Economic Governance in the EU: Challenges and Perspectives

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Main conclusions

1. **Pre-crisis economic governance of the EU failed:**
   - Price stability and fiscal rules were not enough to avoid a deep crisis

2. **Major reforms of recent years:**
   - Revamped fiscal rules and new macroeconomic imbalances rules do not work
   - Economic policy coordination does not work
   - Banking Union was inevitable

3. **Euro may not collapse without further reforms, yet current economic governance framework is suboptimal:**
   - Banking union is incomplete (bank-sovereign 'doom loop' still exists)
   - Decentralisation of structural issues and fiscal surveillance would foster ownership
   - A centralised fiscal stabilisation instrument would be beneficial

1. Pre-crisis economic governance of the EU failed

- **Macroeconomic and structural policies:**
  - **Belief:** fiscal discipline and price stability are sufficient for smart, sustainable and inclusive growth; capital flows reflect integration
  - **Instruments:** Broad economic policy guidelines; "long" Commission reports
    - build-up of macroeconomic imbalances
    - even high public debt (Greece, Italy)

- **Financial:**
  - **Contradiction** between single market and national financial policies (such as bank supervision, resolution and bail-out):
    - distort the plying field
    - source of financial instability

2.1 Economic policy coordination in the EU

- **The key framework for economic policy coordination is the European semester, an annual cycle including:**
  - Highlight of priorities by the European Commission (Annual Growth Survey)
  - Discussion of national Stability and Convergence programmes
  - Enforcement of fiscal rules
  - Enforcement macroeconomic imbalances rules (Macroeconomic Imbalance Procedure)
  - Country-specific and euro-area recommendations by the Council
- **We calculate a European Semester reform implementation index (next slides), which show very weak implementation of Council recommendations**

2.2 Calculation of a European Semester reform implementation index

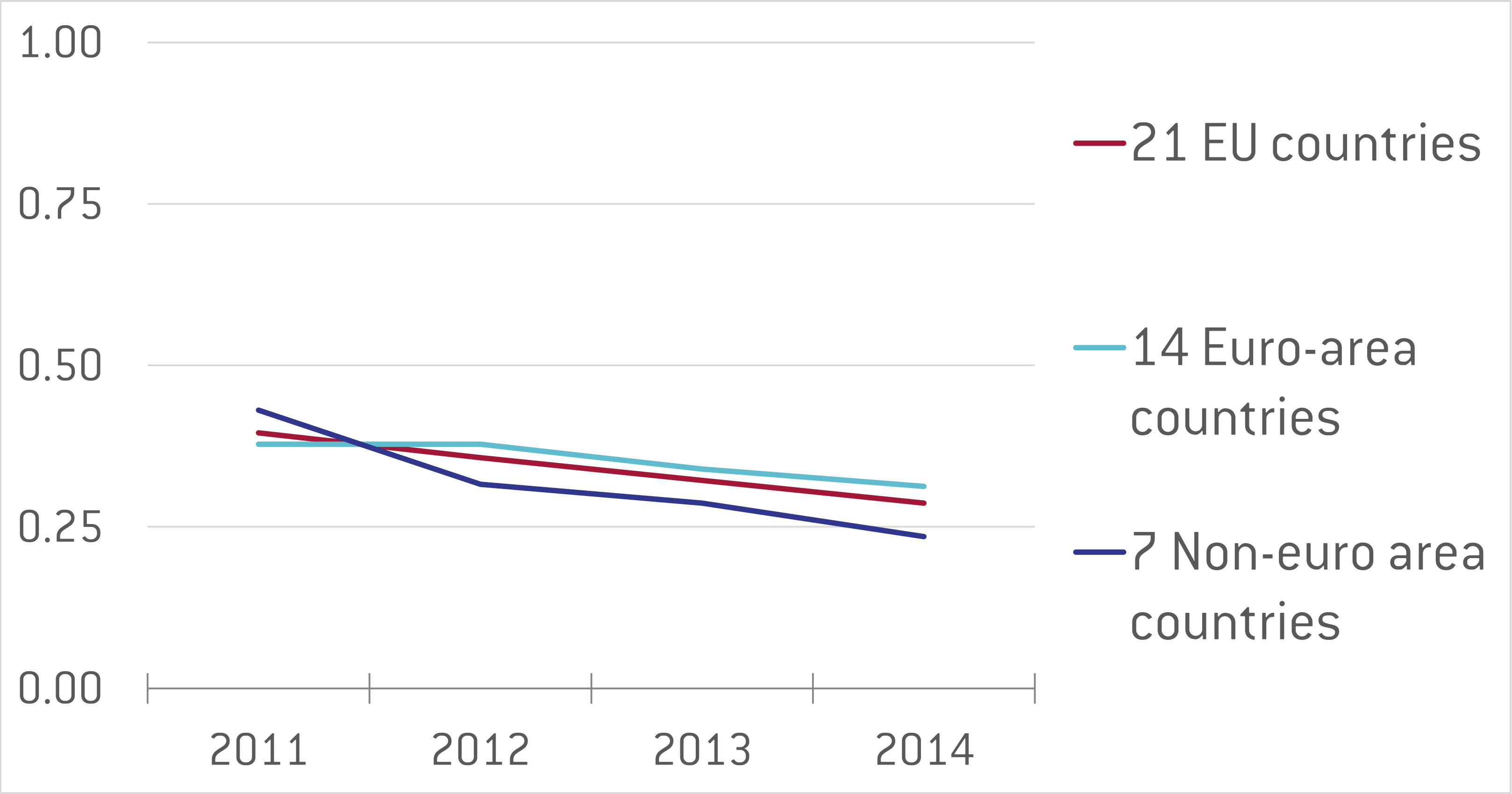
- **The index ranges between zero and one, by considering the European Commission's assessment of the implementation**

European Commission's assessment	Our score
fully implemented	1
substantial progress	1
some progress	0.5
limited progress	0
no progress	0

- We calculate the average score of the recommendations

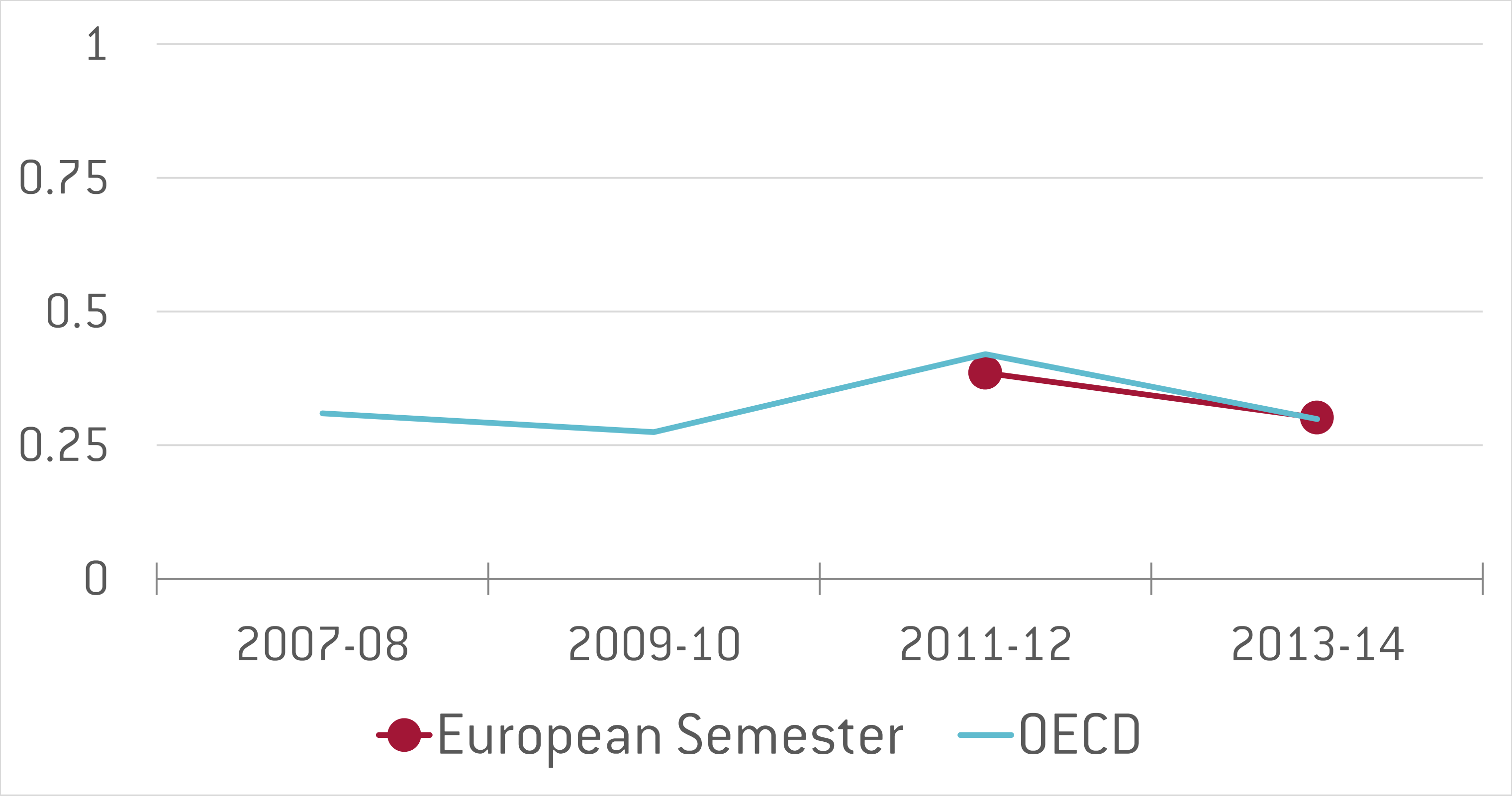
2.3 European Semester reform implementation index

- **Implementation was modest in 2011, and has even steadily fallen since then**



2.4 European Semester reform implementation index in comparison with OECD Going for Growth recommendations

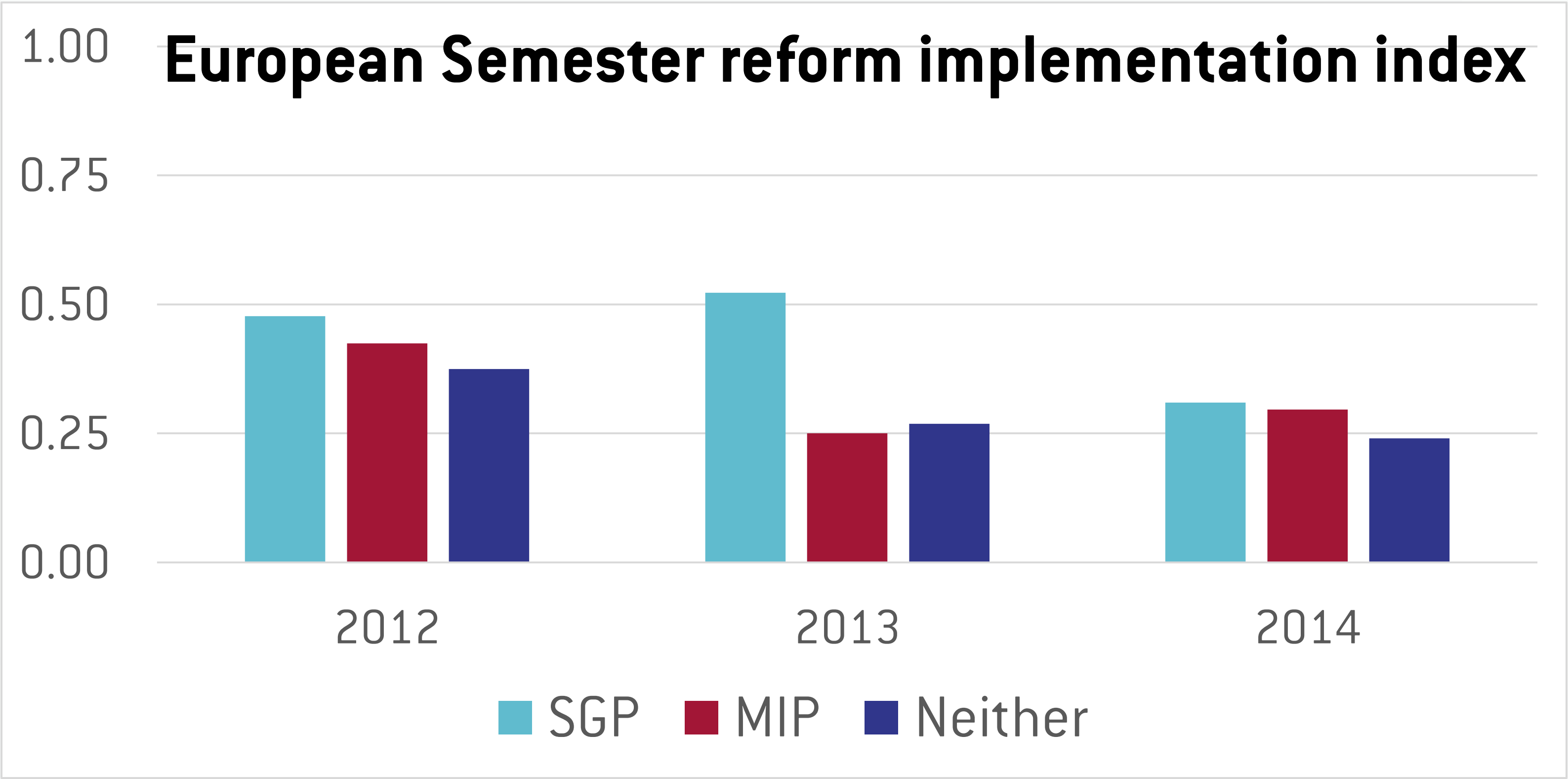
European Semester implementation rate is not higher than the implementation of OECD's unilateral recommendations



Note: Averages for the recommendations made for 16 EU countries

2.5 Revamped fiscal rules and new macroeconomic imbalances rules do not work

➢ **The European Semester is not particularly effective in enforcing the EU's fiscal and macroeconomic imbalance rules**



Notes. SGP: Stability and Growth Pack. MIP: Macroeconomic Imbalance Procedure. Averages for the recommendations made for 21 EU countries.

2.6 Euro-area recommendations

- Euro-area recommendations (except for services market reform) are not reflected well in country-specific recommendations

- Reference to the 'aggregate euro-area fiscal stance' is empty rhetoric

- In 2012, 2013 and 2014, the Council made recommendations for more symmetric adjustment within the euro area (current accounts, wages), but this recommendation has disappeared by 2015

2.7 Fundamental problem of economic policy coordination in the EU

- **Fundamental problem of economic policy coordination:**
  - National decision makers are accountable to their national parliament and follow national interest
- **Coordination tools unlikely to internalise cross-country spillover effects:**
  - Peer pressure did not work so far
  - Threat of sanctions is not serious
- **Reform triggers in ”weak” and ”strong” countries:**
  - More vulnerable countries (e.g. countries with high debts) consolidate and reform when under market pressure or Troika programmes
  - Countries with sound economic positions consolidate and reform when it is in line with domestic preferences. There is no mechanism to force larger budget deficits. MIP is ineffective in reducing current account surpluses.

2.8 Decentralisation

- **Consequently, decentralisation efforts would likely increase domestic ownership of the reform process:**
  - national competitiveness boards
  - greater involvement of national governments/parliaments/social partners in discussions and decisions on the reform process

- **Though we are sceptical about whether cross-country spillover effects will be better internalised**

2.9 Proposals for an improved European Semester

- **Other reforms:**
  - **Split the European Semester into two stages** (1. euro-area issues, 2. country-specific issues): welcome, but if no euro-area stabilisation mechanism or mechanism to force countries to run larger deficits, the optimal aggregate fiscal stance will not be achieved by anything other than pure chance;
  - **Independent advisory European Fiscal Board** is welcome: it should define the *unconstrained* optimal aggregate fiscal stance and its *constrained* version which considers the SGP rules;
  - **Formalising the convergence process**: might help, but major difficulties in the definition of benchmarks, in making them binding and in political enforcement, should a country not comply;

2.10 Proposals for an improved European Semester

- **Other reforms, continued:**
  - **Financial incentives for the reform process:** risk limiting the domestic ownership of reforms, would be unfair to countries that have already implemented reforms and are unlikely to influence those countries that have sound fiscal positions
  - Ex post monitoring of reform implementation by an **independent EU-level "structural council"** would be worthwhile to consider: improve transparency, highlight the steps the European Commission may take to improve the cross-country consistency of CSRs

3.1 Two rationales for a European Banking Union

1. Single Market:

- Free movement of goods, services, capital and people within the EU
- High level of financial integration
- National financial policies (such as bank supervision, resolution and bail-out) are in contradiction with the single market:
  - distort the plying field
  - source of financial instability

2. Euro crisis:

- 'Doom-loop' linking banks and sovereigns:
  - Banking crisis leads to sovereign debt crisis (e.g. Ireland)
  - Sovereign debt crisis leads to banking crisis (e.g. Greece)
- Sovereign and/or banking crisis in a country has negative spillovers into other countries

3.2 Framework for a Banking Union

- **Bank regulation** → for the whole EU
- **The three pillars of the Banking Union (euro area plus):**
  1. **Supervision** → Single Supervisory Mechanism (**SSM**, already operational)
  2. **Resolution** → Single Resolution Mechanism (**SRM**, supposed to be fully operational in January 2016)
  3. **Deposit guarantee** → European Deposit Insurance Scheme (**EDIS**, proposed on 24 November 2015)
- **The two emergency safeguards:**
  - **Lender of last resort** for banks (liquidity provision for sound banks)
  - **Fiscal backstop** for resolution and deposit guarantee (for the case when bail-in and accumulated funds are insufficient)

3.3 A contradiction of the current design of the Banking Union

- **The current setup of the Banking Union is incomplete and will likely be subject to controversy and even perhaps instability:**
  - Supervision and resolution have largely been centralised
  - Deposit guarantee is national
  - Fiscal backstop is primarily national
  - Lender of last resort for banks party centralised (ECB liquidity for banks having adequate collateral), partly national (Emergency Liquidity Assistance at the risk of the national central bank)
  - Bank-sovereign 'doom-loop' reduced, but not eliminated
- **Contradiction between centralised level of supervision and resolution (which can lead to 'mistakes') and national backstops (funding of those 'mistakes')**

3.4 Alternative directions for the Banking Union

- **Two alternatives to resolve the contradiction:**
  1. 'Banking Union light': no further major changes and thereby national powers in supervision and limited risk sharing across countries remain
  2. 'Complete Banking Union': Further limitations for national authorities to use discretion when implementing common rules, limitations on bank holdings of sovereign debt, introduction of appropriate risk sharing across countries and centralised fiscal backstop

- **German objections to risk sharing:**
  - "Risk reduction instead of risk sharing"
  - Large holdings of domestic sovereign debt by banks → risk-sharing would be 'hidden Eurobond' or 'hidden public debt mutualisation'

3.5 Commission proposals for completing the Banking Union on 24 November 2015

- **Key elements of the proposal:**
  - Implementing the rulebook (CRD IV-4th Capital Requirements Directive, CRR-Capital Requirements Regulation, BRRD-Bank Recovery and Resolution Directive, DGSD-Deposit Guarantee Scheme Directive)
  - Thinking about bridge financing and common fiscal backstop for the Single Resolution Fund (SRF)
  - Proposal for a European Deposit Insurance Scheme (EDIS)
  - Proposals to further reduce risk in the banking sector
- **My overall assessment:**
  - Proposals 'sensible' and goes a long way to address German objections (note: a key German demand is not included: sovereign debt restructuring mechanism)
  - Yet German reactions were negative

3.6 How to complete the Banking Union?

- **'Banking Union light' would still be an improvement compared to pre-crisis banking policies…**
  - Not least due to improved supervision and cross-border consistency of prudential measures and bank resolution
- **… but subject to a contradiction**
  - centralised level of supervision and resolution and national backstops
- **… and inferior to a complete banking union, which would require:**
  - Reducing national discretions for banking prudential rules
  - Common backstop for the Singe Resolution Fund (e.g. ESM)
  - Full common deposit insurance with a common backstop
  - Bank risk reduction measures, including appropriate single exposure limits for banks' exposure to sovereigns

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Thank you for your attention

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