



DEEPENING OF THE ECONOMIC AND MONETARY UNION –

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OUTLINE

1. Currency Union: main elements US vs EA
2. Smoothing shocks: Financial Union and Fiscal Union
3. Concluding remarks

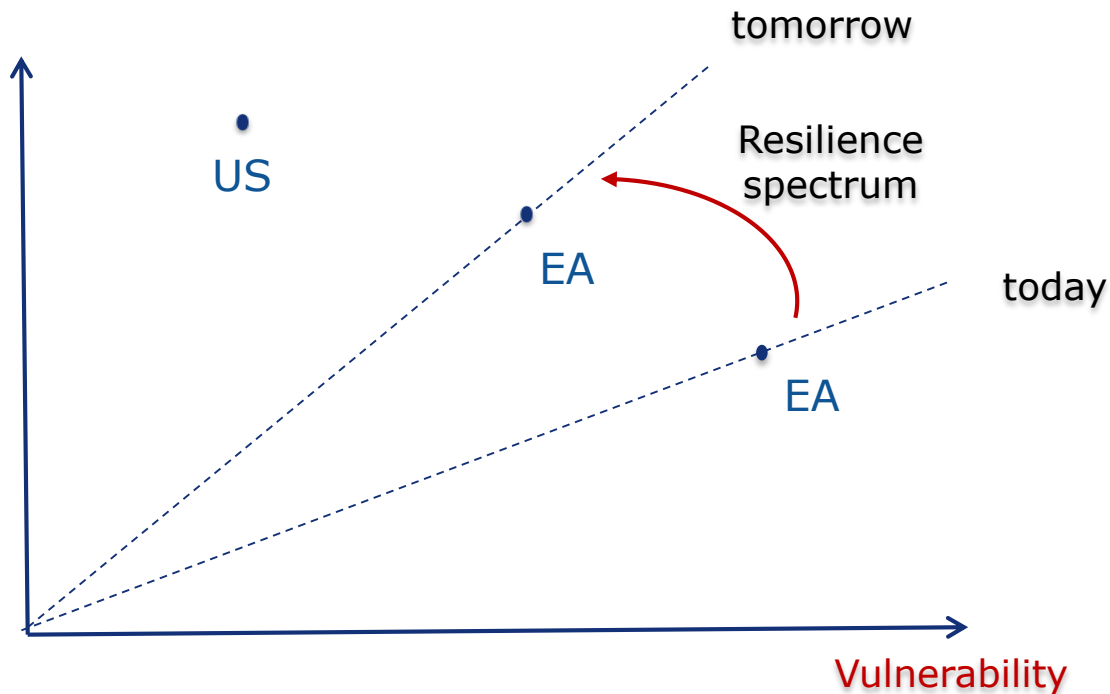
COMPLETING THE ECONOMIC AND MONETARY UNION

WHAT ARE THE MINIMUM REQUIREMENTS FOR A PROPER FUNCTIONING OF A CURRENCY UNION?

	US main institutional arrangements	EU/EA Main institutional arrangements
Lender of last resort	Federal Reserve System	ECB OMT programme ESM
Common Safe Asset	Federal US bonds	None Esbies? Safe Assets?
Integrated banking and financial markets	Effective single financial market: unique security rights, FDIC with backstop (Treasury Supports)	Ongoing process (SSM, SRF, Capital market Union) EDIS??
Federal Budget	>15% of GDP	1.17% of GDP
Federal Taxation/revenues	PIT CIT SSC	None, 0.3 % is levied on national VAT
Stabilisation function	Flexible labour market and US Federal Budget, including a Federal Unemployment Benefit Scheme	None Stabilisation at Member States level

THE EURO AREA RESILIENCE SPECTRUM

- ADAPTABILITY**
- Shock Absorption
 - Reallocation



INSTITUTIONAL CHANGES IN THE EMU SINCE 2011

Fiscal	<i>Stronger preventive arm SGP</i>	<ul style="list-style-type: none"> • Introduction of an expenditure rule (6-P) and balanced budget rule (TSCG) • Possibility of imposing sanctions (6-P) • Surveillance of draft budgetary plans by Commission (2-P)
	<i>Stronger corrective arm SGP</i>	<ul style="list-style-type: none"> • Introduction of a numerical debt benchmark (6-P) • Earlier and more gradual sanctions (6-P) • More automaticity in decision-making via new voting scheme (TSCG) • Enhanced surveillance for MS threatened with financial difficulties (2-P)
	<i>National fiscal frameworks</i>	<ul style="list-style-type: none"> • Mandatory minimum requirements at the national level (accounting & statistics, forecasts, fiscal rules monitored by independent bodies, transparency)
Macro	<i>MIP</i>	<ul style="list-style-type: none"> • Prevention and correction of macroeconomic imbalances via the introduction of the Macroeconomic Imbalance Procedure (MIP) (6-P)
Crisis resolution mechanism	<i>ESM, ECB OMT</i>	<ul style="list-style-type: none"> • European Stability Mechanism (ESM) • OMT programme by the European Central Bank (ECB)
Financial	<i>Eur. System of Financial Supervision</i>	<ul style="list-style-type: none"> • Macro-prudential: European Systemic Risk Board (ESRB) • Micro-prudential: European Supervisory Authorities (ESAs) with EBA (for banks), ESMA (securities), EIOPA (insurance), national authorities etc.
	<i>Banking Union</i>	<ul style="list-style-type: none"> • Single Supervisory Mechanism (SSM) • Single Resolution Board (ERB) and Single Resolution Fund (SRB)

UNFINISHED BUSINESS

- ↳ ***Have the financial sovereign doom loops been sufficiently severed?***
 - Banking union not completed yet
 - Exposure of national financial sectors to sovereigns remains high
- ↳ ***Does the EMU have the capacity to withstand the next large shock?***
 - ESM remains entirely dependent on national Treasuries and slow decision-making
 - No tool for smoothing asymmetric shocks and managing the euro area fiscal stance when needed
- ↳ ***Is the appropriate fiscal stance at the EA level being achieved?***
 - Bottom-up coordination does not work
 - Insufficient collective stabilisation tools
- ↳ ***Too much stabilisation burden on monetary policy***
- ↳ ***Persisting economic and social divergences***
- ↳ ***Complex governance and democratic deficit***

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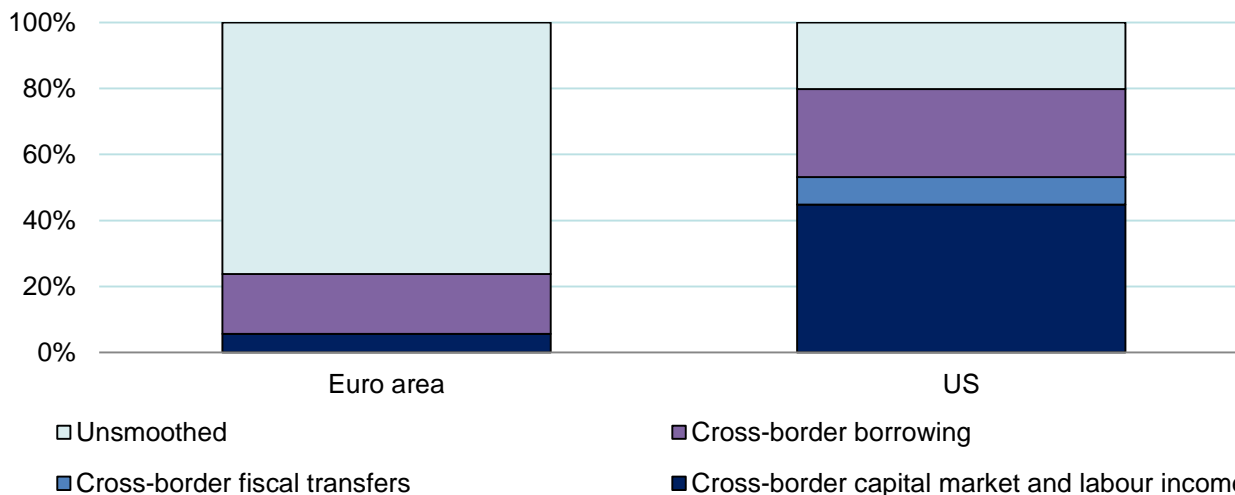
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SHOCKS ABSORPTION CHANNELS US VS EMU

	Private channels		Public channels	
	Capital flows	Portfolio reallocation	Government borrowing	Public risk sharing
US	+++	+++	+	++
EA				
-Before the crisis	++	++	++	0
-After the crisis	+	+	+	0

INSURANCE AGAINST INCOME SHOCKS IN EMU REMAINS LOW

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

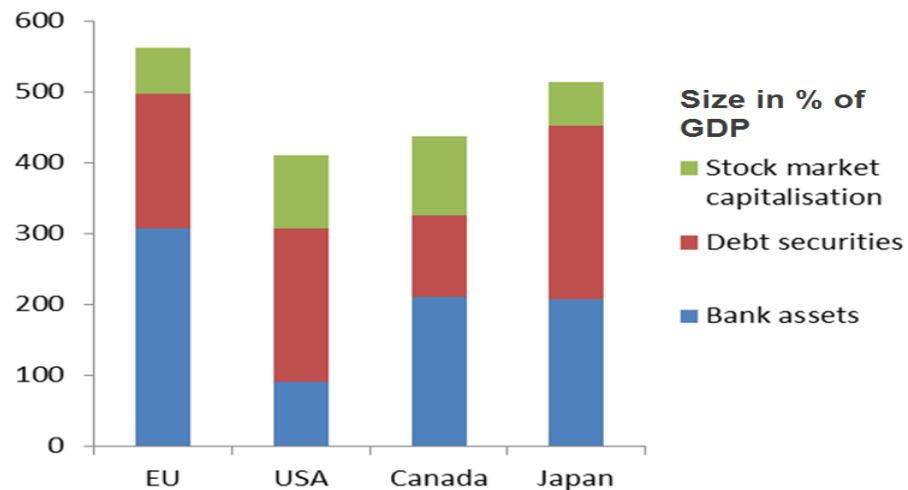


Source: Buti et al. (2016). Smoothing economic shocks in the Eurozone: The untapped potential of the financial union, VOX August.

FINANCIAL UNION: THE MOST URGENT PRIORITY FOR EMU

- Advancing on risk reduction and risk sharing and providing more diversified financing options for firms
- Short-term measures
 - Further reducing risks and building on banks' better capitalisation
 - Completing the three pillars of the Banking Union (BU)
 - Delivering on the Capital Markets Union (CMU)
 - Possible instruments beyond BU and CMU: Sovereign bond-backed securities
- Post-2019: possible additional successive measures
 - European Safe Asset
 - Regulatory treatment of sovereign bonds

FINANCIAL UNION: INTERNATIONAL COMPARISON

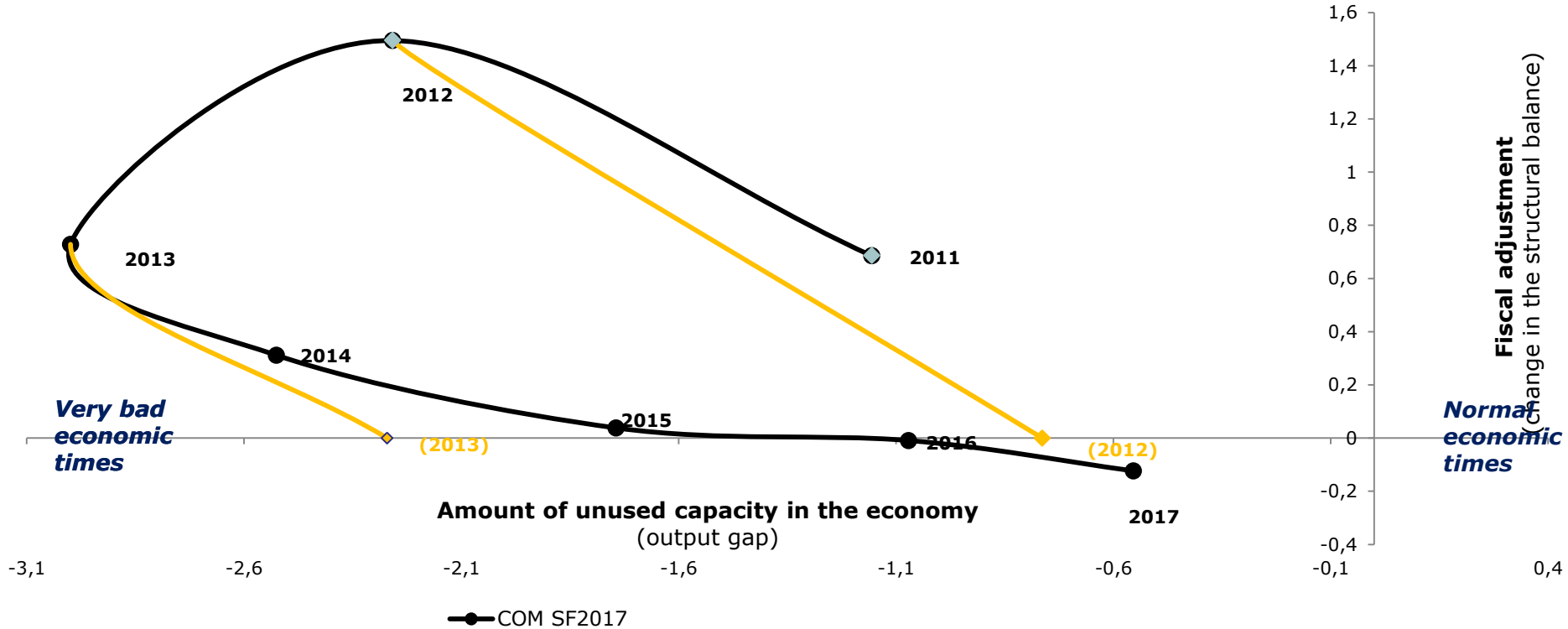


Source: IMF

FISCAL UNION

- Rationale behind a fiscal Union (Reflection paper on the deepening of the EMU):
 - i) sound public finances and fiscal buffers indispensable for a monetary Union;
 - ii) common stabilisation tools at the level of the euro area;
 - iii) combination of market discipline and common simple rules

BENEFITS OF A CENTRAL STABILISATION CAPACITY



SEARCHING FOR THE RIGHT BALANCE

Elements of centralisation

Simplified fiscal rules

A common fiscal capacity

Last resort backstop to the banking Union

Reinforced ability to intervene in case of gross errors

Elements of decentralisation

Operational national rules with links to the EU framework

More binding nature of M-T fiscal planning at MS level

Empowered independent national fiscal institutions

Reinforced market discipline

Fiscal federalism by exception vs No bail out/market mechanism

→ Essential to conceive the different elements of the framework together

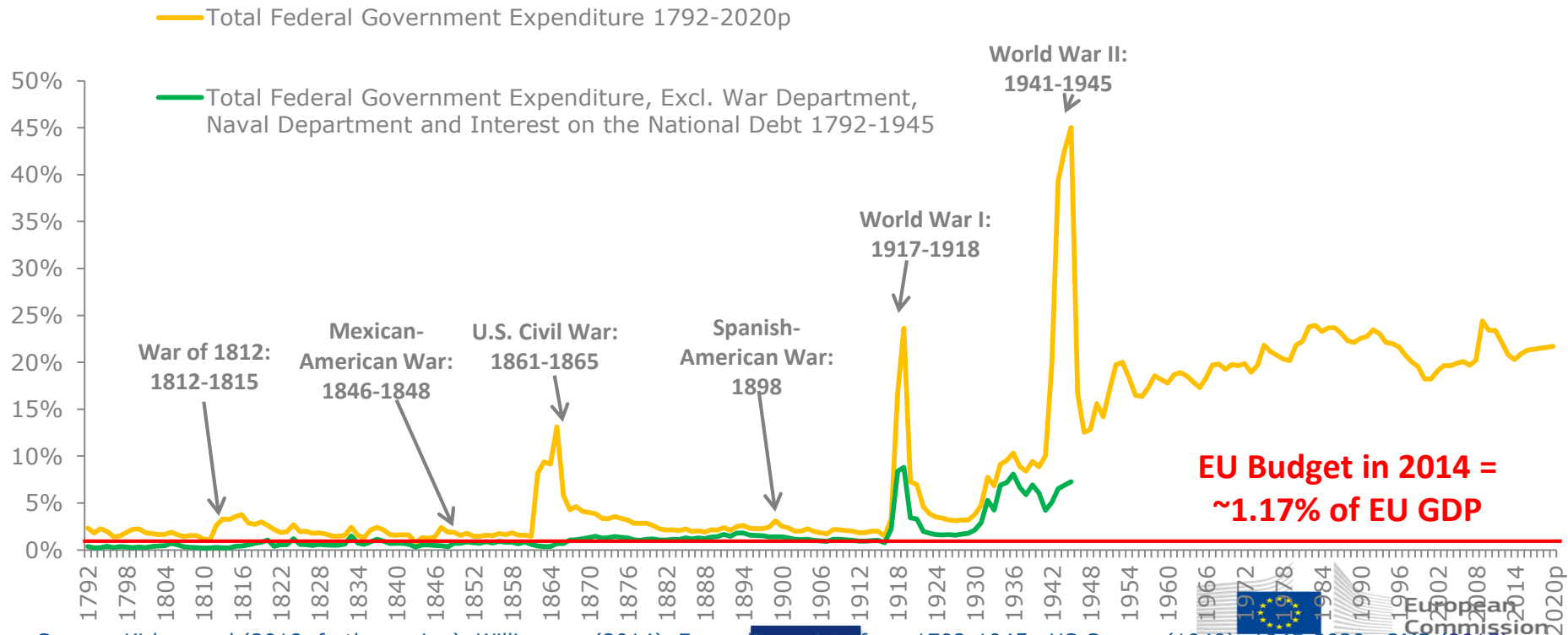
ARE FINANCIAL AND FISCAL UNION SUBSTITUTES OR COMPLEMENTS?

- EMU financial union unlikely to look like in the US in the medium-period (some degree of home-bias will stay, financial system to remain bank-centred);
- Financial market are not Pareto-efficient
- International credit market are pro-cyclical, thus less efficient to absorb shocks
- Fiscal insurance to tackle and reduce shocks arising from the real economy before they reach the financial sector
- US budget (including borrowing) important to reduce state pro-cyclical fiscal adjustment and to absorb symmetric shocks

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LESSON FROM THE US: FISCAL UNIONS TAKE A LONG TIME TO CONSTRUCT



Source: Kirkegaard (2018, forthcoming), Williamson (2014). Expenditure data from 1792-1945, US Census (1949); 1945-2020p OMB (2015).

AN ACCELERATED STEP BY STEP APPROACH

The US and the USD	The EU and the EURO
1776: Declaration of independence. The US are 241 years old	1967: Treaty of Rome. The EU has just celebrated its 60 th birthday
1791*: Congress establishes the First Bank of the United States on the impulse of treasury secretary Alexander Hamilton. 1792: USD coinage act	1971: The Werner report puts forward the first proposal of a Monetary Union 1979: European monetary system
1913: President Wilson signs the Federal Reserve Act into law 1917: Small central government budget** (>5% GDP) 1932: 1 st time US federal budget used in a counter-cyclical manner 1934: Federal Deposit Insurance Corporation (FDIS)	1998: The European Central Bank is founded 1999: Creation of the Euro 2002: Euro in circulation 2012: Banking Union, ESM 2015: EDIS

* Though not a central bank, its power and scope made it a precursor of the FED

** Without military spending

Source: Kirkegaard (2018, forthcoming), Gelpert and Véron (2018, forthcoming)

CONCLUSION

- EMU needs to be completed
- Shocks absorption capacity has to improve
- Financial and Fiscal Union tend to be complementary
- Main goals: complete BU in primis via risk-reduction and risk sharing, conceive a fiscal union balancing rules, institutions and assets
- Lesson from US history: virtue of patience