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 adhoc 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

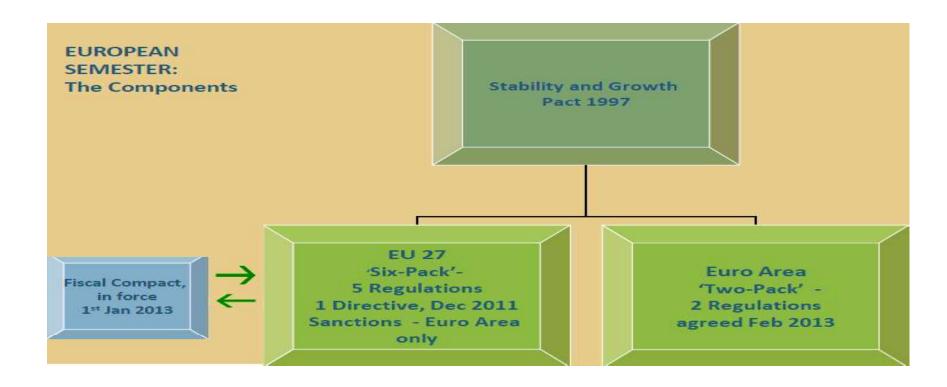
- Monetary union is the most demanding form of regional economic integration
- European monetary union is far from a textbook case for a monetary reform (a step too far?)
- Two design failures of the original euro zone governance
 - Stability and Growth Pact (SGP) the key crisis prevention mechanism; 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)

- 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 proreform appetite was generated (Germany, France)

- 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

- 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

- 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

- 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 tone reforms ...
- the "hybrid" option represents a doable approach for these reforms