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A road map towards fiscal union in Europe

Report of the "Tommaso Padoa-Schioppa Group"

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Under the patronage of Jacques Delors and Helmut Schmidt

Steering Committee:

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This Report was prepared under the auspices of *Notre Europe*
in honour of *Notre Europe*'s former President,
Tommaso Padoa-Schioppa.

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The Group started its proceedings in December 2011. The Report was published on 26 June 2012. Every member of the Group participated in a personal capacity. The views represented in this Report therefore do not necessarily reflect the views of the institutions to which the members of the Group are affiliated.

In memoriam Tommaso Padoa-Schioppa

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FOREWORD

by Jacques Delors and Helmut Schmidt

In the present context of tensions and crisis surrounding the functioning of the European Economic and Monetary Union, it is particularly enlightening to find in- depth analysis and a source of inspiration in the Report elaborated by the "Tommaso Padoa-Schioppa Group" put in place by *Notre Europe*.

Tommaso Padoa-Schioppa was an eminent expert of the economic and monetary integration, not only at theoretical level, but also as a practitioner, given the important responsibilities he held at the European Commission and at the European Central Bank. He had testified, as we do, that the potential difficulties and functional deficiencies mentioned in this Report were not ignored, neither when the European Monetary System was set up in the late 1970s nor when the Economic and Monetary Union was launched in the early 1990s. Most of these deficiencies had indeed been mentioned, but the political compromises concluded at these stages of the European construction did not allow creating a perfect "EMU".

In the new context created by the current crisis, the great interest of this Report is to call on "completion of the euro" on the basis of very acute and pragmatic analyses of the challenges at stake, but also with the objective of proposing both feasible and decisive options. This Report also deserve credit for going beyond the short-term emergencies and trying to identify the main structural problems of the euro area.

Dealing with heterogeneities in a currency union is the first key challenge identified. It leads the Report to stress the need to complete the single market, to reduce the pro-cyclical impact of the ECB real interest rate by allowing the "real exchange rate" channel to work better. It also proposes the creation of a "cyclical stabilisation fund" to help countries recover from EMU-induced cyclical downturns.

Putting in place a "euro area banking union" to break the nexus between banking weaknesses and sovereign debt dynamics is another key proposal put forward by the Report. Now that the negative effects of the banking crisis are clearly visible, it indeed appears all the more useful to create a banking supervision authority able to exercise micro-prudential supervision powers and, in parallel, to set up an EMU agency capable of supplying funds for the resolution of the banking crisis as well as administrating a European bank deposit guarantee scheme.

Promoting a "sui generis fiscal federalism approach" for the euro area is the other key proposal of this Report. It is naturally crucial to propose and adopt a rebalancing of fiscal rights and fiscal duties within the EMU, which could go beyond the decisions already made in the last period: the Report is particularly right to insist on such rebalancing and particularly wise in the selection of the options to move in this direction. This rebalancing must imply much stricter budgetary surveillance from European level and a reinforced coordination of national economic policies.

In addition to the rules proposed to ensure the equilibrium of the system, it is indeed vital to establish true coordination between the economic policies implemented by the Member States, which has been missing sorely until now. This cooperation must guarantee the necessary consistence of the Monetary Union while taking into account the specific situation of each European country.

The report is also right in pointing out the need to shield EMU countries from a 'self-fulfilling solvency crisis'. To this purpose, it proposes the creation of a "European debt agency" jointly guaranteed by all euro area countries, which would assist EMU countries under financial pressure but also provide financing to EMU countries at a rate reasonably above the one of the best-rated countries.

The Report does not propose to modify the role of the European Central Bank, and it is right to do so: the main challenges to address lie elsewhere, and all the Member States must learn to promote competitiveness in the context of monetary stability established by the ECB. The Report does not elaborate extensively either on the need to promote dynamism and cohesion in the internal market formed by 27 countries, on the basis of a good balance between competition, cooperation and solidarity: it was not its central objective to deal with this issue, which has nevertheless to be considered as equally essential as the resolution of the current EMU crisis.

Last but not least, the Report of the Tommaso Padoa-Schioppa group insists on the need for a “Road map” detailing all the operational steps that lead to a more stable and prosperous euro area, from the very short term decisions (which should also include the ratification of the “Fiscal compact”) to the medium term ones (for example the issuing of “Eurobonds”). In this respect, it designs a clear conceptual and political horizon, well beyond the first political agreements already reached, and in which the meaning and impact of the technical options mentioned appear even more consistent.

We wish that all European decision makers could find in this Report the global vision and perspectives that have often been missing since the beginning of the crisis, and that, on this basis, they will be able to reinforce the EMU and the European Union at large.

Jacques Delors and Helmut Schmidt
June 2012

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Preliminary remarks

There is an urgent need to agree on a road map towards a fundamental transformation of Economic and Monetary Union

In April 1987, a Study Group on the "Integration Strategy of the European Community" chaired by Tommaso Padoa-Schioppa1 published a Report that later became the basis for Economic and Monetary Union in Europe. That Report referred to four points that it considered to be "*the basis of the long-term "social contract" between the Community and its Member States*": (I) competitive markets, (II) monetary stability, (III) an equitable distribution of the gains in economic welfare, and (IV) actual growth performance. These four elements have indeed constituted the basis for further political and economic integration in Europe in the past 25 years.

Today, the members of the "Tommaso Padoa-Schioppa Group" consider that the European social contract is at risk. A break-up of the euro area can no longer be excluded. We are concerned that a possible process of monetary disintegration,

1. "Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community", Report of a study group appointed by the Commission of the European Communities, and presided by T. Padoa-Schioppa. April 1987.

once started, could prove impossible to stop and would therefore run the risk of leading to the process of political and economic disintegration in the euro area and the European Union. The ongoing crisis, which has been affecting the European Union and in particular the euro area for more than two years, thus poses a fundamental challenge to the four constitutive elements of recent European political and economic integration.

The principle of competitive markets in Europe, as currently based on the Four Freedoms, increasingly runs the risk of being called into question through a re-nationalization of economic policies, possible protectionist tendencies, and a potential return to national currencies and competitive devaluations in the context of a euro area break-up. We consider the costs related to such a backward movement in European market integration to be prohibitive and fear that the end of a competitive market structure in Europe is likely to lower aggregate social welfare in the euro area.

The principle of monetary stability in Europe, as reflected in the original architecture of economic and monetary union of the Maastricht Treaty, is currently confronted with three dangerous scenarios: (I) First, there is a non-negligible risk of a return to national currencies. Should this risk materialize, this would imply a sudden end to monetary stability, as savings and assets of large parts of the population of the euro area would be subjected to a sudden change in price. (II) Second, there is considerable risk in the banking sectors of several euro area countries. Should the ongoing uncertainty in those systems translate into uncontrollable bank runs or massive cross-border capital flight, there would be a serious risk for bank deposits and thus again for the savings and assets of parts of the euro area population. (III) Third, the stability of the euro itself is seen by many as being put at risk in the context of rescue or stabilization efforts that might involve a far-reaching monetization of debt.

The principle of an equitable distribution of the gains in economic welfare in Europe, as reflected in the widely-agreed framework of the social market democracy (*Soziale Marktwirtschaft*) is currently put at risk. Inequalities, both within countries but even more so across countries are on the rise. Youth unemployment now affects more than half of the workforce in several euro area countries. A continued crisis in the euro area or a break-up of the single currency would be likely to further accentuate societal divisions in Europe.

Growth performance in the euro area is currently threatened at three different levels. (I) The crisis itself has already had a significant negative effect on growth in the euro area. That trend is likely to continue in a context of uncertainty if there is no forward-looking, sustainable and long-term response to the crisis anytime soon. (II) A break-up of the euro area is likely to lower the degree of interconnectedness between economic agents in Europe. We would expect such a development to significantly hamper growth performance in the coming years. (III) The continued focus on short-term debt and deficit reduction runs the risk of lowering overall growth prospects in the euro area in the short to medium term. While excessive debt levels are neither desirable nor sustainable, we see the risk that excessive austerity could translate into a lost decade for growth in the euro area.

Against the background of these risks to the four main components of the European social contract, we present elements for reflection on how to make the euro area more resilient and restore confidence in the single currency. This Report focuses mainly on the long-term responses to the current challenges. It seeks to formulate the questions that will have to be answered so that the euro can become a long-term success. But even if our recommendations do not focus on the short term, our main message should be clear: in the context of crisis, long-term matters are urgent matters.

There were two guiding principles in the deliberations of the group. First, we all share the view that a step backward in the process of monetary integration is simply not an option. In the preceding paragraphs we have provided some elements justifying that principle, but in the core part of the report we do not even consider the option to abandon the euro. Second, we have decided to derive our proposals from the principle: “As much political and economic union as necessary, but as little as possible.” We believe that the current crisis has been triggered by several dysfunctionals inherent to the original framework of monetary union that need to be corrected. But in line with the principle of subsidiarity we also believe that the corrections should be limited to what is strictly necessary for the euro to operate more successfully. So we do not want to advocate “more Europe” for the simple purpose of strengthening the process of European integration. It is not our intention to advocate a European "super-state" or a strong supra-national power. We consider EMU to be incomplete in its current form and put forward elements that we consider indispensable to make the euro work. Not more, not less.

Executive summary

The root cause of the current crisis lies in the contradiction between a single, supranational currency and the continuation of nation-state-based economic policies. Surmounting that contradiction requires neither the creation of a "European Super-State" nor a return to individual nation-states and national currencies. What is needed is a sui generis form of fiscal federalism, which derives from the functional deficiencies of the current common currency framework while respecting to the largest possible extent the budgetary autonomy of euro area member countries. We argue that the single currency requires as much fiscal federalism as necessary for its appropriate functioning, but as little as possible. We present proposals to achieve this objective, deriving them from the main challenges that the euro area had to face during the first decade of its existence.

The first challenge derived from the primacy of the real interest rate effect over the real exchange rate effect. During the first decade of the common currency, price differentials in the euro area were more persistent than initially foreseen. As a consequence, the interest rate set by the European Central Bank was "one size fits none": it had adverse and even self-enforcing pro-cyclical effects on most Member States. This led to excessive cyclical divergences and imbalances. The real exchange rate effect did not trigger a sufficient degree of price convergence and thus failed to stop the imbalances.

The second challenge lies in the area of fiscal policy coordination and fiscal surveillance. Internal imbalances only became a matter of euro area concern when the mechanism of "self-fulfilling solvency crises" set in. As euro area members issue their debt in a currency over which they do not have full control, a liquidity crisis in these countries cannot be solved through devaluation but increases the likelihood of default.

The third challenge derives from the paradoxical set-up of financial markets. Due to the interdependency of banking systems in the euro area, contagion risks are high. At the same time, Member States are individually responsible for banking supervision and potential bailouts. The nexus between national banks and national sovereigns has a self-enforcing effect with strong negative externalities on the rest of the currency union.

To solve these three challenges, policy actions in four areas are required.

a) The first element is the completion and fostering of the Single Market in order to allow the real exchange rate channel to work more effectively. The euro area needs to become a truly integrated economic area. To achieve this goal, domestic institutional adjustments to increase the responsiveness of wages and prices are also required.

b) The second element is a cyclical stabilization insurance fund to counter some of the effects of the "one size fits none" monetary policy. Such an insurance fund, which should be created outside the EU budget and remain under direct control of national parliaments, would work in a largely automatic fashion and, if rightly devised, not lead to long-term transfers in only one direction.

c) The third element is a rebalancing of fiscal rights and fiscal duties in the common currency area. We argue that euro area countries should become subject to much stricter budgetary surveillance and be willing to give up some elements of their sovereignty when they are cut off from the market. The core principle should be: sovereignty ends when solvency ends. But at the same time, the euro area as a whole should ensure that adequately priced access to sovereign financing is generally possible, also in times of crisis. To allow for the implementation of that third element, we suggest the creation of a European Debt Agency (EDA) that would allow a flexible refinancing possibility to countries in exchange for a stepwise transfer of sovereignty. The EDA would (i) be jointly and severally guaranteed by all euro area countries, (ii) serve as a normal financing instrument for an amount of 10% of GDP to all countries, (iii) provide relatively easy access to additional funding in crisis times for relatively small amounts (up to an additional 10% of a country's GDP), (iv) but then ask for much stricter conditionality in pre-defined steps of rising debt amounts with additional debt amounts implying a stepwise transfer of budgetary oversight to the EDA. Should a country require more than 60% of its GDP as EDA-backed financing, it would need a green light from EDA before being able to adopt its budget or otherwise exercise its budgetary sovereignty. Not respecting a red light would not be legally excluded, but would automatically entail the exclusion of any EDA financing and trigger a sovereign default. As an alternative, a full transfer of sovereignty to the EDA could also be envisaged for countries reaching a 60% debt to GDP ratio, but this would require far-reaching changes in national constitutional law.

d) The fourth element is a euro area banking union. To solve the paradoxical set-up of financial market integration and banking supervision, the creation of a euro area banking supervision authority with micro-prudential supervision powers is required. This role could be conferred upon the ECB. In parallel, the creation of an agency administrating a European deposit insurance fund would be required.

To make the required changes possible, the euro area will have to agree on a new institutional and legal structure. This goal can best be reached in a new Intergovernmental Treaty. While formally outside the current Treaty structure, it should be closely linked to it and preserve as much as possible the involvement of EU institutions and bodies. It could be transferred into the existing EU legal framework at a later stage.

Most of the changes required for a better functioning of the single currency are of a long-term nature. But they are urgent. What is required today is a road map leading ultimately but definitively to the desired changes. A short-term “big bang” is unlikely. At the same time, the biggest danger in the current context is excessive short-termism. What is needed is a credible path to necessary change. This would rebuild trust in the single currency and in the continuation of the project of European integration.

Introduction: the underlying challenge - coping with the sui generis construction of Economic and Monetary Union

1 The Economic and Monetary Union in Europe (EMU) is a sui generis construction. There is no other historical example of a monetary union of this kind, bringing together economically highly diverse but politically sovereign countries under the common umbrella of a shared currency administered by a single and independent central bank. The institutional asymmetries of this framework were widely discussed, even prior to the start of the ongoing crisis. And since its very inception more than once the question was raised whether a "currency without a nation-state" can survive.

2 Tommaso Padoa-Schioppa always reminded us that the very question whether a currency without a nation-state could survive was wrong. He insisted that the camp arguing "It can work" was as wrong as the camp arguing "It will never work!" He once wrote: "*Enemies as they are, the two camps share the same prime article of faith: that the nation-state is and will continue to be the absolute sovereign within its borders. Both believe that international relations will continue to be based on the twin postulates of internal homogeneity and external independence, a model invented by the Treaty of Westphalia of 1648. For one, fortification of the citadel is impossible; for the other, it is unnecessary.*

Both fail to see that we already live in a different world, one in which political power can no longer be monopolised by a single holder. Instead, it is distributed along a vertical scale ranging from the municipal, to the national, to the continental, to the global. Both camps seem to ignore that history is a dynamic process driven by contradictions."[2]

3 The main objective of this report is to present proposals for the future of EMU that take into account, and are compatible with, that new "post-Westphalian" order. The group submitting this report shares the belief that neither a "European Nation-State" nor the return towards individual nation-states are appropriate solutions for the future of the common currency. What is required is the implementation of a more effective allocation of activities in economic policy-making. The euro area has come under heavy attack because many market participants do not believe in the robustness of the post-Westphalian project that Europe has been pursuing for sixty years now.

4 During the first decade of EMU, the two key words of economic governance were coordination and cooperation (with few people making a difference between the two). Currently, many proposals on how to reshape economic governance in EMU concentrate yet again on coordination and cooperation. We doubt that this is the way to go. The crisis has shown that the old mode of functioning in EMU can no longer continue if EU level is not recognized as an economic policy actor as such. We do not see how coordination can succeed when the coordinator is primarily constituted by an assembly of those who are the target entities of the coordination effort.

5 The challenge to EMU is accentuated by large structural heterogeneities. GDP per capita rates vary by a factor of 1 to 8 across euro area countries. And even if PPP rates are applied and the benchmark is not the comparison of the richest to the poorest country per capita, but the average per capita GDP rate of the euro area as a whole, then still 10 out of 17 countries deviate by more than 15% from the euro area average. Moreover, such economic indicators only partly reflect the underlying structural heterogeneities across the euro area, which

2. *Financial Times*, 13 May 2010.

are arguably even bigger. These intra-euro area divergences are important as they translate into very different policy preferences of the Member States in their coordination efforts.

6 In the upcoming years, Europe will have to demonstrate that a multi-level governance approach to conducting economic policies can work. This demonstration will have to occur through action, not only in spirit, or through declarations. It will have to formulate a response to the sui generis challenge posed by the common monetary project: how can economic policy in EMU be conducted in an effective way in absence of the traditional nation-state foundations? The current discussions avoid that question and provide more of the same. Member States and even actors at EU level continue to look at EMU as a grouping of economically independent sovereigns that subscribe to a framework of rules, but within this framework act *severally*, not *jointly*.

7 *Joint* action would imply that the sum is more important than each individual part. For the time being, there are very few examples of truly *joint* economic action at EU level in an area other than monetary policy. This is a mistake. The Delors Report already in 1989 pointed out that "*economic union and monetary union form two integral parts of a single whole and would therefore have to be implemented in parallel.*"[3] Monetary union was fully implemented. Economic union was not. The consequences of acting *severally* in economic policy-making have given rise to *joint* problems that in turn require *joint* responses. It would be easier and more effective to act *jointly* from the beginning.

8 What is therefore required is a clarification of who does what, and at which level. To achieve truly *joint* action in the euro area, the responsibilities of each individual actor need to be re-discussed. In particular, the scope of action at EU level itself needs to be refocused. But one has to resist the temptation to recreate the Westphalian model at EU level. EMU needs to be structured at different levels in order to operate in different jurisdictions and to refer to different constituencies. What is needed is a plan of action to renovate EMU. This challenge needs to be taken up urgently and seriously.

3. Committee for the Study of Economic and Monetary Union: "Report on economic and monetary union in the European Community." Brussels 1989.

1. Origins of the current crisis

9 The current crisis in the euro area derives from a multitude of causes that have given rise to a large variety of symptoms. In our view, there is a tendency to over-simplify the origins of the crisis. Explanations focusing solely on wage-setting mistakes or fiscal irresponsibility, on the failure in banking practices or banking regulation, on the failures in policy coordination or the application of sanctions, will all only partially be right. For us, the root cause of the current crisis lies in the contradiction between a single, supra-national currency and the continuation of nation-state-based economic policies. This contradiction has given rise to all the other "causes" of this crisis.

10 To identify what would be required to build a more complete and resilient EMU that will in the future better deal with this contradiction, it is useful to go back to the very origins of EMU in order to understand why and how this contradiction emerged. The origin of the single currency is the single market and a customs union. The very justification of establishing a currency union derived from an assessment of the single market.[4] And at the origin of the single market lie the political will to establish an integrated and peaceful continent.

4. See the Padoa-Schioppa Report as quoted in footnote 1. See also the Delors Report as quoted in footnote 3.

1.1. The Single Market and the Single Currency

11 Open economies that share close trading relations will always have to decide whether they want to give preference to fixed exchange rates or to a monetary policy that is geared towards the stabilization of the domestic economic business cycle. Only if the business cycles of countries that are closely tied via trade relations are very similar and the structural features of those economies are similar, then the conditions of an "optimum currency area" are fulfilled, and the dilemma between stable exchange rates and a domestically-oriented monetary policy disappears. In that case, a single currency and unique central bank will allow to combine fixed exchange rates with a monetary policy that can stabilize the business cycle of all countries connected through trade.

12 Building the internal market in Europe therefore raised the issue of the future of a domestically-oriented monetary policy in each of the Member States participating in the internal market. The Padoa-Schioppa Report described that nexus in the following way: "*The internal market programme creates both opportunities and needs for complementary action to foster macroeconomic stability and growth of the Community. As regards monetary stability, the elimination of capital controls, coupled to the requirement of exchange rate stability, means a qualitative change in the operating environment for monetary policy. It will require moving closer to unification of monetary policy." In a quite fundamental way, capital mobility and exchange rate fixity together leave no room for independent monetary policies. In these conditions, it is pertinent to consider afresh the case for a strengthened organisation of monetary coordination or institutional advances in this field.*"

13 The Padoa-Schioppa Report did not openly advocate a monetary union, but rather recommended a "stage two" exchange rate mechanism that would allow to reconcile capital mobility and "*a high degree of exchange rate fixity*"[5]. Indeed, the experience of the European Monetary System had shown that the combination of significant structural divergences across Europe with the pos-

5. See page 9 of the Report: "The "Stage Two" would not amount to a monetary union. Indeed the Group does not advocate a precipitous move to monetary union, while recognising that this has several first-best properties from an economic point of view."

sibility of ultimately engaging in exchange rate adjustments did produce too much currency instability. For this reason, and as discussed extensively in the Delors Report, the step towards a common currency was the functionally-logical continuation of the Single Market. Tommaso Padoa-Schioppa later related the need to establish the euro to his own "inconsistent quartet", an idea that he had presented as early as 1982[6], referring to the impossibility of combining free trade, capital mobility, fixed exchange rates and a domestically oriented monetary policy. Only a region that is an "optimum currency area" can avoid that inconsistent trinity.

14 However, the euro area has never been an "optimum currency area". This very simple assessment, pointing to the fact that structural and cyclical divergences across euro area countries are very large, has very simple consequences. If growth and inflation rates in euro area Member States diverge, the single interest rate set by the European Central Bank (ECB) will further contribute to those divergences, rather than contributing to further convergence. Right from the beginning of EMU, Member States experienced substantial differences in national growth rates and inflation rates. There is no doubt that the key share of those divergences is attributable to different national economic policies and institutions. However, the single monetary policy further strengthened that trend.

1.2. The "one size fits none" problem of the ECB

15 As the ECB does not base its interest rate decisions on the economic trends of individual Member States, but rather on the euro area as an aggregated whole, its monetary policy will be at the same time too restrictive and too loose for individual countries. In the Member States with higher inflation rates than the euro area average, the common nominal interest rate was translated into low real interest rates, which triggered higher rates of investment and consumption. This, in turn, accelerated the growth over the production potential and had an inflationary effect, in particular in asset prices, such as the real estate market.

6. See his lecture at the University of Milan "Capital Mobility, Why is the Treaty Not Implemented" as reproduced in his book *The Road to Monetary Union* published in 1994.

In countries with lower inflation rates than the euro area average, the opposite was the case: real interest rates were too high, investment and consumption rates were too low. The single monetary policy fosters rather than prevents such divergences. Rather than being "one size fits all", the ECB's monetary policy was "one size fits none". The ECB's monetary policy had adverse and even self-enforcing pro-cyclical effects in those Member States whose economic fundamentals were not in line with the euro area average. And this, although the ECB did exactly what was required of it: the ECB ran the right monetary policy for a country that did not exist.

16 There are three main ways to cope with the self-enforcing real interest cycles. The main mechanical way (i.e. not policy-induced way) to stop them is the real exchange rate effect: high-inflation countries will ultimately face reduced external demand, whereas low-inflation countries will improve their competitiveness. As a consequence, self-enforcing cyclical phenomena will be stopped by a decline (or boom) in exports caused by the real appreciation (depreciation) of the exchange rate. However that presupposes that the different regions are so closely linked economically that there are in fact no regional economic factors any more.

1.3. The real exchange rate channel

17 Prior to the start of EMU, most theoretical analyses of monetary unions assumed that the real exchange rate effect would have primacy over the real interest effect and that domestic stabilization would therefore be generated automatically. This approach was built on the assumption that domestic prices (and thus also real interest rates) in a monetary union are bound to converge given the mobility of goods and services in the internal market. In EMU, however, a significant share of domestic output derives from so-called 'spatially-fixed factors', such as real estate and heavy machinery, which are not affected by direct price competition. Moreover, regional economic adjustments based on real exchange differentials take a significant amount of time. Indeed, while on paper, the EU has admittedly created a single market, we are a long way away from a really integrated economic area.

1.4. Strengthening the European level in economic policy-making

18 The second main way to address imbalances arising from the absence of domestic monetary policy and of adjustment mechanisms at EU level is an appropriate conduct of the remaining elements of economic policy-making (mainly wage-setting, national fiscal policies, but also banking regulation) to stabilize economic cycles. During the first ten years of EMU, however, the national authorities, in particular in the boom countries, failed to adopt the right policy responses to growing imbalances. Member States did live up to the expectation formulated in the first part of Article 121 in the Treaty: “Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council…” (Article 121, TFEU). For almost a decade, the debate on this sentence was focused on the modalities related to “coordination in the Council”. We believe that the failure to take into account the second part of the sentence (“regard their economic policies as a matter of common concern”) is the much bigger challenge.

19 We do not see how coordination can succeed when the coordinator is primarily constituted by an assembly of those who are the target entities of the coordination effort. No meaningful coordination is conceivable unless there is the possibility to oblige a minority to do what the majority wants. During the 2000s, the Council went on issuing general recommendations but did not dare to single out individual EMU countries and ask them for specific policy corrections. Even if the legal provisions based on article 121 of TFEU are weaker than the ones foreseen for budgetary surveillance, the truth is that the Council did not really use its powers in this field during the first ten years of the euro. In effect, the Broad Economic Policy Guidelines (BEPG) - that were supposed to be the backbone of coordination - have been consistently ignored by national policy makers and the only time the Council decided to issue a country-specific recommendation for violating the BEPGs (Ireland in 2001) this was completely ignored by the recipient country. Against this background we have doubts that the Macroeconomic Imbalance Procedure will perform much better.

20 In our view, a stronger economic policy of the EU can emerge only if the actor of the policy is the EU itself and not the assembly of Member States. This implies

a significant transfer of sovereignty. The EU level would have to be recognized as a full-fledged and autonomous actor in economic policy-making, based on appropriate sources of legitimacy. The challenge obviously stems from the fact that a transfer of sovereignty is by definition linked to the possibility that a transfer of resources can follow. It is questionable whether the EU is ready for this. The question of the "*juste retour*" of domestic economic policy choices is all too present in current discussions.

1.5. Rebalancing through redistribution

21 This relates to the third basic way to cope with the economic challenges of a monetary union: to establish some kind of rebalancing through redistribution. Economic historians give numerous accounts of how fiscal federations emerged with the objective to solve the inherent economic challenges arising within a monetary union; yet they also describe how the ensuing redistribution often resulted in break-ups of previously politically-integrated areas.

22 Redistribution with the aim of rebalancing the common currency area and transfers of sovereignty are two sides of the same coin. One is not possible without the other. Looking backwards, it becomes apparent that it should not have come as a surprise that EMU faced considerable functional deficiencies. Firstly, the ECB's monetary policy had pro-cyclical effects in the Member States whose economic fundamentals were not in line with the area average, then reinforcing the diverging trends. Secondly, EMU lacked the adjustment mechanisms that exist in other economically-integrated areas to counter these divergences and that should compensate the Member States for losing most of their instruments for macroeconomic stabilization and the capacity to rely on monetary devaluation Finally, the European institutions failed in preventing and detecting the imbalances and in asking the Member States to adopt the appropriate measures to correct them; the coordination of the economic policies foreseen by the Treaty proved to be rather ineffective and uneven, after several attempts to foster convergence by structural reforms, investment priorities and structural funds

1.6. The challenges in fiscal policy coordination

23 In addition to these built-in institutional deficiencies with regard to detecting and correcting internal imbalances, EMU was also deficient in the area of fiscal policy coordination and fiscal surveillance. In fact, as the crisis later revealed, internal imbalances only became a matter of euro area concern when the mechanism of a "self-fulfilling solvency crisis" set in and EMU lacked the appropriate instruments to respond. As EMU Member States issue their debt in a currency over which they do not have full control, a liquidity crisis in these countries cannot be solved through devaluation, but increases the likelihood of default. Investors anticipate this logic and act accordingly: when an EMU country experiences budget difficulties, there is an over-reaction in the risk attached to the government bonds of the respective country. This in turn increases the interest rates of the country's bonds, aggravating the problems of liquidity and leading to even higher budget deficits. The result is that the EMU countries can be forced by financial markets into a bad equilibrium (characterized by deflation, high interest rates, high budget deficits and a banking crisis) and into a "self-fulfilling solvency crisis": the country becomes insolvent because investors fear insolvency.

24 EMU countries' vulnerability to self-fulfilling attacks was largely underestimated in the run-up to EMU. The implicit assumption at that time was that, by providing the establishment of credible and effective mechanisms to ensure budgetary discipline at national level, the risk of an EMU sovereign default would be close to zero. The crisis, however, has highlighted the shortcomings of the current EMU fiscal discipline regime. First, it has often been pointed out that the failure of some euro area Member States to comply with the originally-agreed rules of the "Stability and Growth Pact" in 2003, was an important root cause of fiscal misbehavior. While we agree that this episode did have negative effects in terms of the credibility of the fiscal surveillance mechanism in general and the likelihood that sanctions would be applied in particular, we do not share the view that fiscal misbehavior should be seen as the starting point of the crisis. There was fiscal misbehavior in several euro area countries. However, countries that had misbehaved did not run into crisis (in particular Germany), whereas other countries, that had played by the rules of the Stability

and Growth Pact experienced fundamental difficulties (notably Spain and Ireland). We therefore believe that an institutional framework conducive to self-fulfilling solvency crises played a much more important role in the recent crisis events than the deficiencies of, or non-compliance with, the Stability and Growth Pact or the Excessive Deficit Procedure.

25 In addition, the crisis also highlighted the fact that the degree of financial integration in the monetary union is such that when some sovereigns are pushed into a bad equilibrium, this affects the other countries. Thus, strong externalities are created, making it impossible to isolate a financial problem of one country from the rest of the euro area. Due to the interdependency of EMU's banking system and economies, the disorderly default of an EMU Member State is likely to trigger strong negative effects in the European financial system and runs the risk of triggering a domino effect on other vulnerable EMU economies.

1.7. Challenges in the banking sector and financial integration

26 Moreover, the crisis exposed a worrisome aspect of the EMU, which is the interconnection between banking weaknesses and sovereign credit dynamics. As Member States are individually responsible for rescuing banks in their jurisdictions, they are highly vulnerable to the cost of banking crises – especially when they are home to banks with significant cross-border activities. The other side of the coin is that banks are exposed to their own governments through their holding of debt securities. This home bias in bank portfolios of EU sovereign debt is apparent in most euro area Member States, namely in Greece (94%), Spain (90%), Portugal (79%) or Italy (78%). This implies that whenever the sovereign finds itself in a precarious situation, banks are weakened as a consequence. In short, national fiscal and banking problems feed each other. Markets have realized that such a configuration is a source of significant vulnerability and they are pricing the risk that governments go further into debt as a consequence of bank weaknesses, or that banks incur heavy losses as a consequence of their sovereign holdings.

27 Finally, as these vulnerabilities of nation-states and their economic and financial implications were largely underestimated prior to the crisis, EMU was not equipped with a debt crisis resolution mechanism, or a banking crisis resolution mechanism to intervene and react to the problem that arose when Member States were losing access to the market.

1.8. Beyond the nation-state: a sui generis approach to fiscal federalism

28 Overall, this short and mainly economic assessment makes the implications of the post-Westphalian challenge quite visible. If EMU wants to survive, it needs to build an economically-sound and politically-viable way to reap full benefits from the single monetary policy, rather than having to deal with its regionally-destabilizing consequences and the external effects from domestic economic policy choices. We therefore have tried to identify a sui generis response to a sui generis problem: which kind of fiscal federalism can be envisaged for a continent that wants to continue to preserve its domestic identity and political culture but at the same time continue to be interconnected on the basis of the Four Freedoms? We have come to the conclusion that a very special type of fiscal federalism is required, which does not immediately seek to build a European Federation but aims at reaching "as much fiscal federalism as necessary for the appropriate functioning of the euro, but as little as possible".

29 An appropriate fiscal framework for the European Union thus has to take up the challenge of combining elements of the old nation-state environment with elements of the post-Westphalian world. It has to solve the paradox of preserving strong domestic political cultures while building a strongly-integrated economic framework and allowing the European level to become an economic actor on its own. What needs to emerge is a sui generis construct that can solve the economic challenges while preserving strong democratically-legitimate foundations. Ultimately, such a fiscal framework could lead to what Jürgen Habermas has labeled a "non-state supranational democratic order" ["*entstaatlichtes supranationales demokratisches Gemeinwesen*"].

30 Our model of this “sui generis fiscal federalism” is presented in the following chapters:

- Chapter 2 assesses how European fiscal federalism could deal with cyclical and structural divergences resulting from the primacy of the real interest rate over the real exchange rate. We suggest responding to that challenge in three ways. (i) First, we identify the completion and fostering of the single market as a key tool to allow the real exchange rate to work much more effectively. The single currency and the single markets are functional complements and should be seen as such. (ii) Second, we argue that solutions should be discussed to allow for a “cyclical stabilization insurance fund” to react to the effects of the “one size fits none” monetary policy. Such an insurance fund, which should be created outside the EU budget and remain under strict control of national parliaments, would not lead to long-term transfers in only one direction. Rather, it would allow for largely automatic adjustments. If rightly devised, the individual country balances would be zero over the medium term, as every euro area Member State would steadily move from the recipient side to the donor side, and vice-versa. (iii) Third, we consider that structural divergences in the euro area between richer and poorer countries or regions are a highly relevant political concern, even if alleviating them is not strictly speaking a requirement for the proper functioning of the euro area. Structural divergences deserve attention from a political perspective to foster the unification of Europe as a more balanced and less divided continent. We suggest that any measure related to this matter should be addressed through a possible expansion of the redistributive side of the EU budget in a context of increasing the EU’s own resources and direct control of the European Parliament. We emphasize, however, that the existence of the euro does not automatically call for a large expansion of redistributive policies in the euro area: various levels of redistribution could be envisaged, in line with various degrees of political integration and pan-European solidarity in Europe.

- Chapter 3 discusses fiscal challenges and presents solutions to make EMU more resilient to future fiscal crises. It argues that the original EMU architecture did not succeed in building a coherent approach of either a “market-based system” (no-bailout clause, sovereign defaults possible, prohibition on monetizing debts) or a “hierarchical incentive system” (top-down approach to fiscal policy-making, sticks and carrots through a strict sanctioning system but in the presence of a lender of last resort). The original EMU approach aimed at mixing weak variants of both. Taking into account the difficulty of such a “middle of the road” system to function properly in the recent crisis, we seek to present a more coherent model that combines much stronger hierarchical and incentive elements with much weaker elements from the market-based system. We argue that EMU countries should become subjected to much stricter budgetary surveillance and be willing to give up elements of their budgetary sovereignty when they are cut off from the market (“sovereignty ends when solvency ends”) but at the same time there would be an EMU level guarantee to assume responsibility on providing adequately-priced access to sovereign bond markets in the context of the creation of a European Debt Agency.

- Chapter 4 goes into a specific area of the single market that has shown to be the main transmission channel of intra-euro area imbalances: the banking system. We discuss to what extent a common regulatory and supervisory framework is needed to allow for proper functioning of the euro area, focusing on regulatory competition, the level playing field in EU financial markets, the need for a euro area banking authority, the linkages between micro- and macro-prudential supervision, and the structure of the financial industry.

- Chapter 5 finally calls for a “road map” to implement the proposals contained in the previous sections. We believe the political, legal, and even cultural barriers on the way to implement sui generis fiscal federalism for the euro area could prove to be an even bigger challenge than the development of the right institutional design. We call for a process that takes up the successful model of the Delors Report, which in 1989 suggested a step-by-step approach to economic and monetary union. Today, a stepwise approach, based on a credible road map is the appropriate way to address completion of the euro area.

2. Dealing with heterogeneities in a currency union

31 One key lesson from the first decade of EMU is that the euro area is confronted with two types of economic heterogeneities: structural divergences and cyclical divergences. Structural divergences reflect different historical models and patterns of economic specialisation. They also point to the relative position in terms of wealth (e.g. GDP per capita) of a country in comparison to the rest of the euro area average. They usually existed prior to the establishment of EMU and are not the most important obstacle to the proper functioning of the single currency. Cyclical divergences, on the other hand, are specific to EMU. They point to the relative position of the business cycle of a country in comparison to the business cycle position of the rest of the euro area and can take different forms (inflation and growth differentials, imbalances in current account positions). They are generally not a problem for the functioning of the single currency if they are temporary. If they persist, however, they can seriously hamper the functioning of EMU. Interestingly, the two types of divergences are not correlated. In the early years after the creation of the single currency, euro area Member States thus fell into four broad categories: (I) there were countries in a relatively weak structural position compared to the euro area average, but with strong cyclical performance (e.g. Portugal, Spain, Greece in its good years), (II) there

were countries in a relatively weak structural position and with weaker cyclical performance than the euro area average (e.g. Greece in its bad years), (III) there were countries in a relatively strong structural position but with weak cyclical performance (e.g. Germany, Austria), (IV) there were countries in a strong structural position with strong structural performance (e.g. Ireland, the Netherlands and Finland in their good years).

32 Not all EMU heterogeneities are harmful. Following the fundamental logic of this Report, we have tried to distinguish between functionally "harmful" heterogeneities (those whose correction is a functional necessity for EMU survival) and rather "innocuous" heterogeneities. The latter do not have to be reduced, unless there is a strong political desire to do so because a reduction of such heterogeneities is seen as desirable for redistributive goals.

33 The current debates on how to address heterogeneities in our view do not pay enough attention to these two different types of divergences. A discussion of transfers in the euro area do not make sense as long as the type of underlying divergence that such transfers should address are not explicitly identified. We propose three different approaches to deal with EMU heterogeneities. Two address cyclical divergences (in our view the origin of "harmful" heterogeneities), one addresses structural divergences.

2.1. How to deal with cyclical divergences

34 Cyclical divergences can arise as a result of asymmetric shocks (exogenous) or of the asymmetric impact of the common monetary policy (endogenous). Before the start of EMU, the main concern of most economists was the risk of asymmetric shocks. However, during the first decade of EMU the latter have been relatively rare. Indeed, the main source of difficulties has not been the occurrence of country-specific shocks but the asymmetric, pro-cyclical effect of the ECB policy, which has not been adequately corrected by the competitiveness channel.

35 In fact, it seems from today's perspective that endogenous shocks should be seen as fundamental challenges to EMU. Indeed, there are good reasons to believe that a truly exogenous-driven asymmetric shock could in fact be solved within the domestic context of the country hit by that shock. The rest of the euro area would, by definition, not be affected and contagion and negative externalities would thus remain relatively low. And even the original fiscal rules framework of the Maastricht Treaty foresaw the possibility of engaging in country-specific stimulus packages beyond the 3% rule in case of a severe economic downturn. Moreover, the lesson of the aftermath of the Lehman crisis provides evidence that truly "symmetric shocks", i.e. a shock that affects large parts of the euro area at the same time, it is probably not a large challenge either. The "Great Recession" dating back to 2007/2008 did trigger a largely joint response in fiscal policy-making at euro area level (nationally decided, but with broadly similar magnitudes euro area-wide); and the ECB provided an accompanying monetary stimulus.

36 The most fundamental challenge in the area of cyclical divergences can be related to "endogenous" asymmetries in the euro area, as resulting from the primacy of the real interest rate effect over the real exchange rate effect: as soon as inflation differentials emerge, the ECB's "one size fits none" monetary policy contributes to further cyclical heterogeneities rather than alleviating them. The ECB should not be blamed for this effect. This is the very nature of a single monetary policy in the presence of a weak real exchange rate channel that would largely automatically lead to the realignment of the inflation rate through price competitiveness.

37 Unfortunately, such realignments of prices in the euro area seem to take far longer than initially expected. Indeed, the core challenge during the first decade of EMU was not so much the magnitude of inflation differentials, but rather their persistence.

38 What can be done to address this phenomenon? We suggest reacting to this challenge in two different ways. (I) The real exchange rate channel needs to be strengthened: As long as euro area economies remain largely national in their core demand and supply components, price signals from a changing position

in external competitiveness will take far too long to be felt in the domestic economy. An enhanced degree of intra-euro area competition would speed up that adjustment through export and import prices. A strengthening of the internal market (Single Market) is therefore a key component in long-term crisis resolution. It is unrealistic, however, to solve the challenge arising from endogenous cyclical divergences with the help of an enhanced real exchange rate channel alone, that will in many areas take decades to develop (consider the example of labor mobility). (II) The euro area will therefore need some kind of cyclical adjustment mechanism to accompany the real exchange rate channel. We suggest a cyclical insurance fund that can take various concrete forms. We limit our proposal to some basic features that can then be implemented in different fashions.

2.2. Completing the Single Market to enhance the real exchange rate channel

39 Strengthening the functioning of the Single Market is a pre-requisite to the proper functioning of a monetary union. At the moment of launching EMU, there was an assumption that the Single Market and monetary union would run as mutually-reinforcing processes. Deeper market integration was expected to improve the functioning of the euro area, and the latter was expected to trigger more trade integration. During the first decade of the single currency, however, the establishment of EMU did not translate into political impetus for deepening the Single Market. On the contrary, political and social support for market integration did not develop as hoped.

40 Soon after the beginning of the Great Recession, a comprehensive relaunch of the Single Market was put on the EU agenda and resulted in the presentation of the Monti Report in March 2010.[7] On the basis of that report, in 2011 the Commission presented a "Single Market Act" Communication, with 12 initiatives to be adopted before the end of 2012. Clearly, not all these 12 initiatives have the same potential to enhance the real exchange rate channel in EMU. Some of them are mostly aimed

7. Mario Monti: "A New Strategy for the Single Market", May 2010

at ensuring socio-political support for a single market re-launch and others have been chosen because of their short-term political feasibility.

41 One of the areas in which there is more potential for growth is the deepening of the single market for services. Services account for 70% of EU GDP but the European service market remains strongly fragmented, with only 20% of the services provided in the EU having a cross-border dimension. Better standardization of services, full implementation of the Service Directive, the removal of administrative obstacles to mobility (see section below) as well as some harmonization of rules shaping the business environment (corporate taxation, consumer protection) would facilitate cross-border service provision and the free establishment of service providers across the EU.

42 Intra-EMU labor mobility would greatly enhance the real exchange rate channel as an adjustment tool in the euro area. However, labor mobility across Europe remains very low (only 3% of working-age EU citizens live in a different EU country). Linguistic and cultural barriers are certainly important, but there are other policy-induced factors hampering the mobility of workers in Europe. A recent OECD report (2012)[8] cites in particular: (I) the lack of portability of supplementary pension rights; (II) scarce cross-country information about job vacancies, (III) the difficult recognition of professional qualifications, (IV) housing market policies that raise the costs of moving, (V) the difficulty in accessing public sector jobs as non-nationals. While we cannot go into detail on these elements, we would like to highlight the fact that facilitating worker mobility in the euro area is a crucial element in enhancing the functioning of the single currency. Taking into account that Single Market legislation is generally a topic for EU-27 but that the motivation for functional reasons could be much larger in the euro area, we suggest serious consideration of the use of "enhanced cooperation" to pass legislation e.g. on the portability of pension rights, or the creation of a closed co-operation agreement between EMU national employment agencies, in order to enhance the functioning of the real exchange rate mechanism in the euro area.

8. OECD Economic Survey, European Union, March 2012.

43 Deepening of the Single Market would have to be complemented with domestic reforms facilitating price and wage adjustments to allow the real exchange rate channel to work more effectively. Such reforms could go in different directions depending on the underlying instruments. Price rigidity generally tends to hamper the real exchange rate channel and should be the target of far-reaching reforms, in particular in the most rigid economies.

2.3. Building a cyclical adjustment insurance fund to alleviate cyclical imbalances

44 Building an automatic cyclical adjustment insurance fund to alleviate the effects of endogenous asymmetries or imbalances is a necessary complement to the strengthening of the Single Market. There are two reasons why the market competition approach alone is unlikely to solve the inherent difficulties very soon: (I) the necessary reforms are likely to take years or decades before showing a far-reaching effect; (II) given the importance of non-tradables in EMU economies, even after a broadening of the tradables market, large parts of the economy will remain 'sheltered' from foreign competition; (III) consequently, even in a much better functioning Single Market context the risk of large endogenous asymmetries would in all likelihood persist: comparisons with fully integrated nation states indicate that the real exchange rate channel is usually a slow adjustment mechanism. In short, it is quite probable that single market measures would not eliminate the risk of endogenous cyclical divergences. For this reason, together with the actions intended to avoid the emergence of cyclical divergences (i.e. deepening of the Single Market), it is essential to set up an EMU-wide stabilization mechanism aimed at counter-balancing the procyclical effects of ECB action.

45 Endogenously-generated cyclical divergences should almost by definition remain temporary. But temporary does not imply short-term: the first decade of EMU has shown that cyclical divergences can persist for as long as a decade, perhaps even longer. We therefore suggest establishing a cyclical insurance scheme that could shelter countries from an EMU-induced cyclical downturn for a certain period of time. It would work on the basis of contributions by national

budgetary authorities (or national social insurance schemes) to a euro area fund, which would logically be outside the EU budget, as only the euro area members would be concerned. In our view, such a fund should be administered independently by a group of representatives of national finance ministries and be under the control of national parliamentarians. It is important to detach such an insurance instrument from the budget and institutions of the EU, as the insurance scheme should function automatically and over the medium term translate into a neutral net-benefit position of the participating Member States.

46 The core idea behind this insurance fund is to facilitate the economically and politically very difficult path towards an internal devaluation. Countries would pay into the insurance fund in exceptionally good years (i.e. when the cyclical growth component is significantly larger than in the euro area average), thus making it politically easier to run surpluses, as a large share or even the totality of the surplus would go into the cyclical component. Receipts from such a cyclical insurance fund could facilitate downward real-wage adjustments or alleviate the pressure on domestic unemployment insurance schemes in a severe downturn and thus reduce pressure on public finances. Receipts from the fund could thus serve as “buffers” in a downturn.

47 We are aware that the technical components of such a scheme are decisive. We do not wish to enter into a detailed technical discussion at this stage but consider the broad principles to be much more important. It would be paramount to make sure that the system cannot become a hidden instrument for permanent transfers, but rather lives up to the idea of a mutually-guaranteed insurance scheme. First, it is important that countries would generally have to pay a standard amount into the insurance fund in good business cycle years, but disproportionally more when starting to overheat (i.e. when benefitting from real interest rates that are more accommodating than appropriate). If rightly designed this would amount to a fiscal equivalent of a tightening of monetary policy. Second, it would be important to establish strict criteria for allowing the access to the resources of the insurance fund, notably with a strong focus on asymmetric downturns, i.e. a symmetric downturn affecting the entire euro area simultaneously (e.g. the criterion could be a growth rate more than 2 percentage points lower than the euro area average). There would have to be

strict limits to the amounts that any country could take from such a scheme (one could go as far as arguing that countries can only take out what they once paid in, although the challenge of the phasing-in would then have to be resolved). The insurance fund would have to be devised in a way that would shield it from direct political influence. We envisage a largely automatic scheme and do not think an intensive parliamentary control mechanism would be required for such a scheme, as it would be rule-based. But the rules themselves should be legitimated by the national parliaments of the countries involved, as the amounts in the insurance fund come from the national budgets and are not transfers or contributions to the EU level.

2.4. How to deal with structural divergences

48 Structural divergences in the euro area are harmful in principle to the functioning of the single currency, as they prevent the emergence of an optimum currency area. However, they are not as harmful to the adequate functioning of the single currency as cyclical divergences. While it is clear that a structurally more homogenous EMU would probably work better, we do not consider that getting rid of structural divergences is an absolute requirement for the functioning of the euro as they are an expression of different economic cultures and models. Having said that, we would like to emphasize that we definitely see that there can and sometimes should be a strong political desire to reduce structural divergences, in particular when they result in large social and inter-regional cleavages. Ultimately, reducing structural heterogeneities is therefore an inherently political decision.

49 Such a political decision should be prepared and discussed in the political realm. We do not wish to enter into detail on how to alleviate structural differences. But the appropriate source of funding is certainly the European Union budget, based on true own resources and on the basis of a political debate in the European Parliament. It would be important, however, to ensure that such funds would be spent effectively and efficiently. In such a political debate on structural divergences and convergence it would also be important to assess to what extent the establishment of EMU might have contributed to the mainte-

nance or aggravation of structural divergences. It can well be argued that while structural divergences existed before EMU, the creation of EMU led to massive capital inflows to less developed euro area countries, and this created a disincentive for EMU governments to reduce these divergences. In a similar vein, one can argue that recent processes of economic specialisation (i.e. the rise in construction in some EMU member countries) were mostly fueled by the real interest channel from the common monetary policy through low or negative interest rates.

50 In short, we take the view that policy-makers should strive to develop a better understanding of the causal linkages between the single currency and structural divergences and – if warranted – act accordingly through adjustments in the EU budget. Indeed, we cannot exclude the existence of a causal link between EMU and structural divergences. We also note that the current crisis might have inadvertently set into motion forces of economic agglomeration which will be very difficult to reverse in the future. Policy makers will have to investigate how much time it will take to ensure that private investment starts flowing again to countries that have suffered from an overvalued real exchange rate. Should that time be too long, then it could be desirable to think about a policy mechanism to reduce or contain EMU structural divergences in the future. This does not necessarily imply transfers. One could also consider harmonizing the corporate tax base within EMU countries and allowing the use of differentiated corporate income tax to compensate for different geographical disadvantages.

3. Making the EMU fiscal framework more sustainable and resilient: a sui generis fiscal federalism approach for the euro area

51 In the traditional nation state environment there are different types of fiscal federalism. The different models vary in the degree of borrowing autonomy of the regions, the share of own resources in comparison to the share of own expenditures, the degree of budgetary control that can be taken over at federal level, the rules governing potential bailouts, the possibility of the sub-units to take part in decision-making at federal level on fiscal matters (e.g. through second chambers), but also constitutional provisions on equal living conditions across regions often implying horizontal or vertical equalization schemes, which can be more or less automatic in transferring resources from federal level to regions or from some regions to others. The main question we seek to answer here is which of these different elements could and needs to be transposed into a sui generis European framework case, taking into account the (I) economic context (in particular in relation to the missing elements of an optimum currency area), (II) the incentive implications related to the collective action problem in fiscal policy-making, (III) the legal pre-conditions, and (IV) the potentially-required degree of political integration.

52 We take the view that the institutional design of a fiscal framework mainly needs to derive from the functional necessities. Given the still strong national roots of

political processes, there should be as little transfer of sovereignty as possible, but clearly as much as needed to make the single currency work. As derives from the previous section, a fiscal framework for the euro area in a minimal form needs to achieve three main functional tasks: (I) allow for a sufficient degree of macro-economic stabilization to react to internal imbalances in the euro area (this was discussed in the previous section); (II) present a workable solution to the problem of fiscal discipline; (III) make the euro area resilient to self-fulfilling solvency crises.

3.1. The main deficiencies of the current model of fiscal policy co-ordination

53 There are two basic models to ensure fiscal discipline in fiscal federations. The first, ("market-based system") is a system in which sub-central units are induced by the capital markets to conduct responsible fiscal policies. It is based on direct market access of the sub-central units to finance their debts. Such a system is usually based on a no-bailout-clause (thus allowing the market to properly price default risk), defaults are possible, and there is a prohibition on monetizing debts. The second type ("hierarchical incentive system") is a system in which sub-central fiscal discipline is enforced by central rules and administrative procedures. As an ideal type, such a system usually has a lender of last resort that can assist the sub-central units in the case of unforeseen emergencies.

54 The original EMU approach, as contained in the Maastricht Treaty, mixed elements of both systems. The risk of debt default was expected to be controlled through the establishment of two "market-based" elements; the Treaty's "no-bailout-clause" in combination with a strict prohibition on monetizing debt through the ECB. In addition, there was a "hierarchical control" procedure in the form of common fiscal discipline rules, as laid out in the Excessive Deficit Procedure in combination with the Stability and Growth Pact.

55 It is useful to note that the Excessive Deficit Procedure and the Stability and Growth Pact are representative of a certain type of rules on which EMU was

built. The underlying logic of the fiscal architecture in EMU put the emphasis on common rules that set *negatively*-formulated limits to fiscal behavior ('you are not allowed to run deficits above 3%'), and did not provide *positively*-formulated guidance ('in 2004 you should reach a budgetary deficit of 1%'). Moreover, the rules are only applied to deficits ('asymmetric rule') and not to deficits and surpluses ('symmetric rule'). The key challenge to any common rule at European level is that it has to be either negative and asymmetric or positive and symmetric. It is impossible to devise a rule that limits Member States' fiscal room for manoeuvre on the surplus side without being prescriptive (setting a surplus limit would not make any sense). In other words, the choice is between preserving an asymmetric, deficit-oriented framework of deficit prevention or agreeing on a positively-formulated stance for Member States' fiscal policies that can then be symmetric as it can also give guidelines on surpluses. The old EMU fiscal framework opted for an asymmetric and negative rule, which – in combination with the self-fulfilling character of the solvency crisis, see below – rendered crisis management more difficult.

56 With the experience of the crisis, the current EMU model looks even less coherent. The "no-bailout clause" is still alive from a legal perspective but it has clearly lost its original power. Moreover, no additional hierarchical control possibilities or direct intervention possibilities in the conduct of national fiscal policies have been established. The current informal EMU system therefore combines the worst elements of both the market and the hierarchical approach, as it currently cannot successfully enforce the no-bailout rule but at the same time has not obtained the required transfer of sovereignty that would be needed in a "hierarchical and incentive-based system".

57 We seek to present a more coherent model that combines much stronger hierarchical and incentive elements with much weaker elements from the market-based system. We argue that EMU countries should become subjected to much stricter budgetary surveillance and at the same time be willing to give up elements of their sovereignty when they are cut off from the market ("sovereignty ends when solvency ends"). At the same time, however, there would be an EMU level guarantee to assume responsibility on providing adequately-priced access to sovereign bond markets in the context of the

creation of a European Debt Agency. The starting point of our approach is that EMU cannot be built on an explicit bailout commitment as is the case in federations such as Germany. However, the group also agreed that the EMU should protect EMU countries facing liquidity problems in order to respond to negative spillovers and contagion.

3.2. Creating a European Debt Agency

58 We suggest the establishment of a European Debt Agency (EDA). Such an agency would be less than a fully-fledged finance ministry or a treasury, but it would be more than a simple European Monetary Fund providing emergency assistance against strict conditionality. While we cannot develop all details of such a proposal here, we see the EDA as a very flexible instrument allowing to cover all the different scenarios from facilitating debt issuance in normal times, to assisting countries under short-term financial market pressure against some conditionality until the scenario where a euro area member in default is bailed-out by the EDA in exchange for a nearly complete transfer of sovereignty. The theoretical option of restructuring the debt of a country in a situation of financial distress should remain possible, but only in truly exceptional circumstances.

59 A potential design for an EDA could have the following core features:

a. The EDA would be jointly and severally guaranteed by all euro area countries. In normal times, all euro area members would issue a pre-defined share of their debt (e.g. 10% of their GDP) through the EDA, thus establishing a very liquid market for EDA debt instruments of about half the size of the current market for *Bunds*. The interest rate on that 10% of GDP would be the market rate of EDA debt, and all euro area countries would pay the same rate on the first 10% of GDP of their debt volume. The rest of the national debt would in principle be issued as national debt.

b. Should a country be affected by the beginning of a self-fulfilling solvency crisis or should a crisis event lead to a sudden increase in borrowing costs, the EDA would allow that country to increase its EDA share to a next level of a strictly limited amount. The limit could be another 10 percentage points of GDP. At that stage, the only conditionality would be that countries ought to have respected the basic legal and institutional requirements of fiscal policy co-ordination ex ante (Fiscal Compact, Stability and Growth Pact). By getting access to such a "discount window", euro area members in a situation of a crisis would be able to overcome short-term refinancing gaps quite easily. The combination of the normal share of national debt (10% of GDP) plus potentially 10 additional percent through the discount window would allow all euro area states to borrow up to 20% of GDP relatively easily through the EDA.

c. A country facing difficulties in refinancing itself in the market beyond those 20% of debt to GDP would then have to comply with much stricter conditions and accept for every additional amount a stepwise transfer of elements of its fiscal sovereignty to the EDA. Also, the interest rate charged by the EDA for tranches above the first 20% of GDP would be above the market rate, but at a reasonable spread (e.g. 200 basis points above EDA rate). The different steps should be decided politically. We would suggest that between 20 and 30 percentage points of total EDA financing the country would have to sign and then respect a Memorandum of Unterstanding; between 30 and 40 percent the country would have to sign up to a full adjustment programme and comply to it, similar to the current Troika programmes. Between 40 and 60 percent of debt to GDP budgetary policy would still be based on the programme, but the EDA would become even more involved in the preparation of the national budget. It would work closely with the national fiscal council (as to be established under the rules of the fiscal compact), provide detailed assessments of the draft budget, and set out the main macroeconomic assumptions (e.g. growth forecast).

d. A country in need of financing more than 60 percent debt to GDP via the EDA would need a formal approval from the EDA before being able to adopt its budget or otherwise exercise its budgetary sovereignty. Not respecting a rejection from the EDA would not be legally excluded, but would automatically entail the exclusion of any EDA financing and thus inevitably lead to restructuring. In simpler terms, countries would have to choose between giving up the political sovereignty over the conduct of their fiscal policies and get a full bailout ("hierarchy and incentive approach") or going into an orderly debt restructuring solution on their national debt ("market approach" based on the no bailout provision). An alternative approach could even include a legal transfer of sovereignty from national level to the EDA. The fiscal policy would then be effectively conducted by the EDA. Such a more far-reaching transfer of sovereignty would require significant legal changes in national primary laws. Whether such a transfer is possible, should be subject of a political decision at European level and later at the level of the euro area Member States.

e. All countries could at all times issue their own national debt. This could be done if the national rate is more manoeuvre than the EDA rate. Or it could be done if a country choses not to comply with conditionalities.

60 As to the governance of the EDA, we argue it should be headed by a "Euro area Finance Minister" that would in normal times ensure compliance with the main fiscal rules agreed upon in the euro area, and in times of crisis successively take over the control of fiscal policy-making in a country financing large amounts of national debt through the EDA. There should be appropriate democratic control attached to the EDA. The group considers that national parliaments that currently detain the key to budgetary decisions would have to be involved in providing the legislative basis of the decisions taken by the EDA Chairperson / Euro area Finance Minister – possibly in a joint committee with representatives from the European Parliament. It could be a worthwhile innovation within the sui generis approach to combine 17 representatives from the EP with 34 members of the national parliaments. The main institutional question would then be whether the 17 MEPs would come from euro area countries. The legal instruments would not be capable of requiring a certain geographic origin, but there could be a political agreement to involve only MEPs from euro area countries. Overall, the group considers that a high degree of legitimacy of the EDA's actions is of paramount importance in the process. The group notes that there are different ways to achieve this and has decided not to take a final view on the exact composition of the appropriate legislative body or committee, as this decision involves quite far-reaching political, legal, and institutional considerations.

61 Setting up a body as the EDA for euro area members requires a fundamental decision on the future of the legal structure of the European Union. After looking

into the different possibilities in combining the new structures presented here with the instruments already foreseen in the existing Treaty (e.g. through Article 136 TFEU, or through enhanced cooperation) the group discarded these options and considered that working in the current EU institutional framework would be very difficult and that other options should be preferred. Consequently, the group agreed on the need to move towards a solution implying more diversification of degrees of integration. It suggests moving forward not on the basis of the present Treaty but by shifting to a new Intergovernmental Treaty (IGT). The group is confident that such a shift could be achieved while still preserving the involvement of EU institutions as much as possible. The group suggests working in the direction of an own EU17 structure that would be parallel to the EU-27 framework, but strongly linked to it. That new legal structure or IGT could at a later stage be integrated into the traditional legal structure of the EU.

4. Banking and the financial sector: towards a euro area banking union

62 Financial market stability has been neglected by the architecture of the Maastricht Treaty. Despite an increasingly integrated EU financial market, with the volume of cross-border banking growing substantially in the 2000s, financial supervision remained a prerogative of Member States, with only a modest degree of supranational coordination. This dichotomy prevented, prior to the crisis, both the detection of the development, in some EU countries, of excessive private sector imbalances and the identification of cross-country and cross-sector interlinkages, which therefore went unaddressed. In addition to these banking supervision deficiencies, the EU faced the financial crisis with no banking crisis management capacity.

63 The lack of a European framework for banking supervision and crisis resolution is, at least partly due to the fact that, until the crisis, the interdependency between national banking systems in the EMU was underestimated. The crisis has highlighted the fact that, given the increased financial integration spurred by the common currency, the financial instability faced by one Member State is a threat for the EMU as a whole. Furthermore, the crisis exposed a fragility of the euro area, which is the interconnection between the banking crisis and

the sovereign crisis that weaken both sovereigns and banks and the whole monetary union as a consequence.

64 As the failure of financial markets is at the heart of the crisis, a comprehensive framework for financial stability is a crucial piece in the EMU puzzle. This implies moving towards a banking union addressing the financial system deficiencies revealed by the crisis. Although it would seem straightforward to establish a banking union for the EU as a whole because of the character of the single financial market as an EU-27 feature, we consider that the euro area should not wait for an agreement in the EU-27 framework and not make any concession in order to move to an EU-27 framework if that entailed a less functional solution for the euro area.

65 We therefore call upon the euro area to take the lead in the setting up of a true banking union. We are aware that it could be a delicate issue to achieve the right rules for financial stability in the euro area without endangering the functioning of the single financial market. But it must be possible to ensure that the banking union within the euro area do not entail distortions to competition between the EU-27 within the single market for financial services and the euro area.

4.1. The recent reforms in EU financial market supervision are not sufficient

66 Following the crisis, the EU supervisory framework already underwent a comprehensive reform, aimed at ensuring a stable, reliable and robust single market for financial services. The new architecture consists of two mutually reinforcing European pillars. On the one hand, a micro-prudential pillar, with the establishment of three European Supervisory Authorities (ESAs) for banking (EBA), securities (ESMA) and insurance and pension funds (EIOPA). The specific powers granted to the three ESAs have been designed to improve the quality and consistency of supervision, reinforce the supervision of cross-border groups, strengthen crisis prevention and management across the EU, and establish a set of common standards applicable to all financial institutions. On the other

hand, a macro-prudential pillar, with the creation of the European Systemic Risk Board (ESRB) with a mandate to prevent and mitigate the build-up of risks to financial stability in the EU financial system and to contribute to the smooth functioning of the internal market.

67 This new framework for financial supervision is a step in the right direction. However, the design as a coordination framework means that national authorities will ultimately retain competence for most decisions. Indeed, the new supervisory agencies have limited powers and resources. The EBA does not have the power and capacity to conduct deep and far-reaching bank stress tests. It still has to rely on information provided by national supervisors, who ultimately have the authority to intervene. The EBA is thus not yet a true European supervisor, and even less a euro area supervisor. The limited supervisory role of the EBA is, of course, related to the absence of financial means at EU level to support banks in difficulty. Taxpayers' resources remain firmly in the hands of national governments and parliaments, and logically therefore Member States have the main responsibility for banking supervision.

68 Concerning the ESRB, it has the task of monitoring the soundness of the whole financial system in the EU; but with more than 60 participating institutions it is unlikely to become a very effective institution. In addition, it has only access to aggregate data. If the ESRB wants to obtain information on individual banks, it has to ask the national supervisors in a complicated process. And even if it identifies risks, the ESRB can only issue warnings and recommendations which are not binding for the country to which they are addressed. Furthermore, the resolution of a cross-border financial institution under the new framework will still be a highly complex task, as several national authorities, national deposit insurance funds and national resolution funds will be involved. The reform undertaken is then insufficient to remedy the problems of financial supervision and crisis resolution in the EMU.

69 We need to move towards a more European solution for both banking supervision and crisis resolution at the EMU level. In designing the EMU banking union, it is vitally important that future arrangements for supervision and crisis resolution of cross-border banks are dealt with jointly as a package and not in

isolation, as the solutions in these two areas are totally intertwined. We cannot separate the supervision from the resolution in the sense that supervision is the preventive arm and even if we prevent crises they will still occur and then we will need the corrective arm.

4.2. A banking union for the euro area

70 The euro area banking union should in the first place include a fully integrated banking supervision for the euro area. This would include having a euro area supervisory institution being responsible for micro prudential supervision with investigation powers. Creating an integrated euro area banking supervisory authority instead of 17 autonomous national supervisors would have obvious advantages compared with the status quo. With integrated supervision, all relevant microeconomic data for euro area banks would be made available to a single institution. This would allow the supervisor to identify all financial links between the Member States, as well as concentrations of lending to specific borrowers, sectors and regions. A euro area institution would be much more independent of national interest groups and politicians than a national supervisor. Thus, the problem of "regulatory capture" could be avoided or at least dramatically reduced.

71 This euro area banking supervisory institution should either be built up within the ECB or closely cooperate with the ECB. Conferring specific tasks upon the ECB concerning policies relating to the prudential supervision of credit institutions and other financial institutions, but not insurances could even be done without changing the Treaty. Article 127.6TFEU allows the Council after consulting the European Parliament and the European Central Bank, to unanimously make that choice.

72 Overall, the group considers that supervision of banks should, as a general rule, be consistent with the EU internal market rules and seek to avoid regulatory arbitrage between different levels. A pan-EU supervisory authority in a position of hierarchical superiority vis-à-vis national layers of supervision would be the most desirable approach. The exact design would have to be determined politi-

cally, in particular with regard to the relationship of euro area countries to the EU-27.

4.3. A euro area deposit insurance scheme

73 In parallel to an enhanced supervision structure, there should also be the setting up of a crisis resolution framework at the euro area level. The euro area should aim at creating a framework inspired by the Federal Deposit Insurance Corporation in the US (FDIC), combining the function of a banking resolution agency and a deposit guarantee scheme. A European FDIC-style agency would have to become involved at an early stage in the resolution of a cross-border banking crisis, assuming a role in negotiating the resolution path, alongside the relevant national authorities. This could include the adoption of ex-ante burden sharing arrangements. This agency could also supply funds needed to facilitate the resolution of a cross-border banking group, provided this was less costly than paying out deposits in liquidation. The euro area-wide bank deposit guarantee scheme, which would serve as a "pay-out box" in case of deposit losses, would be easier to implement and less controversial, as public guarantees on bank deposit across the EU are partially harmonized and less discretionary.

74 The costs of a European FDIC-style agency could be based on an insurance fee raised from the banks, but would clearly have to be complemented with pay-ins from national budgets. As a system of euro area-wide guarantees as a backstop would be necessary for both households and non financial corporates deposits, the amounts involved would possibly be very large. The intervention capacity would therefore have to be financed and backed up by all euro area governments. In order to reduce the moral hazard associated with the potential use of public money, deposit authority should be assigned some "prompt corrective action mandate" (as the FDIC in the US). One option to discuss could be to provide the European deposit/resolution authority with the power to monitor the "recovery and resolution" plans submitted by banks to their primary supervisor. Moreover, there should be clear rules for the resolution authority to impose losses to creditors (bail-in instruments).

Conclusion: a road map towards sui generis fiscal federalism

75 In the late 1980s, the Padoa-Schioppa Report and the Delors Report laid the ground for a stepwise approach to a sui generis economic and monetary union. A decade later, the single currency was introduced in Europe. Today, the basis for a stepwise approach to a sui generis fiscal federalism in the euro area is needed. We therefore call for a road map to credibly determine the path to a more solid and resilient euro area, based on true joint action and the recognition of the EU level as an independent layer of economic policy-making, but acknowledging the national origins of budgetary and economic policy choices.

76 Several proposals presented in this report can be taken up immediately, as they do not require far-reaching legal or institutional changes, but could be achieved in a setting of enhanced cooperation. The proposals on the Single Market can start immediately, so can national reforms facilitating the operation of the real exchange rate channel. Several steps towards a euro area banking union can be implemented within the current Treaty framework on the basis of cooperation between the euro area members, either through enhanced cooperation or intergovernmental agreements. Conferring supervisory tasks upon the ECB needs a unanimous requirement of the EU-27, but can be done within the current Treaty.

So action should start immediately. However, we would like to emphasize that our proposals should not be seen as an “à la carte” – menu. They will only lead to success if they are implemented as a package. It is therefore of the essence to start the longer-term process of the politically and legally more difficult steps of reform, such as the steps towards a cyclical adjustment insurance fund, the EDA or the financial backing of a euro area-wide deposit insurance. These proposals require further work on their respective phasing-ins and therefore on an overall road map leading to sui generis fiscal federalism in the euro area.

77 We are aware that our proposals focus on the medium to long term. We believe that in a crisis, in which short-term action has become the guiding principle – mainly due to the constant short-term pressure arising in financial markets – a credible long-term goal in combination with a credible road map can be an important crisis resolution element. But it can in no case be the only one. Actions in the short run are therefore still required to allow for sufficient time to get the road map process started and put the euro area on a pre-determined path towards sui generis fiscal federalism.

78 But what is ultimately needed, is the agreement in spirit by all euro area members that they share not only a common currency, but also a common destiny. Euro area member countries, but also the institutions and bodies governing them, have to finally live up to the expectation that economic policies are a *matter of common concern*. This should be the guiding principle for the years to come.

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Competition-Cooperation-Solidarity

Completing the Euro
A road map towards fiscal union in Europe
Report of the “Tommaso Padoa-Schioppa Group”

Tommaso Padoa-Schioppa, former president of *Notre Europe* (2005-2010), was a convinced and far-seeing European with strong expertise in economic and financial issues. He played a key role in advancing the argument for a common currency as the author of the report on “Efficiency, Stability and Equity” (1987) and in designing the architecture of the Economic and Monetary Union (EMU) as co-rapporteur of the Jacques Delors committee on EMU (1989).

After his sudden death in December 2010, *Notre Europe* decided to honour his work and his contribution to the success of the euro area with the establishment of a high-level expert group to reflect on the reform of the European and Monetary Union. The “Tommaso Padoa-Schioppa” group met several times from December 2011 until May 2012. This report is the result of its work.

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