The Future of EMU

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These slides do not reflect in any way the views of the Haut Conseil de Stabilité Financière.

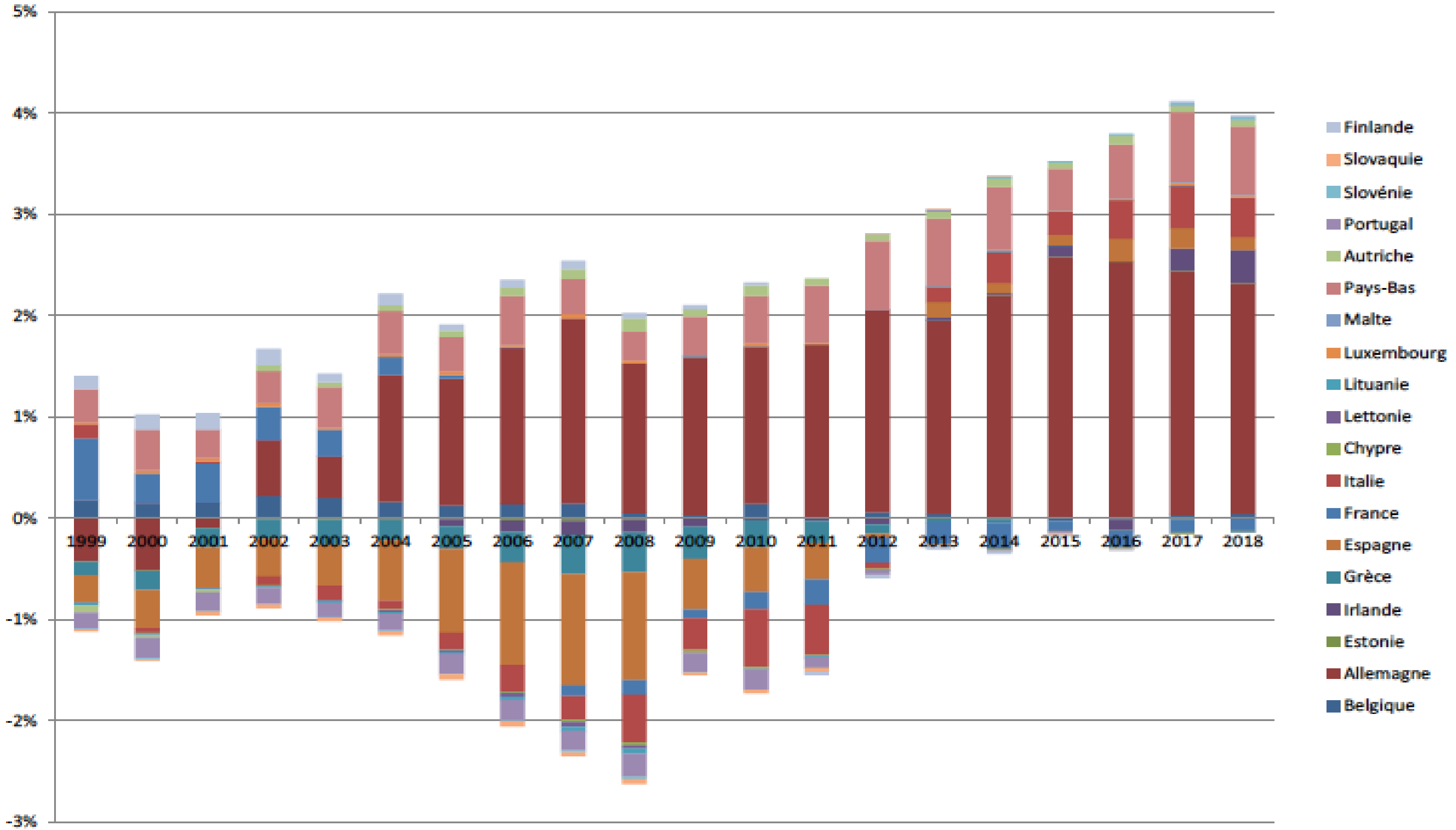
Key issues for euro area

- Euro area macroeconomic imbalances
  - ✓Current account surplus externalities

- Macroeconomic stabilization tools
  - ✓Fiscal authorities and the ECB
  - ✓Macroprudential policy and monetary policy

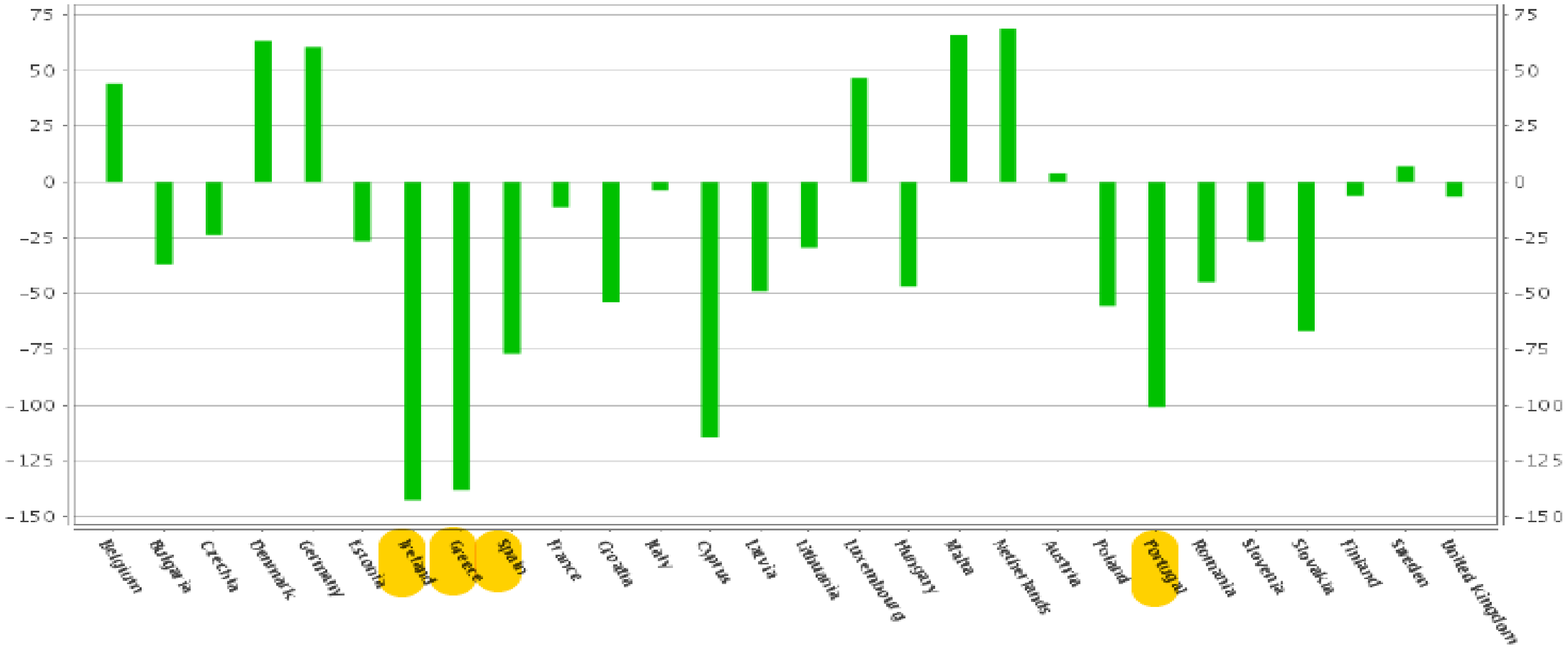
- Monetary sovereignty

Euro area current accounts (% EA GDP)



Source: CNP 2019

Net International Investment positions (% GDP)



Source: Eurostat (2019)

Imbalances: existential threats

- **First imbalances: [euro crisis]**

- Risk build-up (large inflows into the periphery) : 2003-2008
- Crisis and adjustment by the periphery
- Risk premia, doom loop and intervention of the ECB

Imbalances: existential threats

- **Second imbalances: [now]**

- Large current account surpluses in Germany and the Netherlands
- Real appreciation of G&N needed (inflation differential)
- Need for example 3.5% inflation in G&N and 1.5% in periphery for some time– **this is how the euro area *is supposed to work***

Negative externalities

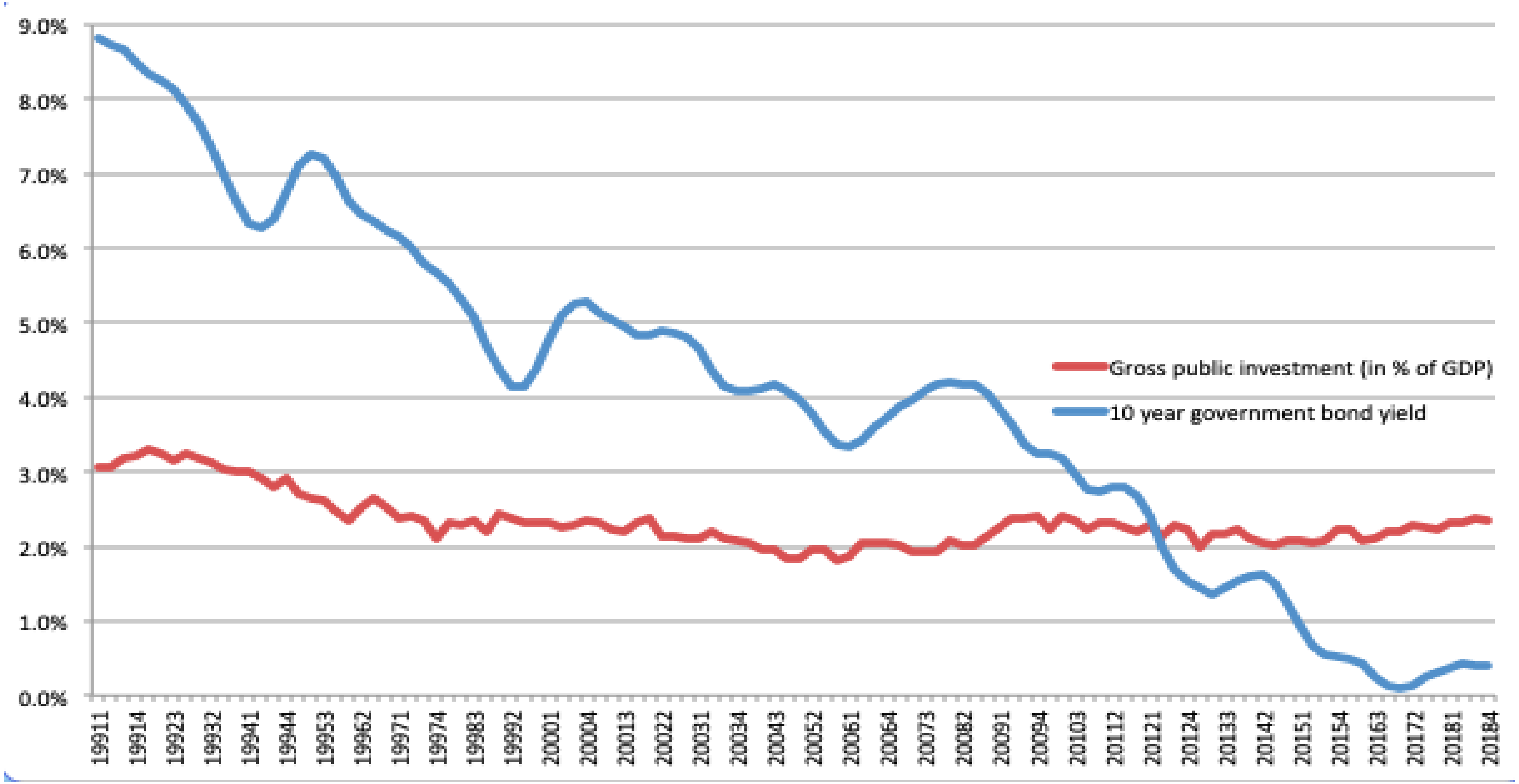
- **Excess Current Account surpluses and too low inflation in the core have negative externalities on the euro area**

- **Deflationary** pressures in the periphery:
  - depresses aggregate demand
  - negative effect on **debt sustainability** (high levels of nominal debt after the crisis)
- Slows down relative price adjustment: makes euro area more **fragile** to shocks.
- Excess savings: **downward pressure on real rate**. Monetary policy already at/close to ELB.
- Higher risk of **trade war** with the US

Adjustment (if no new tools)

- Need expansion of aggregate demand and inflation higher than 2% in core countries.
- Often claimed: Aging population needs saving. So it is prudent to save.
- BUT: ***Not investing now is not prudent***. Example: climate change.
- Prudent policy is to increase public investment (energy transition) now.
- Otherwise bill will be higher later when population older. **Climate debt builds up.**
- On top of this, current very low real rate ($r<g$)

German gross public investment and 10 year yield



Odendahl (2019)

Macroeconomic stabilization tools

- Asymmetric game where ECB has a euro area wide objective while fiscal policy is determined by perceived national interests.

- If countries with fiscal space do not expand enough, monetary policy does the extra mile (and is more likely to be at the ELB)
- Excess burden is placed on the ECB.
- Looser monetary policy implies countries with fiscal space perceive even less need to expand.
- Core countries have a wrong macro policy mix (monetary too loose, fiscal too tight).

Macroeconomic stabilization tools

- We have no euro area budget for stabilization purposes (so far).
- We should have more transparent, less procyclical fiscal rules (see CEPR 7&7 Report)
- We should at least have a sizable investment budget (decarbonisation, AI, research, …) financed by *cyclical revenues* (share of corporate taxes) in order to decrease climate debt, etc…
- Looking forward, this would be prudent and countercyclical.

Macroprudential policy and monetary policy

- Country specific so can help modulate monetary policy in the euro area.
- Countercyclical buffer: up during economic expansions. Gradual build up has little effect on activity.
- Buffer can be released quickly if credit conditions tighten in a downturn. Can then reinforce effect of monetary policy easing.
- Looking forward: Macro prudential policies provide further ammunitions for a downturn.

Sovereignty and euro area

Draghi (2019): “True sovereignty is reflected not in the power of making laws – as a legal definition would have it – but in the ability to control outcomes and respond to the fundamental needs of the people.”

- Monetary sovereignty is constrained :
  - ➢Global Financial Cycle (Fed key driver)
  - ➢Invoicing and pass-through from exchange rate to prices ($ dominant)
  - ➢Payment system (extra territoriality and US law)
  - ➢Fragmentation in euro area: doom loop
- Future of EMU: increasing sovereignty

Conclusions

- A long way since 1999

- Lots of important issues for the EU now (climate, energy policy, defense, research and innovation, Brexit, …)

- Reforms of the euro area should not be forgotten:
  - ➢Imbalances: macrostabilization, prudent investment
  - ➢Monetary sovereignty: Banking union, capital market union, safe asset