

Euro zone governance: where are we and where do we go?

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Introductory remarks

- **Euro zone (and EU in general) is, indeed, at a crossroad**
- **If the euro zone governance reforms do not proceed, the monetary union will be under strong pressure in the next crisis with strongly negative implications for the EU as a whole**
- **Over the last year, a window of opportunity has been opened for these reforms, but it will not remain open for a long time**

Structure of the presentation

- Conceptual framework of the euro zone and its original governance
- Management of euro zone crisis: from *ad-hoc* to more *systemic* approach
- Current situation and key reforms under implementation
- Framework for the euro zone sustainability over longer period of time

1. Conceptual framework of the euro zone and its original governance

- Monetary union is the most demanding form of regional economic integration
- European monetary union is far from a textbook case for a monetary reform (a step too far?)
- Two design failures of the original euro zone governance
 - *Stability and Growth Pact (SGP)* the key *crisis prevention* mechanism; its implementation was rather poor
 - Maastricht treaty does not provide for a *crisis resolution* mechanism

2. Management of the euro zone crisis: from *ad hoc* to more *systemic* approach

- ***Ad-hoc* approach taken to bail-out Greece....**
 - Stand-by arrangement („troika“ was born)
 - Financing provided by IMF and through bilateral loans of euro zone member states
 - EFSF as a temporary crisis resolution mechanism was initiated
 - ECB started to purchase bonds of countries in problems (a hotly debated decision)
- **..... and later on Portugal and Ireland**
 - IMF again part of the deal
 - Funding done via EFSF

2. Management of the euro zone crisis: from *ad hoc* to more *systemic* approach

- Improvements since the 2010 *ad-hoc* approach
 - Strengthened *crisis prevention* arm
 - Introduced *crisis resolution* arm



3. Management of the euro zone crisis: from *ad hoc* to more *systemic* approach

- **In contrast to old SGP (strongly focused on fiscal issues), the new economic governance introduces improvements in several respects**
 - **Coordination throughout the year based on the European semester (coordination of plans with clear timetable)**
 - **More responsive budgeting (better rules and better enforcement of the rules)**
 - **Strengthened surveillance in the euro zone (response to potential contagion effect)**
 - **Monitoring extended to macroeconomic imbalances (Alert Mechanism Report, in-depth review, fines)**

3. Current trends and key reforms under implementation

- **Where do we stand now in managing the crisis?**
 - The immediate danger of the euro-zone dissolution has been removed – crucial role of the ECB
 - Confidence of international financial market has improved
 - Several important systemic improvements of the institutional framework have been made.....
 - *Crisis prevention* mechanism significantly improved
 - *Crisis resolution* mechanisms introduced
 - Substantial adjustments in several members underway
 - but the appetite for further reforms reduced

3. Current trends and key reforms under implementation

- **Key reforms under implementation—banking union**
 - **Single banking supervision under ECB leadership**
 - Key decisions taken in late 2013
 - Stress test results announced in October 2014
 - ECB already supervises over 130 banks covering over 80 per cent of the European banking sector
 - **Single resolution mechanism; precondition for effective supervision**
 - Key decision taken in spring 2014
 - Fully operational in 8 years
 - **Deposit insurance scheme; necessary to prevent flight of deposits (funding still under discussion)**

3. Current trends and key reforms under implementation

- **Key reforms under implementation—new approach towards the sovereign debt problem**
 - **Early stage of the crisis (bail-out)**
 - **Countries in troubles were rescued with large financial packages financed by public funds**
 - **... used largely to service private creditors; otherwise they would have to be rescued**
 - **Since Cyprus case (bail-in)**
 - **Bail-in principle has been introduced as a way to reduce pressure on public funds**
 - **The logic is to use first funds within banks, then within the country, and then on the euro-zone level (ESM)**

4. Framework for the euro zone sustainability over longer period of time

- Collapse of the euro zone was prevented by ECB and it was also instrumental for the recent growth**
- Policy of ECB is not sustainable on a long run, it is buying time to the member states**
- New crisis will strike sooner or later**
- Over the recent year, a consensus was built that further reforms are needed and also pro-reform appetite was generated (Germany, France)**

4. Framework for the euro zone sustainability over longer period of time

- **The key euro area's challenge is a fundamental contradiction between**
 - **Single currency, and**
 - **State-based fiscal / structural policies**
- **Two consistent „clear“ options**
 - **Rule-based governance approach based on fiscal discipline (this option was by and large implemented so far)**
 - **Policy-based governance approach based on active policy coordination**

4. Framework for the euro zone sustainability over longer period of time

- **Common characteristics of these two „clear“ options ...**
 - Fully operational banking union
 - Insolvency rules for sovereigns
- **... and their differences**
 - Different conceptual framework: rule-based vs policy-based
 - Fiscal capacity / transfers: yes or no
 - Transformation of ESM into EMF: yes or no

4. Framework for the euro zone sustainability over longer period of time

- **Overall framework for a „hybrid“ and in my opinion doable option**
 - **It is based on the existing rule-based approach, though it functions sub-optimally; it reflects political reality**
 - **New responsibility/solidarity balance needed, therefore, elements of policy-based approach incorporated**
 - **The option addresses all elements and is to be introduced in phases**

4. Framework for the euro zone sustainability over longer period of time

- **Phase 1 of the „hybrid“ option (no treaty changes needed)**
 - **Fully operational banking union**
 - **Insolvency rules for sovereigns introduced**
 - **Adjustment of the institutional setting and procedures**
 - **Fiscal capacity in the form of an emergency fund introduced**
 - **Transformation of ESM into EFM**

Conclusions

- **Over last years, the collapse of euro zone was prevented**
- **The window of opportunity that has been opened should be used for ambitious euro zone reforms ...**
- **..... the „hybrid“ option represents a doable approach for these reforms**