Euro 2022

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Munich, December 10th, 2012

THE EUROPEAN MONETARY UNION IN 2022

Prologue: Europe and the Euro

The importance of Europe as an economic and political force in the world has been dwindling in recent years. This process is set to continue in a world with newly emerging powers. We must acknowledge that the challenges of demographics and mobility are mounting drastically. Asia's population is set to grow by a further 1.7 billion over the next four decades, and Africa, an immense continent five times larger than Europe, will have a population of 2 billion, half of whom will be under 20 years old. Europe on the other hand will see its population fall by 20 million by 2050. No one single country in Europe will be in a position to exert major influence on the foundations and the values of tomorrow's world economic and political order. Even Germany, with the largest population of all countries in Europe, accounts for only 1.1 percent of the world's population and, with an aging and shrinking population, even this low percentage will decline further. How successful would Germany be in asserting its views for example on environmental issues, social values or on free market policies for that matter in the international arena if it does not team up with its European partners? This argument is all the more pertinent for the smaller countries of the European Union.

Therefore, European integration and European unity must be elevated to a new level. A dissolution of the euro would work exactly in the opposite direction, it would weaken Europe in many different areas. A renationalization of currencies would imply a return to more particular policies. Hardly an answer to today's global challenges. And the political repercussions are often overlooked. Do we really want to put at risk the advances of integration like the free flow of capital, goods, and people or the path towards common foreign and security policies in Europe? Does it make sense to nudge the Nato-member Greece towards exit from the eurozone in a political situation with enormous instability in the Arabic region and growing competition with Turkey and Russia in southeast Europe? The euro is not the raison d'être of Europe, but it is the most important symbol and facet of the deepness of integration. Therefore, the ambition of policymakers should be to eliminate the flaws in the present institutional framework of the euro, to foster integration and unity among the EMU and the EU members. In short: to unite and not to divide the old continent. In the world we live in, European unity is the only way forward if we want to preserve our influence on the international world order, safeguarding our living standards for the coming generations.

Elements of a target picture for Euro 2022

In the present situation of intense economic and political tensions in the Eurozone and the EU, many scenarios for future development are conceivable. Greece might exit the currency union with unclear repercussions on the rest of the Union, reforms in Spain or Italy might hit political and social opposition if unemployment continues to grow, there may be further debt restructurings and all this in the end may lead to a major reshape of the currency union. What scenario develops is not easy to predict. Policy decisions are taken under the pressure of the crisis, irrational outcomes and unplanned and undesirable results can not be excluded (see Lehman). Therefore, it is absolutely important to have a clear compass showing the way ahead. The short-term policy decisions need to be compatible with long term goals. They should be guided by a clear target picture for the EU and the Euro 2022. This paper wants to contribute to the overdue debate about this long-term view that unites all member states behind a common goal.

A target picture for Europe 2022 can be seen from different perspectives; here, an economic point of view is taken. It is evident that the community of countries in the EU and the Euro area must resume growth, overcoming the present instability and the lack of competitiveness some countries are presently experiencing. That requires structural reforms. Economic policy making must be better co-ordinated and fiscal policies should have achieved a significant debt reduction by 2022 in compliance with the fiscal compact and the Stability and Growth Pact. Macroeconomic policies in member countries should be geared to strong growth and higher employment, but should keep countries on a sustainable, non-inflationary path. Financial markets should be overseen by a Euro- or eventually EU-wide bank supervisor that guarantees that the same rules are applied across the region. All this means more decision making on an EU-level and requires stronger political co-operation and clearer democratic governance structures on an EU level.

The call for deeper European integration may not sound controversial, but the process has some caveats. One issue is that more political integration cannot be an instrument of crisis management. If political integration - i.e. a partial surrender of national sovereignty - is justified solely on the grounds of saving the euro it will not be sustainable. The process of political integration must result from a public debate on how much and what type of integration is desirable. Clarity on this is crucial. At the end of the day, the voters will make the decisions, presumably also in public referenda. In some countries they must be convinced that painful reforms are worth the effort and in others that the provision of substantial financial support within the monetary union is no waste of money. A commonly accepted goal for the development of the European Monetary Union would make it easier to justify the present policy measures in a diverse group of countries with diverging interests.

This common goal will be surely not the “United States of Europe”, i.e. a federal state with strong centralized powers and only limited policy sovereignty in national member states. At present this is neither realistic nor advisable. There is no European populace that requires one European state. (Over-)Centralization is not adequate for the EU potpourri;

decisions on taxes, spending, social security or labor market regulations for instance should reflect the cultural and economic differences in the euro area. The principle of subsidiarity must prevail. What is needed is not a common central government but a European constitution that clearly defines the responsibilities of all decision makers, determining the areas where decision making and competencies need to be transferred to the EU level. In the shadow of the current crisis, this definitely needs to include rights of fiscal surveillance and control. But the deepening of integration is not only about fiscal discipline and mutual control. Other potential areas of integration are security and defence issues, foreign policy issues, energy policies or trans-European infrastructure decisions.

Seven steps towards the target picture 2022

1. Strengthening European institutions: Democratic legitimacy

Stronger integration requires at least a limited transfer of sovereign rights to the EU level. As a precondition, the democratic accountability of EU institutions that acquire more responsibility for decision making has to be strengthened.

In a first step, the competencies of the European Parliament should be further upgraded, for example by empowering it to initiate legislative procedures. The result would be a de-facto two-chamber-system, with two powerful legislative branches: the European Parliament on the one side, the European Council on the other. Representation in the former would be more in line with population size, the latter would give interests of small countries disproportionate consideration. Furthermore, co-operation between the European Parliament and national parliaments should be intensified, particularly in the areas of economic and fiscal policy.

In a second step, the executive branch should be streamlined and strengthened, too. The aim should be to transform the EU Commission into a small but capable executive whose membership is based on merit, not nationality. The present posts of EU president and Head of the EU Commission could potentially be merged and a direct election of the EU president seems sensible.

The necessary treaty changes to strengthen EU institutions in such a way have to be decided and adopted by all EU members with unanimity. The political union should encompass the entire EU. The “new” EU institutions have then basically two tasks: to guide national fiscal and economic policies and decide and execute common policies (see below).

2. Different speeds of integration: Who is in – who is out?

The transfer of sovereign rights is the biggest roadblock to a more integrated Europe. The decisions which policy areas are to what extent transferred to the EU level have to be taken by all governments with unanimity. In particular, EMU-members have to find a

consensus on the proper design of fiscal, economy and banking unions (but non-members might be allowed to opt-out). Nonetheless, the transfer of sovereign rights will kick off intense political debates in every member state. Without the explicit consent of the people, these far-reaching treaty changes cannot take place. Referenda to amend national constitutions are required. However, although governments support the changes the outcome of these referenda is uncertain, not least given the nationalistic mood prevailing in many member states today. (Policymakers clearly have to do a better job in explaining the logic and benefits of further integration.)

Therefore, it is necessary to establish a transparent and secure way to abandon membership of EMU, if a member state consistently fails to transfer sovereign rights to the required extent. Presently, the EU treaty offers no clear rules for such a situation. Furthermore, it should also be possible, as a measure of last resort, to exclude countries that are not willing to accept the rules and decisions of EU institutions. This "ultimate weapon" of expulsion should further enhance discipline and public spirit among member states. The possibility of exclusion requires a corresponding change in the EU Treaty.

However, accelerating the process of European integration, a degree of variable geometry may have to be accepted. This was evident recently when the UK opted not to sign up to the fiscal compact. Certainly, there will be progress at different speeds concerning EMU-members and non-members. But the risk of a two-speed Europe is nothing compared to the risk of no Europe at all. And in the end, the logic of further integration will prove irresistible. Standing beside will deprive European countries of any political influence in the international arena. Therefore, by 2022 it is highly likely that most EU members will have joined the EMU. The only exception may be UK and Denmark which have opt-out clauses.

3. Fiscal guidance: Controls with teeth

One of the main tasks of the empowered EU institutions is fiscal guidance: strong mutual control of fiscal policies and an enforceable commitment of all euro-countries to stable and sustainable debt policies. Countries must accept EU-level interference if they breach the rules. The lack of meaningful fiscal controls has been the biggest flaw of the Monetary Union. In the past, compliance was basically based on persuasion. It was doomed to fail. This is not acceptable for a community with an ongoing mutualisation of debt through rescue-fund loans or ECB bond-market interventions.

An effective enforcement of the fiscal rules of the EU requires some transfer of sovereign fiscal rights from the national to the EU-level. On their own, sanctions intended to punish sovereign debtors deviating from fiscal rules will not do the job. What is needed is an EU institution (e.g. EU finance commissioner) with the power to directly intervene in national tax or expenditure policies if countries do not stick to their commitments. Such intervention could entail the earmarking of a percentage of taxes for debt reduction or the enforcement of linear expenditure cuts.

With such strong fiscal controls in place, the possibility of a limited risk sharing between Euro-countries appears in a different light. Then, common financial instruments of Euro members become more palatable for policy makers and voters in the net-creditor countries. Whereas full Eurobonds in the form of joint and several liability would institutionalize major transfers and possibly lead to moral hazard behavior, an alternative would be so called "Eurozone basket bonds" which have the structure of several, but not of joint liability (this was option 3 in an EU commission paper from December 2011). With such a bond, each country is liable only for its share of the revenues, avoiding moral hazard and maintaining market discipline. Eurozone bonds could be constructed similar to the present EFSF bonds and would help to assuage market worries about the peripheral countries without overburdening the stable economies. They would constitute a euro area safe and liquid asset going a long way to sever the fatal link between banks and sovereigns. For international investors they would signal a clear willingness for further integration of the monetary union.

4. Economic guidance: Limiting macroeconomic imbalances

Control of national fiscal policies is necessary but not sufficient. Just as important is the consistency of national economic policies. One of the main lessons of the crisis has been that focusing only on fiscal deficits and public debt dynamics risks overlooking dangerous macroeconomic imbalances that were at the core of the crisis in some countries. Excessive risk-taking by banks, huge private sector leveraging, booms and busts in real estate and mortgage markets, enormous current account deficits are some of the most prominent examples.

Therefore, the EU Council has already added an Excessive Imbalance Procedure (EIP) to the Stability and Growth Pact to monitor and to correct such imbalances. Again, this process needs more teeth. The monitoring of these indicators should be done by the empowered finance commissioner in co-operation with the ESRB (European Systemic Risk Board). Member states' counter-measures and reforms promoting growth and competitiveness should be defined by contractual arrangements giving the EU-Commission the power to force member states to take corrective actions. These decisions would require qualified majorities in both chambers.

Furthermore, the mandate of the ESRB should be expanded, too: from analyzing the evolution of systemic risks in the respective financial systems to monitoring economic imbalances as well; and its powers and instruments to correct these developments (e.g. by tightening regulation or capital requirements in times of financial booms) should be strengthened: recommendations of the ESRB should be binding. In the EU of 2022 the ESRB should be a major factor for macroeconomic and financial stability. A beefed-up macro-prudential policy implies that the new singe banking supervisor (see next paragraph) is also provided with macro-prudential policy tools.

5. Common banking policy: EU-level supervision and regulation

An important element of enhanced fiscal and political integration is EU-level supervision and regulation for European banks. National differences in regulation and supervision

can lead to regulatory arbitrage and relocation of financial activity that is harmful for overall stability. Furthermore, banking crises can easily undermine national fiscal sustainability. The banking crises in Ireland and Spain are cases in point. On the other hand, fiscal instability of a country affects the capital market standing of the respective banks, hampering cross-border capital flows.

The consequence: Financial activities are more and more retrenching within national borders, leading to a re-fragmentation of European financial markets. This process was aggravated by the absence of a coordinated crisis management and consistent resolution arrangements. This is a particular worry for the European Central Bank (ECB) as the increasing fragmentation impairs the monetary transmission channels.

Therefore, a truly European set-up of financial market regulation and supervision is an important element of a functioning Monetary Union. The first steps towards a banking union are welcome. The present moves to install the ECB as a European banking supervisor open a fairly fast track into a closer banking union. The capacity of the ECB in practical oversight will at first be limited to large corporations or those that apply for support through the ESM funds. Over time the coverage of the ECB should expand to all banks, although day-to-day supervision of smaller banks will remain the responsibility of national supervisors.

However, a functioning banking union consists not only of common regulatory requirements, the so-called single rule book, and a single supervisory mechanism (as envisioned today), but also of a common resolution regime with an appropriate backstop for efficiently handling banking crises – by directly re-capitalizing under-capitalized banks or by unwinding failed banks in an orderly manner. Presently, this is possible with resources from the ESM, an important measure to cut the negative feedback between sovereign and banking risks.

6. Common policies: Boosting growth and competitiveness

Fiscal and economic guidance to safeguard stability have to be accompanied by policies to boost growth and competitiveness. Besides national structural reforms, however, common policies of the EU members can contribute significantly to growth and employment: Common policies for education, labor market mobility, transport, and energy are obvious candidates. These policies should not be used for purely redistributive targets (as in the case of agricultural and structural policies) but first and foremost in order to stimulate growth through investments in Europe's physical and intellectual infrastructure. Where EU institutions take decisions for all participating states (with qualified majority), common policies have to be backed by common funds for execution. In this case, common project bonds or similar EU-wide financial instruments seem appropriate. The new "fiscal capacity" envisaged by the roadmap of the van Rompuy group may fulfil these functions: facilitating structural reforms and absorbing country-specific shocks. However, they should be limited to areas where decisions are taken at the EU level; they should not be (mis)used as hidden subsidies for national budgets.

7. Debt restructuring mechanism: Providing a fresh start

Within the next ten years, the EU should succeed in establishing a workable sovereign debt restructuring mechanism. Such an unlikely, but not impossible situation of another sovereign default must be managed efficiently – in order to avoid a repetition of today's situation, where seemingly endless rescue operations are needed to prevent any kind of disorderly default.

By setting clear rules for rescue operations on the one hand, and for defaults with a bail-in of investors on the other, a sovereign debt restructuring mechanism is supposed to prevent potential payment difficulties from becoming disorderly and contagious sovereign defaults. With such a mechanism in place, governments and financial market participants must be aware of the fact that a default of potentially over-indebted countries can occur and that bail-outs are conditional and limited. Ruling out the possibility of default would undermine fiscal and market discipline from the very beginning. The advantage for the indebted country is that an orderly default, properly managed, offers a quick route to restart the economy afresh, without an endless chain of austerity packages undermining confidence.

Basically, the Sovereign Debt Restructuring Mechanism should be designed following the original idea of the ESM, which at the start was intended to serve as a mechanism for potential debt restructuring (but over time mutated into a pure bailout fund trying to limit contagion with all its resources).

To sum up, the following elements need to be put in place in order to improve the foundations of the euro:

1. Reform of EU governance enhancing EU decision making and democratic legitimacy of EU institutions.
2. Explicit exit rules for countries that do not live up to their commitments within the Monetary Union.
3. A precise fiscal rulebook empowering an EU finance commissioner to intervene when necessary paving the way for "light" Eurobonds (European basket bonds).
4. An effective mechanism at the EU level to detect and correct the evolution of imbalances that may derail economies.
5. Enhanced competencies for European institutions, particularly with regard to the European banking system.
6. More common policies that lead investments in Europe's physical and intellectual infrastructure boosting growth and competitiveness.
7. A sovereign debt restructuring mechanism offering liquidity support to governments when appropriate, but also guaranteeing an orderly process in the case of default.

The eurozone: Destination 2022

Economic Union Stable Economic Growth	Fiscal Union Fiscal policy discipline
• Agenda 2020 • EIP (Excessive Imbalance Procedure) • Completion of Single Market • EU Growth Initiative	• European Semester • Reform of Stability Pact • EU Finance Commissioner • Sovereign insolvency law
Banking Union Stable financial markets	**Political Union** Political competences at EU level
• European supervisory regime • Recapitalization fund • Integration of financial markets	• Enhanced initiative powers for EU parliament • Two-chamber system • Direct election of EU President/ Head of EU Commission • Rules for euro-exits