A compass to prosperity: the next steps of euro area economic integration

The euro area should consider several areas of reforms in the coming months, including a modernized capital markets union, an improved banking union, and the creation of a central fiscal capacity, says Christine Lagarde

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The euro area compass

It seems the harsh winter is giving way to signs of spring. Indeed, we are seeing strong growth in nearly every region with global growth at 3.9 percent. In the euro area, the IMF is projecting 2.2 percent growth in 2018. This means the expansion is about to enter its fifth year and the recovery has finally turned into a sustained and broadly shared upswing.

But there are other, forceful headwinds threatening. Think of the rise of populism and the short-sighted siren call of protectionism. We need to find guides for the choppy waters now facing so many parts of the world. My aspiration is that the euro area be one of those guides going forward.

A more unified euro area can be a compass to prosperity for the region and a beacon of hope to the world. It can be a source of global economic stability and proof that international cooperation can still deliver. A look at the numbers reveals the potential.

Measured by GDP, the euro area has the same economic power as China. Measured by population, the euro area is slightly larger than the United States. And while the European project more broadly has come a long way, it is only half-finished. From better migration policies to a common defense system to sustainable energy sharing — the missing pieces are clear to see, but complicated to resolve.

This is especially true for the specific topic I want to focus on — the euro area architecture. If the euro area is to be an effective compass, it cannot only be an economic union of convenience in calm waters. It needs to be strong enough to shield the members against storms. So I would like to offer our contribution to the conversation about where the euro area might travel next and ways the currency union can fortify itself for the challenges ahead.

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Lessons of success and crisis

To start, we should recognize how much the euro area has achieved in the nearly three decades since its inception. Imagine if you had told someone in the aftermath of the Great Depression or World War II that in the year 2018 a majority of European nations would share a single currency. They would have said it was a fantasy. But through co-operation, it has become a reality.

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The IMF has been Europe's partner in this project — from our support of the Maastricht Treaty to helping new members with the adoption of the euro. There is no doubt the work has been difficult, even painstaking at times. The system that was created had gaps that were left unaddressed.

This became abundantly clear during the back-to-back blows of the global financial crisis and the euro area sovereign debt crisis. On March 16th, 2008 — almost exactly ten years ago, Bear Stearns collapsed — a moment I remember well, as I am sure many of you do too. A few months later we experienced the shocking failure of Lehman Brothers. In the years that followed, both the capacity and limitations of the euro area were tested.

- You created new institutions and capabilities. Think of the establishment of the European Stability Mechanism (ESM) and the unprecedented support delivered by member countries to euro area counterparts. Between 2010 and 2016, the ESM and its predecessor provided over €250 billion in loans to five countries hit hardest by the crisis. The European Central Bank showed tremendous leadership when it committed to do 'whatever it takes' to preserve the currency union. These actions held the currency union together and helped pave the way for the recovery.

- Yet there are still limitations. While actions were taken to address crisis legacies, much remained to be done. From building up resilience, to securing the financial sector, to ensuring that fiscal policy plays its part, we know there are still weaknesses in the system.

Now is the time to address them. In the sunlight of our cyclical upswing, we cannot afford to be complacent. As I have said recently, the time to repair the roof is when the sun is shining, as is the time to complete the architecture. As a former finance minister, though, I recognize the difficulty of pursuing reforms just when growth is accelerating.

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It calls to mind what Jean Monnet once said to Willy Brandt, as they debated the creation of a monetary union: *"It is not natural for men to unite. It is necessity that pushes them."*

The reality is that the euro area does have a necessity today. It is the necessity of filling in the missing pieces of the architecture so that the region is prepared for the next crisis. Sooner or later, the next downturn will come and the need for a good compass will quickly become apparent.

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The next steps of euro area economic integration

There are several areas of reforms that should be considered as European countries review the euro area architecture in the coming months. I want to focus on three of them — a modernized capital markets union, an improved banking union, and a move toward greater fiscal integration, starting with the creation of a central fiscal capacity.

The goal of each of these reforms is not to encourage complacency but to create more resiliency for the euro area. To use the technical terms, the union should strike the right balance between 'risk-sharing' and 'risk-reduction.' I prefer to think of it as the idea that members' fates are interconnected. To work well, the euro area needs more mutual trust across countries and increased accountability.

Progress in tandem on trust and accountability would enable the union to realize more of its potential and become greater than the sum of its parts. Of course, it will take time and a lot of hard work to get there. That is certainly the case when it comes to capital markets and banking union.

a) Capital markets union

Here, we already see positive steps in the work to modernize capital markets. The capital markets union (CMU) ac-

tion plan is designed to provide businesses a wider range of domestic and cross-border finance options. This would reduce private sector firms' reliance on banks across the European Union.

We are already seeing momentum in some areas, including recent legislation to improve access to financing for SMEs through high-quality loan securitizations. These instruments will now operate on a level playing-field with similar types of assets.

At the same time, a new 'prospectus' regulation has streamlined administrative procedures and made it easier for smaller companies to raise capital. Firms issuing debt or equity must produce standardized information. This will also allow investors across Europe to have a better sense of risks.

Now, there is even more urgency for action. One of the consequences of Brexit is that many financial services will likely move to continental Europe in the months ahead. Enhanced regulation and upgraded oversight arrangements will be needed to handle the potential influx of these firms.

And efforts can go even further to create a fully integrated EU capital market. More transparent bankruptcy rules could make it easier for investors to at least partially recoup losses in case a business fails. Better harmonized insolvency laws and business continuity plans would promote investments between countries.

Implementing all or even some of these proposals would develop capital markets and stimulate growth for the entire region. The capital markets union is, of course, complementary to the banking union — where we also see both positive steps as well as significant remaining gaps.

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b) Banking union

One of the goals of the banking union is to prevent another crisis. Euro area policymakers have made significant progress on this front. The creation of a single supervisor for banks, the introduction of a new framework for handling bank failures, and development of new tools to address banking crises are all major achievements.

However, the lack of a common deposit insurance scheme and a shared fiscal backstop for the Single Resolution Fund could put these gains in jeopardy. In fact, these are the very instruments that would help stop bank failures from snowballing into financial crises. How so?

Typically, if a bank goes bust, a country's insurance system can at least partly compensate account holders. But in a crisis, when many banks are struggling, the system could be overwhelmed. This makes it impossible to give people their insured deposits back — unless the government steps in. If the costs are high enough, a sovereign debt problem arises. Think of Cyprus in 2013.

A common deposit insurance scheme would allow the costs of bank failure in one country to be shared by banks across the euro area. It would reduce the risk of banking sector problems being shouldered by taxpayers and turning into another sovereign debt crisis. Here, the size and diversity of the euro area could be key strengths.

To make it work, all sides will again need to show both trust and accountability. Significant efforts are already underway. Euro area banks have nearly doubled their capital buffers since 2007. Non-performing loans have been reduced by more than €100 billion in the past year alone.

Many euro area members have embraced the spirit of the words of former EU Commission President Jacques Delors, who said: *"The European model is in danger if we obliterate the principle of personal responsibility."* But in order to

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prepare properly for the next downturn, more action is required. There are a few ideas worth considering.

In return for a common deposit scheme, banks which have high-levels of non-performing loans should commit to aggressively clean-up balance sheets. We welcome recent suggestions to start using action plans with concrete timetables. Banks can also use the current upswing to continue building capital and ensure they have the ability to absorb any future losses.

The upcoming June European Council meetings provide an excellent opportunity to discuss these issues and take the next steps on the banking union.

One encouraging sign is that there appears to be broad support for a common backstop to the Single Resolution Fund. Agreement on a schedule for common deposit insurance, together with a roadmap for reducing vulnerabil-ities in the banking sector, would be an even bigger move in the right direction. At the same time, we know that accounting for sovereign debt held by banks is controversial.

So yes, the path forward is certainly difficult, but the destination is worthwhile: a safer banking system across Eu-rope, one that is self-insured and does not rely on sovereign implied guarantees and does not fall back on taxpay-ers. Just as you are coupling risk-sharing and risk-reduction to generate support for the banking union, the same strategy can be used on the fiscal front.

c) Central fiscal capacity

During the last crisis, monetary policy had to do much of the heavy lifting. Raising taxes and cutting spending — as many in the euro area did between 2011-2013 —exacerbated weaknesses and contributed to a double-dip reces-sion.

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To avoid a painful repeat of this experience, the euro area needs a central fiscal capacity. This would supplement members' own fiscal efforts, which will always be the first and main line of defence in any downturn.

It is not a matter of some countries altruistically helping others. A central fiscal capacity will reassure investors that the euro area has better tools to stop the next crisis from spreading. This will help prevent the near-panic we saw last time.

And the benefits go beyond crisis prevention. This capacity can help smooth out the economic cycle and improve the functioning of the currency union — especially when monetary policy proves insufficient. This is not a new issue. The IMF has long advocated for a central fiscal capacity. We have released a paper showing how this can work.

It proposes creating a 'rainy-day fund' that countries contribute to each year to build up assets in good times. Then, depending on the depth of a downturn countries would receive transfers to help them offset budget shortfalls. In extreme circumstances, the fund would be allowed to borrow, however any borrowing would be repaid by members' future contributions.

By itself, the capacity may not be enough to solve the next crisis — but it certainly would help. By way of illustration, the paper analyzed the case of a large euro area-wide shock when monetary policy is constrained. It found that for a relatively modest cost — 0.35% of GDP per year — a central fiscal capacity could reduce the negative effects on output by more than 50 percent.

It would similarly shrink the divergent impact of the shock across countries. Country-specific shocks would be cushioned by nearly as much. But let me be clear, it will be a temporary cushion and not a permanent pillow. Our suggested approach requires members to take greater responsibility for putting their own houses in order.

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Or, as you might say in German, *Eigenverantwortung übernehmen*. Some countries are understandably worried that by promising to provide support in bad times, other members will pursue less prudent fiscal policies. There are also legitimate fears about whether a central capacity would generate permanent transfers from one set of countries to another.

Our proposal has two innovative approaches to address these concerns.

- First, to make sure that all countries meet their obligations, transfers from the fund should be conditional on a member's compliance with EU fiscal rules. This requirement is critical because it creates incentives for all members to play by the same rules, undertake reforms, and build buffers.

- Second, we recommend that countries pay a premium in good times, based on the benefits they receive from the fund in bad times. It is a bit like raising the cost of insurance after a car accident. This would help avoid the problem of permanent transfers.

We recognize that members' views differ significantly on such a fiscal capacity. The need is not universally accepted and it will be politically difficult to reach an agreement. But we trust policymakers will use these ideas in their upcoming discussions while keeping in mind the ultimate goal of this proposal: a better mix of fiscal policy and monetary policy working together to enhance the resilience of the euro area and prevent another crisis.

Each of the topics I have raised will take time to refine and implement. But we should not let the perfect become the enemy of the good. My hope is that even if it is in small ways, countries can use this moment of global growth to improve the euro area architecture and build a stronger economic union in the days ahead.

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Conclusion

I began by asking you to think about the euro area as a compass to prosperity. You might have thought, well, we all have GPS on our phones! We do not need a compass. I disagree. We need every tool at our disposal.

At a moment when multilateralism is being challenged around the world, many are looking to countries in Europe to show that cooperation can translate into economic security. It is not just Monnet or Delors or any other founding father of economic union who might think so. It is this generation who recognizes the power of integration.

In a recent poll, 74 percent of respondents in the euro area said they support a European economic and monetary union with one single currency — the highest number ever recorded. Amongst all European's surveyed, 71 percent said the region was a place of stability in a troubled world. To show that they are right, we can find ways to improve our ability to navigate.

It will not be easy. It will take creativity, compromise, and patience. My message is that the IMF remains optimistic because we know — just as you do — what can be accomplished when Europeans are united. Europeans can achieve a more resilient, more prosperous euro area and deliver opportunities for millions of citizens. We look forward to continuing to be your partner on this journey in the days ahead. ■

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Endnotes
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