IIEA Economic Governance Group

Comments on Five Presidents' Report,
Completing Europe's Economic and Monetary Union

Edited by Group Chair, Michael G. Tutty
Group Researcher, Fionn Jenkinson

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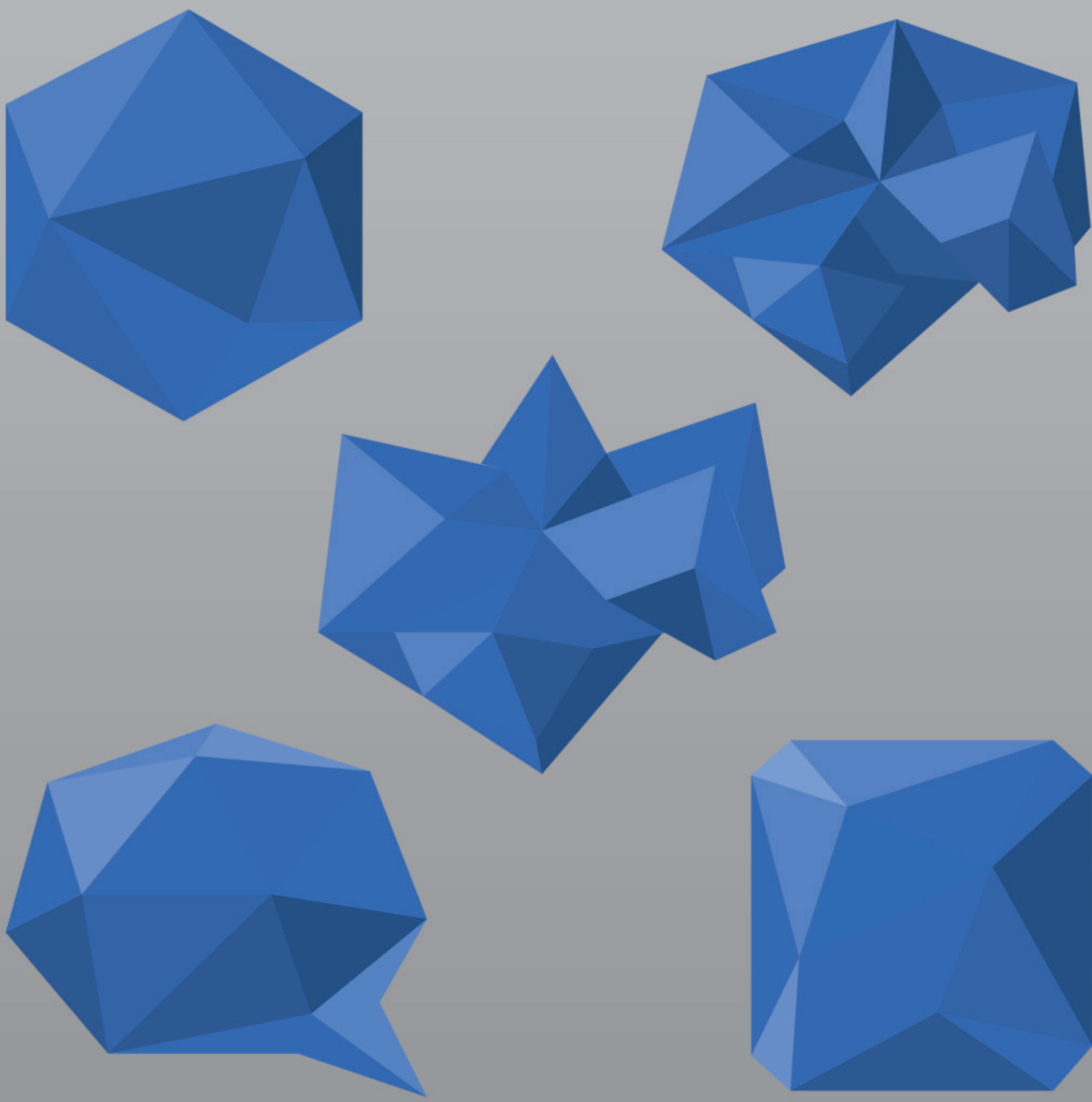

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Introduction

In March 2015, following an invitation from the European Commission, the IIEA Economic Governance Group made a submission on the Analytical Note, *Preparing for Next Steps on Better Economic Governance in the Euro Area* of 12 February 2015. Subsequently, the Five Presidents' Report, *Completing Europe's Economic and Monetary Union* was published on 22 June 2015.

This paper examines which elements of the IIEA Economic Governance Group's previous submission were adopted in the report as well as evaluating the proposals as a whole.

1. Overview of Five Presidents' Report

The IIEA Economic Governance Group supports the need to advance the process of deepening Economic and Monetary Union (EMU). While the Five Presidents' Report covers several economic and fiscal issues, as well as issues of democratic legitimacy, which are reflected in the IIEA's submission, the report is too short on detailed proposals to form any strong view as to how things may develop in practice.

The Need for Urgency

The IIEA Economic Governance Group is concerned with the lack of urgency displayed in the report and strongly believes in the need for faster progress in reforming economic governance in the Eurozone. Any delay in introducing the necessary reforms may leave the EMU at risk of future economic and financial difficulties.

Given the difficulties encountered in the euro area in recent years, which showed the need for the further development of EMU, it would be expected that the Five Presidents would therefore put forward an urgent and substantive plan of action to complete EMU. Instead, the view of the group is that the Five Presidents have produced a disappointing set of proposals envisaging little of real substance for Stage 1 (to mid-2017) and a Stage 2 with no deadline, apart from the Final Stage to be completed by 2025.

While the IIEA looks forward to the Commission White Paper, which will further explore the legal, economic and political preconditions of the proposals, it would be better if the White Paper could be delivered earlier than Spring 2017 in order to get Stage 2 underway as soon as possible.

Internal Conflict

The background to this Five Presidents' Report is one of intense internal conflict within the European Union, most clearly demonstrated by the economic problems of Greece and the intention of the UK to hold a referendum on continued EU membership. The explicit suggestion by a leading German politician and negotiator of a "temporary Greek exit" from the euro zone seriously undermines the premise articulated in Section 1 of the report that "all members of our Monetary Union have given up their previous national currencies, once and for all, and permanently share monetary sovereignty with other euro area countries." (page 4)

Small States in the Eurozone

The key issue for small Member States (MS) is the difficulty in combining supranational rules, which promote growth and stability within the Economic Union, while allowing those states to develop their economies in the ways which best suit their particular characteristics, in such a way that ensures each economy has the structural features to prosper within the Monetary Union.

The Five Presidents' Report does recognise this in broad terms, which should allow some backing for arguments to maintain this combination. It says that the euro area will need to shift from a system of rules and guidelines for national economic policy-making, to a system of further sovereignty sharing within common institutions. "In practice, this would require MS to accept increasingly joint decision-making on elements of their respective national budgets and economic policies." (page 5)

A critical question is whether the approach should be the minimum necessary to achieve these goals, or whether the emphasis will be on maximum joint decision-making, on the supposed grounds of safety. One would therefore be happy with the comment: "In some areas, this will need to involve further harmonisation. In other areas, where different policies can lead to similarly good performance, it will mean finding country-specific solutions." (page 9)

Clarity Required

There is still room for argument, though, on the Five Presidents' suggestion on where common standards should focus primarily: labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base). No evidence has been produced to show that these should be the primary areas for common standards in a successful EMU.

The report includes some unusually precise suggestions – particularly that the standards for labour markets "should combine security and flexibility and could be developed along the various pillars of the 'flexicurity' concept (e.g. flexible and reliable labour contracts that avoid a two-tier labour market)" (page 9). That is a perfectly respectable opinion but there are other equally respectable opinions, such as that labour market policies depend on initial levels of productivity, or that the post-crash employment gains in Ireland and the UK merit further examination as to the success of different approaches.

2. Towards Economic Union – Convergence, Prosperity and Social Cohesion

The Five Presidents' Report correctly points to the inevitability of more sovereignty being shared over time through common institutions. But it defers any such development to at least the second stage. This may be due to recent political developments but it lacks ambition by not even trying to move quickly to shore up the obvious defects in the present EMU.

The first stage outlined in the report includes the completion of the Single Market (including energy, digital and capital markets), creating "stronger public institutions" (although the precise meaning is not clear) and legislation for the 2011 Euro Plus Pack by the Community method.

The action suggested in relation to the 2011 Euro Plus Pact includes:

- a euro area system of Competitiveness Authorities;
- strengthened implementation of Macroeconomic Imbalance Procedure (MIP) (dealing with asymmetry problems currently encountered);
- a greater focus on employment and social performance, including in the European Semester process (i.e. a move away from exclusive insistence on short-term fiscal adjustment measures); and
- stronger coordination of economic policies in a revamped European Semester (including periodic reporting on implementation, cross-examination and benchmarking of performance, better integration of euro area and national level dimensions and a stronger multi-annual approach). The revamp of the European Semester would involve the Commission participating in a "Parliamentary week" in each MS.

All of this is welcomed and the insistence on using the Community method seems to signal an intention to step back from the slide in recent years towards intergovernmentalism.

The IIEA Economic Governance Group reiterates, nevertheless, its concerns on whether the political mindset is ready to accept further pooling of sovereignty and the implicit institutional interference in national policy making. The point is well made that bargaining only works as long as all MS gain from it, but for this to happen all MS must work to improve the resilience of their economies.

Competitiveness Authorities

The IIEA submission on the Analytical Note pointed to the shortcomings of addressing the imbalances simply by urging MS under pain of financial penalty to carry out recommendations and reforms under the MIP procedure. We therefore, welcome the recommendation of a euro area system of Competitiveness Authorities, in line with our suggestion. Such an independent body would inform national policy makers and social partners of the impact on competitiveness of various policy proposals as well as wage and productivity developments, thus helping MS to avoid the buildup of imbalances.

This should improve the operation of the MIP process and the Country Specific Recommendations (CSRs), which in turn could form the conditionality that would create more trust between MS in moving towards more pooled risk sharing and stabilisation referred to below.

While a euro area system of Competitiveness Authorities may well be a useful addition, it should also be noted that Ireland has had such a body for some time without it preventing a loss of competitiveness.

Macroeconomic Imbalance Procedure

The Five Presidents' Report calls for a stronger MIP which would capture imbalances for the euro area as a whole. It is also significant that the report calls for adequate reforms in countries accumulating large and sustained current account surpluses. This is a very important suggestion, given the way in which the surplus countries have been able to ignore advice from the Commission and others up to now. The report states that the MIP should "foster adequate reforms" in such surplus countries. However attempts to successfully "foster" surplus reductions may require significant reforms to the rules governing such matters. Again the details on this will have to be outlined in the Commission White Paper.

European Semester

The IIEA Economic Governance Group supports the strengthening and simplification of the European Semester procedure, such as focusing on a limited number of priorities, and in particular the suggestion that the focus initially should be on the euro area as a whole and then on the country-specific discussions. It is right to hold MS accountable for the delivery of commitments, while allowing them political discretion on implementation measures.

Some movement along these lines is implicit in the IIEA's previous submission. These include the periodic reporting on implementation of agreed policies, regular peer reviews or a 'comply-or-explain' approach.

The IIEA Economic Governance Group agrees that in the convergence process, common standards around all the aspects of competitiveness should prevail, be incorporated into the CSRs and their implementation be conditional to participation in shock absorbing and fiscal stabilization mechanisms. This could eventually lead to the possibility of a somewhat enlarged EU budget including a competitiveness instrument or limited social insurance, all of which should be addressed in the Commission White Paper.

3. Towards Financial Union - Integrated Finance for an Integrated Economy

Section 3 proposes that common high-level standards for the economic convergence process, involving a greater degree of shared sovereignty, should be defined in EU legislation and that significant and sustained convergence towards "similarly resilient economies" should be a condition for access to a shock absorption mechanism for the euro area.

For the completion of Financial Union, it is proposed that there be:

- a common deposit insurance system,
- a Capital Markets Union,
- a bridge funding mechanism to cover the period up to the achievement of a Single Resolution Fund (SRF) (operative from 01/01/16),
- a backstop for the SRF (possibly the ESM) financed by ex-post levies on financial institutions,
- large exposure limits to banks' holdings of sovereign debt, and
- a macro-prudential toolkit for the Capital Markets Union, including a single capital markets supervisor.

The completion of the Banking Union and the development of a Capital Markets Union are both desirable developments. The proposal to launch a European Deposit Insurance Scheme is to be welcomed.

Capital Markets Union

The breakdown of the financial system and the continuing failure to break the link between bank and sovereign debt brings added urgency to rapidly advance all aspects of a full Banking Union. The development of a true Capital Markets Union would also help share the risks of asymmetric shocks. The main impetus here is to bring, particularly to those MS less familiar with raising private capital, the understanding of matching the demand for and supply of capital in one market. This so far has not been clearly expressed in in the Commission's approach to a Capital Markets Union.

4. Towards Fiscal Union - an Integrated Framework for Sound and Integrated Fiscal Policies

For the completion of Fiscal Union, the Five Presidents' Report proposes that:

- "the sum of national budget balances leads to an appropriate fiscal stance at the level of the euro area as a whole … to avoid pro-cyclical fiscal policies at all times" (page 14);
- there be a euro area-wide fiscal stabilisation function; and
- an advisory European Fiscal Board be set up, with a strengthening of the roles of national fiscal boards.

The institution of a euro area Treasury is suggested as a long-term possibility.

European Fiscal Board

The proposal for an advisory European Fiscal Board along the lines of the national Fiscal Advisory Councils could be useful if it focuses on the overall stance of fiscal policy. But the proposal seems to go beyond this, suggesting that the Fiscal Board make judgements on the national fiscal stances and Stability Programmes/Draft Budgetary Plans. It is difficult to see the merit of another body looking at national developments alongside the Commission and the national Fiscal Councils.

This looks on the surface like an extra advisory council, which shows a lack of trust that MS will abide by the spirit of the rules. However, experience with the Irish Fiscal Advisory Council (IFAC) suggests that this system may need more support from Europe. It may well be possible to devise a European Fiscal Board which would back up the work of the national bodies without it becoming an appeals body and supplanting the role of the national bodies.

Euro Area Treasury

This board would be part of moves to some kind of Eurozone treasury, and some pooling of debt, which will require more democratic legitimacy. The report says MS should continue to decide on taxation and the allocation of budgetary expenditures according to national preferences and political choices. However, "as the euro area evolves towards a genuine EMU, some decisions will increasingly need to be made collectively while ensuring democratic accountability and legitimacy. A future euro area treasury could be the place for such collective decision-making." (page 18)

It is not clear which decisions need to be taken collectively. A clear distinction needs to be made between procedures designed to prevent states breaking the existing rules, or dealing with those which have done so, and economic union which does not, per se, require states to follow harmonised economic policies – as can be seen in any large federal nation state, not to mention a confederation, which is what EMU would be in all but name.

Stabilisation Function

The report points out that all mature Monetary Unions have put in place a common macroeconomic stabilisation function to better deal with shocks that cannot be managed at the national level alone. It suggests that this would be a natural development for the euro area in Stage 2 to improve the cushioning of large macroeconomic shocks. This is an important though complex proposal and work on designing such a mechanism should be started immediately as it will take time to develop.

5. Democratic Accountability, Legitimacy and Institutional Strengthening

The report once again tries to improve the interaction with national Parliaments. While the Irish Parliament has been giving more attention to the European Semester process and the country-specific recommendations, this is still at a fairly superficial level and needs to be developed into a more in-depth process.

The IIEA supports the suggestion that national parliaments exercise their right to summon a Commissioner for a presentation on draft budgetary plans or recommendations under the Excessive Deficit Procedure and that national parliaments should be closely involved in the adoption of Reform and Stability Programmes.

The Commission would have to work out model arrangements for these interaction with national parliaments. It would seem wise to accept that there will not be a European polis, and therefore there will not be a European government. The relationships between national parliaments, national governments and the European institutions are not the strongest foundation on which to build a legitimate economic and political union, but they are all that is available.

Consolidation of the external representation of the euro has been an on-going issue, particularly at the IMF, with individual countries being unwilling to give up their separate representation. It is time to make further progress in this area.

The report suggests that a future euro area Treasury could be a place for collective decision-making on fiscal policy. This is a useful suggestion, though it is not included in the recommendations of Stages 1 and 2. It certainly needs to be examined at an early stage in order to develop proposals for future adoption.

Elements of IIEA submission contained in Five Presidents Report

The following concerns of the IIEA Economic Governance Group appear to be met in substance:

Section 2 - Towards Economic Union – Convergence, Prosperity and Social Cohesion

- Full implementation of the Stability and Growth Pact and MIP in every MS
- MIP should better capture imbalances for the euro area as a whole, with focus on correcting harmful deficits and fostering reforms in surplus countries driven by insufficient domestic demand or low growth potential
- An improved approach to issues of competitiveness taking into account the need for some form of local involvement with social partners to gain ownership of reforms (and EU Parliament and MS should have deeper input into the Annual Growth Survey)
- The introduction of a Competitiveness Authority in each MS
- The difficulty of slow price adjustments compared with exchange rate adjustments
- The problem of partial EMU – single monetary policy, no economic or fiscal union

Section 3 - Towards Financial Union – Integrated Finance for an Integrated Economy

- The need for a complete Banking Union and a Capital Markets Union

Section 4 - Towards Fiscal Union – an Integrated Framework for Sound and Integrated Fiscal Policies

- As well as the adherence to the Excessive Deficit Procedure (EDP) and MIP procedures and performance of Country Specific Recommendations becoming a condition for MS to participate in shock absorption and stabilization measures where large-scale transfers between MS are not foreseen (and where labour mobility is relatively limited)
- Development of the roles of national fiscal advisory bodies
- The problem of enforcement at times of fiscal difficulties
- Development of a euro area fiscal stance

Section 5 - Democratic Accountability, Legitimacy and Institutional Strengthening

- Full governmental transparency and parliamentary scrutiny, with the involvement of the Commission at MS level.
- The need for a change in mindset if MS are to shift to a system of further sovereignty sharing and acceptance of increasingly joint decision making on elements of their national budgets and economic policies