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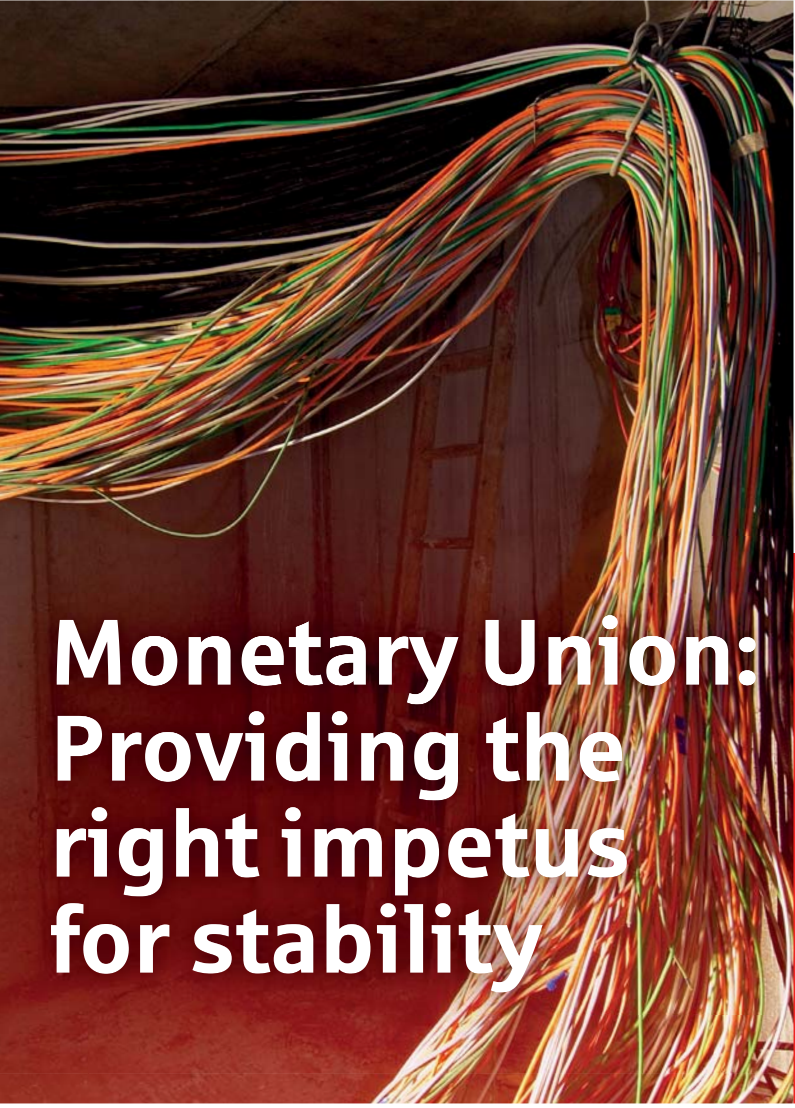

Monetary Union: Providing the right impetus for stability

- The chief economists of the Savings Banks Finance Group welcome the EU's reflection paper, which continues its series on the future of the EU and the European Monetary Union (EMU). Advantage should be taken of the current favourable opportunity for reform to rekindle enthusiasm for Europe in the hearts of its citizens.

- In its paper, the EU Commission rightly stresses the important role of reforms within the individual member states to increase competition. Although the proposed linking of reform measures with the distribution of ESI funds requires careful scrutiny, it would nevertheless be a step towards improving the fundamentals required for stability within the EMU, increasing autonomy and control as well as regional diversity.

- The European Commission's aim of "completing a genuine Financial Union" is to achieve not only full banking union but also Capital Markets Union. In view of the situation in Europe, however, careful consideration should be taken of the steps necessary to achieve this aim, and these steps must be taken in the right order. Full communitisation of European deposit protection and fiscal backstops must be avoided – the matter of how to deal with what in some cases are substantial stocks of impaired loans on bank balance sheets should be of primary consideration, otherwise all other measures will be impeded.

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Authors:
Uwe Burkert - LBBW
Uwe Dürkop - Berliner Sparkasse
Folker Hellmeyer - Bremer Landesbank
Jochen Intelmann - Haspa
Dr. Ulrich Kater - DekaBank
Dr. Jürgen Michels - BayernLB
Dr. Cyrus de la Rubia - HSH Nordbank
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann
 - Kreissparkasse Köln
Torsten Windels - NORD/LB

Coordination:
Dr. Reinhold Rickes - DSGV
dsgv-volkswirtschaft@dsgv.de
Co-coordinators
Georg Huber
Georg.Huber@dsgv.de
Wolfgang Neumann
Wolfgang.Neumann@dsgv.de

Monetary Union: Providing the right impetus for stability

On 31 May the European Commission presented a so-called reflection paper on the future of the European Monetary Union (EMU). A principal aim of the proposals for discussion is to achieve lasting stability for the EMU.

Taking advantage of the current political and economic momentum!

The European Commission's on-going series of discussion papers on the future of the EU and the euro area is welcomed unreservedly. Calling for reform of the EU and the euro area is not only important in times of crisis but also – like now – in times of relative stability. If they are to be implemented, however, the proposals must have an even greater focus on the goal of a competitive Europe. The time window for new reforms would appear to be favourable: economically, the euro area is in relatively good shape. With its ultra-expansive monetary policy, the ECB should be able to assure comparatively favourable monetary conditions by 2020 at the latest. The debt crisis in individual states is not yet resolved, the political situation remains problematic in some countries (especially Italy) and European institutions have other difficult political issues to overcome with Brexit. However, there have been a number of positive political developments. In particular, there is now an opportunity for political cooperation between Berlin and Paris to be reinvigorated. The persistently threatening protectionist trade policy of the United States could well lead to a good many member states acknowledging the advantages of presenting a united EU front.

Anchor points for the evolution of the euro area

Before going into further detail on the individual items in the reflection paper, we should briefly recapitulate where there is a fundamental need for action within the EMU. Against this background, we shall then discuss proposals for the evolution and stabilisation of the EMU.

1. A monetary union is only as stable as its banking sector. It is therefore necessary to take measures that result in a permanently **stable banking sector**.

2. The EMU depends for its stability on sound **public finances**, so that even in periods of economic weakness, the individual states remain capable of action, and the effects of contagion from financially weak states are avoided. For those states which have strayed from the "path of virtue" in the past, despite the European Commission's mechanisms for monitoring public finances, ways must be found to return debt to a **sustainable level**. For this to happen, it is essential that the self-imposed rules laid down on a stable new basis after the crisis are actually complied with.

3. In the EMU, **asymmetric shocks** can destabilise national economies. Their effect is potentially even greater than in the previous currency systems, in which the exchange rate still acted to some extent as a shock processor. New institutions and alternative shock absorption mechanisms must not include the moral hazard of states being "hung out to dry" and should create a balance between autonomy and control.

Avoid risik of moral hazard

4. There will always be differences in productivity within a monetary union, just as there are also regional **differences in productivity** within every country. These sectoral differences give rise to adaptive processes and thus can stimulate growth. This is why regional diversity and **competition** are crucial. These differences in productivity become a problem when wage growth decouples itself from them and the competitiveness of the affected countries is compromised. In such cases, the result is often higher debt levels and imbalances in the form of above-average deficits on current accounts. Affected countries are more susceptible to crisis than countries with lower overall debt. Measures to increase productivity and competitiveness at member state level are therefore necessary if the aim is to make the euro area more crisis-resistant. Greater structure-political attention must therefore also be paid to countries with current account deficits than to those with a surplus.

Increasing in productivity and competitivness remains important

5. In the interests of "unity in diversity" within the EMU, **disparities in income** must be used in such a way as to ensure that growth processes become catching-up processes. However, in the long term, excessive disparities harbour the potential for political tensions. Measures to reduce an overly large **wealth gap** by increasing competitiveness between support measures with conditions attached, for example as part of a cohesion policy, would therefore seem to be expedient. At the same time, attention should be paid to the European Commission's published thoughts on social union, with a view to observing social standards when promoting competition within the internal market.

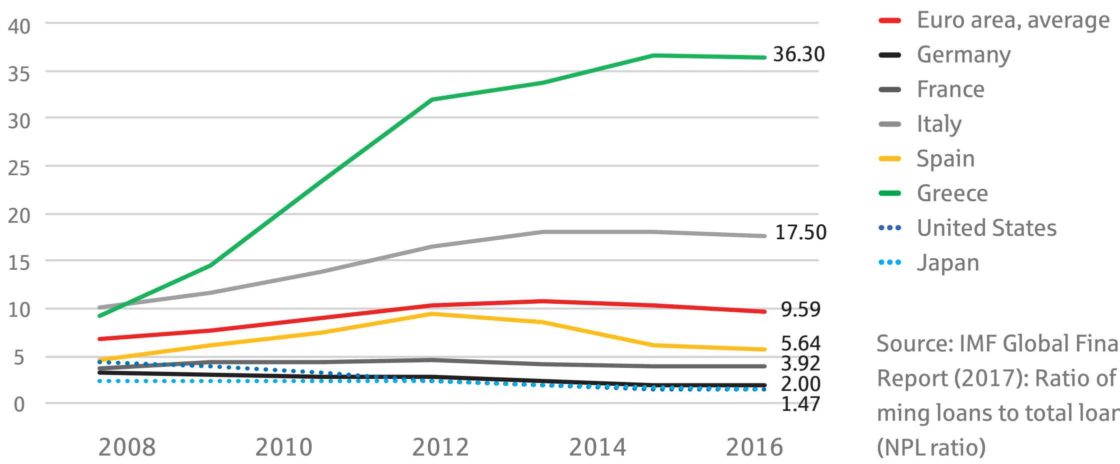
6. In an EMU with a coordinated national economic, financial and social policy, the **central bank** has particular responsibility for stabilising the economic situation. The central bank is nonetheless **overstretched** by having to perform the above-mentioned functions of increasing competition and guaranteeing the financial security of states. This is not the function of monetary policy, as also described for the first time by the European Commission in the reflection paper and, this being the case, it is becoming increasingly important to raise it to the status of a declared premise at European policy level.

Appraisal of the proposals of the European Commission

Completing a genuine Financial Union, the main requirement is a reduction of non-performing loans

The European Commission declares itself to be in favour of "**real financial union**" and would above all like it to drive permanent stabilisation of the banking sector, as well as to foster "Capital Markets Union".

Non-performing loans in the euro area and in international comparison



Source: IMF Global Financial Stability Report (2017): Ratio of non-performing loans to total loans of a country (NPL ratio)

The European Union correctly states that the high proportion of non-performing loans is having a negative effect on the profitability of the banking sector of the EMU, and it is also making the sector vulnerable to shocks. That the corresponding measures to reduce the number of **non-performing loans** are to be implemented locally and given **priority** is to be welcomed. The Commission clearly sees itself as having a coordinating function here. In Europe, new rules for handling impaired loans have been agreed, with numerous new regulations for banks and savings banks. For this reason, any new regulatory burdens connected with the setting up of a central "bad bank" should be avoided – not to mention the legal difficulties of such a construct. The key argument here remains that old debt cannot be jointly written off by the community as a whole before there is joint control of banking business.

Reduction of non-performing loans is essential for the stability of the banking sector

In parallel with the cleaning up of banks' balance sheets, the European Commission would like to set up a fully communitised **European Deposit Insurance System** (EDIS), together with a fiscal backstop (that would apply for both deposit insurance and bank resolution). The aim is for these facilities to be enacted by 2019 and fully operational by 2025.

Do not misuse the ESM for the European Deposit Insurance System (EDIS)

The credibility of the deposit insurance system depends on the fiscal backstop planned, and for this the European Commission is proposing a credit line from the European Stability Mechanism (ESM). We are of the view that the ESM should – as originally conceived – be focussed on supporting states. The latest exceptional regulations for individual banks, which run contrary to the spirit of the European Banking Union, give strict instructions to refrain from further discussion of new communitisations and even of the ESM.

Therefore, with the banking union in mind, the primary task remains to ensure that national budget resources and/or commercial solutions are used to **discharge** the banking sectors of their **old stocks** of non-performing loans. Those stocks date back to times when there was no common control and, in accordance with the precept of combining **responsibility and control**, cannot be resolved communally.

Do not reduce the diversification of financing

The European Commission also includes the desired **capital markets union** as part of a financial union. Its declared aim here, and this should be supported, is to be able to make sustainable and diversified financing sources available. We do not, however, share the view that the European financial market is too “dependent on bank credit”, as considerable stability effects are associated with classic bank credit. Of course, companies should be able to diversify their refinancing options, but this must under no circumstances manifest itself in a “bank financing versus capital market financing” situation. A company that cooperates with various banks that in turn have various business models (regional versus supra-regional internationally active institutions) already benefits from considerable **diversifying effects** as a result. Although the American system is more strongly capital market-based than that of continental Europe, where traditional lending by banks is preferred, there is no information on which system is more stable. Empirical studies around this issue have been inconclusive.

In this connection, the paper indicates that the Commission is currently conducting a comparison of the regulations on loan enforcement in an attempt to achieve a permanent lowering of risk and promote access to finance. Complete harmonisation of both loan enforcement and insolvency law across all EMU members remains undesirable: only convergence of **loan enforcement** is necessary to open up more business opportunities for banks that operate supra-regionally. This would reduce segmentation of the credit markets and could also be a way of better absorbing asymmetric shocks within the EMU. Even more vigourous action on the part of the European Commission would be welcomed at this point.

Strengthening the market for Venture Capital

Avoid additional regulatory burdens!

It seems to us that the European Commission's desire to improve access to risk and equity or venture capital is more expedient than the replacement of loan-based financing with securities. According to KfW, approximately seven times more venture capital investments were transacted in the United States than in Germany in 2014 (measured as a proportion of GDP in each case). Development of this market is very important if the innovative strength of the euro area is to be increased.

The European Commission's most concrete measure to achieve capital markets union is the introduction of a single **supervision mechanism for the European capital markets**. The intention is to thereby create a "truly integrated" financing environment. As a matter of principle, we say: no to new regulatory burdens for financial services companies. Banks and savings banks already have their hands full in the new regulatory world following the financial crisis. Whether a new supervisory institution would lead to increased efficiency for the cycle of savings and demand for capital is highly questionable; a coordinating authority for the national supervisory institutions would suffice for this. On the contrary, amid the general efforts for harmonisation it is essential to ensure that financial market products that have gained acceptance in certain countries are not "harmonised out of existence", as this would only be **counter-productive** for the countries concerned.

Ultimately, the European Commission sees the need to develop safe investment in the form of securities collateralised by government bonds, or **Sovereign Bond-Backed Securities** (SBBS). What is envisaged is a structure that excludes any communitisation of the debts of member states. The idea is that these bonds will address the problem of inter-relations between states and banks, as empirical findings have shown that banks have invested a disproportionate share of their investments in the government bonds of their countries of origin. This is also intended to reduce any destabilising flight of capital from financially weak to financially strong countries by creating a safe asset class – similar to US Treasury bonds – in which all member countries would invest.

It is correct that the problem of the **downward spirals** observed during the crisis, between banks and national debt (as seen, for example, in Ireland and Spain), must be tackled. The observed overstretching of the European Central Bank, as lender of last resort for banks and states alike, is also connected with this. The tightening of regulation and of equity capital requirements has already helped somewhat. At first glance, SBBSs would appear likely to lessen this problem further, but the question must be asked: why does this type of bond not already exist? After all, banks are already able to offer bonds with this structure. The fact that this is not happening is probably due to a lack of demand for papers of this sort, as well as to the associated regulatory drawbacks. We do not believe it would be expedient to foster the growth of the market through changes to this particular regulatory setup, and in this respect we agree with the critique of the scientific committee of the federal finance ministry.

Accountability Bonds more favorable than SBBS

A much more promising approach might be to introduce **subordinated bonds** or so-called accountability bonds for states, even if there would be little economic benefit from the debtor's point of view given the current low interest rates. According to this model, devised by Johannes Becker and Clemens Fuest, each euro member state would be required to finance any structural budget deficits exceeding 0.5% of GDP with subordinated bonds. If the country had to make use of the ESM programme, their doing so would be conditional upon them stopping servicing the subordinated bonds. Top-grade government bonds, on the other hand, would remain unaffected by this regulation. The advantages are clear: market discipline would affect the issuers, and the ECB, which would be prohibited from purchasing subordinated bonds, would not be forced into a fiscal role.

Ultimately, in the context of financial union, the reflection paper reminds us that it is possible to change the **regulatory treatment of government bonds** (until now there has been no capital adequacy requirement under the standard approach, e.g. for the euro area). The aim of this measure would also be to reduce the nexus between states and banks. Such measures can, however, jeopardise not only state financing but also even the financing of the SMEs, who are the drivers of the upturn in Europe. The banking system must also generate substantial amounts of equity capital which, under certain circumstances, is no longer available for granting loans to companies. Under such circumstances, very long transitional periods would have to be agreed in order to avoid destabilisation of the financial markets. In addition, there would have to be differentiation between countries on the basis of their individual debt status, as well as national solidarity within member states, depending on the overall structure of the state in question. As for the need for global regulation, the European Commission does at least broach the subject, and rightly so.

Capital adequacy requirement for government bonds only useful under various conditions

Economic and social convergence: competitive strength should not be forgotten

In its reflection paper, the European Commission stresses the importance of economic and social convergence. According to the Commission, it is preferable that this is achieved through deepening economic integration. The internal market (free movement of goods, services and capital, as well as free movement of the workforce) should operate alongside a so-called digital internal market, an energy union and a banking and capital markets union.

The economic thinking behind this idea is obvious: it's about optimum allocation of the production factors within the EU and/or the EMU: the deeper the integration, the stronger the development of the Union's potential for growth. Above all, convergence is intended to increase the ability of individual member countries **to withstand shocks**.

In this connection, the European Commission sees a greater need for **coordination of economic policy**. The European Semester has a major role here, as it is intended to help in the coordination of economic policy measures, as well as to facilitate the monitoring of both budgetary rules and the Stability and Growth Pact. The European Semester is also to be amended in a way that will allow productivity-raising reforms to be better implemented in the individual member states. The importance of regional economic cycles, however, is unfortunately not stressed here. Also, the fact that the value of country-specific recommendations has now significantly increased due to intensive dialogue within the countries in recent years can be seen as progress.

Principle of subsidiarity needs to be inforced

The proposals for "more convergence" seem to us to be very ad hoc and poorly thought through. Convergence in the sense of equalisation of per capita income is not what is meant here, but rather convergence of economic policy, right through to the harmonisation of administration mechanisms. The question of how the term subsidiarity is to be applied in practice in commercial life is a fundamental one. Before the introduction of convergence mechanisms, we would like there to be a conceptual discussion about **the areas in which such convergence is useful**, and where the advantages of diversity within Europe balance out its disadvantages. In addition to this, it is not clear at what point the policies of the individual member states are to converge. Europe lacks an economic policy concept of the kind that exists in the form of the social market economy for Germany or planning [französisch: planification] for France, and on which fundamental decisions on economic policy can be based, such as the harmonisation of framework conditions.

Also to be taken seriously is the argument that **European recommendations** or **rules**, for example in the case of the Stability and Growth Pact, would not be observed anyway. The fact is that many countries breached the terms of the Stability and Growth Pact for several years in succession. However, this has not rendered it worthless: it just needs revitalising. Let us take an example from the field of road transport: it is true that many drivers exceed a **speed limit** of 120 km/h and instead drive at 140 or 150 km/h, but there are very few who drive at 220 km/h. Overall, therefore, the speed limit helps to make the motorways safer. Indeed, the fact that withdrawal of one's driving licence (220 km/h) or draconian fines (140/h) are threatened for speeding is also an indication that serious thought should be given to effective and economically meaningful sanction mechanisms in Europe.

Benchmarking as a favorable method

This then raises the question of the extent to which the sanction mechanisms should be encumbered with exceptions (120 km/h, "except when the sun is shining", etc.), and who will implement these sanctions.

Drawing on the June 2015 report by the five presidents, the European Commission proposes the **creation of standards** for public expenditure, investment in education and competition, as well as for tax and social insurance systems. Even minimum social standards are brought into the discussion.

Some **scepticism** towards mere **standards** is necessary. **Benchmarking**, on the other hand, is **productive**. If one country is particularly adept in the use of its education investment, then other countries can learn from it. The same applies to an efficiently working administration or the dual training system in Germany. This is significantly more difficult with tax and social insurance systems. For example, the level of taxes and contributions should always be seen in relation to the resulting public services. Depending on the structure and competences of the individual countries' regional administrative bodies, quite different systems can result. This makes a convergence of standards very difficult and, bearing in mind the aim of unity in diversity, is not always worth aiming for.

As regards the desire to implement productivity-raising **reforms**, the Commission proposes **linking** the use of **EU funds** (EU Structural and Investment (ESI) funds) more closely with the successful implementation of reforms. Currently, the member countries are asked to ensure that the form of programmes financed by ESI funds is influenced by the country-specific recommendations of the European Commission. The withholding of funds in the event of failure to do so is so far not envisaged.

Such an approach is to be welcomed on condition that it only involves measures that do not come under the **precept of subsidiarity**, but are evidently of fundamental importance for the **deepening of integration** within the EU and/or the EMU. Such measures could just as well include the expansion of power grids and broadband networks, as the extension of transport routes for heavy goods vehicles, cars and rail freight. Evidence of common European interests should then be found that would strengthen the regional economic cycles when the measures were implemented.

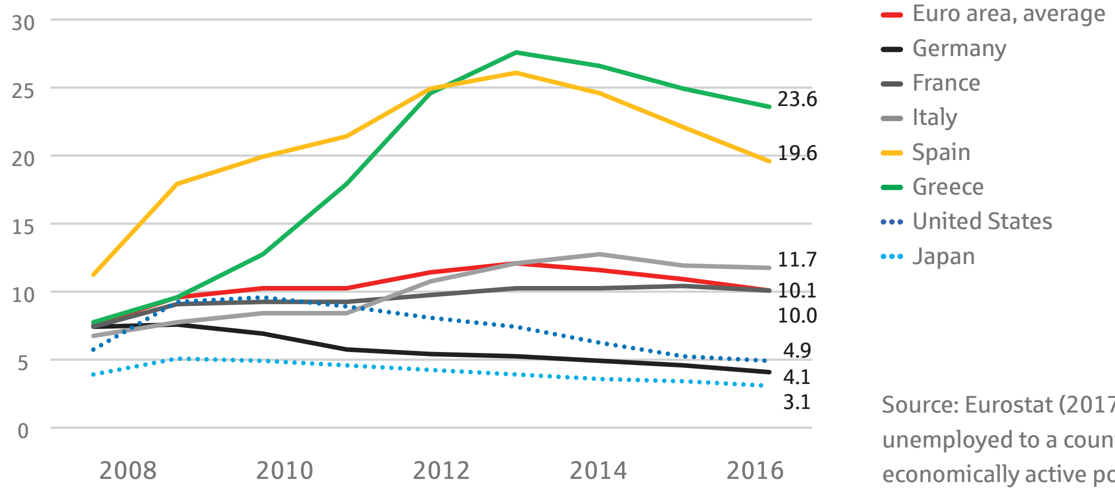
„Level playing field" for corporate taxation

Europe must further extend market regulation aimed at creating a level playing field. Profit-shifting should therefore only be limited by the use that can be made of differences in tax legislation. **Minimum taxation rates** can prove useful for the avoidance of such strategies.

Macroeconomic stabilising function: the EU should not be overstretched
As a third point, the European Commission suggests that a **macroeconomic stabilising function** be introduced for the EMU. Two instruments have been mooted: an instrument for the protection of public investment activity and **European unemployment** reinsurance. A c**ommon finance minister** and a **common budget** are also under discussion.

With regard to the two instruments, "protection of public investment activity" and "European unemployment reinsurance", the Commission provides very little detail on how they would be organised, and it is of course precisely these details that matter. A few models for the European unemployment reinsurance are admittedly doing the rounds, but there is no clarity on how the individual responsibility of the various countries for reducing unemployment is to be strengthened.

Unemployment in the euro area and international comparison



Source: Eurostat (2017): Ratio of unemployed to a country's entire economically active population

In principle, **unemployment insurance** could function as an automatic stabiliser of an economy without cuts or increases in expenditure having to be debated. This is because during an upturn, state expenditure on the unemployed falls and has a dampening effect on growth, and during a downturn the effects of a recession are softened by additional expenditure on the labour market. The United States shows that unemployment insurance can also be discussed at a European level: in addition to the insurance systems at federal state level, there is also a **central unemployment insurance** system in Washington that can act as a stabiliser during crises and thus help to absorb asymmetric shocks.

European unemployment insurance as an automatic stabiliser

Fears that Euro countries with above-average unemployment would benefit disproportionately could be dismissed by virtue of the fact that, with European unemployment insurance, the **eligibility period** for drawing unemployment benefit is relatively short, so there is incentive within the member countries to quickly reintegrate the unemployed into the labour market. Long-term or structural unemployment would still have to be financed by the national states. Differentiation problems might, however, arise in relation to national unemployment insurance. The European Commission does not make clear precisely what is meant by **reinsurance**. Only one facility could be meant here, and that underpins the unemployment schemes of the one or two countries affected by particularly severe shocks, although it would only help to contain cyclical unemployment. However, as is the case with all other redistribution mechanisms, participation in such a system should be linked to reforms resulting in an efficient labour market. For the time being it is therefore crucial that responsibility for combatting unemployment is placed at a national level and only goes hand in hand with national political responsibility.

A common Finance Minister without a renegotiation of the European Treaties is impossible

There is also a proposal to introduce a **treasury department**, or finance ministry, for the euro area. As the European Commission sees it, this treasury department would be responsible for monitoring economic and budgetary policy, as well as having a fiscal capacity, performing a macroeconomic stabilising function (for example, European unemployment insurance). It would also be responsible for issuing any secure investment (SBBS), as well as being responsible for the ESM and/or any European currency fund that was created. In connection with the common treasury department, the European Commission also reiterates the idea of having a common finance minister who, the Commission explains, would be the president of the euro group and thus of the Ecofin (Economic and Financial Affairs) council.

The fact is that important questions remain unanswered here that, in our opinion, are essential - for example regarding the **democratic legitimation or the receipts side** of the treasury department. It thus remains unclear how a common finance minister would be politically legitimised – by the European Parliament or/and the European Council, for example? What is more, the creation of the office of Common Finance Minister would have to be linked to a renegotiation of the European Treaties, as a common finance minister for the EMU would also have to be given the competence to receive revenues i.e. to raise taxes. The European Treaties contain nothing on this.

At the same time there is a chance that a common finance minister would carry more weight on an international stage in matters such as financial market regulation and tax legislation (watchword: tax havens).

The idea of changing the ESM into a **European currency fund**, which would then have recourse to a concrete mechanism in the event of crisis, might well strengthen the EMU if this fund were sufficiently equipped. As regards the type and volume of this ESM, the European Parliament would then have to be brought in, with retention of the German Federal Parliament's right of veto being assured. This would constitute another step towards strengthening the **stabilising function** for Europe, its member countries and its regions.

Conclusions

Now is the time: Leading EMU to the right direction

Overall, we understand the European Commission's reflection paper on the consolidation of the EMU to be an answer to the uncertainty that has resulted from Brexit and the popularity of populist movements within the EU. In the wake of the parliamentary elections in France, the timing of this debate has been well chosen, as with the change of government in France a new start can be made on the political work, bringing progress not only for the euro area, but for Europe as a whole.

Most of the suggestions and demands of the European Commission are sufficiently clearly formulated for the member countries and the institutions that support them to be able to contribute their own ideas. At the same time, the direction is clear: we should press ahead with integration. The fact that the autonomy of the individual member countries plays a crucial role here should be emphasised, and it is good that the Commission picked up on this. If the momentum can now be generated to really promote currency union, this could encourage the member countries to redouble their mutual efforts over the coming months and years. From a regulatory point of view, overarching European institutions and rules must act as a catalyst through the creation of more transparency and reward systems. This represents a good opportunity to create the kind of European social market economy in Europe that combines the best elements of national experiences.

Disclaimer

The present position paper of the Chief Economists does not necessarily correspond to the attitude of the DekaBank or the attitude of the respective Landesbanken and Savings Banks.

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DSGV-Volkswirtschaft@DSGV.DE
www.DSGV.de

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Franz Metz, Berlin

Photography
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Management
Pia Jankowski – DSGV
Head of Department Economics, Financial Markets and Economic Policy
Pia.Jankowski@DSGV.DE

Dr. Reinhold Rickes – DSGV
Head of Economics, Department European Economic and Monetary Policy, Financial Stability
Reinhold.Rickes@DSGV.DE

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