The New Political Economy of European Integration, Post-Crisis

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Outline

1. Euro Area Management of the Crisis
2. An Existential Crisis?
3. A Political Economy Perspective
4. The Way Forward: A New Synthesis Wanted
5. Deepening EMU
6. Can We Do It?

¹The opinions expressed are personal and should not be attributed to the European Commission.
1. EURO AREA MANAGEMENT OF THE CRISIS
A difficult transition

- **SLOW RECOVERY**
  - EA vs US
  - Risk of a Debt – Deflation Trap?

- **LOWER POTENTIAL OUTPUT GAP**
  - Declined from an estimated 2% in the pre-crisis period (2001-07) to 1/2% since then (2008-14). In the US, the decline was less pronounced from 2 ½ % to 1 ¼ %.
  - Weak and declining TFP

- **WEAK BANKS**
  - High NPL
  - Structural weaknesses
Equipping ourselves

• REFORM OF GOVERNANCE
  ➢ CRISIS MANAGEMENT
    ➢ European Financial Stabilisation Mechanism
    ➢ European Financial Stability Facility
    ➢ European Stability Mechanism
  ➢ CRISIS PREVENTION
    ➢ Fiscal Framework
    ➢ Macroeconomic Imbalance Procedure
    ➢ Banking Union

• VULNERABLE COUNTRIES ARE RECOVERING
  ➢ Ireland, Spain and even Portugal
  ➢ Greece: a case apart
Crisis Response

**Fiscal compact**
- More effective preventive arm of SGP
  - Expenditure benchmark
- Better enforcement of rules
  - New Regulation on Sanctions
  - New Directive on national budgetary frameworks
- Focus on debt developments
  - Numerical benchmark in the corrective arm of the SGP
- Sound fiscal policy
- Prevention and correction of macro imbalances
  - New surveillance procedure and possible sanctions
- EU Semester
- Balanced growth
- Regulation, supervision and resolution of financial market
- Macro-prudential supervision
2. AN EXISTENTIAL CRISIS?
## Convergence and Divergence in the EA

<table>
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<tr>
<th>Pre-EMU</th>
<th>First EMU decade</th>
<th>(Post)-crisis period</th>
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| • Nominal convergence  
  • Real convergence | • Real convergence  
  • Structural divergence | • Nominal divergence  
  • Real divergence  
  • Structural convergence |
| • Capital flows from core to periphery  
  • Convergence in nominal interest rates and inflation  
  • Income-per-capita convergence | • Sustained capital flows; periphery overheats  
  • Competitiveness losses and Growing share on non-tradable output in periphery, housing bubbles  
  • Competitiveness gains and "small economy" syndrome the in Core | • Capital outflows from periphery; divergence in interest rates  
  • Countries with lower income per capita stop growing faster  
  • Incipient competitiveness gains in periphery; output re-composition away from non-tradables |
The First 10 Years of EMU

- **REFORM ANAESTHESIA**
  - During the period of relatively strong growth following the creation of the EMU, many EA Countries disregarded the structural reforms

- **"SUPER WALTERS" EFFECT**
  - Not only cyclical positions, but also economic structures were driven by persistent real rate differences

- **HIDDEN FISCAL INDISCIPLINE**
  - Non-Core Countries spent the EMU bonus
Structural Convergence: Tradable vs Non- Tradable

Note: Note: countries grouped according to their external position.
EA group A: BE DE LU NL AT FI EA; EA group B: EE IE EL ES FR IT CY LV LT MT PT SI SK; Rest of EU DK HR SE UK BG CZ HU PL RO.
Current Account Balances

Widening before the crisis, asymmetric rebalancing afterwards

Note: countries grouped according to their external position.
EA group A: BE DE LU NL AT FI EA; EA group B: EE IE EL ES FR IT CY LV LT MT PT SI SK; Rest of EU: DK HR SE UK BG CZ HU PL RO.
Real Convergence: Unemployment

Convergence up to the crisis, divergence afterwards

Note: countries grouped according to their external position. EA group A: BE DE LU NL AT FI; EA group B: EE IE EL ES FR IT CY LV LT MT PT SI SK; Rest of EU: DK HR SE UK BG CZ HU PL RO. Moving aggregate - countries included according to availability.
Spending the automatic fiscal benefits of EMU

PRIMARY DEFICIT, INTEREST BURDEN

PUBLIC DEBT

PRIMARY DEFICIT VULNERABLE COUNTRIES
INTEREST BURDEN VULNERABLE COUNTRIES
PUBLIC DEBT VULNERABLE COUNTRIES

Launch of the €
Lehman Brothers
EFSF
Banking Union+
"Whatever it takes" (Draghi)
3. A POLITICAL ECONOMY PERSPECTIVE
A Crisis of Trust

DIFFERENT READING OF THE ORIGIN OF THE CRISIS ROOTED IN THE STRUCTURAL DIVERGENCES OF THE FIRST 10 YEARS OF EMU

- Fiscal indiscipline
- Financial regulation failure
- Lack of competitiveness in the South
- Mercantilism in the North

- GREECE PLUS "LAW OF CREDITORS" SET THE TONE
- THE "ULTIMA RATIO" LOGIC PREVAILED
The "Ultima Ratio" Logic

DENIAL

PUT YOUR HOUSE IN ORDER

ACKNOWLEDGEMENT OF A COLLECTIVE PROBLEM, BUT TOO LITTLE TOO LATE

BOLD SOLUTIONS FACING THE ABYSS

BACKTRACKING WHEN SITUATION IMPROVES

"It's an American crisis, not an EA one"

"Correct fiscal profligacy in peripheral countries"

Greek Loan Facility

ESM, BU
"Whatever it takes"

Current phase?
4. THE WAY FORWARD: A NEW SYNTHESIS WANTED
Trust in the Institutions

From Eurobarometer Standard, 2015
Trust in the Institutions

From Carparelli and Ferri, 2014

Lehman Brothers + EFSF

Banking Union
decision
"Whatever It Takes" (Draghi)
The single currency: for it or against it?

From Eurobarometer Standard, 2015
Trust in the Future

From Eurobarometer Standard, 2015
Trust in the Euro

- Launch of the €
- Lehman Brothers
- EFSF
- Banking Union decision + "Whatever It Takes" (Draghi)
OVERCOMING INCONSISTENT TRINITIES...

EMU was built on the Mundell – Padoa Schioppa Impossible Trinity: one cannot have at the same time fixed exchange rates, independent monetary policies and free capital movement (and a single market *tout court*)

BUT OTHER INCONSISTENT TRINITIES HAVE COME TO THE FORE:

A. INCONSISTENT POLITICAL TRINITIES

B. INCONSISTENT POLICY TRINITIES

... TO ACHIEVE A NEW SYNTHESIS
Inconsistent **POLITICAL** Trinity

a) Political Integration

- Deep political integration
  - More European federalism and a more accountable EU
  - Inter-governmental decision making and concerns about democratic deficits

- Traditional democratic processes → Nation state
  - Subsidiarity, domestic checks and balances, 'accountable intergovernamentalism', national vetoes, ineffective, EU (pre-SEA)
Inconsistent **POLITICAL Trinity**

b) Institutional Relations

Government develops a positive narrative on EU integration so citizens understand why certain choices are made collectively at EU level and national sovereignty is devolved to the EU/EA in certain matters.

Eventually, and the contradiction between preaching Brussels and blaming at home becomes untenable. As a result, populist, anti-EU parties flourish.

Support for devolving competences to the EU gets eroded and EU integration is rolled back resulting in sub optimal nation repatriation.
Inconsistent POLITICAL Trinity

c) Global Governance

ROLE IN GLOBAL GOVERNANCE

Overcome fragmentation of external representation

Tangle of bilateral arrangements

PREFERENCE FOR MULTILATERAL SOLUTIONS

No weight of Europe in multilateral arrangements

DISPERSION OF EXTERNAL REPRESENTATION
A New POLITICAL Synthesis

- Positive Narrative on European Political Integration (Domestic Task)
- Unified External Voice (Global Task)
- Overcoming Intergovernmental Coordination (EU Task)
Inconsistent POLICY Trinity

a) Social and Fiscal Viability

Unambitious Structural Reforms

- Cuts in social spending undermine European Social Model
- Increase in social spending resulting in unsustainable finances

Sound Fiscal Policies

Generous Welfare

Need to boost Potential Growth
Inconsistent **POLICY** Trinity

b) Adjustment Objectives

- **Inflation Consistently Below Target**
- **High Inflation in the core**
- **Risk of a Debt – Deflation Trap**
- **Sustainability of High Debt Burdens**
- **Competitiveness Gains in Vulnerable Economies**

ECB to deliver Price Stability
Inconsistent **POLICY Trinity**

c) Restoring financial integration and stability

Financial Stability

- Back to financial nationalism
- Banking Union and Capital Market Union

Integrated Financial Markets

National Supervision and Resolution

High risks of financial instability and disruptive capital movements
A New POLICY Synthesis

Genuine BU and CMU

More Symmetric Adjustment

Deep Structural Reforms
5. DEEPENING EMU
Road map toward a complete EMU: The 5 P Report

**PHASE 1 → IMMEDIATE STEPS**

**PHASE 2 → COMPLETING THE ARCHITECTURE**

- Economic Union
- Financial Union
- Fiscal Union
- Democratic Accountability, Legitimacy and Institutional strengthening
Risk Sharing and Risk Reduction: Different MS preferences

- **EX ANTE RISK REDUCTION**
  - Strong economic coordination and strong governance
  - Rule-based fiscal policy
  - Preventive approach

- **EX POST RISK SHARING**
  - More emphasis on stabilisation
  - Risk sharing via central transfers
  - Rather corrective approach
Risk Reduction Instruments

- **STRINGENT FISCAL GOVERNANCE:**
  - Compliance with fiscal rules
  - Power to reject national budgets

- **ECONOMIC COORDINATION:**
  - Macroeconomic Imbalances Procedure
  - European Semester

- **BANKING UNION:**
  - Common supervision
  - Regulatory innovation to break bank-sovereign link (exposure limits, risk weighs)?

- **EFFECTIVE NO BAIL OUT CLAUSE:**
  - Procedure for orderly insolvency and debt restructuring?
Risk Sharing Instruments

• **MACROECONOMIC STABILIZATION:**
  - Unemployment insurance at EMU level
  - Stabilisation fund (transfers triggered by output gap developments)
  - Investment capacity

• **FISCAL BACKSTOPS**
  - Financial assistance instruments
  - Backstop for banking union: ESM?

• **PRIVATE SECTOR RISK SHARING**
  - Banking Union and Capital Markets Union to facilitate private sector risk sharing
Risk Reduction **CUM** Risk Sharing: Fiscal

- Stringent fiscal rules to allow for the full play of economic stabilisers in bad times + discretionary policy margins

- Stabilisation capacity to provide ex post insurance for large shocks and to smoothen business cycle as risk sharing

- Credible prudent fiscal policy could reduce the sovereign rate spread in case of shocks ("confidence sharing")
Risk Reduction CUM Risk Sharing: Banking

- Common banking supervision to support risk reduction ...
- ... limiting the scale of risk sharing ensured by fiscal backstops (ESM) ...
- ... which break sovereign-bank feedback loop and raise confidence (lower risk-premia)
- Capital markets union to facilitate private risk sharing and complement public risk sharing
Democratic Accountability, Legitimacy and Institutional Strengthening

- Revamping the European Semester
- Strengthen Parliamentary Control
- Integrate the ESM into the EU law framework
- Toward a EA treasury
6. CAN WE DO IT?
Agreeing on an economic narrative for the crisis

- The EA crisis was NOT a fiscal crisis (apart from Greece)
- But lack of fiscal space hindered the policy response during the crisis
- The EA crisis was a "sudden stop" crisis following capital misallocation in pre-crisis years
- In the absence of policy space, crisis management tools, well-functioning markets, EA membership worked as crisis amplifiers
No overcoming the crisis without trust in the future

Eurobarometer Standard, 2013
Parallel progress on Risk Sharing and Risk Reduction: An economic, not only a political logic

- More fiscal risk sharing and a central Investment Capacity prevents overburdening the ECB
- More private risk sharing (via BU and CMU) allows less fiscal risk sharing
- A central risk sharing tool and investment capacity enhance the enforcement of the SGP at national level
There is a need for significant reforms to improve the performance of our economy? (% - TOTAL 'AGREE')

Overcoming Reform Anaesthesia is possible

Data from Eurobarometer Flash, 2015. Core Countries: BE DE LU NL FI; Periphery Countries: ES FR EL IT SI
The "Juncker Curse" doesn't need to apply

PROBABILITIES OF RE-ELECTION AND NO RE-ELECTION

1987-2007

- No reelection: 40%
- Reelection: 60%

- Elections preceded by reforms: 30%
- All elections: 70%

2008-2012

- No reelection: 50%
- Reelection: 50%

- Elections preceded by reforms: 40%
- All elections: 60%

PROBABILITY OF RE-ELECTION OF REFORMIST GOVERNMENTS

1987-2012

- High Financial Freedom Index: 70%
- Low Financial Freedom Index: 30%

- High government expenditure on GDP: 60%
- Low government expenditure on GDP: 40%
Thank you for your attention!