The Economic and Monetary Union: Time to Break the Deadlock

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Abstract

The European construction is at a standstill. The legacy of the crisis and geopolitical tensions are fuelling distrust, fears and even prejudices once thought long buried. In the areas of public finance, bank crises management and financial stability preservation, the Union is better at prohibiting things than at getting them done. This paper elaborates on these issues, which hamper the achievement of further progress.

1. Introduction[1]

In the last ten years the euro area has withstood formidable tensions. The effects of the global financial crisis had not yet been absorbed when the sovereign debt crisis erupted. Triggered by weaknesses in individual countries, that crisis was fuelled by the incompleteness of the Economic and Monetary Union (EMU). Hesitancy in defining the procedures to support countries in difficulty fed fears of a break-up of the euro. Spreads on government bond yields widened dramatically, in some cases by much more than what would be justified by the economic conditions and the public finances of the countries affected.

Measures to deal with emergencies have been progressively flanked by the implementation of reform processes of euro-area and European Union (EU) institutions, initiated by intervention in public finance rules and macroeconomic surveillance. In the summer of 2012 the President of the European Council published the report “Towards a Genuine Economic and Monetary Union”, jointly prepared with the Presidents of the European Commission, the Eurogroup and the European Central Bank. The report proposed to take, over the course of a decade, concrete steps towards a banking and a fiscal union and towards a strengthening of the democratic legitimation of the common institutions, the embryo of political union.

The reform process outlined in the report envisaged a gradual renouncing of national sovereignty in economic and financial matters and the reinforcement or replacement of national intervention tools with corresponding common instruments. During the past six years the implementation of these reforms has been significant but uneven, as subsequent proposals have become less ambitious: the restrictions on the use of national mechanisms were put in place quickly, but the introduction of their supranational counterparts has been delayed.

Today the banking union remains an unfinished business. No concrete steps have been undertaken towards the creation of a euro-area budget and the issuance of common debt. Efforts have been directed primarily at reducing the risks proper to individual member states or banks, while possible systemic problems have generally been neglected. This has generated undesired vulnerabilities: there is the material risk not only that national and European authorities will be

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unable to react adequately to major shocks, but also that they will have trouble avoiding contagion, even in case of apparently circumscribed tensions. To effectively reduce the overall risk, the measures designed to attenuate specific fragilities must be accompanied by adequate safety nets created by supranational instruments.

Progress appears to be on hold for now owing to concerns about the public and private financial vulnerabilities accumulated during the crisis and to mutual distrust which feeds on tensions originating in individual countries. This deadlock must be broken and the conditions must be created to allow for steps to be taken in the future that appear impossible today.

2. The Meseberg Declaration

In June 2018, France and Germany issued a rich document, the Meseberg Declaration, which spans from foreign policy and defence to education and innovation, from migration and security to climate change and scientific research (https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806). Its premise that "the EU faces existential challenges" can be widely shared, as well as "the belief that the only appropriate answer to these challenges lies in European cooperation. Merely national and un-coordinated actions pave the way for failure and division."

The Declaration has a large section on EMU governance and the proposals therein were recently discussed at the Eurogroup meeting held on 19 November 2018, where no formal agreement was reached. They fall in line with earlier ones (including those in the June 2015 "Five Presidents" Report), which have gradually weakened compared to the 2012 "Four Presidents" Report. The Declaration is overly focused on measures aimed at reducing specific risks (which, in some cases, may even turn out to be counterproductive) and is very vague, to the point of lacking credibility, when it discusses future tools and resources to shield the economies of the euro area against major economic shocks.

A key part concerns proposals to change the Treaty of the European Stability Mechanism (ESM). The modifications suggested have two objectives. The first is to improve the prevention of sovereign debt crises and make their resolution as smooth as possible. The second concerns the introduction of a common backstop for the Single Resolution Fund.

The attainment of the first objective is, in turn, based on two pillars: providing the ESM with the capacity to assess the overall economic situation of member states (a task presently assigned to the European Commission) and making the ESM a facilitator in the dialogue between member states and private investors during a crisis (while introducing single limb aggregation CACs in sovereign bonds).

The second objective is conditional upon further progress in reducing bank risks, most notably non-performing loans (NPLs), and upon "preserving the key features of its [the ESM's] governance". It is envisaged that "in 2020, the relevant authorities will provide a report on the trend of NPLs and the building up of subordinated bail-in buffers. On that basis and if risk reduction is satisfactory, the final decision on an accelerated entry into force of the backstop should be taken".

The Declaration also proposes to establish, as of 2021, a common budget for the euro area within the framework of the European Union, to promote competitiveness, convergence and stabilisation in the euro area. With specific reference to stabilisation, however, the Declaration only promises to "examine the issue of a European Unemployment Stabilisation Fund, for the case of severe economic crises, without transfers". The common budget would finance investment in "innovation and human capital" and be financed "from both national contributions, allocation of tax revenues and European resources". There is no mention of the size of the budget, which is likely to have a very limited scope.

In the following sections we shall elaborate on four issues: (*i*) the dangers of focusing exclusively on mechanisms of sovereign debt restructuring while overlooking the need to deal with legacy debt; (*ii*) the problems created by a selective risk reduction strategy in the banking sector; (*iii*) the need for a common budget for the euro area; and (*iv*) the progress and the obstacles ahead on the way to a capital markets union.

3. Sovereign debt restructuring

The presence of countries with a high level of public debt in a currency area is a source of systemic risk. Even if these countries are fundamentally solvent, they are more vulnerable to liquidity shocks (and recent events in Italy show how sensitive markets can be to uncertainty about the commitment of national authorities to financial stability). In addition, in a currency area, a sovereign debt crisis – irrespective of its trigger – would have worse repercussions for neighbouring countries, given the closer economic and financial links. Against this background, a number of proposals, which undoubtedly also provided inspiration for the Meseberg Declaration, have suggested introducing a European sovereign debt restructuring mechanism.

Clarifying the conditions and procedures for restructuring would reduce the part of the cost of a sovereign default caused by uncertainty over the manner and timing of its solution. A restructuring mechanism would also make the no-bailout clause in the European Treaties more credible and would facilitate the formation of bond prices that are in line with the issuer's credit risk, with positive effects on budgetary discipline.

But the uncertainty over the manner and timing of a restructuring is only a small part of the cost of sovereign insolvency. Given the tight economic and financial links among euro-area countries, the negative effects of a debt crisis would be extremely serious and unpredictable for both the country directly involved and the other member states.

Earlier proposals even suggested introducing an automatic link of debt restructuring to the breach of predetermined debt thresholds or to a country's request to the ESM for financial assistance (see e.g. Weber *et al.*, 2011). It is worth stressing how damaging these would be.

First, there is no way in which all the information relevant to distinguishing between an insolvent and a temporarily illiquid country can be assessed in a mechanical way. Debt sustainability is not an exact science, there will always be grey areas and discretion will need to be exerted. Using automatic triggers would therefore be a big mistake.

Second, setting rigid debt thresholds for restructuring may make liquidity crises more likely and fuel pro-cyclical behaviour. For example, an economic slowdown caused by an exogenous shock which causes debt to approach the threshold could trigger speculative sell-offs, increase the risk premium, raise debt servicing costs and worsen economic conditions, up to the point at which the threshold is eventually exceeded.

Thus, the small and uncertain benefits of a debt restructuring mechanism must be weighed against the huge risk that the mere announcement of its introduction may start a perverse spiral of expectations of default, which may turn out to be self-fulfilling – a risk which is greater when several countries have high debt levels, as it is in Europe today. We should all keep in mind the dire consequences of the announcement of private sector involvement (PSI) in the resolution of the Greek crisis after the Deauville meeting in late 2010. The announcement came after the creation of a temporary and modestly financed backstop to support countries in difficulty (the European Financial Stability Facility, EFSF). It was confirmed by a decision of the Council of the EU in the summer of 2011 and followed, in the autumn of the same year, by a recommendation of the European Banking Authority to the main European banks to build capital buffers ("exceptional and temporary") against sovereign exposures (regardless of the issuing country). Only in 2012 was the financial endowment of the EFSF increased, and later the fund was replaced by a permanent institution (the European Stability Mechanism). It is likely that with a different sequence of decisions the impact of the PSI announcement would have been less harmful.

In this respect, it is reassuring that in the statement released after the November meeting, the President of the Eurogroup announced that "there is no support in the room for introducing any automaticity or mechanic approaches in the context of debt restructurings" (https://www.consilium.europa.eu/media/33785/131201.pdf).

It is somewhat surprising that Europe is not focusing on how to support the efforts put in place by member states to reduce their debt. The importance of rigorous budgetary policies at a national level cannot be overestimated. But reducing the debt-to-GDP ratio requires time and there is the risk that a crisis might interrupt the process, just as it did in Italy during the recent double-dip recession (which is of course very different from a situation in which the interruption is the direct consequence of a policy decision).

For this reason, many observers have suggested flanking the consolidation of the public finances at a national level with coordinated supporting action at a European level – for instance via the creation of a European "debt redemption fund" (ERF), which would take on a share of the public debt of each member state. This proposal has been criticised out of fear that it would generate systematic transfers of resources to countries with a lower credit rating. However, the mechanism can be designed in a way that prevents such systematic transfers while reducing the risk of financial instability for the whole area. The introduction of an ERF would strengthen national commitment to debt reduction (the share transferred to the ERF would be backed by a dedicated revenue stream) and reduce the systemic relevance of (residual) national debt. This would be instrumental in enhancing the credibility of the no-bailout clause and the enforceability of European fiscal rules (Cioffi *et al.*, forthcoming, discusses possible options for the design of the ERF as well as the potential benefits of its introduction).

4. Risk reduction in the banking system

In the academic and political debate, the institution of a sovereign debt restructuring mechanism is often linked to the proposal to introduce prudential requirements limiting banks' sovereign exposures. Moreover, the latter, as well as the reduction of the risks stemming from NPLs, are often considered as preconditions for the completion of the banking union with its third pillar, a common deposit insurance scheme.

Concerning the prudential treatment of sovereign exposures, it is important to take into account three issues. First, simply shifting risky bonds from the balance sheet of banks to those of other sectors does not reduce the overall risk. Second, the sovereign-bank nexus does not operate exclusively through banks' direct exposures: a sovereign crisis would impact them through an increase in their cost of funding (also due to rating downgrades) and, above all, through its effects on the overall economy. Thus, if we really want to break the sovereign-bank nexus, we need to reduce the risk embedded in sovereign bonds, not just the amounts held by banks. Third, prudential requirements on sovereign exposures are not imposed in any other jurisdiction. Therefore, if we introduce them in the EU or in the euro area, we need to provide financial markets with an alternative "risk-free asset", such as a Eurobond of some sort.

Turning to NPLs, their link to the overall conditions of the economy is very strong (Visco, 2018). For Italy, for example, a number of Bank of Italy studies have shown that the credit deterioration recorded during the crisis was mostly attributable to the negative developments in Italy's macroeconomic outlook. With regard to bad loans in particular, for which a homogeneous series of data is available from the start of the 1990s, our research shows that the worsening outlook explains nearly 90 per cent of the new bad loans recorded from 2008 to 2016. Indeed, based on previous experiences, the consequences of the double-dip recession on the financial system could have been far worse: even at the end of 2015 peak, the ratio of net bad loans to total loans remained lower than the levels recorded in the mid-1990s, after an economic crisis that was far less severe than the one just past.

Another important issue in the debate on the reduction of banks' risks is that all risks should be considered, not just a subset of them. In particular, the share of Level 2 and Level 3 assets in euro-area banks' balance sheets is very high. At the end of 2016, Level 3 assets amounted to almost €200 billion and Level 2 to €3.4 trillion respectively. The corresponding figures on the liability side were almost €150 billion and over €3 trillion. While the riskiness of these instruments is hard to assess, the available evidence clearly suggests that they are illiquid, opaque and complex. Therefore, a serious debate on risk reduction cannot overlook them.

Fears of moral hazard are focussing the discussion on risk reduction. A clear commitment to financial stability by all parties involved is essential in order to avoid continually pushing the need to introduce a common backstop for the single resolution fund into the background. We are currently failing even to simply discuss how this would work in practice. Indeed, the statement in the Meseberg Declaration that the ESM should act as the backstop while "preserving the key features of its governance" may imply that dedicated financial resources will not be made available at all. We should not forget that bank crises and resolutions take place over weeks, if not days, not over months or years. In Italy we have experienced how costly it is to delay action, even when crises affect relatively small banks.

Current crisis arrangements are especially problematic for smaller banks, which – it must be noted – are called on to contribute to the Single Resolution fund despite the fact that they cannot benefit from its intervention in case of need (given that debt resolution procedures cannot be applied to them). The support provided by deposit guarantee schemes (with its alternative interventions besides those which pay out covered depositors) would certainly facilitate a smooth liquidation. Indeed, while it is true that the European Commission can authorise member states to use public funds to support the winding-up process (as in the case of the Veneto banks), this is a rare exception, something to be considered on a case-by-case basis and according to timeframes that might prove incompatible with those needed to ensure an orderly solution. The rules on the interventions of deposit guarantee schemes, then, should be changed to facilitate the winding up of small banks in order to avoid losses of value, protect retail creditors, and maintain the supply of critical financial services at a local level. Partial progress was made on this front on 13 April 2018, with the Commission's approval of the crisis management scheme for the smallest banks.

Compliance with market and competition protection rules is, of course, crucial. But in assessing the role of public institutions in preventing and resolving crises, including through deposit guarantee schemes, great care should be taken in distinguishing between policies designed to encourage market solutions and avoid potential threats to financial stability, on one hand, and solutions involving State aid which actually distort competition, on the other.

5. A common budget for the euro area

Economic theory as well as the concrete experience of other successful monetary unions, most notably the United States, suggest that the euro area would greatly benefit from the establishment of a supranational fiscal capacity. Kenen (1969) was the first to point out that a shared fiscal policy would reduce the costs of being a member of a monetary union. He argued that area-wide automatic fiscal stabilisers would limit the reduction in domestic prices and wages in countries affected by adverse asymmetric demand shocks. This mechanism would be particularly desirable in the euro area, due to its lower labour mobility across jurisdictions compared to the US and to its stronger regional heterogeneities, which make it more likely to be hit by asymmetric shocks.

It may be argued that national fiscal policies could absorb the effects of cyclical fluctuations in member states and that financial markets could provide an insurance analogous to the one that would be provided by a fiscal union. However, cross-country spillovers may reduce the effectiveness of national initiatives and, in the current situation, national budgets may have little room for manoeuvre due to high debt levels. In addition, European financial markets are not perfectly integrated and risk-sharing through financial markets is not easily accessible for low income households.

In the United States, in Canada and in other federal countries, a significant share of individual states' income variability is offset by the federal fiscal system (estimates based on different methods average at 10-15 per cent for both the US and Canada). The difference between the euro area and fully-fledged federations in terms of shock-absorption capacity is even higher when we look at capital markets.

Indeed, a report on the appeal of a fiscal union (the MacDougall Report) was published as early as 1977 on behalf of the European Commission, and reference to the desirability of a common budget is present even in the 1970 Werner Report. Later on, the technical papers accompanying the 1989 Delors Report discussed the topic in depth. On 3 May 1998, when Europe was completing the last steps before the adoption of the single currency, Tommaso Padoa Schioppa wrote in a column in Corriere della Sera: "The Union has full competence for microeconomic policy […], but its capability for macroeconomic policy is, with the exception of the monetary field, embryonic and unbalanced: it can avoid harm (excessive deficits) but it cannot do good (a proper fiscal policy). […] It is thus right not only to applaud yesterday's step but also to underline its unfinished nature, the risks and the rashness".

Nevertheless, little progress has been made in the way of defining stabilising mechanisms which can supplement national budgets. The need to remedy the asymmetry of a single monetary policy and multiple national budgets was recognised in reports released in 2012 by the European Commission and by the President of the European Council. Both envisaged the creation of a fiscal capacity for the EMU to support member states in the absorption of shocks and in the implementation of structural reforms. However, discussion of a subsequent proposal by the European Commission in March 2013 to implement such proposals did not bring any fruitful result. Since then, the official debate on a fiscal union for EMU has been at a stand-still.

Yet, there are different technical solutions to the implementation of a fiscal union in the euro area. Proposals to create a rainy-day fund present major practical difficulties associated, inter alia, with the uncertainty characterising the identification of shocks in real time. A more appropriate solution, consistent with how risk sharing operates in existing federations, may consist in centralising (part of) specific public functions. One example would be to introduce a basic common unemployment benefit (e.g. Brandolini *et al.*, 2014); the creation of a euro-wide, notional defined-contribution pension scheme could also be considered (Balassone *et al.*, 2014).

A common budget can only be achieved by further transfers of national sovereignty and an adequate strengthening of the democratic legitimacy of supranational institutions. It would make it possible to implement policies consistent with the cyclical conditions in the various member states and in the euro area as a whole, promptly and with no doubts as to their legitimacy. The single currency needs to interact with a single fiscal policy.

6. The capital markets union

The objective of creating a capital markets union is especially important as it aims at broadening non-bank sources of financing and lowering barriers to cross-border investment. Indeed, while the European economy is mainly based on bank-financing, in advanced economies much risk-sharing is carried out through capital markets. In particular, risk-sharing is enhanced by the direct cross-border ownership of assets, notably under the form of equity holdings and firms' ownership claims.

The construction of a financial system that can provide the economy with diversified financial support – not in the shadows, but in full transparency – cannot be deferred. In 2015 the European Commission put forward an action plan for the creation of a capital markets union. More than 30 proposals, legislative and non-legislative, have been presented since then to be adopted or finalised by 2019. This process recently gave rise to two further separate action plans, one on Fintech and the other on sustainable finance, to be completed well beyond 2019. The former aims to ensure that the European financial sector remains innovative and competitive; the latter is intended to create the conditions for sustainable economic growth.

The Meseberg Declaration commits France and Germany "to making decisive progress towards a capital markets union", with a view to fostering financial stability, increasing the resilience of the financial system and supporting the economy at large. France and Germany in particular are committed to reaching an agreement on certain key files, such as the proposals for a personal pension product, on corporate insolvency and on the review of investment firms.

However, negotiations over most of the Commission's legislative proposals to promote the capital markets union – including those related to the files mentioned above – have made little progress. Following the latest adoption, in 2017, of measures on simple, transparent and standardised securitisation, important to revive the securitisation market, no other measures have been approved.

The success of the capital markets union requires making progress in the harmonisation of company, securities, bankruptcy and tax laws, as well as of supervisory procedures, where significant obstacles still remain and are difficult to overcome. We must be ambitious: while harmonisation can start from portions of the relevant national legislation and focus on those areas which may produce broader effects, the ultimate goal must be one of achieving a single rulebook.

For example, in the area of insolvency laws, a directive on preventive restructuring would be an important step forward, but it would not address some of the core issues that drive a wedge between national legislations, such as the definition of insolvency and the ranking of claims. Achieving a single rulebook is also a precondition for handing over the supervision of markets to a single supranational authority, a topic which has gained prominence in the run up to Brexit.

7. Conclusions

The European construction is proceeding by gradual and increasingly difficult stages. There has been a significant transfer of sovereignty on economic and financial matters, especially in recent years. It is indeed illusory to believe that we can direct the course of the economy and finance, patently global phenomena, from within the narrow confines of individual European countries. The construction, however, is lopsided and incomplete; its very sustainability requires that the missing elements be incorporated soon.

Today, progress appears more difficult. The legacy of the crisis and the anxieties generated by geopolitical tensions – especially the management of migration flows – have been aroused in the sentiments of many European citizens and, at times, in the governments that give voice to them, fuelling fears and prejudices once thought long buried. Distrust leads to disaccord, and in the exasperated pursuit of mutual reassurance and short-term gains, the necessary steps are hard to take.

During the crisis the task of safeguarding the stability of the euro area fell almost entirely to monetary policy, owing to the persistent fragility of the other elements of the institutional framework, which have been only belatedly and insufficiently rectified. It is not easy to recover trust or create a sense of belonging; nor is it possible to ignore the underlying reasons fuelling protest among national public opinion and criticism of political institutions, especially European ones. Well-being and security are basic needs: however, guaranteeing them by responding to global challenges in a fragmented manner and keeping threats at bay by rebuilding national barriers have little chance of success; on the contrary, they inevitably inflict further damage.

The concrete achievement of monetary union, banking union, capital markets union, and even the prospect of a common fiscal policy, all call for a leap in quality. As noted in Visco (2017), Europe must remain an anchor of stability in a world that appears ever more unstable and politically unpredictable. The willingness to cooperate more closely on issues such as immigration, defence, security, justice and representation at international forums is undoubtedly a positive signal. We must continue on this path, tackling the issues that still stand in the way of the effective economic governance of the euro area.

In the areas of the economy and finance, European governance has relied almost exclusively on rules that, in an exaggerated pursuit of mutual guarantees, constrain the choices of each country. The result has been a Union that is better at prohibiting things than at getting them done. This is evident in the public finances. In the absence of a common budget, at the height of the crisis it has been hard to lend support to the economy. It is also evident in the management of bank crises and in the preservation of financial stability, where the splitting of powers among a large number of authorities makes it difficult, at times, to identify the measures to be adopted and slows down actions that, to be effective, must instead be taken quickly.

Proceeding by means of compromise is becoming increasingly difficult. Completing the banking union and establishing a capital markets union are clear and immediate objectives. But the true completion of the European construction will only be achieved with the development of democratically designated institutions, mandated to exercise common sovereignty. It is important for all countries – Italy certainly included – to be present in forums where the future of the European Union is to be decided. Our destiny is that of Europe, the large and integrated economic area we are all part of. Its development determines ours and at the same time depends on it.

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