The Euro – A tale of 20 years and priorities going forward

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Content

1. EMU@20 = EMU@10 + 10
2. Did EMU change policy behaviours?
3. Euro area throughout the crisis
4. Reforms during the crisis and way forward
The Evolution of the Euro Area

From 11 to 19 Members

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain</td>
<td>1999</td>
</tr>
<tr>
<td>Greece</td>
<td>2001</td>
</tr>
<tr>
<td>Slovenia</td>
<td>2007</td>
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<tr>
<td>Cyprus, Malta</td>
<td>2008</td>
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<tr>
<td>Slovakia</td>
<td>2009</td>
</tr>
<tr>
<td>Estonia</td>
<td>2011</td>
</tr>
<tr>
<td>Latvia</td>
<td>2014</td>
</tr>
<tr>
<td>Lithuania</td>
<td>2015</td>
</tr>
</tbody>
</table>

Since 1999 (11 members)

Other euro area members (+8 members)

Other EU members (9 members)

Used by 341,5 million people in Europe in 2018

A GDP of 11,572 billion euro in 2018

Population, millions of people

GDP, 2018, €bn

Source: Ameco
MAASTRICHT ASSIGNMENT

Institutional setting in EMU (strong version of the “consensus” on policy making of the 80s’ – see Buti Sapir 1998)

i) Monetary Policy (centralised) by independent central bank instrumental to credibly bring down inflation <= conservative, independent central bank to bring down inflation, Barro-Gordon (1983), Rogoff (1985)

ii) Fiscal Policy (decentralised) action limited to automatic stabilization (normal cycles) <= Barro (1979)

iii) Ban on excessive government deficits & on monetary financing of government deficits <= avoid fiscal dominance and no government bailout, Sargent & Wallace (1981)


v) Competition (trade and internal market) increases efficiency, OCA criteria are endogenous <= Cecchini Report (1988), Frankel & Rose (1998)
MUSGRAVE + and the MAASTRICHT ASSIGNMENT

- **Efficiency** ++
  (but certain aspects, like productivity/reforms fully decentralised)

- **Stabilisation** +
  (only based on monetary policy and automatic stabilisers)

- **Equity** 0
  (interpersonal fully in the hands of Member States; cohesion between countries in EU budget)

- **Sustainability/Stability** +++
  (necessity of supranational fiscal rules to secure sustainability and protect monetary policy from deficit bias and debt spillovers/ ECB as the most independent CB in the world)
## Our early beliefs… and what happened in the first 10 and then 20 years

<table>
<thead>
<tr>
<th>Category</th>
<th>EMU@0</th>
<th>EMU@10</th>
<th>EMU@20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Efficiency</strong></td>
<td>- Financial markets lead to efficient capital allocation</td>
<td>- Anaesthetic effect of EMU on structural reforms</td>
<td>- Destabilising role of financial markets in absence of BU</td>
</tr>
<tr>
<td></td>
<td>- &quot;Transparency shock&quot; improves resource allocation</td>
<td>- Capital allocation not always efficient</td>
<td>- Agglomeration effects</td>
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<td></td>
<td>- &quot;There-Is-No-Alternative (TINA) argument&quot; leads to structural reforms</td>
<td></td>
<td>- Positive incentives for structural reforms</td>
</tr>
<tr>
<td><strong>Stabilization</strong></td>
<td>- Financial markets as shock absorbers</td>
<td>- Pro-cyclical fiscal behaviour in good times</td>
<td>- Need of a central stabilization function</td>
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<tr>
<td></td>
<td>- &quot;House in order&quot; allows automatic stabilisers to cushion country-specific shocks</td>
<td>- Aggregation of national fiscal stances do not necessarily give an adequate EA stance</td>
<td>- Divergence in fiscal space</td>
</tr>
<tr>
<td></td>
<td>- Monetary policy takes care of common shocks</td>
<td></td>
<td>- Active fiscal policy needed under exceptional circumstances</td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td>- National redistribution done by MS</td>
<td>- Real convergence being achieved</td>
<td>- Divergence between original EA members, convergence new members</td>
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<tr>
<td></td>
<td>- Cross-country cohesion via EU budget</td>
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</tr>
<tr>
<td><strong>Sustainability/ Stability</strong></td>
<td>- Strong emphasis on the credibility of the central bank</td>
<td>- Established credibility of the ECB</td>
<td>- Political ownership of fiscal rules diminishes</td>
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<td></td>
<td>- Expectations that MS would maintain sustainable public finances</td>
<td>- Unsustainability of internal CA imbalances</td>
<td>- More symmetric adjustment of external imbalances needed</td>
</tr>
<tr>
<td></td>
<td>- No consideration of internal imbalances</td>
<td></td>
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Content

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GDP growth per capita broadly at par with the US

* EU-28 GDP data only available as of 1995 and EU-28 GDP growth rates only available as of 1996

Source: Ameco
Credibility of the Central Bank

Inflation target versus actual inflation in EA-19 (in %)

Dispersion of HICP inflation (in %)

Notes: EA-19 only available as of 1996 with CY, LV and MT data missing from the 1996 aggregate and the EA-19 aggregate is complete as of 1997/. The EA-19 aggregate does not reflect the changing composition according to entry date in EA. EA changing composition is aggregated according to entry date in EA. EA-11 corresponds to the eleven Member that joined the EMU in 1999. Dispersion is measured as an unweighted standard deviation.

Source: Ameco
Not all Member States improved sufficiently public finance sustainability

Government debt/GDP (%)

10-year government bond yields (%)

Maastricht treaty (Feb-92)  Euro launch (Jan-99)  Lehman Collapse (Sept-08)  « Whatever it takes » (Jul-12)  QE announcement (Jan-15)


Data source: AMECO
Real convergence mostly driven by 'new' euro area Member States

GDP per capita (in PPS) before and after the start of the financial crisis

Note: Countries which were in 1999 (left chart) and in 2008 (right chart) not members of the euro area are highlighted in red. The black regression line is based on the full sample of countries, the blue one excludes the 'new' euro area Member States, which are highlighted in red.

Source: Eurostat
Imbalances and resource allocation

Increasing imbalances

Cumulative growth rate of non-tradable/tradable value added

Note: Centre includes Austria, Belgium, Finland, Germany, Luxembourg and the Netherlands. The periphery includes Cyprus, Estonia, Greece, France, Ireland, Italy, Latvia, Lithuania, Malta, Portugal, Slovakia, Slovenia, and Spain. Centre and periphery Eurozone countries grouped according to their external position. Updated from Buti and Turrini (2012).

Source: Commission calculations based on AMECO and Eurostat
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Origin of the EA crisis: my preferred reading

• A "sudden stop" crisis following capital misallocation in pre-crisis years

• A banking crisis triggered a feedback loop: bank solvency concerns \(\rightarrow\) higher bond yields and debt service \(\rightarrow\) default worries \(\rightarrow\) deeper recession

• The euro-area crisis was not a fiscal crisis (apart from Greece), but lack of fiscal space hindered the policy response during the crisis

• Heterogeneity in the euro area much larger than assumed before the crisis: different growth models and agglomeration effects

• Structural divergences during the first 10 years of EMU led to divergent social and political preferences \(\rightarrow\) "ultima ratio" mode
Upon sudden stops, short-term flows were replaced by central bank lending.
**ECB intervention: rates and balance sheet**

**ECB policy and euro overnight rates, Eurosystem Balance Sheet (BS) size**

- **Lehman Collapse (Sept-08)**
- **Start of EA Sovereign debt crisis (Oct-09)**
- **"Whatever it takes" (Jul-12)**
- **OMT (Aug-12)**
- **ECB negative policy rate (Jun-14)**
- **QE announcement (Jan-15)**
- **QE end (Dec-18)**

**Notes:**
- OMT: Outright monetary transactions, QE: Quantitative easing
- Source: Macrobond, ECB

**Source:**
- Macrobond, ECB
Fiscal policy tends to be pro-cyclical

Fiscal stance over the economic cycle, EA 2011-2020e

Source: Commission calculations
Structural reform uptake

Source: OECD (PMR), LABREF Database
Programs: the euro-area crisis was not a fiscal crisis (apart from Greece)

Five financial assistance programmes

**Ireland (2010-2013): €85bn**
Growth rates:
- Year 1 of the program: 1.9 %
- Post programme (average): 9.7 %

**Portugal (2011-2014): €78bn**
Growth rates:
- 2011: - 1.8 %
- Post programme average: 2.1 %

**Spain (2012-2014): financial sector support €40bn**
Growth rates:
- Year 1 of the program: - 2.9 %
- Post programme average: 2.9 %

**Greece: 1st €110bn in 2010, 2nd €172.6bn in 2012 and €86bn in 2015 €, exit in 2018**
Growth rates:
- 2010: - 5.5 %
- Post programme (average): 2.0 %

**Cyprus (2013-2016): €10bn**
Growth rates:
- 2013: - 5.8 %
- Post programme (average): 4.1 %

Source: Ameco, Post programme average is the average until 2018
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EMU reform during the crisis: a lot has been done, but…
...the job is not completed

1. Financial Union

2. Economic and Fiscal Union

3. Institutions and Governance

Complete Banking Union and Capital Markets Union

Banking Union (including EDIS, backstop to Single Resolution Fund), Capital Markets Union proposals

Economic and social convergence

Budgetary instrument for convergence and competitiveness

Common fiscal stabilisation function

Commission proposal of a European Investment Stabilisation function

Accountable institutions and effective governance

Commission proposal to transform the ESM in a European Monetary Fund
Completing the Financial Union

- Economic objectives
  - Delinks banks / Sovereigns
  - Reallocation of excess savings via equity

- EU initiative
  - Banking Union
  - Capital Market Union

- Instruments
  - Delivered: SSM, SRM
  - Pending: EDIS, SRF backstop
  - Delivered: Political agreement on 11 proposals
  - Pending: 2 proposals not agreed politically

- Private Risk-sharing
Risk-sharing: the EU versus the US

Cross-border risk sharing through different channels, in % of total asymmetric shock to output

Euro area
- Unsmoothed
- Cross-border borrowing
- Cross-border fiscal transfers
- Cross-border capital market and labour income

US

Possible forms for a European safe asset

Source: Buti, Deroose, Leandro and Giudice (2017)
The evolving EA fiscal framework

*Increased adaptability at the expense of simplicity...*
Impact of a central stabilisation capacity in bad times

Fiscal stance over the economic cycle, EA 2011-2020e

Source: Commission calculations

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Towards a stronger international role of the euro

A more diversified (new economic powers and technologies) and multipolar system:
- More unpredictable US
- China’s (very) active support of RMB internationalization
- Euro already the 2nd most important global currency

But, the euro can take a stronger global stance:
- Stronger EMU, capital markets and banking union
- Tackle possible sectoral inefficiencies (e.g. forex markets, energy, transport, food and commodities)

Currency composition: $ and € shares in foreign currency reserves and outstanding international debt securities

Source: MF COFER and BIS international debt securities (all issuers, currencies and sectors, international markets)
## Completing EMU’s architecture: progress but at slow pace

<table>
<thead>
<tr>
<th>Key issues</th>
<th>Deliverables</th>
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<tbody>
<tr>
<td><strong>ESM</strong></td>
<td><strong>By June 2019</strong>: Amendments to the ESM Treaty*</td>
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<tr>
<td>Improve further the crisis prevention and resolution capabilities in the euro area</td>
<td></td>
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<tr>
<td><strong>Banking Union</strong></td>
<td><strong>By June 2019</strong>: provide roadmap for political discussions on EDIS (interim report in April)</td>
</tr>
<tr>
<td>European Deposit Insurance Scheme (EDIS): disagreements, notably on the level of risk reduction already achieved</td>
<td><strong>By 2020</strong>: Common backstop to the Single Resolution Fund (SRF) operationalisation + assessment of risk reduction</td>
</tr>
<tr>
<td>Common backstop to the Single Resolution Fund (SRF): need to agree on the terms of reference</td>
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<td><strong>EA budget</strong></td>
<td><strong>By June 2019</strong>: main features of the budgetary instrument for convergence and competitiveness to be agreed</td>
</tr>
<tr>
<td>Budgetary instrument for convergence and competitiveness: need to reach consensus on the design, modalities of implementation and timing of the tool</td>
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Note: * including the backstop to the Single Resolution Fund
Conclusions

- Crisis is over, a lot has been done, but EMU is not yet complete
- Incremental steps are only apparently safer
- Populist pressures call for a new balance between Musgrave+ goals
- Brexit and geopolitical challenges add motivation to strengthen the EMU
- How to lower the discount rate of governments and rebuild trust to overcome the creditors/debtors divide?
Habermas’ characterisation of solidarity

- “A mutually trusting relationship between two actors who have become part of a joint political project of their own free will.”
- “Those who engage in solidarity are willing to accept short-term disadvantage in the service of their long-term self-interest and in the knowledge that the other will behave the same way in a similar situation. Reciprocal trust – in our case, trust across national borders – is just as important a variable as long-term self-interest.”
- “Trust bridges the time span until a service in return is due, though it is unsure when or if it will ever come due.”

Source: J. Habermas (2018), “European Union: are we still good European?”, Interview in die Zeit (6 July 2018)
Thank you!
Completing EMU: two polar models

<table>
<thead>
<tr>
<th>&quot;Back-to-Maastricht&quot;</th>
<th>Fast forward to federalist EMU</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stronger enforcement of EU fiscal rules to restrain debt and deficits</td>
<td>Distribution of fiscal efforts to achieve an appropriate aggregate fiscal stance</td>
</tr>
<tr>
<td>Mechanism of imbalances procedures (MIP) focused on competitiveness of lagging countries</td>
<td>Symmetric adjustment to help weak countries and reduce Euro area current account surplus</td>
</tr>
<tr>
<td>Banking Union does not need common deposit insurance</td>
<td>Full Banking Union to ensure financial stability and private risk sharing</td>
</tr>
<tr>
<td>End to the risk-free status for sovereign debt and establish sovereign debt restructuring mechanism</td>
<td>Fiscal capacity for public risk sharing and eventually sovereign debt mutualisation</td>
</tr>
<tr>
<td>More market discipline</td>
<td>Euro area Treasury</td>
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</table>

In their « pure » form, both are economically and/or politically unfeasible
1. Completing the Economic and Monetary Union, Banking Union, Capital Markets Union

2. Measures to foster a deep European financial sector
   - Strengthening the liquidity and resilience of European market infrastructure
   - Ensuring a reliable framework for a trustworthy interest rate benchmark
   - Supporting a fully integrated instant payment system in the EU
   - Consultation about euro liquidity in foreign exchange markets

3. Initiatives linked to the international financial sector
   - Supporting Central Banks’ collaboration to safeguard global financial stability
   - Increasing the share of euro-denominated debt by European bodies
   - Fostering economic diplomacy to promote the use of the euro in payments and as a reserve currency
   - Technical support to improve access of developing countries to the euro payment system

4. Promoting the use of the euro in key strategic sectors
   - Energy:
     - Recommendation to promote a wider use of the euro in international energy agreements and transactions
     - Consultation on expanding use of euro-denominated transactions in oil, refined products and gas
     - Consultation on increasing use of the euro in raw materials and food commodity trading
     - Consultation on expanding use of the euro by transport sector manufacturers (aircraft, maritime and railways)
Availability of homogenous safe asset
(Perceived) risks from an increased international use of the euro

- **Implies a stronger exchange rate** because of the large demand for the currency (check the longer-term value of the dollar against the euro ⇔ monetary policy is more powerful)
- **Implies a current account deficit** because the country emits debt more easily (does the US intentionally run current account deficit to satisfy global demand for USD-denominated assets? ⇔ US runs external deficits but still has stable net international investment position)
- **Constrains the conduct of monetary policy by the ECB** because of a tension between domestic priorities and longer-term global interests (the ECB’s mandate is given - it retains control over the path of short-term euro interest rates and thus remains capable to fulfil its mandate ⇔ admittedly larger feedback loops to be taken into account)
- **Constrains the monetary analysis by the ECB because** monetary developments would reflect foreign demand for euro bills and bank deposits (M3 is not so relevant anymore ⇔ a more holistic approach taking into account all counterparts and drivers of monetary developments)