Position paper

of the Association of German Banks
on the future of economic and monetary union

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Executive summary

Main political messages

- Fundamental reforms are needed both in euro states and at community level to achieve long-term stabilisation of the eurozone and better integration of the euro states.
- Incentives should be created for greater economic convergence and international competitiveness in order to eliminate institutional weaknesses in eurozone members and stop them disregarding jointly agreed rules.

Basic principles

- Euro countries should explicitly commit to making stronger economic growth their top economic policy priority.
- Liability and responsibility should as far as possible exist side by side at the same level; deeper integration requires more sovereign rights to be exercised at community level.
- Integration, subsidiarity and solidarity can go hand in hand; but the risks arising from national economic policy decisions need to be removed.
- Economic and monetary union should for the time being be moved forward under the existing treaties or by means of intergovernmental mechanisms.
- We are in favour of a Europe of variable geometry with graduated levels of integration in diverse fields; member states should be able to opt into individual integration measures.

Core recommendations

- Compliance with the clear existing conditions for joining the currency union – including those requiring the necessary degree of economic convergence.
- Clearer and more transparent coordination of economic policy under the European Semester with greater commitment to growth-oriented national economic policies.
- Transformation of the European Stability Mechanism (ESM) to a European Monetary Fund (EMF) endowed with credible authority to continuously monitor the budgets of euro states.
- Creation of a eurozone budget by establishing two new eurozone facilities, alongside the ESM/EMF's emergency facility for members with financing problems, with funds earmarked for special emergencies (such as natural disasters) and the promotion of the structural reform needed in member states.
- Creation of a euro finance minister to represent the eurozone (as Chair of the Eurogroup, representative of the euro states on currency issues, head of the facilities for emergencies and for promoting structural reform).
- The possibility of a euro state becoming over-indebted should primarily be addressed by collective action clauses. Possible compromise in the debate on insolvency proceedings for states: limited, automatic extension of bond maturities if ESM/EMF help is needed.

The Association of German Banks sees this position paper as a contribution to the discussion on the future of economic and monetary union ahead of the release of the European Commission's proposals and the deliberations of the European Council in December 2017. This is only one aspect of EU reform; the Association of German Banks will continue its work on specific elements, such as Banking Union or Capital Markets Union.

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The future of European economic and monetary union against the backdrop of …

… developments to date

European economic and monetary union has gone through some turbulent times. First of all, the eurozone was hit by the international financial crisis. Then, at the beginning of 2010, this was followed by the sovereign debt crisis. The debt crisis was the result of two main developments: first, the soundness and credibility of the fiscal policy of some member states was severely called into question. Investors were no longer prepared to fund the budget deficits of the countries involved without a very high risk premium. Second, some eurozone members had lost a huge amount of international competitiveness. The associated current account deficits also came under the spotlight of investors. These developments combined to trigger contagion which spread – also through the banking sector – to more or less the entire eurozone. A few voices even called the very survival of the currency union into question.

Emergency measures were taken to combat the immediate consequences of the sovereign debt crisis, with the monetary policy of the European Central Bank playing a key role. Financial bailout packages were put together, too, dispensed first by a temporary (EFSF) and later by a permanent (ESM) institutional mechanism. It should also be borne in mind that so-called TARGET2 balances acted as (unintended) balance of payments aid.

With the help of these emergency economic policy measures, the eurozone has now got back on track. Clearly, however, fundamental reforms at both member state and community level are indispensable if long-term stabilisation is to be achieved. It is therefore vitally important to create incentives which will help

- promote greater economic convergence (in terms of economies and economic policy);
- tackle the lack of international competitiveness in some euro states and make the alignment of competitiveness across the eurozone a permanent task;
- remedy the unwillingness to follow jointly agreed rules and eliminate the difficulties which arise partly as a result of interim solutions and the weakness of some EU institutions.

… overarching challenges

Another reason for reforming the currency union without delay is that the risks and side effects of monetary policy support are increasing and the European Central Bank needs to recover its “conventional” monetary policy tools. The current economic upswing in the eurozone will not continue indefinitely.

In addition, credible modifications should be made to the structure of the eurozone in order to take the wind out of the sails of nationalist and isolationist tendencies in the euro states.

And before the next elections to the European Parliament, which will be held in mid-2019, “Europe” should demonstrate its ability to act as one, thus testifying to the significance of the European elections and the democratic credentials of the European Union.

The ongoing development of the currency union is, moreover, a fundamental item on the European Union’s major reform agenda. Realisation of this reform agenda would meet the perquisites for the Continent to be internally successful. But a reform agenda is also needed to cushion the impact of the UK leaving the EU. A greater understanding of the fact that Europeans are dependent on one another in an increasingly globalised world is indispensable. In a global context, a stable, economically and politically well-functioning community of European states is therefore essential if Europe’s common interests are to have any chance of obtaining a worldwide hearing. Substantial tasks such as managing migration flows or ensuring internal and external security can only be undertaken jointly at European level.

… the European policy beliefs of the Association of German Banks

The Association of German Banks is convinced that the European internal market is the key to economic, social, and also political integration in Europe. The entire continent will benefit from a strong, true single market. It offers the economic basis for Europe’s political role and influence in the world. In consequence, the completion and maintenance of a true European single market is the central challenge for European and national economic policy. For the Association of German Banks, therefore, banking and financial market policies also belong on the European reform agenda, especially the completion of the single market for financial services through projects such as Capital Markets Union and Banking Union. The fragmentation of the internal market for financial services must be overcome right across Europe.

A further crucial aspect, in our view, is that the responsibility for national tasks should not be shifted onto Europe. Each member state should make its own contribution to its own competitiveness. Only at member state level can challenges in fields such as education, innovation and infrastructure be met, and only at this level can demographic change and its impact on social security systems be addressed. This applies also – and in particular – to Germany.

We believe member states most certainly have enough scope for action and sufficient policy options to rise to these tasks. Member states should, moreover, see their endeavours to find independent policy solutions as a fruitful competition of ideas. At a community level – preferably at EU level – a supporting benchmarking or best-practice framework should be established to allow the efficacy of these policy approaches to be compared easily and systematically.

Five key basic principles for Europe

Growth through competitiveness the key objective of economic policy

A precondition for successful reform in the eurozone is that the euro states come to an explicit agreement on economic policy priorities. Different economic policy objectives too often become intermingled and secondary or downstream objectives are wrongly prioritised. In the view of the Association of German Banks, continuous, sufficiently strong growth is a key prerequisite for high employment and robust social security systems. Supporting sustainable growth should therefore be the central task of European economic policy.

But this can only succeed if suitable framework conditions are in place, especially targeted measures to boost and sustain the international competitiveness of businesses and state activities geared towards the growth target.

Above all, open and clearly communicated agreement is needed on this objective and on its relationship with other political and economic policy objectives, particularly that of solidarity both between and within member states (principle of the social state).

In achieving this objective, however, the focus should be not only on European measures but also on national efforts (subsidiarity principle). We are therefore strong proponents of structural reform in the member states of the eurozone and of the entire European Union. This expressly applies to Germany as well, where the longer-term growth trend continues to be too flat.

Decision-making and responsibility belong on the same level

As we see it, the basic democratic principle underlying the European Union requires that the collective exercise of decision-making powers at community level go hand in hand with corresponding responsibility and liability at community level too. Conversely, member states should not be permitted to shift the consequences of policies enacted at national level onto the community. All euro states have been guilty in recent years of “passing the buck” and blaming “Brussels” for all sorts of trials and tribulations which their national policymakers are “powerless” to do anything about. This practice has to stop.

In an increasingly integrated European Union and a currency union comprised of most member states, the joint exercise of sovereignty at community level is a logical development. This transfer of sovereignty does not always function according to a textbook on constitutional law and interim solutions are often needed because the European Union and the eurozone are confederations of states, not federations. In the complex evolution of the European Union, this means that the rules and regulations for the exercise of collective sovereignty have to be not only agreed on, but also observed.

Jointly set rules – provided that they are respected and seen as binding – are to some extent a substitute for community structures. As such, they can serve as an interim solution until all (democratic) checks and balances have been established at central level. It is therefore profoundly wrong to dismiss jointly agreed and negotiated rules as too “technocratic” or as a “straitjacket”. On the contrary, binding rules are a fundamentally important tool in the process of integration and in the final analysis represent a means of exercising collective sovereignty at community level.

Integration, subsidiarity and solidarity are not a contradiction in terms

There will be no one-size-fits-all solution when moving forward European integration. Some questions, such as the integration of the internal market, or foreign policy and security, must be solved at European level. This is not true of many other fields, such as education or promoting economic development. The Association of German Banks is in favour of applying the principle of subsidiarity and seeking solutions at member state or even regional level if it is not absolutely necessary to tackle an issue at EU level. European integration is not an end in itself, as we see it, but a compelling need in certain areas.

It is not helpful to engage in political displacement activities and artificially shift problems to EU level with the aim of demonstrating an ability to act. What is more, the transfer of sovereignty to European level implies that member states have to take steps to eliminate any risks caused largely by national economic policy.

This link becomes even clearer when it comes to greater solidarity between European states. There seems to be an increasing realisation that the eurozone, where integration is now much deeper not least as a result of a common monetary policy, will not enjoy long-term stability without a certain amount of solidarity. Yet greater solidarity will not, in itself, lead to a more stable currency union. There is a huge danger of redistribution structures becoming entrenched and creating the totally wrong incentives for economic policy in some euro states. This would open the door to a “transfer union”, which would overstrain all sense of solidarity and ultimately split Europe and the eurozone down the middle. The mere redistribution of risks would dissolve the link between risk and liability which is such an essential element of a market economy.

Small steps in the right direction

As things stand, making changes to the European treaties is a lengthy exercise and fraught with political risk. For the time being, therefore, the task of moving forward economic and monetary union should be tackled within the framework of the existing treaties or by intergovernmental agreements.

Optimising and harmonising existing rules, such as those governing Banking Union, should be a further priority.

A Europe of variable geometry

Another aspect of European reality is the lack of complete consensus among member states about exactly where, and to what extent, European integration should be deepened. This is not a problem as long as there is a core of jointly held views – on the single market, for instance, and the rule of law – and countries which wish to move forward more quickly are not prevented from doing so.

A Europe of variable geometry, where member states pursue individual paths of integration in different formats and constellations, will be our European reality for the foreseeable future, will gain political acceptance and thus prove effective. For the time being, this will also apply to a lesser extent within the eurozone, manifesting itself in the harmonisation of tax rates and tax assessment bases, for example, or in detailed aspects of a greater convergence of markets. Absolute prerequisites for such a model of graduated integration are transparency and the ability for member states to opt into certain integration measures.

Six projects for moving forward economic and monetary union

Enlarging the eurozone

There is a clear agreement in force governing both membership of, and accession to, the eurozone. This agreement needs to be strictly observed – including the rules concerning the necessary degree of economic convergence – and should not be subject to attempts to exert tactical political influence.

Germany’s private banks are convinced that it makes good economic and political sense for all EU member states to join the eurozone in long term – provided that all the criteria for doing so are met. We are equally convinced, however, that the most important task at the present time is to move forward economic and monetary union and that it makes no sense to force member states to join against their will.

Improving the coordination of economic policy

The coordination of economic policy under the European Semester currently lacks transparency, momentum and binding force. A clearer, more transparent approach should be sought and best practices should be promoted more strongly.

Structural reform which strengthens competitiveness and growth is ultimately in the interests of each and every member state. Nevertheless, thought should be given to how the initial cost of structural reform could be cushioned by means of community aid. It is absolutely essential, however, that there is a broad social consensus in the member state involved about the need for such reform.

A European Monetary Fund

The European Stability Mechanism (ESM) should be expanded and turned into a European Monetary Fund (EMF). This would enable responsibilities and expertise to be pooled when designing and administering an emergency facility for a member of the eurozone. The efficacy of the institution would be enhanced.

The EMF should be entrusted with three basic tasks:

- monitoring the budget of member states and making recommendations to the Eurogroup on the basis of its findings;
- administering an emergency facility for member states in financial difficulties;
- acting as a backstop for the Single Resolution Mechanism.

Monitoring member states’ budgets is necessary because of the immense importance of fiscal policy for the stability of the eurozone. This is one of the lessons learned from the sovereign debt crisis. On top of that, it will encourage euro states to respect the principle of the greatest possible congruence between authority, on the one hand, and responsibility and liability, on the other.

If it is to monitor member states’ compliance with the prescribed budgetary framework, the EMF needs to be endowed with credible authority. In addition, the provision of financial aid needs to be tied to conditions and the right to intervene in a member state’s national fiscal policy. These conditions and intervention rights could be on a sliding scale according to the EMF’s previous assessments of the state’s fiscal policy. This would strengthen the incentive to set sustainable budgets. It should be clear, however, that the euro states are the owners of the EMF and, as such, it is they, and not the Commission, which have ultimate control over the fund.

A eurozone budget

In addition to the EMF with a contingency fund for member states in financial difficulties, the German private banks advocate the creation of two dedicated eurozone facilities. The first should be for special emergencies, such as natural disasters or severe, asymmetric economic shocks. The task of the second facility would be to promote the structural reforms needed in member states.

To obtain support for national structural reform, a state should need to draw up credible plans. And parameters need to be defined to set the right incentives for national economic policy – namely encouragement to tackle necessary structural reforms as swiftly as possible instead of putting them off.

Both facilities should be funded by member states. We see no need, and do not believe it would make good sense, to put a broader eurozone budget in place.

A euro finance minister

A lively discussion is underway about creating a euro finance minister, though there appears to be no clear idea of exactly what the post would entail. The Association of German Banks would recommend establishing a few ground rules: until all EU member states have adopted the euro, the euro finance minister can only represent the eurozone. As with the President of the European Council, the position should be a full-time job. The euro finance minister should have the following responsibilities:

- chairmanship of the Eurogroup;
- representation of the interests of euro states on currency matters;
- administration of the first new eurozone facility (“rainy day” fund),
- administration of the second new eurozone facility (structural adjustment fund).

The democratic legitimacy of the euro finance minister and the new eurozone facilities would derive from the national states, particularly their approval of the funding and use of the funds of the two facilities. This integration step could therefore be carried out without setting up a special parliament for the members of the eurozone.

Sovereign debt restructuring measures

A debate has been going on for some time about the greater involvement of creditors in the event of a member of the eurozone getting into excessive debt. Proposals for insolvency proceedings for states with predetermined and therefore predictable mechanisms look convincing on paper. They would create important incentives to avoid public over-indebtedness if at all possible.

In practice, however, insolvency proceedings for euro states would be fraught with pitfalls.

- The problem of legacy debt
  The eurozone cannot start from scratch when it comes to dealing with sovereign debt. Public debt levels in seven members of the eurozone are currently close to or above 100% of GDP. The introduction of insolvency proceedings for states could lead to extremely high risk premiums in these countries, thus triggering a negative shock. A possible solution would be to set up a common “legacy debt retirement fund” but owing to the huge amount of debt which would need to be redistributed and the lack of fiscal union, this is an unrealistic prospect at the present time.
- A lot of financial market experts have serious reservations about the idea of insolvency proceedings for states because the markets would lose the benchmark provided by “safe” government bonds.
- If insolvency proceedings for states were introduced, the privileges enjoyed by government bonds in banking regulation would have to be changed. Such a step would need to be taken very cautiously, however, and very lengthy transitional periods would need to be applied. Grandfathering arrangements would have to be guaranteed for existing debt. On top of that, competitive distortion would need to be avoided at international level, meaning that capital requirements for government bonds, for example, would have to be renegotiated globally.

Given these substantial obstacles, there is little chance of introducing insolvency proceedings for members of the eurozone in the foreseeable future. For this reason, the main focus should be on the effectiveness of collective action clauses (CACs). These clauses state that if a certain percentage of creditors agree to change the terms of a bond, all bondholders will have to accept these changes. Since 2013 a standardised CAC on debt restructuring has been included in the terms of all government bonds issued by EU member states.

As a “compromise” between maintaining the status quo and introducing insolvency proceedings for states, consideration could be given to a mechanism under which the maturity of government bonds issued by a country receiving aid from the ESM would be automatically postponed by three years. This procedure has been proposed by Deutsche Bundesbank, for example. A mechanism of this kind could create a certain incentive for long-term fiscal prudence without the fear of excessively high and unsustainable risk premiums in the event of a country getting into difficulties.