Dr. Marek Dabrowski—Written evidence (EMU0010)

1. Introductory remarks

1. This note has been written in response to the UK House of Lords European Union Committee's Call for Evidence on 'Completing Europe's Economic and Monetary Union'. The opinions presented here represent solely the view of their author and not necessarily the institutions, which he is affiliated with. Thus, these opinions can be attributed publicly to the author only.
2. The author of this note is not an expert on financial sector and financial industry and, therefore, will not be able to answer part of the Question 16 related to the potential impact of new initiatives on the city of London. Similarly, not being an expert on the UK economy and UK governance system my opinions on the potential impact on the UK will remain of rather general character. Nevertheless, I will try to address the problem of how the initiatives aimed at completing Europe's Economic and Monetary Union may change a relative status of non-Euro area EU member states versus those, which adopted the Euro.
3. Taking into consideration author's background (international macroeconomics) the comments presented in this note will concentrate on economic content and mechanisms of actual and potential future EU legislation rather than its legal aspects.
4. This note is divided into ten sections, which deal with the following issues: general characteristics of the 'Five Presidents' Report (Section 2), fiscal rules and fiscal discipline (Section 3), convergence, jobs and growth (Section 4), the European Semester and related mechanisms (Section 5), Macroeconomic Imbalances Procedure (Section 6), Banking and Capital Market unions (Section 7), prospects of the Fiscal Union (Section 8), external representation of the Euro Area in international financial institutions (Section 9) and relations between the Euro area 'Ins' and 'Outs' (Section 10).

2. The 'Five Presidents' Report and its implementation

5. The report on 'Completing Europe's Economic and Monetary Union' (see Juncker et al, 2015) called popularly the 'Five Presidents' Report (henceforth referred as the Report) summarizes the debate on the Deep and Genuine Economic and Monetary Union (EMU). The debate was launched by publication of the European Commission's Communication on 'A Blueprint for a Deep and Genuine EMU' in November 2012 (see European Commission, 2012).
6. In comparison with the 2012 Communication, the Report is less ambitious but, at the same time, less controversial in presented ideas and more realistic in terms of its implementability. For example, the 'Five Presidents' Report does not contain proposal of debt mutualization presented in the 2012 Blueprint. It would further undermine fiscal discipline on national level, already compromised by several bail-outs of the troubled countries and continuous breaching of fiscal criteria established by the Treaty on Functioning of the European Union (TFEU) and the Stability and Growth Pact (SGP) – see Section 3.
7. All measures, which are to be adopted in the Stage 1 (between July 1, 2015 and June 30, 2017) as 'Immediate Steps', do not require changes in the EU Treaties. They can

be implemented through either EU secondary legislation or the Commission's own decisions. This cannot be said about the Stage 2 ('Completing the EMU Architecture') that will require changes in the Treaties although the time horizon proposed (until 2025) makes this potentially feasible (if accepted by all EU member states).

8. The subsequent Commission's Communication 'On steps towards Completing Economic and Monetary Union' (henceforth referred as Communication) (European Commission, 2015a) and other enclosed documents (to be discussed in the subsequent sections of this note) aim at implementation of the Stage 1 measures proposed in the Report.

3. Fiscal rules and fiscal discipline

9. Fiscal stability of EU member states whether members of the Euro Area or not should be considered as an important European public good preventing the entire EU and its common market from cross-country contagion and negative impact of excessive fiscal imbalances on financial sector and financial markets. Rapid increase in public debt was the basic cause of the financial crisis experienced by Euro area peripheral economies since 2010, which triggered the entire debate on an EMU architecture.
10. Although at the end of 2015 fiscal imbalances in the EU and EMU look slightly less dramatic than in 2010-2012 (except Greece) they have not disappeared. On the contrary, the number of EU member states in which general government (GG) deficit exceeds 3% of GDP and GG debt stays above 60% of GDP, is still substantial (Dabrowski, 2015a). Situation can deteriorate again in case of adverse economic shock or inevitable increase in interest rates, which remain now on a historically low level.
11. The large number of EU member states, which have problems in meeting the Treaty's fiscal criteria creates a serious collective action problem within the entire EU. Despite reinforcement of the SGP in 2011, obliging EU member states to internalize Treaty's fiscal criteria into their national constitutions and secondary legislations, and signing the Treaty on Stability, Coordination and Governance in the EMU (the Fiscal Compact) there is little improvement so far if any. The so-called corrective arm of the SGP (the Excessive Deficit Procedure (EDP)) has been used rather leniently; for example, financial sanctions against offenders have been never applied.
12. An even more dramatic challenge concerns market discipline, which was assumed in the Treaty as the main incentive mechanism to ensure prudent fiscal policies on a national level. Circumventing the Article 125 of the TFEU (the so-called 'no bail out' clause) aftermath the Greece's debt crisis in 2010 created the dangerous precedent. It made all official creditors to Greece hostages of a limited reform commitment of the subsequent Greek governments (Dabrowski, 2015b) and force them to offer Greece subsequent bailouts (the recent one in July 2015), the typical moral hazard problem.
13. The Report does not offer any new ideas of how to rebuild market discipline based on credible threat of sovereign default within the EU and EMU and how to increase effectiveness of the SGP. The Communication promises 'improving transparency and reducing complexity of the current fiscal rules', revamping the European Semester (see Section 5) and few other technical measures (like publication of the SGP vade mecum) at the Stage 1. They may be useful (depending on details) but they will not address fundamental weaknesses of EU fiscal rules and return market discipline

compromised by the rescue programs to troubled countries. The expected revue of the SGP legislation should not cause its diluting in the name of higher 'flexibility' (it is flexible enough).

14. At the Stage 2, the Report proposes incorporation of the intergovernmental agreements - on the European Stability Mechanism (ESM) and the Fiscal Compact – into the EU Treaties. This could be a useful step from the point of view of consistency and transparency of the EU governance framework but as such, it would not increase fiscal discipline.

4. Convergence, jobs and growth

15. The Report tries to address the key weaknesses of the European economy (apart from fiscal imbalances), i.e., its slow growth (or stagnation), high unemployment and insufficient competitiveness. This requires acceleration of structural and institutional reforms aimed at increasing flexibility of markets for goods, services, labor and capital. However, the EU competences in this area are limited to issues related to the EU internal market (i.e., movement of goods, services, labor and capital flows between member states), external EU trade relations and some general regulations in respect to employment and social policies. All other regulations remain in national domain.
16. To circumvent this formal obstacle the Report and Communication propose further development of various mechanisms of indirect and largely 'soft' pressures on national policymaking, which include surveillance, peer review, policy coordination and mandatory expert involvement. This concerns the already existing European Semester and Macroeconomic Imbalance Procedure (MIP) and creation of new advisory bodies on both national (national competitiveness boards (NCBs)) and EU level (European Fiscal Board).

5. The European Semester and related mechanisms

17. The European Semester that was initiated in November 2010 is an annual cycle of policy consultation between individual member states and the European Commission and the Economic and Financial Affairs Council (ECOFIN). It combines the role of preventive arms of the SGP (Section 3) and MIP (Section 6), i.e., the surveillance role in policy areas where the EU has some decision powers with soft policy coordination in other areas, which belong to member states' prerogatives but according to the Article 121 of the TFEU remain '*…a matter of common concern*'. Country specific recommendations (CSRs) prepared by the Commission and approved by the ECOFIN serve as an instrument to influence national fiscal, economic and social policies.
18. The experience gained so far demonstrates that both European Semester and CSRs have a limited impact on decision-making process on a national level, especially in large member states (Darvas and Leandro, 2015; Gros and Alcidi, 2015) even if sometimes they provide useful benchmarks for the national debate and peer pressure on worst-performing countries. This failure can be explained by accountability of national policy makers to national parliaments and electorates and lack of decision-making power (or sanctions for non-compliance) on the EU level in respect to many issues covered by the CSRs. From the national perspective, both the European Semester and CSRs look like intrusive mechanisms short of democratic

legitimacy. As result, there is no progress in coordination of national policies in comparison with the pre-2010 period, i.e., before introducing European Semester.

19. Both the Report and Communication propose changes to European Semester's annual timetable, reducing the number of CSRs and similar pragmatic modifications. Indeed, they may help in simplifying and streamlining policy dialogue and make CSRs better tailored to countries' specifics. However, they may be unable to strengthen incentives on national level to observe those recommendations (they will be even more intrusive than before) under the current division of competences between the EU and national authorities.
20. The similar comment applies to the idea of NCBs. They may help in professional strengthening of national debates on microeconomic reforms and income policies but they can hardly change political economy and politics of reform processes on a national level (see Gros and Alcidi, 2015).

6. Macroeconomic Imbalance Procedure

21. The MIP was introduced by the EU secondary legislation in 2010-2011 as the part of so-called Six-Pack, in reaction to European debt and financial crisis. Formally, it aims to monitor current account imbalances of member states, and factors and policies, which determine them and member states' competitiveness[1]. Similarly to the SGP, it has the character of surveillance procedure backed by the corrective arm, i.e., the Excessive Imbalance Procedure (EIP), including possibility of using financial sanctions against non-complaining member states (only in respect to EMU members). However, practical implementation of the MIP raises two kinds of problems: conceptual and related to division of competences between the EU and member states.
22. On the conceptual ground, its focus on monitoring countries' current account balances raises serious doubts (see Dabrowski, 2015a). In the highly integrated area of unrestricted capital movement such as the EU, current account balances and real exchange rates remain outside effective control of national authorities even if country has its own currency. Furthermore, having balanced current account (what seems to be preferred by the MIP scoreboard indicators) is not always necessarily the evidence of macroeconomic health and makes sense. Both historical and contemporary evidence suggests that individual countries can become, for various reasons, capital exporters or capital importers on a sustainable basis (depending on their long-term saving rate and in-country investment opportunities). Moreover, the catching-up growth assumes permanent capital flow from higher-income to lower-income countries.
23. Other indicators used by the MIP scoreboard may be debatable from the point of view of international specialization of individual national economies. For example, some countries serve as the international financial centers for the entire EU or even to the outside world, so they can record higher rate of growth of credit to private sector. Some indicators are hardly controllable by national governments, at least in short term, because they are determined by market forces. The concrete reference values, which define the zones of vulnerability, can also raise doubts.

[1] See http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/index_en.htm

24. Furthermore, most of these indicators as well as policy issues analyzed by the MIP scoreboard, Alert Mechanism Reports (AMR) and In-Depth Reviews (IDR) belong to the sphere of national competence, for example, the entire area of labor market and social policy regulation. This makes the MIP and even more the EIP intrusive from the point of view of the national sovereignty, similarly to the SGP and European Semester, and hardly enforceable (also given conceptual doubts discussed above).
25. The Report declares further strengthening of the MIP as an instrument to influence member states' microeconomic and structural policies. From the conceptual point of view it would make more sense than dominant focus on current account balances (see above) but there is unsolved problem of the MIP intrusiveness (from the point of view of national sovereignty and current division of competences between the national and EU level) and enforceability.

7. Banking and Capital Market unions

26. The Report puts correctly the emphasis on completing the Banking Union at the Stage 1 and starting building the Capital Market Union. Both are important for increasing capital mobility and private risk sharing within the Euro area and completing the single financial market for financial services within the EU. They will also have a positive impact on both macroeconomic and financial stability in the EU and Euro area.
27. While the Capital Market Union project involves all EU member states the Banking Union is limited to the EMU members and those non-Euro-area member states that opt to join it. Such a division between 'Ins' and 'Outs' may lead, in longer term, to creating market barriers between members and non-members.
28. To complete the Banking Union there is necessary to adopt the European Deposit Insurance System (EDIS), the third, still absent pillar of this project. However, to ensure its right functioning and eliminate moral hazard risk respective safeguard measures must be adopted. They should include sufficient 'bailing in' measures in case of bank resolution mechanisms (within the Single Resolution Mechanism), proper functioning of the Single Supervisory Mechanism, and departing from the regulatory practice of assigning zero risk to government bonds.

8. Prospects of Fiscal Union

29. Fiscal union can be defined, in very broad terms, as transfer of part of fiscal resources and competences in the area of fiscal policy and fiscal management from the national to supranational level. Using such a definition, one may conclude that the EU is already a sort of fiscal union albeit the shallow one (the EU budget centralizes ca. 1% of its GNI). Apart from common budget, the EU fiscal union includes cross-country fiscal transfers, some elements of federal taxation, partial tax harmonization, fiscal discipline rules (see Section 3), fiscal crisis resolution mechanism and federal bailout facilities (see Dabrowski, 2014 for detail analysis). There are few additional fiscal integration mechanisms and facilities within the EMU, related to fiscal discipline rules, bailout facilities and (forthcoming) Eurozone-wide deposit insurance and banking-crisis resolution facilities.
30. The very existence of monetary union does not require parallel fiscal or political union. There are several historical and contemporary examples of monetary union of

sovereign states, which do not involve other forms of integration (for instance, the Western African Economic and Monetary Union or the Central African Economic and Monetary Community). Also on the ground of an optimum currency area (OCA) theory there is no definite arguments on necessity of fiscal transfers within a monetary union.

31. When discussing economic rationale of closer fiscal integration within the EU and EMU, the theory of fiscal federalism can serve as primary guidance helping to determine '*which functions and instruments are best centralized and which are best placed in the sphere of decentralized levels of government*' (Oates, 1999, p.1120). In practical terms, it requires a functional analysis aimed at identifying those policy areas and public goods where centralization of competences and resources could either offer increasing returns to scale or help address cross-border externalities.
32. Apart from minor changes in fiscal surveillance procedures (see Section 3), the Report proposes at the Stage 1 creation of the new advisory European Fiscal Board[2]. This may be a useful initiative from the point of view of providing a formal expert platform for discussing EU- and EMU-wide fiscal policy stance and problems. The same concerns strengthening EU and Euro area dimensions in the European Semester. However, as far as the size of the EU budget remains on the level of ca. 1% of its GNI it is unrealistic to think about any Union-wide autonomous fiscal policy stance (in the sense of countercyclical fiscal policy). The Union-wide stance will remain just a sum of national fiscal stances driven by national interests and national business and political cycles. As discussed before, an active coordination of national policies, especially in respect to budgets, is a formidable task, difficult to accomplish within the current division of competences (which can be modified only by the Treaties change).
33. According to the Report, a macroeconomic stabilization function for the Euro area to cushion large macroeconomic shocks should be set up at the Stage 2. The details of such a mechanism and scale of fiscal resource centralization has not been determined in the Report.
34. As history of other fiscal federal arrangements suggests development of macroeconomic stabilization function usually follows fiscal centralization determined by other factors or needs (increasing returns to scale or dealing with common externalities) and not vice versa. Such sequencing may also happen within the EU and EMU, for example, by strengthening the Common Foreign and Security Policy, common protection of EU external borders, common asylum policies, etc.

9. External representation of the Euro area

35. The proposal to move gradually towards the common representation of the Euro area in the International Monetary Fund and other international financial organizations may help in streamlining governance in these organizations and strengthening of Europe's position in global decision making processes (actually it would make sense to involve all EU members into consolidated representation instead of limiting it to EMU members). However, it will have no impact on intra-EU and intra-EMU economic governance and has nothing to do with democratic accountability and legitimacy.

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[2] It was already created by the Commission decision of October 21, 2015 (see European Commission, 2015b).

10. Euro area 'Ins' and 'Outs': EU of two speeds

36. Introduction of the common currency that is not used by all EU member states had to lead to their internal differentiation into two categories: those, which decided to introduce Euro ('Ins') and those, which either decided to retain their own currencies[3] or did not manage to meet formal EMU membership criteria (the so-called Maastricht criteria) yet ('Outs'). A common currency due to its economic role (in fact, this is an important component of the common market because it eliminates currency exchange costs and exchange rate risk) and necessity to complement monetary union with other forms of integration (regardless their detail architecture which might be debatable) have led inevitably to Europe of 'two speeds'[4].
37. The process of completing the EMU, even if not very ambitious, especially in the Stage 1, must lead to further deepening of internal division between 'Ins' and 'Outs' unless 'Outs' will opt-in to participate in some projects addressed primarily to the EMU members like the Banking Union.
38. The desire of the UK government to renegotiate some of its EU membership terms and conditions, which will lead in practice to more opt-outs, will further deepen the above-mentioned diversification of membership statuses and various speeds of integration processes within the EU.
39. The same effect will result from reluctance of some member states (including the UK) to deepen integration within the EU (including changes in the Treaties) even if the cost-benefit analysis speaks in favor of such deepening. Reacting to inability to reach a consensus regarding either new EU legislation or changes in the Treaties countries interested to move ahead can either use mechanism of enhanced cooperation or sign intergovernmental treaties outside the *acquis* (as it happened in case of the Fiscal Compact). This will lead not only to further differentiation of individual countries' membership statuses and increasing marginalization of 'Outs' but it will also make the EU governance system even more complicated and less transparent than it is now.

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[3] In this note I will skip discussion on legal nuances of non-participating in the common currency project. Two EU members (UK and Denmark) have a formal opt-out clause in the Treaty. Others who are formally obliged to join the EMU at some point do not hurry with meeting membership criteria and do not apply for membership.

[4] Actually we have Europe of 'many speeds' because some EU members states do not participate in the Schengen area, common justice and home affairs policy and are subjects to other exemptions from the *acquis communitaire* (temporary or permanent).

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