

"How to Make the Monetary Union More Robust"

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Interviews

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Elections in Austria, the Netherlands and France have brought victories for Europe-friendly politicians. The success of the new French President Emmanuel Macron in particular shows that voters are convinced of a pro-European programme. The debate about the future of the monetary union has become stronger since that moment, though no decisions will be made before the German elections in September. Still, now is a good moment to review the euro area, and to explain the efforts to strengthen it taken during the crisis. It is also a good time to demonstrate why the introduction of the euro, and the efforts to defend it, were sound. Not only from an economic, but also from a legal point of view. And we should think about the next steps to strengthen the monetary union.

The euro area countries have made a lot of money available to stabilise the euro. So far, the ESM euro crisis fund and its predecessor, the European Financial Stability Facility, have disbursed almost €273 billion in rescue loans to Greece, Ireland, Portugal, Spain and Cyprus. These five so-called programme countries will need to pay the loans back in full, and with interest. So no money is being transferred, although the euro area does take on risk.

The ESM uses a "Cash for Reform" approach for its loans, a principle the IMF has successfully used for decades. These reforms usually include reducing the fiscal deficit, structural reforms and repairing the financial sector. These measures are often painful for the population, and governments are often punished at the next election. Ireland, Portugal, Spain and Cyprus have successfully ended reform

programmes. The loans have bought these countries time, and granted them the fiscal space to make their economies competitive again and fix problems in the banking sector. These efforts are paying off: Ireland and Spain have the highest growth rates in the euro area, and the numbers in Portugal and Cyprus are also solid. Unemployment is coming down across the board. The establishment of the ESM has strengthened the monetary union. Former programme countries are contributing to the fact that the euro area is solid again, and dynamic, and can withstand the comparison with the United States, China or Japan.

Greece is a special case. It had the biggest problems, and the weakest administration. That is why the stabilisation efforts still continue even in the seventh year of the programme. After the most recent disbursement of €7.7 billion, the ESM in total has disbursed more than €39 billion to Greece since the beginning of the programme in 2015. Together, the two crisis mechanisms have issued more than €181 billion in emergency loans to Greece. The ESM and its predecessor, the EFSF, are holding some 51 percent of Greek public debt, and the ESM programme will continue until August 2018. However, loan disbursements will stay clearly below the maximum €86 billion available in the programme.

In Germany, one hears time and again that nothing has happened in Greece since the start of the programme. That is an insult to the Greek people, who have suffered cuts to wages and pensions that would have been unthinkable in other countries. Fiscal progress is particularly remarkable. In 2009, the deficit was more than 15 percent of the size of the economy, expressed as Gross Domestic Product. In 2016, Greece had a budget surplus of 0.7 percent, roughly the same as Germany. That would not have been possible without thorough reform. The most important of these measures were the reforms of the Greek public administration - which now has a quarter fewer staff - and of the pension system, the labour market and the banking sector. Such reforms explain why Greece came out as a reform champion several times in studies by the OECD.

Greece can also become a success story, if the government sticks to the agreed reforms. The ESM's extremely favourable lending conditions - with interest rates of one percent and loan maturities of more than 30 years - enable it to overcome a deep crisis without costs for taxpayers in other euro area countries. Moreover, the euro area countries are willing to help with further debt relief measures if this is still needed beyond August 2018, provided that Greece successfully ends its ESM

programme and the agreed reforms.

In granting its loans, the ESM has copied the methods of the IMF. Loans only take place in return for strict reform programmes. But in financing its loans, the ESM functions quite differently from the IMF, which gets the money for its loans from central banks in its member states. The ESM however, has been granted overall capital of €700 billion by its 19 member countries. More than €80 billion of this has been paid in. But the ESM does not use this paid-in capital to grant loans. Rather, the money serves as a guarantee backing the ESM's excellent credit rating. This means that it can borrow money at very favourable rates in the market, which it uses to finance its loans. In short, not a single euro of taxpayer money changes hands towards the loans to stabilise Greece and the other programme countries. But it is true that the member states do take on risk. That is why the German finance minister needs approval from the German lower house to approve an ESM programme and the disbursement of a next tranche of a loan. This assumption of risk is an act of solidarity between euro area countries, but it does not mean that the economic and monetary union is also a transfer union.

But still, the accusation that the ESM is operating outside the law comes up repeatedly. This despite the fact that the German Constitutional Court has repeatedly confirmed the legality of the EFSF and the ESM. Since 2011, it has come out with five different opinions on the matter. Through these decisions, it has strengthened the role of the German lower house and its members, and has explicitly concluded that establishing the EFSF and the ESM, and the commitments for Germany that came with it, are within the law. And the European Court of Justice, in its opinion of 27 November, said that the granting of assistance loans by the ESM does not violate the "no bail-out clause". The reason is that programme countries remain liable for their own obligations towards creditors.

Germany continues to debate whether the euro is good for the country, and for Europe. Support for the monetary union in the German population stands at 80 percent. The advantages of the monetary union are clear. Cross-border trade between euro area countries has benefited, and transaction costs have dropped by an estimated €20 to 25 billion. Price transparency has gone up, which in turn has led to more competition. More competition leads to higher productivity and more growth. With its central position in Europe, and as an export-oriented economy, hardly any country benefits more from the euro than Germany.

Critics of the euro also tend to forget that the introduction of the single currency has put an end to currency turmoil between European countries. Such turbulence was frequent in Europe in the period between the end of the Bretton-Woods system in the early 70s and before the introduction of the euro. The German Bundesbank deployed billions during market interventions, and the German economy often suffered painful blows to growth. The crises of the past years would certainly have caused similar heavy economic and political turmoil in the countries of the euro area, had they still used their national currencies, and not the euro.

With the euro, Europe has gained relevance on the global stage that individual countries would no longer have. The euro is the second-most important reserve currency of the world. Europe nowadays is a strong actor that can see eye to eye with the United States, Japan and China. That is important, because the relative weight of the European economy is steadily declining. In 1970, Europe made up 32 percent of the global economy – nowadays it is 23 percent. By 2050, the number is expected to come down to just 9 percent. Individual countries – even big European economies like Germany – would hardly count any longer if they were on their own.

The conclusion therefore is that it is worth defending the monetary union, for Germany and for all euro area countries. In early 2010, the members of the monetary union were facing a situation that the founders of the euro though was unimaginable: the loss of market access by a country inside the monetary union. The institutional architecture of the euro area was showing a gap. There was no instrument that could help in such a case, and remedy it. In that situation, first the temporary EFSF was established in 2010, and then the ESM as a permanent institution. Their mandate was to grant rescue loans in return for economic reforms, to euro area countries that had temporarily lost market access. If this rescue shield had not been there at the height of the euro crisis, countries such as Greece, Ireland and Portugal would likely have exited the euro in a chaotic fashion, with the risk of contagion for the integrity of the euro.

Europe has now left the crisis behind it. It has come out stronger than before, both economically and institutionally. This is through the establishment of the EFSF and the ESM as lenders of last resort for governments. It is also through reform programmes, in particular in programme countries. Furthermore we now have the Banking Union, with the SSM single supervisory mechanism and the single resolution fund, the SRF. These crisis measures have laid the foundation for solid economic

growth. Euro area economic growth was above that of the United States in 2016. That doesn't mean that all our problems are solved. Unemployment in some euro area countries is still unacceptably high, particularly under young people.

Now what else can be done to strengthen the monetary union? Euro area countries should in the first place implement the rules they have already agreed to. Moreover, these rules should be made simpler – particularly when it comes to monitoring fiscal policy. The rules have become too complex, even for experts. Secondly, countries should continue to make structural reforms to boost their potential growth rates and implement the European Commission's country-specific recommendations. That is true for all euro area countries, not just for the five that received ESM support.

Any additional steps needed to complete monetary union are limited compared to that what has already happened. We need neither a full fiscal union with additional transfers, nor a full political union. In the first place, we should complete Banking Union. This would strengthen financial integration in the monetary union, as well as risk-sharing through private markets.

What is missing from Banking Union is a backstop for the Single Resolution Fund, in case its capacity is exceeded in exceptional situations. Such a backstop would enhance its credibility. The other improvement would be a European deposit insurance. However, for this to happen, legacy issues that still exist in certain euro area banks need to be dealt with first. No country with a healthy banking system should have to pay for the past mistakes made by banks and their supervisors in other euro area countries. Still, there are considerable advantages to a deposit insurance. It would put an end to the risk of a run on a country's entire banking system. If a country comes under pressure from markets, bank clients will know that it isn't just their own country that is backing the deposit insurance, but the entire euro area. Setting up a common deposit insurance is therefore a strong guarantee that it will never be used. Capital Markets Union would further strengthen financial integration and make the euro area more robust. Harmonising corporate, tax and bankruptcy law across Europe would lower the hurdles that often still stand in the way of cross-border investments at the moment.

A further step towards a more resilient monetary union would be a limited budget, to counter economic shocks in member states. Examples from the United States show that this can be done without debt mutualisation and without permanent transfers.

This is the case for instance with a rainy day funds for carefully defined exceptional situations, or through a complementary unemployment insurance. In both cases, states can get extra money when they fall on hard times for a limited period of time, but have to pay it back later. A limited joint budget, or fiscal capacity, to fight such so-called asymmetric shocks would be important, because monetary policy cannot take on this role. Monetary policy cannot even out the different growth cycles between its members. In fact, it usually works pro-cyclically. Real interest rates tend to be too low in countries that are growing rapidly, while they are too high in those that are expanding at a slower pace. This is why it would make sense to have a limited joint budget as a stabilising function in a monetary union.

However, the euro area does not need an additional investment budget. This already exists for the entire European Union with the so-called Juncker Plan and the European Investment Bank. If needed, these funds should be increased. Additional permanent transfers to promote economic convergence in the EU aren't needed either. Transfers from richer to poorer countries have been happening for 60 years from the EU budget, and rightly so. They can be up to 3 percent of the economy of the receiving country. We also do not need large additional budget means to fight joint crises. After the outbreak of the global financial crisis in 2008, Europe has shown that it can effectively fight a deep crisis in a truly exceptional situation by a targeted increasing of public spending. The Stability and Growth Pact contains an exception that allows countries to exceed the 3 percent budget deficit maximum during a deep crisis.

It would be useful to have a permanent full-time chairman of the Eurogroup, which comprises the finance ministers of the euro countries. He or she should represent the euro area in international bodies such as the G7 group of industrial nations and the IMF.

The Commission, politicians, central bankers and academics have held numerous discussions about a European Monetary Fund, which could develop out of the ESM rescue mechanism. There is a consensus that the IMF will continue to be involved in Greece while the euro area solves this last remaining problem of the euro debt crisis. But the IMF won't play the same role in any future euro area crisis, and the ESM could play an even larger role. Already now, the ESM does more than just financing rescue loans. It also takes part in surveilling programme countries and analyses debt sustainability. With its Early Warning System, it monitors former

programme countries' capacity to pay back their loans as agreed. The debate about a European Monetary Fund contains proposals that are sometimes mutually exclusive. Some would like it to take on the monitoring of fiscal policy, something that is currently a responsibility of the Commission. Others are thinking of a euro area Treasury, or an institution to manage a euro area fiscal capacity. Much more debate among euro area countries is certainly needed before we have a final concept. It is of course possible that the ESM will develop into an institution that resembles the IMF even more than it does already. It is equally certain that would require at least a change of the ESM Treaty - if not the EU Treaty. For that to happen, consensus among all member states is first required.

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