

Lecture

Economic and Financial Challenges for the European Union in 2017

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This text, while not a verbatim transcript, is based on the author's oral delivery and his unprepared but prepared notes. The webpage for the lecture, including a link to video footage, is at <https://www.esmt.org/school-networks/events/esmt-open-lectures/esmt-open-lecture-nicolas-veron>.

At a time when there is much uncertainty in the world, this open lecture will focus on the challenges that are facing the European Union this year and, among them, on those that have a specific economic and financial dimension and may be addressed by European policy initiatives in the near future. I am very grateful to Jörg Rocholl, president of ESMT, for his generous invitation to speak today in this intimidating historic room, and to Michał Grajek, who has kindly accepted to moderate the questions-and-answers session after my initial remarks.

A more stable outlook after ten years of turmoil

The title of this lecture is an invitation to look forward, but it is also important to remember where we come from. The European Union is only slowly emerging from nearly a decade of continuous economic and financial emergency, which started with the first indications of major dysfunction in the financial system in the middle of 2007—including here in Germany, with the rescue of IKB in late July of that year. Financial and economic turmoil later morphed into disruptive political developments, which in turn generated economic and financial challenges of their own.

Of these political developments, at least one will certainly have lasting structural consequences—the choice made last year by the United Kingdom to leave the EU, or Brexit. Apart from the UK, there are many current challenges in European politics, but it remains to be seen whether they are of more than a temporary nature. The initial political impact of Brexit itself has been weathered by the rest of the EU, better than many observers (including myself) would have anticipated. There has been shock and disbelief, but no obvious contagion to other member states in terms of collapse of public support for European integration; if anything, the opposite has been observed in several opinion polls since June 2016. It is early in the year, of course, and a string of elections later this year will give us a number of new data points. As for financial system aspects, there is no question that Brexit represents a significant shift in the European landscape, given the central role of London as a capital markets hub for the entire European Union in the recent past and the present.

2017 is likely to mark the end of the EU's decade-long sequence of economic and financial emergency. Such a statement may appear overly optimistic given all the catastrophist media headlines about the EU and the euro, which are routinely depicted as on the verge of collapse. But while that alarming picture was definitely appropriate during the transatlantic financial meltdown of the early autumn of 2008, or during the climax of the euro-area crisis in late 2011 and early 2012, or even during the high drama of the Greek crisis in mid-2015, it rings less true now.

The last major pockets of country-specific banking sector fragility—in Portugal and Italy—are belatedly on the way towards being properly addressed, at least if a number of important ongoing transactions are confirmed. These include the privatization of Novo Banco, the capital increases of BCP and Caixa Geral de Depositos in Portugal, and in Italy, the public recapitalization of Monte dei Paschi di Siena and that of the entity resulting from the announced merger of Banca Popolare di Vicenza and Veneto Banca. If and when all these are completed, which I hope and expect will be the case in a few weeks, a picture will emerge of a euro-area banking sector still in need of considerable restructuring but no longer in a situation of systemic fragility (even though smaller banks in Italy and elsewhere will remain a concern).

Similarly, while negotiations on continued financial assistance to Greece remain difficult, they are unlikely to degenerate into the kind of unreasonable brinkmanship that occurred in mid-2015. And while Brexit creates significant challenges for the financial system of the EU-27 (the 27 other EU countries, excluding the UK), it is unlikely to generate financial instability given the long lead times that will allow financial firms to adapt their structures and anticipate even the most non-cooperative outcomes. Altogether, in a broadly probable baseline scenario, there will be situations to manage in 2017, but they won't be as existential as in every year of the last decade. Of course there are tail risks that could trigger severe financial instability—such as a far-right government in France, for example—but their likelihood should not be exaggerated. In a turbulent global environment, and somewhat ironically given the recent experience, the European Union (minus the UK) could even quickly become an area of comparative stability.

The need for further reform

Even if one accepts this comparatively benign assessment, there is evidently no room for complacency. The European Union is far from having reverted back to a normal economic and financial condition. The clearest sign of this is the continuation of extraordinary monetary support by the European Central Bank (ECB), including in the form of the current program of quantitative easing. Greece is very far away from regaining market access for its sovereign financing. And as previously mentioned, the European banking system cannot retain its current structure; major changes in the financial landscape will have to happen before it becomes healthy again.

Thus, the desirable transition back to normal will only happen if further efforts are made, including in the area of new policy development. This lecture focuses on outlining a realistic agenda for such efforts, which should also draw appropriate lessons from the last almost ten years of crisis. One hopes that 2017 will be a busy year for the EU policy debate, so that the new governments that will emerge from the sequence of elections scheduled this year in several key countries, including this one in September, will be able to initiate useful actions once they are in place.

Such new policy initiatives at the European level should not be thought of as overly radical. Experience suggests that paradigm shifts in EU governance only occur under massive short-term pressure and, as highlighted above, such pressure is not expected to be repeated in the year ahead, at least in a baseline scenario. In particular, there should be no expectation of treaty change in the immediate future. Indeed, treaty change would be very hazardous as long as the negotiation with the UK on Brexit is not completed.

In the same vein, there should be no expectation of fiscal union, understood as a fully-fledged system of debt issuance and revenue collection at the European level. The euro area has limited elements of a fiscal framework, such as size-bound financial firepower (including the ability to issue debt) at the European Stability Mechanism, and a limited-purpose levy on European banks to feed into the Single Resolution Fund, which is expected to become fully transnational by 2024. More

longstanding arrangements include the European Investment Bank's financial capacity and the EU's own resources, such as customs duties and sugar levies. But these arrangements stop well short of a full fiscal framework. There is no expectation here that the political and legal parameters which so far have prevented the emergence of genuine fiscal union in the euro area will change any time soon.

Even within these constraints, a lot can be done. Four areas in particular can be singled out for bold reform. They may be labelled, respectively: a stronger banking union; a reframed capital markets union; a common information backbone for fiscal policy; and renewed thinking on how to achieve a true single market in regulated services sectors, which may also be thought of as economic union. The rest of this lecture is devoted to examining these four possible projects in a bit more depth.

A "steel-framed" banking union

Banking union refers to the pooling of banking-sector policy instruments at the European (in this case, euro-area) level to achieve the objective "to break the vicious circle between banks and sovereign" as memorably stated by the euro area political leaders in their landmark declaration of June 29, 2012, which started this project, and in subsequent pronouncements. This unusually clear statement of intent came from the painful lessons of the months preceding that mid-2012 policy breakthrough. During that period (late 2011 and early 2012), it became increasingly evident to all that the financial linkages between national banking systems and the respective sovereign issuers, through mechanisms that may variously be labeled implicit government guarantees of the banking sector, financial repression, and banking nationalism, were generating a destabilizing dynamic of contagion and escalation that came close to forcing an irreversible breakup of euro-area monetary integration. As long as genuine fiscal union was not on the cards, banking union was eventually, and correctly, identified as the only way to break that vicious circle.

Several policy initiatives came from this recognition: mainly the creation of a brand-new system of European banking supervision (also known as the Single Supervisory Mechanism) in which the central role was entrusted to the ECB, operational since late 2014; the acceleration and strengthening of the hitherto tentative shift from a default assumption of public rescue (or bailout) of creditors of failed banks towards that of burden-sharing by private stakeholders (or bail-in), materialized in the Bank Recovery and Resolution Directive (BRRD) of 2014; and the partial centralization of bank resolution decisions in the euro area through the establishment of the Single Resolution Board and Single Resolution Fund, both in place for more than a year now. But despite these pathbreaking achievements, Europe's banking union remains, to borrow the words (if not the full analysis) of Germany's finance minister in a 2013 article, "timber-framed," an unfinished construct that mitigates the bank-sovereign vicious circle but is not strong enough to break it. To achieve that aim, again borrowing Mr. Schäuble's expression, a "steel-framed" banking union should replace the timber structure, and this requires further legislative reform.

The specific content of such reform requires public debate, which itself can only be fruitful once the European public, including observers in this country, has been sufficiently persuaded that the existing system works as intended, and in particular that European banking supervision is "tough and fair," as its officials often put it. This requires clear indications of progress in countries such as Portugal and Italy, but also a sense of direction on high-visibility German cases such as Deutsche Bank or, in a completely different category, HSH Nordbank. The lack of that perception in the past goes a long way towards explaining, in particular, the lack of progress in the discussion on "strengthening banking union" during the Dutch Presidency of the Council of the EU in the first half of 2016. But if, as previously suggested, the picture of ECB supervisory effectiveness improves

significantly in the near future, then a much broader space will be opened for further constructive steps.

There is not enough time today to describe in much detail what these steps should look like. But they should include at least three dimensions. First, the framework for bail-in should be made more consistent across member states, an aim that inevitably entails harmonization of bank insolvency law. Second, regulation should ensure that banks cannot be used by governments as instruments to get easy funding, which suggests a binding framework of well-calibrated exposure limits on banks' sovereign debt portfolios, with proper transition arrangements. This is a complex and important matter that requires much more public debate than has happened so far, but the euro area will not escape that debate—nor can it be successfully delegated to international bodies such as the Basel Committee, because the problem is the unduly high home bias in euro-area banks' sovereign debt exposures and this problem is essentially unique to the euro area. Third, there is a need for explicit risk-sharing to rule out the possibility that local banking problems, especially in smaller countries, may trigger sovereign default. This should take several forms, including the creation of a European Deposit Insurance System broadly along the lines suggested in November 2015 by the European Commission, a financial backstop from the ESM for the Single Resolution Fund and the future European deposit insurance fund, and also the ability for the ESM to intervene financially in precautionary bank recapitalizations under the conditions set by BRRD.

These three dimensions are mutually interdependent, not only politically but also on substance, and should be envisaged as a single policy decision package, even though their implementation will inevitably occur in several stages. In addition, more work is needed on subsidiarity and proportionality in the banking union architecture, to ensure that smaller banks are subject to consistently high prudential and supervisory standards without burdening them with unnecessary administrative requirements. This latter objective may take more time to achieve but also deserves open discussion as soon as this year.

Capital Markets Union 2.0

The EU project of Capital Markets Union (CMU) was initially announced in July 2014 as part of the broader policy program of the new European Commission led by Jean-Claude Juncker. At the time, the aim was to reduce excessive dependence on bank intermediation in Europe's financial system but also, plainly, to signal a financial-market-friendly attitude in the run-up to the UK referendum. But far from rendering CMU obsolete, Brexit actually adds to the project's urgency and should force a reframing on how to achieve its aims.

The underlying reason is that London's role as a central hub has meant that the EU's wholesale financial markets were overseen in a consistent way—by the UK authorities—because they were overwhelmingly located in a single member state. In a EU-27 context post-Brexit, there is a major risk of oversight fragmentation, with different national authorities taking different approaches leading to regulatory loopholes, lack of enforceability of EU policies, and a higher cost of funding for the EU economy.

Even though banks represent a major share of financial intermediation, banking union per se doesn't address this challenge, if only because many of its aspects are unrelated to prudential supervision. For example, the enforcement of the Markets in Financial Instruments directives and regulation (known as MiFID/MiFIR) is largely in the hands of securities authorities, not prudential supervisors, and in most member states (though not Germany) these are entirely separate organizations. Thus, the new incarnation of CMU in the changed context created by Brexit should put the emphasis on the reform of the oversight architecture (possibly complemented by regulatory harmonization

projects), in order to reach a status in which, to borrow a recommendation from the last annual report of the German Council of Economic Advisers, “the oversight of financial markets [should be] located at the European level.”

In practice, this would require a reform and reinforcement of ESMA, the European Securities and Markets Authority created in 2011, to make it the hub of policy-setting in that area. Many individual decisions would remain in the scope of national authorities, but under ESMA’s binding oversight, in a hub-and-spokes framework akin to those for competition policy or for banking supervision. For example, ESMA should have authority over the enforcement of International Financial Reporting Standards throughout the EU, and similarly for the oversight of audit firms and of critical market infrastructure (such as clearing houses), as it already has over credit rating agencies and trade repositories (disclosure: I am an independent director in a trade repository supervised by ESMA).

This vision for “CMU 2.0” would also allow for the creation of third-country regimes that would allow European authorities, including ESMA and the ECB, to oversee market infrastructures located outside of the EU-27—for example, in London—if they play a critical role for the EU-27 financial system. Such a vision is not at all utopian, since a framework along these lines already exists for US authorities, which have arrangements in place to directly supervise and inspect some critical financial infrastructure in London and elsewhere. It is high time for the EU to revise its approach in this area and learn the right lessons, both from the American experience and from the shortcomings of its own frustrating past attempts to address this challenge through the means of equivalence recognition.

[A reliable information base for fiscal policy](#)

As mentioned earlier in this lecture, it is arguably not realistic at this stage to advocate decisive steps towards fiscal union—eurobonds, eurotaxes, and euro-spending even if they’re not called that way. There is a sound intellectual case to be made for such things, but it is abundantly clear that Europe is not yet ready for them politically and can most likely overcome its current challenges without them. But that doesn’t imply that nothing can or should be done to improve the euro area’s current highly imperfect fiscal framework.

Sadly, the Maastricht treaty’s stability pact (later, stability and growth pact) has not worked as intended by its framers—and my country and yours, France and Germany, were the ones who first and foremost breached it almost fifteen years ago. Since then, increasingly complex patches have been applied, but their credibility has not been better. If the rules are simple, they tend to be too rigid and in many cases even “stupid,” as was memorably put by a former president of the European Commission; in order to better meet economic objectives, the framework requires more nuance and judgment, but then it quickly becomes overly complex and open to political tweaking, which is more or less the present situation.

Meanwhile, the EU does not appear to have fully drawn the lessons from its most obvious fiscal policy failure: the repeated misrepresentation by Greece of its true fiscal condition (under different political coalitions) that led to the well-known drama of 2010 and ever since. Some changes have been introduced to make national numbers more reliable, but they have not gone nearly far enough.

One case summarizes the problem: that of Mr. Andreas Georgiou, head of the Greek national statistical office for five years from 2010 to 2015 and, in that capacity, the one who established the definitive figures for Greece’s deficit and GDP developments in 2009 in particular. These figures have been validated by Eurostat and have not been questioned outside of Greece. Within Greece, however, they have become a matter of highly emotional controversy. The government has

repeatedly declined—again under successive political coalitions, including but not limited to the current one—to vouch for them. Worse, Mr. Georgiou was accused of harming the national interest by publishing them and has been the target of a number of high-profile lawsuits that are still ongoing. It is evidently not acceptable that a statistician should be persecuted for doing his job with integrity and left to his own devices by both national and European authorities for his defense. As long as such a thing can happen, the potential for undue political interference in the production of national accounts and statistics is achingly obvious, and not only in Greece. This situation cries for reform.

What is needed is—with reference to the arrangements existing in the private sector and in particular those covering publicly listed companies—a proper accounting and auditing framework for European governments, with a robust enough central function to ensure relevance, comparability, reliability, and understandability. The accounting standards should be based on the age-old principle of accruals accounting, which has only recently been introduced into government accounting in some countries, including some EU member states but far from all of them, for example Austria but not Germany. Equally important, the current oversight by Eurostat should be transformed into a genuine euro-level auditing authority. These more centralized arrangements should also apply, with due adaptations in accordance with the subsidiarity principle, to the accounts of subnational governments, to the extent that they contribute to national aggregates. Such ideas are bound to be controversial, but the lessons from the Greek tragedy in general, and from the more specific but significant Georgiou tragedy in particular, must not be allowed to be lost.

[EU-level structural reform: the single market in regulated services](#)

The Four Presidents' report of June 2012, whose lead author was then-President of the European Council Herman Van Rompuy, has popularized a framework of “fourfold union” to think about the missing pieces of euro-area policy: financial union (i.e., banking union and capital markets union), fiscal union, economic union, and political union. This lecture has already included suggestions for financial union and for a sounder information basis for fiscal policy even as fiscal union is left for a more distant future. Political union is not discussed here, beyond the observation of the EU-27's initial resilience following the shock of the Brexit vote.

Economic union, however, deserves more debate and attention than it has habitually received since Mr. Van Rompuy's report. Different analysts have used the expression in many different ways. It is proposed here that it may best refer to those structural economic policies that are conducted at the European level, not the national level. Viewed that way, economic union may be taken as just another name for the completion of the European single market, particularly in services sectors where EU-wide market integration is partial at best.

Single market policy has been very successful in markets for goods and unregulated services but much less so in regulated services sectors. This distinction is especially significant since regulated services tend to represent an increasing share of the EU's economies, and this increase implies that national economies become less not more integrated if the EU is not able to complete the single market in such sectors. The underlying reason for the gap is that, in regulated sectors, market structures are shaped not only by the content of rules and regulations but also by the way they are implemented and enforced, which typically involves a degree of administrative discretion and judgment. If such administrative oversight and enforcement is in the hands of national authorities, as is habitually the case, then markets tend to be segmented across national lines. One aspect of this is the tendency of national authorities to give preferential treatment to “national champion”

companies, as is being illustrated by the burgeoning cases about the control of car emissions—even though one would expect this type of technical standards not to be susceptible to national twisting.

“Capital markets union 2.0” as previously discussed, and indeed also banking union, can thus be viewed as early examples of a new and promising approach to promoting EU single market integration in regulated services sectors, by complementing the structure of national enforcement authorities with a European overlay, thus achieving a hub-and-spokes architecture comparable to the one that has long existed for the implementation of competition policy. This approach can and should be extended to an increasing range of regulated sectors, be it energy (e.g., electricity and gas networks), digital services (e.g., the enforcement of privacy protections), as well as various regulated professions, commercial health and education services, and more.

Overhauls of EU supervisory architecture through the creation of sector-specific EU-level authorities with a mandate for binding decision-making, not just loose coordination, has long been considered unachievable politically. But the initial successes of European banking supervision have led to a shift in perceptions. With the UK veto removed by Brexit, it may now be time for the EU-27 to envisage new initiatives to create appropriate institutional settings that would allow for the vision of a seamless single market to be achieved, in a broader range of economic sectors than has been the case so far.

Concluding remarks

The theme of this lecture has been that the EU-27 is just exiting a decade-long period of short-term emergencies, and now needs to consider fresh initiatives to reach a more consistent framework for banking, capital markets, fiscal (if only as regards the information base), and structural economic policies, building on the early achievements of recent shifts such as European banking supervision. This might strike some observers as an exceedingly optimistic way of looking at the EU’s current situation and challenges.

Only time will tell if there is too much optimism in this vision, but in any case it should not be mistaken for complacency. As previously emphasized, even assuming no new dramatic development in the EU-27 in 2017, the area is far from having returned to a normal economic and financial condition. This is precisely why a strategic, forward-looking policy debate is so important this year. As the old American saying has it, Europeans will hang together or hang separately.