On the future of EMU
Targeted reforms instead of more fiscal integration

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Arguments for a euro area fiscal stabilisation mechanism

Multiple crises and their legacy

Rising private and sovereign debt

Confidence crisis, bank-sovereign-nexus

Debt overhang, weak demand

Monetary policy at ZLB

<u>EMU shortcoming:</u>
susceptibility to asymmetric shocks
- heterogeneity of EMU countries
- divergence due to real interest rate effect

Fiscal policy as a key adjustment mechanism

- but limited effectiveness:
- **limited leeway and incentives** for expansive counter-cyclical fiscal policy on national level
- lack of coordination to achieve adequate **common EA fiscal stance**

<u>EMU shortcoming:</u>
limited adjustment capacity to shocks
- wage and price flexibility
- labour mobility
- financial risk sharing

Proposal of a euro area fiscal stabilisation mechanism
to improve the counter-cyclicality of fiscal policy

Key Message

Case for EA fiscal adjustment mechanism questioned:

> current crisis was exeptional and can be solved

> future crises should be less severe

Remaining short-term problems are temporary and need temporary instruments

- unconventional monetary policy, more active EFSI, etc.

Reforms have addressed key roots of crisis

> implementation needed

Specific further reforms needed

in the financial system in particular

Specific features of the euro area debt crisis

High private and public debt
- Deep and long crisis, subdued recovery
- Aggravated by weak banks and financial fragmentation

One-off interest rate decline at the onset of EMU in the EA periphery	**Financial crisis** and **Great Recession**	**Excessive credit cycle -> high private debt** in the EA periphery	**German labour market reform**	**Globali-sation shock in southern Europe**

Reforms taken to make the next crisis less severe

Boom-bust cycles – high private debt	Government debt	Lack of lender of last resort	Problems in the banking system	Weak optimum currency area
MIP	SGP reform	EFSF/ESM with conditionality	Recapitali-sation (Basel III, EBA)	Structural reforms more flexibility & homogeneity
Macro-prudential supervision (ESRB, SSM)	Fiscal Compact	OMT with conditionality (TARGET2)	Banking Union (SSM, SRM with bail-in)	Higher labour mobility and financial risk sharing

Arguments for an euro area fiscal stabilisation mechanism

Multiple crises and the legacy

Rising private and sovereign debt

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Remaining debt overhang (NPLs, banks), Demand weakness

Monetary policy of ECB restricted at the ZLB

EMU Shortcoming:
Susceptibility to asymmetric shocks
- Heterogeneity of EMU countries
- Divergence trend due to real interest rate effect

Fiscal policy seen as central adjustment mechanism

But effectivity seen as limited due to:
- **Limited leeway and incentives** for expansive counter-cyclical fiskal policy on national level (?)
- Lack of coordination of national fiscal policies in order to achieve adequate **common fiscal stance** in euro area (?)

EMU Shortcoming:
Limited adjustment capacity to shocks
- Wage and price flexibility
- Labour mobility
- Financial risk sharing

Proposal of more fiscal integration
in the form of a fiscal macroeconomic stabilisation mechanism
(mainly in order to improve the capacities for counter-cyclical fiscal policy)

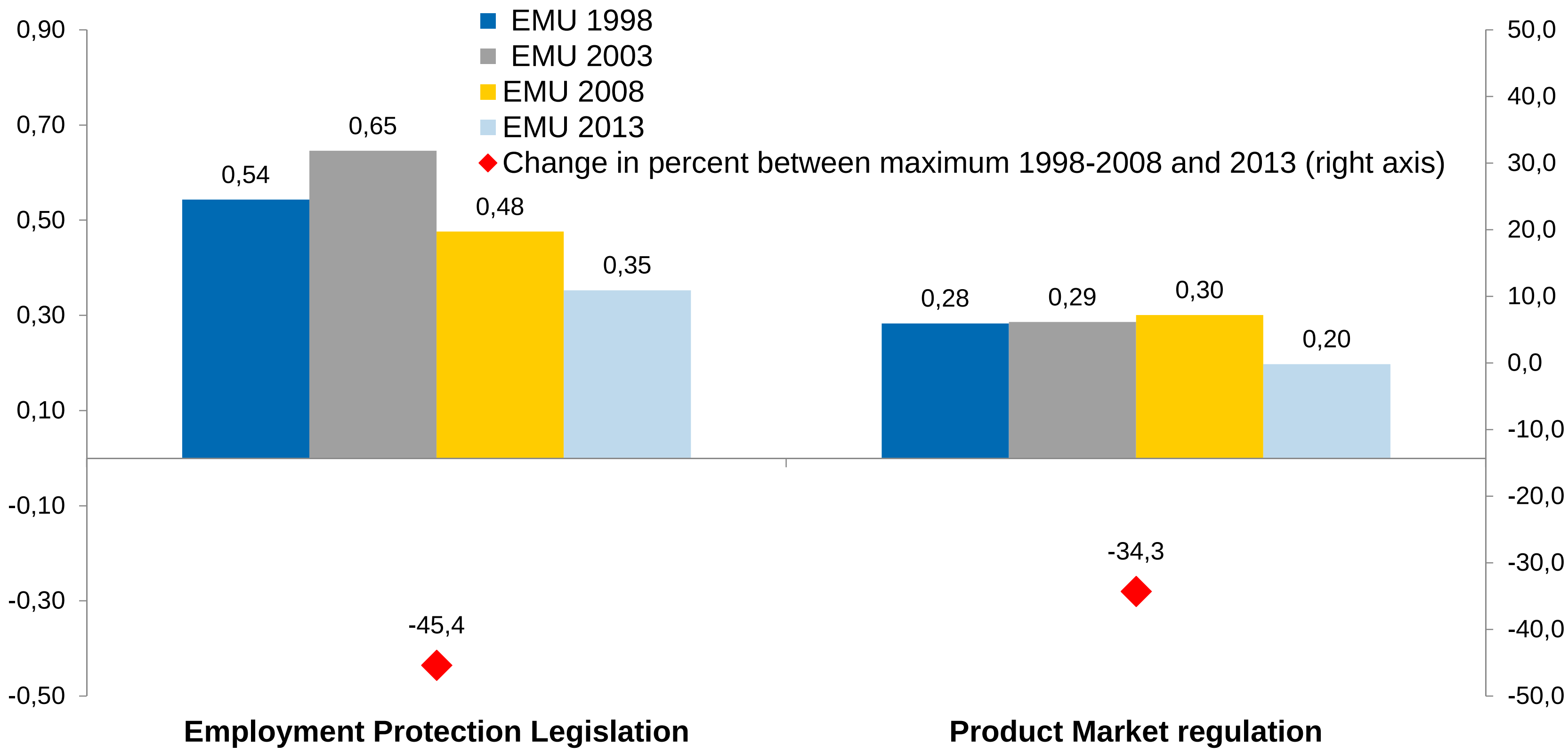
Reforms of collective bargaining systems since 2008

	PT	ES	GR	IT
Decentralisation / firm level orientation				
Priority to firm level agreements	x	x	x	
Limits to the extension of wage agreements	x		x	(x)
(More) opt-out possibilities		x	x	x
More working time flexibility	x	x	x	x
Agreements possible for non-members of trade unions	(x)		x	
Duration/time extension for agreements reduced	x	x	x	
Wage indexation eliminated or significantly reduced		x		x

Preliminary evaluation, not to be quoted.
Note: x: significant reform, (x) partial reform.
Source: Own compilation based on a various studies from Eurofound European Industrial Relations Observatory (EIRO), OECD Economic Country Surveys, IMF Article IV consultations, EU and IMF programme reviews, European Semester reports

EPL and PMR: decline in heterogeneity

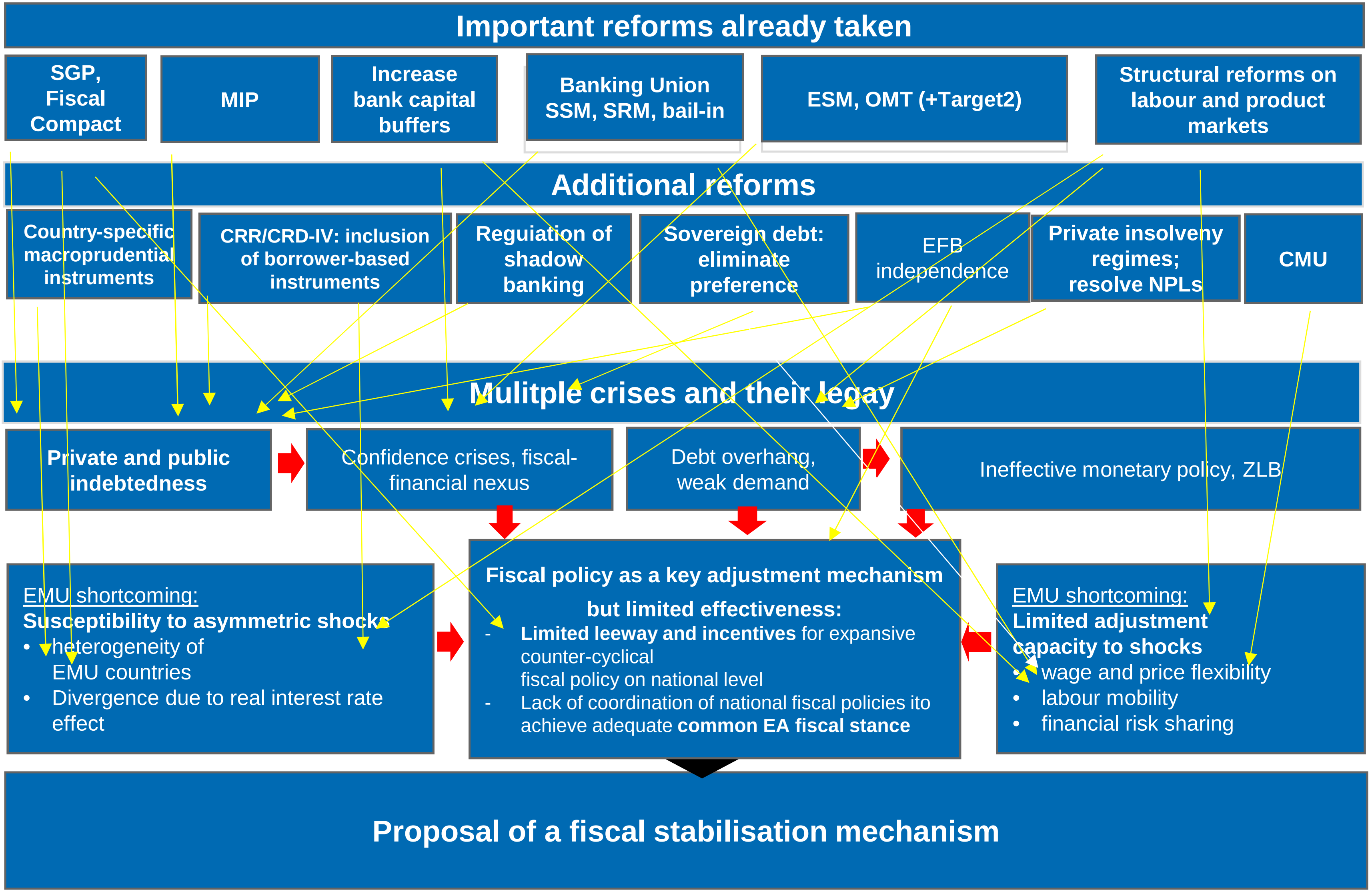
Standard deviation among sample of EMU countries*



*Reduced sample due to lack of data availability for 1998 for some countries.
Sources: OECD; IW Köln

Implementation of existing reforms and specific additional reforms needed

Tackle private debt legacy	Make banking system more robust	Tackle „one size does not fit all“ problem	Strengthen financial risk sharing	Strengthen anticyclical capacity of SGP
Further improve private insolvency regimes	**Further strengthen banks‘ capital base; use anticyclical CRD IV tools**	**Active use of regional macro-prudential policy**	**Incentives for diversification of assets and investors and against short-term exposure (e. g. capital rules)**	**Achieve MTOs; account for financial cycles**
Make banks recognise NPLs; appropriate bad bank solutions	**Phase out preference for sovereign bonds**	**SSM access to borrower-based instruments**	**Phase-out preference for debt financing over equity**	**Secure independence and effectiveness of Fiscal Board**


Important reforms already taken
SGP, Fiscal Compact
MIP
Increase bank capital buffers
Banking Union SSM, SRM, bail-in
ESM, OMT (+Target2)
Structural reforms on labour and product markets
Additional reforms
Country-specific macroprudential instruments
CRR/CRD-IV: inclusion of borrower-based instruments
Regulation of shadow banking
Sovereign debt: eliminate preference
EFB independence
Private insolvency regimes; resolve NPLs
CMU
Mulitple crises and their legay
Private and public indebtedness
Confidence crises, fiscal-financial nexus
Debt overhang, weak demand
Ineffective monetary policy, ZLB
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• Divergence due to real interest rate effect
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• financial risk sharing
Proposal of a fiscal stabilisation mechanism

Discussion

Thank you for your attention

Central role of financial and banking sector

Financial market underestimated risks before crisis

Global financial crisis led to large increase in sovereign debt

Banks main source of large credit boom
within/among EA countries
> private debt increase; large financial cycle
> source of BoP crisis

Financial system

Sovereign-bank nexus
Banks vulnerable to sovereign debt crises

Weakened banks
> credit supply, recovery and transmission of monetary policy hampered
> risk of bank runs

Break-down of financial risk sharing - financial fragmentation

Arguments for fiscal adjustment mechanism

Euro area is no OCA

- Heterogeneity of EMU countries
- Wage and price rigidities esp. in the EA periphery
- Lack of other market-oriented adjustment mechanism
  labour market mobility / financial risk sharing proved inefficient

Current crisis as evidence for lack of adjustment capacity

- Inability to use anticyclical fiscal policy
  due to high sovereign debt, bank-sovereign nexus, danger of self-fulfilling crises
- Deep and prolonged balance sheet recessions
  with severe social impact

ECB with “one size does not fit all” monetary policy

- Detrimental real interest rate effect

Fiscal spillovers and lack of fiscal policy co-ordination

Check up of arguments for fiscal adjustment mechanism

Euro area is no OCA

Heterogeneity of EMU countries – **considerably reduced by regulation**

Wage and price rigidities (esp. in the EA periphery) – **reduced; Productivity Boards**

Labour mobility – **significantly increased – more needed**

Financial risk sharing – **recovering (bank capital, BU, CMU) / more needed**

Current crisis as evidence for lack of adjustment capacity

Inability to use anticyclical fiscal policy

- **Consolidation creates new fiscal space**
- **Smarter use of automatic stabilisers needed**

Deep and prolonged balance sheet recessions (weak demand and investment)

- **Response: unconventional monetary policy, increase in bank capital, reform of private insolvency regimes, EFSI**

ECB with „one size does not fit all“ monetary policy

- **Regionalised macro-prudential policy necessary**

Fiscal spillovers and lack of fiscal policy coordination

No strong empirical case