HOW THE INCOMPLETE MONETARY UNION UNDERMINES THE INTERNAL MARKET

Europe at the Crossroads: A Union of Austerity or Growth Convergence?

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Presentation Objectives

- Highlight the key role of capital movements in causing structural weaknesses in an imperfect monetary union
- Explain the key role of the EU freedom of capital in the EMU
- Evaluate the risks of an incomplete monetary union for the Single Market
- Explain the possibility future restrictions by a 'renegade' state
- Propose/discuss alternatives to save the internal market from deleterious fragmentation

‘Freedom of capital’ Is the cornerstone of the Internal market

- It certainly encompasses movements of capital not only at the intra-EU level but also between EU member states and 3rd countries
- It is directly applicable
- No definition in the Treaty of 'movement of capital'
- In lieu of a Treaty definition the ‘nomenclature’ of the annex to the Council Directive 88/361/EEC is used
- Directive 88/361/EEC removed exchange controls
- The ‘nomenclature’ has only indicative value
- Essentially, it is the CJEU and the Commission which provide meaning to the freedom

The ‘nomenclature’

- Capital movements means transfer of funds on a cross-border basis which may cover transactions pertaining to:
- **investments** which establish or maintain **lasting links** between a provider of capital (investor) and an enterprise (in effect setting up, taking-over, or acquiring an important stake in a company or institution);
- **Real estate investments or purchases**;
- **Securities investments** (e.g. purchases of shares, bonds, bills, unit trusts);
- **Lending or otherwise granting of credit (e.g., credit cards)**; and
- **Other operations with financial institutions**, including personal capital operations such as dowries, legacies, endowments, etc.

Lawful restrictions

- *De lege* restrictions
  - The prudential carve out
  - The 'safeguard principle' for non-EMU members when it comes to payments to third countries when a member faces current account difficulties
  - Money laundering
  - In the general interest
- *De facto*
  - Differentiated (but not discriminatory) taxation regimes
  - Conduct of business/private law divergences as regards consumer contracts/retail transactions

In practice capital flows are divisible and the unity view is excessive

- Long-term commitments such as FDI
- Commercial Payments
- Short-term flows (speculative capital)
- Flows that have no valid economic rationale other than evasion of a restrictive regime
  - Depositor exodus to avoid a bail-in haircut
  - Flows to avoid a restrictive tax regime or evade taxation altogether

The prudential carveout

- Prudential regulations in the EU are fully harmonized and supervision in the EMU is centralized
- So any restrictions could realistically only be invoked ex post in the event of a severe financial stability crisis
- But by then it would be too late because all loose funds will have left the country in crisis

Why Freedom of Capital is so Important for the EMU?

- The imperative of completing the internal market – hence removing the 'safeguard principle', which had allowed for restrictions in the event of balance of payments difficulty for EMU members
- For EMU members the imperative of creating a currency that is immune to any border restrictions on payments in that currency and undertaking investment in that currency in order to boost Euro's attractiveness as reserve currency.
- The neo-liberal view on capital flows treated all of them the same – the homo economicus would be shifting funds to the most efficient use
- NB: Home economicus is not susceptible to panics and runs and does not follow investment fads

Three Major Intellectual Flaws and a half-truth

- Short-term capital flows are as beneficial as long-term capital flows
- In a currency union there are no runs on member states as the stronger members preserve the value of the currency
- A currency union alleviates competitiveness gaps and balance of payments disparities through factor mobility
- There can be no balance of payments crisis in the sense as those that occurred in fixed exchange rate systems because in a monetary union internal foreign exchange markets have disappeared.

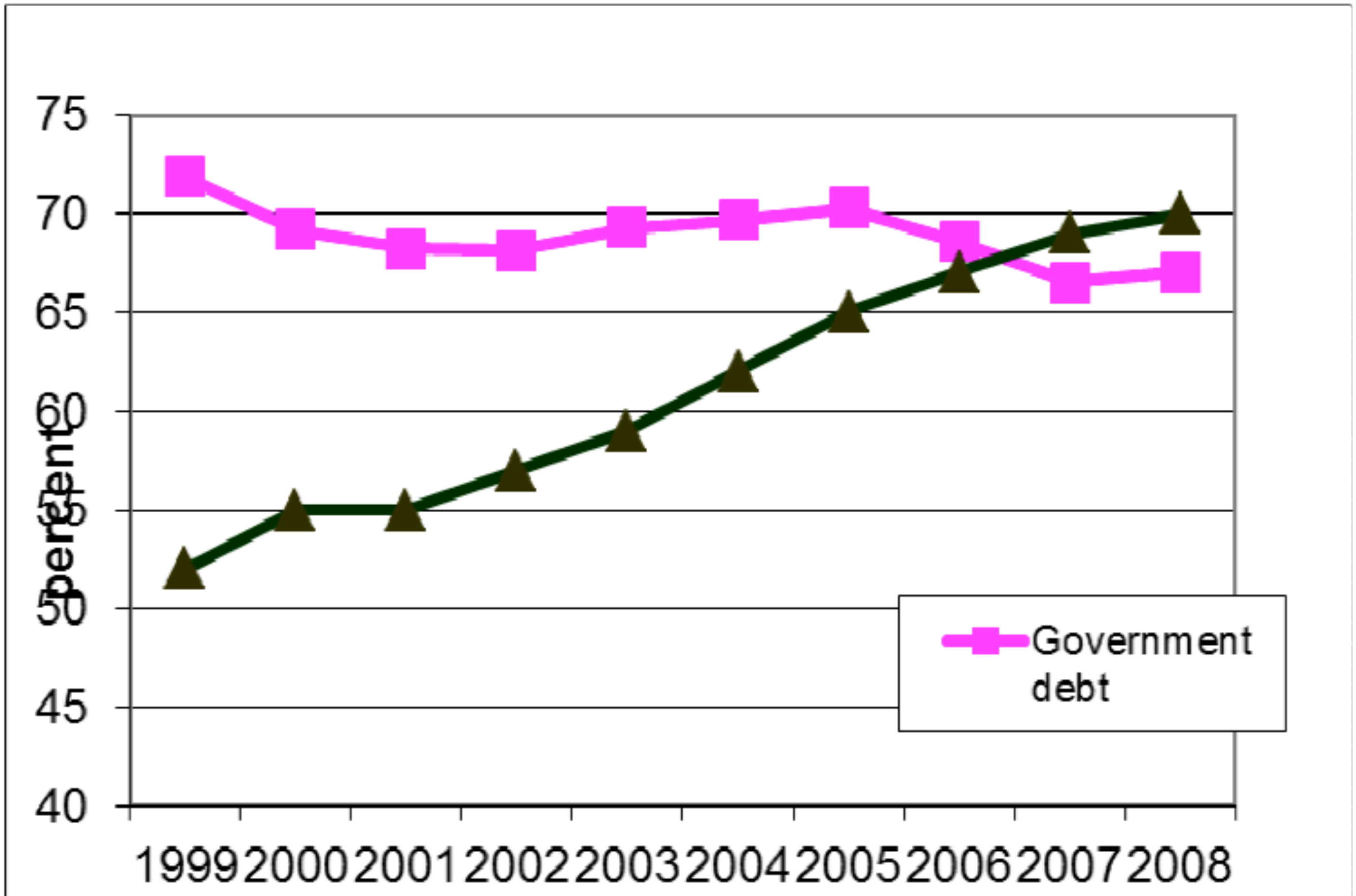
In Reality (i)

- When in a monetary Union 'the fiscal position of a country deteriorates, e.g. due to the deflationary effects of an internal devaluation, investors may be gripped by fear leading to a collective movement of distrust.
- The ensuing bond sales lead to a liquidity squeeze in the country concerned.
- This "sudden stop" in turn leads to a situation in which the government of the distressed country finds it impossible to fund its outstanding debt except at prohibitively high interest rates.' (Paul De Grauwe)
- NB: **In such case the country in question will have every incentive to resort to semi-compulsory internal lending which may only be possible if capital restrictions are reinstated**

In Reality (ii)

- The Eurozone crisis was the product of unsustainable private debt accumulation which probably triggered a Minsky moment (De Grauwe, 2012)
- Household and bank debt were increasing fast prior to the debt crisis.
- With the exception of Greece public sector debt remained unaffected since the inception of the EMU and until the 2008 crisis that necessitated gradual injections of public money to failing banks (e.g., Ireland, Spain, Cyprus)
- The private debt accumulation in the eurozone allowed booms and bubbles to develop. When these became unsustainable and crashed, a large number of banks, firms and households, found themselves unable to repay their debts.

Figure 3: Household and government liabilities in Eurozone prior to crisis (per cent GDP)

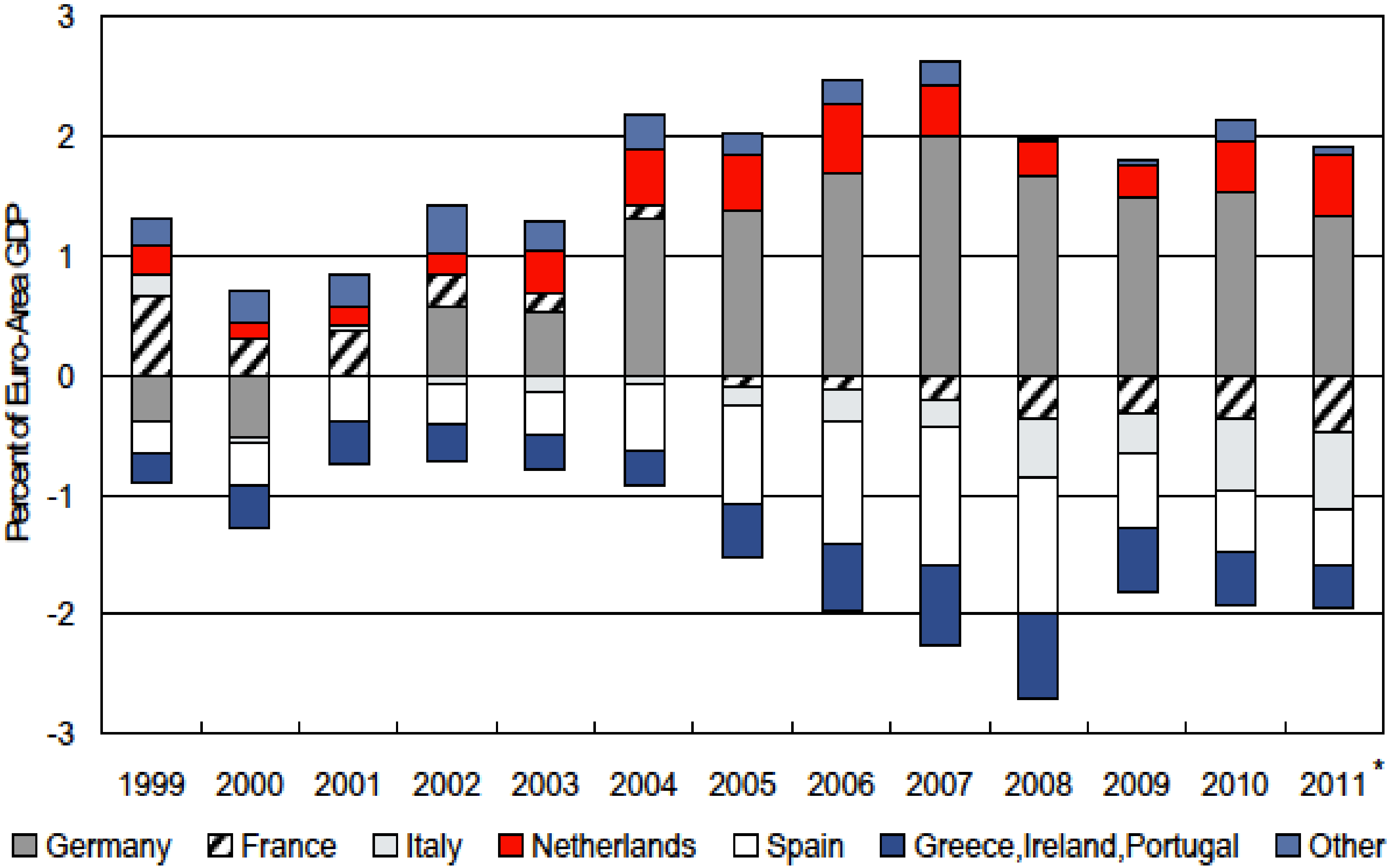


Source: European Commission, AMECO database and CEPS

In reality (iii): booms and busts and the impossibility of adjustment

- The dynamics of booms and busts continued to work at the national level and and busts.
- No stabilizers and no pain free & effective solution
  - the less competitive members cannot depreciate their currency to increase the value of imports and make their exports more attractive
  - Decreasing the cost of production to boost competitiveness entails massive social and political costs
  - If other members are not importing internal depreciation is fruitless

Figure 2: Euro-Area Current Accounts



In reality (v)

- In the absence of investment to boost productivity in the less competitive members and in the absence of common fiscal governance structures (including fiscal redistribution mechanisms), fiscal divergences in a common currency area normally worsen instead of improving

A macroeconomic/fiscal risk restriction?

- **Key rationales:**
- (a) the absence of a common European Treasury to absorb national fiscal shocks and
- (b) the fact that in environments where fiscal governance is weak free movement of capital undermines fiscal stability.
- Short-term capital flows can be destabilizing (IMF 2013)
  - They cause panic and undermine confidence in the capital exporting country's economy
  - They can undermine financial stability through an exodus of deposits

In the general interest –

- Measures liable to hinder or make less attractive the exercise of fundamental Treaty freedoms must fulfil four conditions:
- — they must be applied in a non-discriminatory manner;
- — they must be justified by imperative requirements in the general interest;
- — they must be suitable for securing the attainment of the objective which they pursue;

and

- — they must not go beyond what is necessary in order to attain it.

Under What Conditions?

- **Condition 1**: The state in question faces a fiscal crisis, which has not yet produced major financial stability threats (**imperative requirement in the general interest but no room to invoke the prudential carve-out**).
- **Excessive Budget deficit** on the basis of irrefutable evidence provided via country submissions with the Commission, unless the Commission has provided reasoned objections to that assertion (**transparency**).

Under What Conditions/ (ii)

- **Condition 2:** Restrictive measures are of a provisional nature, i.e., the automatic right to cross-border exports of capital is suspended not cancelled (**proportionality**)
- **Condition 3**: Restrictive measures do not extend to commercial/trade payments, prior FDI commitments, or payments required to cover proven personal needs (e.g., payment of tuition fees)) (**proportionality**);
- **Condition 4: <u>non-discrimination</u>**)
- **Condition 5: legal certainty, <u>suitable for securing the attainment of the objective which they pursue</u>**: fiscal stability

Why not widening the prudential carveout instead?

- If triggered ex post, e.g., following the formal declaration of bank bail-in it would be too late
- If triggered ex ante, i.e., before restructuring measures have been agreed it will only worsen panic and intensify the crisis
- Besides the SSM and National Competent Authorities do not supervise macroeconomic risk
- Also unwilling to sanction the measure for two reasons:
  - in order not to intensify panic,
  - because it is reasonable for them to wait until the very last minute before they take resolution action and assume the (shared) blame of bank failure

Evaluation of a possible macroeconomic risk restriction

- It is temporary and as is on macroeconomic/fiscal grounds (inc. a loss of output or threatened loss of output) – lifted once macroeconomic/fiscal risk has been looked after
- Applies the brakes to short-term flows and to some extent it contains panic
- Contains the impact of the internal exchange rate
- It does not restrict FDI, trade flows and commercial payments, and essential payments
- It is non-discriminatory
- No precedent thus far
- The ambit has to be defined with great precision otherwise open to abuse by member states
- Ineffective if a fiscal restructuring plan is not agreed concurrently

Any Alternatives?

- Capital restrictions would
- GROSSLY UNDERMINE THE COHERENCE OF THE EMU AND THE CREDIBILITY OF THE EURO
- Then?

- **<u>A Common EMU Treasury</u>**

- **<u>Limited debt mutualisation</u>**

EMU debt mutualisation has to have strict rules

- First, it should be partial to ameliorate moral hazard (Bruegel 2010 & Delpla and von Weizsäcker 2010).
- Secondly, an internal transfer mechanism between the members of the pool must ensure that the less creditworthy countries compensate (at least partially) the more creditworthy ones (De Grauwe and Moesen 2009).
- **I suggest that this could be in the form of assignment their share of ECB seigniorage income or in ECB profit** in a variation of the PADRE proposal
- Third, a tight debt control mechanism must be attached to such facility (De Grauwe)

Any other grounds?

- The internal interest rate differential, bubbles and depressions, and other consequences of an incomplete monetary union which lead to fiscal shocks are not the only strong arguments in favour of a common EMU Treasury and debt mutualization
- The Banking Union is reliant on effective resolution which is in turn is very dependent on effective bail-ins

But effective bail-ins may prove elusive

- Avgouleas & Goodhart (CEPR, 2014) suggest that the benefits of bail-ins may be exaggerated
- Bail-ins may trigger contagion and creditor flight
- Cyprus was more an one off situation due to the existence of plethora of foreign creditors
- At the very least bail-in will increase the cost of bank re-financing
- BUT
- If that's the case and there is no confidence in effective cross-border resolution of Eurozone banks, fragmentation of the internal banking market and subsidiarisation will be the order of the day undermining further the internal market

Conclusion

- Massive trade imbalances may force ‘renegade’ member states to resort to short-term capital restrictions
- In principle, they might be able to do so without violating the EU Treaty
- They may also resort to taking other protective measures at the expense of the internal market (e.g., large VAT differentials) or a race to the bottom vis-à-vis corporate and income tax
- **This will be a slow and long-drawn process unless the EMU proceeds to part-mutualize member states debt and acquire a single EMU Treasury!**