# Viability and future of the Eurozone


## Pierre Gramegna

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## Ensuring Europe's economic success: more sustainable, competitive and inclusive

In 2019, Europe's economy is set to expand for the seventh year in a row. This trend has led to a sizeable improvement in labour markets, with employment growing to record levels and unemployment receding markedly. Importantly, these favourable economic conditions have been widely shared, benefitting people and businesses across the entire EU.

Europe has come a long way since the crisis, thanks to determined action at both the European and national levels. A combination of structural reforms, sound fiscal policies and continued investment, improving our economies' competitiveness and raising the growth potential, has been the recipe for this success.

Throughout these past years, Luxembourg has been living by these same key principles. On the one hand, structural reforms have been implemented to enhance competitiveness: not only by strengthening the labour market, supporting private investment and redoubling investment in education and skills, but also by fully embracing the international tax agenda. At the same time, Luxembourg carried out a comprehensive modernization and restructuring plan, which has helped the country to rebalance public finances and lower its debt-to-GDP ratio, while raising investment to record levels, with a particular focus on key areas such as mobility and digitalization to support the country's future prosperity.

Looking ahead, Europe must continue with this virtuous triangle of structural reforms, investments and sound fiscal policies to make its economies more resilient and competitive. A balanced approach is also needed to address future challenges:

First, it will be paramount to ensure the sustainability of our economies. If Europe wants to effectively address climate change and respect its commitments under the Paris Agreement, our economies need to become greener and investments must be targeted towards this objective. In this context, Luxembourg has notably developed a roadmap that establishes a comprehensive sustainable finance strategy contributing to the long-term sustainability goals through the engagement of public, private and civil-society stakeholders.

Second, the EU should build common action points fostering competitiveness. Low productivity growth was a key contributor to the slow recovery in the aftermath of the crisis. It will be key to step up efforts and improve the quality of investments, focussing on areas such as digitalization. Such a focus will be more conducive to the long-term success of our economies than yet another discussion on the perceived deficiencies of the European construction. In Luxembourg, for instance, a dedicated Ministry of Digitalization has been set up, with the focus to accelerate the digitisation of businesses, research and public services and thus to resolutely prepare the country for the future.

Third, economic resilience can be further increased by firmly embracing inclusiveness. The crisis has left scars on large swathes of the population, shaping negative perceptions and hampering trust in the successful European economic and social model. If trust is to be regained, it will be important to ensure that no one is left behind in a rapidly evolving world. The European workforce must therefore be prepared for a changing work environment. In Luxembourg, this structural change is considered a major opportunity to tap into new sources of productivity growth, notably through the so-called "Digital Skills Bridge" initiative, which aims to equip employees with the necessary skills in the digitalized workplace. At the same time, Luxembourg has recently also increased minimum wages by 100 euros to reduce inequalities and support an inclusive society.

If we collectively focus on all these key elements and develop the right solutions to address the most pressing challenges, whilst fully respecting our common rules such as those from the Stability and Growth Pact, Europe will continue to be a symbol of shared prosperity and remain a role model for others to follow.

# Bruno Le Maire

Minister of Economy and Finance, France

## The euro area budget will improve economic policy coordination in the Euro area

Economic policy coordination in the Euro area is essential for a well-functioning monetary union. It makes no sense over the long run for economies which share a currency to diverge too much. Although we have strengthened the Eurozone considerably since the crisis, it still has weaknesses and its biggest is perhaps that economies of the Eurozone continue to diverge. Deeper and earlier coordination of economic policies should help the Eurozone's economies converge over time.

Today, the state of public finances in Eurozone countries is extremely varied. On the one hand, some countries still have high debt levels in the aftermath of the crisis. They have little room for manoeuvre for fiscal expansion. On the other hand, other countries have more fiscal leeway and could use this space to support economic activity. It is even more the case when there also are high current account surpluses. Such surpluses reflect economic competitiveness but they also underline the weakness of domestic demand. Using this fiscal space is even more important at a time when there are clouds on the horizon and economic forecasts are more gloomy.

The differences between Euro area economies call for a genuine coordination of economic policies in the Euro area. In case of a more severe economic slowdown, such coordination could make a real difference to the speed of recovery in the Euro area. The objective should be for member states to define together an efficient and appropriate Eurozone macroeconomic policy with takes on board where countries are in the economic cycle and their specific structural situation. Four principles should prevail: (i) continuing to reduce the high levels of public debt, (ii) pursuing the most needed structural reforms (iii) making use of fiscal space where available, and (iv) coordinating actions among European partners to maximize their benefits.

We all know that implementing structural reforms is of utmost importance as it is what makes the biggest difference to long term growth and competitiveness. France has taken decisive steps in this direction and will continue to do so. The PACTE bill, which should see it final adoption by Parliament before the summer, will overhaul the business environment to encourage business growth. It will help our SMEs to grow into mid-caps. Other ambitious structural reforms are also on the agenda: transforming our unemployment insurance scheme and our pension system to make them more resilient and fairer over the long run.

However, it is equally crucial to use fiscal space where it exists in order to support household's purchasing power as well as investment. Policies to that end include reducing the income tax for low-income households, supporting a robust wage growth and increasing public investment, where the focus should be on digital infrastructure, education, R&D and innovation. Such policies will also help to reduce Euro area macroeconomic imbalances, not by eroding competitiveness but by strengthening domestic demand. It will be a win-win approach that delivers higher growth for all Member States and lower debt for the Euro area as a whole, and in particular in today's high-debt countries.

Last but not least, our reliance on national fiscal policies in cases of downturns will be alleviated by the implementation of a budget at the Euro area level. The principle of a budgetary instrument for the Eurozone was agreed by Heads of State last December. Now we need to agree on its modalities by June 2019. It needs to be a real Euro area budget with permanent resources and a Euro area governance, which finances permanent expenditure targeted on actions that enhance future potential growth. Designing the Euro area budget in this way will ensure it supports the competitiveness and convergence of Euro area economies. When we have such a common budget, and it should be operational by 2021, this will be a key step in helping finance Ministers decide together priorities for investments and thus also a big step towards greater coordination of economic policies.

# Hartwig Löger

Federal Minister of Finance, Austria

## Tackling structural weaknesses in the Euro area: time to move ahead

The euro area is a political project to establish lasting peace in Europe and an economic project with the aim to improve the well-being and prosperity of its citizens. The straight line towards convergence that we have once believed to be an automatic result of the internal market and liberalisation of society has turned out to be a more tortuous path than expected. Due to the Great Recession the economic project experienced a significant setback, which sometimes is dubbed the "lost decade". In political terms, the crisis has swept many governments out of office and populist parties emerged and play a stronger role in Europe.

It is to remember that the crisis lead to the immediate emergence of solidarity and risk sharing in the euro area by establishing the EFSF and then the ESM, with significant firepower alongside the IMF, which got more resources from Europe. The principle of the ESM is solidarity, shelter and buying time in order to fix the structural problems of a country in times of severe economic distress. Fixing structural problems does not go without some pain, but ten years after the start of the crisis no country continues to be under a programme and all have regained access to financial markets. Notably, all former programme countries have much more resilient and fit-for-the-future structures than before the Great Recession.

This is not to say that structural problems in the economies are a thing of the past. While citizens tend to evaluate progress by their immediate surroundings, little seems to be known about the big leaps forward at the European and euro area level.

The new European architecture of the banking system and the financial markets is certainly a major achievement since the past crisis. Under the headings of "banking union" and "capital markets union" many of the weaknesses of the past could be resolved. In the second half of 2018, the Austrian EU Presidency made significant progress concerning financial services, including such complex issues as the banking package on risk reduction measures or the pan European pension product. Deepening financial integration in the Eurozone is an important contributor to economic growth. Protecting taxpayers' money and reducing risks in the EU banking system will lead to a more resilient euro area. By establishing a stronger and more unified European capital market we will bring together investors and innovators, including on new financial services such as FinTechs, and thereby lay the ground for higher productivity growth in Europe.

We have not yet resolved all problems and legacy issues of the crisis put a burden on the debate. But these sometimes lengthy, repetitive and emotional debates allow us to develop a better mutual understanding and visions about the future of the euro area. I'm deeply convinced it is a path that is worth following, an effort that is absolutely required from us in order to build a better Europe.

Populist movements tend to question basic institutions of Europe. One topic in this field is central bank independence. For us it is a core value of institutional stability, which must never be put into question. Without any doubt a well-functioning state has to guard and protect central bank independence and it is a matter of concern to us that this appears to be coming under threat even in Europe.

In the absence of a political union, the rule of law forms the basis of the European project. It is necessary for all European Member States to stick to our common rules. As a minister of finance and from a European perspective this first and foremost applies to our common fiscal rules. These rules are not only needed to avoid negative spill-overs to other Member States, but are essential for not excessively burdening the national future generations, as those are at the same time the future generations of Europe.

This brings me to the euro area budget. With the same argument in place, it cannot be based on extra credit-financing and it should finance structural reforms of euro area Member States. Austria is willing to contribute to lessening the pain of structural reforms by means of a euro area budget.

The Treaty on the Functioning of the EU has left many important competences at the national level. There is no lack of ideas on reasonable and useful structural reforms. With the European Semester, Europe has developed a useful device to detect structural problems in the Member States. Let's reinforce this instrument via the euro area budget.


# Tuomas Saarenheimo

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## A fiscal union would not complete EMU

The present debate presents the EMU as an incomplete structure. Lacking independent monetary policy, and absent the stabilizing effect of a true federal budget, Member States are vulnerable to asymmetric shocks, leading to higher risk of economic and financial instability. Deeper fiscal integration within the Eurozone is regularly proposed as key remedy for this shortcoming. A Fiscal Union would entail mechanisms of fiscal risk-sharing between Member States and —as a prerequisite for such risk-sharing— stronger controls over Member States' fiscal and macroeconomic policies.

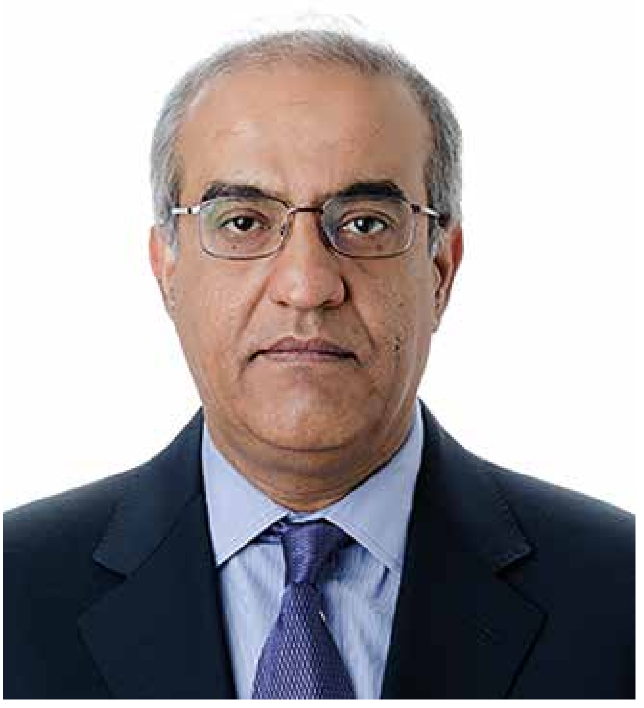
It is easy to agree that EMU is, in some ways, incomplete. In particular, the Eurozone's fragmented financial landscape remains a clear source of instability. While on the regulatory side, the Banking Union has taken important steps forward, the same cannot be said about progress on cross-border integration of the banking industry. European banking continues to be largely national, making financial sectors overly exposed to the same asymmetric shocks as their domestic sovereign. Further, compared with the US and other well-developed monetary unions, the role of European capital markets in cross-border risk diversification remains small. Consequently, asymmetric shocks are absorbed primary nationally, and the coincidence of sovereign distress and financial instability remains high. Fixing this is by far the most important part of creating a stable EMU.

In contrast, the significance of fiscal integration for the stability of EMU is much less clear. Contrary to the popular perception, evidence from major federations consistently shows that the role of the federal budget in smoothing state-level fluctuations is actually small, and even that small contribution tends to deal primarily with symmetric (ie. federation-wide) shocks. For state-level asymmetric shocks, the primary focus of the European discussion, the federal role tends to be almost nonexistent. On this evidence, it is difficult to see how the lack of federal level fiscal stabilization could be the missing element from a complete EMU.

There is another, deeper reason why a fiscal union alone might not only fail to stabilize EMU but could instead add new fragilities to it. Compared to other dimensions of integration that are part of EMU, such as monetary and financial regulatory integration, fiscal integration is fundamentally different. Whereas monetary policy and financial supervision are, in all developed countries, administrative tasks delegated to non-elected experts, fiscal policies remain everywhere in the hands of elected politicians. In national elections, budgetary programs constitute a key part of parties' electoral platforms. They are what mobilize people to vote.

This is a key difference. Common monetary policy and the Banking Union shifted responsibilities from national expert bodies to European expert bodies and thus had little if any effect on the democratic politics of the participating Member States. In contrast, fiscal integration would shift responsibilities from national elected bodies to the hands of European non-elected bodies, thus narrowing the scope of democratic decision making. The risk here is hollowing out of national democratic life. Taken too far, the outcome could be alienation and apathy among voters and, eventually, voter backlash with unpredictable consequences.

A stable EMU cannot stand on unstable political foundations. An effective and democratic fiscal union is only possible together with a much stronger political union. This is not about symbolic changes such as a European Finance Minister but about far more fundamental reforms. It is about creating a true European political space, with true European political parties with complete political programs, a true European media that can hold European politicians accountable, and a deep European civil society to channel citizen participation. Such a political union remains a long-term prospect, at best. Therefore, steps towards deeper fiscal integration should be taken with caution. ●




# Mahmood Pradhan

**Deputy Director, European Department, International Monetary Fund (IMF)**


## Getting financial integration back on track

Euro area financial integration has been derailed since the crisis. We need to get it back on track. Cross-border interbank lending amongst euro area banks is back to 2005 levels. Cross-border private sector risk sharing through the capital markets remains low, partly because institutional investors in the euro area, such as pension funds and insurers, exhibit significant home bias in their asset holdings. And euro area households concentrate over 80 percent of their financial assets in bank deposits and deposit-like instruments.

This is a far cry from the integrated financial union that the euro area was envisioned to become—a currency zone where private sector risk sharing across countries would flourish to the benefit of all. In this vision, the creation of the economic and monetary union was meant to facilitate a diversification of risk exposures by financial intermediaries in all member states, across both national borders and economic sectors. That was to become a financial union where equity capital in one jurisdiction could support prudent risk-taking in another jurisdiction; where deposits in one country could fund sound lending in another; and where financial and nonfinancial firms alike could issue equity and debt into a single and integrated European capital market, to a single European investor base.

We need a renewed push to achieve this vision of finance without internal frontiers. In practice, this means completing the banking union, pressing forward to build a capital markets union, and ensuring seamless integration between the two.

While we have seen a lot of progress on unified supervision with the creation of the Single Supervisory Mechanism, gaps in supervisory powers—in the ability to impose fines, to name just one example—need to be filled. While there has been some progress on bank resolution with the creation of the Single Resolution Mechanism, here too there is much work still to be done. Steps such as creating a common backstop to the Single Resolution Fund are certainly positive, yet the banking landscape is riddled with loopholes, with countries able in some cases to resort to national bank insolvency frameworks that still vary considerably.

Moreover, the third pillar of the banking union—a single European deposit base—is still missing. The European Commission has put forward concrete proposals to ensure that greater cross-country risk sharing through common deposit insurance be accompanied by further risk reduction in banks with higher nonperforming loans and concentrated risks. But there is still much resistance in many quarters, and we have yet to see material progress on this front.

Taken together, all of the missing elements in the banking union superstructure mean that national ring fencing of bank liquidity and capital remain the norm, not the exception, limiting cross-border risk sharing and—ultimately—a more uniform cost of intermediation and funding for the real economy.

Creating a true capital markets union is no less of a challenge. Reducing the costs of cross-border portfolio flows through more uniform standards across national capital markets and incentivizing a shift in the investment behaviors of both professionals and households is a long-term project. Here too, policymakers will eventually have to tackle difficult hurdles, such as modernizing and harmonizing national corporate insolvency regimes. Yet meaningful progress is possible. There are some obvious wins —take a fully portable European pension product, for example, which would also support labor mobility.

Euro area policymakers need to identify the less contentious reforms, where faster progress is within reach, and spend scarce political capital on pushing those through now. Because achieving the envisioned degree of financial integration in the euro area will be a long journey, it is all the more urgent that we do not let progress simply stall, that we keep trudging toward the final destination.