Active is: Anticipating what's ahead

EMU reform must go further to be effective

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Summary

A stronger monetary union is essential to guard Europe against future financial crises, but to achieve it, countries will have to work much closer together.

Key takeaways

- The strength of an economy is not in its economic growth during the good times, but in its resilience during a recession
- The EU needs a consistent strategic vision and consolidated approach to fiscal discipline, and a way to enforce it, but too-strict control could reduce trust in EU institutions and increase nationalism
- Financial integration is key to making EU economies more resilient; better integration could dissipate shocks through the financial markets
- The EU has implemented some reforms that will prepare it for the next crisis, but more must be done
- Without reform, the euro may weaken and the EU stay at the periphery of the global economy – but the EMU will be blamed before the politicians

Following the 2008 financial crisis, the European Union (EU) resolved to further strengthen the economic and monetary union (EMU). It implemented a number of reforms with an aim to reinforce macroeconomic and structural policies, including a banking union and the European Stability Mechanism (ESM), which acts as a lender of last resort.

However, by 2010 economic growth in the region was recovering and discussions regarding euro-zone budgeting, further fiscal integration and approaches for cushioning asymmetric shock all fell by the wayside as political will gave way to division, tension and political mistrust.

As the global economy moves late cycle and is increasingly threatened by trade rifts, Europe is likely to face recession, the depth and severity of which is unknown. With public debt at high levels and euro-zone banks owning large amounts of sovereign debt, the EU needs to continue evolving the EMU in order to safeguard its member countries and avoid the banking and sovereign doom-loop of previous crises, where national banks were laden with debt from sovereigns facing distressed financial outlooks.

Yet European capital markets remain incomplete and fiscal regulation limits government ability to respond to idiosyncratic shocks. To strengthen, the EU needs to progress further towards a capital markets union (CMU) which means first creating a functioning fiscal union. A CMU would complement the banking union and create diversification within funding sources while removing cross-country barriers, making it easier for investors to access capital markets.

No longer can the EMU remain a source of division and tension and no longer can

A number of reforms were suggested after the height of the European sovereign debt crisis with the aim of protecting the EMU against future crises:

there be separation between trade and monetary arrangements. A true political union, such as that in the US, has a centralised institution to provide fiscal relief to member states in economic or financial shock. But in Europe, negative attitudes towards further integration remain; topics like a shared instrument to pool national debt remain contentious. The EU is supposed to be primarily a political union, but has been criticised for instead behaving like the sum of national egos.

The proposition that European safe bonds (ESBs) may increase the stability of the banking union has also caused tension. ESBs would split member states between those that are fiscally responsible and those that are less so, essentially penalising fiscal discipline with higher interest rate costs. Yet arguably ESBs could strengthen the EMU by preventing capital flight, and helping break the loop between national banks and sovereign states.

Implementation would likely mean a treaty change and, as national identity within Europe is generally stronger than any pan-European identity, any change to the treaty would likely involve years of negotiation, ratification by national parliaments, and possibly even referenda in several countries. Treaty amendments may also create ramifications for Target2 balances, which since 2012 have been used to help prop up the euro-zone banking system, and some sovereigns' ability to borrow.

If one of the prerequisites for a successful EMU is a need for shared objectives, the fundamental issue in the euro zone is a lack of a consistent and consolidated approach. In the US the President and the Federal Reserve Board meet regularly and, when faced with a crisis, come together to find a resolution. In Europe, 19 different governments meet ad hoc with no framework and no regulation on how to tackle an issue, and each has a different perspective of the crisis.

The banking union ensures that EU banks are better supervised and more transparent. It is comprised of three main elements: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM) and the controversial European deposit insurance scheme (EDIS).

The European Stability Mechanism (ESM) is aimed at facilitating dialogue between private and public investors to act as a lender of last resort for distressed member states. However, for the ESM to be successful and credible, it needs a Europe-wide treasury to work alongside.

The capital markets union (CMU) is an initiative to unite the capital markets of the 28 EU member states with regulation affecting business interests in Europe, from banks and pension funds, to SMEs and credit rating agencies.

European safe bonds (ESBs) are an instrument designed to pool national debt. They could allow financial institutions to diversify their bond holdings and break the "doom loop". However, ESBs remain a sensitive political topic which would split member states into those which are considered safe havens and those which are economically vulnerable.

Target2 is a cross border payment system created to minimise systemic risk in the payments market and maintain the stability of the euro-zone money market. Since 2011 Target2 has been criticised as acting like a bailout system enabling indebted euro-zone economies the ability to borrow financial assets.

This in itself causes issues as, if Europe's system is to dissipate shocks, policymakers need to focus on becoming one economic and politically homogenous region. This could mean establishing a common framework on national budgets in an attempt to harmonise taxation across the region.

For example, certain EU member states currently offer accommodative tax structures, resulting in accusations of behaving like tax havens. As all tax measures must be agreed unanimously by all 28 members of the EU Council member states are able to protect this status by blocking any meaningful tax reforms.

Member states argue that they should be free to determine their own taxes according to national priorities. However, to create economic stability politicians need to implement European – not national – solutions. This is one of many issues against a backdrop of the recent European parliamentary elections, which show ever greater fragmentation of political parties and a rise in nationalist rhetoric.

Although many euro-zone countries have similar priorities, they do not hold shared interests and this failure is the key issue underlying the argument for fiscal discipline. Ultimately, the resilience of the EMU is currently achieved through the fiscal discipline of each individual country. Stricter enforcement of this could lead to further political mistrust of central institutions, already at an all-time high due to the perceived uneven imposition of both monetary policy and fiscal austerity. This is reflected in growing budget tensions between Italy and the EU.

The growth of Eurosceptic sentiment will cause yet greater divergence between political states and economic outcomes. Deeper integration and strengthened institutions could foster trust within the EU, but the current bitterness between countries has focused the debate on risk-reduction and risk-sharing.

The great sadness is that the lack of political will to implement European reform will likely result in the EMU remaining ineffective and its shortcomings still present. The EU will continue to face existential risks if it is unable to secure the necessary tools to protect itself from future crises and provide an efficient monetary union. Ultimately the euro may remain weaker and at the periphery of the global economy as it will be vulnerable whenever economic difficulties emerge in the region. In the end it will be the EMU that is blamed and not the politicians.

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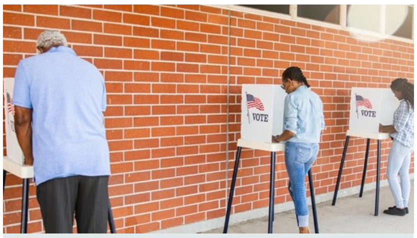

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The ECB is ready to take action

by Franck Dixmier | 17/06/2019

Summary

The ECB's next meeting on 25 July is of major importance, and markets should welcome confirmation of its new forward guidance. We expect the central bank to reaffirm that it has the will to support growth and manage inflation, and the tools needed to take action.

Key takeaways

- At the ECB's next meeting, we expect confirmation of the statements Mario Draghi made in Sintra on 18 June: the central bank is ready to take all measures to support growth and move closer to its inflation target, and will likely provide new forward guidance
- We do not expect any concrete action until the ECB's September meeting, which should open a sequence of lower deposit rates followed by the launch of an asset-purchase programme at the end of the year
- The official confirmation of this new forward guidance should be welcomed by the markets, and should help anchor rates at extremely low levels
- We have entered an undeclared currency war

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