Stabilisation and future of the EMU:
A Czech Republic contribution to the European debate

Introduction

This non-paper is a contribution to the on-going European debate about the future of the euro area, the Economic and Monetary Union and the EU as a whole. The paper suggests potential solutions to some of the existing problems. Its aim is to present the view of the Czech Republic on the current reform plans for the euro area introduced by the President of the European Council in 2012 for open discussion. The Czech Republic has made a commitment to join the euro area in the future and has a vital interest in its long term success and sustainability. Similarly, preserving the integrity of the EU and its internal market is absolutely crucial.

There are multiple ways how to achieve stable functioning of the Eurozone and sustainable growth of its economies. Further political integration in economic and budgetary policies ultimately leading to European federation is, without doubt, a possibility. The Czech Republic, however, proposes a different direction: a flexible integration reflecting and accommodating specific needs and conditions of individual Member States which will keep the prime responsibility for implementation of necessary reforms and will secure efficiency of policy-making. This flexible integration model should naturally be centred round a strong common basis for all Member States which is a well-functioning and open internal market, the sharing of common EU institutions and a common legal framework based on EU Treaties. A rapid completion of the internal market in principal areas and true respect for and enforcement of rules for economic and fiscal policy coordination are therefore of utmost priority.

This document contains possible reform measures as regards euro area heterogeneity, diverging competitiveness of individual Member States, fiscal rules and economic policy coordination and financial markets overhaul. Measures presented hereunder should be considered only as selected options, which the Czech Republic believes can substantially contribute to addressing the current economic problems, and as a contribution to the European debate.

I. Addressing the asymmetric economic development, differences in competitiveness and macroeconomic imbalances of euro area Member States.

Where states share a common currency, neither changes in exchange rates, nor autonomous monetary policy are feasible as adjustment mechanisms. Asymmetric economic shocks within the monetary union can be tackled with measures which would increase labour force mobility, flexibility of wages and prices, or by fiscal policy. Fiscal transfers on the EU level should not be used for that purpose, as they involve numerous risks, not least of moral hazard and lower efficiency. Instead, measures aimed at increasing labour market flexibility should be fully put into effect.

National employment regulation, including legal provisions regarding employer-employee relations (such as rigid rules concerning redundancy payments or restrictions imposed on the conditions of employment contract termination) should be reviewed. The present regulation in some countries increases the downward rigidity of wages and thus also raises unemployment.

Regulatory restrictions should be removed and contractual freedom between employers and employees extended (herein decentralization of wage-bargaining processes could be a possibility). Further measures enhancing labour market flexibility could involve adjustments in scale and scope of unemployment benefits so that these benefits increase motivation for job search.

A reform of the education system, which would ensure that skills of young entrants after the completion of their higher education or vocational training correspond to employers' demand, is also closely related to the establishment of a better-functioning labour market. The present imbalance between labour supply and demand should be analysed and addressed, for example, through reform measures which would involve partial shift of education costs to its beneficiaries who would thus be more motivated to choose such fields of study which are in demand in the labour market.

Last but not least, labour force mobility, including cross-border mobility, which is a vital element of the internal market, is inhibited by a number of administrative and other barriers which should be removed. These include complicated recognition of professional qualifications, difficulties with transferability of pensions, as well as low accessibility to housing and other circumstances, which make settlement in a foreign country difficult in practice. Labour force mobility should be increased by eliminating administrative and legal barriers, as well as by deregulation of housing markets and reconsideration of housing support programmes, where appropriate. The above mentioned measures belong mostly to the competences of Member States. However, the European Union can contribute by appropriate coordination of the reform efforts, by promotion of their targets, and also by issuing appropriate recommendations. The Commission should also continue to duly supervise thorough implementation of the existing legislation.

II. Addressing the issue of diverging competitiveness

Lack of competitiveness and its diverging trend across euro area Member States are at the core of the Eurozone crisis. Reform measures increasing Member States' competitiveness could also contribute to the reduction of macroeconomic imbalances accumulated within the euro area and thereby to the reinforcement of its long term sustainability.

Indicators, such as unit labour costs and total factor productivity suggest that major reforms in the euro area and in the EU as a whole should strive to renew price competitiveness, as well as to reinforce innovation competitiveness of firms. This could be achieved through labour market flexibilisation (as already explained above) and product market deregulation, complemented by business friendly environment. Moreover, any steps towards enhancing companies' innovative capacities should not be limited to public investment into research and development only. They should also include creating conditions supportive of innovation, such as ensuring a well operating judicial and legal system (e.g. ensure property rights enforcement, investor protection, and lower costs related to starting a business or property registration), transparency, predictability and efficiency of public institutions, and well-functioning competition. The main goal of all reforms proposed for both product and labour markets should be to realign labour costs with labour productivity.

Thus, it is highly important to eliminate barriers to cross-border trade, e.g. in the form of different national requirements on technical standards in the manufacturing industry or on regulation of cross-border services, as well as to remove barriers to entry and exit to the single market. The Czech Republic also fully supports swift adoption and orderly implementation of 12 key measures of the Single Market Act I and II initiatives.

Labour market reforms have a potential to deliver gradual improvement in countries experiencing most severe economic difficulties. Also measures focused on product market deregulation and improvement of country-specific business environment might deliver positive results in the medium or long term. Thus, reforms in both areas are necessary in order to enhance long term competitiveness of the EU and the stability of the euro area.

III. Addressing fiscal policy failure and non-compliance with EU rules on coordination of fiscal and economic policies

Rising debts have become a common phenomenon across most of the EU, although the pace varied across Member States. While a lot of the most recent deterioration was due to cyclical developments and fire-fighting the financial crises, non-compliance with European legislation in the area of fiscal policy severely undermined smooth functioning of the European Union and stood in the centre of consequent fiscal policy failures.

Discipline of the Member States must be the starting point of our future fiscal policy. With the *six-pack*, the fiscal compact and the imminent adoption of the *two-pack*, the Eurozone has already a number of potentially powerful tools. Adherence to them and enforcement at the EU level (where relevant) should be sufficient to prevent recurrence of past mistakes.

Concerning economic policy, wide-ranging structural reforms are the right way to overcome the crisis. They should be implemented by individual Member States. The European Union can contribute, however, through consultations, promotion and coordination of national measures. As is the case with fiscal policy coordination, there is also already a number of tools in the area of EU economic policy coordination such as Country-specific Recommendations on economic and budgetary policies and monitoring of macroeconomic imbalances. We need some time to see whether economic policy rules enacted in the *six-pack* or the *two-pack* prove sufficient. Efforts to stabilize the euro area should begin with maximising the impact of all these instruments. Without adequate reflection on the functioning of the existing framework further strengthening is premature.

The basic principle of coordination should be a differentiated approach towards non-euro area and euro area countries. For the former, the existing framework of coordination of fiscal and economic policies is sufficient. For the latter, the coordination should take into account the degree of risk that particular Member State poses to the smooth functioning of the monetary union. It is possible to discuss additional options how to motivate euro area Member States threatening the well-functioning of the monetary union to implement the necessary reform measures to the benefit of the whole. Member States whose economic situation is stable and their public finances sustainable should remain free to decide on their own fiscal policies and economic reform measures as long as they observe the relevant EU law. After all, they are the ones best suited and legitimized to choose the most appropriate approach.

IV. Addressing the problems on the financial markets

The development of the EU financial sector represents an important aspect of the crisis which has been noticeable to some extent from its very beginning in 2008-2009. As a response, various measures have been discussed and adopted on the EU level aiming to increase bank capital adequacy ratios, improve bank supervision, address funding pressures and an adverse feedback loop with sovereigns and the real economy.

The Banking union could enhance stability of the euro area financial sector. However, not all of its individual initiatives would necessarily eliminate the identified problems and improve effective functioning of the single market. Legislative harmonisation, mainly in the area of functioning of financial institutions and harmonisation of rules for efficient supervision and resolution of credit institutions would be a more responsible and effective alternative to an excessive centralisation and mutualisation of fiscal costs. A clear set-up of effective rules for cooperation of national supervisory and resolution authorities involved in dealing with cross-border operating entities (foreign bank branches, intra-group relations etc.) is especially needed, taking into account responsibilities of Member States not participating in the Single Supervisory Mechanism for their own financial stability.

Recent experience pointed out to possible negative fiscal consequences of foreign bank branches in difficulties for host Member States. In accordance with our general preference to keep the bank supervision and resolution on the national level which would respect the responsibilities of individual Member States, the role and competences of national supervisory authorities over cross-border operating credit institutions and groups thereof, including intra-group financial support, resolution and insolvency issues, must be clearly defined. In this context, the host country competent authorities in the Member States not participating in the Single Supervisory Mechanism should have decision-making powers necessary to be able to fulfil their responsibilities.

Furthermore one of the main Bank Recovery and Resolution Directive principles – bail-in – should be preferred over bail-out. Costs resulting from resolution of financial institution failure should primarily be borne by its owners and unsecured creditors. Member States should also enjoy full discretion regarding the parameters of national resolution funds which should be strictly separated from the deposit guarantee schemes. The possibility to provide financial means from these funds in one state to similar funds in another Member State, if requested, should also be voluntary.

The natural deepening of financial market integration in the EU is an important element of the internal market and leads to higher efficiency, economic growth and prevents reoccurrence of similar crises in the future. Therefore, it is highly important that all adopted measures in this regard fully respect the integrity of the internal market and do not cause any distortions. In this context, for instance, direct recapitalisation of credit institutions from EU funds should be applied only in exceptional cases, as a last resort measure.

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