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The Design of Economic and Monetary Union

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Frankfurt, 1 July 2019
Relevance of institutional frameworks

i. **Institutions matter:** recent times have provided ample evidence around the world for how important they are in determining the environment in which central banks operate.

ii. **Institutional reform has become a policy variable:** fixing deficiencies in institutional frameworks is key to ensuring effective economic policies.

iii. **The Economic and Monetary Union and its experience during the crisis provide ample evidence** for i) and ii).
Starting with a piece of good news

20 Years of the EURO

#EUROat20
A bit of history

European Coal and Steel Community
Treaty of Paris
“make war between France and Germany [...] not merely unthinkable, but materially impossible …”
Robert Schuman

European Economic Community
European Atomic Energy Community
Treaties of Rome

European Communities
Treaty of Brussels
(so-called Merger Treaty)

European Central Bank
Established on 1 June 1998

Introduction of the Euro
Notes and coins

1952
1958
1967
1992/93
1998
1999
2002

1999

Introduction of the Euro
Virtual Currency

European Union
Treaty of Maastricht
Economic and Monetary Union
Single Market
EU accession criteria
Copenhagen criteria

Euro

Notes and coins

Overview of EU history and geography

EU accession criteria

European Communities

Virtual Currency

Notes and coins

Introduction of the Euro

Notes and coins

Introduction of the Euro

Notes and coins
Current euro area members

- EU Member States which have adopted the euro
- EU Member States with a special status
- EU Member States with a derogation
Representation of Member States the Council

Heads of State or Government
- European Council
- Euro Summit

Ministers
- ECOFIN
- Eurogroup

Senior Officials
- Economic and Financial Committee
- Economic Policy Committee

Experts
- EFC Alternates
- EFC Working Group
- EPC Working Group
- EWG Alternates
- Task Force on Coordinated Action
Direct representation of citizens: the European Parliament

- **Strong role in economic and financial legislation** (co-decision powers and contribution to agenda-setting)

- **Accountability function for EU institutions** (e.g. European Commission, ECB)

- **Very limited role in intergovernmental coordination** (e.g. economic dialogues)
## Overview

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1 The rationale for Economic and Monetary union
A political project

The euro is the most tangible symbol of European unity and identity. 341 million people use the euro in 19 countries.

“The euro is the most tangible representation of European integration that our citizens encounter, on a daily basis. (...) Over the years, elected representatives and leaders (...) have rightly recognised that ensuring economic prosperity and stability over the long term is a shared challenge that is best faced collectively. We are stronger together.”

Mario Draghi, Speech at the European Parliament to mark the anniversary of the euro, 15 January 2019
Security of purchasing power

Removal of transaction costs

Price transparency

Elimination of exchange rate risks

“With the Single Market, we have a powerful engine of sustainable growth to underpin our living standards. The euro has safeguarded the integrity of the Single Market. Today, our economies are integrated to a point that was not imaginable when the euro was designed. Intra-EU exports rose from 13% of EU GDP in 1992 to 20% today and value chains are everywhere in the euro area.”

Mario Draghi, Speech at the European Parliament to mark the anniversary of the euro, 15 January 2019
Integration of financial markets, financial infrastructures and financial institutions

- results in economies of scale, larger variety of financial products at lower cost
- enhances transmission of monetary policy impulses
- contributes to safeguarding of financial stability and smooth operation of payment systems
The impossible trinity

Source: The Economist
The euro is one of the world’s most widely-used currencies. The proportion of international payments made in euros and US dollars is roughly equal and the euro is the world’s second most-used currency for borrowing and lending.

“Today most challenges are global and can be addressed only together. It is this “togetherness” that magnifies the ability of individual countries to retain the sovereignty over the relevant matters, sovereignty that would otherwise be lost in this global world. It is precisely in this sense that the single currency has given to all members of the euro area their monetary policy sovereignty, compared with the pre-existing monetary arrangements. It is together that we have a voice in the regulation of international financial markets (...).”

Mario Draghi, Speech at the European Parliament to mark the anniversary of the euro, 15 January 2019
A controversial project initially

• **Politically**: initial fears by part of the population of losing sovereignty and of price increases upon changeover

• **Economically**: concerns over risks of moral hazard and one size fits all; diverging views on whether EMU would foster economic convergence or divergence; debate on cost-benefit balance in light of optimal currency union theory
The euro now enjoys strong support...
Support for EMU and the euro (Nov 2018)
2 Initial design and reforms during the crisis
Convergence criteria

Conditions for euro area accession

Sustainable convergence is assessed on the basis of:

- Price stability
- Public finance discipline
- Interest rate convergence
- Exchange rate stability
- Legal convergence
Pre-crisis framework (I)

A central monetary policy but decentralised financial, fiscal and economic policies with weak coordination

EMU of the Maastricht Treaty (1992)
Pre-crisis framework (II)

And key principles designed to ensure appropriate incentives for policy making
The crisis revealed the limits of the pre-crisis framework

1. Debt crisis (private and sovereign)
2. Banking crisis
3. Competitiveness and growth crisis
4. Political crisis (national & European levels)

Crisis of confidence

No easy or single remedy – Europe faced a decade of adjustment
Failures of the pre-crisis framework

1. Failure to enforce rules of fiscal policy framework -
   - Insufficient internalisation of EU rules at national level
   - Practice of “non-interference” and weak enforcement (sanctions never used)

2. Failure of market discipline
   - Presumption of rational behaviour
   - Solidarity vs. ‘no bail-out’ clause

3. Lack of a competitiveness framework
   - Lack of surveillance of competitiveness and macroeconomic imbalances
   - Processes of surveillance and coordination were non-binding

4. Insufficient integration of financial sector policies; unsatisfactory quality of banking supervision

5. No crisis resolution mechanism to provide financial support to EA countries
Crisis reforms: stronger fiscal and economic surveillance

“Six Pack”
- Strengthened Stability and Growth Pact
- Macroeconomic Imbalance Procedure (MIP)

Fiscal Compact
- Mandatory balanced budget rule (structural deficit <0.5% of GDP)
- Reduction of debt/GDP ratio by 1/20th per year in case of public debt>60%

Improved Coordination
- European Semester
- Euro-Plus-Pact

“Two-Pack”
- Strengthened oversight of countries under financial assistance
- Supervision and assessment of draft budget laws
Crisis reforms: Stronger financial surveillance

European System of Financial Supervisors

Macro-prudential oversight
- European Systemic Risk Board
  - ECB
  - National central banks
  - European Supervisory Authorities
  - European Commission

Micro-prudential supervision
- European Supervisory Authorities
  - European Banking Authority
  - European Insurance and Occupational Pensions Authority
  - European Securities and Markets Authority
  - Single Supervisory Mechanism National supervisory authorities
Crisis reforms:
Stronger crisis management tools

• Five euro area countries have received financial assistance during the crisis: Greece, Ireland, Portugal, Spain (for the Banking sector) and Cyprus.

• Reform programmes were monitored by the European Commission, the ECB and the International Monetary Fund.

• In 2012 the European Stability Mechanism (ESM) was established, endowed with a capital up to €700 billion.

• Single Resolution Fund was created for banking crises.
3 Completing the Economic and Monetary Union
Objectives

**Financial union**
- Break sovereign-bank nexus
- Foster private risk-sharing
- Create more resilient and efficient financial sector

**Fiscal union**
- Reduce country imbalances and vulnerabilities
- Create tools for macro-economic stabilisation

**Economic union**
- Reduce country imbalances and vulnerabilities
- Bolster shock absorption
- Increase potential growth

**Political union**
- Right balance of competences between European and national level
- Commensurate legitimacy arrangements
The Five Presidents’ Report

**Economic Union**
- A EA system of competitiveness authorities
- A stronger MIP
- A streamlined European Semester

**Financial Union**
- Completing the Banking Union
- Launching the Capital Markets Union

**Fiscal Union**
- A new advisory European Fiscal Board
- A fiscal stabilisation function for the euro area

**Political Union**
- More accountability towards the EP and NPs
- Consolidation of Eurogroup
- A euro area Treasury
Essential elements need to be further ironed out in 2019 and 2020

- **EDIS - HLWG**
  - Agreement on principles

- **Liquidity in resolution**
  - Further work H2 2019

- **ESM Backstop**
  - ESM guidelines
  - Adoption of ESM reform package

- **ESM reform (PCCL, ECCL, DSA...)**
  - EG agreement on ESMT

- **Budgetary instrument**
  - Features of the instrument
  - Financing

- **Fiscal stabilisation**
  - Technical discussions

- **Fiscal and economic rules**
  - Review of 2-pack and 6-pack
  - COM report, Council conclusions, (poss.) Amending proposal

- **Safe asset**
  - Regular legislative process on SBBS proposal
Conclusion: what is the momentum for EMU deepening?

Key drivers: urgency, salient issues, reviews of existing legislation

Conditions: willingness to compromise based on packages/sequencing

- Crisis momentum for EMU deepening waning
- The European Parliament and European Council are more fragmented
- Trust in EU and institutions low but recovering
- Slow progress - where could new momentum come from? Will resilience be tested?
- Challenge to bridge differences of views amongst the Member States
- Other emergent policy issues (environment, trade/single market, digitalisation, taxation, AML) high on the agenda: provide a new angle for shaping EMU?
Thank you for your attention!