ENGINE FOR EUROPEAN GROWTH AND STABILITY

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> "A relationship, I think, is like a shark. You know? It has to constantly move forward or it dies. And I think what we got on our hands is a dead shark. "
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> Woody Allen, "Annie Hall" (1977)

1. A creative crisis?

The groundbreaking of the original building yard for the European Monetary Union (EMU) dates back to 1970 with the Werner Plan envisaging the gradual introduction of a single currency in member states of the European Union. The dollar and oil crises of 1971-1973 imposed a suspension to the construction process of almost ten years, followed by another decade of "learning by trial and error" within the European Monetary System (EMS), an alternative governance framework for defying costly exchange rate risk. The real final steps for the introduction of the Euro were enacted only several years after the multiple crises brought up by the breakdown of the EMS in the beginning of the 1990s.

1. The opinions expressed are those of the authors and do not necessarily reflect the official views of the Bulgarian National Bank and the European System of Central Banks.

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In a nutshell, the launch of the euro and its underpinning institutional infrastructure were held back by one crisis, while accelerated by another one, the latter also being uplifted by the euphoria of German unification. Now the question is whether the current crisis would break the EMU of the European Union (EU) or deepen it. Furthermore, the worldwide encompassing nature of the current economic and financial crisis turns rescue by external events or by further welfare-enhancing widening of the Union unlikely. The experience during the past six years of crisis leads us to believe that the EMU is facing a critical trilemma: either a slow death by asphyxiation, or sudden collapse, or initiation of a new building yard for the EMU in particular and EU in general.

2. A backward view

But let us first remind ourselves of how we arrived at this point of a “do or die situation”. In August 2007 the Euro area’s interbank market was frozen with fear, rightfully justified by counterparty default risk stemming from exposure to US mortgage-backed securities, which were previously classified as risk-free. The ECB was the first to react by fully satisfying interbank demand for liquidity becoming virtually its sole provider. The next year revealed that this is not a temporary episode of a “financial markets turmoil”, as initially downplayed in ECB´s official communication, but a deeply rooted structural problem encompassing the financial sector, real economy, state finances and governance in the euro area, as well as globally. New problems were constantly surfacing prompting the recurrent re-evaluation of risks and downward adjustment of expectations for future prospects. Banks in countries like Germany, the Netherlands and Belgium with considerable private savings and efficient liquidity management heavily reliant on global financial innovation happened to be worst affected. Fighting simultaneously deep and persistent recession, as well as strengthening the banking system through bank recapitalisations strained government finances leading to the emergence of sovereign debt vulnerabilities in Greece, Ireland, Portugal, Cyprus and more recently Spain and Slovenia.

When growth is missing for a considerable period of time, the hope about the future prospects, which nourishes economic activity and social consensus, is replaced by heated discourse on fair redistribution of scarce sources of incomes. In the US context, the public support to the financial sector during the initial phases of the crisis brought more hostility and scrutiny towards the banking sector. In the euro area's governance framework, the great danger is to intensify the discussion on burden sharing and limits to solidarity to a point where the general public starts doubting the viability of the single currency.

The current governance framework revealed problems in terms of incentive compatibility. It could neither prevent imprudent accumulation of debt above the 60 per cent target, nor could it avoid core countries benefiting both from installing doubts in their solidarity and commitment to the Euro project, and from enjoying too low sovereign debt rates. The latter being justifiable only on the grounds of "flight to quality" given the perceived instability of the euro as a currency. [2] A prolongation of such perverse incentives could solely produce some short-term Pyrrhic victories and defeats.

Another governance issue was the confrontational way in which the sovereign debt crisis was approached in 2010 which, as a consequence, could have been pushing the EMU into a bad equilibrium for both debtor and creditor countries. From a political point of view, the euro enthusiasm could be lost and replaced by euro scepticism, which might become a true obstacle for finding agreement for necessary reforms, to starting a new building so to say. And what is a new building worth for if its inhabitants are living affluently but in mistrust and bitter arguments with each other?

3. Other irreversible small steps or a leap forward?

In the process of this new building, the EU governance institutions and member states' leaders could distract themselves from the main challenge, namely improving the EU's growth potential. Furthermore, in a general equilibrium framework with rational expectations, partial default risk and circular feedback effects between economic decisions of governments, banks and the wider

2. Note that even countries exemplary on fiscal prudence such as Germany had debt to GDP ratio of over 80% in 2012; the Netherlands and Austria were at 70 per cent debt to GDP ratio.

economy, any fiat currency, including the euro, is as good as the economies behind it, as well as the credibility of governments as ultimate guarantee providers (see Shubik, 1999; Tsomocos, 2003 and Tsenova, 2013). Banks and other financial intermediaries are central in the transmission of monetary policy, aimed at affecting both prices and real output, while at the same time they can generate their own real effects. The central banking authority with the key tasks of providing price and financial stability (see Goodhart, 2010) should be able to have all necessary monetary and macro-prudential tools to install the right incentives for banks to smoothly transmit monetary policy, hence to support growth and stability (see Calomiris, 2011).

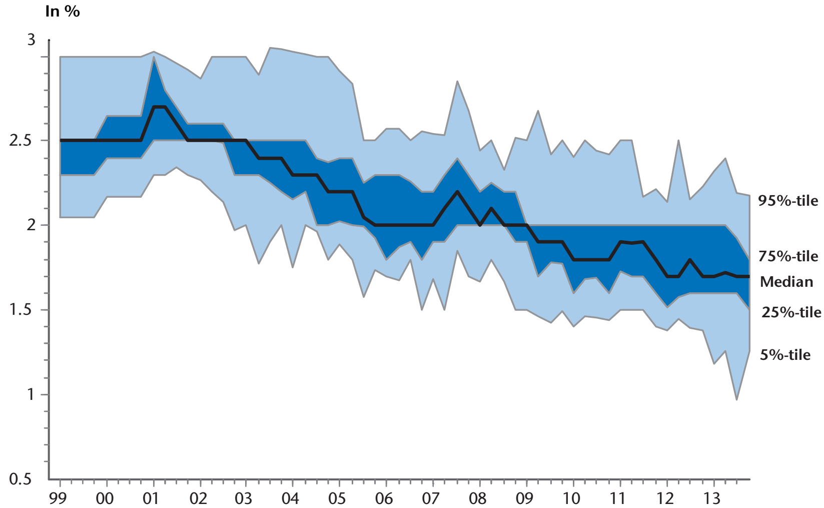
Given the global structural transformation induced by the crisis, the EU would be better relying also on own home-grown solutions, inclusive of prudent financial system, production, consumer markets and welfare enhancing internal trade. World trade growth could not go on at the pre-crisis rates for decades (see Khazin 2008). There is a persistent drive for more safety, transparency and fairness within the different banking systems with the natural consequence of reaching a less efficient in the short run, but more sustainable and prudent livelihood. There are underlying movements for future import substitution with home manufacturing. In addition, there are indications for re-industrialisation in the US also enhanced by its recent energy independence.[3]

The evolution of euro area's prospects delivered by its governance institutions could be observed from the views of the professional forecasters depicted on Figure. The long-term output growth forecasts indicate the equilibrium level towards which output would converge, after the impact of initial conditions and shorter-term shocks had vanished and structural policies directed towards the medium-term had become fully effective. They also represent indicators of credibility or ability of responsible institutions to enhance economic efficiency and welfare. Apparently the euro area has been on a declining path of long-term natural rate of growth ever since 2001: from 2.7 per cent in the first half of 2001

3. See for example "In U.S., Steps Toward Industrial Policy in Autos" by Steve Lohr, 19 May 2008, *New York Times* and "US manufacturers "reshoring' from China" by Ed Crooks, *Financial Times*, 24 September 2013.

the median long-term growth is at 1.7 per cent in 2013. The last two quarters of the sample have seen further deterioration in the whole distribution. The lower confidence interval of the distribution (5-th percentile) even reached 1 per cent. One wonders how would the euro area manage to function without a pivotal breakthrough in governance.

Figure. Long-term output growth expectations in the euro area (cross-sectional probability distribution)



Source: Survey of professional forecasters.

In June 2012 there were first promising signs that the euro institutions would be starting on a road towards the latter alternative of the above trilemma, a new building yard for EMU. This road may be hard, but it is the only viable option to which Europe is bound in its shared destiny, as declared by Mrs Merkel in her speech to the German Parliament in June 18, 2012: "we are convinced that Europe is our destiny and our future". Later in July the President of the ECB Mario Draghi clarified and confirmed the full institutional commitment to the euro by all stakeholders with the statement "the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough".[4] In September the same year this

4. Speech by Mario Draghi, President of the ECB at the Global Investment Conference in London, 26 July 2012.

commitment statement was supported by announcing the Outright Monetary Transactions (OMT) which proved to be fully incentive compatible, because of preventing self-destructive behaviour creating doubts in the irreversibility and unity of the euro area, and calming financial markets without even being used so far.

A systemic crisis could be overcome by a considerable change in the system of governance, taking into account not only the desired objective to be achieved for the functioning of the EMU in the "new normal" times, but also the orderly transition towards that aim. It would be really misfortunate if the target could never be achieved in practice and the euro area would be stuck indefinitely in a deflationary liquidity trap of misery, with inadequate inflation, meagre output and credit growth, because of mutual mistrust leading to dogmatism and inflexibility in implementing the systemic changes. Given the demanding times, in which we live, the construction of the new institutions must be more ambitious than those in 1999.

The objective is set at creating a Banking Union and all its underpinnings with the broader purpose to weaken the feedback effects between the sovereign debt of the member states and banks holding that debt in order to guarantee the continuous smooth monetary transmission and safeguard the deposits of the population. In a press release, the European Council provided a firm commitment for this on 29 June 2012: "We affirm that it is imperative to break the vicious circle between banks and sovereigns." It seems that since then only a gradual progress is being made.

The pace of building the new institutions might eventually turn out to be insufficient to pull Europe out of the current Long Recession. The Single Surveillance Mechanism (SSM) is expected to be operational only at the beginning of 2015. In the meantime, the Asset Quality Review (AQR) of the 130 banks to be supervised by ECB is likely to be conducted without having constructed a uniform definition of the Non-Performing Loans (NPL). The AQR will be followed by stress tests to be released in the second half of 2014. The Single Resolution Mechanism (SRM) has not been fully agreed upon yet. The direct recapitalisation of banks by ESM is no longer envisaged, and the single resolution authority is still under discussion. Not to mention the European Deposit Insurance system and the necessary common guarantee fund.

The main background obstacle is the fear by some member states that a Banking Union might work as a Trojan horse, i.e. a disguised way of bringing up a Fiscal Union and mutualisation of member states' debt, or, at least, sprouts of them. Moreover, in designing the transition to the new institutions there is undue emphasis on problems of moral hazard or free-riding, i.e. that in expectation of support from the others, weaker member states would behave irresponsibly generating risks for themselves and the system. Avoiding such problems is important, but we should not forget that meeting the currently unprecedented global challenges and exiting the Long Recession on a sustainable growth trajectory requires immense effort, taking of risks, strong confidence and a leap of faith. One could wonder how Europe would have developed if the Marshall Plan was not implemented to avoid problems of moral hazard and free-riding.

It is clear that the full process of implementation of the Banking Union will be a long one, which is consistent with the EU's implicit rule of taking small but irreversible steps. The issue is that this strategy might be too slow and inappropriate for the current challenges. Indeed, a breakthrough from an institutional point of view seems to be necessary in order to eradicate those self-fulfilling negative expectations that locked Europe in such a bad equilibrium. Furthermore, a U-turn is needed in the implementation of the rules to allow much more flexibility to help single countries to get out of the recession. Deep structural reforms are not easily implemented while the economy is imploding, and that is why the European Council decided in 2003 not to enforce the Treaty law for the persistently breached deficit rules by France and Germany even if that was not a period of general crisis.

The numerous reasonable discussions on how to avoid the next crisis should not distract our focus from agreeing on real operational measures to emerge from the current one, and by doing so avoiding the perilous options of asphyxia or a sudden breakdown mentioned above. The only implicit measure that seems to be followed in the EU to prevent the current crisis from further deterioration is to allow countries in difficulties both on growth, and on budget deficit not to enact more austerity in order to take care of the negative effects of past austerity on the government budget. As previously stated, we need governance not only for the normal times, but also for crisis times: extra ordinary governance. In fact, the potential growth in EMU will remain subdued as long as sovereign debts and banking systems' problems do not find a solution. For instance, in connection with the AQR process and the conduct of stress tests a coordinated solution at the European level on the NPL (perhaps through a European bad bank) could help not only peripheral countries, but also boost internal EU trade reversing the process of credit crunch, goods and financial markets fragmentation, thus enhancing the welfare of the European citizens.

The member states' current accounts have strongly improved mainly in the peripheral countries as a result not only of higher growth of exports, but also due to substantial decline of their imports. This cannot be considered the "new normal" for Europe; it is, instead, a result of fragmentation of the financial markets with corresponding reduction of capital movements, which required adapting the current account to the new size of the foreign financing.

The EMU governance should aim at eradicating the currently observed market fragmentation, thus enabling the peripheral countries to become the new engine of growth in Europe. According to the Prometeia international model, a one-percentage point of GDP shock on domestic demand in the peripheral countries (Ireland, Italy, Greece, Portugal and Spain) would produce an increase of EMU's GDP of 0.39 per cent. The same shock on German domestic demand would generate an increase of 0.26 per cent.

4. Epilogue

Summing up, the future prosperity of the EMU depends on its governance successfully resolving two main challenges. Firstly, letting the engine of European growth re-start through speedy and efficient implementation of the Banking Union, as well as providing a grace period to enable peripheral countries to restructure and positively contribute to the European recovery. Secondly, implementing institutional reform to ensure the safety of government debt to provide risk-free assets necessary for the financial industry in an ageing European society.

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