

A New Fiscal and Monetary Framework for the EMU?
The EU Presidents' roadmap in 2018

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TOWARDS A GENUINE ECONOMIC AND MONETARY UNION

Herman Van Rompuy, President of the European Council

In close collaboration with:

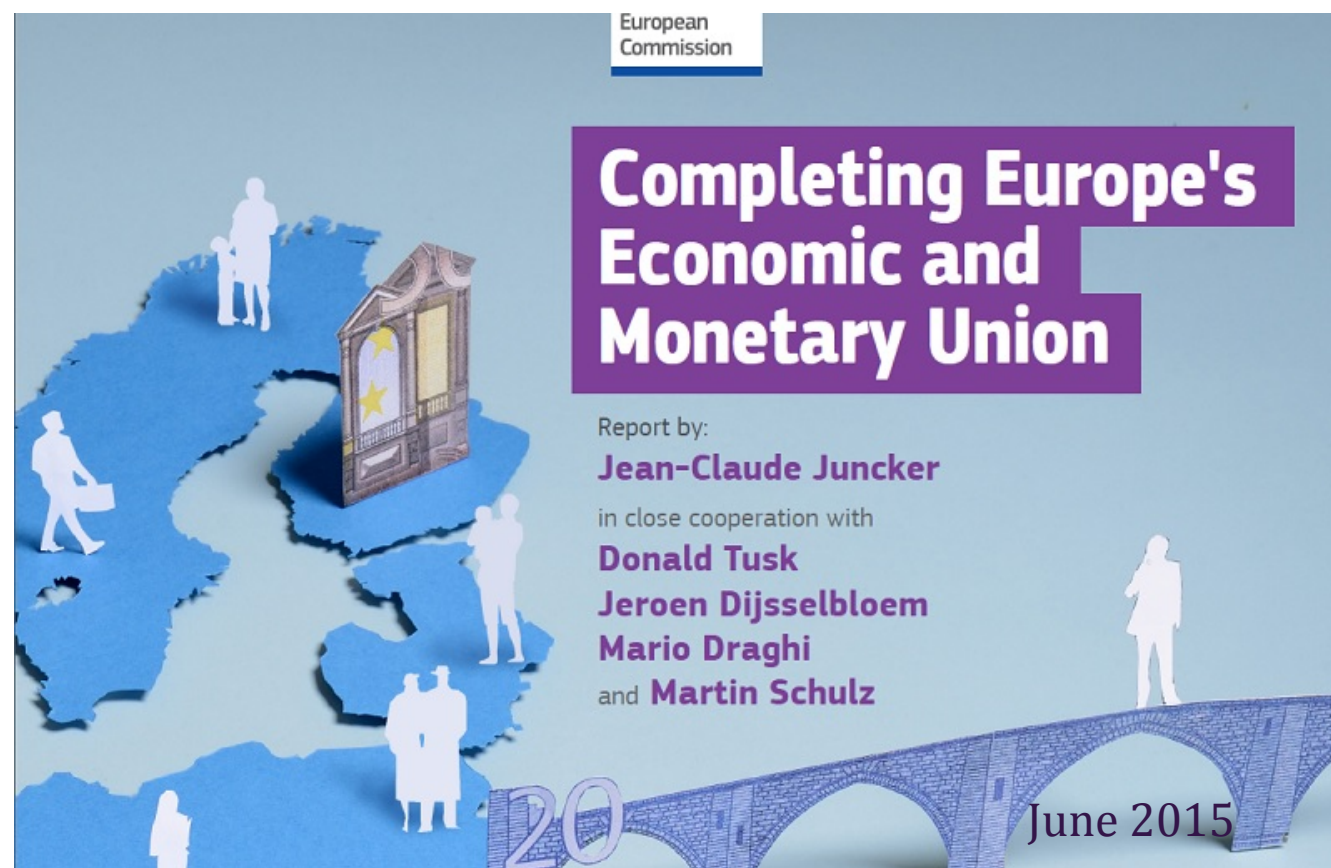
José Manuel Barroso, President of the European Commission

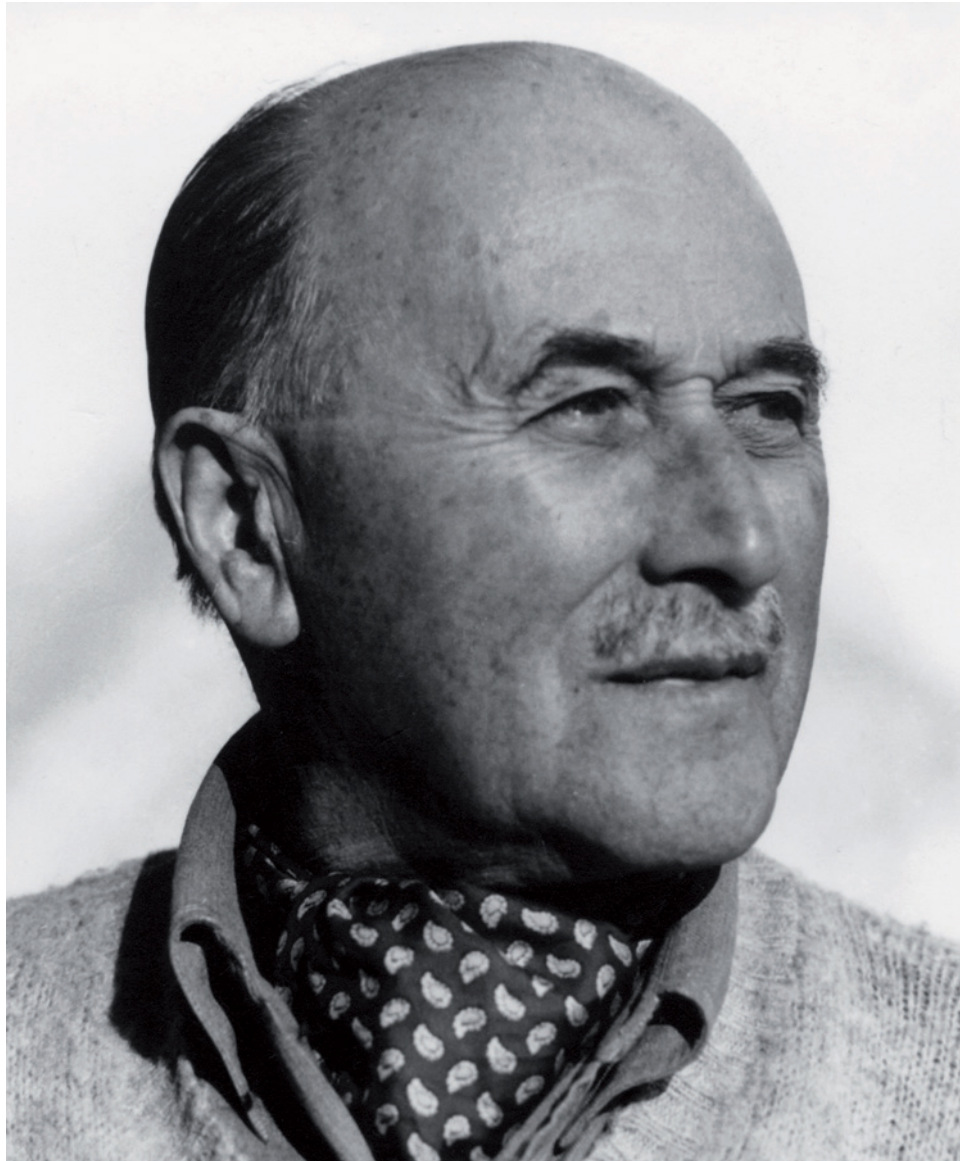
Jean-Claude Juncker, President of the Eurogroup

Mario Draghi, President of the European Central Bank

December 2012

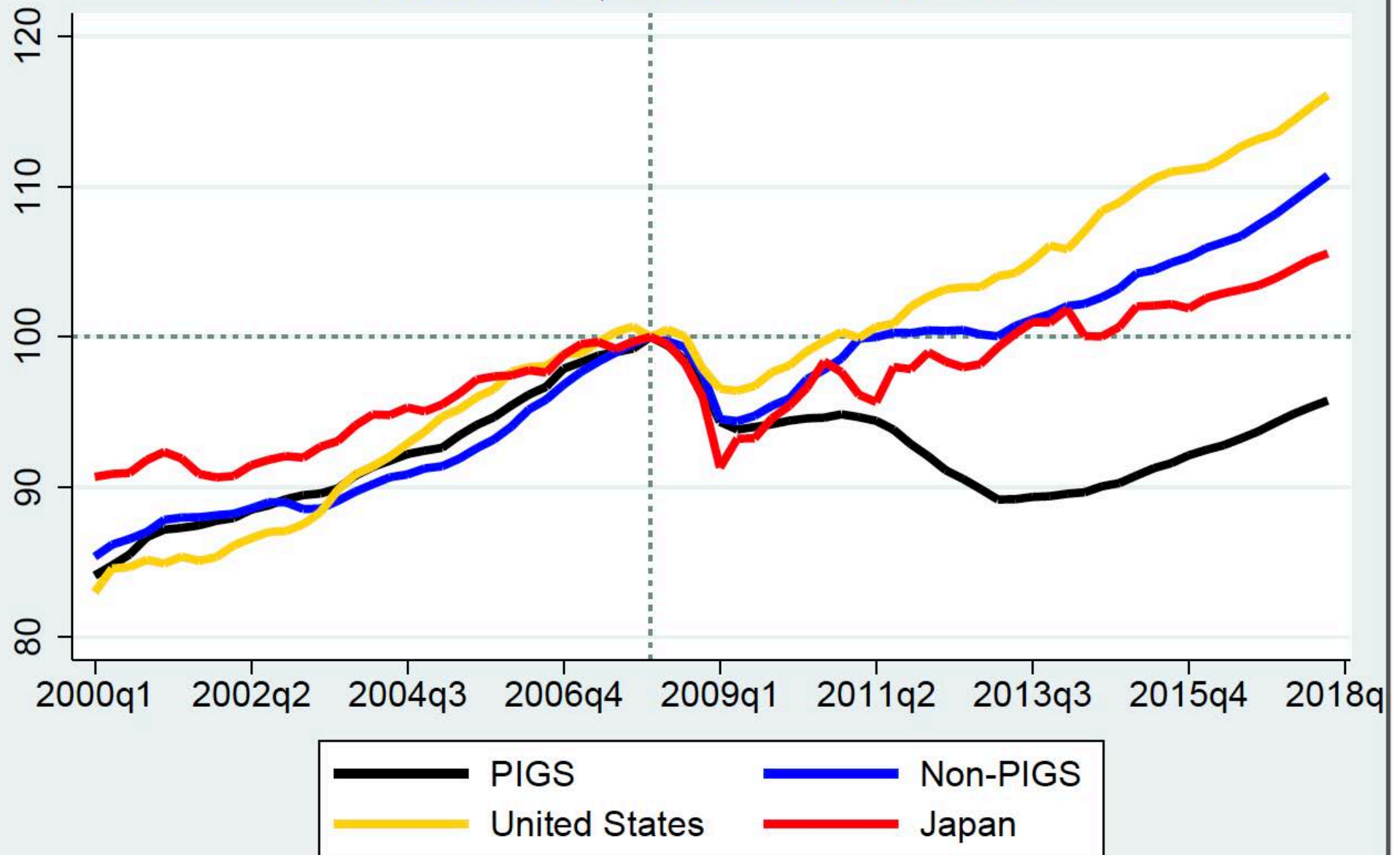
The Presidents' Roadmap!





Europe will be
forged in crisis

Real GDP, Index 2008Q1=100



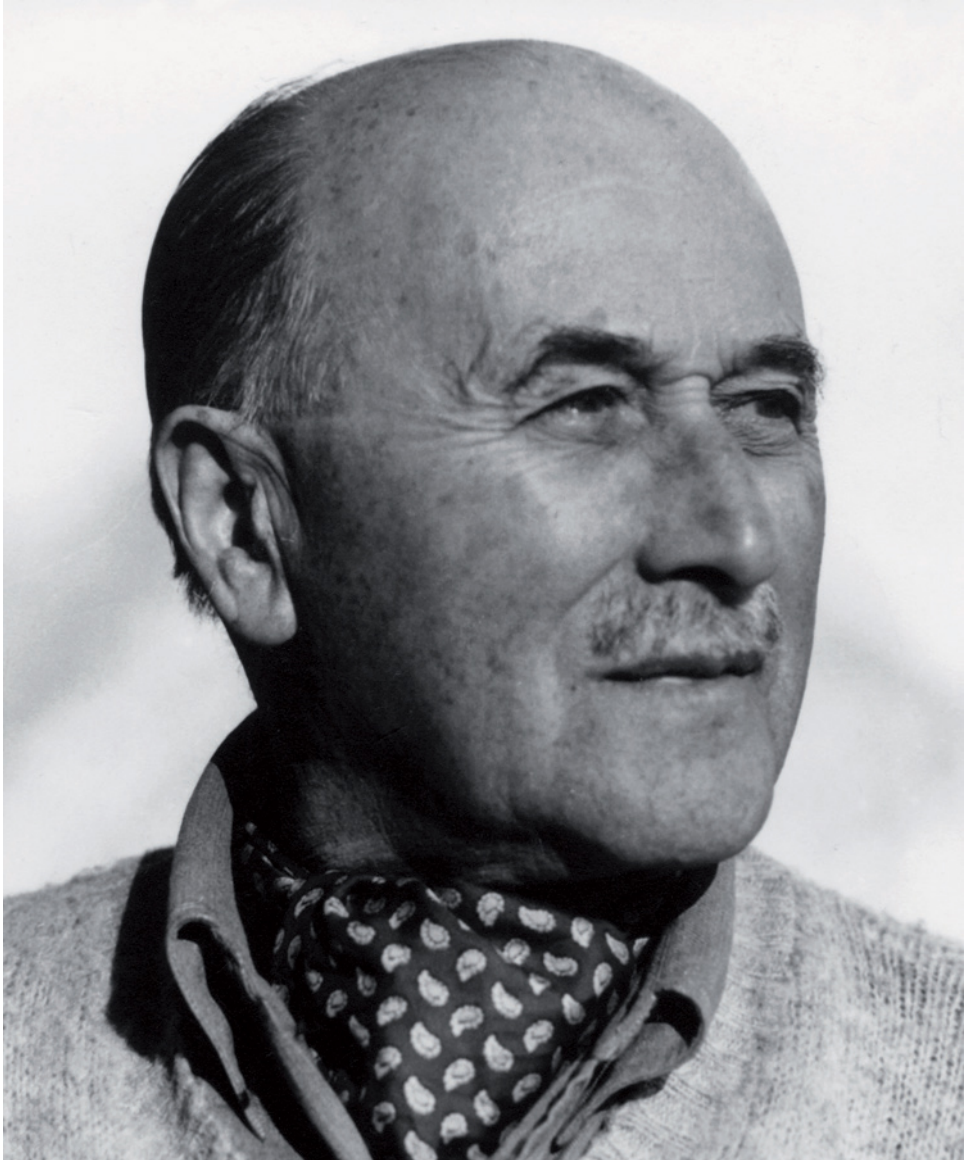
Seasonally adjusted data

PIGS: Portugal, Italy, Greece & Spain; Non-PIGS remaining 15 Eurozone

European Union (before Brexit)

Economic and Monetary Union





Europe will be
forged in crisis

Will it be this time?

European Union (after Brexit)

Economic and Monetary Union

Economic and Monetary Union: Growth and Stability!

Monetary
Union

Economic
& Fiscal
Union

Financial
Union

Economic and Monetary Union: Growth and Stability!

Monetary
Union

Price
Stability

Economic
& Fiscal
Union

Economic
Stability

Financial
Union

Financial
Stability

Solving time-inconsistency problems!

Economic and Monetary Union: before the euro crisis

Monetary
Union



Economic
& Fiscal
Union

Stability and
Growth Pact

Economic and Monetary Union after the euro crisis (roadmap)

Monetary
Union



Economic
& Fiscal
Union
Stability and
Growth Pact II

European Stability Mechanism



Financial
Union

Banking Union
SSM & SRM

Capital Markets
Union

Economic and Monetary Union vs. other unions (e.g. US)

Monetary
Union



Similar

Economic
& Fiscal
Union
Stability and
Growth Pact II



Complex &
incoherent

Financial
Union

Banking Union
SSM & SRM

Capital Markets
Union

Complex &
incomplete

Economic and Monetary Union: Growth and Stability!

Monetary
Union

Price
Stability

Economic
& Fiscal
Union

Economic
Stability

Financial
Union

Financial
Stability

Solving time-inconsistency problems?

Economic and Monetary Union

Solving time-inconsistency problems?

Monetary
Union



✓ but...

Economic
& Fiscal
Union
Stability and
Growth Pact II



SGP nudging?
ESM ✓ (crises)

Financial
Union

Banking Union
SSM & SRM

Capital Markets
Union

No proof of
concept yet

Economic and Monetary Union

Solving time-inconsistency problems?

Monetary
Union



✓ but...

Economic
& Fiscal
Union
Stability and
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SGP nudging?
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Financial
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Capital Markets
Union

No proof of
concept yet

Monetary Union

✓ but...



The ECB cannot be over stretched

Monetary Union

✓ but...



The ECB cannot be over stretched

✓ although

the ECB has become
the leading EMU institution!

The EMU...





Financial Union

(beyond the euro area & according to roadmap)

The three legged

Banking Union

Single Supervisory Mechanism (SSM)

Single Resolution Mechanism (SRM)

European Deposit Insurance Scheme (EDIS)

Financial Union

(beyond the euro area & according to roadmap)

The three legged

Banking Union

Single Supervisory Mechanism (SSM) ✓

Single Resolution Mechanism (SRM)

complex (with some proof of concept)
& incomplete: fiscal backstop

➡ ADEMU's *ESF* !

European Deposit Insurance Scheme (EDIS)

➡ ADEMU's call for
experience rating

➡ & the role of narrow banking

Financial Union

(beyond the euro area & according to roadmap)

and the mysterious

Capital Markets
Union

Financial Union

(beyond the euro area & according to roadmap)

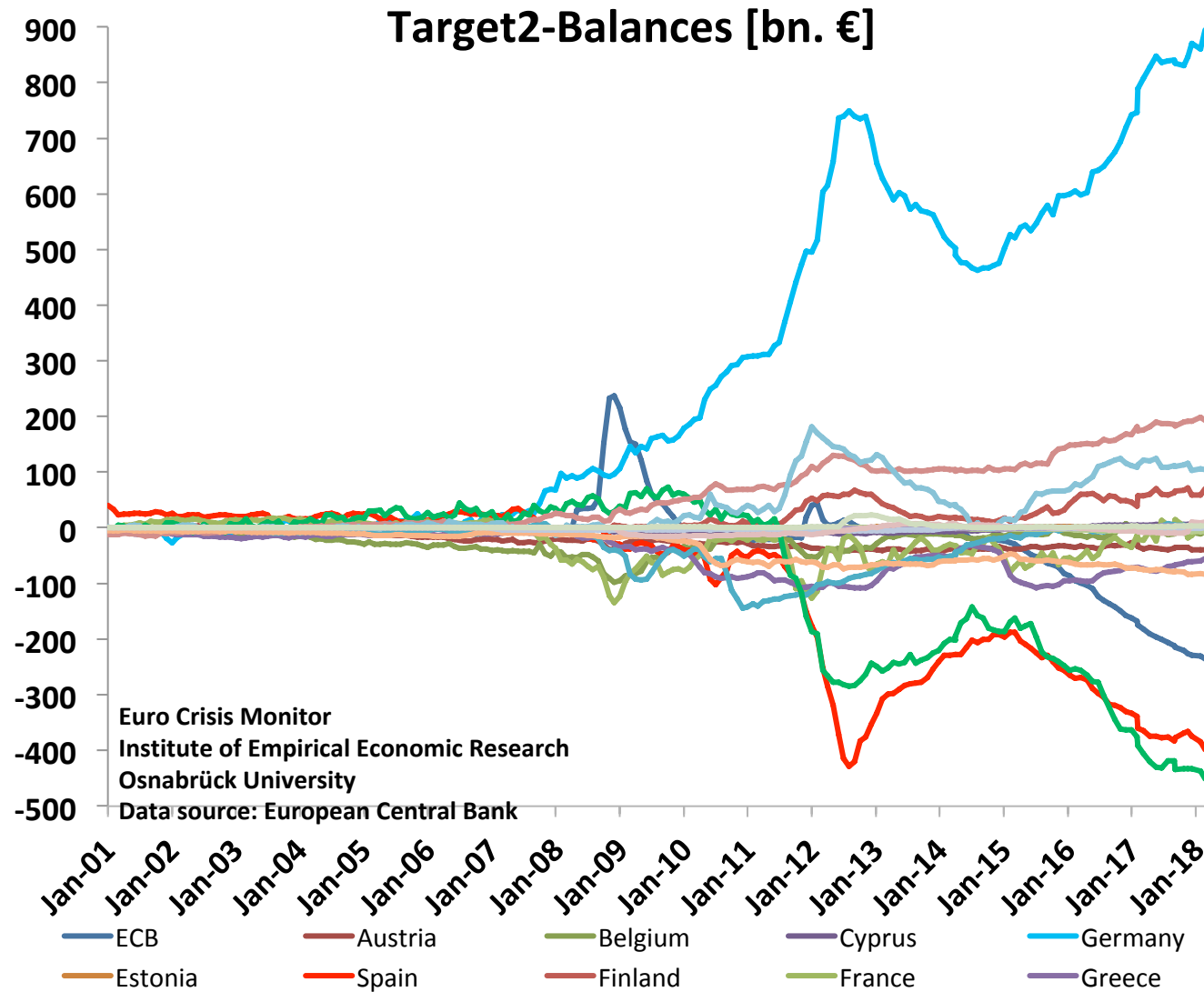
and the mysterious

Capital Markets
Union

Capital Markets ✓

Union !?

Target2: The real-time gross settlement system of the Eurozone



Economic and Monetary Union

Economic
& Fiscal
Union

Economic
Stability

Solving time-inconsistency problems!

Economic and Monetary Union

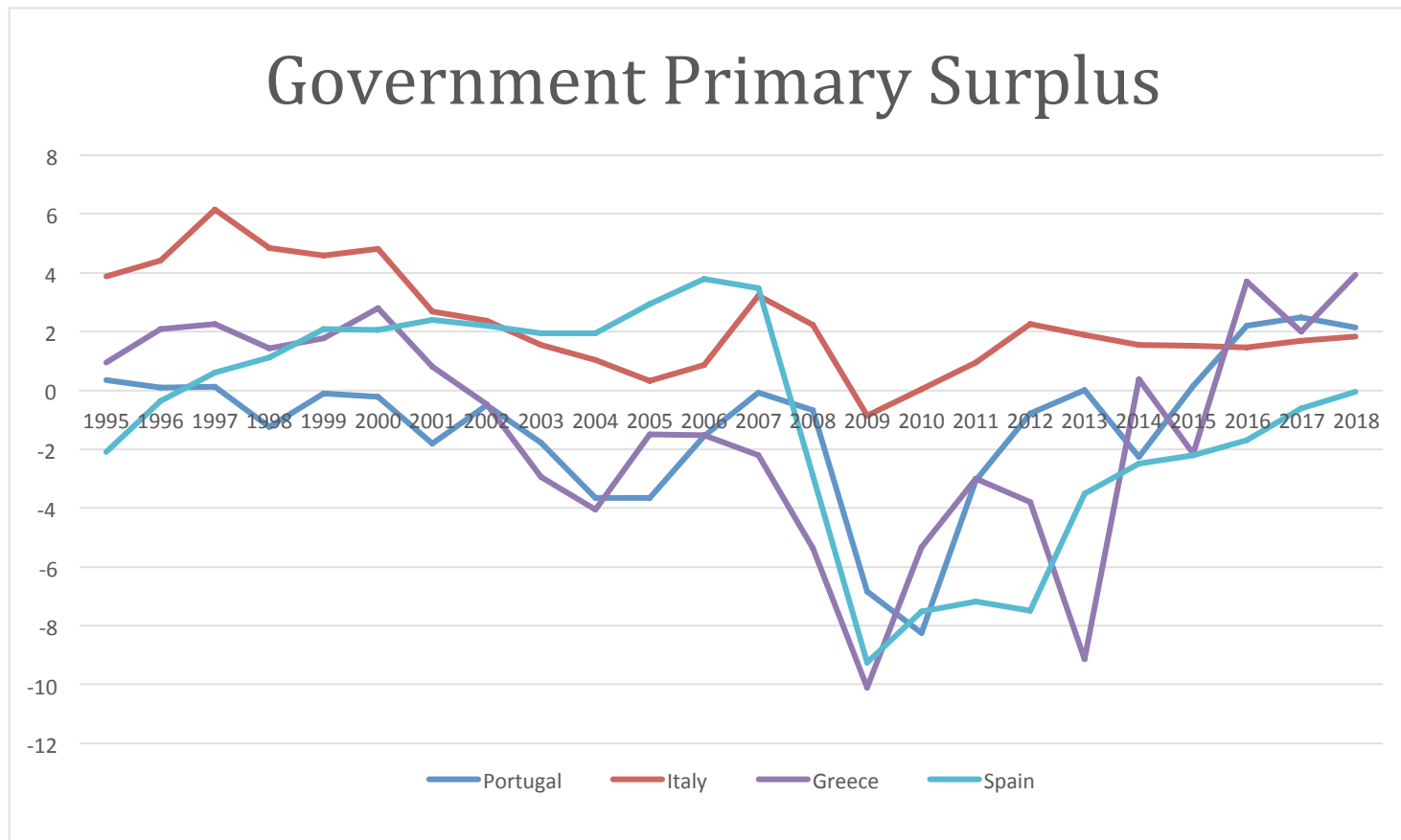
Growth and Stability!

Economic
& Fiscal
Union

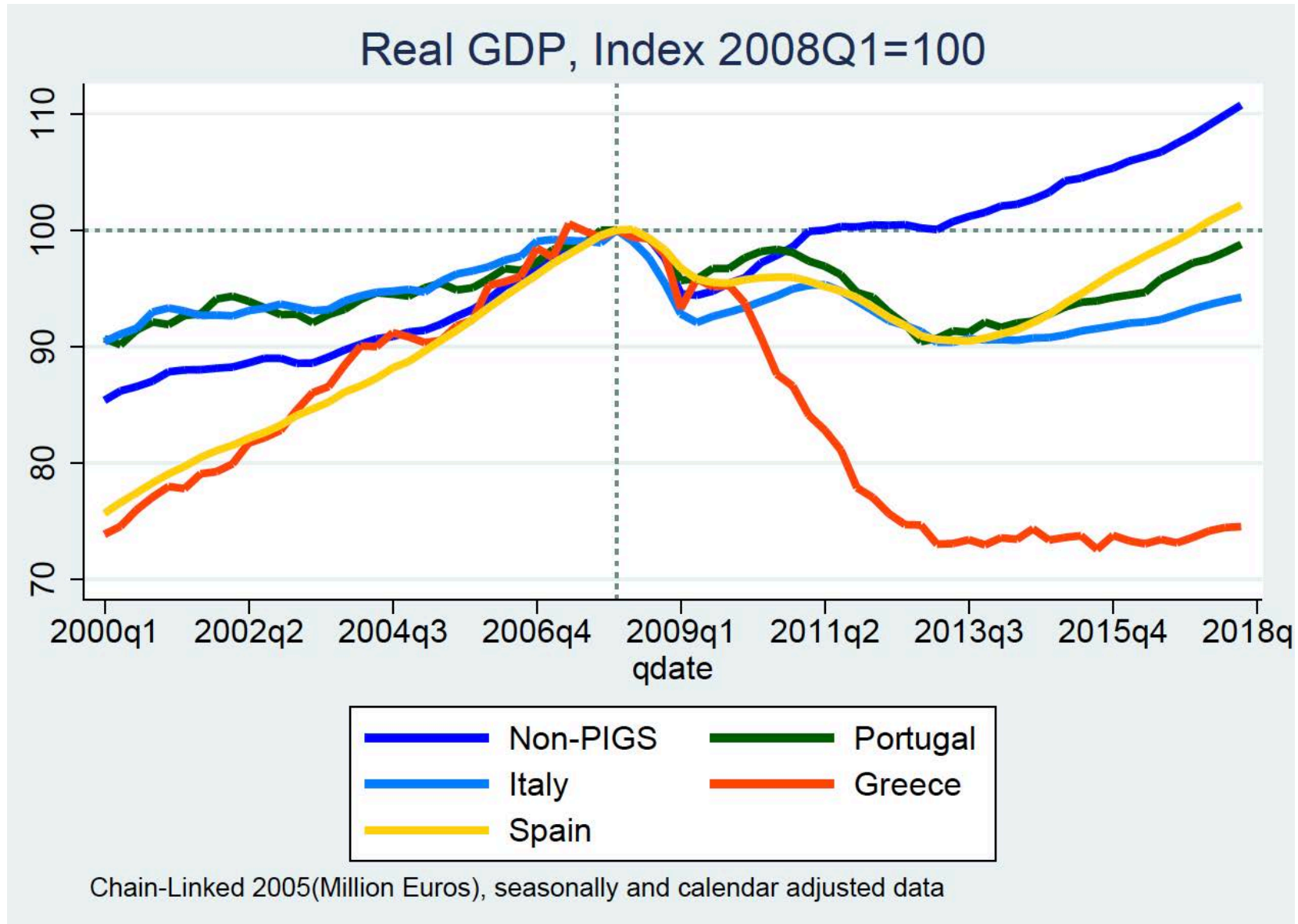
Economic
Stability

A difficult problem!

The PIGS, finally, in primary surplus



A good idea for Greece? What about Spain?



Economic & Fiscal Union

Stability and Growth Pact II + Fiscal Compact

2 surveillance mechanisms under the lead of the EC:

Macroeconomic Imbalance Procedure (MIP)

European Semester

Economic & Fiscal Union

Stability and Growth Pact II + Fiscal Compact

2 surveillance mechanisms under the lead of the EC:

Macroeconomic Imbalance Procedure (MIP)

European Semester

- Information and advice
- Peer pressure
- Policy coordination

Economic & Fiscal Union

Stability and Growth Pact II + Fiscal Compact

2 surveillance mechanisms under the lead of the EC:

Macroeconomic Imbalance Procedure (MIP)

European Semester

- A mechanism without 'carrots' and non-credible 'sticks'
- Mixing 'watch-dog' surveillance with non-credible threats
- Broad surveillance interfering with 'sovereign ownership of fiscal policies'?

Economic & Fiscal Union

Stability and Growth Pact II + Fiscal Compact

2 surveillance mechanisms under the lead of the EC:

Macroeconomic Imbalance Procedure (MIP)

European Semester

While there is now an independent 'watch-dog':

The European Fiscal Board!

Economic & Fiscal Union



- A mechanism with ‘carrots’ (financial assistance)
- But just a ‘crisis resolution mechanism’
- With more than a proof of content:
Greece, Cyprus, Portugal, Ireland and Spain,

Economic & Fiscal Union

What about EMU stabilization and risk-sharing?

“...all mature Monetary Unions have put in place a common macroeconomic stabilization function to better deal with shocks that cannot be managed at the national level alone”
Five Presidents' Report (Juncker et al. 2015)

Economic & Fiscal Union

What about EMU stabilization and risk-sharing?

“...all mature Monetary Unions have put in place a common macroeconomic stabilization function to better deal with shocks that cannot be managed at the national level alone”
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but added:

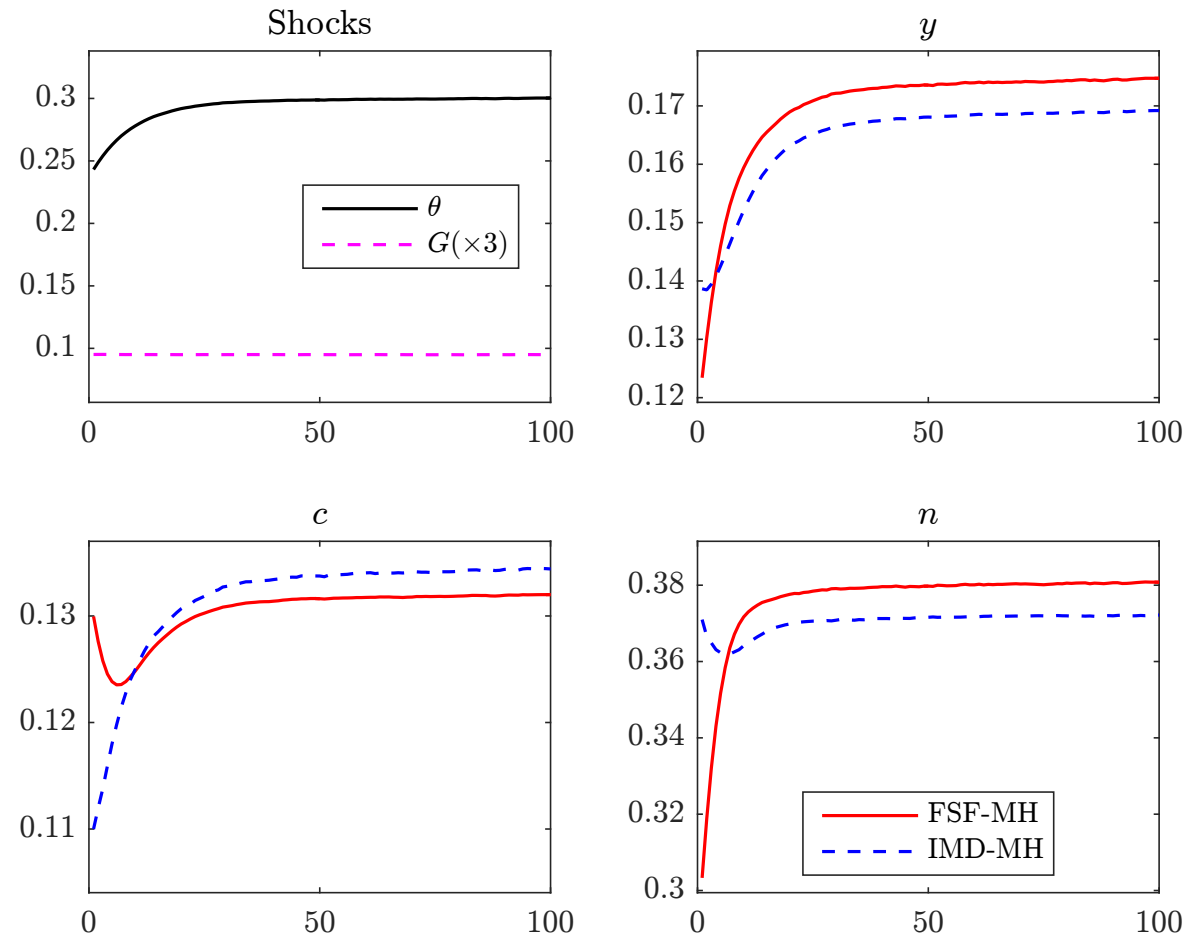
“This would be a natural development for the euro area in the longer term...” !?

ADEMU's *European Stability Fund*

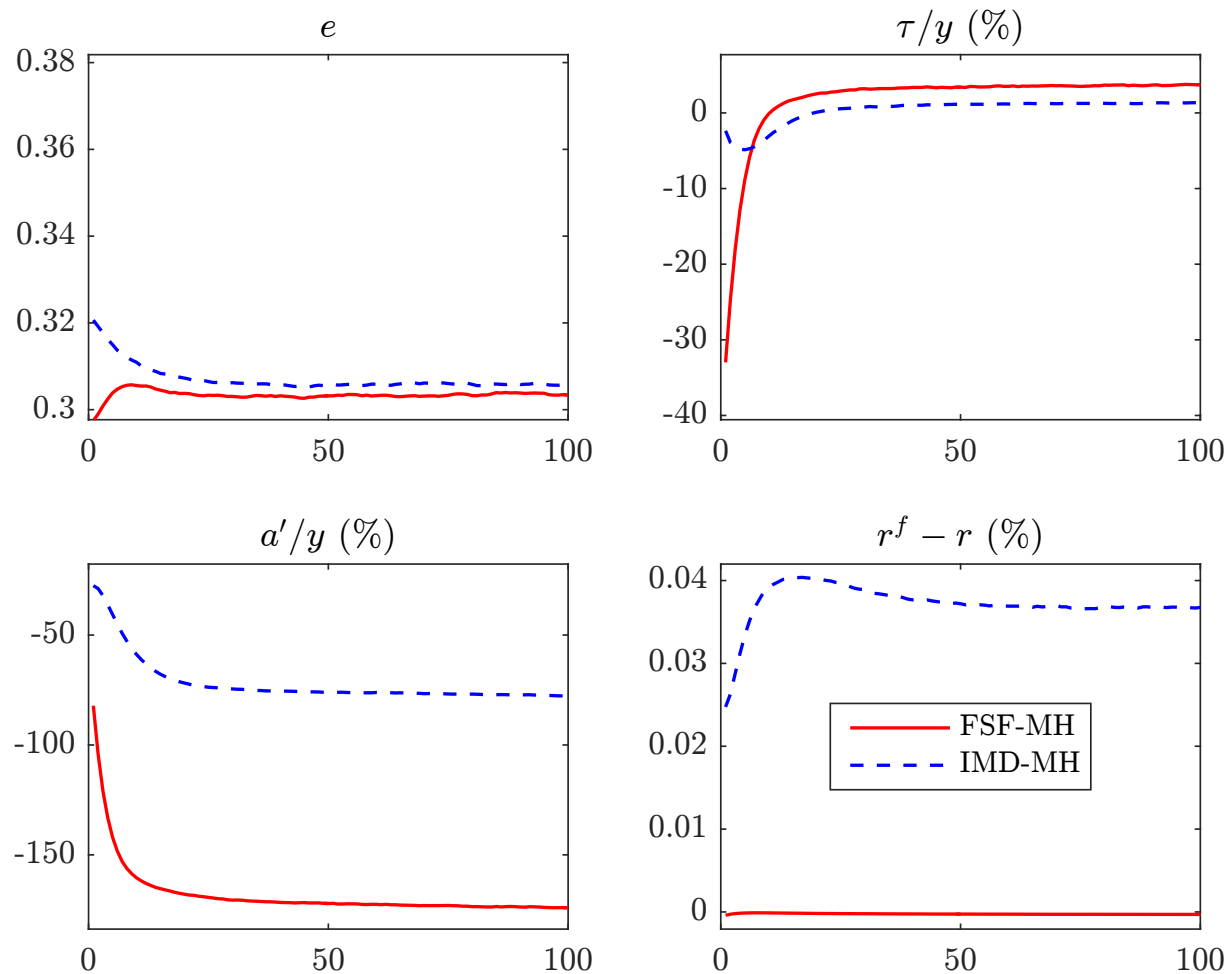
Interesting finding: solving for a

- I. Stability Fund as a 'constrained efficient risk-sharing mechanism' also helps to:
- II. deal with severe crises,
- III. resolve a debt crisis, and
- IV. develop 'safe assets'.

An example: comparing a negative productivity shock in an ‘stressed economy’ with ‘defaultable sovereign debt’ or with the **ESF** (with Moral Hazard)



With the **ESF** there is no consumption crisis,
nor moral hazard problem: confronting a crisis
with risk-sharing!



Properties of the ESF design

- Long-term contract between the ESF and an EU country, based on a risk-assessment.
- The contract fully respects 'sovereignty' (limited enforcement).
- The long-term contract defines state-contingent transfers, in contrast to unconditional debt contracts.
- Contingency is ex-post, in contrast with ex-ante eligibility conditions (e.g. austerity programme conditions).
- The ESF contract induces countercyclical fiscal policies (it is not a crisis resolution debt contract).

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Properties of the ESF design

- There are no ex-post permanent transfers (solidarity limited by the amount of redistribution desired).
- The ESF contract accounts for moral hazard problems.
- Transforms non-contingent risky debt into a state contingent riskless asset.
- High capacity to absorb severe shocks (& existing debts).
- Normal-times-transfers build trust, in contrast to crisis-relief-transfers which tend to create stigma & resentment.
- The ESF can act as a EMU Fund (e.g. backstop for SRM, and EUIS fund).

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A light version can be
an interesting improvement
of the ESM to be

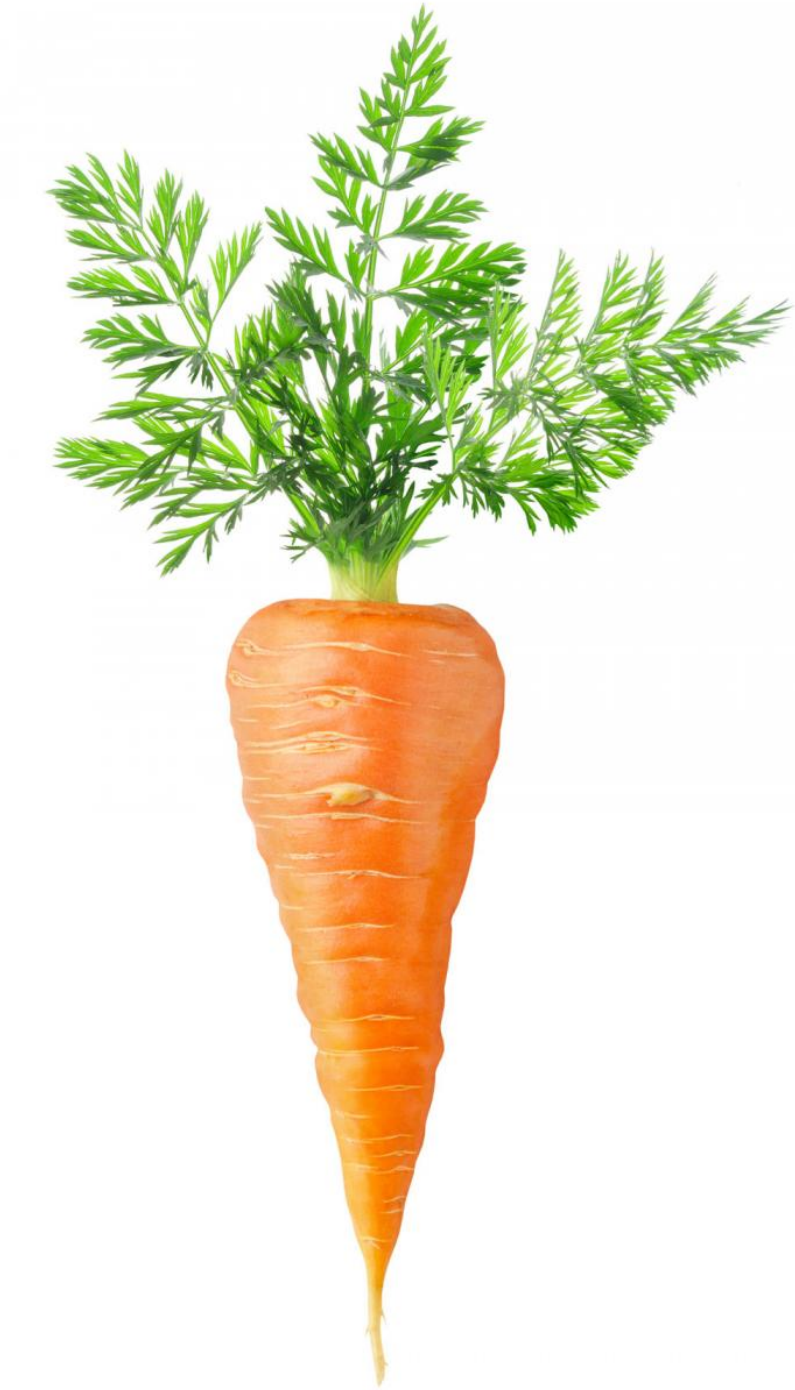
Light version

- ESM implements ESF contingent contract on crisis resolution contracts (existent and new)
- ESF conditionality becomes *ex-post*
- ESF is allowed to provide risk-sharing contracts (e.g. countries that may fail SGP conditions)
(The Macroeconomic Imbalance Procedure with an opportunity instead of a non-credible threat!)

A light version can be
an interesting improvement
of the ESM to be

but it can also be...

The new...



The new...



Economic & Fiscal Union

What about EMU stabilisation and risk-sharing?

The European Commission's “stabilisation function” proposal, with three options:

1. European Investment Protection Scheme
2. European Unemployment Reinsurance Scheme
3. Rainy day fund

+ loans from (the separate) ESM, grants from EU budget, etc.

Economic & Fiscal Union

What about EMU stabilization and risk-sharing?

What about...

- ① European Fund of Strategic Investments (EFSI) as a growth mechanism (marginally stabilising?)



ADEMU's (research based):

- ② European Unemployment Insurance System (EUIS)
- ③ European Stability Fund (ESF)

Economic & Fiscal Union

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ADEMU's (research based):

- ② European Unemployment Insurance System (EUIS)
- ③ European Stability Fund (ESF)

ESF an integrated approach with better incentives!

It does not require 'eligibility conditions', but 'experience-rating and, possibly, ex-post conditionality (ESF contract) or policy coordination (EUIS).

European Unemployment Insurance System

A pure research outcome...

A substantial welfare improvement (& agreement)
for a union with heterogeneous labour markets.

UI policy coordination on:

- 15% replacement rate & unlimited duration.
- “Experience rating taxes”.

Incentives for labour market reforms

Possibly implemented with the ESF as central EUIS fund

Thanks