Comments on the Five Presidents’ Report

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Content of Five Presidents’ Report

- **Economic Union**
  - Convergence & Competitiveness

- **Financial Union**
  - Banking Union & Capital Markets Union

- **Fiscal Union**
  - Coordination & Stabilization

- **Accountability, Legitimacy, Institutions**
Economic Union: Convergence & Competitiveness

Current account balance (in bn EUR)

Source: Bruegel based on AMECO, Eurostat
Economic Union: Convergence & Competitiveness

ULC-based real effective exchange rates (vs. EA19)

Source: ECFIN
Economic Union: Convergence & Competitiveness

Compensation and productivity developments

Source: Bruegel based on AMECO; Notes: Compensation is deflated using the EA19 GDP deflator, productivity is GDP per hour worked and is deflated using the national GDP deflators.
National wage formation and bargaining systems vary widely → divergences in competitiveness may result.

Two solutions (in the absence of exchange rate mechanism, see Sapir and Wolff, February 2015):

1) Creation of single EA labour market, with large migration flows → not desired in foreseeable future

2) MIP?

3) National competitiveness-monitoring frameworks → Creation of **Eurossystem of national Competitiveness Councils**: (focus on wages and on productivity)
% of shock smoothed by the different channels:

Completing Banking Union

- Deposit insurance necessary to complete BU, inconsistency between European supervision and national responsibility
- EC proposal: EDIS as re-insurance system
- Risk sharing and risk reduction: Single exposure rules to deal with public debt
- Better principles for insolvency legislation to address private debt overhang

Launching CMU, but progress slow
1) **Retail banking:** constrained by national borders (with small EA and CEE countries as exception, Sapir and Wolff 2014)

Percentage of the banking system that is foreign owned:

Source: Bruegel based on ECB data
2) Wholesale banking: highly integrated in the run-up to the crisis. Since then, euro area experienced decreasing cross-border interbank financing.
3) **Equity markets**: remain characterised by a strong home bias.

Proportion of equity held in the euro-area countries of domestic origin, 2010

Source: Bruegel based on World bank data on stock market capitalisation and IMF CPIS data on cross-border holdings following Balta and Delgado (2009).
Véron and Wolff (2015):

- Because of the structure of financial systems → CMU is no quick fix to repair bank-lending channel
- Two objectives (enhancing capital markets development and fostering cross-border financial integration) might require different policies
- SME funding will not be directly impacted by CMU
- Deeper and more integrated capital markets should spread economic risk, but potential financial stability risks need to be managed (→ supervision (ESRB?))
- All member states will gain from better access to finance, but agglomeration effects will intensify.
Two diverging views on governance

• Green paper (Commissioner Hill):
‘A capital market union should be built on firm foundations of financial stability, with a single rulebook for financial services which is effectively and consistently enforced.’
(Building a capital markets union, February 2015)

• 5 Presidents’ report:
‘[…] closer integration of capital markets could lead to risks of financial stability. There will be a need to expand and strengthen the available tools to manage financial player’s systemic risks prudently (macro-prudential toolkit) and the supervisory framework. This should ultimately lead to a single European capital markets supervisor.’
(Completing Europe’s EMU, June 2015)
The key issue is not so much risk-sharing but rather coordination so that

- spillovers taken into account and
- aggregate fiscal stance is appropriate for the euro area

Federations have solved this huge coordination issue with centralisation of large parts of fiscal policy in the hands of the federal government, yet...

...this goes to the heart of democracy and legitimacy as it is about spending significant resources.
Current attempt to solve coordination problem: all countries agree on fiscal rules that are „smart“

But complete contract impossible to write. Rules have numerous problems.

Fiscal policy requires decision making and national authorities increasingly do so…

...undermining quest for coordination

...European Commission exercising discretion, raising question of legitimacy!
New advisory European Fiscal Board has been created:

- Overview implementation of rules
- Provide opinions on fiscal stance

Stage 2?: Eurosystem of Fiscal Policy

- composed of a euro area finance minister and his board as well as national ministers:
- mandate: sustainability and fiscal stance
- Giving voting power also to the center in exceptional times
- Euro area chamber of European Parliament to approve decisions in exceptional times rendering them binding
- power to activate fiscal resources of a fund (ESM)
Wide issue, at the core of the entire discussion

Fiscal legitimacy is national, yet national fiscal policy leads to suboptimal results with negative effects on others → Readiness to change that?

Exercising discretion at European level requires legitimacy.

Report fails to reflect on role of non-EA countries
Thank you for your attention!

References:

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