

Architecture reform for an heterogeneous EMU: National vs. European institutions

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What was wrong with EMU 1.0?

- Impact of EMU on financial integration underestimated & consequences for financial stability ignored:
EMU 1.0 liable to financial crises
- Nature of EMU sovereign debt ignored:
EMU 1.0 liable to sovereign debt crises
- Loss of the ER instrument not compensated:
EMU 1.0 liable to adjustment problems

How should EMU avoid or deal with financial crises?

- EMU needs a common mechanism for supervision, resolution and deposit insurance guarantee for banks

- EMU 2.0 provides a partial answer

- EMU 3.0 needs to
 - » Improve SRM, create a common deposit insurance guarantee scheme
 - » Eventually merge SSM, SRM and DIGM into one institution
 - » Reduce bank dependence: Capital Markets Union

How should EMU avoid or deal with sovereign debt crises?

- EMU needs common mechanisms to lower national sovereign debt and to reduce the exposure of banks to sovereign debt

- EMU 2.0 provides a partial answer

- EMU 3.0 needs to
 - » Better enforce fiscal rules to reduce debt levels
 - » Envisage Eurobonds/Eurobills
 - » Replace ESM by EMF and include a European SDRM
 - » Limit the exposure of banks to sovereign debt

How should EMU avoid or deal with adjustment?

- EMU needs national and common mechanisms to reduce or handle adjustment problems

- EMU 2.0 provides a partial answer

- EMU 3.0 needs to
 - » Improve market mechanisms at national and EU levels
 - » Improve fiscal mechanisms at national and EU/EA levels
 - » Reduce **heterogeneity** among MS

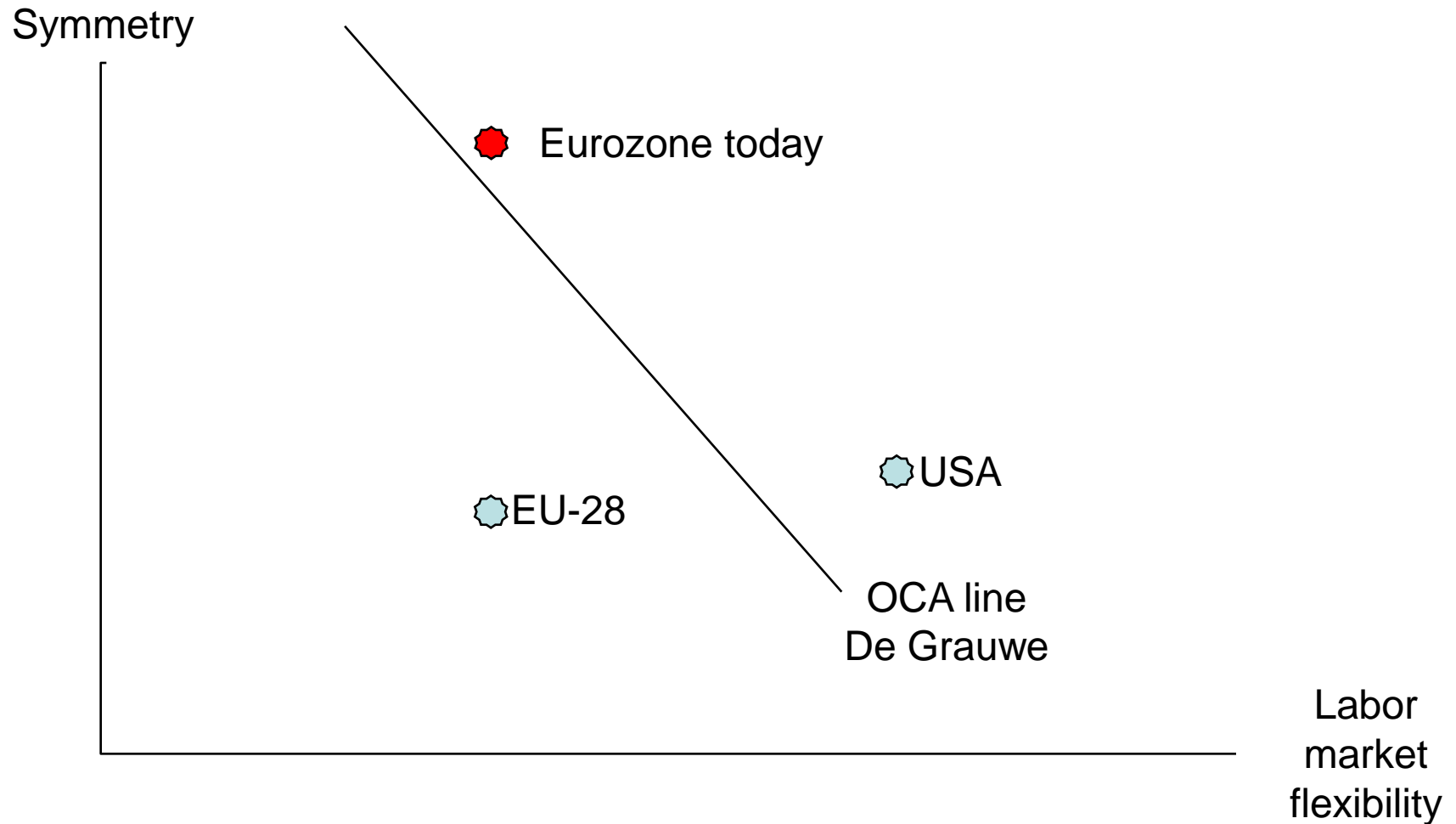
Heterogeneity in EMU was and is large and problematic

- Heterogeneity in EMU is large
 - » It was large at the start of EMU
 - » It remains large today

- Heterogeneity in some areas is problematic for two reasons
 - » Still insufficient national mechanisms for adjustment
 - » This makes EMU problematic
 - » Heterogeneity also makes creating new common mechanisms problematic

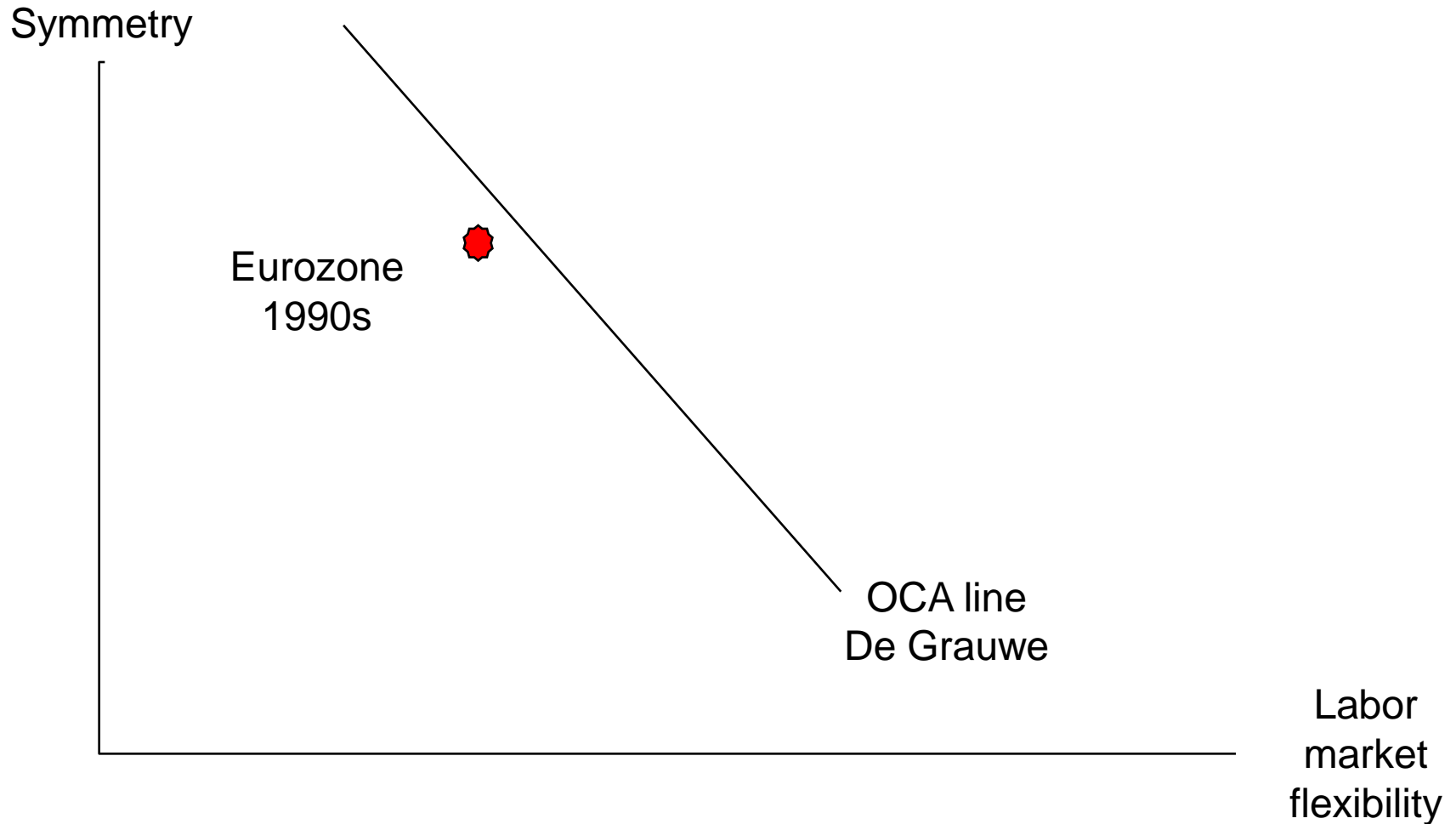
Traditional OCA approach

Symmetry and labor market flexibility today

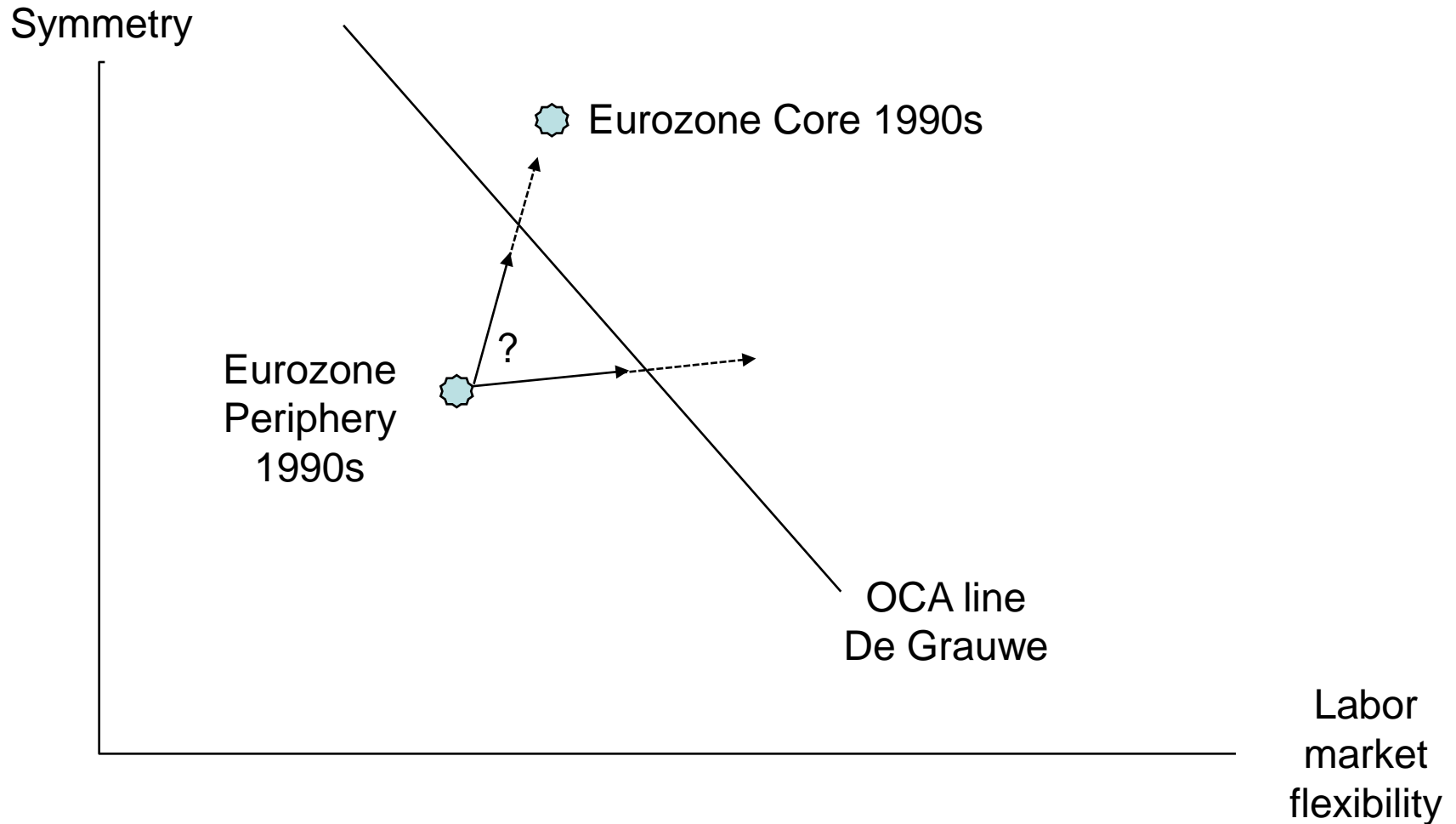


Traditional OCA approach

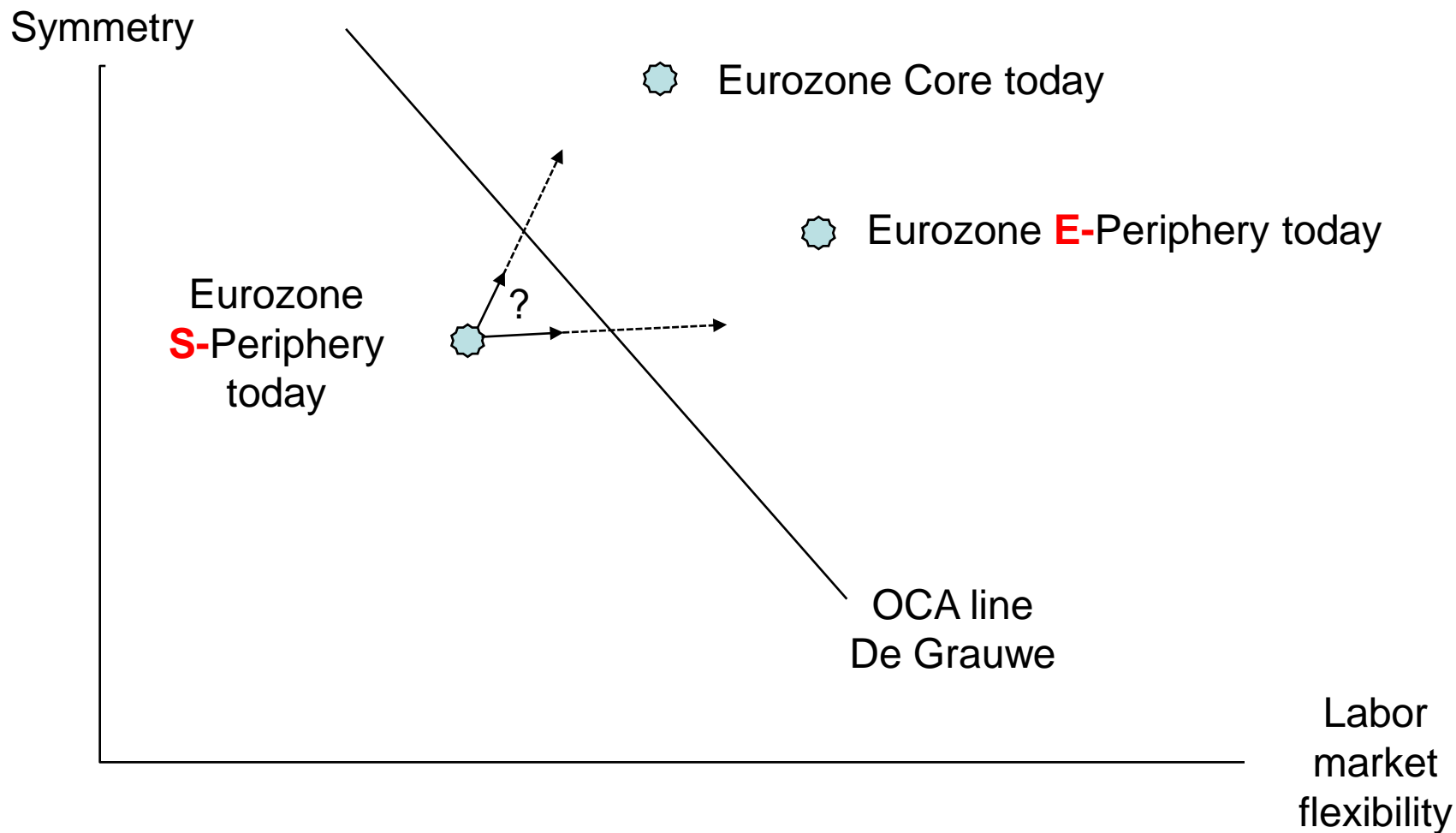
The situation at the start of EMU



Heterogeneity at the start of EMU and expected convergence

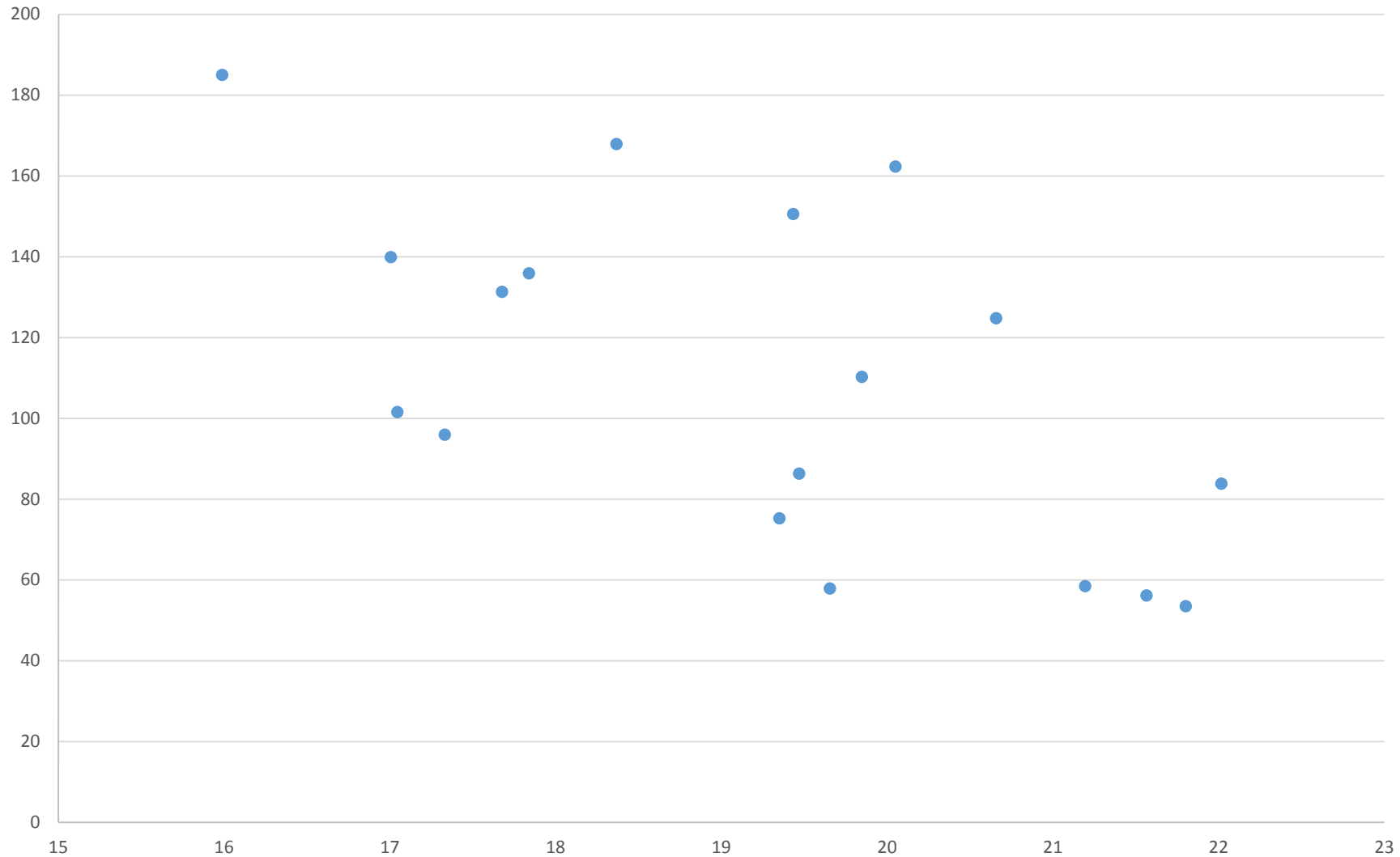


Heterogeneity in EMU today and necessary convergence



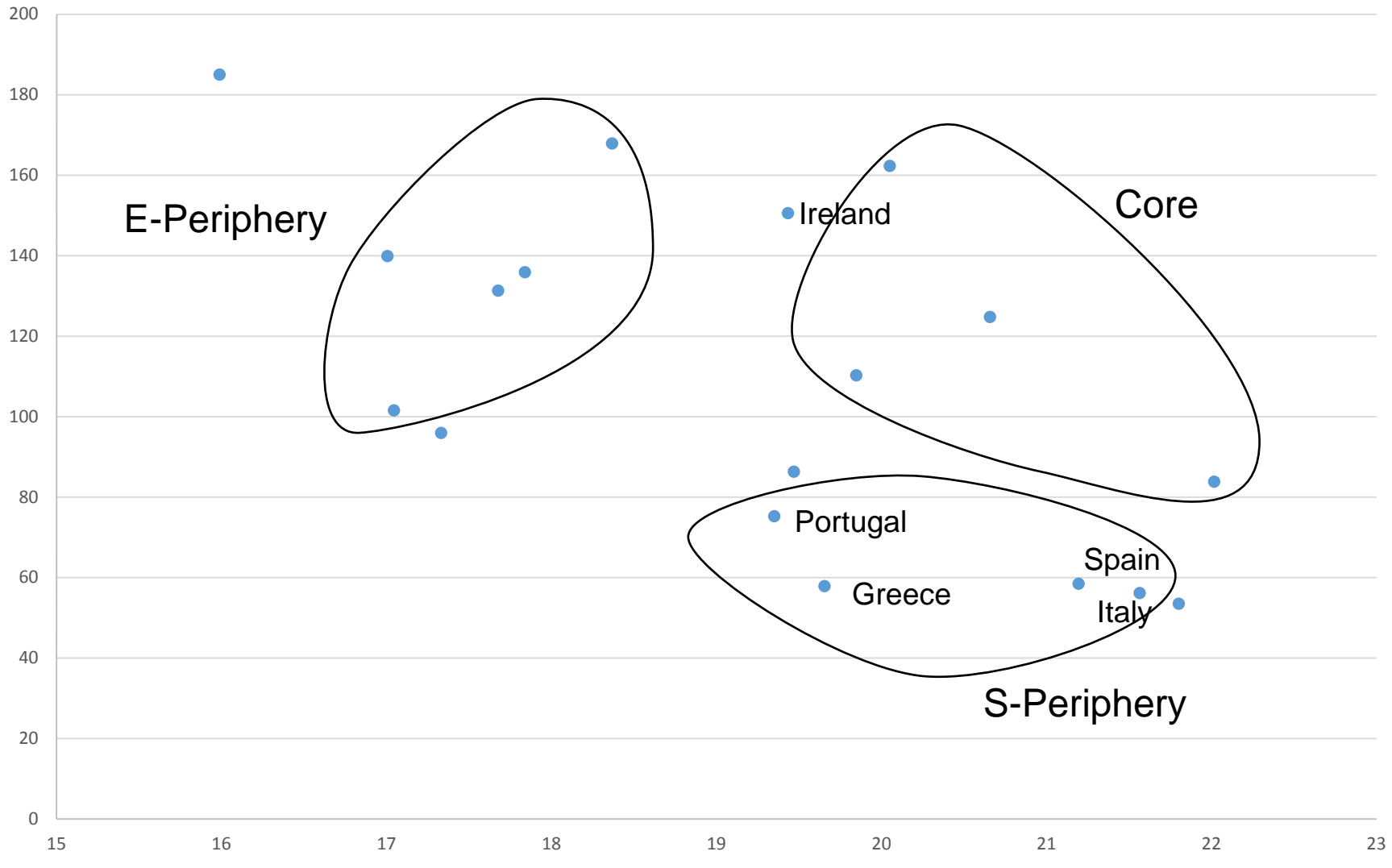
Symmetry? Heterogeneity in trade openness

Eurozone-19 (excl. Lux), 2008 (X+M of goods and services/GDP)



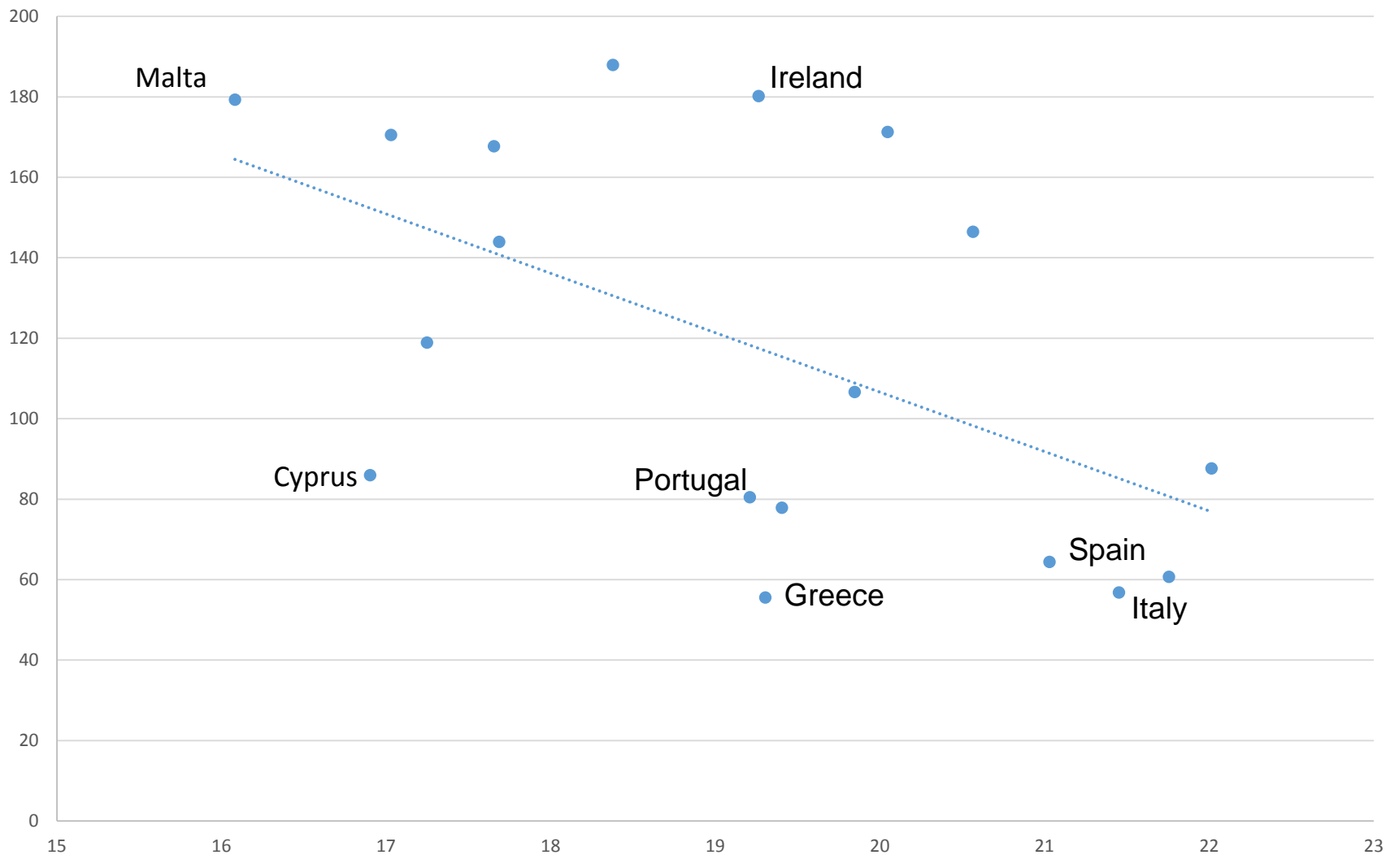
Symmetry? Heterogeneity in trade openness

Eurozone-19 (excl. Lux), 2008 (X+M of goods and services/GDP)



Symmetry? Heterogeneity in trade openness

Eurozone-19 (excl. Lux), 2013 (X+M of goods and services/GDP)



National vs. EA/EU adjustment mechanisms: state of play

■ Market mechanisms

» Labor markets

- ✓ National wage bargaining systems and ULCs, no EU mechanism (but MIP)
- ✓ Migration: EU mechanism

» Financial/capital markets: EU mechanism

■ Fiscal mechanisms

» Automatic stabilizers: national fiscal policy, no EU/EA mechanism

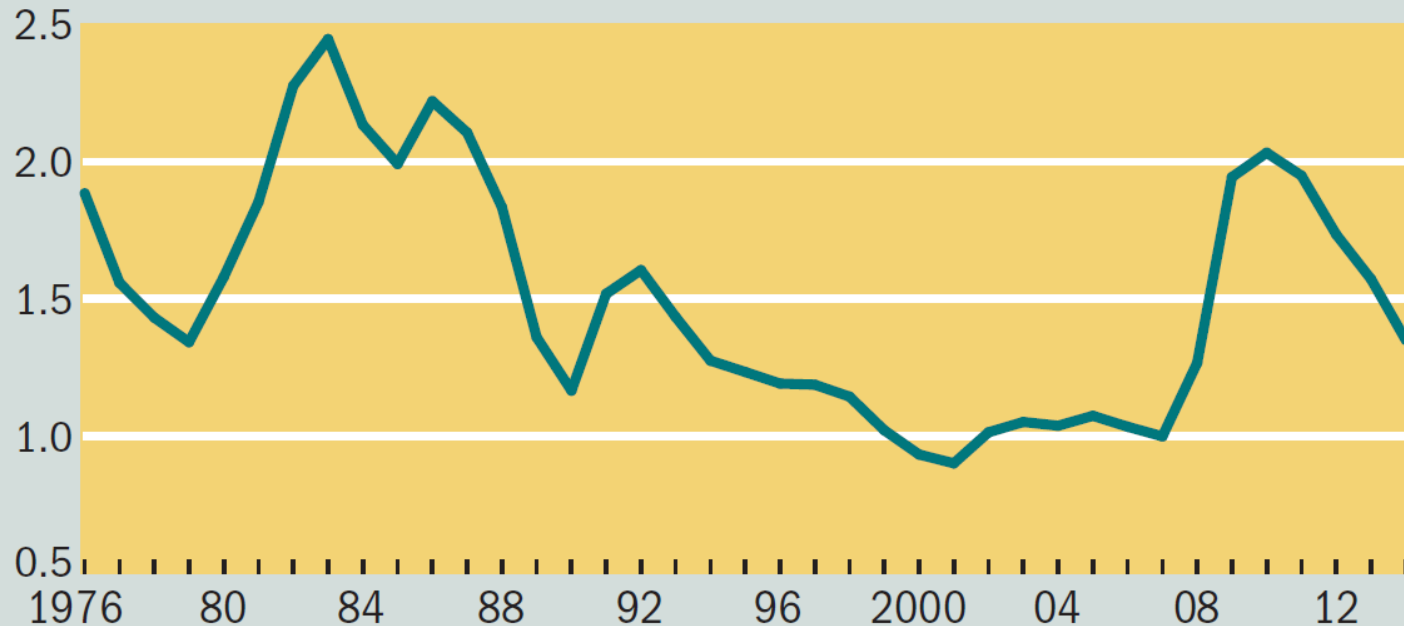
» Discretionary stabilizers:

- ✓ Loans: EA mechanism (ESM)
- ✓ Transfers: no EA mechanism
- ✓ Fiscal policy: national fiscal policy, no EA mechanism

Labor markets as adjustment mechanism: Variation of unemployment rates among US states

The variation of unemployment rates among U.S. states has subsided to precrisis levels.

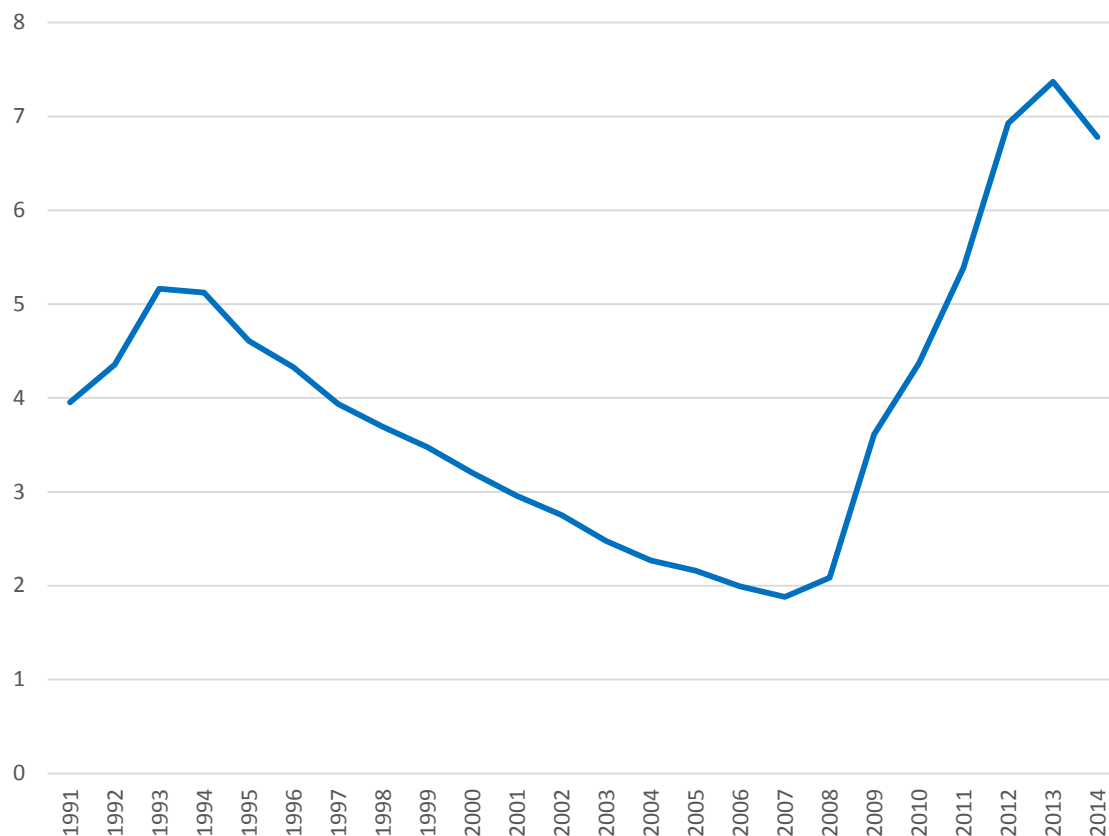
(standard deviation of unemployment across U.S. states)



Source: Loungani (2015)

Labor markets as adjustment mechanism: Variation of unemployment rates among EA member states

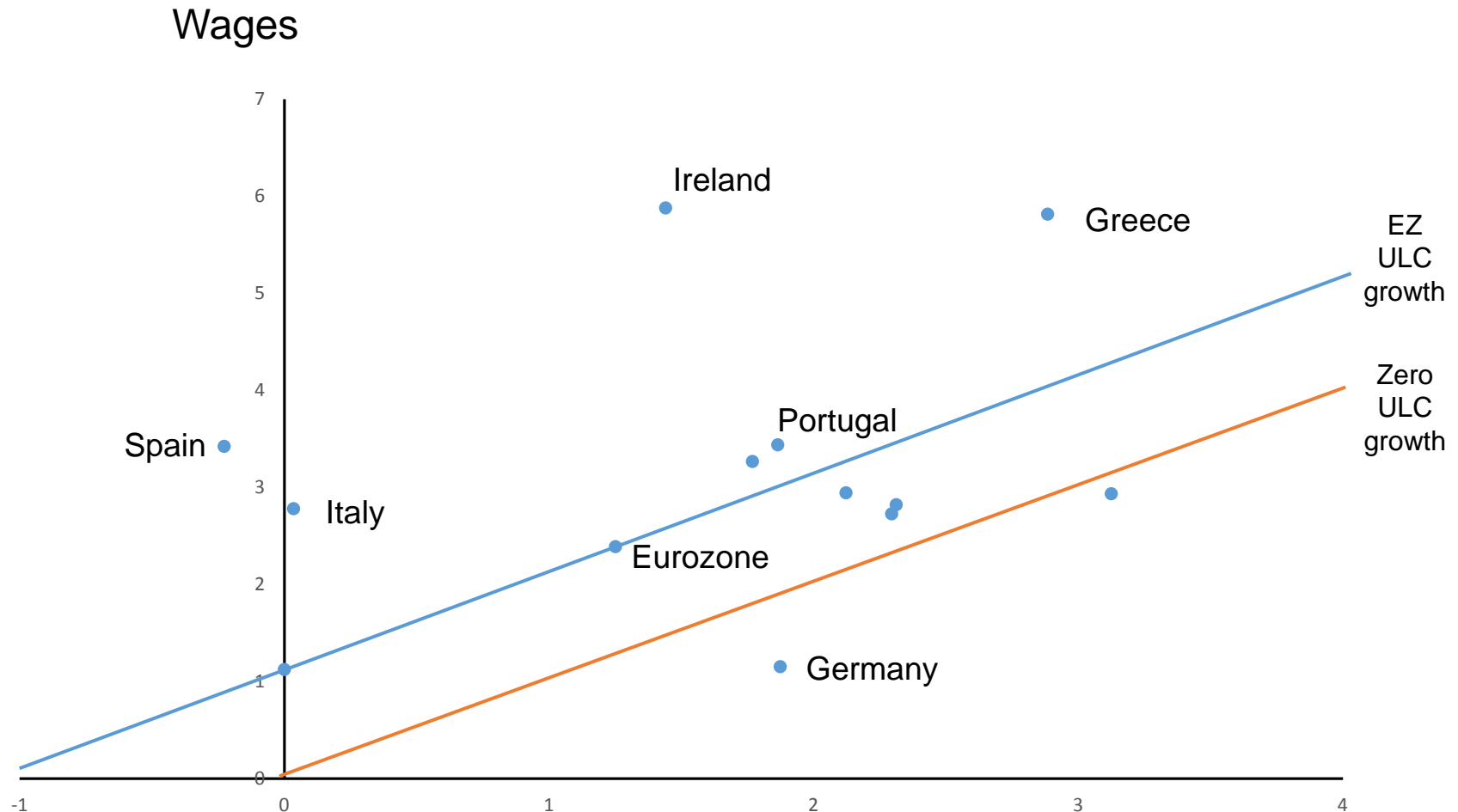
(standard deviation of unemployment across EA-12 member states)



Source: Own calculations using AMECO data

ULCs: Wage growth vs. labor productivity growth

Average annual growth rates 2001-2007 (Non-agricultural business sector)



Source: Own calculations using OECD data

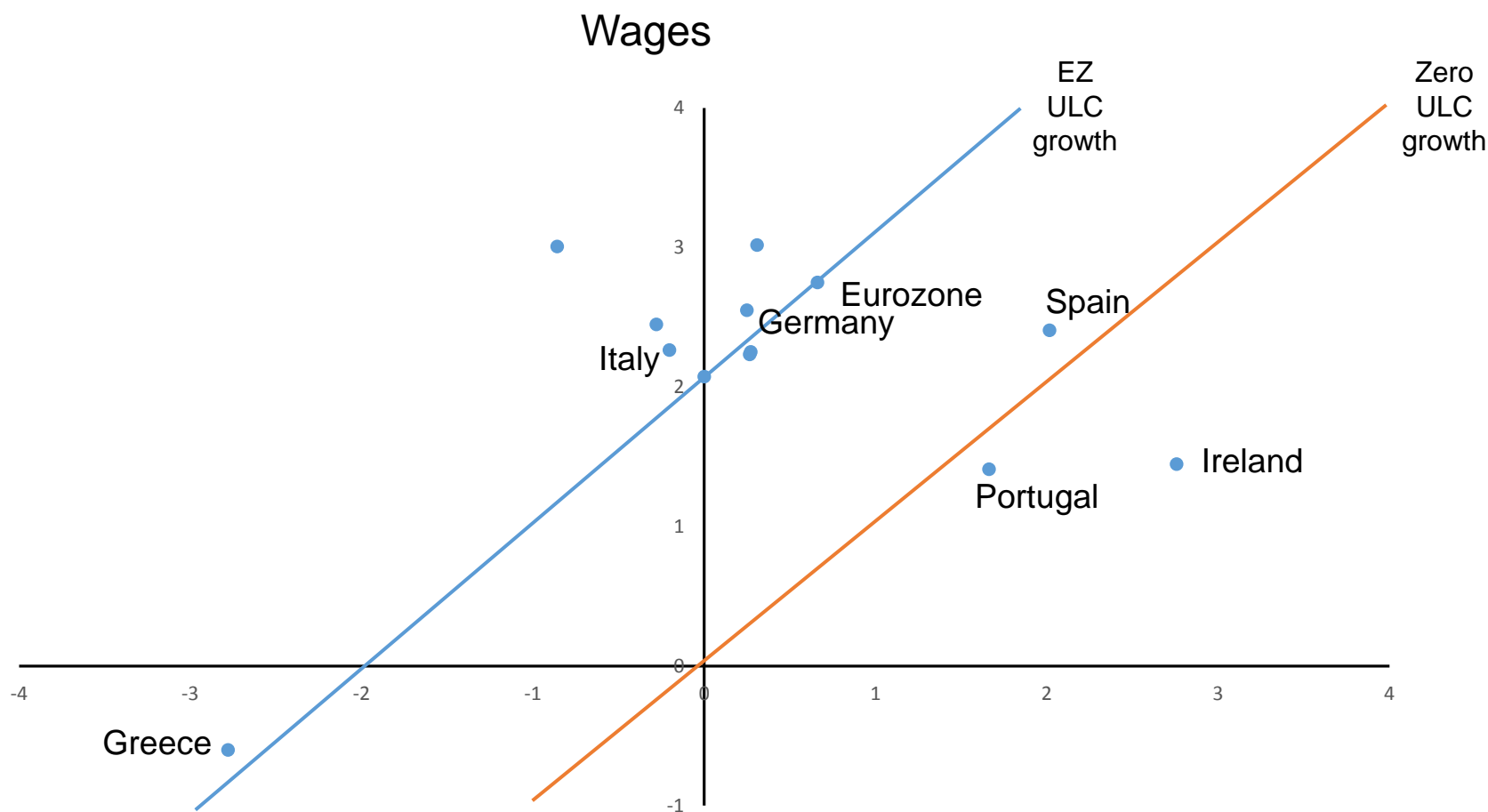
Labor markets as adjustment mechanism

- Little migration, though it has increased with E-Periphery

- Adjusting ULCs:
 - » Raising productivity growth through product market reforms in high ULC/high unemployment countries
 - » Adjusting wages: decreasing (increasing) nominal wage growth in high (low) ULC/high (low) unemployment countries

ULCs: Wage growth vs. labor productivity growth

Average annual growth rates 2007-2013 (Non-agricultural business sector)



Source: Own calculations using OECD data

National vs. EA/EU adjustment mechanisms in EMU 3.0

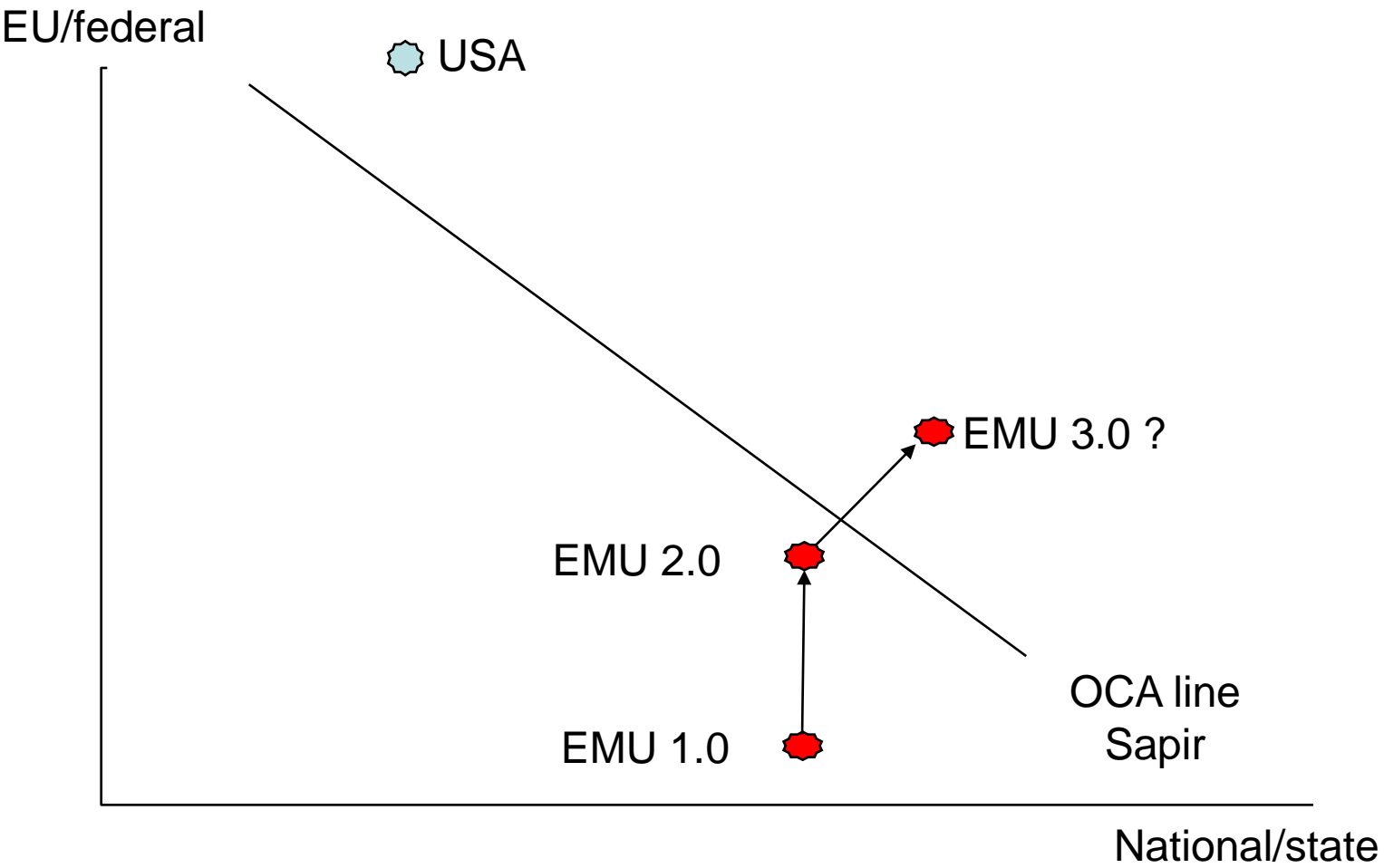
■ Labor market mechanisms

- » EU/EA truly integrated labor market not feasible
- » National wage bargaining systems difficult to change
- » **Eurosystem Competitiveness Council** to monitor and correct competitiveness multilaterally and symmetrically

■ Fiscal mechanisms

- » Fiscal policy instruments will remain mainly at the national level
- » **Eurosystem of Fiscal Policy** for fiscal debt sustainability **and** appropriate Eurozone-wide fiscal position
- » Eventually, **European unemployment insurance** for catastrophic risks

Beyond the traditional OCA approach: A new view EU vs. national mechanisms to deal with shocks



But heterogeneity is a constraint to common mechanisms

- Heterogeneity in labor market outcomes and in fiscal policies must be reduced to permit creating new common mechanisms

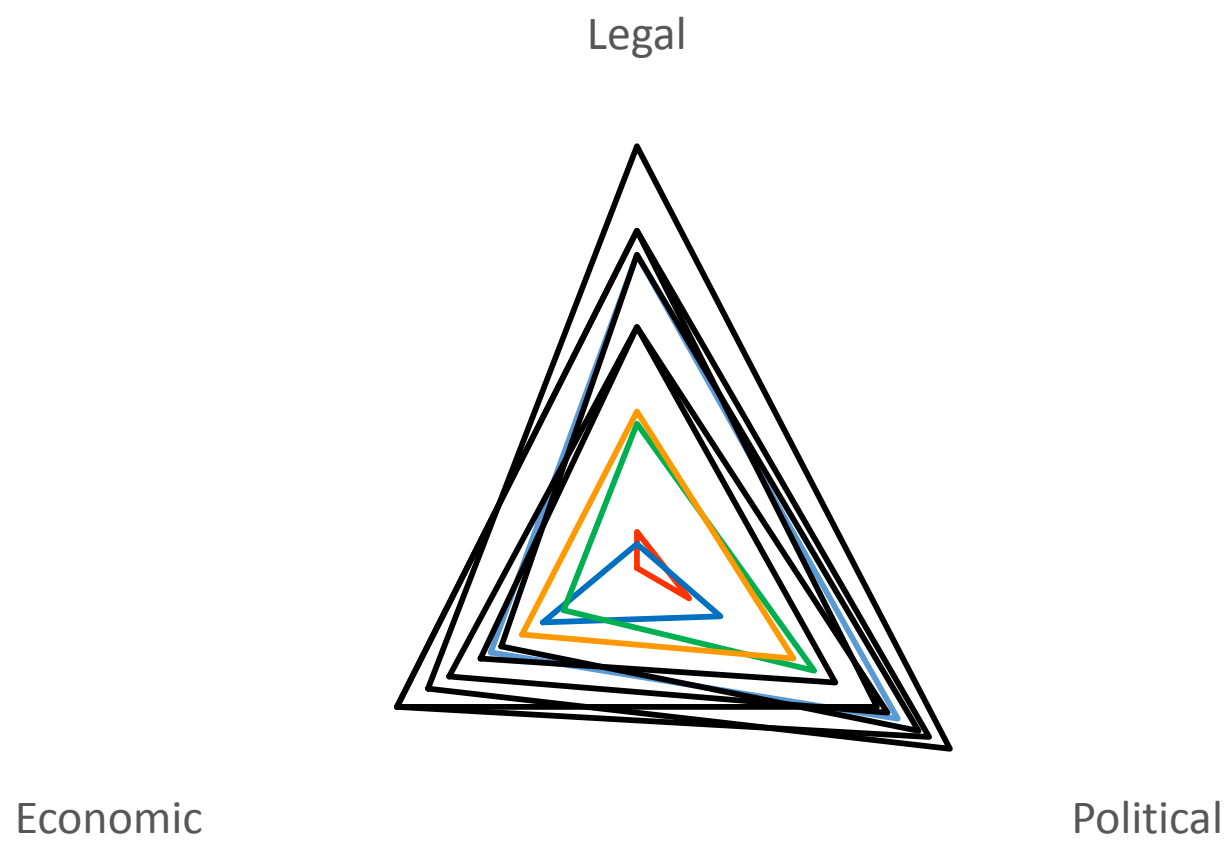
- But heterogeneity is a deeper phenomenon
 - » Institutional quality
 - » Preferences for the euro before EMU and for closer coordination today

Heterogeneity - Institutional quality 2000 and 2010

Country	Legal institutions		Political institutions		Economic institutions	
	2000	2010	2000	2010	2000	2010
Austria	0.89	0.86	0.79	0.85	0.72	0.74
Belgium	0.78	0.80	0.76	0.84	0.77	0.78
Finland	0.92	0.95	0.88	0.90	0.72	0.80
France	0.80	0.80	0.72	0.79	0.72	0.75
Germany	0.87	0.86	0.80	0.87	0.72	0.73
Greece	0.63	0.63	0.71	0.65	0.63	0.60
Ireland	0.85	0.88	0.78	0.83	0.76	0.83
Italy	0.72	0.62	0.67	0.68	0.67	0.69
Netherlands	0.91	0.88	0.87	0.88	0.83	0.83
Portugal	0.75	0.72	0.77	0.77	0.68	0.67
Spain	0.76	0.73	0.73	0.75	0.73	0.71

Source: Kuncic, A. (2014). Institutional Quality Dataset, Journal of Institutional Economics

Heterogeneity - Institutional quality 2010

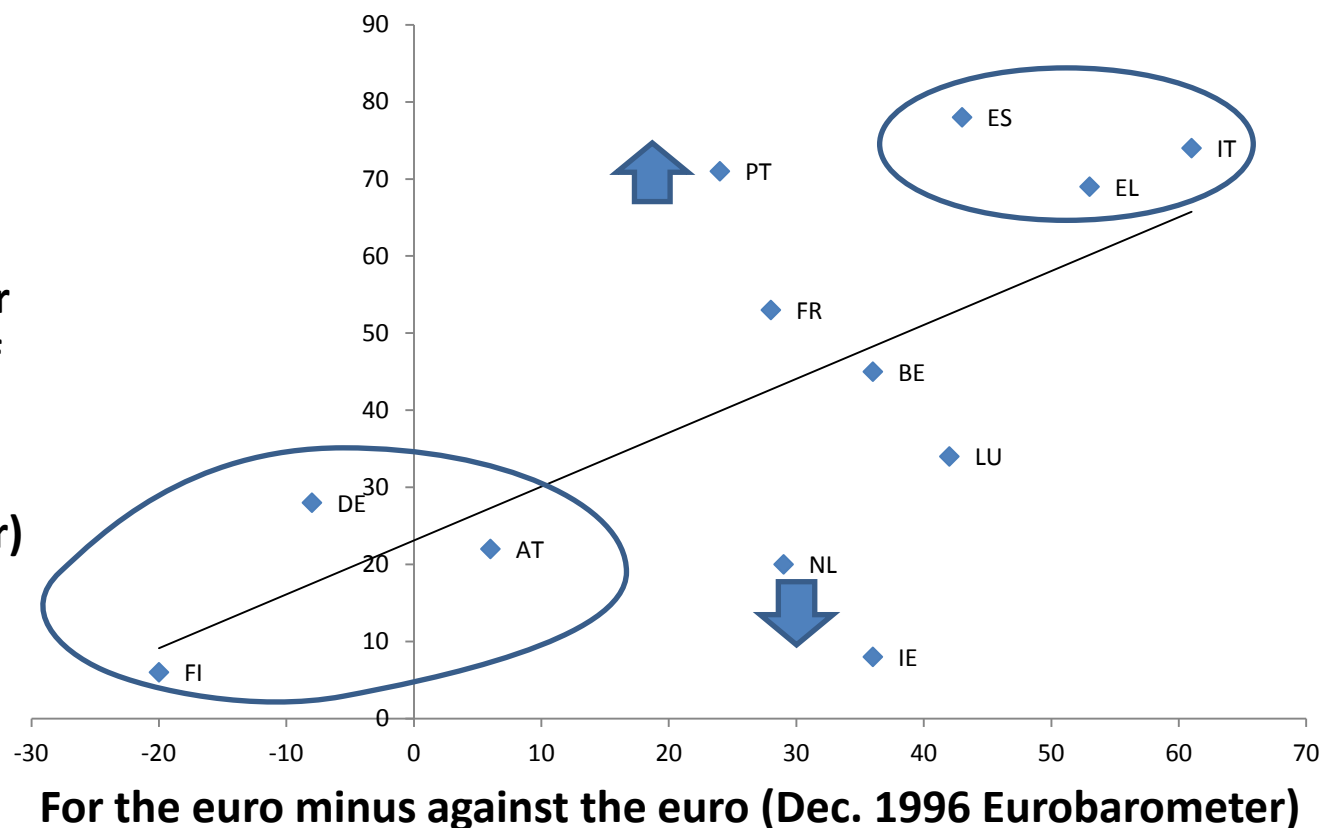


— Austria — Belgium — Finland — France — Germany — Greece — Ireland — Italy — Netherlands — Portugal — Spain

Source: Kuncic, A. (2014). Institutional Quality Dataset, Journal of Institutional Economics

Heterogeneity - Preferences for the euro in 1996 and for economic policy coordination in the Eurozone in 2014

More
coordination
minus same or
less degree of
coordination
(Oct. 2014
Eurobarometer)



Conclusion

- EMU 1.0 was inadequate on 3 grounds: financial stability, sovereign risk and macroeconomic adjustment
- EMU 2.0 offers partial answers. How much? I would say 50% max
- EMU 3.0 needs to go further by improving both national and EU/EA institutions to achieve more responsibility (in competitiveness and fiscal sustainability) and solidarity