-out programmes
- Doubts about sovereign debt sustainability
- Doubts about sovereign debt sustainability
Bank problems, sovereign debt sustainability and monetary integration

• Monetary integration makes problems in banking sector worse
  – With national oversight: External effects of insufficient oversight are not taken into account
  – Financial market integration leads to bigger banks
    • Concentration (Krugman’s argument)
    • For smaller countries: lager market
    • „Too big to save“ becomes more likely
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Crisis cause #4:
Self-fulfilling market panics

- With intermediate debt levels, multiple equilibria are possible:
  - If investors believe in solvency, interest rates remain low and country remains solvent
  - If investors doubt solvency, interest rate increases and country might be pushed into insolvency
- Lender-of-last-resort can solve this problem
- EMU has introduced „original sin“ through the back door
Crisis cause #5: Boom-and-bust-cycles

- Euro introduction prolonged and deepened cycle as national monetary policy was not available to dampen cycle anymore.

![Graph showing deviation from trend growth with examples of Spain and Germany before and after the euro.](image-url)
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Crisis cause #6: Structural divergence of competitiveness
Crisis cause #7: Interaction of political/financial market crisis

• Trust in the EU has eroded in many countries
  – Feeling is that EU/euro framework is forcing policies onto countries which are not wanted (and possibly not good)

• Populists have gained in many countries

• Danger: Interaction of populism & financial markets
  – Imagine populists promising a euro in/out referendum come close to power
  – This could trigger outflow of bank deposits
  – No proper tool available to counteract outflows
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Crisis cause #7: Interaction of political/financial market crisis

Italy, Government Benchmarks, 10 Year, Yield

Percent

02.08.2019
Prof. Dullien
Trust in the EU seems to be related with economic performance: Greece

I would like to ask you a question about how much trust you have in certain media and institutions. For each of the following media and institutions, please tell me if you tend to trust it or tend not to trust it.

The European Union
Greece (from 10/2003 to 11/2017)
Trust in the EU seems to be related with economic performance: Italy

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The European Union
Italy (from 10/2003 to 11/2017)
Trust in the EU seems to be related with economic performance: Spain

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The European Union
Spain (from 10/2003 to 11/2017)
Problems of legitimacy

People were promised...

- ...improved living standards
- ...more jobs
- ...creation of policy space at EU level to replace policy space lost at national level
- No transfer union (in the North)

People perceive outcome as..

- ...stagnating living standards
- ...high unemployment
- ...the troika implementing „neoliberal“ reforms against democratic will
- ...forced transfers to the South
In order to counter these feelings

• Euro area needs to prevent replay of last crisis
• Euro area needs to rekindle growth and job creation
• Euro area needs to show a social face
• Euro area needs to strengthen democratic rule and push back intergovernmentalism
• Overall, thus EMU/EU will be able to provide protection of the „European way of life“

• These measures might not win back all populist voters, but potentially those from the left
PRE-2017 REFORMS OF THE EURO-AREA
Euro area reforms so far

• Six Pack/Two Pack
  – Limiting deficits and debt
  – Preventive and corrective arm of SGP; macroeconomic imbalance procedure

• Fiscal compact

• ESM and OMT

• Banking union (but only partial)
### Which problems were tackled by past reforms?

<table>
<thead>
<tr>
<th>Problem</th>
<th>Six Pack</th>
<th>Two Pack</th>
<th>Fiscal compact</th>
<th>ESM &amp; OMT</th>
<th>Banking union</th>
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<tr>
<td>Excessive deficits</td>
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<td></td>
<td>Completely unaddressed</td>
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</tbody>
</table>

Unresolved/partly resolved problems

Completely unaddressed
So, despite the reforms, euro-area architecture still seems fragile.
REFORM DEBATES AND PROGRESS SINCE 2017
Reform proposals since 2017 (I): EU Commission’s „Saint Nicholas“-package

• Turn ESM into „European Monetary Fund“ & fiscal backstop of banking union
• Bring fiscal compact into EU treaties
• (Small) budget element for Begrenztes Haushaltselement zur Konjunkturstabilisierung & „Förderung von Reformen“
• Merge positions of president of eurogroup and vice president of EU Commission into a „European Minister of Economy and Finance“
New reform proposals (II): 14 GER-FR economists’ paper

- Common deposit insurance
- Backstop for Banking Union at ESM
- Capital market union
- New rules for government bonds in banks’ balance sheets („concentration charge“)
- Creation of safe assets in banking system („ESBies“)
- Facilitating debt restructuring („single limb aggregation“)
- Automatic maturity extension for junior bonds when ESM programme is triggered
- Reform of fiscal rules: expenditure path & junior bonds for excessive spending
- Reform of ESM: Enable ESM to act without IMK
- New credit line at ESM
- Fiscal capacity for €-area: Unemployment Reinsurance
New reform proposals (III): Macron’s vision

- Eurozone budget
  - Several percent of GDP
  - Investments and joint projects such as European universities, research
  - Financing through tax revenue
  - Controlled by the EP
- Euro finance minister
- Increased cooperation in the realms of foreign and security policy, refugees, and external borders
New reform proposals (IV): Meseberg declaration

- **Reform of ESM**: Move into EU-treaty, more technical competence
- **New credit line at the ESM**
- **Eurozone budget** to promote „competitiveness and convergence“
- **European Unemployment Stabilization Fund**
- **Facilitating debt restructuring** („single limb aggregation“)
Scholz’s proposal for a „European Unemployment (Re-)Insurance“

• Basic idea:
  – Each country contributes into national compartments
  – In crisis times, money is paid out
  – If compartment is empty, countries can borrow from other compartments

• Unclear whether there would be transfer elements (as in Dullien/von Weizsäcker 2018)
Decisions taken at euro summit in December 2018

- Facilitating debt restructuring („single limb aggregation“)
- ESM Reform
- ESM as Backstop for Banking Union
- Fiscal capacity for „competitiveness and convergence“
- Roadmap for negotiations of common European deposit insurance scheme
Macron

"Saint Nicholas" package Meseberg

Fiskal Compact into EU law

Euro finance minister

Eurozone budget
  Technology- and growth policy
  Harmonisation of corporate tax

Single limb aggregation for debt restructuring
Common deposit insurance
ESM credit with ex-anteconditionality
Unemployment reinsurance

ESM reform
ESM as Backstop for banking union
Completion capital market union

Expenditure path instead of deficit rules
Junior government bonds for excessive debt
Automatic maturity extension for junior bonds in case of ESM loan
Introduction of "Esbies" as safe asset

Bold: Decisions taken at euro summit in December 2018
EVALUATING THE REFORMS
Reform proposals and causes for crisis

<table>
<thead>
<tr>
<th></th>
<th>Bisherige Reformen</th>
<th>Nikolaus-Paket</th>
<th>14 Ökonomen</th>
<th>Macron</th>
<th>Meseberg</th>
<th>Beschlüsse Dezember '18</th>
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<td>Euro finance minister; euro taxes; technology and growth policy</td>
<td>Tax harmonisation; taxation of digital companies</td>
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02.08.2019
Conclusions

• The first round of reforms (since 2009) has made euro-zone more resilient, yet vulnerabilities remain

• Progress since 2017 has been disappointing
  – there is only a road-map for the common deposit insurance
  – the euro-budget will be marginal and only as part of the multiannual financial framework (EU budget)
  – there is no proper fiscal stabilization function
Open Question: How will the new European Commission act?

• Ursula von der Leyen has made bold promises, including pushing a European Unemployment Reinsurance
• Will she be willing/able to deliver?
THANK YOU VERY MUCH FOR YOUR ATTENTION