



TOWARDS A MORE INTEGRATED AND STABLE EUROPE:  
CHALLENGES AHEAD OF THE EURO AREA  
AND CENTRAL, EASTERN AND SOUTHEASTERN EUROPE

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The autumn of 2011 marks the twentieth anniversary of the events which have shaped a new European reality of the last two decades (the emergence of new European states following the disintegration of the former Soviet Union and the former Yugoslavia and the political agreement on the creation of the Economic and Monetary Union). Hence this will be a good opportunity to assess progress achieved so far in the process of economic integration and draw conclusions for the future. In particular, the part of the assessment that relates to future prospects should predominate in the analysis, as the overall goal of the conference is to discuss challenges on the road to a more integrated and stable European economy. In this assessment one should look at both the EU as a whole, and its two different, but intertwined segments: the euro area and CESEE. The economic and financial ties between the western and the eastern parts of the continent do not warrant a flawlessly operating financial system but still they are strong enough to generate contagion effects working in both directions.

### I. Euro area

The establishment of the monetary union was a great success but its sustainability in its current form (with insufficient progress towards an optimum currency area going along with an absence of political union) is under considerable strain. **The main challenge to the euro area countries is to shield their economies against the repetition of bank and fiscal crises and make progress in structural reforms that would enable better harmonization of European policies.**

We have realized that some elements of EMU's framework are not working well. Problems in the financial sector – though generated outside Europe – were first to uncover systemic weaknesses of that framework. The EMU's fiscal rules were too weak to prevent some countries from running unsustainable deficits that ignited severe crises.

It seems that the euro area is in need of either further efforts to achieve more homogeneity and get closer to meeting the conditions of the optimum currency area or move closer towards at least some elements of fiscal federalism. The lack of homogeneity was to be compensated by fiscal coordination within the euro area, but the latter unfortunately failed to generate widely expected results. The insufficient institutional framework is said to be among the main reasons behind the failure and is undergoing a reform process. Nevertheless, the prolonging inability of becoming an optimal currency area makes some economists and policy-makers contemplate the idea of moving beyond fiscal coordination. The idea of launching Eurobonds is the best example of this. However, fiscal federalism seems unlikely to take place in the foreseeable future and hence cannot be perceived as a full-fledged substitute for the inevitable requirement to approach closer to the fulfilment of conditions of the optimal currency area. That is why the western part of the continent is in need of pushing through structural reforms in order to address current rigidities of several domestic economies.

### II. CESEE

**The main challenges for CESEE are to cope with the increasing mobility of international capital flows and make decisive progress in fiscal consolidation.**

The new approach to the conduct of monetary policy (quantitative easing), together with differences in the level of economic development and subsequently more volatile performance make the eastern part of the continent still wary of capital flows. Consequences stemming from the concept of so called original sin (B. Eichengreen, R. Hausmann) are still posing serious challenges for policymakers. The nature of monetary framework pursued

by domestic authorities does matter, but even a full floating exchange rate may generate tensions. Full float may be efficient in mitigating painful adjustments in the real economy, but it cannot entirely shield the financial sector from all possible sources of tensions. Developing local currency capital markets could be beneficial in this respect. In addition, action needs to be taken in view of the potential spillover of market instability caused by the tensions over sovereign debt in advanced economies. Thus, the fiscal policy's role cannot be neglected. Fiscal consolidation in CESEE is as necessary as in the case of Western Europe, but for different reasons. Although a fiscal stance (especially the one measured by stock) seems to be in a better shape than in the West, prudent consolidation remains of essential importance. A fiscal policy which is not tight enough may stimulate lending boom. Furthermore, in the wake of CESEE's ambitions to join the euro area one day, there is a clear need for the so called room for manoeuvre. And the latter can be achieved thanks to imposing consolidation which goes beyond thresholds set by the Maastricht criteria. One should put more emphasis on reaching fiscal Medium Term Objectives (MTO). Once MTOs are fulfilled, there should be more breathing space for fiscal policy at the time of unexpected economic shocks.

### **III. European banking after the crisis**

**The major lesson for CESEE countries from the international bank and fiscal crises is the necessity to include supervisory tools into stabilization policies. In the case of the CESEE countries the specific problem is the coordination between host and home supervisors in order to prevent repetition of boom-bust credit cycles caused by large scale foreign exchange lending.**

The fragmentation of banking supervision in Europe made this industry more vulnerable and the reversal of this process should be watched closely. For a supranational institution – or at least in a truly cooperative cross-border approach - it would be easier to tackle some sensitive issues, such as foreign currency loans, which have already exposed vulnerabilities of the CESEE's systems. The launch of common supervision standards for the entire European banking system would be helpful in restoring discipline in the financial sector of the CESEE economies. Other prudential measures are worth considering as well.

### **SPECIAL SESSION:**

#### **The history and prospects of the EMU – beyond economics**

The American saying goes: if it ain't broke, don't fix it. Today one can see that the EMU system is flawed and it needs mending. It is more or less known what should be done in order to restore confidence in the economy of the euro area. The European Commission and H. van Rompuy Task Force have proposed numerous modifications and changes to the system of economic governance in the EU and EMU. They are gradually being discussed and implemented. However, they seem to fall short of what is required to ensure prospects, not to mention guarantees, for the long-term economic stability of Europe. Was then the single currency a false start?

On the other hand, the establishment of the EMU was, truly, a breakthrough in the modern history of Europe. As this giant step was possible indeed, is it really unimaginable to make another step of a similar great stature to install, inter alia, at least certain elements of fiscal federalism? Do the Europeans lack statesmanship or conviction? Are European elites capable of convincing their constituencies about that need? Are these elites convinced themselves? If not, what will be the future of the euro and the European project?

These questions deserve a broader look, beyond the machinery of pure economics. That is why they will be put forward to a panel of prominent personalities with outstanding achievements in history, politics or political science.

The panel will be preceded by a keynote speech to be delivered by the head of one of EU institutions of paramount importance from the point of view of economic governance in the European Union.