

## Olli Rehn: Don't delay Eurozone reform due to political uncertainties

Remarks by Mr Olli Rehn, Governor of the Bank of Finland, distributed in writing (as he was unable to attend the event) for the visit of the EU Heads of Mission to the Bank of Finland, Helsinki, 27 November 2018.

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Political fortunes in the member states of the European Union have been quite cyclical recently. This should not delay the euro area reform that is necessary to reinforce the institutional foundations of the single currency. While there is political turmoil in several member states, at the same time there is broad support for the euro among citizens.

This fact is highlighted by the results of *Parlemeter2018*, the latest Eurobarometer survey measuring public attitudes to the EU across the member states. The survey contains some reassuring results. It indicates that the confidence of Europeans in the EU and in their common currency is on the rise, and is now actually higher than for many years: 77 per cent of the respondents residing in the euro area countries say that they are for the monetary union, the highest figure recorded since 2004.

These results are welcome, but do not justify any complacency. A look at the time series reveals that the support for European unification much depends on the economic situation of the citizens. The recent positive results are probably driven by the improved performance of the euro area economy, in particular employment. The number of jobs in the Eurozone has now passed the 2008 peak, and unemployment is still falling. Political risks, emanating from the continuing global trade disputes, the badly scripted Brexit drama and the worries about the Italian budget, have not derailed the European recovery, at least not yet.

Despite the major reforms in 2010–2014 to reinforce economic governance and build up the banking union, we should not close our eyes from the remaining systemic weaknesses of the euro area architecture. The lessons learnt from the crisis should be remembered, and the breathing space created by the recovery as well as the support of the electorate should be used for completing the institutional and functional reform of the monetary union.

It is clear that financial stability was grossly neglected when the Economic and Monetary Union was created – it proved to be the “neglected stepchild” of Maastricht, as has been said. The work for correcting those mistakes is still incomplete.

It is now widely accepted that financial stability requires a banking system that can better withstand shocks; the severing of the doom-loop linkage between banks and sovereigns; and that we need efficient mechanisms to manage and resolve banking and sovereign debt crises that may emerge even despite strong preventive action. And obviously we need macroeconomic policies that limit excessive volatility of assets prices and indebtedness. There is a danger, however, that the political momentum to achieve these goals is weakened before the resilience of the EMU is sufficiently improved.

Going forward, there are several reform initiatives on the table. In my view the manifesto of 14 French and German economists, published earlier this year, is a particularly important contribution. It outlines a functional synthesis of the core principles of “German” economic thinking, which calls for sound incentives and rules, and those of “French” economic thinking, which in turn emphasizes insurance and stabilization.

This kind of a genuinely European synthesis could pave the way to a solid stability union, where the main responsibility for economic policies should rest with the member states, balanced with

the insurance provided by common structures designed to safeguard financial stability.

The most urgent task is the finalization of the banking union. The Eurozone Summit in June decided on a credible backstop for the European Resolution Fund, so that any bank resolution can be effectively managed with bail-in, without returning to the politically damaging bank bailouts and turning again to taxpayers' pockets. Moreover, ensuring financial stability calls for building a common European Deposit Insurance Scheme, to prevent any bank runs that can be very costly to the taxpayers and the society.

These remaining elements would require convincing measures of risk reduction parallel to the founding of enhanced risk-sharing arrangements – possibly with some co-insurance features. Legacy problems in the banking sector, especially the still large stock of non-performing loans in some countries, should be worked out in the member states, without shifting them to the Eurozone level.

Fiscal rules of the European Union are there to support macroeconomic stability. Several reforms – of which I have first-hand experience – were agreed during the crisis, and they have helped to stabilize public debt. Yet further reforms are necessary to put in place simpler, more transparent and less pro-cyclical rules to safeguard the medium-term sustainability of public finances. Shifting the emphasis on medium-term expenditure rules, instead of structural deficits (which are notoriously difficult to measure) seems to me a reasonable way forward.

While institutional reform is important, Europe needs to work towards sustainable growth and job creation on many fronts. Putting the real economy truly center-stage means that we should build such Europe that opens up opportunities to innovate and create new businesses and thus jobs. Better institutions to prevent and manage crises, including stabilization policies, are no substitute for structural reforms that are needed to improve Europe's productivity and real competitiveness.

Finally, let's recall that Eurozone reform is closely linked to the overall future of Europe and its Union. The values of the Enlightenment, which underpin the European social and political model, are now challenged both politically and socially, both from the inside and the outside.

In this context the Eurozone reform is an essential element of a broader endeavor to strengthen Europe. As Europeans, we should recognize the urgency of this effort, especially now as Europe's duty as a standard-bearer for liberal democracy and multilateral international order has become even more critical than it was still some years ago.