A *Better* EMU Blueprint

By Lucas Papademos

The current system is "conceptually incomplete and functionally ineffective."

When European leaders decided in the 1990s to create a monetary union and introduce a single currency, the euro, it was understood that this undertaking was part of a more ambitious and longer-term project of establishing a broader and closer union of member states' economies and policies. They were also fully aware that, historically, a single political or national entity, including a reasonably integrated economy and a single fiscal policy, almost always preceded or coincided with the adoption of a single currency.

Since a political and economic union of the European Community member states was not a realistic, or even a desirable, option in the 1990s, leaders adopted the alternative and unprecedented (with few exceptions marred by failure) approach of introducing the euro as the first and central element of an intended plan for creating "an ever-closer union."

The introduction of a single currency was economically desirable as the essential complement of a single market for goods, services, labor, and capital, which has been a main European policy objective. It was convincingly argued and politically accepted that

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the completion and efficient functioning of a single market required a monetary union and a single monetary policy geared to maintaining price stability across member states. It was envisaged that the other components of a more complete, or genuine, union would follow at the right time. Hence, economic reasoning and political reality jointly defined the blueprint for and the road map to the Economic and Monetary Union that was established in Europe in 1999.

Politics in a number of member states have become increasingly polarized.

To be sure, it was also realized from the outset that monetary union could not function efficiently and preserve price stability effectively in the absence of a framework which would ensure that national fiscal policies would be consistent with—indeed supportive of—the single monetary policy geared to the maintenance of price stability. This was reflected in the adoption of the Stability and Growth Pact comprising rules and procedures aimed at preventing excessive fiscal deficits in member states and at correcting them in the event they materialized.

It became progressively evident in the mid-2000s and it was painfully demonstrated during the eurozone debt and economic crisis that the economic pillar of EMU was conceptually incomplete and functionally ineffective. It involved a policy framework which did not succeed in fostering and coordinating national economic and fiscal policies so that they would be consistent with the stability-oriented monetary policy of the European Central Bank. Moreover, financial supervision in several member states failed to assess credit, sovereign, and liquidity risks in an adequate and timely manner. Hence, bank balance sheets became vulnerable to shocks stemming from property, loan, and sovereign bond markets.

LOOKING BACK IN THE WAKE OF THE EUROZONE CRISIS: ENHANCED DESIGN AND GOVERNANCE

What should have been done differently in designing European monetary union at the time of its genesis, when the euro was introduced, that would have prevented or mitigated the crisis and have fostered a better economic performance in the eurozone?

It is no doubt easier to redesign the blueprint with the benefit of hindsight. But it is useful to do so in the light of the lessons drawn from experience with the eurozone crisis that have important implications for the efficient functioning of monetary union and the credibility of the euro in the future.

A number of enhancements of the economic policy framework and an expanded set of criteria for joining EMU would have been desirable:

- First, a more comprehensive and more effective surveillance system of economic developments and policies in member states, which would assess the sustainability of fiscal positions, the evolution of competitiveness, and current account balances, as well as the efficiency of labor and product market functioning;
- Second, a more rigorous and effective governance of the economic policy framework which would prevent excessive and systematic deviations of fiscal positions and competitiveness indicators from agreed norms and would enforce policy adjustments when such norms were not achieved;
- Third, a more centralized, and thus harmonized, oversight of financial institutions that would ensure the application of the same rules and practices in the supervision of financial institutions and would aim at protecting the stability and soundness of banks in countries sharing the same currency;
- Fourth, and taking into account the stronger economic pillar of EMU outlined above, a broader set of criteria, which member states would have to fulfill in order to join monetary union and which would include, *inter alia,* indicators of fiscal sustainability, structural competitiveness, and efficient market functioning in order to assess a member state’s capacity to adjust to shocks—external or policy-induced.

The inclusion of the above enhancements in the design of monetary union would have resulted in a much stronger economic pillar and a more balanced architecture of EMU. Also, it would have helped prevent the adoption of inappropriate fiscal policies and

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labor market practices and the emergence of banking system vulnerabilities that caused or contributed to the eurozone crisis.

But a better EMU design and a more centralized economic policy framework would have entailed the surrender by member states of a higher degree of national sovereignty with regard to fiscal policy and financial supervision. This was not politically acceptable in the mid-1990s. Indeed, it would not have been acceptable even later on, during the first decade since the launch of the euro. In the mid-2000s, the Stability and Growth Pact was amended so as to become more flexible in principle and it was less adhered to in practice. It did not encourage the necessary fiscal discipline and permitted the build-up of excessive fiscal imbalances. Later on, suggestions by the European Commission and the ECB to tighten and broaden economic surveillance and to adopt a common rulebook for financial regulation and supervision did not receive adequate political support from member states.

Hence, when monetary union was created and during its first ten formative years, political considerations reflecting narrow and short-sighted national interests prevailed over economic arguments favoring a more balanced EMU architecture and a more centralized and effective economic governance. Consequently, changes to the initial blueprint for monetary union that in retrospect would have been constructive, such as those suggested above, would not have been politically feasible at the time.

LOOKING AHEAD: A MORE PERFECT ECONOMIC AND MONETARY UNION

It was only when the eurozone crisis broadened and deepened in 2011 and 2012—when the monetary union vessel started leaking dangerously—that significant steps were taken to improve the architecture and governance of EMU. A crisis can create opportunities. European leaders and institutions took far-reaching actions, which would have been unthinkable earlier, to resolve the crisis and prevent the recurrence of similar episodes in the future. These actions included:

- The creation of the European Stability Mechanism;
- The adoption of a new intergovernmental Treaty to ensure balanced budgets in member states;
- The introduction of a reinforced economic governance framework that will strengthen the surveillance of national economies and the coordination of economic policies;
- The decision of European leaders to take further steps towards establishing a genuine EMU, starting with the creation of a banking union.

Undoubtedly, these fundamental institutional changes and political commitments address serious weaknesses in the design and policy framework of EMU and will improve the economic performance and financial stability of the eurozone. The European leaders' political commitment to pursuing the objective of establishing a "genuine" EMU, starting with the creation of a banking union, should not be underestimated, despite delays in the implementation of some components and uncertainties about the overall design and the timeframe for achieving the goal.

In particular, of major significance is the establishment of the European banking union, with a Single Supervisory Mechanism for all systemic banks in the eurozone, which should be fully operational in 2015, and a Single Resolution Mechanism for failing banks, including a common public backstop fund. The European banking union will complement and strengthen the monetary union by various means. It will contribute to the resolution of the still-ongoing crisis and play a crucial role in protecting financial stabil-

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ity and boosting economic growth in the monetary union over the medium and longer run.

Nevertheless, the current blueprint for the banking union and the envisaged sequencing of establishing its various components may prove to have a rather modest positive impact on persisting financial fragmentation in the eurozone over the short and medium run. Hence, an important policy priority at the present time is to employ other instruments in order to ensure the homogeneous transmission of the ECB's monetary policy across the eurozone and improve financing conditions in countries under stress.

Looking further ahead, in order to create a "more perfect" monetary union, which will preserve price stability, safeguard financial stability, and foster stronger economic growth, it will be necessary to take additional steps towards greater fiscal and economic integration. The main economic arguments supporting this proposition and a vision for the future of EMU are contained in the reports prepared by the presidents of four EU bodies and institutions. These reports have been broadly endorsed by the European Council.

Closer fiscal and economic integration will involve joint decisions on certain budgetary and economic policies that are political by nature. Establishing a centralized fiscal policy and a political union is not envisaged. It will, however, be necessary to set up a mechanism to provide democratic legitimacy and accountability for joint decisions. In addition, more integrated fiscal and economic decision-making will require broad public support. Once again, what is reasonable from an economic policy point of view and has been agreed by European leaders in principle may prove difficult to implement in practice because of emerging political constraints reflecting narrow national interests, public opinion, and a much more favorable financial environment.

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A crisis can create opportunities.

As financial market conditions have significantly improved and the eurozone debt crisis has abated, the sense of urgency that prevailed twelve or eighteen months ago for building a more complete and stronger EMU has dissipated. Moreover, public support of European integration has also declined according to the findings of opinion surveys. Politics in a number of member states have become increasingly polarized and have been characterized by populism focused on public concerns usually related to issues of national or local importance.

At present, public attitudes and national politics in member states do not bode well for actions towards the build-up of a genuine EMU. However, the rise in nationalism and the decline in public support for European integration seem to reflect mainly the effects of the eurozone crisis on the economies and politics of member states. Economic adjustment costs and bailout fatigue have played a role. A stronger and more resilient EMU, which would foster higher economic growth and lower unemployment, would influence public attitudes favorably towards further European integration. There is, therefore, an urgent need to strike the right balance between economics and politics that will allow continued progress in the establishment of a stronger monetary union in Europe that will preserve stability and support growth.

A main conclusion to be drawn from the eurozone crisis for the future of the euro is the importance of completing sooner rather than later the appropriate economic policy framework and institutional architecture—the economic foundations—of monetary union. Eurozone member states should not wait for the next bout of market turbulence or another economic crisis to do what will ultimately have to be done to secure the credibility of the euro in the long run. It is encouraging that the majority of the European public strongly supports the euro because it values the direct and indirect benefits the single currency entails for stability and growth in the eurozone and beyond. Political leaders should therefore adopt economic policies and institutional reforms that are broad-based and far-sighted in order to build a stronger economic and monetary union in Europe. Member states have a fundamental common economic and political interest in preserving the credibility of the euro and should act accordingly. ◆