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Overview of EMU

In-depth Analysis

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Overview of EMU

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICY

Overview of EMU

IN-DEPTH ANALYSIS

Abstract

This note focusses on selected policy issues as outlined in the Five Presidents' Report and which are relevant for parliamentary work. The note provides an overview of the main steps undertaken and of the proposals planned to make EMU more resilient to shocks by addressing the policy and governance challenges unveiled by the financial crisis. These include: i) labour and product market reforms to raise long-term productivity and growth; ii) financial integration (Banking Union) to improve market confidence in banks, stabilize financial markets, eliminate fragmentation and cut the sovereign-bank negative feedback; iii) plans for a Capital Market Union to enhance market-based financing to the economy, diversify the sources of financing, thereby spreading the impact and risks of financial shocks; iv) plans for a Fiscal Union or fiscal capacity as a macroeconomic stabilization tool against income shocks. Fiscal union is politically challenging, as it involves ceding even more sovereignty from national levels to the euro-area level and is, therefore, strongly connected with political integration (Political Union). The note is complementary to the document "Institutions and Bodies in the Economic and Monetary Union", which provides an overview of the governance framework of EMU.

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EXECUTIVE SUMMARY

The financial crisis has shown that the Economic and Monetary Union (EMU) needs reforms. The euro area is far from being an optimal currency area: while there has been nominal convergence (i.e. for inflation rates and interest rates), little convergence has been observed for real variables (i.e. per-capital income levels) among the countries sharing the same currency. Real convergence has been held back by several factors, including weak productivity growth in some economies, labour and product market rigidities, weak governance and lack of enforcement. But a specific feature of the monetary union has been the large (private and public) capital flows which took place in the decade before the financial crisis between the "core" and the "periphery" of EMU, with the latter borrowing massively from abroad. When the crisis started in mid-2007, there was an abrupt reduction in cross-border lending. This led to a deterioration in the financial position of banks in the countries depending on foreign lending. As governments stepped in to save their banks, government deficits increased, also due to lower growth, and economic imbalances widened. The current account/financial crisis mutated into a government debt crisis. EMU mattered because (rising) cross-country imbalances were supposed to self-adjust. It did not happen. The lack of a governance framework and of an automatic shock absorption mechanism (either temporary or permanent) to deal with the impact of EMU-wide and country-specific shocks amplified the effects and the persistence of the crisis. As of today, the output has yet to recover the pre-crisis level even in some EMU countries not overheating before the crisis.

Despite EMU vulnerabilities, the euro is consistently viewed favorably. The economic and financial crisis unveiled several vulnerabilities in the governance framework of EMU. However, the popular support to EMU and the common currency has remained surprisingly high through the crisis and has been on an improving trend more recently (Eurobarometer survey).

In recent years, progress has been made towards foster growth, correct imbalances and improve governance. Labour and product market reforms have been implemented and competitiveness has improved. Changes in legislation are aimed at decentralising the wage-setting system, reforming welfare-related benefits and pursuing market liberalization and deregulation. These are expected to have positive effects on growth, even though the benefits of structural reforms are not felt immediately. Most crisis-hit countries have also made progress in correcting their current account and fiscal deficits. The crisis showed that the lack of common supervision and regulation of financial markets may lead to a major destabilization, when the exchange rate policy tool is not available. Meanwhile, progress has been made on financial supervision and resolution mechanisms as part of the Banking Union programme, with visible improvements in terms of financial stability. In addition, EMU's capability to early identify and tackle macroeconomic/financial imbalances has been strengthened, in the context of the European Semester.

Comprehensive and politically challenging proposals for the future of EU/EMU integration have been put forward through a two-stage process. The Five Presidents Report (2015) 'Completing Europe's Economic and Monetary Union' published in June 2015, proposes a two-stage implementation process with measures for economic, financial, fiscal and political union. Stage 1, which runs until June 2017, comprises reforms that build on existing instruments and can be implemented within the current legal framework, such as:

- Boosting convergence, jobs and growth through i) the creation of a system of Competitiveness Authorities to monitor the evolution of unit labour costs and limit divergences; ii) better implementation of the Macroeconomic Imbalance Procedure, making the implementation of country-specific recommendations more

binding (e.g. possibly endorsed by national parliaments); iii) stronger / more efficient coordination of economic policies within the European Semester;

- Completing the Banking Union with the third pillar, i.e. agreeing on a Common Deposit Insurance Scheme
- Progressing on the Capital Market Union, as it can make EMU more resilient by facilitating SME financing, supporting government investment programmes, improving monetary transmission mechanism and reducing the 'home bias' effect on banks' balance sheets.

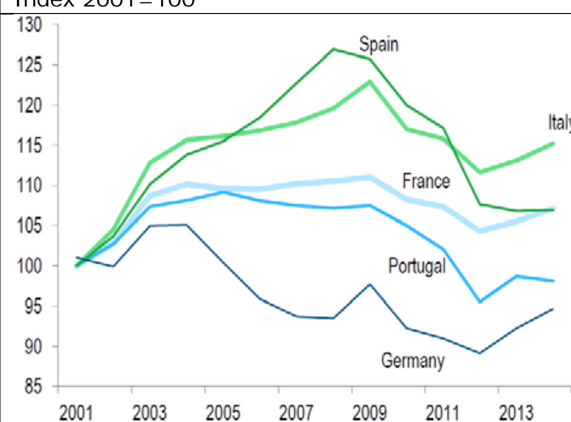
A long-term stabilization of EMU will require the significant deepening of the Fiscal and Political Union. According to the Five Presidents Report, Stage 2, which runs until 2025 at the latest, encompasses all reforms that will require amendments to existing Treaties to complete the EMU, such as:

- Formalising and making more binding the convergence process, by further harmonization in some areas such as corporate taxation or "flexsecuirity" for the labour market;
- Setting up a macroeconomic stabilization mechanism for the Fiscal Union with three elements: i) provide incentives for the implementation of structural reforms, to foster economic and social convergence within the euro area and to improve its economic competitiveness and resilience; ii) endow EMU with an instrument to cope with symmetric shocks (hitting the region as a whole), in particular in the context of a zero lower bound environment; iii) address asymmetric shocks stemming from differences in Member States' business cycles with an instrument which provides an immediate stabilisation effect (shock absorption effect). A common Unemployment Insurance Scheme is one such model with a cyclical absorption capacity. As with other fiscal stabilization mechanisms, the concept of unemployment insurance would have a stabilising function, but should be designed in a way that prevents permanent fiscal transfers between member states. It is likely, however, that negative incentives can be reduced but not fully eliminated. Eurobonds are also debated as another measure to cut financing costs and reduce the dependence of individual member states on the financial markets of other member states. In this case too, forms of negative incentives may set in (permanent fiscal transfers between surplus and deficit countries).
- Strengthening democratic accountability and legitimacy for the Political Union. Alongside the creation of new institutions and common policy instruments, the increased provision of public goods in EMU must go hand in hand with a strengthening of democratic accountability and institutional legitimacy of the decision-making process and, therefore, of the role of the European Parliament. Setting up a euro-area Treasury with a veto over national budgets is also a challenging step which calls for deeper democratic and political union. The Commission will publish a White Paper in spring 2017 to present the second stage in more detail.

1. THE CRISIS AND ITS AFTERMATH: SOME STYLISED FACTS[1]

The recent financial and economic crisis revealed flaws in the self-adjusting mechanisms of EMU[2] and institutional deficiencies in its structure. It was believed that the adoption of a common currency would have been enough for member states to move towards economic and political integration and that a set of (Maastricht) convergence criteria would have been enough to compensate for and protect against the loss of the exchange rate as a policy tool. But EU/euro-area economies did not converge as expected. Imbalances built up since the introduction of the euro. As an illustration, after the introduction of the euro, unit labour costs rose much faster in Italy and Spain as compared to Germany and a deterioration in competitiveness is visible also in France and Portugal (Figure 1). Meanwhile, a number of countries of the EMU "periphery" experienced strong private capital inflows. Ideally, these flows would have been driven by profitable investment opportunities, cause an adjustment of labour costs to restore competitiveness thereby supporting growth and convergence of per-capita incomes for the region as a whole. What happened instead was a misallocation of capital, with funds often fuelling property booms or increasing public consumption rather than being allocated to productive purposes. Macroeconomic imbalances and, in particular, current account deficits, widened as macro-prudential tools were too weakly applied. In other countries, current account surpluses ballooned. When the crisis hit, a sudden reversal of capital inflows took place, resulting in credit booms and busts in EMU periphery for which there was no automatic correction mechanism, with long-lasting consequences in term of growth. Indeed, some of these countries have yet to recover their pre-crisis level of output. This cast doubts on the ability of the EMU/euro-area to respond to shocks: the crisis revealed flaws in the self-adjusting mechanisms of EMU.

Figure 1 – Competitiveness (unit labour costs), in selected EMU countries
Index 2001=100



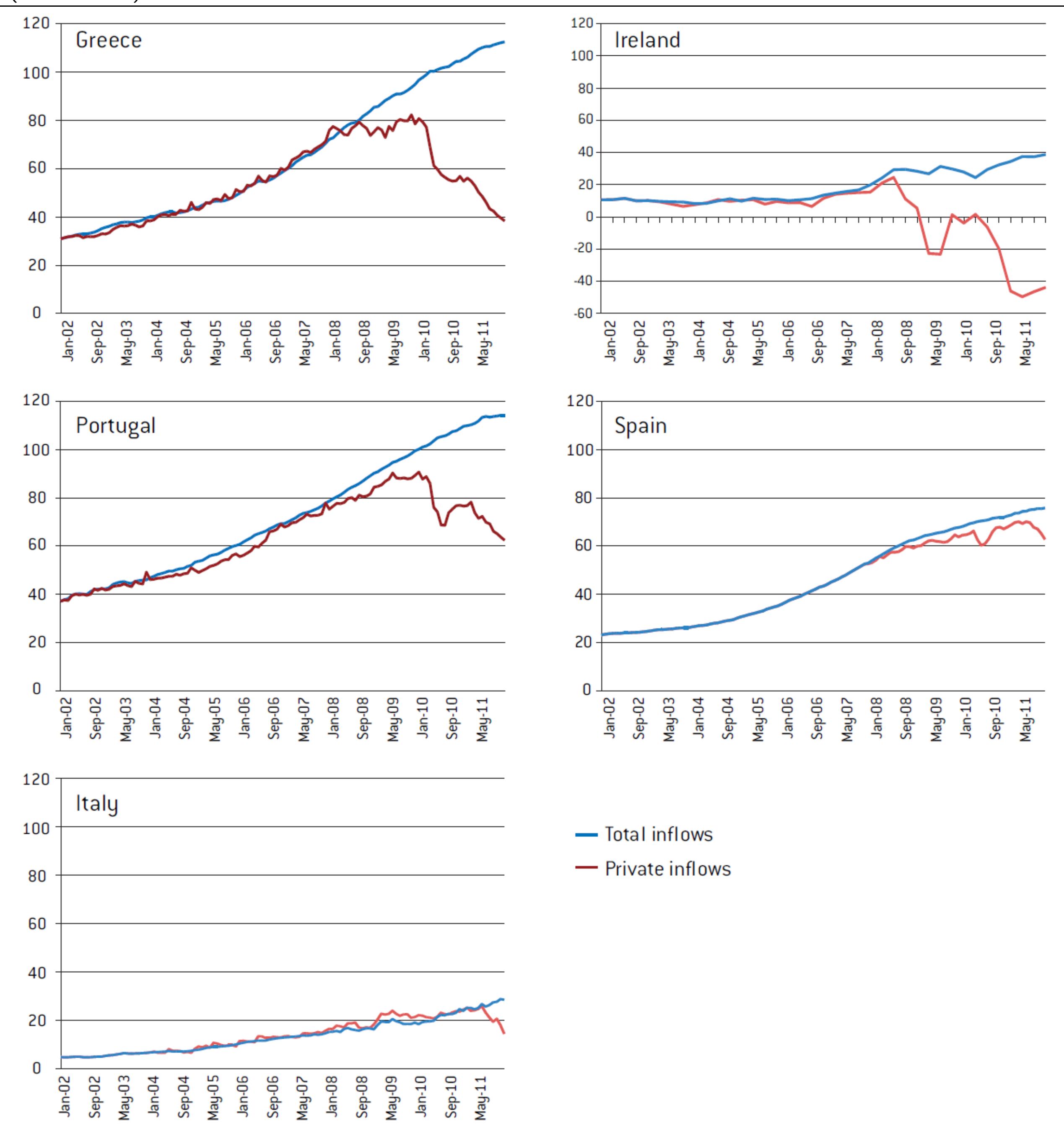
Source: AMECO Database, DG ECFIN

With the crisis sizeable capital inflows reversed suddenly in a number of countries. In Greece, Portugal, Spain, Italy and Ireland, significant inflows of private capital funds took place between 2002 and 2007-2009 (Figure 2) which were then followed by timely-concentrated outflows ("sudden stops"). In Greece, private capital inflows and outflows amounted to about 40% of (2007) GDP as of June 2012. In Ireland, inflows were limited, but outflows reached 70% of GDP as of early 2011. In Portugal, inflows and subsequent outflows accounted for about 30% of GDP. In Spain and Italy private capital inflows and outflows started later and were less sizeable, but nevertheless they were of significant size. Not surprisingly, the ensuing adjustment process in these countries was painful.

[1] The note is complementary to the document "Institutions and Bodies in the Economic and Monetary Union", which provides an overview of the governance framework in EMU, http://www.europarl.europa.eu/RegData/etudes/BRIE/2016/574388/IPOL_BRI(2016)574388_EN.pdf

[2] Economic and Monetary Union, http://ec.europa.eu/economy_finance/euro/emu/index_en.htm

Figure 2 – Total and private capital inflows in selected EMU countries, 2002-11
(% 2007 GDP)



Source: Merler S., Pisani-Ferry J. (2012)

Positive economic developments in recent years, but the weakness of investment stands out even in a historical perspective. Through the turbulence of recent years, EMU has taken major steps to overcome the crisis and to strengthen institutions and governance. Most crisis-hit countries have managed to correct domestic and external imbalances and improved competitiveness. Fiscal deficits have been reduced. Employment prospects have improved in EMU as a whole, even though unemployment (both actual and long-term) is still above pre-crisis levels and the employment rate is too low[3], adding scope for further labour market reforms. Productivity, a key driver of the standard of living and per-capita income growth, remains subdued. Growth was dragged down chiefly by the collapse of investment during the crisis (Figure 3). While this was particularly visible in the EMU periphery, the contraction of investment (gross fixed capital formation) has been severe also for the region as a whole: in the euro area for instance, in 2015, the observed investment-to-GDP ratio was still about 3 ½ percentage points of GDP below its level in 2007 (a contraction equivalent to about EUR 350bn) and almost 2 ½ percentage points below its average between 1993 and 2007, corresponding to a gap of EUR 240bn (Figure 4).

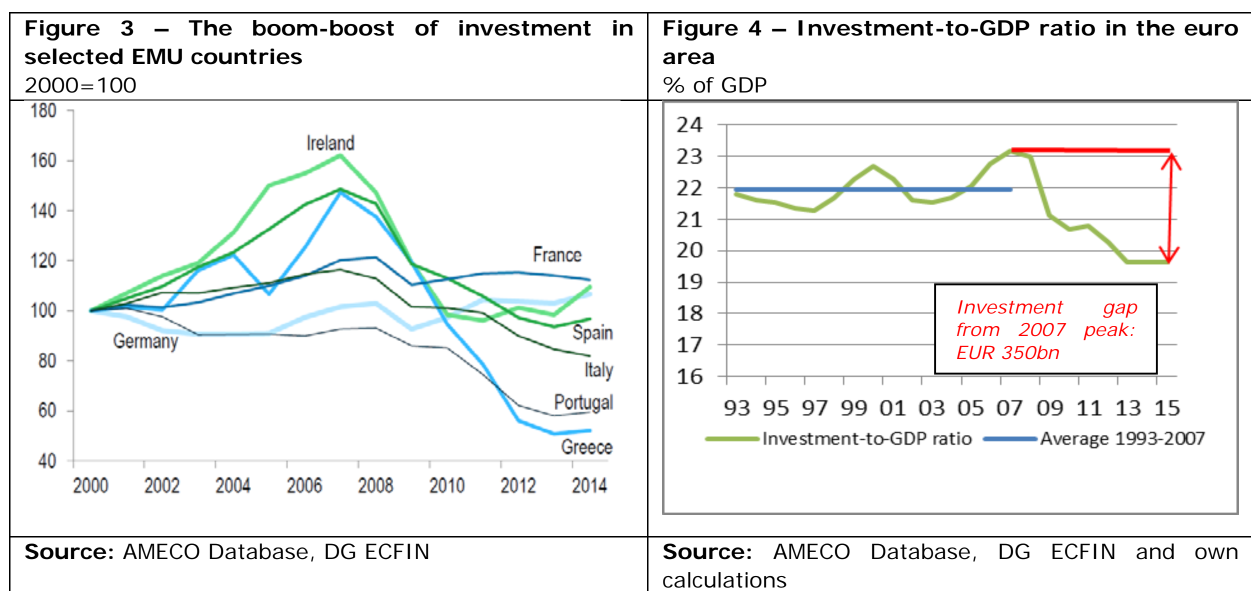


Figure 3 – The boom-boost of investment in selected EMU countries
2000=100

Source: AMECO Database, DG ECFIN

Figure 4 – Investment-to-GDP ratio in the euro area
% of GDP

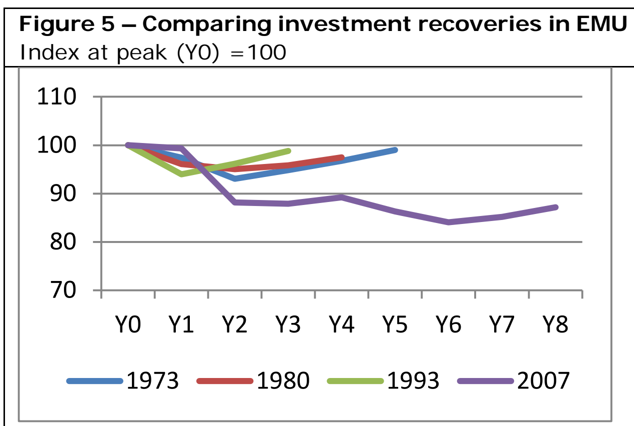
Source: AMECO Database, DG ECFIN and own calculations

Recoveries from major recessions have always tended to be sluggish and hesitant in most euro area countries, especially when compared with the US. But, even against such a dismal record, the weakness of the euro area recovery after the global financial crisis clearly stands out. Among the components of domestic demand (consumption and investment), investment, in particular, appears to have been much weaker than would normally be expected in a 'typical' recovery. Figure 5 shows the investment recoveries of the three major recessions of the 1970s, 1980s and 1990s in the euro area. Such inter-temporal comparisons should be considered with caution, if only because of the radical institutional and structural changes brought by the single currency. However, they quite neatly illustrate the "abnormally" subdued pattern of euro-area investment during the current recovery. To account for the depth of the fall, as well as the delay in the rebound of investment, structural factors related to private balance-sheet adjustments from the debt overhang must be at work, beyond standard determinants of investment. If households and corporates deleveraging is an important feature for the current subdued level of investment, the European Investment Plan[4] should help to address the market gap and revive capital formation by mobilising additional private resources through the financial support of the

[3] As compared to other advanced economies of similar dimension, such as the US.
[4] http://ec.europa.eu/growth/industry/innovation/funding/efsi/index_en.htm

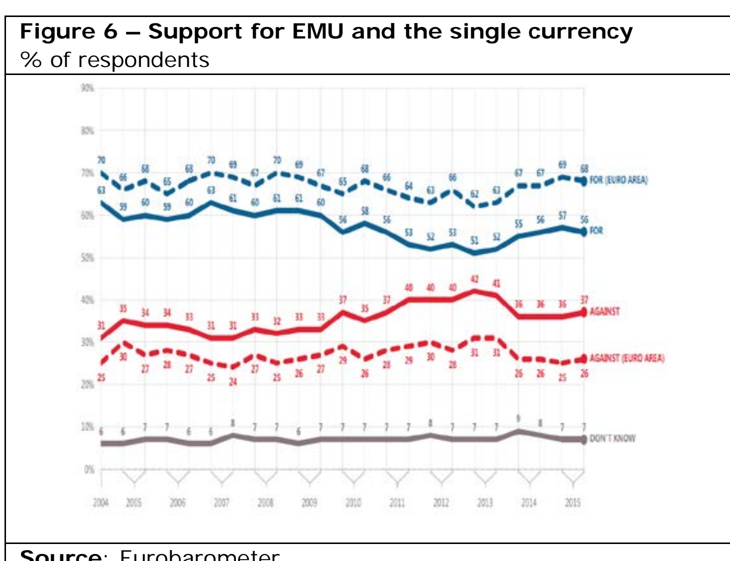
European Fund for Strategic Investment. In this context, the Banking Union (although still an unfinished project) is instrumental to reduce fragmentation in credit markets, enhance the provision of credit to the private sector and, overall, make the investment climate more favorable.

Figure 5 – Comparing investment recoveries in EMU
Index at peak (Y0) =100



Source: AMECO Database, DG ECFIN and own calculations.
Note: *Y0 marks the year of the investment peak*

Figure 6 – Support for EMU and the single currency
% of respondents



Source: Eurobarometer

The severe crisis have reduced the trust of citizens, but support for EMU and the single currency has remained strong so far. The cause of the recent economic and financial crisis in EMU was not high public debt (only). Countries like Spain and Ireland had very low public sector deficits and debt levels for a long time. But these countries were then hit by sharp recessions caused by the bursting of the real estate bubble, the ensuing banking crises and its huge costs in terms of public finances. The incomplete governance framework of EMU could not prevent the soaring of imbalances and their sudden reversal. But the financial crisis also revealed that the vulnerabilities that come with high public debt can significantly reduce the fiscal space available for a policy response. This highlighted the need for tighter controls of government deficit and debt levels and to establish a robust framework for the prevention and management of financial crisis, including financial supervision and resolution mechanisms (Banking Union) as a pre-condition for EMU to avoid similar crisis in the future and remain on a sustainable growth path. Moves to tighten integration in the context of a severe and long-lasting crisis associated with vulnerabilities in governance have reduced the trust of citizens in EMU and the single currency. But popular support to for EMU and the single currency remains strong. According to latest data (November 2015) from Eurobarometer, 56% of EU citizens support "a European economic and monetary union with one single currency, the euro", while 37% say they are against. The support has increased continuously since autumn 2013 and although the positive trend has halted recently, evolutions are limited. A similar pattern can be detected also among euro-area citizens, but here the support for EMU and the single currency is stronger, as it stood at 68% in November 2015 and never fell below 62% (Figure 6).

2. HOW EMU WAS ACHIEVED

The international currency stability that reigned in the immediate post-war period did not last. The post-war order for the market economies of Europe, North America and Japan was founded on the Bretton Woods system which provided the international framework for currency stability, with gold and the US dollar as the predominant monetary standards. The Bretton Woods system had already begun to show signs of strain in the late 1950s, and towards the end of the 1960s a new era of currency instability threatened the international currency stability when market turbulence forced a revaluation of the German mark and devaluation of the French franc. This endangered the stability of other currencies and the common price system of the common agricultural policy, a pillar of what was then the European Economic Community[5]. In response, the Werner Plan (1970) set up a process on how Monetary Union could be achieved, including a currency union by first narrowing exchange rate fluctuations. But this system was then abandoned in the wake of the oil crisis (mid-70s) to enable the member states to respond to the (external) shocks by adjusting their currencies. It was thus only in 1979 that the European Monetary System (EMS) was launched. It was built on exchange rates defined with reference to a newly created ECU (European Currency Unit), a weighted average of EMS currencies. An Exchange Rate Mechanism (ERM)[6] was used to keep participating currencies within a narrow band.

This success provided the impetus for further discussions between the member states on achieving economic and monetary union. The MacDougall Report (1977) took stock that free trade in goods and services within the Community had been largely achieved and examined a key element in monetary unions, which was still largely missing in the context of European integration, namely the establishing of a Community budget in order to absorb economic shocks and provide a minimum degree of income convergence. The report argued that around five to seven per cent of GDP would be the appropriate EU fiscal capacity to counter the impact of (external) shocks. The Delors Report (1989) abandoned the concept of a fiscal union (fiscal federation) in favour of other mechanisms to ensure the stability of the EMU. It proposed a three-stage plan to achieve an economic and monetary union, spanning the period 1990 to 1999:

- Stage 1: completing the internal market (1990-1994), namely through the introduction of the free movement of capital;
- Stage 2: preparing for the European Central Bank (ECB) and the European System of Central Banks (ESCB), and achieving economic convergence (1994-1999); and
- Stage 3: fixing exchange rates and launching the euro (1999 onwards).

The new Treaty on the European Union, which contained the provisions needed to implement an economic and monetary union as recommended in the Delors Report, was agreed at the European Council in Maastricht (December 1991). This Council also agreed the 'Maastricht convergence criteria'[7] that each member state would have to meet to participate in the euro area. The convergence criteria are formally defined as a set of macroeconomic indicators which measure i) price stability, to show inflation is controlled; ii) soundness and sustainability of public finances, through limits on government borrowing and national debt to avoid excessive deficit; iii) exchange-rate stability, through participation in the Exchange Rate Mechanism (ERM II) for at least two years without strong deviations from the ERM II central rate; iv) long-term interest rates, to assess the durability of the convergence achieved by fulfilling the other criteria. The Maastricht criteria on upper limits for deficit and overall

[5] http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=URISERV:xy0023&from=EN
[6] http://ec.europa.eu/economy_finance/euro/adoption/erm2/index_en.htm
[7] http://ec.europa.eu/economy_finance/euro/adoption/who_can_join/index_en.htm

debt were designed to provide member states with sufficient leeway at the national level for discretionary and automatic stabilisers to take effect. The euro was launched on 1 January 1999. At the same time, the euro area came into operation, and monetary policy passed to the ECB, which was established on 1 June 1998 in preparation for the third stage of EMU. Euro coins and banknotes were launched on 1 January 2002 for the 12 countries comprising the then euro area.

Table 1 - Timeline of the Economic and Monetary Union (EMU)	
1978	The Werner Report sets out a process on how to achieve a monetary and currency union
1978	Governments set up the Exchange Rate Mechanism (ERM) to reduce volatility between European currencies
1989	The Delors Report maps out the road to EMU in three stages:
1990	- Start of 1st stage of EMU: closer economic policy coordination and liberalisation of capital movements. Britain joins the ERM.
1992	Maastricht Treaty setting up the EU and committing EU countries to EMU.
1994	- Start of 2nd stage of EMU: creation of the European Monetary Institute (EMI), a precursor to the ECB. Member states are required to work to fulfil the five convergence criteria.
1995	European leaders agree to call the new single currency the euro. Stage 3 of EMU is set out.
1997	The Stability and Growth Pact is agreed at the Amsterdam EU summit, to ensure that member states maintain budgetary discipline in the EMU. The European Council also agrees on the revised exchange rate mechanism (ERM II), which links the euro and currencies of non-participating member states.
1998	The European Council agrees to launch the third stage of EMU on 1 January 1999 and states that 11 of the 15 member states meet the criteria to adopt the single currency. It establishes the ECB, which replaces the EMI as of 1 June 1998.
1999	- Start of 3rd stage of EMU: the euro is launched as the single currency for 11 member states. However, the euro only exists as a virtual currency.
2000	Introduction of euro notes and coins.

Box 1 - Monetary Unions in theory

The academic basis for monetary unions was laid down in the works on Optimal Currency Areas (OCA), pioneered by Robert Mundell (1961). OCA describes a region (a set of countries) in which per-capita output would be maximised if the entire region shared a single currency. The four often cited criteria for a successful currency union are:

- Labour mobility, which includes physical ability to move across the region as well as institutional arrangements to allow for income transfers;
- Capital mobility and price and wage flexibility, so that the market forces of supply and demand can allocate resources where they are needed;
- A redistributive transfer mechanism to counter the effects of shocks affecting a specific sector/ country, in case prices and wages are "sticky", i.e. they fail to signal scarcity in resources (labour/capital);
- Similar business cycles, for the (single) central bank to adopt a single common monetary policy to stimulate growth in downturns and to contain inflation in booms. With dissimilar business cycles, the common monetary policy would be sub-optimal for some of the members in the region.

Benefits of a single currency stem from the reduction in transaction costs of switching between different currencies, better information provided by price movements and less uncertainty for businesses and consumers following the elimination of the currency risk. In turn, this boosts growth, mainly through trade integration and improves price and financial stability by spreading/sharing the impact of shocks across the region.

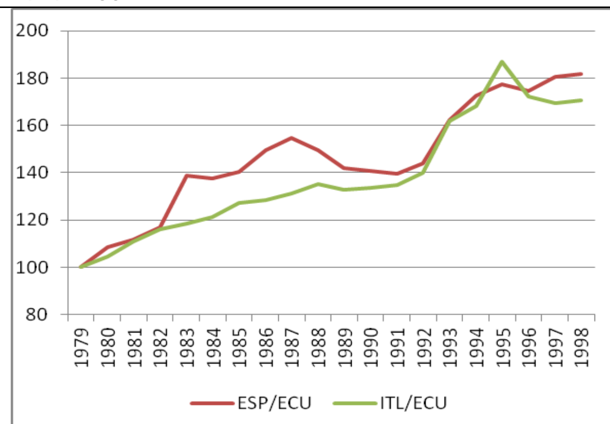
Costs mainly stem from the loss of independent monetary policies and the exchange rate as a policy instrument. In a currency union, therefore, the degree of price/wage flexibility (internal devaluation) is crucial to minimize the adjustments costs in terms of employment and output. In contrast, outside a currency area, adjustments can take place through a devaluation of the national currency / exchange rate (external devaluation).

3. IMBALANCES AND ADJUSTMENTS

3.1 Imbalances

Under the Exchange Rate Mechanism (ERM), peripheral countries used the exchange rate as a tool to improve their price competitiveness. Under the ERM, participating currencies could move only within a fixed band of 2.25% around ECU, apart from Italy, Spain, Portugal and the UK which operated under a 6% band. But there were periodic devaluations. From 1979 to 1999, the Italian lira depreciated about 70% versus the ECU and the Spanish peseta depreciated about 80% (Figure 7). Exchange rates were used as a key policy tool to regain competitiveness, especially against Germany. In this respect, EMU represented a new and unprecedented experiment for the coordination of monetary policies between EU member states.

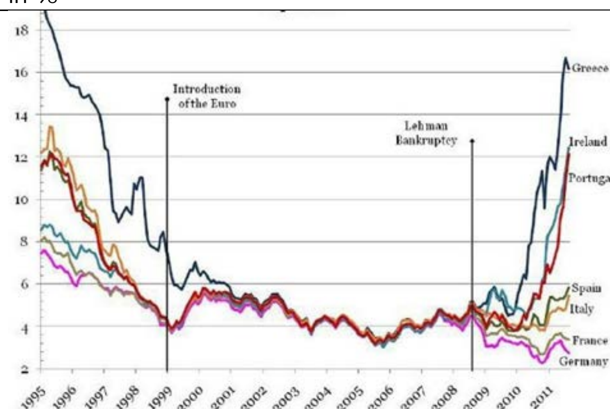
Figure 7 - Exchange rates of Peseta (ESP) and Lira (ITL) versus ECU (European Currency Union)
1979=100



Source: Eurostat

Nominal convergence versus real divergence under EMU. With the introduction of the euro in 1999, the exchange rate as a policy tool disappeared. Once exchange rates are irrevocably fixed, any loss in competitiveness – as measured, for instance, by unit labour costs – can only be restored either by reducing costs (primarily wages) or by increasing productivity (output per worker).[8] This did not happen and, instead, significant divergences in competitiveness indicators[9] emerged among euro-area countries in the aftermath of the euro adoption. While unit labour costs decreased in core euro-area countries (most notably Germany) under the combined effect of wage restraints and higher productivity, they rose substantially in the periphery, in a context of persisting low productivity developments and higher inflation. In addition, borrowing by government and private agents in the periphery was facilitated by the marked decline of interest rates in the run-up to EMU. To put this in perspective, in 1995, interest rates of 10Y-Government Bonds in selected euro-area countries (excluding Greece) fluctuated between 12-14% (Spain, Italy, and France) and less than 8% (Germany); the following years saw a strong convergence of

Figure 8 – Interest rates on 10Y-Government Bonds in selected euro-area countries, 1990-2011
in %



Source: ECB

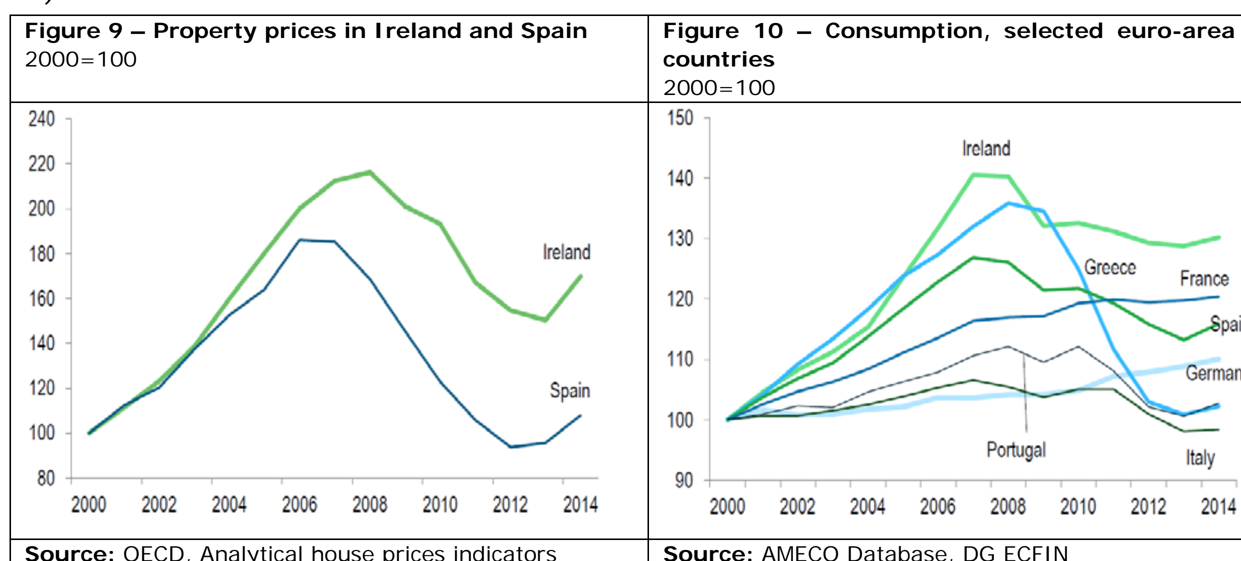
[8] With floating exchange rates, if unit labour costs in the local currency increase, market forces would cause the national currency to depreciate and restore competiveness.

[9] Such as unit labour costs or real effective exchange rates (REER). The nominal exchange rate is an index which measures an individual country's currency value relative to another country's currency. REER adjusts this index for the relative importance of trade with other countries and for the effects of inflation. REER is real value that an individual consumer will pay for an imported good.

interest rates and by 1998, one year before the introduction of the euro, the interest rate differential had almost disappeared (Figure 8) and started to diverge again in the wake of the financial crisis (Lehman bankruptcy). Hence, nominal convergence was very visible in the run-up to EMU. But diverging unit labour costs led to a significant widening of current account imbalances[10], with expanding current account deficits in some countries and rising current account surpluses in other countries. Unlike government deficits and debts (Maastricht criteria), there were little concerns and therefore no limit to current account deficits and surpluses, as "rational" financial markets were supposed to correct these imbalances by transferring funds across euro-area regions where investment returns were higher. As it turned out, however, the flows of investment from core to periphery were not always allocated to productive purposes. In Ireland and Spain, for example, capital flows fuelled a construction boom[11] leading to unsustainable property prices and a massive debt overhang (Figure 9). In several countries of the periphery, a large part of the capital inflow was also used to increase private and public consumption rather than to finance investment (Figure 10).

Figure 9 – Property prices in Ireland and Spain
2000=100

Figure 10 – Consumption, selected euro-area countries
2000=100

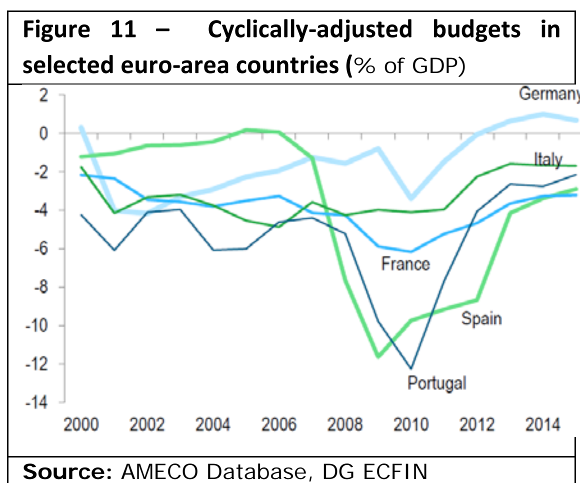


Source: OECD, Analytical house prices indicators

Source: AMECO Database, DG ECFIN

Deteriorating budgetary positions contributed to the euro-area crisis. The Stability and Growth Pact was supposed to bind countries to limit their debt/GDP ratios to 60% and government deficits to 3% of GDP. But, the rules were not fully applied, even by core countries (e.g. Germany and France). Moreover, the notion that no sovereign could default on its debt led markets to significantly misprice sovereign debt. For instance, in 2006, Greek 10Y government bond yields were trading at a spread of just 30bps above German Bunds. These led governments to believe that interest rates would have been "permanently" low, driving up public spending. There were few market sanctions to curb rising spending and deficits and existing governance rules lacked appropriate enforcement mechanisms (Figure 11).

Figure 11 – Cyclically-adjusted budgets in selected euro-area countries (% of GDP)



Source: AMECO Database, DG ECFIN

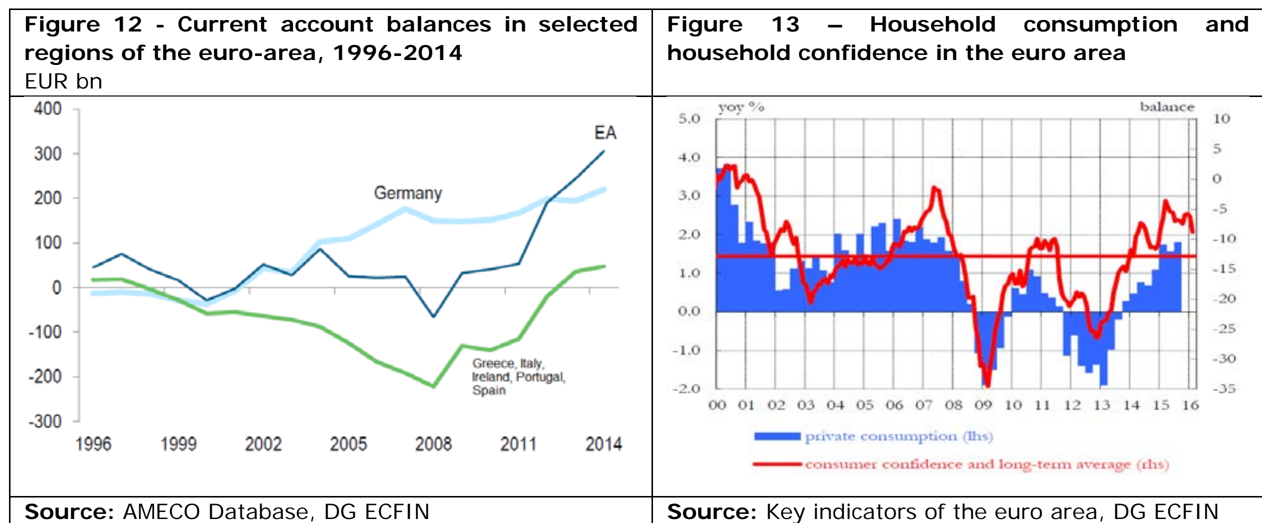
[10] The current account balance measures the difference between lending to and borrowing from abroad.
[11] Construction is a sector traditionally characterised by lower than average productivity.

3.2 Adjustments

Macroeconomic adjustments taking place, albeit unevenly. At the beginning of the crisis, the adjustment was mainly through demand compression: by lowering investment as a result of poor demand prospects and the need for firms to reduce the debt overhang; and by lowering consumption - both domestic and imported – largely as a result of fiscal restraint (austerity measures), deteriorating labour markets, in turn affecting household incomes, and higher precautionary saving mirroring the fall in confidence. Labour and product market reforms then led to improvements in competitiveness and a pick-up in exports in the periphery. As of today, most crisis-hit countries have improved their external balance. However, they did so not by adjusting against core euro-area members, but against the rest of the world (Figure 12). The euro-area current account has, as a result, moved from being roughly balanced to a surplus of about 3% of GDP. Consumption has also started to recover, led by improvements in the labour market, rising real wages, a stabilisation of the saving rate and, more generally, the return of confidence (Figure 13). Investment, by contrast, remains very weak and well below pre-crisis levels even though the downward trend seems to have bottomed out (see Figure 3 above).

Figure 12 - Current account balances in selected regions of the euro-area, 1996-2014
EUR bn

Figure 13 – Household consumption and household confidence in the euro area

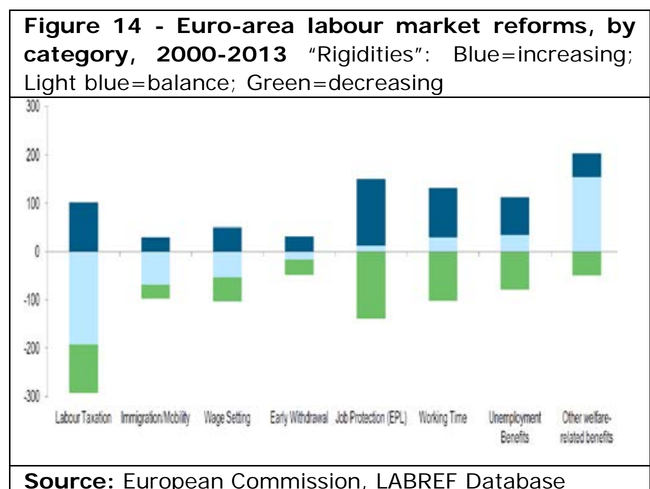


Source: AMECO Database, DG ECFIN

Source: Key indicators of the euro area, DG ECFIN

Labour market reforms improving economic efficiency. Governments have been active in reducing labour market rigidities. According to OECD labour market indicators[12], reforms in the labour market have tended towards lowering labour taxation and increasing work incentives; easing wage-setting regulations and reforming employment protection regimes with a view to encouraging job creation; aligning wage to productivity developments to restore competitiveness; reducing the scope for early retirements and working-time arrangements; but also strengthening welfare-related benefits to support higher unemployment after the onset of the crisis (Figure

Figure 14 - Euro-area labour market reforms, by category, 2000-2013 "Rigidities": Blue=increasing; Light blue=balance; Green=decreasing



Source: European Commission, LABREF Database

12 http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm . See also: Turrini A., Koltay G, Pierini F., Goffard C., Kiss A. (2015), A decade of labour market reforms in the EU: insights from the LABREF database, available at http://izajolp.springeropen.com/articles/10.1186/s40173-015-0038-5.

14). Reform activity has tended to accelerate especially in crisis-hit countries which were more in need of rebalancing their economies.

Product market reforms pursuing market liberalisation and deregulation. The scope of these reforms is to boost growth by cutting anti-competitive regulation. According to the Product Market Regulation (PMR) indicators of the OECD [13] in the past 10 years several euro-area countries, both in the core and in the periphery (Figures 15 and 16), have managed to lower entry barriers, to reduce the number/length of procedures to set up a business and the time for a firm to comply with tax regulations as well as to make electronic filing more widespread. The indicators also indicate shortcomings, in particular as regards the enforcing of contracts, the liberalisation of professional services and still too limited improvements of the judicial system.

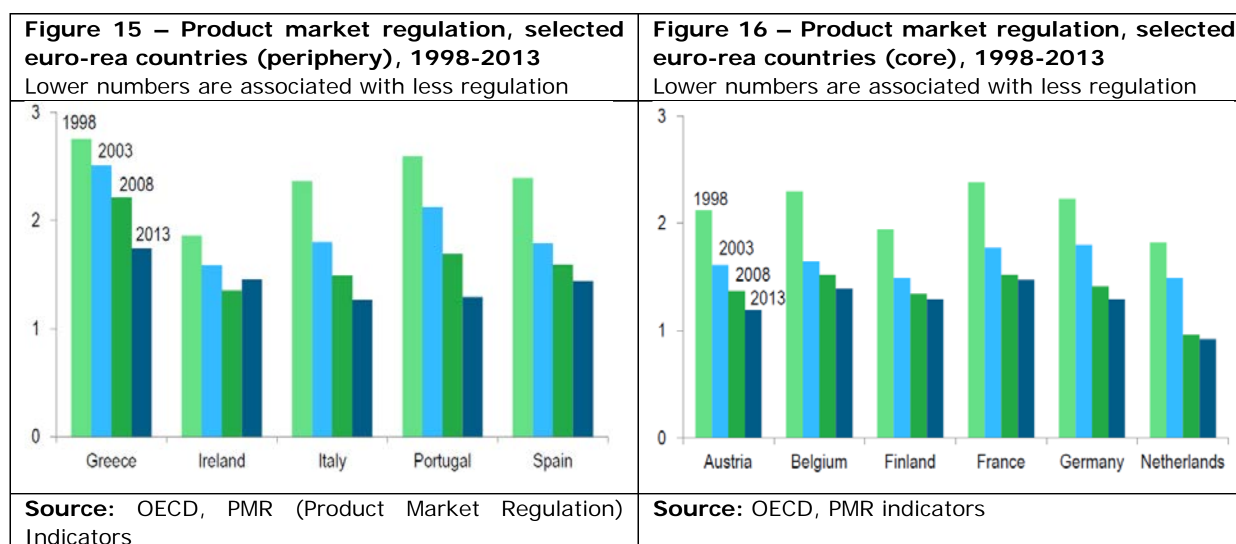


Figure 15 – Product market regulation, selected euro-rea countries (periphery), 1998-2013
Lower numbers are associated with less regulation

Source: OECD, PMR (Product Market Regulation) Indicators

Figure 16 – Product market regulation, selected euro-rea countries (core), 1998-2013
Lower numbers are associated with less regulation

Source: OECD, PMR indicators

[13] Koske I., Wanner I., Bitetti R., Barbiero O. (2015), The 2013 update of the OECD's database on product market regulation - Policy insights for OECD and non-OECD countries, available at: http://www.oecd-ilibrary.org/economics/the-2013-update-of-the-oecd-s-database-on-product-market-regulation_5js3f5d3n2vl-en

4. REFORMING AND COMPLETING EMU: THE PROPOSALS FOR AN 'EVER CLOSER UNION'

The 'Five Presidents' Report. In June 2015, the European Commission published the Report 'Completing Europe's Economic and Monetary Union', which proposes a two-stage implementation process with measures for economic, financial, fiscal and political union. European Commission President, Jean-Claude Juncker, led the compilation of the Report, in close co-operation with the four presidents of the EU Council, Eurogroup, ECB and European Parliament. Stage 1, which runs until June 2017, comprises reforms that build on existing instruments and can be implemented within the current legal framework: completing the Banking Union, launching the Capital Market Union and streamlining the European Semester. Stage 2, which runs until 2025 at the latest, encompasses all reforms that will require amendments to existing treaties and complete the EMU: formalising and making more binding the convergence process for the economic union; setting up a macroeconomic stabilisation mechanism for the fiscal union; strengthening democratic accountability and legitimacy for the political union. The Commission will publish a White Paper in spring 2017 to present the second stage in more detail. The Report builds on the assumption that the EU needs to move towards an "ever closer union".

4.1 Economic Union

The Report mentions a number of economic reforms to boost convergence, jobs and growth. These include:

The creation of a system of Competitiveness Authorities to monitor the evolution of unit labour costs and make sure divergences do not occur. The aim of the Competitiveness Authorities should not be to harmonise practices and institutions in charge of wage formation across borders. Those processes vary widely within the EU and reflect national preferences and legal traditions. Based on a common template, each member state should decide the exact set-up of its national Competitiveness Authority, but these authorities should be democratically accountable and operationally independent. National actors, such as social partners, should continue to play their role according to the established practices in each member state, but they should use the opinions of the Authorities as guidance during wage setting negotiations.

Strengthening implementation of the Macroeconomic Imbalance Procedure[14]. The Macroeconomic Imbalance Procedure is a surveillance mechanism to detect and address economic trends that may affect the proper functioning of a member state and have spillover effects on other member states or the EU/euro area. It aims to identify potential risks early on, prevent the emergence of harmful macroeconomic imbalances and correct the imbalances that are already in place. The annual starting point of the Macroeconomic Imbalance Procedure is the Alert Mechanism Report. Based on a scoreboard of indicators, the Alert Mechanism Report identifies countries for which a closer analysis (in-depth review) is deemed necessary. The outcome of these in-depth reviews forms the basis for further steps under the Macroeconomic Imbalance Procedure, whereby a graduated approach is followed reflecting the gravity of imbalances.

The Commission may propose that the Council issues recommendations to countries identified with imbalances. Countries for which imbalances are considered excessive are subject to an enhanced process of specific monitoring or could enter the Excessive Imbalance

[14] See: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

Procedure, which can eventually lead to sanctions for euro area member states in case of reiterated lack of compliance with obligations. Against this background, the track record of the country specific recommendations has been, however, very poor so far. Increased discipline among member states could be achieved, for instance through parliamentary procedures that makes the implementation of country-specific recommendations binding.

Greater focus on employment and social performance to promote fair and well-functioning labour markets and social safety nets. According to the Report, the key challenges are getting more people of all ages into work; striking the right balance between flexible and secure labour contracts; avoiding the divide between 'insiders' with high protection and wages and 'outsiders' with too little protection; shifting taxes away from labour; delivering tailored support for the unemployed to re-enter the labour market; improving education and lifelong learning; ensure access to adequate education and effective social protection system; reform pension and health systems, including by aligning retirement age with life expectancy; facilitate geographic and professional mobility, including through better recognition of qualifications; easier access to public sector jobs for non-nationals and better coordination of social security systems.

Stronger coordination of economic policies within the European Semester[15] to enable EMU to deal with economic and financial problems in a (more) efficient way. The European Semester has significantly strengthened the coordination of economic policies. However, the addition of 'packs', 'pacts', 'procedures' and manifold reporting requirements has blurred the rationale and effectiveness of the European Semester. Compliance to the rules has been poor due to the exploitation of loopholes and weak enforcement. According to the Report, further steps must be pursued by a) giving member states concrete and ambitious Country-Specific Recommendations, especially as regards their expected outcome and the time-frame, while allowing a degree of freedom on the exact measures to be implemented; b) holding member states accountable for the delivery of their commitments, though periodic reporting on implementation; c) better structuring EMU and national dimensions by discussing recommendations for the euro-area ahead of national discussions (as put in place for the 2016 European Semester), so that the national recommendation reflect the common challenges; d) introducing a multi-annual approach as recommendations take more than one year to be implemented.

Formalising and making more binding the convergence process. This is an ambitious task as it requires the enshrining of convergence criteria in law. As such, this process is likely to require Treaty changes (stage 2). In very general terms, the Report recommends further harmonisation in some areas and common standards in others. It specifically mentions a common corporate tax base, a "flexicurity" concept for the labour markets and the adoption of a wide "shock absorption mechanism" (fiscal stabilisation function). Concerning the latter, the Report outlines four guiding principles: the mechanism should not create permanent fiscal transfers; it should not undermine incentives for sound fiscal policy or to address structural weaknesses; it should be consistent with the existing EU fiscal framework; and it should not be an instrument for crisis management since that is the role of the European Stability Mechanism.

[15] http://ec.europa.eu/economy_finance/economic_governance/the_european_semester/index_en.htm

4.2 Banking Union[16]

The fragmentation of the banking system and the bank-sovereign vicious circle were key ingredients in the propagation of the crisis. During the crisis, doubts over banks' solvency and governments' ability to intervene resulted in deposit outflows, widening spreads and raising costs in the periphery, impairing the monetary policy transmission mechanism, increasing bank's fragmentation and the risks of contagion among euro-area banks. The banking sector was supposed to serve as a risk-sharing mechanism, allocating capital where it is most efficient. In the early stages of the euro-area debt crisis, the banking sector acted instead as an amplifier of contagion rather than a back stop mechanism. Cross-border bank lending declined sharply as major banks tried to limit their foreign exposure. In addition, the general effects of fiscal distress on the economy damaged banks' asset quality. This was further exacerbated by rating agencies' downgrades of banks' ratings following a downgrade in the sovereign rating. As economic performance worsened, more loans became non-performing. Banks' holdings of sovereign debt also exposed them to their government's problems. This led to higher funding costs and higher lending rates, in the periphery, exacerbating the fragmentation of the banking system.

The purpose of a Banking Union is to avoid similar problems in the future through a more resilient banking sector. This is to be achieved by a) raising confidence through a common level-playing field (Single Supervision Mechanism); b) ensuring the smooth resolution of failed banks and minimising the costs to taxpayers (Single Resolution Mechanism); and, eventually, c) protecting depositors when a bank is in trouble (common Deposit Guarantee Scheme). These are the key pillars of the Banking Union project. Banking Union is mandatory for all euro area states, while non-euro area Member states can opt to participate, on a voluntary basis.

The first pillar: the Single Supervisory Mechanism[17]. The Single Supervisory Mechanism was established in 2013 to supervise the banks in the Banking Union. In the framework of the Single Supervisory Mechanism, the ECB is exclusively competent to carry out a number of supervisory tasks, aimed at ensuring the safety and soundness of credit institutions, contributing to the stability of the financial system and preserving the internal market by ensuring consistent supervision. The ECB took over supervisory responsibility on 4 November 2014 following the comprehensie assessment of banks' balance sheets. Ahead of this, banks had deleveraged significantly and written down non-performing loans to clean up balance sheets. The ECB supervises the largest banks in the euro area, which together account for more than 85% of aggregate assets. It has the power to grant and withdraw banking licences to any bank in the euro area. Reducing the degree of uncertainty related to the strength of banks' balance sheets is critical in reducing the fragmentation across the region and in re-starting bank lending.

The second pillar: the Single Resolution Mechanism[18]. The Single Resolution Mechanism has been operational since 1 January 2016 and gives the Single Resolution Board the power to resolve failed banking institutions and the ability to impose bail-in conditions. The resolution process involves imposing losses on senior creditors and uninsured depositors of non-viable banks.

The Single Resolution Mechanism allows for a) more uniform financing conditions, thanks to a single mechanism to deal with the failure of banks (irrespective of the member state of origin), thus reducing the interdependence between credit supply and the health of public finances; b) preservation of financial stability and, therefore, a more predictable environment for consumption and investment decisions, through centralised crisis management for large

[16] http://www.consilium.europa.eu/en/policies/banking-union/
[17] https://www.bankingsupervision.europa.eu/home/html/index.en.html
[18] http://ec.europa.eu/finance/general-policy/banking-union/single-resolution-mechanism/index_en.htm

and cross-border banks, whose disorderly failure could otherwise cause contagion and panic; c) reinforced protection of taxpayers via the bail-in tool and if necessary a Single Resolution Fund pooling financial resources for crisis management, to be provided by banks ex-ante, across all participating member states. The Single Resolution Fund will be built up over a period of 8 years with 'ex-ante' contributions from the banking industry.

The third pillar: the Common Deposit Guarantee Scheme[19]. As long as the deposit guarantee remains with the sovereign, the ability of the sovereign to reimburse covered depositors in case of large-scale bank failures may be at risk. This is what a common Deposit Guarantee Scheme aims to solve. The Commission has recently presented a proposal for an European Deposit Insurance Scheme (EDIS) as a three-stage process, starting with re-insurance, then switching to co-insurance and finally to full direct insurance of deposits via a 'single' Deposit Insurance Fund. This final stage should be reached in 2024, which is also the date at which the Single Resolution Fund will have reached its funding level. EU legislation already ensures that all deposits up to €100 000 are protected, through their national Deposit Guarantee Scheme, in case of a bank failure. However, national Deposit Guarantee Schemes can be vulnerable to large local shocks. The European Deposit Insurance Scheme provides a stronger and more uniform degree of insurance cover for all retail depositors in the Banking Union, ensuring that the level of depositor confidence in a bank would not depend on the bank's location. Any divergences, perceived or real, between national Deposit Guarantee Schemes can contribute to market fragmentation by affecting the ability and willingness of banks to expand their cross-border operations. The European Deposit Insurance Scheme would ensure a level playing field for banks across the Banking Union by reducing the vulnerability of national Deposit Guarantee Schemes to large local shocks, weakening the link between banks and their national sovereigns, and boosting depositor confidence overall. Overall, the EDIS proposal identifies a number of risk reduction measures presented as counterbalancing measures: *'If the costs associated with bank failures and insolvencies are to be mutualised, it is essential that the risk of incurring such costs is contained to the maximum extent possible'*. However the exact scope and timing of a number of these de-risking measures is yet to be specified given the complexity of the issues at stake (e.g. treatment of sovereign risk in the Euro Area in the absence of an alternative risk-free asset).

Repairing banks' balance sheets and correcting their "home bias" remain key challenges. Banks with weak balance sheets (or/and with a large share of non-performing loans) cannot lend money to the real economy. Repairing banks' balance sheets is, therefore, a key challenge and a main objective of the Banking Union project. Countries have used different approaches to deal with this problem. Some have introduced so-called 'bad banks', pooling non-performing loans together in one institution in order to raise confidence for the rest of the banking sector. Others have sold packages of loans to specialised investors at a discount. European banks also exhibit a 'home bias' in their holding of sovereign debt. Some of them hold a very high share of the sovereign debt of their home country, despite all having similar regulatory treatment in calculating risk-weighted assets.

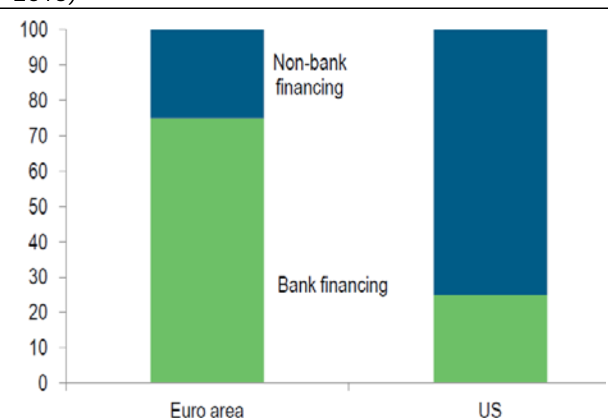
[19] http://ec.europa.eu/finance/bank/guarantee/index_en.htm

4.3 Capital Market Union[20]

Too extensive reliance on bank financing in EMU. The recent crisis revealed another major weakness of EMU: its extensive reliance on banking-sector financing (Figure 17). In the euro-area, for instance, about 80% of financing comes from the banking sector, with the rest coming from capital markets. This can be compared with the US, where capital markets are much more developed and account for about 70% of lending to the economy. Both equity and debt capital markets in Europe are underdeveloped relative to the US. Hence, the Banking Union can only provide a partial answer to increase risk-sharing.

Figure 17 – Financing the economy: Euro area and the US

% of bank financing to total financing (average 2005-2013)



Source: IMF [21]

Banks affected by the crisis and by more stringent regulatory requirements. The debt crisis weighed significantly on the euro-area banking sector and led to banks cutting back lending sharply. This has been a great concern for the transmission mechanism of monetary policy. If banks' ability to lend is severely impaired, then no matter how loose monetary policy is, banks are unable to boost lending until they repair their balance sheets. This contributed to the collapse of investment. In mid- 2015 fixed investment in the euro area was still about 15% below its pre-crisis levels. Had a strong capital market existed, it would have filled some of the void left by the banks. In addition, the regulatory response to the financial crisis has increased the need for more market-based financing and less bank financing. Basel III regulations[22] require banks to hold more capital than before.

Capital Market Union as a complement to the Banking Union. The Capital Market Union is the term used to describe the European Commission's plan to create deeper and more integrated capital markets in the EU. Capital markets-based financing is essentially any type of non-bank lending, including corporate bonds, securitisation, direct lending by non-banks. The key aim of Capital Market Union is to create a single market for capital in in the EU/euro-area, by removing barriers to cross-border investment and improve the matching between savers and borrowers.

Capital Market Union can make the EMU more resilient through different channels. First, by contributing to lower borrowing rates as a EU-wide capital markets infrastructure would raise the incentives for international investors to increase the pool of capital.

Second, by facilitating SME financing. Large corporations can have easy access to capital markets, obtain cheap funding and benefit from ECB's easing policies. This is not the same case for SMEs, the backbone of the EU economy. Market-based finance to SMEs is more problematic due to the non-homogenous nature of SME loans which makes it difficult to bundle these loans together in a securitised standardised product. Capital Market Union should facilitate the standardisation of SME loans within and across EU member states, "creating" a market, enhancing the quality of securitisation and lowering borrowing rates for

[20] http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf
[21] http://www.imf.org/external/pubs/ft/scr/2014/cr14199.pdf
[22] http://www.bis.org/bcbs/basel3.htm

SMEs. The ECB has actively supported securitisation by including asset-backed securities based on SME loans in its asset purchase programmes.

Third, by supporting government investment programmes. Spending constraints and high debt levels have reduced governments' ability to fund large public-sector investment programmes, despite current very low borrowing costs. Capital Market Union aims to harmonise the treatment of infrastructure projects, foster securitisation and spread the risks of long-term investment projects.

Fourth, by improving monetary transmission mechanism and reduce the 'home bias' effect. Capital Market Union should strengthen cross-border capital flows, reducing fragmentation. Capital Market Union would improve the transmission of monetary policy as, currently, the banking sector accounts for most cross-border transactions. The Capital Market Union would help other investors such as pension funds, insurance companies and retail investors to reduce their home bias by increasing their investments in other jurisdictions.

4.4 Fiscal Union[23]

Fiscal union is the most challenging integration step. The aim of a Fiscal Union is to promote convergence and macroeconomic stability. Most monetary unions have fiscal capacity. In the US, for example, an adequate federal tax and transfer system cushions the impact of country-specific (asymmetric) income shocks, contributing significantly to macroeconomic stability. The Five Presidents' Report argues that a fiscal capacity is a culmination of a process of convergence in EMU. To prevent permanent transfers between countries and moral hazards, access to the fiscal mechanism must be tightly linked to compliance with the fiscal policy framework (European Semester, Six-Pack, Two-Pack). There are, however, a wide set of issues, ranging from the appropriate volume of fiscal capacity, options for financing needs (EU budget, surcharges of national taxes, issuance of Eurobonds), the identification of tax categories (corporate taxes, VAT) and, importantly, the type of stabilization (fully rule-based automatic stabilization, fully discretionary management of fiscal capabilities). Fiscal Union is politically challenging for at least two reasons: i) it involves transferring additional sovereignty from the national level to the euro-area level; ii) it represents a major step towards a Political Union as the administration of revenues and expenditures by a federal body calls for strong democratic oversight by the European Parliament. It is therefore not without reason that the Five Presidents' Report proposes to deal with these issues as part of the reforms to be completed in stage 2.

Further reform proposals complementary to Fiscal Union. Alongside the proposals included in the Five Presidents' Report, debates on the future of the EMU cover aspects and instruments that affect also the EU as a whole. Two measures most frequently debated are the European unemployment insurance and Eurobonds.

A common Unemployment Insurance Scheme[24]. As with a fiscal capacity, the concept of EMU unemployment insurance is designed to have a stabilising function. In the event of a country-specific shock the mechanism would act as an automatic stabilizer to soften the negative effect on labour. Unemployment insurance expenditure is, indeed, a very cyclical component of government spending. If it were funded centrally it could act as a cushion in the event of a substantial shock to the public finances of the affected member(s) state(s). Member states with a (temporarily) weak economy and rising unemployment rates would receive transfers from countries in a good economic position.

[23] http://ftp.iza.org/pp39.pdf
[24] https://www.ceps.eu/publications/european-unemployment-benefits-scheme-rationale-and-challenges-ahead

GDP shocks would thus be absorbed and cycles/imbalances less pronounced, with beneficial effects for EMU as a whole. But a common Unemployment Insurance Scheme may also trigger negative incentives and moral hazards. A common Unemployment Insurance Scheme should thus be designed in a way that prevents permanent fiscal transfers between member states. It is likely, however, that negative incentives can be reduced but not fully eliminated.

Eurobonds. Different proposals have been advanced regarding commonly issued bonds. In its Green Paper on the feasibility for introducing Stability Bonds[25], the European Commission outlined various possible forms and their consequences for the euro area. The core idea of this instrument is to cut financing costs by improving the credit rating on the one hand and partially reducing the dependence of individual member states on the financial markets on the other. The various forms (e.g. "red- or blue-bonds") differ in particular in the portion of individual sovereign debt that is commonly issued and in the type of guarantee. Eurobonds would provide a highly liquid and secure investment vehicle for the financial markets that is no longer tied to a national issuer. Again, however, disadvantages exist in the form of the negative incentives that they may trigger (permanent fiscal transfers between surplus and deficit countries).

4.5 Political Union

The Five Presidents' Report outlines key next steps regarding the reform of political institutions. In particular it suggests

i) to strengthen parliamentary oversight as part of the European Semester through greater co-operation between the European Parliament and national parliaments, more systematic interaction between the Commission and national parliaments both on the Country-Specific Recommendations and on national budgets and more systematic consultation and involvement by national governments and social partners before the annual submission of National Reform and Stability Programmes;

ii) to reinforce the role of the Eurogroup in the European Semester with (in the long run) a full-time President with a clear mandate and possibly even representing the interest of the single currency in international fora. However, consolidating the external representation of the euro area on international committees will face strong national interests;

iii) to set up a euro area Treasury - as a further step towards integration and the transfer of fiscal competences – with a veto over national budgets if they represent a threat to fiscal sustainability;

iv) to integrate the Treaty on Stability, Coordination and Governance, the relevant sections of the Euro Area Plus Pact and the intergovernmental agreement on the Single Resolution Fund as well as the European Stability Mechanism into the EU legal framework to enhance democratic accountability, legitimacy and institutional strengthening.

[25] http://ec.europa.eu/europe2020/pdf/green_paper_en.pdf

5. CONCLUSION

The economic and financial crisis revealed governance deficiencies in the structure of EMU. It also highlighted the uneven performance of EMU economies since the introduction of the euro and demonstrated that a single currency and a set of convergence criteria were not enough to ensure economic and financial convergence and ward off the negative consequences of (external) shocks.

Through the turbulence of recent years, EMU has taken major steps to strengthen institutions and governance. Progress has been made on banking supervision and banking resolution as part of the Banking Union project. And the European Semester has proven to be an effective tool for diagnosing macroeconomic imbalances, even though the implementation of the ensuing economic policy recommendations by most member states has been, so far, very poor. Labour and product market reforms have improved the business environment.

The completion of EMU is likely to require additional reforms and the Five Presidents' Report presents important proposals to make the EMU architecture more resilient to crisis. Some of these steps can be implemented in the short term, while others will first require further convergence to take place within EMU. Proposals include i) labour and product market reforms to rise long-term productivity and growth; i) financial integration (Banking Union) to improve market confidence in banks, stabilize financial markets, eliminate fragmentation and cut the sovereign-bank negative feedback; iii) plans for a Capital Market Union to enhance market-based financing to the economy, diversify the sources of financing, thereby spreading the impact and risks of financial shocks; iv) plans for a Fiscal Union or fiscal capacity as a macroeconomic stabilization tool against income shocks. Fiscal union is politically challenging as it involves ceding even more sovereignty from national levels to the euro-area level and is, therefore, strongly connected with political integration (Political Union). The common denominator of these proposals is to foster convergence, improve risk-sharing and smooth the impact of future shocks.

Despite all its seatbacks, the popular support for EMU and the single currency remains very high. And the short story of the euro tells us that the exit threshold for a single member is very high as shown, for instance, by the experiences of Greece, which faced an extended period of forced banks closures, and Cyprus, which faced a significant bail-in of depositors' wealth, and still both countries chose to stay in the euro.

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Overview of EMU