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Prioritizing EMU advancement domains to increase convergence and well-being

Only one year ago it would be unthinkable to believe that the European policy debate would be focused, with a considerable degree of consensus, on the need to deepen the Economic and Monetary Union (EMU). Political challenges from within and outside the EU have fuelled this necessity: the EMU needs a set of adequate instruments to deal with short-term and long-term challenges.

The asymmetric shocks in a monetary and economic union with free movement of labor and goods and services place specific short-term challenges to an optimal allocation of resources, which are only made worse without the adequate instruments. Take the example of labor. An uncompensated shock to wages in a monetary and economic union generates temporary and inefficient flows of labor, as shown by a large literature on unemployment search models. Reforms of the EMU need to consider the development of Union level instruments. Individually, countries cannot counteract such asymmetries. Europe's recent experience, if imperfect, is proof of this.

The political economy of reforms in Europe was limited. Neither the sequence nor the depth of reforms was calibrated. The mainstream views prescribed some sort of renewed Say's Law, according to which all supply side reforms would create their own demand. If long ago

economists repealed this 19th Century law, the crisis has proven this approach questionable again.

A structural reform is intended to expand the frontier of production possibilities and to improve societies' well-being. The reforms, per se, were well intentioned. However, applied in a context of crisis, they generated additional social and economic hardship.

The reform process was implemented at the same time in many countries, which reinforced the (lack of) demand dimension of the crisis. Investment recovery in the euro area waited until 2014; too long by historical standards. If price increases signal demand pressures in an economy, they are totally absent in Europe.

The bright side is that coming out of a prolonged crisis, the majority of Governments and Citizens feel the need to deepen the EMU.

Taking advantage of this requires determination and clear priorities. The reflection paper on the deepening of the EMU is an excellent base. The completion of the Banking Union should be the priority for the immediate future. It should precede the establishment of a more ambitious governance architecture. The financial fragmentation is not compatible with economic integration and growth. As it stands, the EMU is creating divergence instead of convergence.

There is a need to set up a common backstop for the Single Resolution Fund to boost confidence in the European banking system. Currently, European countries are implementing ambitious reforms to consolidate their banking systems. However, in doing so, banks have many times reduced their operations abroad. This is curtailing the creation of a single market, limiting the access to finance and the prospects of investment. Going forward in this area requires also a European Deposit Insurance Scheme, which is a cornerstone of a healthy banking system.

The state of the European institutional landscape illustrates in perfection why, as it stands, the EMU is creating divergence instead of convergence.

With confidence reinforced and clear mechanisms of shared risks and responsibilities, it would then be possible to start thinking on a more stable and complete governance architecture. One of the proposals put forward to foster the integration within the Euro area is the creation of a macroeconomic stabilization function.

This is a key instrument for the management of any monetary union, as the American experience shows. The way to move forward would be to design the simplest and most automatic mechanism possible. This automatic stabilization function should prevent moral hazards and allow for support in case of relevant asymmetric shocks or symmetric shocks with systemic nature. It should be designed to avoid permanent transfers, and to complement national schemes. An unemployment insurance scheme would work like this. It would be enacted only in exceptional times, when the national unemployment rate exceeds a threshold, and even then only at the margin. This would not consume major resources, contributing to an embryonic Euro Area budget.

As an institution and a currency, the euro is still in its infancy. We should provide it with a better institutional landscape, one that allows it to strive, not one with broken bridges or dead-ends. The citizens of Europe expect this from their leaders: a structural reform is an expansion of our production frontier, thus of the well-being of citizens. The only process compatible with a democracy. ●