Deepening the Economic and Monetary Union:
which role for a budget for the euro area?
A contribution to the reflection launched by the European Movement – Italy

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Executive Summary

The functioning and future of the Economic and Monetary Union (EMU) is a matter of interest for all European citizens and reflections on the possible functions and perimeter of a budget for the euro area have been ongoing for some time at the technical level. The analysis from the European Movement represents a timely contribution and largely point to crucial challenges that will have to be addressed in the deepening EMU process. Surely, following the last crisis important governance steps have already been taken to bolster the resilience of the European Economic and Monetary Union (EMU). The changes include putting in motion a banking union, establishing the European Stability Mechanism (ESM), and strengthening the surveillance framework. However, there is broad acceptance that the current set up remains prone to shocks and further progress is therefore needed for a stable EMU (e.g. European Commission, 2017; Benassy Quéré et al. 2018).[1] In general, from an economic perspective, a major remaining 'problem' can be described as a lack of adjustment channels to large shocks, given the incomplete nature of the financial union and the absence of common fiscal instruments. Reflections on the budget for a euro area should therefore address this issue and the recent Commission proposal for a European Investment Stabilisation Function (EISF) goes in the right direction. A second issue is that the Economic and Monetary Union is not yet able to reverse sufficiently the social, economic and competitiveness divergences that emerged from the crisis. In this context, the recent proposal for a Budgetary Instrument for Convergence and Competitiveness (BICC) for the euro area – although limited in size – responds to a real challenge. From an economic perspective, it could also be seen as complementary to the EISF, with the latter focusing on (large) cyclical shocks and the former on structural divergences. Finally, since the euro area will account for more than 85% of the EU's economy after Brexit, it is appropriate for a budget for the euro area intended in its broader sense to focus on the provision of EU common goods, in full respect of the principle of subsidiarity and with a view to enable – through 'vertical coherence' – synergies between national and EU finances and respond to challenges emerging at a global level as well as possible associated developments at the local level.

*DG Economic and Financial Affairs, European Commission. The views set out in this article are solely those of the authors and do not necessarily reflect the official opinion of the European Commission.

[1] European Commission (2017), Reflection paper on the deepening of the Economic and Monetary Union, Brussels, 2017, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf
Bénassy-Quéré A, Brunnermeier M, Enderlein H, Farhi E, Fratzscher M, Fuest C, Gourinchas P-O, Martin P, Pisani-Ferry J, Rey H, Schnabel I, Veron N, Weder di Mauro B and Zettelmeyer J (2018), "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", CEPR Policy Insight No 91.

The establishment of the single currency is one of the most substantial and tangible results of European integration. Since the very beginning, it has been conceived as much more than a purely monetary matter: the economic and monetary union (EMU) is based on a promise of stability and prosperity.

This promise of stability and prosperity has become more important after the late 2000s crisis and the ensuing recession, the worst recession experienced in Europe since the post-war period. In this context, the broad set of actions undertaken during the past decade to improve the architecture of the euro area has contributed to partially meet these expectations.[2]

However, in the medium term, the deepening of EMU will require further progress. As already noted in the reflection paper on the future of EMU published recently by the European Commission (European Commission, 2017)[3], our economic and monetary union is still lacking in three respects.

First, despite being stronger than before, EMU is not yet completely shock-proof, especially in case of large shocks.

Secondly, EMU is not yet able to sufficiently mitigate possible structural economic divergences as the ones unveiled by the crisis, both between its members and within them.

Finally, the combination of these cyclical and structural developments - even if primarily economic and financial - can have repercussions at other levels, for example 'political' or 'social', which in turn have to be considered, especially in a context of increasing economic integration at the global level or inequality at the local level.

I would therefore like to take the opportunity given to me by the European Movement to dwell briefly into each of these points. I will outline some of the progress made so far, but also reflect on the many challenges ahead. In doing so, I will try to put them in relation to the proposal for a budget for the euro area formulated by Piervirgilio Dastoli and Paolo Ponzano and the technical analysis of on its macroeconomic impact by Mario Baldassarri.

Indeed, I see that there is some broad agreement among us on the premise that the boundaries of a reflection on the budget of the euro area should be set in a way that is sufficiently broad to allow to at least lay the foundations for facing, over time, the aforementioned challenges.

Moreover, on each of these issues, much has already been done by the outgoing Commission, although progress has often not been fully noted.

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[2] Several new tools have been created and used by the European Central Bank to increase the effectiveness of monetary policy in a context of low growth and inflation. Supervision of the major credit institutions was centralized within the European Central Bank (ECB) and a Single Resolution Fund is now operational, although still limited in size. The creation of the European Stability Mechanism has also made it possible to directly support the Member States facing financial difficulties, whereas the Stability and Growth pact has been reformed and reinforced.

[3] European Commission (2017), Reflection paper on the deepening of the Economic and Monetary Union, Brussels, 2017, https://ec.europa.eu/commission/sites/beta-political/files/reflection-paper-emu_en.pdf

As Director-General for Economic and Financial Affairs, I have followed the first issue, that of macroeconomic stabilization within the area euro, with great attention and even passion over the last ten years.

As already mentioned, important tools have already been introduced to strengthen the so-called "resilience" of the euro area (strengthening of the ECB, banking union, ESM, reform of the stability and growth pact, etc.).

In 2018, the Commission itself proposed the establishment of a European Investment Stabilisation Function (EISF) in the next Multiannual Financial Framework (MFF) to provide access to subsidized credit for up to € 30 billion in the event of serious economic shocks.[4]

However, there is a broad consensus that the current architecture remains vulnerable, particularly to shocks of very large magnitude. As noted by several observers, further progress is needed for a stable architecture of EMU (e.g., Benassy Quéré et al., 2018).[5]

In general, given the incomplete nature of our financial and fiscal union, the key ingredients to overcome these gaps and improve the shock-absorption capacity of the euro area are the completion of the banking union and capital market union (CMU), as well as the introduction of a central adjustment channel to respond to large macroeconomic shocks.

As argued in a recent contribution (Buti et al., 2016)[6] , risk sharing by the private sector remains very limited in the EU, as evidenced by the comparison with the situation in the United States.

In the euro area it has so far eased only 6% of asymmetric shocks, compared to over 40% estimated for the US. The potential for improvement in this sector is therefore wide and a CMU would certainly contribute to this.

However, a financial and capital market union is not, in itself, a substitute for a stabilization function. The two are in fact complementary (Buti M. and Carnot N., 2018)[7]. This is so for two reasons. On the one hand, it is unlikely that full financial integration can be achieved in the short term, as it requires profound structural changes.[8] A central budgetary capacity would therefore be necessary at least until the degree of financial integration remains limited.

However, a second - even more fundamental – question, is whether the completion of a financial union can be seen as a substitute for a targeted fiscal capacity, or if the two act in a complementary way, reinforcing each other, as it is the case in the United States. Specifically,

[4] Alternative proposals concerning unemployment benefits have recently re-emerged in the public debate, also following the Franco-German declaration of June 2018, and the programmatic speech of the Commission's President-elect Ursula von der Leyen, who has cited among its priorities the establishment of a common unemployment reinsurance scheme.

[5] Bénassy-Quéré A, M Brunnermeier, H Enderlein, E Farhi, M. Fratzscher, C Fuest, PO Gourinchas, P Martin, Pisani-Ferry, H Rey, I Schnabel, N Veron, B Weder by Mauro and J Zettelmeyer (2018), " Reconciling risk sharing with market disciplines: A constructive approach to euro area reform ", CEPR Policy Insight No 91.

[6] Buti M, Leandro J and P Nikolov (2016), "Smoothing economic shocks in the Eurozone: the untapped potential of the financial union ", VoxEU.org, 25 August.

[7] Buti M. and Carnot N. (2018), The case for a central fiscal capacity in EMU, 7/12/2018, https://voxeu.org/article/case-central-fiscal-capacity-emu

[8] For example, it will take time to diversify transnational financial holdings and a certain degree of domestic bias may persist even in the long term in the presence of information asymmetric.

there is evidence that financial markets behave in a pro-cyclic way when left entirely on their own (Furceri and Zdzienicka 2015; Fahri and Werning 2017).[9]

Empirical evidence, in fact, seems to suggest that the stabilization capacity operated by the financial and public channels are substitute in normal times, but need each other in periods of crisis. In times of intense market stress, therefore, the shock-absorption capacity of a financial union will depend on the existence of a credible and effective central budgetary capacity.

This also suggests that the transition to a true capital union will require an approach that goes beyond the simple consolidation operated by financial operators and it can only benefit from parallel progress on other fronts, including the banking union, which is another essential tool to ensure macroeconomic and financial stability in the euro area.

Although the prudential and *bail-in* rules help to contain and reduce risks and minimize possible fiscal impacts, they do not eliminate the need for a common fiscal backstop. To improve its resilience to shocks, the banking union must therefore be supplemented by a single resolution fund (already approved, albeit of limited capacity) and the European deposit insurance system (still under discussion).

The introduction of these public forms of risk sharing is fundamental to consolidate the system by strengthening financial stability, reducing pro-cyclicality and maximizing the ability to mitigate asymmetric shocks through risk sharing in the private sector. In this context, the introduction of a *safe asset* would also take on a central role (Buti et al., 2017).[10]

As for the second challenge, that of structural convergence, much has already been done. Since the beginning of its mandate, the Commission initiatives have been recalibrated around the "virtuous triangle" constituted by the relaunch of investments (e.g. Juncker Plan), the stepping-up of structural reforms (e.g. European Semester and Macroeconomic Imbalances Procedure) and the implementation of responsible budget policies (e.g. Stability and Growth Pact). More recently, social fairness has also been recognized as a cardinal principle and has led to the approval of the European Pillars of Social Rights. There have also been important initiatives to reform and expand the single market. The latter is deepening in the areas of capital, energy and digital markets, to become an even stronger source of jobs, growth and innovation.

However, given the magnitude of the challenge, the issue will remain a priority for the next Commission and further initiatives are currently underway. From a euro area perspective, for instance, the agreement reached on June 13 in the Eurogroup foresees the creation of a specific budget line, within the general EU budget, to facilitate convergence and competitiveness within the eurozone.

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[9] In the case of EMU, cross-border financial flows increased slightly in the pre-crisis period and collapsed afterwards. In other words, the private insurance channel did not operate during the euro area crisis and actually worked in reverse (Furceri e Zdzienicka 2015). Private risk sharing is more effective when working in conjunction with public sector risk sharing. Some studies also point out that financial markets are not Pareto-efficient as private agents fail to hold the kinds of portfolios ensuring proper risk sharing in large shocks (Fahri and Werning 2017). .

[10] Buti M, Deroose S., Judge G and J Leandro (2017), "Completing EMU", VoxEU.org, EU, 13 July.

As rightly mentioned by Pier Virgilio Dastoli and Paolo Ponzano, the financial capacity will probably be limited initially and the instrument –as currently conceived - is unlikely to cater for a macroeconomic stabilization function.

However, I would like to underline that for the first time there is a broad political consensus on the inclusion of a budget line specific to EMU within the European budget. In line with current discussions, this tool could support both reforms and investment. For the first time, convergence and competitiveness - which concern not only price dynamics but also productivity - are recognized as key objectives for the monetary union. These bases seem useful to initiate a medium-term process to further promote – through the EU budget - competitiveness and convergence within EMU.[11]

At the same time, and we come to the third challenge, it is already in the short term that EU institutions and policy settings are prone to populist attacks from both a purely economic and a more cultural 'nativist identity' angle. It is true that this challenge by and large concerns the European Union as a whole, but with the exit of the United Kingdom, the euro area will account for more than 85% of the economy Union. It remains, hence, highly relevant in the context of broad longer-term reflections on the perimeter of a euro area budget.

Indeed, current Community competences, which are mostly confined to the harmonisation and organization of markets, are only partially able to cope with redistributive problems and social issues. This makes the EU appear - rightly or wrongly - as an 'agent' of globalization in Europe, rather than a 'European response' to globalization.

The emergence of so-called anti-systemic forces in several European countries is just the tip of a *iceberg* and it must be recognized that the issue has deeper roots and has not exhausted with the results of the recent European elections. Nor it is a purely European issue, as can be seen by recent events and dynamics overseas.

Despite the complexity of the matter, it is clear that European integration cannot be pursued or perceived as project of the 'elite'.

The growing polarization and discontent in our societies must therefore be addressed by finding better and more incisive ways to combine the advantages of open markets, financial stability and economic integration with democratic inclusion, social protection and equity.[12] The adoption of the European Pillars of Social Rights, strongly advocated for by Jean Claude Juncker, represent an important step forward, but certainly not the last word about it.

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[11] This proposal should therefore be considered a complement, and not a substitute, of the proposal to introduce an investment stabilization function for the euro area. While the former is intended to strengthen the growth potential and economic resilience of a Member State through the implementation of relevant reforms and investment projects, the second would contribute to mitigate the impact of serious economic shocks, which could still happen.

[12] Rebalancing is even more complicated in the EU integration context, where the divide between winners and losers does not merely follow the traditional fault lines along the functional and the personal distribution of income and wealth, but often also carries strong nationalistic connotations of north-south and east-west conflict. Regardless of its limited size, the current, rather rigid, structure of EU budget – largely inspired by the principle of *'juste retour'* - lends itself to a limited degree of redistribution. Indeed, it has been calculated that for each euro paid to the EU budget, on average, only one quarter crosses a border (D'Apice, P., 2016; Budget-related cross-border flows: EU vs US, Voxeu.org).

In the past, I have already had occasion to reflect on this kind of problems and, in that context, I outlined some guiding principles for a new positive EU narrative, largely inspired by the concept of 'European public goods'.[13] I see with great pleasure that this notion has a central place also in the proposal of the European Movement. However, the question remains multidimensional and - in some ways - goes beyond reflections on the utility and benefits of a single instrument.

Today's reality requires therefore a rethinking of the principle of subsidiarity in the EU. Decisions should be taken as closely as possible to the citizens and in line with the capacities available at national, regional or local level.

It is in this context that there is room for improvement in coordination and synergies - what I once called 'vertical coherence'[14] - between the Community budget and national ones. An answer to the fears of those who have not benefited from globalization, in the short term, can only materialise through joint efforts and coordination across different layers of government.

Similar considerations apply to the necessary response to climate change, the defining challenge of our time and a global public good, which can only become an ever-increasing priority in Europe, but will inevitably have different economic and social repercussions across countries, regions, firms and households.

To conclude, all this shows that - as already noted in the discussion paper on the deepening of EMU - the journey of EMU has just begun. We must never underestimate the need to strengthen its architecture.[15] Yet, if the foundations can only rest on solid economic basis and advice, its overall architecture cannot do without the contribution and support of civil society. As stated by Jurgen Habermas, « *Civil society is composed of those associations and movements that more or less spontaneously intercept and intensify resonance aroused in the private spheres of life by problematic social situations, and transmit and amplify this resonance to the political sphere* ". It is in this context that the proposal of the European Movement for a budget for the euro area and the simulations of its positive macroeconomic impact represent a fundamental and timely contribution to the debate.

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[13] Buti M. and Pichelmann K. (2017), European integration and populism: Addressing Dahrendorf's quandary, 22 February 2017; https://voxeu.org/article/european-integration-and-populism-addressing-dahrendorfs-quandary

[14] Buti M. and Nava M. (2003), Towards a European Budgetary System, RSC No. 2003/08, Robert Schuman Center for Advanced Studies, Florence.

[15] The report of the five presidents of June 2015 recalled the need to complete EMU and has outlined a roadmap until 2025. The first phase, which lasted until June 2017, consisted of «deepening by doing». The initiatives part of the second phase, to be completed by 2025, are still being discussed by Member States. It will be a duty of the next Commission to continue this discussion and help shape a common vision of the challenges to face and the path to follow.