Strengthening the Economic and Monetary Union (EMU)

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A monetary union does not by itself create economic convergence.

The Eurofi Macroeconomic Scoreboard (September 2022) underlines that the eurozone is a currency area comprising heterogeneous countries with a low level of federalism (their productivity levels, productive specialisation, level of fiscal deficits and indebtedness, and level of labour force skills being different).

Many Member States have relaxed their macroeconomic discipline over the last twenty years and those who played the card of fiscal vigilance turned out to be the winners. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States. In this context, it is important that the implementation of Next Generation EU is a success[1].

But as long as it is not sufficiently understood, notably in highly indebted countries, that excessive debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to progress in Europe towards more public or private risk sharing.

It is also an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth. It is not because budget deficits are monetised that they disappear. In addition, central banks will not always be able to buy everything, and the quality of a state's signature is an essential element of confidence that shall be preserved at all costs for the country's future.

It is economic growth that eventually solves indebtedness issues. The only way of promoting robust growth in the EU is to implement ambitious structural reforms in all Member States.

Monetary policy can erase spread differentials but cannot address structural issues and notably the lack of confidence and the persistence of structural discrepancies, which explains the limited capital flows from North to South. Europe benefits from a large pool of savings which could contribute to finance long term investments and notably those related to the green and digital transition, provided that such savings are not taxed but remunerated. However, these savings exit the EU and finance the rest of the world (in particular the United States). This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect as the lack of a genuine Banking Union and integrated financial markets as well as persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries.

If the divergence of interest rates between the two sides of the Atlantic continues to increase in favour of the United States, the problem of transfer savings to higher interest rate areas could have very negative consequences for Europe.

The result of a too slow monetary normalisation in the euro area, in a context of persistent and very high inflation – HICP inflation is above 2% in the euro zone since April 2021 and increased to 8,9% in July 2022 compared to 8.6% in June 2022, 8,1% in May and 7.4% in April 2022 – would be an acceleration of inflation and low growth (productive investment would continue to fall as we have seen over the past 20 years in periods of very low interest rates).

Consequently, the eurozone has to embark on the right course: fighting inflation, which requires vision and courage, more fiscal responsibility and more supply reforms geared to increase productivity, as well as steps to complete the Banking Union and implement the Capital Market Union. But this move can only be envisaged if sufficient discipline starts reversing the trend of ever-growing economic heterogeneities across Member States.

Ultimately, the paradox of the euro is that a single currency and national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy have been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth Pact should help to resolve these contradictions and thus make the euro sustainable.

1. The Recovery and Resilience Facility is the biggest programme of the recovery plan with a maximum of EUR 672.5 billion of loans and grants for Member States to finance reforms and investments. The aim of the Recovery and Resilience Facility is to mitigate the economic and social impact of the coronavirus pandemic and make European economies and societies more sustainable, resilient, and better prepared for the challenges and opportunities of the green and digital transitions

To be viable, the eurozone needs:

- To combat very high and persistent inflation without further delay by gradually returning to positive real interest rates. As the 2022 annual economic BIS report reminds us, the most pressing monetary policy task is to restore low and stable inflation and to sustainably rebuild monetary buffers. Higher rates will also reduce central banks remittances to the governments. The reappearance of spreads should not dominate the decision-making process.

  It is usual in times of high inflation to increase nominal and real interest rates to avoid further increases in demand. The recommendation is therefore to raise interest rates and gradually move to positive real interest rates. This would only not be the case if the economy were in a deep economic crisis with rising unemployment or a risk of deflation, which is not the current situation (nor the one that has prevailed since the beginning of the second quarter of 2021, when inflation returned strongly). As long as interest rates remain negative or zero, the nominal increases implemented can only generate very weak recessionary effects.

- National budgets under control in all parts of the Union. No responsible state cannot be expected financing current public deficits generated by other eurozone members of the Union that do not follow the rules of the Union. The future – and notably the solution to market fragmentation – depends on a consolidation of present weak fiscal positions (primary surpluses) and a shift towards quality of expenditure and investment. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment. The revision of the Stability and Growth Pact is of paramount importance in this respect. Postponing discussions on the revision of the Pact delays the solution, exacerbates tensions within the market (due to the lack of benchmarks) and only complicates the resolution of problems that are likely to become even more acute.

- Domestic structural measures towards increasing growth potential should be encouraged and monitored. Reducing output gaps cannot be ensured just by subsidies to the labour markets. This requires more substantially to increase the productivity of the system, which necessitates more competition and long-term investment. Making the European recovery plan a success is therefore essential and should contribute to boost potential growth.

- An active banking and integrated capital market in Europe. In sum, members of the Monetary Union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn out fine. Ultimately, the fate of euro will depend on the political will to achieve genuine cooperation within the euro area.