ECONOMIC AND FINANCIAL STRUCTURAL REFORM IN THE EUROPEAN UNION

Introductory thoughts on the current situation

It was decided at the Conference of Heads of State or Government in Maastricht on 09.–10.12.1991 to adopt a common currency in these countries. This laid the foundation for the European Economic and Monetary Union. This was and is intended to be a preliminary stage for the creation of the European political union – *United States of Europe* – according to the model of the United States of America.

U.S. economists, above all, were sceptical about this project as a comparison of these two federations would reveal quite considerable differences between the countries. The opinion of Milton Friedman (1912–2006), the 1976 Nobel Prize Laureate, attracted particular attention. He referred to the fact that U.S. experience cannot be transferred to Europe very easily as individual European countries – unlike U.S. states – vary a lot both in economic and sociological terms. In the U.S. most public expenditures are born by the federal government so it is relatively easy in case of regional economic disparities to redirect sufficient aid resources to regions which are in a crisis situation. The labour force and officials are much more mobile between regions due to the common language, in principle commonly perceived culture and relatively few personal connections with their home states. In addition, the labour markets are much less regulated than in Europe. On the basis of all these factors, salaries and wages can be more easily adjusted to different levels of development of economic areas. The same applies to capital flows which can move between the states without any barriers; in Europe, on the other hand, different regulations have been applied.

When the essence of the Monetary Union began to acquire a clearer shape in August 1997 after long discussions in competent committees, Milton Friedman expressed his opinion in a paper that European countries should not give up the balancing impact of flexible currency exchange rates and independent monetary policies. He dreaded that introduction of the euro would increase political tensions and cause disruptive conflicts. That would prove to be an obstacle for the achievement of the stated goal of political unity.

The current crisis seems to confirm the correctness of Milton's statement. Due to the very different initial situations and developments that have taken place meanwhile in the different countries of the eurozone, the way to the European Economic and Monetary Union (EMU) and as a final goal to a political union has turned out to be more difficult than it was assumed at first. The institutional structures of the union that have developed by now have proved to be inadequate and with shortcomings. It is necessary to reform this project which is politically so important for Europe in order to prevent its failure. The current system according to which each member state has still largely its own fiscal and economic policy will have to develop into a union where decision-making and control over fiscal and economic activities and also responsibility for the consequences of these activities have been transferred to the competence of EU institutions. This assumes the reform of the EU Treaty together with the Convention of the Future of Europe. When moving towards this goal it will become clear whether the

current regulations effective in certain countries are in such a conflict with the adjustments, corrections and additions required on the European level that several referendums would have to be carried out. This is particularly important considering the strivings for setting up a political union which make it necessary to amend national constitutions and therefore require an absolute majority in the parliaments of these countries or even referendums. It is quite unsure whether electors agree to the delegation of increasingly more competencies to EU institutions.[1]

In order to explain the way towards the political union set as the goal, Jean-Claude Juncker, President of the EU Commission, prepared the respective memorandum in close cooperation with the presidents of the remaining four EU institutions[2]. This outlines the measures which could be taken according to the above-mentioned presidents to overcome the crisis in the still immature European Economic and Monetary Union encumbered with shortcomings and how to complete the creation of this union by the end of 2025.

According to the group of presidents, structural and institutional framework conditions will have to be developed in three directions for the creation of a 'deep, genuine and fair' European Economic and Monetary Union: ***Creation of a 'genuine', real economic union, establishment of a monetary union*** through the completion of a banking union and accelerated formation of a union of capital markets, and ***formation of a fiscal union*** on the basis of common budgetary policy and giving up sovereignty to a large extent. Progress in these three directions would create *uno actu* also an absolutely necessary framework for the creation of a ***political union*** as all these four above-mentioned unions will be formed on the assumption of the existence of the other unions. For instance, transfer of competences related to social policy to EU institutions would probably be impossible without an actual political union.

A particularly important condition for a genuinely functioning economic union would be the reform of the existing structures in the respective countries in the course of several years right at the initial stage, in the direction of comparable, modern systems immune to crises. But what actually happened? Political authorities ignored such absolute requirement. Their priority from the very beginning was to set up a monetary union as soon as possible. Thus euro was introduced as the currency unit without the creation of stable preconditions. Thus the current ongoing crisis was already pre-programmed at that time.

In order to create *'United States of Europe'* according to the model of the United States of America on the basis of unification of the levels of development, economic growth and employment and without prolonged crises, the structural and institutional conditions in the eurozone should be similar to those in the U.S.A. This would assume above all the following:

• more financial competence to the central government;

---

[1] "The euro is more than just a currency. It is a political and economic project." (Europäische Kommission, Nachricht 22/06/2015, Fünf-Präsidenten-Bericht: Die Wirtschaft- und Währungunion Europas vollenden, S.4 [*European Commission, Communication 22/06/2015), Five Presidents' Report: Completing European Economic and Monetary Union, p. 4*]

[2] EU Council, European Central Bank, Eurogroup, EU Parliament.

• centralisation of financial supervision;
• free financial markets, i.e. deregulation of capital flows, in order to use the capital as efficiently as possible;
• more mobility of labour in the labour markets of the eurozone;
• less impact of national authorities on the economy.

The strategy of planned *approximation* of the levels of development, integrating and sustainable *economic growth*, *stability of prices* and stable *employment* consists of three main elements:
→ Reduction of the effect of the state on the economy through liberalisation agenda. Further increase in the loan burden will be not allowed for the governments of the countries of the Economic and Monetary Union. Instead, they will be required to pay their national debt from current incomes. Banks are only allowed to have government bonds in limited quantities.
→ In order to avoid in the future again the situation where an initially banking crisis would develop into a government bonds crisis – like it happened in the years after 2007 – the new arrangements for financial markets provide separation of banks from the states. According to the European Single Resolution Mechanism (SRM) for crisis situations and the European Single Supervisory Mechanism (SSM) for banks, the losses would be born in the future first by creditors (bail-in) and subsequently by the European Single Resolution Fund (SRF) for banking crises. The Member States themselves will only bear responsibility according to the principle of subsidiarity – closeness.
→ Improvement of international competitiveness is the central task. This applies to each single Member State to avoid problems within the union due to different initial competitive situations. As salaries and wages have no central importance as sources of demand or basis of well-being but only for incurring costs, their increases have to be restricted by the progress of productivity. As to pension payments, the postponement of retirement age should be considered due to longer life expectancies. Capital costs will not be taken into account in long-term plans.
→ Unemployment should be fought on all levels in the framework of comprehensive active involvement policy by supporting professional training, further training and continuing education, also mobility in the labour markets. Further sufficient financial security should be offered when these measures are not successful due to personal circumstances. This, however, should only be used if the person clearly wants to continue working. On the other hand, protection against lay-offs should be restricted. Stimuli should be created for labour with low qualification to induce them to start working, such as the earned income tax credit[3] used in the U.S.A. for paying additional support to low income earners.
→ It is planned to level off asymmetric cyclical developments in single EU Member States through the introduction of the EU unemployment insurance. Also imposing of restrictions would be considered to prevent situations where countries in crisis would receive longer support payments as unemployment is not always caused only by the economic cycles but also by structural factors. Thus the approximation of payment flows within the Community should be limited to only sudden losses of jobs and have a

[3] EITC, tax credit provided in case of low to medium income, is applied by stages depending on the number of children in the family.

maximum duration of up to twelve months. Besides, the countries assisted would have to co-finance the support to the extent of half of the amount.[4]

→ The clause of assumption of liability (no bail out clause) effective in the European Union will have to be retained, in principle. Exceptions will have to be clearly regulated by strict conditions and have to be unambiguous.[5] If rules can be bent, it may prove to be a serious obstacle to integration. According to the current experience, such bailout measures planned for different needs cause egocentric behaviour of nations (moral hazard) and provoke opposition in donor countries.

→ It is planned to merge the EU financial market, currently fragmented into numerous national parts, into a large capital market union and to generally facilitate access to this market. In order to avoid the dependence of small and medium-sized enterprises from bank loans only and to allow them to seek financing more easily directly from financial markets, it is planned to amend directives and make it easier to prepare stock exchange prospects, making them shorter, more easily understandable and more specific. The bureaucracy of the bonds market will have to be reduced in the future, harmonising mandatory auditing of the accounting and financial reports and facilitating the flow of risk capital into start-up businesses.

→ The European Fund for Strategic Investments (EFSI) has been set up to remove obstacles from investment activities, favouring of investments in key areas, such as infrastructure, education, scientific research and innovation, and establishment of new businesses. The Fund is financed from the EU budget and from the funds of the European Investment Bank (EIB).

→ It is debatable whether the regulation of insolvency would have a stabilising effect on the insolvency proceedings of countries and consequently it should be included in the EMU legal framework. Such a regulation may, however, be used tactically by countries and induce them to borrow more lightly – hoping for regular insolvency proceedings. This would set the stability of financial markets at risk. Besides, risk premiums of interest rates would rise at the appearance of first signs of insolvency and an impending insolvency proceeding to such an extent that a country would go bankrupt even if it has no excessive debts.

On the other hand, a country without solid financial management would have to take into account risk premiums of their credit interest rates. Thus the establishment of an insolvency regulation would have a discouraging effect and would force eurozone countries to follow their budgetary discipline. The procedures described would also make it possible to evaluate better the risks of recourse on national debt to allow creditors to give up debt collection more easily on the basis of rational economic considerations in case of sudden insolvency. Thus the insolvency proceeding mechanism can be an important instrument for the prevention of crises.

[4] But still: as long as labour market policy remains fully within the competence of single Member States, it is not possible to exclude that the European unemployment insurance becomes just a union of distribution of support payments.

[5] In connection with the clause of assumption of liability in exceptional situations, it is important to emphasise specifically in addition to those mentioned also the need to remove structural weaknesses, and allowing of exceptions has to be made contingent on following a solid budgetary policy in the future.

Should the European Stability Mechanism (ESM) check whether the state budget is actually in an emergency situation which makes paying off debts unavoidable? Ultimately also leaving the eurozone should be possible for a Member State as *ultima ratio*.

→ In most eurozone countries in Europe the bank deposits have been secured with deposit guarantee schemes to the extent of 100,000 euros per each depositor and bank. As a result of such national regulations the quality of each single guarantee depends on the financial capacity of the eurozone country where the bank is located. This, however, generally contradicts the principles of the common monetary area. For this purpose the introduction of a common guarantee system (European deposit insurance scheme) is discussed, the more so that such a system would have lower costs for Europe. This would create a fund to which all countries of the union would make payments and from which services could be provided to bank clients in case of losses. Such a common guarantee for deposits in Europe would become the third column of the banking union next to the independent banking supervision mechanism of the eurozone introduced at the end of 2014 (Single Supervisory Mechanism, SSM) and the European common crisis management mechanism (Single Resolution Mechanism, SRM) effective from January 2015.

→ As the financial world in eurozone has practically no borders between countries any more, it was logical to centralise banking supervision. But it would have been more reasonable to transfer the supervision of banks to some neutral institution. This in its turn would have required the respective amendment of the EU Treaty. It is certainly questionable whether it would all have been possible in the course of such a short time. Instead, the task was hurriedly imposed on the European Central Bank. Such a double function of an authority of monetary policy and simultaneously a supervisory authority will create a risk that a conflict of interests may affect the monetary policy. Certainly, a need for a so-to-say clean solution still remains.

The current persisting crisis of the European Economic and Monetary Union makes the need to carry out a sustainable reform increasingly urgent. Therefore it is important for the respective common institutions to reach the results as soon as possible.

March 2016

Manfred O. E. Hennies
Kiel/Warder
Germany

Matti Raudjärv
Tallinn/Pirita-Kose and Pärnu
Estonia