LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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COMPLETING THE ECONOMIC AND MONETARY UNION AND THE PIVOTAL ROLE OF ITALY

PART 1: ITALY'S RISK REDUCTION IS INDISPENSABLE FOR THE PROGRESS OF EUROPEAN INTEGRATION

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Executive Summary

This note argues that the Five Presidents' Report outlines an ideal roadmap for the completion of the EMU since it identifies the necessary milestones. However, the report has limitations and ambiguities pertaining to the actual contents of each milestone and the process has not been endorsed at the political level. We believe that there is an urgent need to resume negotiations on a European Deposit Insurance Scheme, the fiscal backstops for the resolution fund, and eventually, the creation of a European safe asset—jointly guaranteed by the member states—capable of providing financial intermediaries and investors with a riskless instrument for the management of their liquidity. This instrument would also represent a tool for risk sharing and a source of cheap financing for the ESM and its activities in promoting the financial stability of the eurozone. The responsibility for managing this European financial instrument should be entrusted to a euro area Minister of Finance, in charge both of establishing the appropriate fiscal stance for the area as a whole, overseeing and enforcing the common economic and budgetary policies, and taking responsibility for the orderly management of the common debt instrument.

Italy has a paramount role to play in facilitating such progress, by restoring full confidence in its budgetary and economic policies and by attacking with determination certain weaknesses still plaguing its banking and financial system. Economic convergence and stable financial policies in Italy would open the way to mend financial market fragmentation and elicit substantial capital inflows from the rest of the euro area to support the needed recovery in private investment. A separate Policy Brief by the LUISS—SEP examines in greater detail the Italian policies and presents a proposal for a contractual agreement between European Institutions and Italy to overcome weak confidence and bring private investment back to life.

Overview

The Financial Crisis (2008-09) and the sovereign debt crisis (2010-13) are both behind us. The European Union's economy is finally recovering, and labor market conditions are rapidly improving, including employment rates which are returning to pre-crisis levels almost everywhere.

However, certain important economic imbalances persist in the euro area, which need to be corrected: the investment rate remains exceedingly low (cf. the twin SEP Brief "A joint intervention for Italy: a non-punitive plan for investment and reform"); the current external balance shows a large surplus (3% of GDP), a reflection of even bigger imbalances within member states (Germany's current external surplus exceeds 8% of GDP); much of the large increase in public and private debt following the two crises still needs to be reabsorbed; real economic adjustment lags behind in a number of member states, which is partly reflected in the vast amount of banks' non-performing loans (some € 1 trillion for the Union). Moreover, there is a negative legacy in terms of social problems, which has been greatly aggravated by the twin crises of 2008-2012. Inside the euro area and each of the euro area member states, there was a polarization of income and wealth, with large numbers in the population falling below the poverty line; and too many youths neither working nor studying or in training, particularly in the Southern periphery. A significant question, in this regard, concerns Italy, one of the Union's biggest countries, which continues to lag behind the rest of the euro area in terms of growth, productivity, employment, sovereign indebtedness and banks' balance sheet repair.

An observable manifestation of these problems is the difference in the interest rate structure of peripheral countries and that of the virtuous 'core' countries of Central and Northern Europe—the infamous spread. The spread between different interest rates reflects the perceived borrower risk; when it applies to sovereign debt within the monetary union, it indicates the presence of an adverse national risk premium, which is inevitably extended to all the country's borrowers, systematically penalizing them with higher credit cost and lower credit availability (especially for smaller businesses). This influence can also imply a credit quantity rationing, thus impeding or retarding the transmission of the ECB's expansionary monetary policy to the very parts of the economy most in need of that stimulus. Moreover, the European financial market is fragmented; this fragmentation adds distortion to the transmission of monetary policy and reduces the shock-absorbing capacity of capital markets when cushioning financial shocks

A positive spread indicates, at its root, the existence of a redenomination risk—perceived or real, it matters little—that is the risk that the country may decide or be forced to leave the monetary union. In other words, it reflects the possibility that borrowers in that country will attempt to fulfill their commitments with a new and devalued national currency. These fears in turn denounce an underlying financial fragility—high sovereign indebtedness, under-capitalized banks and an underperforming economy—that could rapidly degenerate into a fully-fledged banking and financial crisis, closing access for the country to international capital markets, should international investors see a threat to their claims and run for the door. Those advocating Italy's exit from the euro need to know that would lead upfront to a banking and financial crisis, almost inevitably entailing the country's default on its sovereign obligations as well as widespread private defaults. Past experience shows that democracy may not survive an event of such magnitude, particularly where the country already suffers from weak institutions and fragmented political systems. Therefore, while much remains to be done to establish a more solid foundation for the Economic and Monetary Union (EMU), raising the alternative of abandoning it is utterly irresponsible.

This Brief argues that an adequate roadmap for the completion of EMU is contained in the Five Presidents' Report[1] (henceforth, the Report). It identifies four phases: a 'genuine" economic union, a financial union, a fiscal union, and, finally, a political union. It must be clarified that this process neither implies nor requires the EU's complete transformation into a federal state, but only the "federalization" of economic and political functions necessary for insulating the euro once and for all from destructive financial shocks.

Economic Convergence

One must start with economic union for obvious reasons: the existence of ample divergences in productivity and costs within the single currency area constitutes a major source of instability ultimately making the monetary union unsustainable. Therefore, a renewed convergence process is needed to make the economies of participating countries uniformly stronger and capable of withstanding the challenges of technological changes and globalization. The paramount instruments to meet these challenges are massive investment in human capital and innovation on the one hand, and integration in the internal market on the other.

Human capital is not absent in Europe, and neither are big universities and research centers. Mobilization of these resources in the direction of new technological advancements and their applications, however, seems as yet inadequate. Not even the German economy appears sufficiently innovative when it comes to the new challenges of digitalization. Meanwhile, peripheral economies face striking delays and distortions in the quality of university and post-university education, the allocation of research funds, the collaboration of industry with advanced research centers, and the younger generations' employability. Unfortunately, Italy scores high on all of these shortcomings.

The springboard for restarting investment can only come from re-launching integration within the internal market by dismantling protections, bringing in new players, and accepting the challenges brought by new technologies. The return to state interventionism to protect weak national industries constitutes a mortal threat to the continent's chances of staying on the path of prosperity and growth.

Public investment and European funds, through an enhanced Juncker Plan, should concentrate on building the needed infrastructural inter-connections between network utility services markets—energy, transport, and communications—where enormous wells of productivity gains and innovation would be in reach once restricted national and regional market structures were sprung open.

Overcoming divergences in productivity and costs is—to a large extent—the responsibility of member states, but, as already stated, it is also a fundamental condition for the monetary union's cohesion and stability. This justifies the establishment of common policies for economic convergence, as provided for by the European Semester procedures and the Council's economic policy recommendations. The recent addition of new national authorities for assessing the convergence process, already under way, and the strengthening of procedures for correcting macroeconomic imbalances are identified by the Report as tools for achieving greater 'ownership' of the common policies by the member states. The goal of convergence must also adequately include social cohesion, employment, above all of youths, and combatting exclusion and poverty.

[1] *Completing Europe's Economic and Monetary Union*, a report by Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz, Brussels, 22 June 2015. <https://ec.europa.eu/commission/publications/five-presidents-report-completing-europes-economic-and-monetary-union_en>

As underlined in the Report, the procedures for convergence need to be made more binding through the fulfillment of the European fiscal rules and the adoption of common standards for the functioning of the labor market, competitive market structures, a business environment fostering entrepreneurship and innovation, and the quality of the public administration. These standards would leave wide margins for differentiating national policies and taking different contexts into account, but they could help countries objectively measure progress and identify areas where they should concentrate their efforts.

Without visible progress on this front, every advance in other pillars of the EU's construction is bound to get blocked. Loosening the common disciplines cannot be seen as the proper way to achieve solidarity because, by undermining economic convergence, it undermines the sustainability of the common currency.

On this, a discussion has opened on the possible role of the European Stability Mechanism (ESM) in overseeing the economic policies of euro area countries —whether as a complement or a substitute to the Commission still is not clear. In this regard, some member states do feel that a 'politicized' Commission may be a less effective enforcer of economic and budgetary disciplines, and therefore are eyeing the possibility of transferring this task to a body more directly under the control of the member states (or rather, creditor countries).

Banking and Financial Union

The second pillar of EMU is financial union, which includes banking union and capital markets union. The banking union—already in advanced stage of implementation—includes the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM, assisted by the Single Resolution Fund, SRF), and the European Deposit Insurance Scheme (EDIS). The SSM and the SRM (with the SRF) already are up and running and have contributed to resolving banking sector problems left by the two financial crises. On the other hand, negotiations on EDIS, along with the creation of a common backstop for both the EDIS and SRF are not progressing.

This blockage is the result of disagreement within the Ecofin Council about the proper sequence in addressing risk reduction and risk sharing in national banking systems. Last Spring Italy successfully blocked the examination by the Eurogroup—the euro area finance ministers—of mechanisms designed to encourage the reduction of sovereign bond holdings by the banks, a measure seen by many as necessary in order to sever the link between banking and sovereign risks, but which would have had significant repercussions especially on Italian banks, still holding oversized portfolios of national sovereigns. This had the consequence of halting negotiations on EDIS as well as on the fiscal backstop for the resolution fund and EDIS itself.

Thus, in its June 2016 Conclusions, the ECOFIN Council announced that "On a European Deposit Insurance Scheme (EDIS), [...] negotiations at the political level will start as soon as sufficient further progress has been made on the measures on risk reduction", and also "took note of the intention of Member States to have recourse to an IGA (i.e. an intergovernmental agreement) when political negotiations on EDIS start". This latter condition indicates that unanimity will be required for any further progress—an evident reaction to the fact that a minority impeded the deliberation by a qualified majority on risk reduction mechanisms. The European Council repeated the ECOFIN Council's decision *verbatim* in its December 2016 and March 2017 final communiqués, reiterating that EDIS cannot progress without *prior* adequate risk reduction measures.

Of course, deposit insurance is available at national level (and has been reinforced by the recast directive 2014/49). However, cross-border deposit insurance is necessary to protect the euro area from idiosyncratic shocks hitting one national banking system, or large parts thereof, and resulting in depositors running away from most or all of the banks in that country. In practice, almost by definition such an event would be the result of a liquidity drain generated by a confidence crisis—something that could be stopped by determined interventions by the ECB, provided its governing council agreed to do it. If EDIS was there, the shock would be much less likely to materialize; were it nonetheless to happen, the availability of an adequate public backstop, for the eventuality that the deposit insurance fund proved insufficient to halt the rout, would further contribute to stabilizing expectations of wary investors. Similar considerations would also apply to the SRF. In practice, the likelihood of a destabilizing event generated by fickle financial investors would be much diminished, if not entirely eliminated.

However, the announcements that have been described by the ECOFIN and European Councils amount to a public declaration whereby, in the case of idiosyncratic shock hitting the country, Italy would be alone in confronting it and no mechanism for collective risk sharing from EMU institutions would be available. This may be seen as a central aspect underpinning the risk premium on Italy's sovereigns in the present circumstances. There is little doubt, however, that such a shock would result utterly destabilizing also for large parts of the euro area banking system, in view of their large exposure to Italian banks.

Therefore, there is little doubt that financial stability in the euro area urgently requires that negotiations for the completion of the banking union are resumed, and this will not be feasible unless the Italian authorities accept to reopen discussion on mechanisms to foster risk reduction in the Italian banking system, in the form either of risk penalties under prudential capital rules or of straight caps to sovereign holdings by the banks. The latter alternative will appear reasonable and feasible, if accompanied by the introduction of a new safe asset that could be represented by a composite bond of the different euro area government bonds, weighted in terms of key-capital. This composite bond would be a necessary condition to 'complete' European financial markets, if government bonds of member states were treated as risky bonds (see also below). In any event, such a mechanism would only enter into force over an adequate transition period. As already stated, an effective and smoothly functioning capital markets union (CMU) would have the twin benefits of opening the door to the deployment of currently idle vast excesses of savings over investment in Germany, the Netherlands, and other surplus countries in the rest of the euro area, notably including Italy. But, this cannot happen as long as markets remain fragmented by redenomination risks—whose elimination may be greatly facilitated by EDIS and, more fundamentally, by placing public debts on a path of sustained consolidation (on this last condition, Italy still stands out as a source of special concern).

The full realization of an integrated capital market requires in addition a number of measures to foster cross-border equity and bond issues and investment, which today are still impeded by regulatory fragmentation in the implementation of the common rulebook. Accordingly, the CMU Action Plan, set out by the European Commission in 2014, should be strengthened by measures to expand the investors side of capital market integration, removing the still substantial disincentives to long-term and equity investment by institutional investors, like insurance companies and pension funds, created by prudential regulations. It is also necessary to overcome the excessive burdens on private placements and public offers, and to create a less unfavorable environment for access to public markets by SMEs and growth companies.

The CMU risks to be a missed opportunity if its ambitions are not redesigned to confront the challenges raised by Brexit. The chronic shortage of capital and in particular of equity capital for European SMEs and growth companies may be exacerbated by the uncertainty about the status of most important financial centre in Europe, the City of London, in the post-Brexit scenario.

These obstacles are not likely to be overcome without the creation of a single supervisory authority able to unify and greatly simplify regulatory practices, as has been done for the banks. The current supervisory authorities, ESMA (for capital markets) and EIOPA (for pensions and insurance) have not revealed up to the task, due to staunch resistance of national regulators within these authorities' governing boards. This points once again to a fundamental flaw in their governance—the lack in those boards of an executive committee independent of national authorities, as provided for in the ECB. This explains why progress in bringing about sufficient convergence in regulatory standards has been so limited.

Fiscal Union

The Report identifies fiscal union as the EMU's third pillar. On this, the Report leaves few doubts: "One of the main lessons of the crisis has been that fiscal policies are a matter of vital common interest in a Monetary Union. […] Responsible national fiscal policies are therefore essential." This policy's lynchpin are the Stability and Growth Pact (SGP), reinforced after the sovereign debt crisis by the Six Pack and Two Pack, and the so-called Fiscal Compact, which is nothing more than the transposition of the Six Pack into national legislation (with laws hierarchically superior to ordinary legislation).

The idea that these disciplines can now be substantially weakened or altogether cancelled is outlandish, since their approval was a key condition for allowing the ECB to announce its willingness to intervene without limits to protect the euro's integrity in the Summer of 2012 (through the OMT program), which reassured investors and stabilized financial markets. The ability of the ECB to intervene in defense of the euro could not survive such an overt repudiation of budgetary discipline. In effect, in line with the Report's recommendations, euro area institutions have been moving in the opposite direction through the establishment of independent national supervisory authorities for public budgets and budgetary policies and, more recently, of a council of experts at EU level to supervise the functioning of national budgetary councils and promote best practices.

We can see here fresh attempts to reinforce discipline through new independent technical entities, reflecting a weakened trust in the Commission (at least by some member states). Whether these mechanisms can function in the absence of a serious political commitment to the common goals of fiscal discipline by national governments remains highly doubtful. Moreover, the structure of national budgetary consolidation programs should always be strengthened by explicit obligations to bring public spending under control also, when required, by ambitious overhauls of organizational models for the provision of public services.

Meanwhile, serious consideration should be given to correcting the excessive complexity of common rules governing public budgets. One way forward, already proposed some time ago by former Italian prime minister Mario Monti, would be to scrap the overly complicated mechanical rules for the application of the SGP and,

- (i) re-establish in their place the obligation to keep always in equilibrium and without exception the current fiscal balance; and
- (ii) allow for the possibility of capital account deficits, but only for public investments capable of strengthening economic convergence that would generate returns, certified by European authorities (e.g. the European Investment Bank), greater than their cost in capital markets.

Respect of these rules should be assisted by stronger disciplining devices such as mechanisms for the automatic restructuring of sovereign obligations—as has been advocated by some influential German economists—together with a new rule providing for an immediate triggering of the obligation to adopt an adjustment program under the aegis of the European Stability Mechanism (ESM) for the countries violating their obligations under the GSP.

The two key ingredients of fiscal union are the creation of a "fiscal capacity" for the euro area and the emission of a "safe" debt instrument by a European Treasury. On the former, the current discussion is now limited to the twin hypotheses of a scheme to help cushion cyclical macro-economic shocks—e.g. the Italian proposal for an EU unemployment insurance system toppling national schemes—and a general common fiscal backstop in case of financial shocks overcoming national and European tool to meet a banking crisis. The way forward here lies in allowing the ESM to evolve into a true European Monetary Fund able to provide financial support in all the forms required to meet real and financial shocks—including liquidity shocks—that may hit a member state and the euro area as a whole. It is important to recognize that such a development may only be conceivable once the imbalances still plaguing the fiscal and financial conditions of some member states are removed and their policies are brought back to a credible convergence path.

As to the safe debt instrument, once the Maastricht "no bail out" rule (Article 125 TFEU) is fully reestablished, this would render the sovereign debt of member states 'risky,' as they would be subject to restructuring. As such, for the area's financial markets to work, a "safe" public debt instrument—i.e. one collectively guaranteed by all member states in the euro area, issued at the federal level—that banks and other financial intermediaries could use to manage their liquidity. This debt instrument would allow for the sharing amongst member states of some sovereign risks, but in an environment of financial stability and budgetary discipline, which would prevent both lax budgetary policy and the institutionalization of permanent transfers between member states. Interesting proposals going in this direction have been developed under the aegis of the European Systemic Risk Board.

The existence of a fiscal capacity of the euro area and a safe bond issued under its countenance by necessity postulates a responsible authority in charge of their utilization, and indeed more broadly of an effective framework for deciding common policies and overseeing their implementation: a euro area minister of finance, that could be at the same time chair of the Eurogroup and vice-president of the European Commission, i.e. with an arrangement similar to the High Representative for the common foreign and security policy. Such a figure should have effective powers to elicit a prompt correction of emerging divergences in national policies, but also prod countries to act as required to implement the common fiscal stance decided by the Eurogroup. It should also have powers to initiate the actions needed to respond to financial and real shocks endangering the stability of the euro area and, more broadly, to promote risk reduction and risk sharing arrangements consistent with the stability of the common currency.

A Footnote on Democratic Legitimacy

The tasks that have been described for the Minister of Finance require some further centralization of sovereign powers that today belong to national governments and national parliaments. The straight way to restore political control over these powers and attendant decisions is to bring them under effective control by the European Parliament, possibly under an adapted 'community method' whereby the Commission would propose and the Eurogroup would decide after obtaining the Parliament's assent. National parliaments could be brought into the picture by various arrangements designed to make national ministers fully accountable for their role in the Eurogroup, as well as allowing for debates before national parliamentary committees of decisions taken at euro area level. Some of these mechanisms could be applied to the remaining part of the European Union. This a complex matter that cannot be discussed here at sufficient length but certainly deserves further attention.

The way forward

In this context, Italy's responsibilities loom large. The persistent fragility of the country, due to its high public debt and low growth, disappointing productivity dynamics, and banking instability is more than a threat to the country itself. The smooth functioning of economic convergence within the Internal Market is predicated on the lack of intrinsic sources of instability. In other terms, Italy's fragility hampers the full deployment of the benefits of economic integration, financial union, and fiscal cooperation. Finally, Italy's unresolved problems hinder further common advancements at the European level, as described in the Report and in these pages. The second brief, proposed in this SEP initiative, tackles Italy's problems, staging them within a constructive non-punitive European framework.