Monetary union and the single market: what governance challenges?

Guntram Wolff
Bruegel

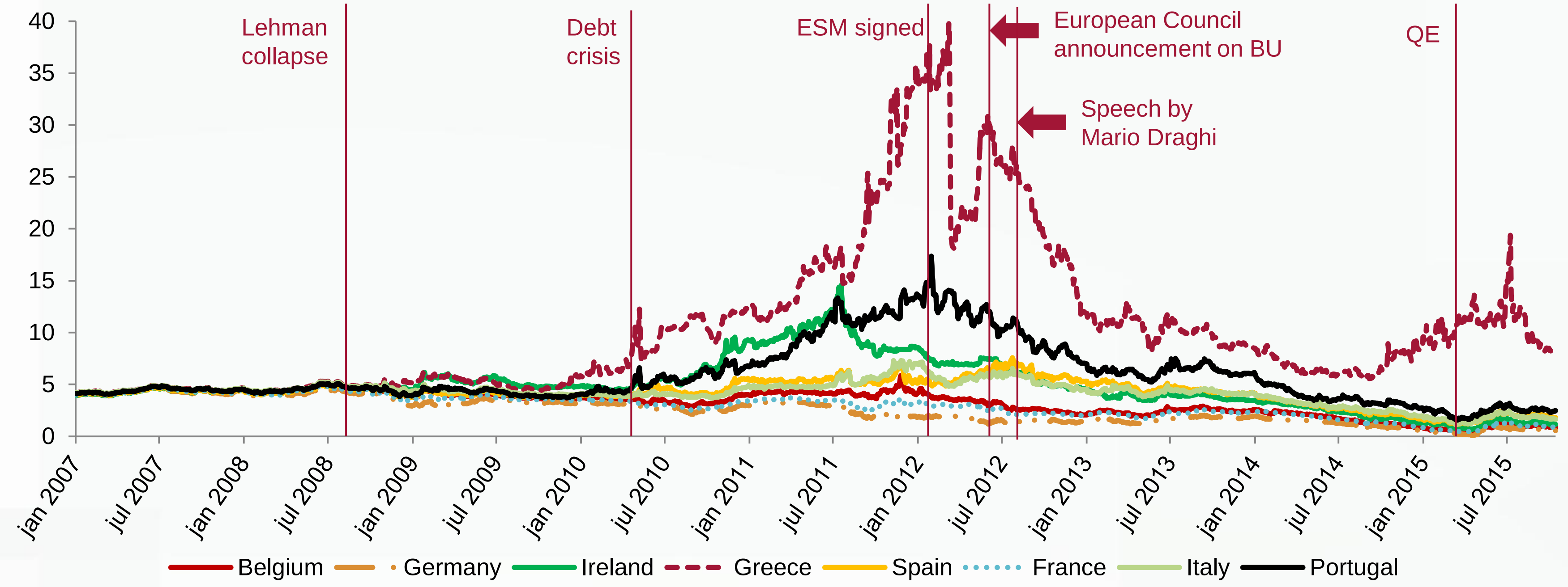
12 November, 2015
Stockholm

Outline

- How governance “geometry” became more variable and complex
- What further steps are needed to stabilize the euro area?
- Two parallel and potentially contradictory logics: monetary union and single market
- Policy implications

Timeline of events

10-year government bond yields (%)

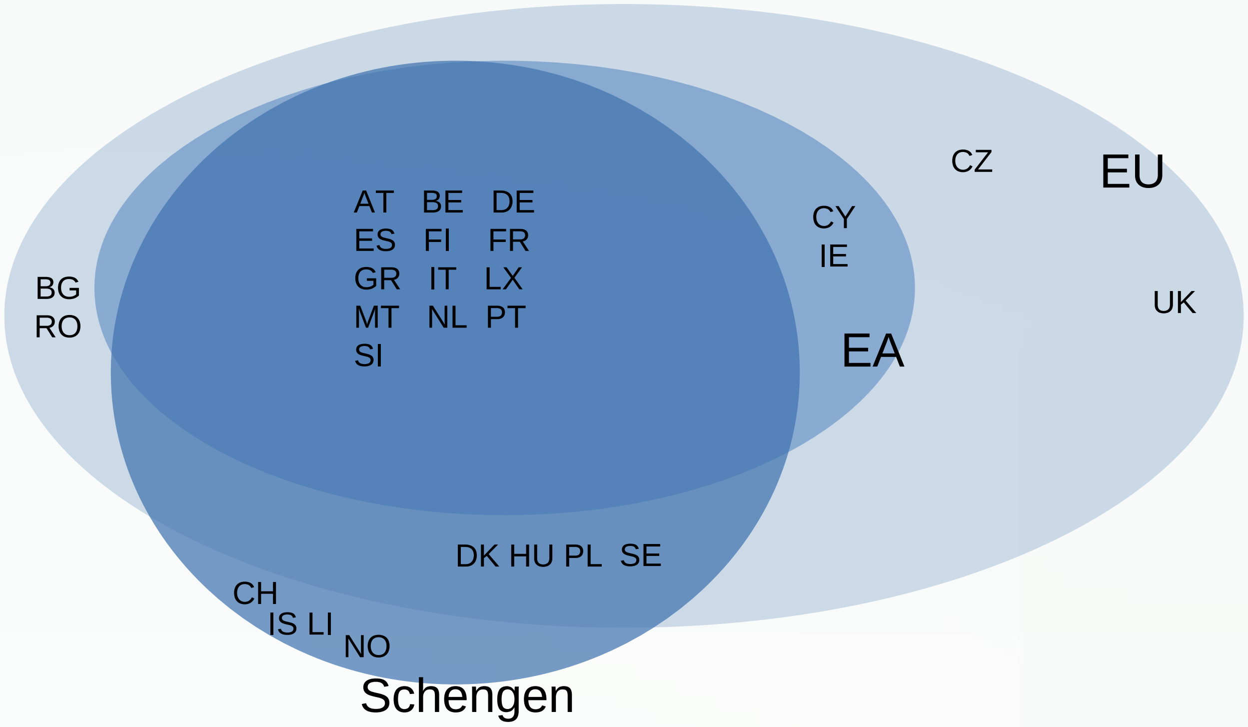


Source: Bruegel based on Datastream

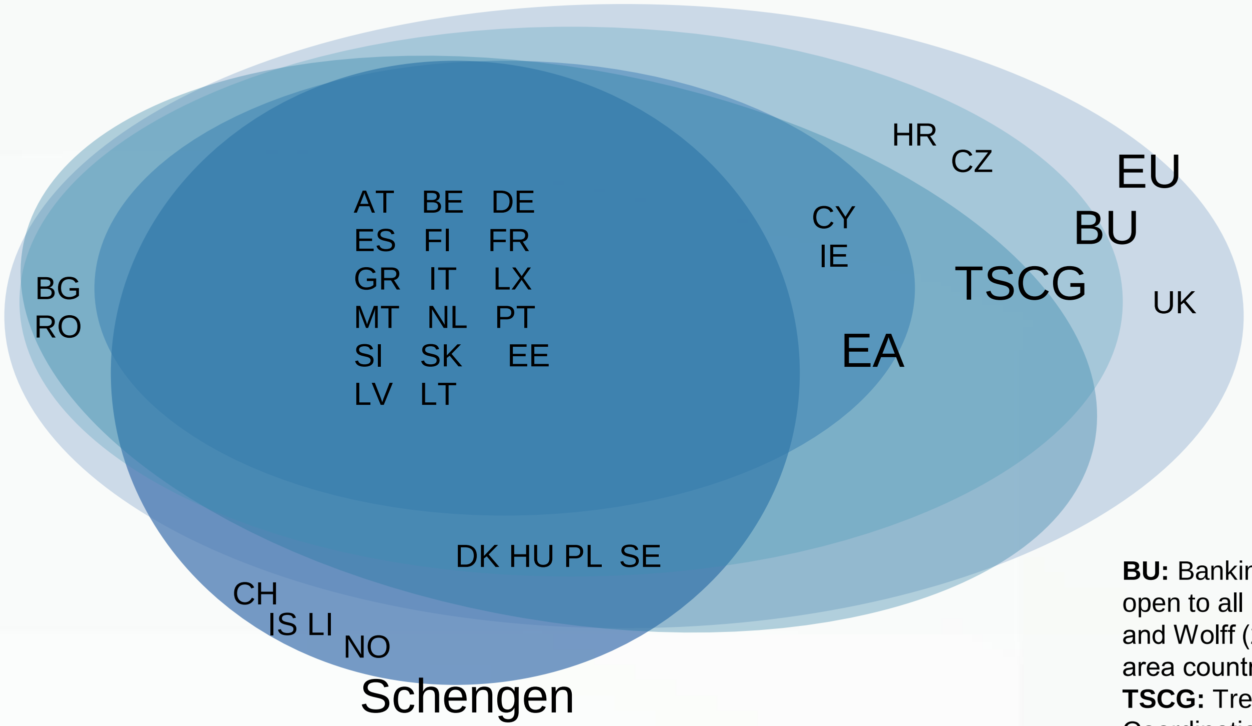
Key governance decisions already taken

- **European Stability Mechanism (ESM)**
- **Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG)**
- **Sixpack (fiscal law package of 5 regulations and 1 directive)**
- **Banking Union (BU)**
- **OMT programme**

Variable geometry pre-crisis



Variable geometry now



BU: Banking Union, BU is in principle open to all EU countries, see Darvas and Wolff (2012), “Should non-euro area countries join the banking union?”
TSCG: Treaty on Stability, Coordination and Governance (Fiscal Compact)

Legal framework

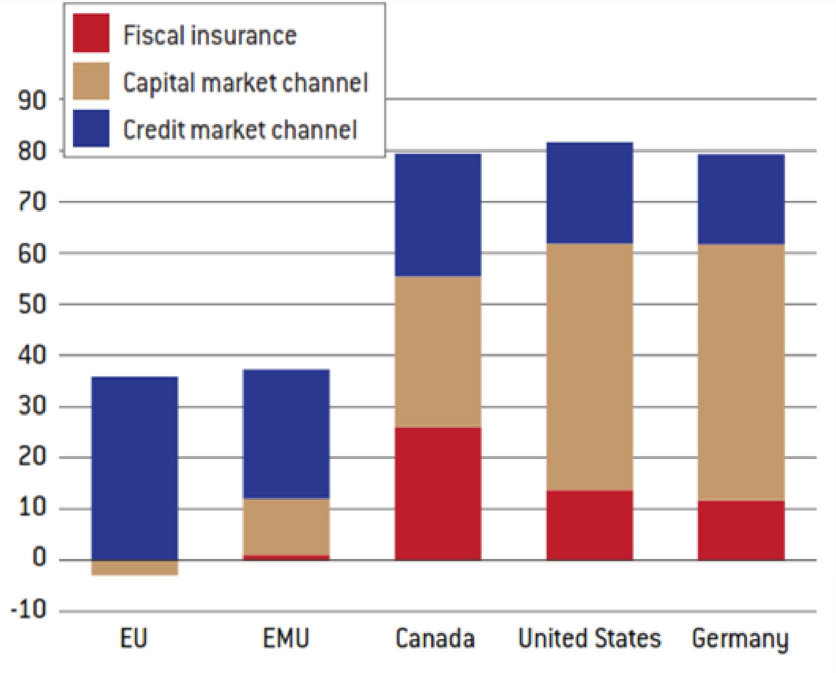
Outside the Treaty	Inside the Treaty
European Stability Mechanism (followed an amendment of Article 136 of the Treaty) Fiscal Compact (intergovernmental treaty ratified by 25 member states, except for Czech Republic, UK, Croatia)	Single Supervisory Mechanism (SSM) (Article 127.6 of the Treaty) Single Resolution Mechanism (SRM) (Article 114 of the Treaty)
Single Resolution Fund	
Transfer of contributions raised nationally towards the Single Fund and the mutualisation of the national compartments is set out in an Intergovernmental Agreement (IGA) between 26 participating Member States.	The Fund and the decision-making on its use is regulated by the SRM Regulation. National contributions will be merged to the Single Fund after 8 years of transitional period.

The euro area: an unfinished construction

- **Banking union**
- **Adjustment in EMU**
- **Low inflation**
- **Risk sharing: which channels?**
- **Debt overhang**

Channels of shock-absorption

% of shock smoothed by the different channels:



Source: IMF, 'Towards a Fiscal Union for the Euro Area: Technical Background Notes', 2013

Understanding the challenge

- On a number of dimensions, EU requires different forms of integration than EA.
- Deeper EA integration with more political integration: what consequences for political and governance relations with the non-EA countries and in particular the opt-outs?
- What is the issue at conceptual level?
- Where are we in practical terms?
- What governance/reform issues are currently discussed (at least in Brussels)?

Two fundamental logics - Concepts and theory

	Economic and Monetary Union	Single Market
Labor	Labor mobility as adjustment mechanism in OCA (Mundell, 1961) → More integrated labor market legislation	Free movement of people for better allocation of labor (Zimmerman, 2013)
Capital and Financial	Important risk-sharing mechanism for asymmetric shocks (Asdrubali, Sorensen and Yosha, 1996) → More integrated capital markets	Better allocation of capital (more a question of convergence) (Abiad, Leigh and Mody, 2007)
Banking	Shock absorption through credit, maintain access to credit → More integrated banking	Allocation of capital (Allen, Bartiloro and Kowalewski, 2005)
Budget	Shock absorption through fiscal transfer to region hit by shock (Kenen, 1969)	Common budget acts as an allocation mechanism and compensation of losers (i.e. agriculture) (see Mariniello, Sapir and Terzi, 2015 on distributional considerations)
Fiscal	Fiscal coordination for proper fiscal stance Fiscal sustainability in the monetary union, preventing monetary financing and contagion	Weaker contagion (see Hallerberg, Strauch and von Hagen, 2007 on different forms of fiscal governance in the EU)
Structural and Other Economic Policies	Policy shifts have a much bigger implication on the EMU than the SM (i.e. tax, social security, energy)	(Single Market initiatives- Digital Single Market, Energy Union)

Two fundamental logics - Institutional assessment

	Economic and Monetary Union	Single Market
Labor	No common Euro area labor market policy, but loose coordination	Free labor mobility
Capital and Financial		CMU (?)
Banking	Banking Union (SSM, SRM, missing European deposit insurance)	Single Rulebook, EBA
Budget	No common budget, but ESM acts as a backstop	EU budget
Fiscal	Two-pack, Sixpack, SGP, Fiscal Compact (TSCG)	Convergence criteria for joining; UK (subject to the corrective arm of the SGP, the Council opened the Excessive Deficit Procedure for the UK on 2 December 2009)
Structural and Other Economic Policies	Country-specific recommendations given through the Macroeconomic Imbalance Procedure (MIP) Policy shifts have a much bigger implication on the EMU than the SM (i.e. tax, social security, energy)	(Single Market initiatives- DSM, Energy Union)
People	**Schengen Agreement**	
	Excluding Ireland	Excluding UK (Romania, Bulgaria, Croatia, Cyprus obliged to join)

What is next?

5 Presidents’ report on the completion of EMU

The positive elements:

- Monetary union is not sustainable in its current set-up, improvements needed
- Emphasis on structural divergence, again link to **European competitiveness councils**
- **Finalise banking union:** backstop to the single resolution fund & deposit insurance
- **Fiscal union** remains on table

The missing and negative elements:

- Missed the **opportunity to question current system of fiscal rules**
- **Democratic legitimacy** should be emphasized
- Fails to reflect on the **role of non-euro area countries** (opt-out clauses)
- Too little emphasis on **crisis resolution:**
  - Public debt: how to reduce exposure of banks to sovereign debt
  - Private debt: better principles for insolvency legislation

→ **A lot of this needs a treaty change!**

What is next?

- **Single market initiatives**
    - Capital Markets Union - ?
    - Digital Single Market - ?
    - Energy Union - ?

→ **Significant enforcement challenges**

"While the "old" single market in goods and unregulated services was satisfactorily addressed through standards harmonization, the new single market challenge is all about regulatory enforcement institutions " Nicolas Véron, Bruegel blog "Europe's Capital Markets Union and the new single market challenge"

David Cameron‘s letter

- **Economic governance**
  - legally binding principles that safeguard the operations of the Union for all 28
- **Competitiveness**
  - single digital market and capital markets union
  - cutting excessive regulation
  - trade
- **Sovereignty**
  - ever closer union?
  - role of national parliaments?
  - subsidiarty fully implemented
  - JHA
- **Immigration**
  - limit EU labour mobility, in-work benefits

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)

Policy questions

- **To prosper, monetary union will need greater integration measures and institution building. This poses governance and political challenges for EU28, safeguards may be limited.**
- **Deepening single market may require institutions but probably less forceful ones than currency union.**
- **Frictions are likely to arise and need to be managed proactively**
- **Some of David Cameron‘s demand will require treaty change**

→ This is ongoing research, I look forward to discussion!

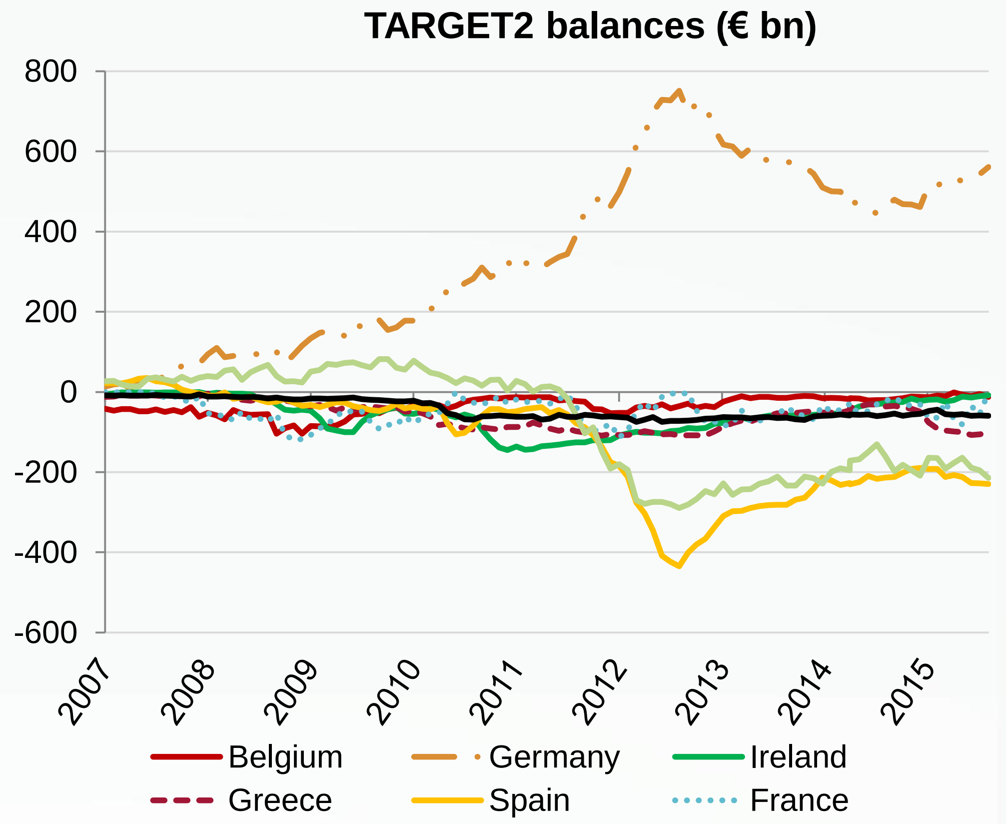
Thank you for your attention

Guntram.Wolff@bruegel.org

References:

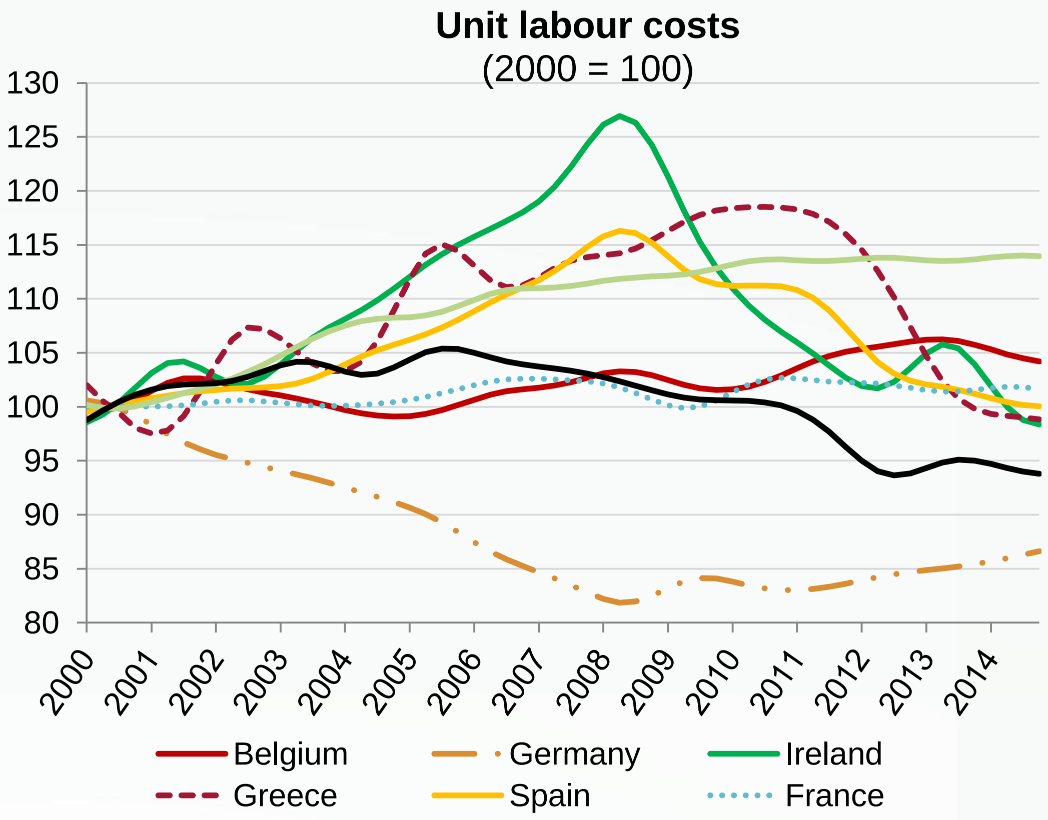
Abiad, Abdul G., Daniel Leigh, and Ashoka Mody (2007). "International finance and income convergence: Europe is different." *IMF Working Papers*, 1-36.
Allen, Franklin, Laura Bartiloro, and Oskar Kowalewski (2005). "The financial system of the EU 25." *Available at SSRN 871454*.
Asdrubali, Pierfederico, Bent E. Sorensen, and Oved Yosha (1996). "Channels of interstate risk sharing: United States 1963-1990." *The Quarterly Journal of Economics*: 1081-1110.
Darvas Zsolt and Guntram Wolff (2013). "Should non-euro area countries join the single supervisory mechanism?" *Bruegel Policy Contribution*, Issue 2013/06
Hallerberg, Mark, Rolf Strauch, and Jürgen Von Hagen (2007). "The design of fiscal rules and forms of governance in European Union countries." *European Journal of Political Economy* 23.2, 338-359.
Kenen, P.B. (1969). 'The theory of optimum currency areas: an eclectic view.' In: Mundell, R.A., Swoboda, A.K. (Eds.), *Monetary Problems of the International Economy*. University of Chicago Press, Chicago, pp. 41–60.
Mariniello, Mario, André Sapir, and Alessio Terzi (2015). "The long road towards the European single market." Bruegel Working Paper 2015/01, March 2015.
Mundell, R. A. (1961). 'A theory of optimum currency areas.' *The American Economic Review*, 657-665.
Véron Nicolas (2015). 'Europe's capital markets union and the new single market challenge', *Bruegel blog*
Zimmerman, k. (2013) The Mobility Challenge for Growth and Integration in Europe
(substantially revised version published in: European Debates No. 4, May 2014. See also the introduction by the Editor. [Open Access] / an updated and extended version published as 'Migration, jobs and integration in Europe' in: Migration Policy Practice, 2014, 6(4), 4 - 16)

TARGET2 balances



Source: Bruegel based on Euro Crisis Monitor

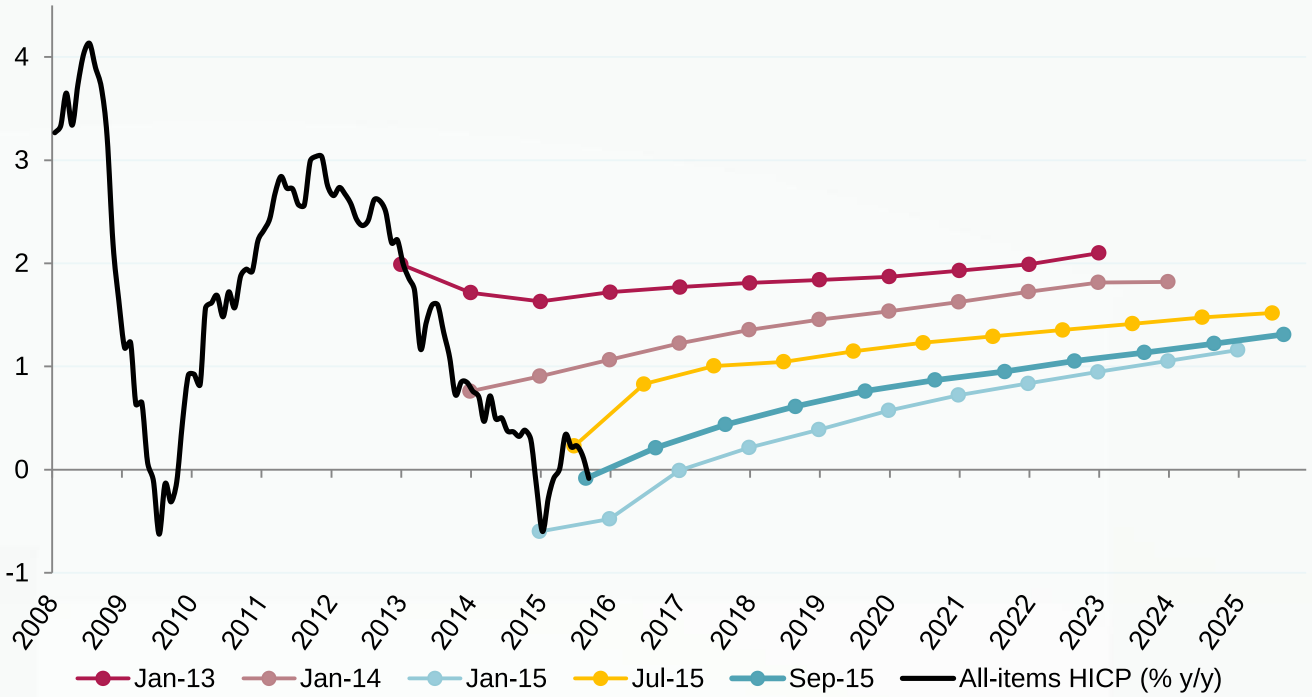
Unit labor cost divergence



Source: Bruegel based on European Commission data

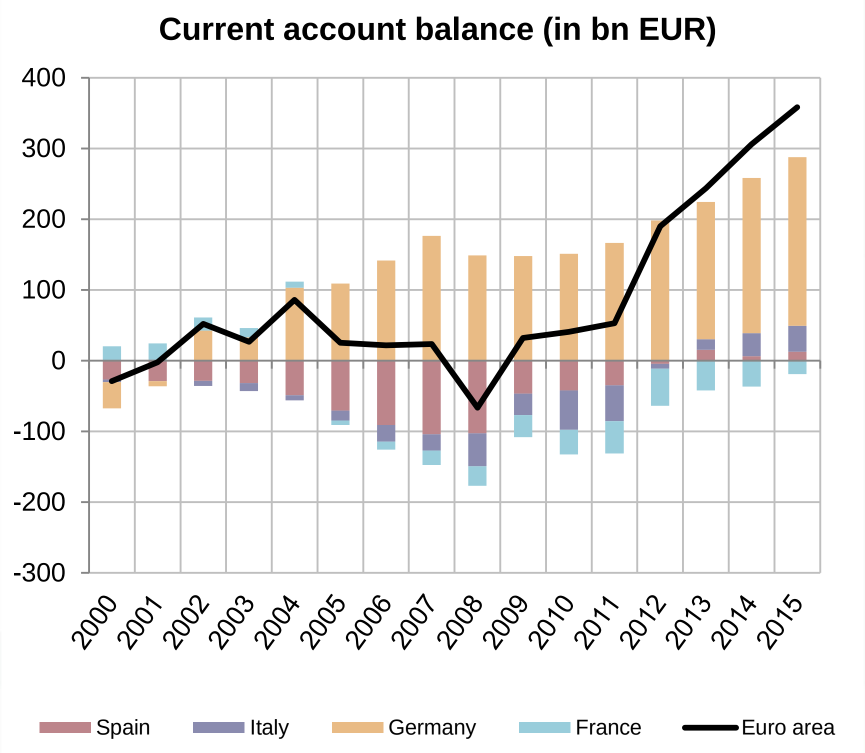
Inflation developments

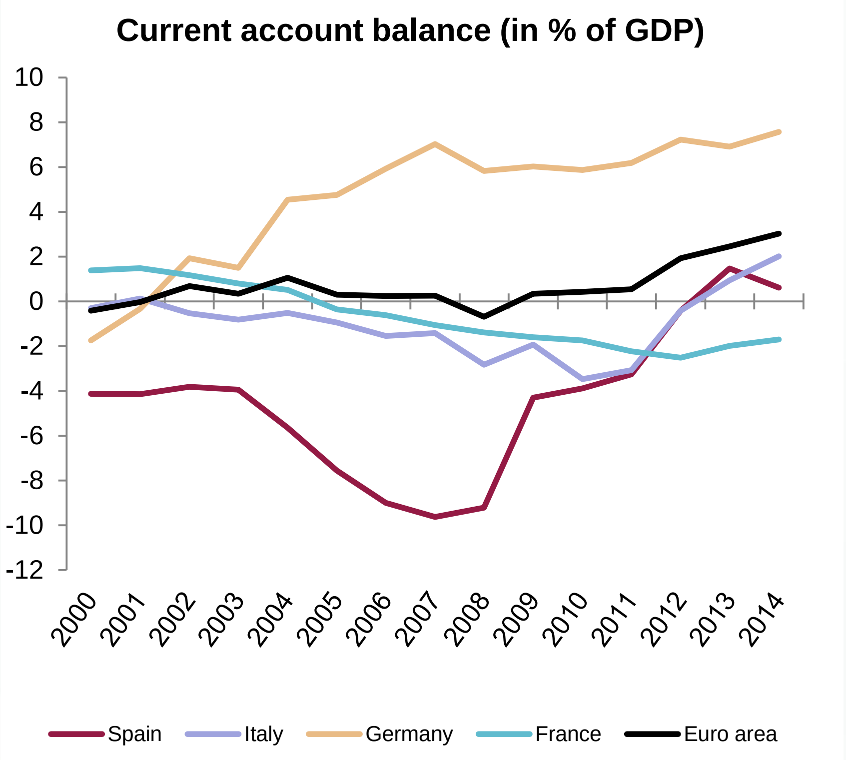
Market-based inflation expectations



Source: Bruegel based on Datastream

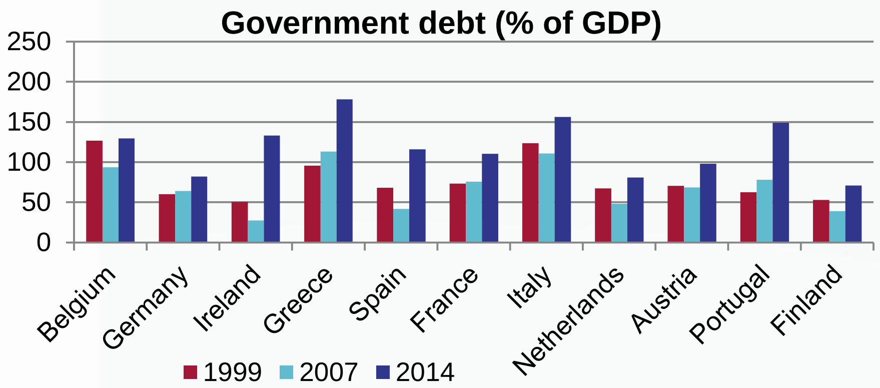
Current account

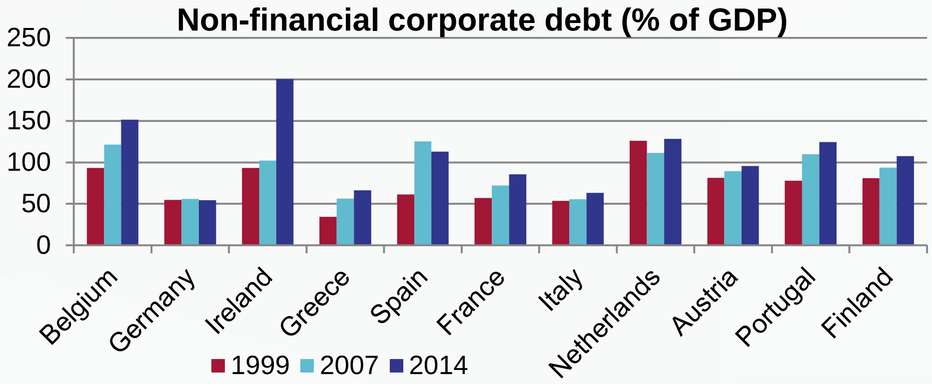




Source: Bruegel based on AMECO, Eurostat

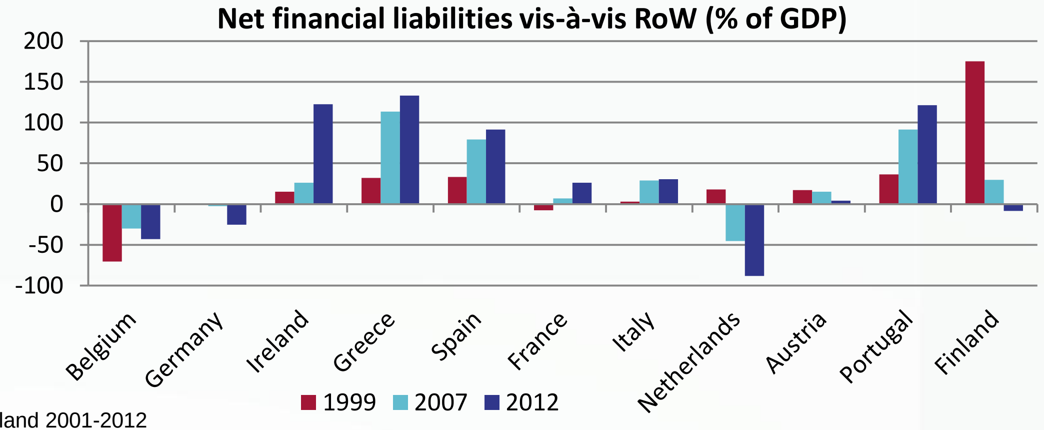
Debt and external liabilities





Ireland 1999-2013

France 1999-2013; Ireland 2001-2014



Ireland 2001-2012

Source: Bruegel based on Eurostat, OECD