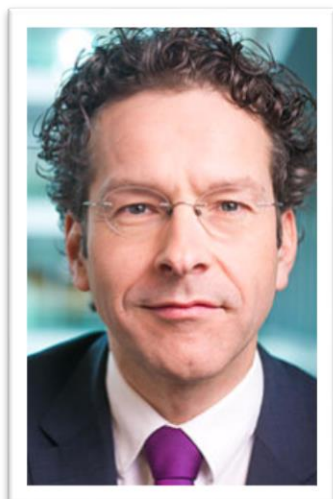


## A solid common landing ground for EMU



### **Jeroen Dijsselbloem, former Chairman, Eurogroup**

The Economic and Monetary Union (EMU) is a community of values, formed by countries which have joined their economic faith. It implies rights and obligations, but also solidarity and responsibility. The key of the debate is how far this solidarity and responsibility goes. Can 'Brussels', as center of EMU, intervene in all domains? What should member states do themselves?<sup>1</sup>

We may not forget that the joint fiscal strength of the member states is 50 times higher than the size of the budget of the EU. Most macro-economic tools are also still in the hands of national governments: income tax, pensions, housing, labour market, social security, health care. So, member states still are key players in financial and macro-economic policy.

Of course, there are basic rules for the member states such as the 3% budget deficit limit with engagement to move towards equilibrium, the 60% public debt rule and the prospect to go beyond towards a lower level.

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<sup>1</sup> Report of the speech given by Jeroen Dijsselbloem, former Chairman of the Eurogroup, at the Belgian Financial Forum on the 29th of January 2018 in Brussels, written by Frank Lierman, Chairman of the Editorial Board of the Revue bancaire et financière/Bank- en Financieuzen.

Within the EMU it is clear that the member countries lost their sovereignty on monetary policy, on exchange rates, on interest rates. In return they received stability and trust after many currency crises in the 70's, the 80's and the 90 's, even with lower interest rates. Nevertheless, the risks are still quite different between member states. No differentiation is possible within in the common monetary policy.

Before the start of the financial crisis in 2008 we had a real credit boom in Europe. Member states have not taken their responsibility to intervene. All disposable instruments have not been used. Some figures to illustrate that:

- between the start of the euro and 2008 the mortgage debt increased up to 300% of GDP due to the housing price boom in the Netherlands and Denmark, which is not a member of the EMU;
- the balance sheet of the bank sector reached the level of some six times the GDP in the Netherlands in 2008 or eight times the GDP in Cyprus;
- the credit to the private sector jumped from 100% to 200% of which 155% for the real estate sector in Spain;
- the total balance sheet of the Irish banks was eight times the level of GDP in 2008;
- in Greece consumer spending went up by 40% between 1999 and 2008, budget deficit reached -15% of GDP and debt jumped above 100% of GDP.
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All those developments could to some extent be acceptable if they were supported by an attractive increase of productivity, which was more than +2% in the 90's, but came down to only +1 à +1,5% in the years 2000. In Spain productivity was up +0,5% on yearly basis while wages went up 35% between the start of the euro and 2008. In Ireland wages increased 45% and in Greece wages of public servants jumped even 80%.

All in all, bad national policies have been developed, which hampered the competitiveness of Europe as a whole. While our societies are ageing, we all know that our social welfare state is costly and need substantial structural reforms to remain sustainable.

The crucial question is not: what can Europe do for us? but how to take our national responsibility in the process of structural reform?

The financial crisis which started in 2008 was more than a wake-up call. The first reaction was a denial because the subprime mortgages crisis was considered as a pure US problem. The next step was the public rescue efforts to help the banks in a lot of countries. This was followed by the development of fiscal stimulus via more coordination decided within the Group of 20. But very soon a lot of countries ran out of money in their efforts to stimulate the economy and save banks. Costs of the rescue jumped up. This pushed Europe towards the debt crisis in 2010.

The initial rescue of Greece was characterized by improvisation: bilateral loans, the start of the European Financial Stability System (EFSF) as temporary, joint structure. We lost 2 years because only in the second half of 2012 major steps were taken towards structural improvement.

I see 4 crucial elements that define this turning point:

- the agreement to build a European banking union in June 2012;
- the statement of Mario Draghi in London in July 2012 “Whatever it takes, it will be enough”;
- the start of the European Stability Mechanism (ESM), end 2012, as a long-term emergency fund;
- the start of structural reforms in the member states in order to correct wage and price issues, to improve competitiveness.

It is clear that the structural answer to the crisis in the Eurozone took too long and it came at a huge price, mainly of social consequences.

Today the Financial Times speaks of the “Euroboom”. They refer to the strong growth of the European GDP. The ECB changed its wording because Mario Draghi speaks now of expansion instead of recovery. Exports jump, internal demand is supportive, investments increase. The PMI for manufacturing is strong. Jobs increase is the highest since 17 years. But public expenditures are not yet helpful in many countries due to the still too high deficits and in particular the debt levels.

Most discussions over the future are dominated by “trying to win the last war”. But the next crisis will be different. Many new risks are underestimated:

- the overheating of the economy;
- the inflation upward movement;
- the new jump of real estate process;
- the correction in some financial markets.
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What has to be done to avoid a new crisis?

The European road map, put forward by the European Commission this fall is focusing mainly on governance and institutional issues, on the debate about intergovernmental versus supranational frameworks. This is an interesting debate, but there was a very cool reception by analysts, observers, even politicians.

We need to focus on substance rather than institutional issues, in order to increase economic competitiveness which is still the key issue for the Euro area. Following steps must be taken:

- member states must activate structural reforms to attract more investment and must decrease the sovereign debt in order to create fiscal space to face the next crisis;
- the ECB must carefully decrease its QE programme;
- the bank supervisors must develop a more pro-active policy to tackle the non- performing loans in some member states, to stimulate the building up of capital, to fine tune the regulation;
- the EMU must be reformed via four major steps.

The first is finishing the European banking union. It is a surprise that in the government agreement for the GROKO in Germany no reference to the banking union can be found. It is crucial that the third pillar, the European Deposit Insurance System (EDIS) is put in place. This is crucial for confidence and cross border capital flows. Bank balance sheets need to become healthier. And the taxpayer must be protected from the costs of bank failures. Private investors must be able to carry the risks they have taken on in search for yield. The Single resolution fund will in the coming years gradually be filled up by the sector and a creditline should be setup from the ESM to the SRF. In other words, lets finish what we started.

The second is the launching of the European Capital Markets Union (CMU) to deepen the monetary union, to diversify the way we finance our corporate sector, and stimulate the privatisation of risk sharing. But it is also necessary for the further deepening of the internal market.

The reform of institutions is the third step. This implies the increase of the ESM capacity. The ESM works efficient and effective since five years. The funding is no problem at all. It is also necessary to review the experience with the Troika, which is not so efficient. In my mind the ESM has to play a leading role in the future in designing, negotiating and monitoring support-programs for countries in a temporary economic setback. The ESM should also be the central authority to conduct, where appropriate, the restructuring of unsustainable sovereign debt.

And the ESM should, as mentioned before, provide the backstop, or creditline, to the resolution fund.

Finally, the Commission can support member states in their reform programme. The launching of contracts between member states and the Commission, as it has been proposed by the German Chancellor Merkel, is a valid starting point. The Commission can use the current instruments already available in the EU-budget, for this purpose. And most importantly, the Commission must continue to play its key role as the guardian of all the European pacts and regulation.

The fourth pillar is the search for fiscal instruments necessary to optimise the currency area, as it has been described by the Nobel prize winner Robert Mundell.

Mundell argues that three things are needed for the optimal functioning of a currency area: Sufficient free flow of capital and labour between member states, sufficient price and wage flexibility within member states and fiscal transfers within the union.

If we follow Mundell advice, still most work has to be done by the member states. This is about better functioning of markets, better risk management and improvement of business opportunities.

On the condition that member states do their share for the union, we can ask what the union can do for us. A joint fiscal capacity is usefull in case of adverse shocks. But can only be accesed on the condition of compliance to the Growth and Stability pact. It could be set up as a rainy-day fund or as a joint financing facility, preferably from the ESM.

But we must manage our expectations. The debate on the future of the EU-budget is going to be extremely tough. The Brexit has a major impact on the EU fiscal reform due to the loss of many billions of euro for the EU budget. May we expect a positive attitude of the net contributors to increase their funding or for the net receivers to accept less EU money? On top of which there are new European public goods to finance, such as outside-border control, common defence policy and fighting climate change. New challenges which need to be fitted into the EU budget. There will be little fiscal room for a big new eurozone-budget.

To sum up. Do not blame the EU for all problems we have. The responsibility of the member states is huge. The EU will not solve all your problems via more centralized policy and stronger institutions. Major structural reforms are still needed at national level. The EMU must become a value community. This implies more solidarity between member states and more responsibility from member states. The one goes hand in hand with the other.