

Peter Praet: EMU - how much federalism?

Keynote address by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the 5th Frankfurt Conference on Financial Market Policy, organised by the SAFE Policy Center of Goethe University, Frankfurt am Main, 27 October 2017.

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Ladies and gentlemen,

I would like to thank the organisers Jan-Peter Krahnen and Hans-Helmut Kotz for inviting me to speak at the fifth edition of the Frankfurt Conference on Financial Market Policy.

The theme of the conference is well-chosen. Despite significant improvements to its architecture over recent years, there is a clear sense that Economic and Monetary Union, or EMU, remains incomplete. There is much less clarity and precious little agreement on what a complete EMU would look like, however. This is why the question posed by the organisers – “how much federalism” – is so relevant.

In my remarks, I would like to first review how federalism has evolved in the EU, highlighting that it is as much a process as it is an end-state. I will then – drawing on the economic concept of fiscal federalism – look more at the question of “how much federalism”, focusing on issue of risk-sharing and the role of different levels of governance within EMU.

Federalism in the EU

The nature of the discussion on federalism in Europe has changed quite dramatically over time. Shortly after the Second World War, the ambition for some was to create a “United States of Europe”, mainly as a way to avoid renewed, devastating war.

This vision was shared by those who laid the foundations of the European Union in the 1950s, most notably Jean Monnet, the first President of the European Coal and Steel Community. From today’s perspective, it may seem surprising that the start of such a grand project was confined to an area as specific as coal and steel. But Monnet and the other early architects of European integration clearly understood that political federalism was the end-point of long process, which had to be achieved incrementally and through focused actions in limited policy areas where the benefits of European cooperation could be clearly seen.

To quote one of Monnet’s contemporaries, Alcide de Gasperi, “*we must begin by pooling only what is strictly essential to the achievement of our immediate aims, and do this by means of flexible formulae which can be gradually and progressively applied*”. For these “fathers of Europe”, however, it was self-evident that such incremental measures would gradually move Europe deeper into federalism. Indeed, this clear sense of direction was, in their way, a key motor to keep the integration process moving forward.

Since then, the European integration process has tended to move in waves. There have been times when it has stalled, such as the during the “empty chair crisis” in the 1960s. And there have been times when it has unexpectedly sped ahead, such as with the launch of the Single Market Act in the 1980s, and the commitment to Economic and Monetary Union (EMU) in the 1990s. But today, there is some confusion as to where we stand.

In some ways, the degree of ambition to achieve a full political federation seems to have become more limited, which has led some to wonder whether the integration process will lose its forward momentum. This reflects in part the failure of the Constitution for Europe in 2005. The unsuccessful referendums in France and the Netherlands can be interpreted in different ways, but they clearly suggested that the people of the European Union were not ready to embark on

the road towards full political federalism – or at least not at that point in time. It is also fair to say that the appetite for such federalism today is not much different from in 2005. In recent years there have been growing doubts about the European project.

At the same time, polls consistently show that European citizens support federal decision-making in a wide range of areas, ranging from energy to migration to the fight against terrorism. This reflects the fact that the benefits of federalism are much broader than its economic, fiscal and monetary dimensions. Indeed, since the EU was originally devised as a peace-keeping device, it is not surprising that one of the early initiatives for European integration was a motion to establish a European Defence Community, although this failed in 1954. While a full defence union is probably still unrealistic, there are increasing signs that further integration in this area could happen in the near future.

The Commission reflection paper published on 7 June of this year lays out proposals for establishing a European Defence Fund, which could form the nucleus of a future defence union. Last week, the European Council welcomed the significant progress made by Member States in preparing a Permanent Structured Cooperation (PESCO) in the field of defence, and the work done on the Commission's proposal for a European Defence Industrial Development Programme (EDIDP). All this clearly chimes with the preferences of European citizens, three-quarters of whom support "a common defence and security policy among EU Member States".¹

The conclusion that follows is that we have to distinguish federalism as a *state* from federalism as a *process*. It may be the case that a full political federation is not currently desired by European citizens. But that does not mean that they reject the process of federalism – which is to say, the dynamic allocation and reallocation of responsibilities to different levels of government according to the preferences and needs of the time. While this process may benefit from the gravitational pull of a pre-defined end point, it can also advance without it, so long as actions are taken in areas where the benefits of cooperation are clear and the steps taken are legitimate in the eyes of citizens. Indeed, what gave the EU both momentum and popular legitimacy in the years after the war was its achievements – effective actions in specific areas – not necessarily the visions of a unified Europe.

So how much federalism would satisfy these requirements today? One way to assess this is through looking at the economic aspects of federalism. Certainly, as Richard and Peggy Musgrave wrote, "economic analysis does not tell us what degree of closeness the member units of a federation should feel toward each other". Political aspects transcend economic ones. But economic analysis can help us better understand the consequences of various institutional arrangements and choose the instruments we should use to pursue our common objectives. In the rest of my remarks I will zoom in on some of these aspects of federalism.

Economic aspects of federalism

An important theme – one aspect of which will be addressed in the first session today – is risk-sharing. The crisis has reminded us that both private and public risk-sharing are underdeveloped in Europe, and that this underdevelopment comes at huge cost.

So, there is general agreement that risk-sharing channels need to be improved. There is less agreement on where the emphasis should lie. Some argue that the priority should be to strengthen private risk-sharing, by completing the banking union and establishing a truly integrated capital markets union. Others argue that EMU needs to focus on public risk-sharing, be it through introducing a central euro area fiscal capacity or creating safe assets.

In reality, separating these two channels of risk-sharing is far from the obvious solution. Is private risk-sharing a substitute for public risk-sharing? Or do they complement each other? There are several arguments in support of the view that the two channels complement each other – but only if the right powers are matched at the federal level.

For example, it is clear that the banking union would not fully achieve its goal of severing the toxic link between banks and national governments without a central fiscal backstop for the already-existing Single Resolution Fund, as well as for the European Deposit Insurance Scheme that is still under discussion. At the same time, fiscal backstops generally raise legitimate questions about incentive structures to protect taxpayers, which need to be addressed in parallel by appropriate fiscal governance at the federal level.

The process of building the banking union also illustrates how important it is to reach an appropriate degree of federalism to achieve the objective of a stable and integrated financial system that supports the European economy. Ideally, in a genuine banking union banks would operate in the Single Market just as they operate in their domestic market. This is essential to reap the full benefits of financial integration. The country in which a bank is headquartered should be irrelevant. But, in practice, it remains relevant for as long as the consequences of potential bank failures are still predominantly national. The irrelevance of a bank's headquarters, therefore, depends on the institutional structure of the banking union.

Let me take one very specific example to illustrate my point. The banking union is not yet considered a single geographical area in the supervisory methodology applied to globally systematically important banks. These G-SIBs are subject to additional capital requirements, which are calibrated on the basis of a cross-jurisdictional indicator. This indicator reflects the fact that failures of global banks are more difficult to handle owing to coordination difficulties and cross-border spillover effects.

When the responsibility for banks is shared, additional capital buffers for cross-border activities lose their *raison d'être*. A single set of harmonised prudential rules for all banks in the European Union would not, in and of itself, be sufficient for the EU to be considered as a single geographical area. But the Single Rulebook, the existence of a single supervisor, the Single Supervisory Mechanism (SSM), of a single resolution authority, the Single Resolution Mechanism (SRM), and of a common backstop, the Single Resolution Fund (SRF), when taken together, have equipped the banking union with all the features of a single geographical area. This should mean that the banking union is treated as a single geographical area in the supervisory methodology in future.

Finally, there is the question of how to design fiscal risk-sharing mechanisms for EMU, while taking into account EMU's unique nature. In existing federations the stabilisation function of the central budget is usually a by-product of redistribution via large tax transfer systems. At this stage of European integration, it is clear that any politically acceptable euro area fiscal capacity will be modest in size. So, the key question for the economics profession is whether it is possible to remove the link between the stabilisation function and the redistributive function, allowing for a central budget of moderate size to have a meaningful macroeconomic stabilisation effect. If this were possible, such a central budget could help monetary policy, especially in times of deep recessions when nominal interest rates may reach their effective lower bound. The European Commission set out some proposals in its reflection paper published on 31 May – these require further study.

Conclusion

Let me conclude.

The answer to the question of today's conference – “How much federalism?” – is not easy. Yet, speaking as an economist, I think it is likely that the right answer lies on the side of “more than today” rather than “less than today”.

Monnet famously said that “*Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.*” He was certainly right that further integration will proceed incrementally rather than in a big bang. What I hope, though, is that Europe will not be forged in crises only.

Significant progress towards a genuine Economic and Monetary Union has been achieved in times of acute crisis. Today's improved economic environment offers a window of opportunity to demonstrate that progress is possible in quieter times, too.

I thank you for your attention and hope you have productive discussions at today's conference.

¹ Standard Eurobarometer 87, Spring 2017 (fieldwork: May 2017).