CAN THE EURO STILL BE SAVED?

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What was the EMU objective and what did we miss?

The EU and therefore the euro was developed on one premise and one promise:

- The promise of a gradual convergence in living standards
- The premise that transfers between Member States would be limited and each Member State should be able to stand on its own

The euro is viewed either as:

- A kind of augmented fixed exchange rate arrangement,
- A step towards a fully-fledged monetary union that requires deeper policy and political integration including, in the end, an extensive risk sharing arrangement, leading to some centralization of fiscal and economic policy decisions

Economic convergence has not significantly improved since euro inception because of:

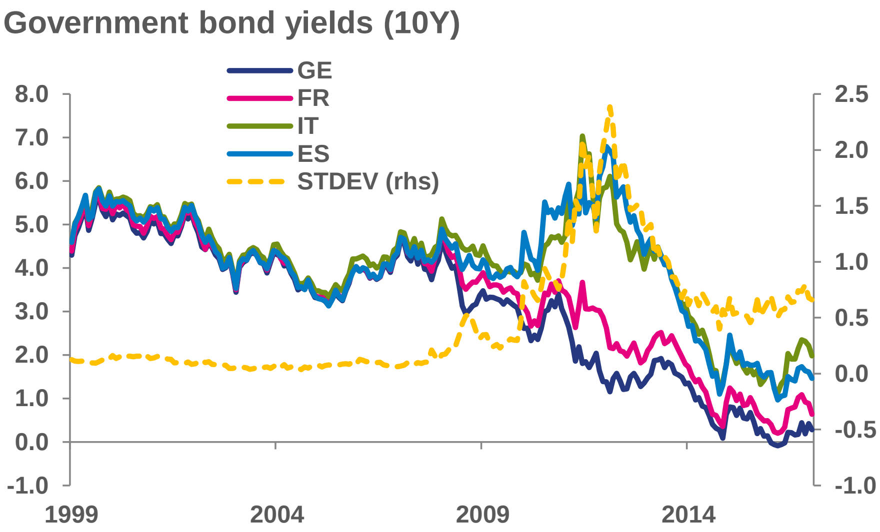
- Divergent credit dynamics
- Inadequate policies at national level and inappropriate supervision at EU level
- Flaws of EMU architecture (agglomeration of capital and skills in core regions)

Current policy framework has little ability to foster convergence

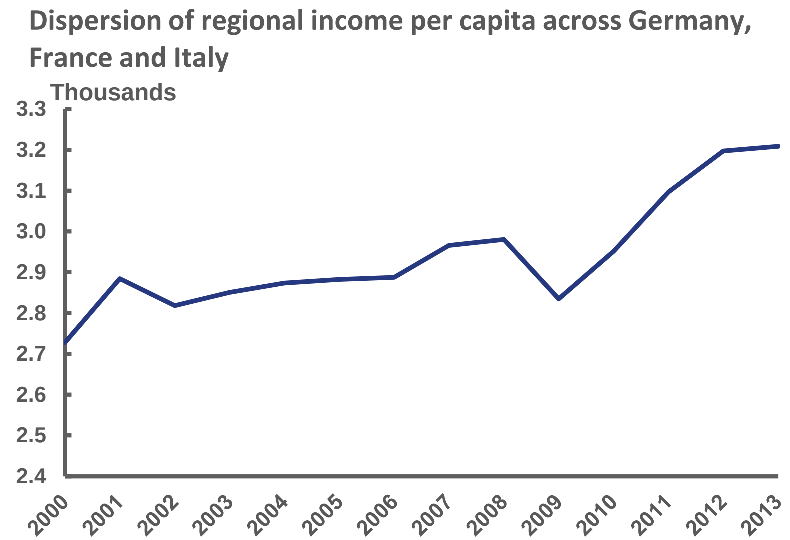
- Europe 2020 strategy: weak coordination process
- Macro Economic imbalance procedure: no lever on the necessary policies to avoid divergences
- Social and tax policies: not coordinated

Single currency did not foster convergence yet

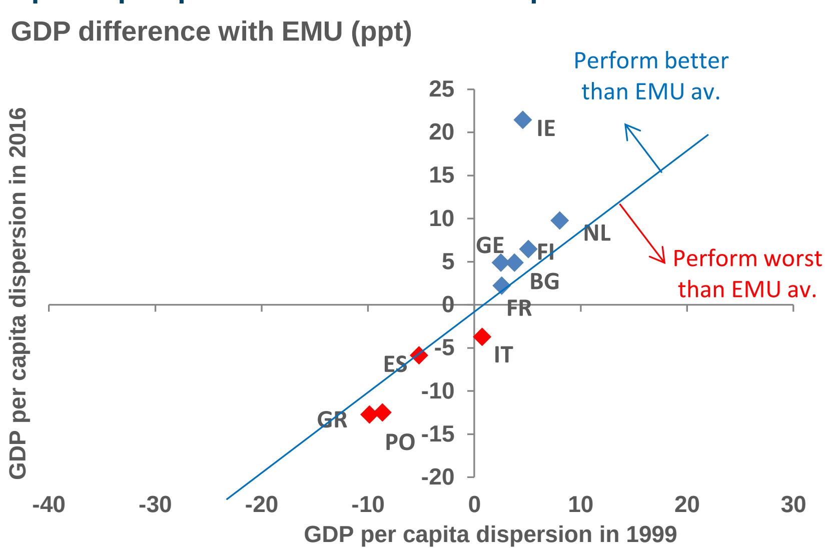
Interest rates divergence still above pre-crisis level



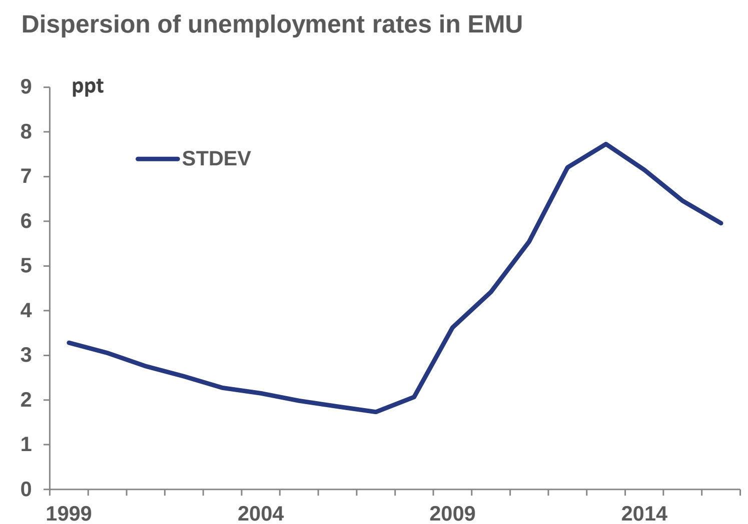
Regional economic divergence has increased recently



GDP per capita polarised since euro inception



Unemployment dispersion spiked during the crisis



Source: Datastream and AXA IM Research

There has been some progress due to the financial and sovereign crisis

The euro architecture has been augmented compared to Maastricht along key areas:

- Collective insurance (EFSF, ESM)
- Enhanced surveillance (6-pack, 2-pack, TSCG)
- Reciprocal intrusion
- Integration via more institutions (SSM, SRM, EBA…)

Current architecture remains insufficiently integrated and cannot ensure EMU sustainability:

- Economic potential is not fulfilled
- Social discontent undermines political stability
- Financial structural issues not solved yet (Italian banks for instance)

Agenda of reforms concerns:

- Financial integration (banking union, capital markets union)
- Fiscal integration (toward more federalism)
- Business cycle smoothing (unemployment insurance for instance)
- Political integration

A need to focus : what is needed for EMU to work better?

- EMU members should review all policy areas and decide whether they should be the object of (from loosest to strongest form of coordination):
  - → Cooperation
  - → Coordination
  - → Harmonisation
  - → Centralisation

Policies	Cooperation	Coordination	Harmonisation	Centralisation
Monetary				X
Budgetary	X (National budgets)			X (EMU budget line)
Fiscal			X	
Financial				X
Labour market	X (Wages)			
Social		X (Rights portability)		
Education		X		
Micro (innovation)	X (Loose form)			

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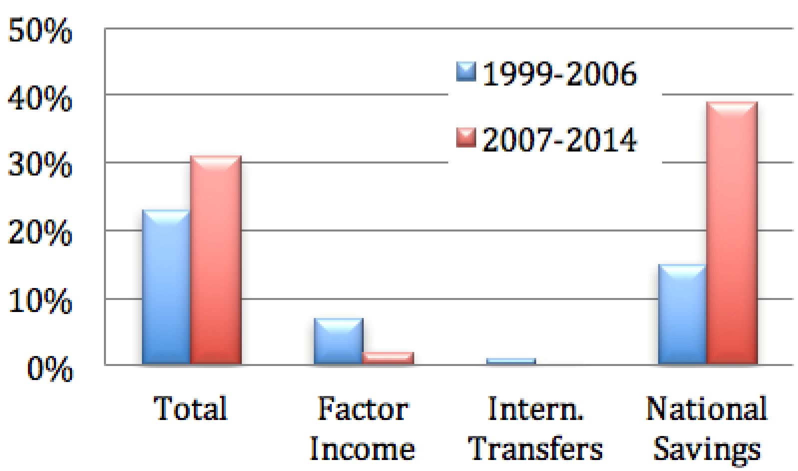
Banking union and capital market union

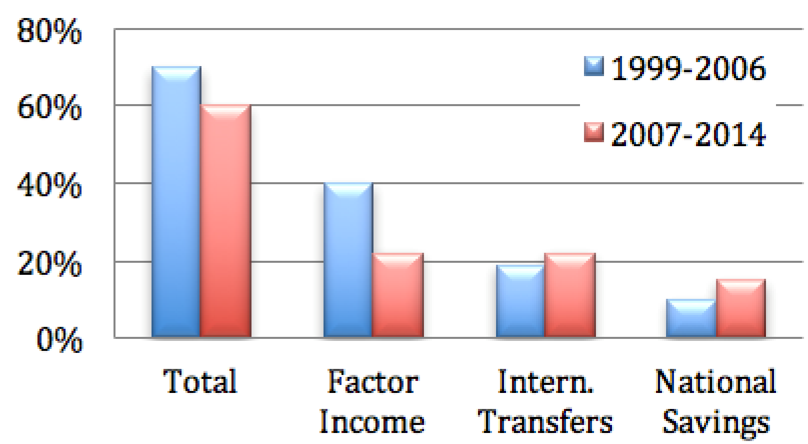
- Financial risk sharing is very low in the euro area as compared with US
(see Milano and Reichlin (2017), charts below)
- Recent efforts to strengthen risk sharing via financial markets:
  - **Banking union** (SSM and SRM)
  - **Capital Market Union** (EU initiative)
- Efforts failed in bringing more risk sharing yet, as recently illustrated by inability in solving Italian banking system issues

Risk sharing in the Eurozone, before and after the recession



Source: Milano and Reichlin (2017) and AXA IM Research

Risk sharing in the US, before and after the recession



Source: Milano and Reichlin (2017) and AXA IM Research

Some proposals

- The current proposal for capital markets union falls short of some key objectives concerning
  → banking union
  → and financial integration of non-bank activities

- For the banking union
  → SSM more independent from the ECB: set a clearer separation between monetary policy and supervision ?
  → SRM to be strengthened and be governed by an EU commissioner
  → Deposit guarantee scheme: ensure stability of deposit and free up the ECB from the *de facto* insurer of deposit

- For non-banking intermediation
  → Prudential regulation
  → Regulation of accounting, auditing and financial transparency requirements for companies seeking external finance
  → Supervisory framework for financial infrastructure firms, such as central counterparties that are central to the payment system
  → Common bankruptcy policy to ensure transparency across states and develop funding instruments

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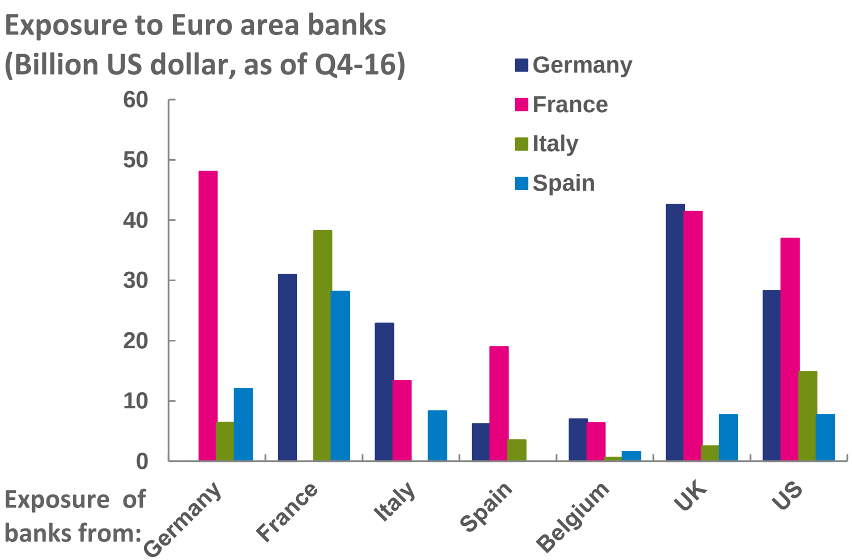
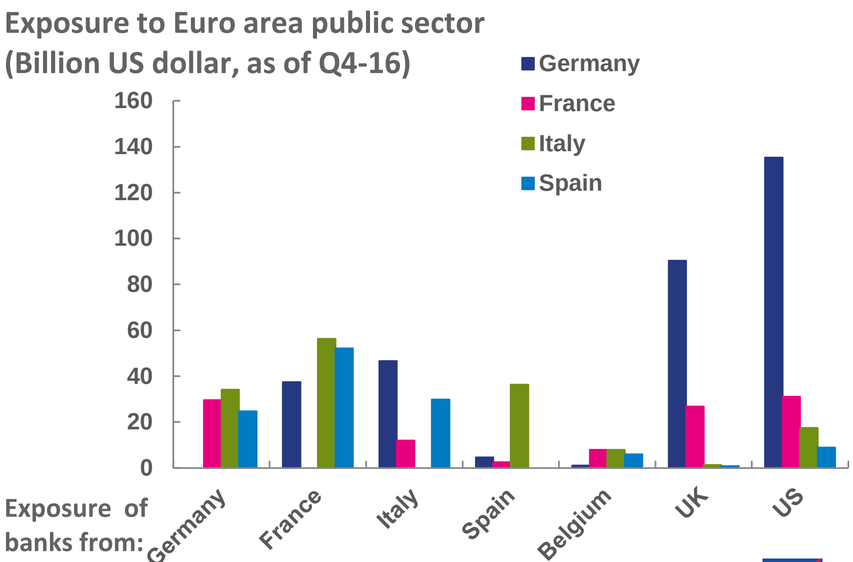
What kind of fiscal union?

- EMU will not be like the US with large federal budget
- EMU will not be a federation like Germany with strong transfers and bail outs between landers
- Il will have to develop an intermediate framework based on:
  - → **Fiscal rules** to ensure fiscal discipline, simpler and more readable, with degree of discretion at national level
  - → **Restructuring framework** to ensure that sovereign debt can be restructured and defaulted without destabilisation of financial system?
  - → A financial framework in the form of a revamped ESM
  - → **An EMU budget** with 2 objectives: provide macro stabilisation with minimum unemployment insurance, provide an investment capacity to foster convergence at national level

High level of cross-border exposure across banks…



… and between banks and sovereign



Source: BIS and AXA IM Research

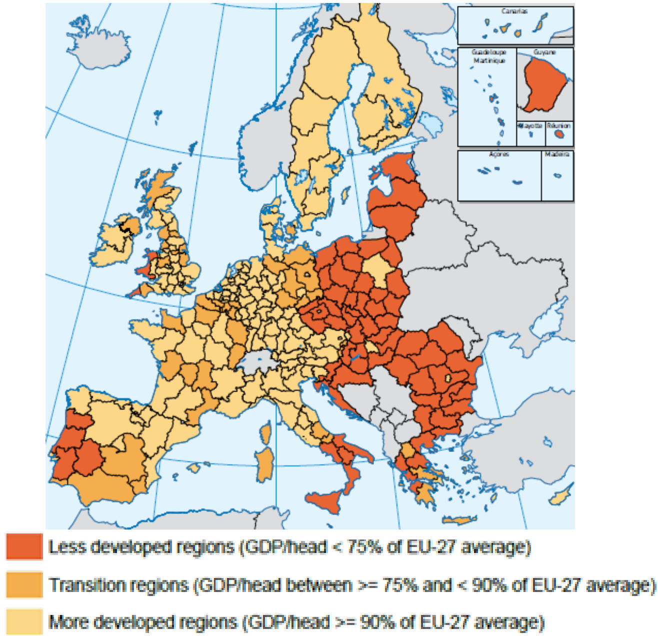
Existing funds have not fulfilled their objectives

The has been EU (not EMU) attempts at fostering convergence

Implementation has lagged behind conception:

- small size
- and targeting EU rather than EMU
- May have focused more on efficacy

Categories of regions for European structural funds



- **European structural and cohesion funds**
  - 5 funds in line with Europe 2020 (adapted from the Lisbon Strategy)
  - Financing investment projects in regions depending on 3 GDP per capita categories:
    - 50% of resources allocated to less developed regions
    - 10% for transition regions
    - 15% for more developed regions
  - 2014-2020 program: €450bn (€350bn for cohesion policy; €100bn for rural development)

- **Juncker plan (2015-2017)**
  - Objective: €315bn of investment in 3 years
  - Slow pace : €164bn as of end-2016
  - Many Juncker plan projects (42 over 55) were highly similar to EIB-funded projects

A new investment program at the EMU level?

- Create a public investment program at the EMU level
- Initially proposed by Pisani-Ferry and Enderlein (2014)
- Efficiency to depend on size and timing of implementation

3 types of financial support:

i) “**Target grants**" : available as a proportion of capital key for projects of common interest - though not redistributive across member states
Ex: Defense

ii) “**Solidarity grants**“: redistributive, so not linked to capital distribution, targeted at economies under fiscal strain to ensure continued investment in commonly defined strategic projects

iii) “**Excellence grants**“: merit-based for national projects with potentially large knock-on effects for other member states

Extending the debate beyond EMU

Two key themes on the table in Franco-German discussions:

Convergence of corporate tax

- Objective
→ fight against tax competition in the euro area

- Common willingness of France and Germany to find an agreement soon

- European commission proposed CCTB in Oct 2016 (Common Corporate Tax Base)
→ Harmonised rules on the calculation of a company's tax base in all member states.
→ Discussed at European council in May, more flexibility to be introduced in the proposal. No agreement yet.

Strengthen Europe of Defence

- Recent steps
→ European Council asked for a more ambitious roadmap in terms of European Defence (Dec 2016)

- Going forward?
→ Project should favour cooperation across countries between police, intelligence and judiciary services
→ Create a "European FBI", although national sovereignty issues is an obstacle in near-term
→ Bring the defence effort to 2% of GDP
→ Strengthen the role of the European agency of Defence, created in 2004 and doted with a limited budget (€30 millions)
→ Reinforce European construction by launching a Security union (prevention and fight against terrorism, cyber-crime, traffics…)

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An IMF for EMU

- Schaüble proposition
- Provide ex-post assistance to EMU members in case of banking or sovereign crisis
- Transform existing ESM into an European Monetary Fund (EMF), the new fiscal counterpart to the ECB

EMU governance: from Maastricht (EMU 1.0) to EMF (EMU 3.0)

	Sovereign debt			Banks		
EMU framework	**EMU 1.0**	**EMU 2.0**	**EMU 3.0**	**EMU 1.0**	**EMU 2.0**	**EMU 3.0**
Surveillance	SGP	2-P, 6-P, SGP		Supervision	Supervision	Supervision
Institution in charge	*EC*	*EC*	*EC*	*national*	*SSM-ECB*	*SSM-ECB*
Crisis management	--	EA loan and OMT	EA loan and OMT	LOLR	LOLR	LOLR
Institution in charge	--	*ESM & ECB*	*EMF & ECB*	*National ELA*	*National ELA*	*National ELA*
Crisis resolution	--	--	SDRM	Resolution & DI	Resolution & DI	Resolution & DI
Institution in charge	--	--	*EMF*	*National*	*SRB & National*	*SRDIB with EMF*

Source: Bruegel (May 2017) and AXA IM Research

Note: SDRM stands for Sovereign Debt Restructuring Mechanism. SRDIB stands for Single Resolution and Deposit Insurance Board. LOLR stands for Lender of Last resort

An IMF for EMU

The project is only a partial answer : it only applies to crisis management, does not prevent them

- It should not distract from the discussion of a budget for EMU by restricting the focus country-specifics
- It is a way of expanding the veto of large countries at the expense of the EC
- The proposition of quasi-automatic debt restructuring runs the risk of creating financial instability if it does not go hand in hand with the creation of a real budget (as in other federal institutions)
- Main danger is the weakening of European institutions by strengthening role of ESM
- It turns ESM board (Finance ministers of Eurogroup) into an enforcer of rules

Proceeding with a euro Treasury and the possibility of debt restructuring is a better way to restore discipline ex-ante while strengthening resilience thanks to more stabilisation capacity

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