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 „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 tone reforms ...
• ..... the „hybrid“ option represents a doable approach for these reforms