Op-ed by Klaus Regling: "A window of opportunity to strengthen Economic and Monetary Union further"

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"A window of opportunity to strengthen Economic and Monetary Union further"

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After years of economic crisis, indicators confirm a recovery with a strong positive outlook for the euro area. The favourable economic and political environment provides a window of opportunity to implement reforms and address weaknesses in the euro area architecture. These reforms should include simplifying the fiscal rules, completing Banking and Capital Markets Union, and creating a limited fiscal capacity.

A well-functioning monetary union needs a credible and sustainable fiscal framework. The euro area fiscal rules anchored in the Stability and Growth Pact were implemented in 1997. They were strengthened and revised in 2005, 2011, and 2013. The last revisions introduced improved governance structures, ex-ante coordination and tighter ex-post follow-up. These revisions improved the fiscal rules but also added to their complexity, making them harder to understand and more difficult to communicate. This complexity undermines their credibility. They should, therefore, be simplified to make them more binding, predictable and effective.

The completion of Banking Union, including the creation of a European Deposit Insurance Scheme and credible and well-functioning backstops, should also be prioritised. Taken together these reforms will strengthen the credibility of the safety net, reduce the risks of escalation in case of a crisis, ensure more long-lasting investor confidence, and better protect citizens. This step will be possible when legacy assets of the past have been sorted out. In addition, a fully fledged Capital Markets Union would increase legal certainty for cross-border transactions of businesses, investors, and savers. More cross-border investment and financing will enhance private-sector risk sharing. In addition, promotion of cross-border equity investment will reduce reliance on bank financing and further weaken the sovereign-bank nexus.

In a successful monetary union, public-sector risk sharing complements these private sector insurance channels. The experience in some countries, such as the United States, shows that market risk sharing mechanisms are insufficient. In a monetary union, countries have to weather asymmetric shocks to the economy without being able to rely on national monetary policy. Public-sector risk sharing, through a central fiscal buffer, can cushion asymmetric shocks and enhance the euro area's financial stability without creating permanent transfers or debt mutualisation, as examples in the United States show.

Some proposals for the euro area to establish a central fiscal capacity are not necessary. A facility to deal with symmetric shocks is not really needed. In case of a symmetric shock, monetary policy can intervene, countries would rely on automatic stabilisers (which are the largest in the world) and, in an extreme crisis, repeat the approach of 2008-09 to suspend the 3%-deficit ceiling for a limited time. Other proposals would overlap with mandates of existing institutions. Maintaining a stable level of investment, also in a crisis, can be managed by the European Investment Bank and the European Investment Fund in charge of the successful implementation of the Juncker Plan. Similarly, support for real convergence is the primary goal of the EU regional and cohesion funds. The EU budget has provided for decades substantial transfers of up to 3% of GDP for poorer Member States.

Instead, a useful instrument to strengthen the euro area is a fiscal capacity that can absorb asymmetric shocks. Such a capacity could take the form of a stabilisation fund or an insurance scheme. It would enhance risk sharing without creating permanent transfers or debt mutualisation. Fiscal arrangements integrating many of these principles already exist in the US with a complementary unemployment insurance and rainy day fund arrangements. The implementation would be possible without necessarily changing the EU Treaty. The size of this fiscal capacity would not overburden Member States' public finances, as 1-2% euro area GNP would constitute a sufficient buffer that could be accumulated over a number of years. The framework for such limited fiscal capacity could be designed to prevent moral hazard and free-riding.

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