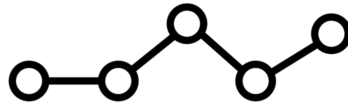

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POLICY BRIEF

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Repair and Prepare: Growth and the Euro after Brexit – a comment

Ricardo Cabral rcabral@uma.pt
Luís Teles Morais luistm@ipp-jcs.org
Joana Andrade Vicente joanav@ipp-jcs.org

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This policy brief analyzes the "Repair and Prepare: Growth and the Euro after Brexit" report, (hereafter, the report). The report proposes a policy toolkit to strengthen the Economic and Monetary Union (EMU) and is an important contribution for the discussion regarding improvements to the euro area architecture. Such improvements are required in order to avoid further crisis and to ensure economic stability and growth in the euro area. The report is comprehensive and nuanced, with an array of detailed policy ideas within each group of proposals.

It is not possible to do the report full justice in this short policy brief. As a consequence, the aim of this brief is to identify and analyze the report's main strengths and weaknesses and we focus only on the first "two blocks" of the report. The "third block" represents the vision of the report's authors for the long term and, as such, is still quite vague.

The report implicitly acknowledges a few of the many political constraints of the (EMU). In particular, its proposals are designed to partly address problems in euro area governance and the lack of significant fiscal transfers between euro area member countries. In our view, the problems in governance arise from the nature of the main intergovernmental "executive bodies" of the euro area: the European Council and the Council of the European Union, foremost in its Ecofin/Eurogroup modality. It is very difficult to come to an agreement in those *fora* because they often work as a zero-sum negotiation game: typically, a solution for a given country's problems imposes costs on the remaining member countries. These incentives and effects are counterproductive, from the perspective of the euro area as a whole. Examples of those types of intergovernmental negotiations include the search for solutions to respond to Italy's Mediterranean immigration crisis, or the UK's repeated concerns about intra-EU migration to the UK, which ultimately led to the for-"Brexit" vote.

Furthermore, there is currently a strong political unwillingness to transfer fiscal resources among member countries, from richer to poorer countries, i.e., some degree of fiscal redistribution. Not only can this arguably make the euro area inherently more unstable but it has also, hampered the development of risk sharing facilities for the EMU, long known to be important to enhance the area's capacity to respond to crisis and, in particular mitigate the effects of asymmetric shocks, to individual member countries.

While the report does not recognize or characterize these fragilities explicitly, it proposes a piecemeal approach that implicitly recognizes and partly addresses those two types of political obstacles (which we designate here as "political impossibilities"), in a manner that could probably be politically acceptable. This is one of the main contributions of the report: it designs a possible policy implementation path that would result in a euro area institutional arrangement that would likely be more robust than the current framework. This is crucial if the euro area is to overcome future economic crisis and is to ensure sustainable and balanced growth for its member countries.

The report emphasizes the idea that the EMU is in an urgent need of strong economic performance, which will help to strengthen it politically, and to consolidate the euro as the currency of the euro area and, ultimately, the EU.

1 Henrik Enderlein, Enrico Letta, Jörg Asmussen, Laurence Boone, Aart de Geus, Pascal Lamy, Philippe Maystadt, Maria João Rodrigues, Gertrude Tumpel-Gugerell and António Vitorino (2016). *Repair and Prepare: Growth and the Euro after Brexit*. Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin, and Jacques Delors Institute – Paris.

2 The European Stability Mechanism was created in 2012 in part to address this weakness, and has a theoretical lending capacity of approximately 500 billion euros.

Essentially, the report proposes a step-by-step transfer of fiscal resources and policy powers (sovereignty) towards an unstated Federal Union – which requires growing pools of fiscal funds, available to (non-elected) euro area decision makers, avoiding the need for intergovernmental negotiations in addition to authorizations national parliaments.

Notwithstanding the merits of the proposals, which would indeed partly address current weaknesses, the first two blocks of proposals discussed in the report – regarding the three building blocks that comprise the reform plan – are likely not sufficiently large to stabilize the EMU as aimed, given large legacy imbalances from the past.

Regarding the first issue, there is enormous resistance regarding the implementation of moderate or large fiscal transfers between member countries. The European Union does not even have "the tools required to create an effective policy mix by coordinating the fiscal policies of its members or by stabilizing the euro area through EU-level action", as mentioned in the report, despite the fact that a majority of Europeans think that there should be some solidarity amongst the euro area member states.

The report argues that although the European Central Bank (ECB) role was extremely important in stabilizing the euro in 2012, its intervention was meant to be only temporary, partly overlooking the fact that the ECB asset purchase programme - a quantitative easing programme -, which started in March 2015, has had a much larger effect on economic activity and financing conditions in the euro area. Thus, the report, seems to implicitly criticize this expanded role of the ECB, when it argues that European governments rely excessively on the ECB for the stabilization of the system in times of crisis. In fact, in our view, through its unconventional monetary policy (key reference rates below zero, quantitative easing), the ECB has been the EMU "savior-of-last-resort", by implementing an appropriately sized euro wide economic policy. Monetary policy has been key to the economic and

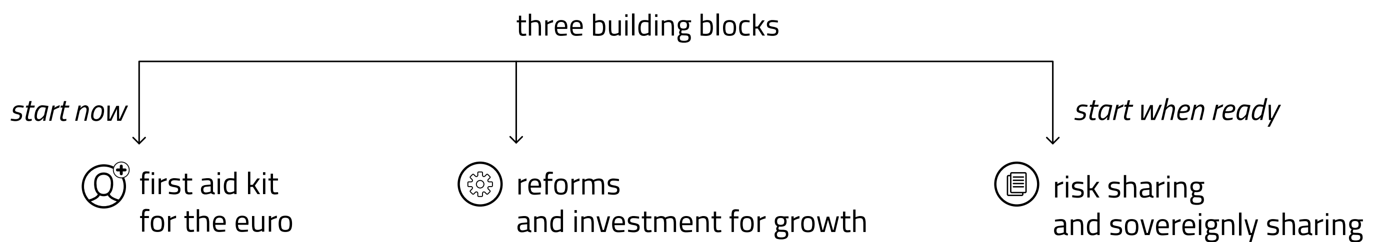

Figure 1. Three building blocks for the reform plan proposed Enderlein, Letta, *et al* (2016)

Source: modified from Enderlein, H., Letta, E. *et al.* (2016) (see footnote 1 for full reference).

What are the "political impossibilities" of the EMU?

The political impossibilities which the report seeks, implicitly, to address are:

1. Fiscal transfers between member countries;
2. The role of the European Central Bank;
3. Transfers of sovereignty away from member countries towards a "central federal government".

employment growth observed in the last 15 quarters. But even so, the effects of the ECB asset purchase programme only provide a temporary respite from the legacy imbalances that have accumulated between euro area member countries.

In order to understand the role of the ECB in a monetary union, and to contextualize the report's criticism, it is important to note the following operational constraints of the ECB:

- It does not guarantee interest rates compatible with sovereign debt sustainability;
- It is not lender-of-last-resort for sovereigns; and
- It is lender-of-first-resort for banks, but it is not lender-of-last-resort.

Concerning the first two points, one can argue that, in the implementation of the European Financial Stability Facility and the ESM, EU member countries were able to share risk and sovereignty. Notwithstanding, these institutions do not have the necessary scale, given the size of the euro area economy and of some of its member countries. Thus, they would likely not have sufficient resources to respond to a large crisis and to stabilize the euro, should the need arise.

Of course, the euro area has other political impossibilities, which we do not address here.

How can the EMU survive?

Right now, the only way for the EMU to work is if all member countries run, on average, a balanced or in surplus current account. And in fact, euro area austerity policies in response to the euro crisis have resulted in a very large improvement of the current accounts of the crisis countries, which are also those countries that traditionally ran current account deficits. As a result, the euro area as a whole ran a current surplus of approximately 3.5% of GDP in Q42016 larger than China's. Germany reached a current surplus of 8.3% of GDP, and Netherlands 8.4%.

This is an unsustainable situation. These very large surpluses by the euro area and by Germany represent a problem for the euro area and even for the world economy, since they depress economic growth in the rest of the world.

The substantial and continuous reliance on net exports by the euro area – a type of mercantilist policy – and Germany leading role in defining the euro area economic policy to the image of Germany's "successful" export-based economic model, leads to the question: do we not have today a "German euro area?".

In our opinion, the continuing survival of the EMU depends on an objective assessment, appropriate consideration and answer to the following questions. It is not the case that:

- The problems of the euro area are a consequence of the political impossibilities, which ignore economic reality at great cost?
- Economic policy designed to circumvent political constraints (e.g. the report) may have to opt for second-best economic solutions (work-arounds) that do not quite work as well as the first-best solutions?
- Blocks 1 and 2 of the report (addressed in detail in the next sections), which may be implemented in the short-term, are large enough to avoid the collapse of the euro area?

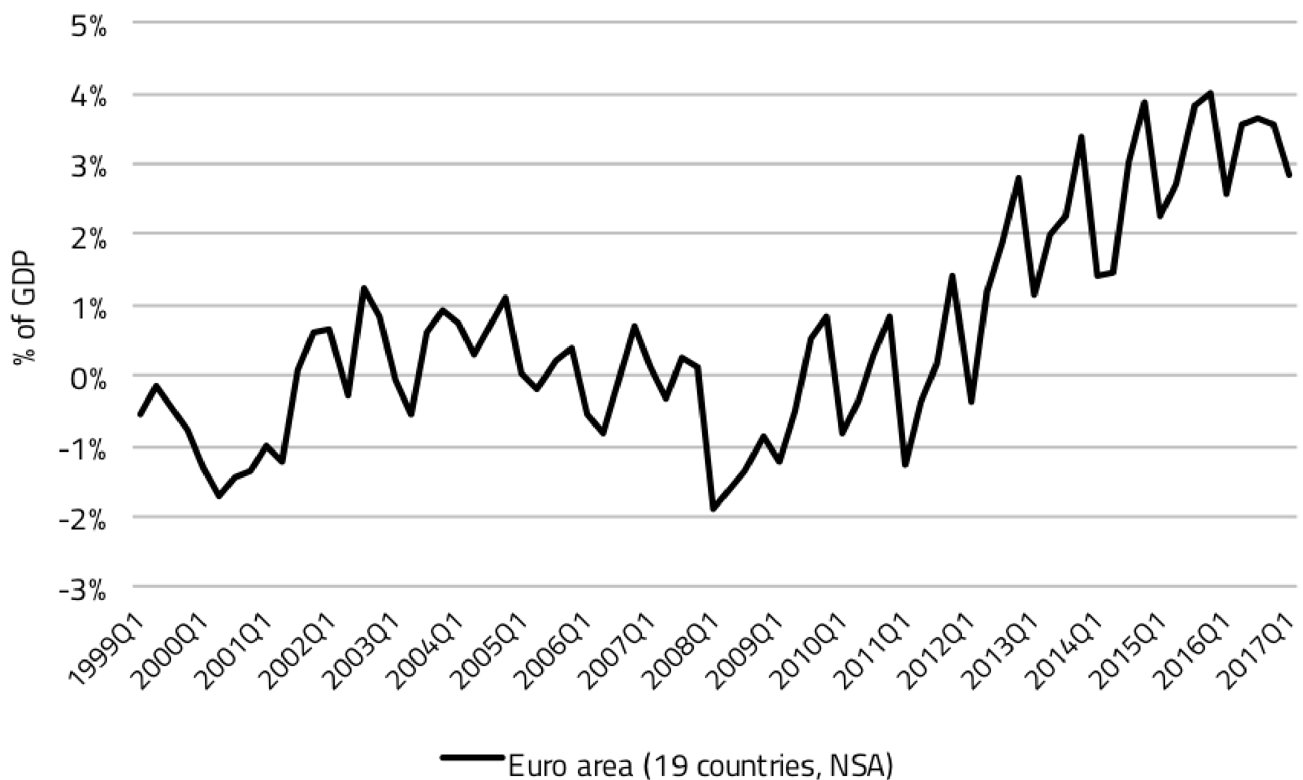

Figure 2. Euro area current account balance

Source: Eurostat

Report implicitly acknowledges political constraints and proposes work-arounds

The first block of solutions proposed in the report focuses on a solution to ensure sustainability of member countries' sovereign debt, a problem which is still in need of a morerobust answer. The authors propose what we would call "creeping" fiscal transfers. They suggest an upgrade of the ESM, terming it "ESM+". It would be initially prefunded with €200bn war chest, for which all the subscriber countries would be jointly liable.

This would be a building block towards a true European Monetary Fund, which should have the stated goal of having fiscal resources of up to 10% of euro area GDP (~€1.0 trillion).

The ultimate aim of having such a pool of fiscal funds to respond to crisis in individual member countries is really to avoid sovereign debt default and to avoid sovereign debt trajectories that become unsustainable. The mere existence of the

funds could work as a signal to markets regarding the safety of member countries sovereign debts. Through sovereign debt purchases or government loans with conditionality, it would contribute to put in place an upper bound to sovereign debt interest rates, thus providing added stability to markets and to public finance management. In our view, however, this is clearly a “second best” to intervention by the central bank.

Also, loans to member countries would necessarily require strict conditionality a la IMF. This would involve partial sovereignty transfer only for those member countries that require ESM+ bailouts (rather than as part of a uniform, Union-wide process). This could potentially worsen political tensions, especially since legacy imbalances may suggest a priori which countries would be "the first" to resort to the fund.

Problems with first block

The first block solution proposed in the report is reminiscent of discussions at the Bretton Woods conferences, by adopting the solution, defended (imposed) by the US, that prevailed in the final Bretton Woods agreements: balance of payments crises would be addressed through a multilateral lending facility (the IMF), which would provide loans on strict conditionality. It can be argued, however, that the proposal that did not prevail during the Bretton Woods negotiations, the International Clearing Union might be a superior alternative to IMF led bailouts. Thus, if the euro area is designing a bailout mechanism around the ESM, should it only have the IMF – designed in the 1940s –, as a role model, or should it not consider whether it is possible to improve on the IMF? Our view is that the report, and other similar proposals, must look into alternative solutions for a multilateral lending facility in the euro area, even if it the end it would opt for an ESM+ modelled after the IMF.

Also, the size of the "rapid-response facility" proposed in the report might be insufficient: note that if, as proposed, it was limited at €200bn, only the amounts required for the bailout of Portugal and the first bailout of Greece would have exhausted it.

“(…) [W]hen a management with reputation for brilliance gets hooked up with a business with a reputation for bad economics, it's the reputation of the business that remains intact.”
Warren Buffett

The report proposes that the ESM+/EMF would loan funds on strict conditionality and, in time, its president would become the euro area minister of finance. The implicit logic of strict conditionality and “central government” of that proposal is, to a certain extent, based on the belief that public finances in euro area debtor countries would benefit from a supposedly wiser, more competent administration by European Commission, the ESM+ or any form of central or federal government. However, decision-makers’ competence is very likely not the key issue at hand. Moreover, in the current scenario, not only does the appropriate political framework not exist, but European institutions lack scale, governance, adequate staff levels, democratic scrutiny, and feedback mechanisms to function properly.

Banking Union

The report argues for the completion of the set of European legislation known as the Banking Union. However, it is necessary to consider that the Banking Union also seem to be a sub-optimal

solution to deal with structural EMU deficiencies that affect most directly member countries' banking systems and sovereign debt.

The main purpose of bank regulation and supervision (including resolution and deposit insurance facilities) is to ensure financial stability, i.e., to minimize the likelihood of bank failures and their impact when they occur, to promote sound credit policies, etc. Thus, the ultimate theoretical aim of the bank supervision and regulation is to preserve economic activity and to promote economic growth. The objective of bank regulation and supervision is not to break the so-called bank-sovereign nexus, important as it may be.

It is necessary to keep that distinction in mind, but that does not seem to be the case with the EMU, the Banking Union, whose often-stated objective is precisely that. As a consequence of this misguided aim, in fact, the Banking Union seems to be worsening divergences in the EMU. It also results in an excessive concentration of powers in the ECB. In this respect, reports seem to be headed in the right direction because it advocates a Banking Union with a greater degree of (implicit) fiscal transfers or risk sharing.

Reforms and investment

In this second pillar, the report follows the same approach as with ESM+ and Banking Union, aiming at a "second best" approach.

The key initiative proposed here is a strong public investment programme, but other measures envisioned are also important. Examples are suggestions such as a change in statistical rules for investment outlays (relevant for the Excessive Deficit Procedure), and earmarking national tax revenues for a euro area-wide investment programme.

Focusing the analysis on the public investment programme measure, the report suggests starting small (initially), which implicitly seems to mean that each country would approximately get as much funds as it provides to the European investment program. Thus, at least initially, the European investment program seems to foresee no fiscal transfers between member countries. This is a key weakness of the proposed investment program, but it is understandable given the degree of political resistance to the idea of overt fiscal transfers between member countries.

The likely result is that, over time, investment spending in the euro area would be progressively transferred from national governments to a euro area government, with larger fiscal transfers occurring between member states. However, the size of investment programme and of fiscal transfers is not quantified.

Concluding remarks

The report is an important attempt at improving the institutional framework and the architecture of the EMU. It prioritizes political expediency and feasibility over economic rationality, which means that the economic solutions that it proposes are second best solutions designed to circumvent some of the “political impossibilities” embedded in the EMU project.

Still, they represent an important step forward that would reinforce the EMU architecture and have a realistic, if small, probability of implementation given its overwhelming political logic. But we should not delude ourselves into believing that the report proposals are enough to address the euro area architecture fragilities.

Blocks 1 and 2 do not seem sufficient to stabilize EMU, nor do they seem sufficiently large to respond to a new crisis, particularly given legacy imbalances, in terms of high (youth) unemployment, and in terms of high levels of public, private, and external debts by some euro area member countries. In this context, significant doubts about the feasibility of these solutions remain.

IPP Policy Brief 10 . july 2017
ISSN: 2183-9352

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Authors: Ricardo Cabral, Luís Teles Morais, Joana Andrade Vicente

Rua Miguel Lupi, nº20, 1249-078 Lisboa, Portugal
+351 213 925 986 info@ipp-jcs.org

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This policy brief is based on a talk prepared
for the Conference on "Repair and prepare: Growth and the Euro after Brexit"
in Lisbon, 22nd February 2017.

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The authors

Ricardo Cabral is Assistant Professor
at the University of Madeira
He is also a member of the Board of Directors at IPP.
rcabral@uma.pt

Luís Teles Morais is a researcher and executive director of IPP,
and teaching associate at ISEG - University of Lisbon.
luistm@ipp-jcs.org

Joana Andrade Vicente is a research fellow at IPP.
joanav@ipp-jcs.org

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