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Making progress in economic and monetary union

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The state of the economy in Europe

The recovery that has been developing over the past several quarters in Europe is encouraging but modest. To obtain stronger and more sustained growth and job creation, decisive policy action is needed beyond the current policy mix and the positive contribution by the ECB policy stance. Action must be accelerated on several fronts: structural reforms, investment, and deeper economic integration. If on the contrary, complacency were to slow down policy efforts, visible progress in growth and job creation would fail to materialise. In such a case, as EU citizens are still heavily affected by the legacy of the crisis, in terms of unemployment, poverty, and inequalities the disaffection towards the European project would become more widespread than what already seen, boosting consensus for populist perspectives.

The European Union, and the euro area in particular, stand at a crossroads between muddling through a hesitant recovery or tackling the challenges of restoring growth potential, fostering employment within a stable macroeconomic environment, and rebuilding trust between the European institutions and European citizens. The Greek crisis and the possibility that exiting the euro could become a serious option has increased the risk that monetary union could become revertible and eventually unfold. We need a stronger policy mix, more effective economic governance, a consistent institutional architecture for the euro area and a stronger effort towards integration in the EU as a whole. We must proceed, along, and beyond , the lines recommended by the Five Presidents' Report "Completing Europe's Economic and Monetary Union", keeping in mind that a first set of measures can be implemented within the existing EU Treaty, while more far-reaching measures might require changes to the Treaty.

The policy mix in the EU

The current policy mix in the EU is moving in the right direction. The ECB's QE, is having a positive impact on interest rates and financial markets. The weakening of the euro should also be seen as an indirect consequence of QE. It is important to note that the move towards a more proactive monetary policy stance in the Eurozone has been facilitated by the implementation of responsible fiscal policies and national reform programs in the EU Member States. QE also helps create more favourable conditions for the implementation of structural reform in Member States as reforms deliver better results in an expanding economy. The Commission's Communication on flexibility, in January 2015, has provided incentives to Member States to introduce and implement structural reform measures, through the structural reform clause. Overall such a policy environment, boosted also by lower oil prices, provides a window of opportunity that must be exploited without hesitation.

Recovery of investment is crucial to put the EU back on a path of sustainable growth. Investment, supports demand in the short-term, and strengthens supply and potential output in the medium-term. Over the recent past, the fall in investment in the European countries has been dramatic and widespread. To help reverse this trend, the Commission has launched the Juncker Plan and created the European Fund for Strategic Investment (EFSI). The Plan is an important opportunity to boost private investment with public support, that would bear the additional risk private companies are not prepared to take on.

But more needs to be done to support growth. Further strengthening the internal market is a priority and an opportunity that needs to be fully exploited: there is ample scope for additional benefits, through deeper integration, and stronger competitiveness. The single market has been at the heart of the European growth strategy for more than two decades, however, national interests, institutional barriers and bottlenecks, both at national and at EU level, have prevented to reap the full benefits in terms of competitiveness and growth. The ongoing efforts to revitalise the single market, targeted at removing obstacles to the single capital market and creating a Capital Markets Union, overcoming the segmentation of the energy market, and promoting the digital economy and innovation go in the right direction. Beyond this we should keep in mind that the ultimate source of growth in an ageing economy such as the EU is through innovation driven productivity. In this respect the goal should be to move towards a fully fledged Innovation Union, i.e the EU should adopt an integrated set of initiatives, to stimulate knowledge creation through education and research, which are the main drivers of innovation.

Structural reforms must be coordinated more effectively with fiscal policy, as recognized in the EU Commission's Communication on flexibility. Strong structural action will boost medium term growth thus supporting consolidation of public finance that will, in turn, strengthen economic growth. Better and more targeted use of fiscal space, in both spending and taxing decisions will reinforce the impact of structural measures. All EU countries need to implement structural reforms. The more so euro area members that need to compensate the loss of an independent monetary policy with more flexibility and resilience in labour and product markets (this is, after all one of the pillars that underpin optimum currency areas). **More symmetry is needed in macroeconomic adjustment.** Countries with current account surplus should take measures to reduce them, preferably though more investment. And structural reforms would support such rebalancing as they open profit opportunities that stimulate investment. Accommodative monetary policy would enhance the impact of structural reforms by maintaining favourable financing conditions.

The implementation of the Juncker Plan must be swift and provide a genuine additionality effect of public resources. The Plan should activate projects which would not otherwise materialise, due to excessive risk, market failures, or financial and budgetary constraints. The identification of high quality projects is one of the crucial issues for the success of the Plan. Last but not least the success of the Plan depends also on the contributions from national development banks, some of which have committed to supporting projects and platforms in the framework of the Plan.

A Capital Markets Union is a welcome initiative. The capital market in the EU is relatively less developed compared with the U.S.A. In the EU business environment funding is dominated by the banking system, and it is largely organised along national lines. Deeper and more accessible capital markets could contribute to boost investment, growth and jobs. To become effective in a long-term perspective, the EU single capital market requires greater convergence in corporate and bankruptcy regulatory regimes, as well as in tax law systems within the EU.

Much remains to be done in energy and labor markets. With regard to energy, the integration of national markets, would have a significant impact on the competitiveness of the European economy, Harmonisation of national regulations of the labor market would encourage labor mobility and would be enhanced by the pooling of resources to support adjustment and reallocation. A common unemployment insurance scheme would increase the resilience of the Union (and more importantly the euro area) and facilitate macroeconomic stabilisation (I will return to this point later). Furthermore, the portability of individual pensions would help pooling national pension funds at European level, that could boost long term investment projects at EU level.

Changing governance

To boost the performance of monetary union changes in governance are also needed. A monetary union is ultimately unstable if structural differences persist among member countries. EMU cannot survive in the long term unless it continues to move forward in terms of integration and convergence, ultimately leading to a political union. We cannot stay still. If we do we risk a return to the vicious circle of "fragmentation - short-termism - further fragmentation" that we have seen at work in the years of crisis, 2011 and 2012; we must instead put in place a virtuous circle of "integration-long-term strategies- more integration." To obtain such a change in direction the current policy mix must be strengthened along the lines discussed above; however, we also need significant changes in the governance and functioning of the Union.

To make monetary union really irreversible a change of approach is required: we must manage our European common house, not only on the basis of national interests, but by adopting a systemic, common vision.

This approach can be applied to a variety of policy dimensions. Much has been done towards a more coordinated assessment of national fiscal policies within the European Semester and at the Eurogroup level with the dedicated session to discuss the Draft Budgetary Plans before the final national approval of budgets. Nevertheless, more progress remains to be achieved for the definition of a coherent policy strategy, which considers, in a more systemic and explicit way, the supranational dimension and the implications for each country. We need to establish a much closer link between the analysis and policy recommendations at the aggregate level and their implications for individual countries, taking into account the spillover effects of national economic policies on other countries.

A stronger monetary union needs strong common institutions. Here too we are making progress but more needs to be done, in the short term, within the existing treaties and in the long term contemplating treaty change.

Let me offer an example, presenting briefly a proposal advanced by the Italian government.

To complement the national efforts to reform labor markets a European mechanism to mitigate the cyclical unemployment and its consequences would enhance labor market adjustments, reinforcing the effectiveness of national reforms. It could also create incentives to increase convergence in labor market regulation. It would help consolidate medium term growth by smoothing downturns and preventing or limiting hysteresis. It would be a further sign of the irreversibility of the Euro, with a positive impact on expectations. Such an instrument could be established without treaty changes.

The development of a stabilisation function to cope with asymmetric shocks implies an increasing degree of integration and fiscal transfers financed by a common fiscal capacity. Crucially, such a European insurance scheme should - and could - be designed in a way to avoid permanent or unidirectional transfers. These mechanisms, which are part of existing well functioning monetary unions, would give countries a chance to smooth out the adjustment needed in presence of adverse shocks, avoiding, altogether, overly restrictive adjustment policies. More generally mechanisms that strengthen the real side of the economy, labor and product markets, would complement existing institutions that underpin the architecture of EMU starting with Banking Union.

Let me quickly and partially list the "to do" agenda. Banking Union, is a great achievement in the process of institutional innovation. However, two elements are still missing: a single deposit guarantee scheme, and the implementation of the agreement on the establishment of a common public support (the so-called common backstop) for the Single Resolution Fund. A fully fledged

Banking Union requires that all the pillars are at work. They are key to definitely break the sovereign-bank nexus and increase resilience against future crises.

The completion of the Banking Union should go hand in hand with the establishment of a genuine single capital market, a Capital Markets Union. In addition to boosting investment and growth this would also introduce a further element of risk sharing through the development of financial markets and the related insurance mechanisms. Moreover, the ties between euro and non euro member states would be strengthened.

The institution of the European Stability Mechanism (ESM) has been a major advance for the management of sovereign crises, through the use of pooled resources. As the urgency of the crisis is waning, we should focus on how to fully exploit the benefits of this pool of resources while preserving its ultimate firewall function. An ambitious goal, would be transforming the ESM into a European Monetary Fund. In the shorter term, the ESM could become the backstop for the above mentioned resolution fund to testify the determination of the euro area countries to jointly and effectively safeguard financial stability in the Union.

Finally, monetary union needs to be complemented by a Fiscal union. I cannot dwell on this aspect but limit myself to noting, all in all, that the process of institution building along these lines would ultimately lead to political union.

This leads me to the issue of trust. One lesson arising from the crisis, is that the stability and progress of economic and monetary union requires more mutual trust, and a more forceful systemic approach, which implies more attention to the positive externalities of the integration process. Mutual trust can be accumulated by showing peers that one country abides by the rules. Rules must be designed so as to reward good individual behaviour and discourage uncooperative behaviour (i.e. prevent moral hazard). At the same time, rules must provide for risk sharing mechanisms which increase payoff for cooperative behavior. Risk sharing mechanisms are a key component of well functioning monetary and economic unions. In other words rules must allow for mutualization. The two elements are reciprocally reinforcing. Preventing moral hazard strengthens trust and supports mutualisation. Risk sharing and mutualisation offer a powerful incentive to abide by the rules and prevent opportunistic behaviour.

Crises are detrimental (also) because they destroy trust, i.e. the very fabric of a monetary union. This is especially true for prolonged crisis. To strengthen monetary union we need to replace the vicious circle "mistrust-fragmentation", which dominated during the crisis, with the virtuous sequence "confidence-mutualization". EMU was conceived from the very beginning as a means to build confidence. Rebuilding trust among Member States, and defusing national prejudices are the principles that should guide the actions of European governments in our effort to learn from the crisis.

Conclusion

To conclude. The debate on the future of monetary union is a great opportunity to strengthen the resilience of the European economy and of the European project at large. How we move forward in this new challenge should be guided by a few key principles.

1) The link between short term and long term issues should be strengthened and based on a common vision. There should be no excuse for concentrating only on the short term
2) The distinction between measures that require Treaty changes and those that do not should not be an obstacle to ambitious policy goals. Much can be done with the current treaty, and thus build support for treaty changes when needed
3) Economic union is a multidimensional project. Strengthening monetary and financial integration should go hand in hand with measures to boost growth and jobs. This would show European citizens that Europe can be a part of the solution and not part of the problem
4) Strengthening EMU should be an opportunity to strengthen the relationship between EMU and non EMU member states with reciprocal benefits for all of us and Europe as a whole.