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EUROPEAN INTEGRATION IN THE TIME OF MISTRUST

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Abstract

This paper reviews the debate on completing the institutional architecture of the European Economic and Monetary Union (EMU). In response to the sovereign debt crisis, reforms have resulted in significant progress towards greater integration, as best epitomized by the establishment of the European Stability Mechanism and the first two pillars of a Banking Union. In addition, the fiscal governance framework has been overhauled, with stricter rules and more powers at the supranational level to affect national budgetary policies. Because of these reforms, as well as of other policy measures at the national level, risks in the sovereign and banking sectors have been substantially reduced. The paper argues that major advances in *risk reduction* have not been matched by parallel progress in *risk sharing*: this asymmetry leaves the EMU vulnerable and may undermine its longer-term viability. Priority needs to be given to closing the gap between risk sharing and risk reduction as, at the current juncture, the former is *in and of itself* a conduit for the latter.

JEL Classification: E58, E62, F42, F45, G28, H63.
Keywords: economic and monetary union, banking union, fiscal capacity, sovereign-bank nexus.

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[*] Bank of Italy and International Monetary Fund.

Wisdom comes to us when it can no longer do any good
Gabriel García Márquez, Love in the Time of Cholera, 1985

1. Introduction[1]

While the causes of the sovereign debt crisis that began in Greece in 2010 – and the policy responses – remain the subject of an intense debate,[2] the way the Economic and Monetary Union (EMU) has come through the crisis is *per se* a source of wonder among scholars of European integration, who ask themselves a fundamental question: why did the EMU become deeper and more integrated when many feared for its survival?[3]

The crisis has dramatically exposed the flaws in the EMU's institutional architecture and has acted as a very powerful agent of change. The ensuing reforms have resulted in important achievements towards greater integration. The banking sector has been fundamentally strengthened by the entry into force of two pillars of the European Banking Union – the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) – in November 2014 and January 2015, respectively. Equally relevant, the risks of future sovereign debt crises have been addressed by overhauling the European Union's economic and fiscal governance framework, by means of new institutions, stricter rules and more powers at the supranational level to monitor national budgetary policies. The setting up of the European Stability Mechanism (ESM) in October 2012 provided the EMU with a lender of last resort to sovereigns, a critical instrument for crisis management. In February 2015 the European Commission launched an initiative to establish a Capital Markets Union, with a view to fostering financial integration, diversifying firms' financing sources and increasing the scope for private risk sharing.

These reforms – and the unprecedented monetary policy response by the European Central Bank – have paved the way for major improvements in macroeconomic and financial conditions in the euro area, with growth and job creation strengthening since 2015, albeit at a different pace across member states. Despite these positive developments, there is ample recognition that the EMU as emerged from the crisis is "at a crossroads", i.e. that more needs to be done to overcome persistent vulnerabilities, complete its institutional architecture and further strengthen its crisis prevention and resolution capabilities. It is most telling that – more often than not – the adjective "existential" has been used to define the crises, threats, risks and challenges faced by an incomplete EMU or, more broadly, by the European Union (EU).[4]

This paper provides a critical review of the debate on completing the institutional architecture of the EMU. Discussions have often been framed in terms of a *risk sharing versus risk reduction* dispute, with market discipline as a cross-cutting key component; one of the major questions is whether the introduction of mechanisms for public risk sharing[5] at a supranational level should precede, coexist

[1] The views expressed are those of the author and do not necessarily reflect those of the Bank of Italy or the International Monetary Fund. For their useful comments, I would like to thank Fabrizio Balassone, Marco Committeri, Domenico Fanizza, Maura Francese, Nicola Giammarioli, Alessandro Leipold, Francesco Paternò, Maurizio Trapanese and Ignazio Visco. The usual disclaimers apply.

[2] The literature on the causes of the euro area crisis and the policy response is obviously very vast and will not be discussed here. See, for example, Bastasin (2015), Baldwin and Giavazzi (2016) and Wyplosz (2016).

[3] Hoeksma (2015); Ioannou, Leblond and Niemann (2015); Verdun (2015).

[4] Juncker (2016), Praet (2018), Regling (2018) and the Franco-German Meseberg Declaration of 19 June 2018 (https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806). Berger *et al.* (2018) conclude that without decisive progress to foster fiscal risk sharing the EMU will continue to face "*existential risks*".

[5] We are referring to *public* (or fiscal) risk sharing as opposed to private (market-based) risk sharing, achieved usually via capital and banking markets. Bénassy-Quéré *et al.* (2018 and 2019) place emphasis on improved market discipline as a needed complement to more risk sharing (and to further risk reduction in the banking sector). The debate is at times shaped around a *crisis mitigation versus crisis prevention* dichotomy.

with, or follow the reduction of risks in the sovereign and banking sectors at the national level. Most of these risks reflect the "legacy issues" in the countries hardest hit by the crises: high ratios of non-performing loans (NPLs) in banks' balance sheets, elevated sovereign debts and large exposure of national banks to their sovereign bonds ("home bias"). While there is some consensus in principle – including at the official level – that progress on risk sharing and risk reduction should go "hand in hand", because they are complementary objectives for a more integrated EMU, there has been plentiful disagreement among member states about the relative priorities, the practical solutions and the appropriate sequencing;[6] as a result of this disagreement, the process of advancing the EMU has in many respects reached a stalemate.

Against this background, the paper argues that, all in all, the quest for completing the EMU has so far made important but asymmetric progress: major advances in risk reduction in the sovereign and banking sectors at the country level – which have often introduced limits on the use of previously available national policy levers[7] – have not been matched by parallel progress in risk sharing at a supranational level. This asymmetry is most evident in the failure to establish a European Deposit Insurance Scheme (EDIS), the Banking Union's third pillar, not to mention the so far merely aspirational prospects for a "central fiscal capacity" for macroeconomic stabilization.

This asymmetry is unsafe and needs to be remedied for the EMU to ultimately secure longer-term viability and to better foster stability and growth. One of the most powerful cases for completing the EMU is the evidence that, in the aftermath of the 2008-09 global financial crisis, output losses suffered by euro area economies were notably higher than in other advanced economies. While in the U.S. real GDP had already recovered its pre-crisis level by 2011, in the euro area this only happened four years later, in 2015; these developments were mirrored by strong increases in unemployment across many euro-area member states, with divergences in unemployment dynamics even larger than those for GDP.

These outcomes primarily reflect the sovereign debt crisis but also a lower capacity of the current EMU architecture to absorb and recover from shocks, which is mainly due to two factors: the more limited national policy levers– in a context of common rules – available for adjustment to shocks and the remaining gaps in the EMU architecture, notably the lack of supranational countercyclical capabilities (IMF, 2018; Berger *et al.*, 2018). The latter has long been singled out as one of the EMU's most critical flaws, one that can be particularly detrimental at a time when monetary policy space is limited; it is also in striking contrast with the substantial strengthening of the rules and powers at the European level to constrain national fiscal policies. In the same vein, a Banking Union without a credible EDIS may entail financial stability risks in case of doubts on the absorbing capacity of national deposit guarantee schemes and may provide incentives for geographical ring-fencing of banks' capital and liquidity.

The asymmetric progress between risk reduction and risk sharing resulting from the recent reforms of the EMU governance adds to other foundational asymmetries[8] (e.g. a single monetary policy facing multiple national fiscal policies) and leaves the EMU particularly exposed to risks of self-fulfilling crises, contagion and negative spillovers arising from problems originating in either individual sovereigns or national banking systems.

[6] Pisani-Ferry (2018) argues that the divergence of views on what the priorities are to fix the EMU may reflect, on the one hand, diverse interests (e.g. low-debt states against high-debt states) arising from distributional concerns ("the battle of interests") or, on the other hand, cognitive issues leading to a different appreciation of risks ("battle of ideas").

[7] Balassone and Visco (2019).

[8] Discussed in Section 3.

Priority should thus be given to gradually establishing common institutions and instruments that overcome possible trade-offs between containing risks of moral hazard and misaligned incentives, on the one hand, and preserving macro-financial stability, on the other. The paper's key argument – substantiated in Section 4 – is that, at the current juncture, further (substantial) risk reduction is endogenous to the availability of mechanisms for public risk sharing: in other words, progress on public risk sharing is *in and of itself* a conduit for both risk reduction – namely macro-financial and sovereign risks – and for increased private risk sharing. To be enabled, the latter requires public sector policies at the national and European level: contrary to the often-held view that it can be a substitute for further advancing the EMU, private risk sharing follows from a deeper EMU and can only be a complement to public risk sharing (Draghi, 2018).

To some extent, the risk sharing-risk reduction controversy has taken on a somewhat "ideological" meaning – often politically-charged – for various reasons: the weight of legacy issues in some countries; the possible fiscal implications of risk sharing mechanisms, i.e. the scope for financial transfers between euro-area member states; and the potential for trade-offs between risk sharing arrangements and incentive-compatible policies (Bénassy-Quéré *et al.*, 2018).

While these reasons are all relevant, this controversy may ultimately also reflect a trail of mistrust that lingers among EMU member states, which can be ascribed to a number of causes: differences of views about the sources of current and future risks – including from legacy issues – and the attendant policy priorities; perceptions of hesitation to fully comply with current macroeconomic and fiscal rules; concerns over the effectiveness of these rules and surveillance procedures; resistance to the scope (if not the case) for reforming them; a misplaced growth versus fiscal discipline compromise; and the spectres of a "transfer union" and "austerity".

Failure to close the gap between risk reduction and risk sharing may contribute to perpetuating this mistrust. On the contrary, concrete steps toward reinforcing common risk sharing mechanisms would enhance crisis preparedness for the next downturn while boosting confidence and dispelling uncertainty over the commitment to ensure the longer-term viability of the EMU. Uncertainty over a clear, inspiring and shared vision of the future of the EMU and the EU could further fuel the dissatisfaction that the severe impact of the recent crises has spread across Europe.

The rest of this paper is structured as follows. Section 2 reviews the ongoing debate on why and how to make progress towards a more complete EMU, while Section 3 substantiates the asymmetry between risk reduction and risk sharing that has resulted from the post-crisis reforms. Section 4 articulates the reasons for urgently closing the above asymmetry, with a focus on the role of the EDIS. Section 5 reviews the case for a central fiscal capacity and the various design options for this critical element of the EMU. Section 6 offers some concluding remarks.

2. (Safe) Options for strengthening the EMU: integration versus decentralization

Discussions on completing the EMU largely revolve around the proposals set forth in a number of official reports (Box 1), most notably the "Five Presidents' Report" (Juncker, 2015) published in June 2015 and the Reflection Paper on the Deepening of the EMU released by the European Commission (2017d) in May 2017.

Discussions taking place inside European institutions are continuously enriched by an abundance of contributions from academics and policymakers alike. Building on these proposals, as well as on the political guidance by the Ecofin Council and the European Council, the European Commission has put forward several sets of concrete proposals, notably the "Banking Package" (or "Risk Reduction

Box 1 – Official proposals on completing the EMU

At the official level, the current debate was initiated in June 2012 by the report "Towards a Genuine Economic and Monetary Union" by the President of the European Council; it set out a vision for the future of the EMU over a decade, based on four building blocks: three "integrated frameworks" for financial, budgetary and economic policies, complemented by mechanisms to strengthen the democratic legitimacy and accountability of EMU decision-making for "*the joint exercise of sovereignty for common policies and solidarity*".[9] In October 2012, an Interim Report introduced the concept of a "fiscal capacity" for the EMU. The following month, a comprehensive contribution was provided by the European Commission's "Blueprint for a Deep and Genuine EMU – Launching a European Debate" (European Commission, 2012), which envisaged an ambitious three-stage roadmap covering the short, medium and longer term (beyond five years). Deeper policy coordination and surveillance at the European level were meant to be combined with more solidarity and financial support for member states. Importantly, the Blueprint touched upon the legal options and implications of further EMU integration for the integrity of the EU, emphasising the use of a legal basis (Art. 136 TFEU) of the Lisbon Treaty.[10]

In December 2012 the "Four Presidents' Report" (Van Rompuy, 2012) took into account the Blueprint's proposals and envisaged a three-stage sequencing, with priority given to ensuring fiscal sustainability and progressively establishing a Banking Union; the Report also discussed in depth the case for an EMU fiscal capacity and for "contractual arrangements" to foster structural reforms in members states[11]. On December 13-14, 2012 the European Council agreed on the roadmap for the completion of the EMU, based on "*deeper integration and reinforced solidarity*".

Two and a half years later, the Five Presidents' Report (Juncker, 2015) foresaw another three-stage approach to achieve greater union in the four key dimensions. In the first stage ("*deepening by doing*") European institutions and euro- area member states would build on existing instruments and *"make the best possible use"* of the existing Treaties. This stage would include the establishment of the EDIS and the common backstop for the Single Resolution Fund, as well as the transposition into the EU law framework of several intergovernmental agreements created during the crisis (such as the Fiscal Compact and the Single Resolution Fund). Furthermore, initial steps to strengthen democratic accountability and legitimacy would be taken, for example by a more integrated European Semester to allow for more parliamentary control and better cooperation between the European and national parliaments.

The second stage ("*completing EMU*") would encompass specific measures of a far-reaching nature to complete the EMU's institutional architecture, such as a fiscal stabilization function, a treasury and the integration of the ESM into the EU law framework;[12] these measures require amendments to existing Treaties. Once all the previous steps are fully in place, a final stage would mark a deep and genuine EMU.

It is noticeable that, contrary to both the previous Four Presidents' Report and the Commission's Blueprint, the Five Presidents' Report does not contain any reference to the issuance of common debt ("Eurobonds"), while mentioning a path towards a fiscal union and a euro area treasury.

For its part, the European Parliament has come forward with proposals that set out its vision on the future of Europe, while calling for "a qualitative leap in integration" for the euro area (European Parliament, 2017). On March 1st, 2017 the European Commission (2017c) released a White Paper on the Future of Europe.

Package"[13]) in November 2016 (European Commission, 2016b) and the "EMU Roadmap" in December 2017 (European Commission, 2017f), which are at various stage of approval.[14]

[9] A key objective is to ensure that a further integration of policy making and a greater pooling of competences at the European level be accompanied with a commensurate involvement of the European Parliament, on the basis of the guiding principle that democratic control and accountability should occur at the level at which decisions are taken.

[10] See European Commission (2012), Box 1, p. 13.

[11] See Section 5.

[12] The Report did not include a proposal on the European Monetary Fund, which was subsequently launched in the EMU Roadmap of December 2017 (European Commission, 2017f).

[13] The Roadmap to complete the Banking Union approved by the Ecofin Council on 17 June 2016 has set the background for the Banking Package.

[14] See Section 3.2. On the Capital Markets Union (CMU), in September 2015 the European Commission adopted an action plan setting out a list of over 30 actions and related measures to establish the building blocks of an integrated

A continuum of views inevitably defines the current debate on the future of the EMU, with divergences that relate not only to the level of ambition but also to the priorities and sequencing of further reforms. There seems to be broad agreement that more integration – with political union usually seen as a key feature of its final stage – is the option that would provide the strongest foundation for the EMU governance and help overcome what may be viewed as the euro's "original sin": a "currency without a state" (Padoa-Schioppa, 2004, p. 35).[15]

It is therefore no wonder that deeper integration towards a "*deep, genuine and fair*" EMU is not only the objective of the proposals set forth by the leaders of European institutions, but also an option advocated by leading policy makers and academics alike.[16]

A common feature of many such proposals is that they envisage a time-bound, stage-based approach, whereby greater integration is achieved gradually – following a "roadmap" – by making progress in four areas: financial, fiscal, economic and political; besides, greater integration is envisaged to advance in parallel with the necessary improvements in democratic legitimacy and accountability. The various stages are often defined by whether changes to the current EU treaties are required. Given the interlinkages between the four areas, it is usually underlined that measures in each area need to be devised in a holistic way, as elements of a mutually reinforcing package in which each stage builds on the previous one.

European institutions' views on the future of the EMU have been complemented by a long string of analytical contributions. Some proposals (Weidman, 2015; Feld *et al*., 2016) rest on the premise that the EMU institutional framework can ensure stability only if it abides by the "principle of unity of liability and control", whereby policy instruments need to be allocated at the level (national or supranational) where both responsibilities and risks belong. For example, this principle underpins the "Maastricht 2.0" model advocated by the German Council of Economic Experts (Feld *et al*., 2016) and its three pillars of financial regulation, the crisis mechanism (for prevention, management and resolution) and the fiscal framework. While it is acknowledged that the post-crisis reforms of the EMU have moved in the direction of Maastricht 2.0, a further strengthening of these pillars (notably the crisis mechanism) is called for. Risk sharing instruments – an EDIS or a central fiscal capacity – are not allowed until member countries agree on transferring some national sovereignty over economic and fiscal policies to the European level.

More recently, much attention has been paid to a comprehensive proposal by a group of fourteen French and German economists (Bénassy-Quéré *et al*., 2018 and 2019; Pisani-Ferry, 2018), defined by a number of founding principles: the need for reconciling market discipline and risk sharing, fiscal prudence with demand policies, and rules with policy discretion; and the recognition of the existence (and potential seriousness) of trade-offs between risk sharing arrangements and prudent policies. A distinctive feature of this proposal is that, to avoid second-best compromises, it aims at improving policy trade-offs by means of "*a package deal, a grand bargain, a balanced approach*" (Feld, 2018). Other commentators (Messori and Micossi, 2018) offer a less benign view, noting that some elements of this package may increase, rather than reduce, risks to financial stability and weaken the EMU's defences against financial shocks.

capital market in the EU. In June 2017, the Commission updated and complemented the CMU action plan by strengthening existing actions and introducing new measures in response to evolving priorities and challenges.

[15] To be sure, the institutional incompleteness of the EMU is also thought of as a virtue (i.e. a driver of more integration) by the "functionalist" theory of European integration centered on Jean Monnet's "chain reaction" principle. See Spolaore (2013).

[16] See, for example, Visco (2015), Baldwin and Giavazzi (2016), Feld *et al.* (2016), Schäuble (2016), Villeroy de Galhau and Weidmann (2016), Lagarde (2018) and the Meseberg Declaration.

Further contributions to advance integration emphasize that the crisis-driven reforms have reinforced the transformation of the euro area – initiated by the Lisbon Treaty signed in 2007 – from an EMU with a currency *without* a state (as established by the Maastricht Treaty) to a union with a currency *beyond* the state (van Riet, 2016). In the former, EU institutions and all member countries have an *individual* responsibility for the integrity and stability of the EMU; in the latter, sovereignty is shared in areas of vital importance for the functioning of the EMU, while national and supranational policy actors all take on a *joint* responsibility. However, despite this move toward a "post-crisis EMU", progress has so far largely continued to be based on the principle of nation states *coordinating* rather than *sharing* their sovereignty; this results an as yet incomplete institutional architecture, which exposes the euro area to several challenges that limit the effectiveness of crisis prevention, management and resolution. To safeguard the euro as a currency beyond the state, there is a need to move from a post-crisis EMU to a "sustainable EMU": to this end, a further pooling of national sovereignty is called for to achieve a higher level of risk control and risk sharing, subject to the adequate democratic legitimacy of supranational institutions.

This principle of increased risk sharing in exchange for more shared sovereignty cuts across most – if not all – proposals, despite differences and nuances among them. As a result, the defining feature of a deeper EMU is that key national functions and powers are increasingly – but not necessarily completely – centralised at the European level. In exchange for this transfer of sovereignty, new euro area-wide institutions and policy instruments would be created, including for risk sharing. The scope for centralisation appears to be the broadest in the fiscal domain, where the (gradual) establishment of a central fiscal capacity would overcome the euro area's defining institutional asymmetry: a common monetary policy coexisting with fiscal policies that largely remain a national responsibility but, because they are a "matter of common concern",[17] need to be coordinated for the viability of the EMU. In this context, ambitious reform proposals involving the establishment of a euro area treasury or a finance minister would mark a progressive shift from the current rules-based approach to fiscal policy coordination (governed by the Stability and Growth Pact and complemented by the European Semester) to an institutions-based approach.[18]

Given the level of ambition of a fully-fledged EMU, the currently low political appetite for further transfers of sovereignty and the limits to political integration,[19] an opposite route to strengthen EMU governance has been envisaged, based on a "decentralized" approach (or "Maastricht Plus"):[20] responsibilities for economic policy, first and foremost in the fiscal area, are strengthened at the national level. Yet, in order to ensure the viability of the EMU, these responsibilities have to be balanced by tighter rules and procedures aimed at reducing risks and potential negative spillovers to other members that can arise from national economic policies. Furthermore, given the recognition that, if member states retain fiscal autonomy, rules alone would not be sufficient to safeguard the sustainability of public finances,[21] this approach places great emphasis on the need to reinforce market discipline[22] by improving the credibility of the "no-bailout clause" (Article 125 of the

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[17] Article 121 of the Treaty on the Functioning of the European Union, which extends to the EMU, states that "*Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council*".

[18] See Section 5.5.

[19] Eichengreen and Wyplosz (2016) note that it took the U.S. more than a century (and a civil war) before it became a true political union.

[20] Dyson (2012); Weidmann (2015).

[21] Weidmann (2017a).

[22] This rather evocative expression usually refers to the ability of markets to correctly and timely price credit risks by means of risk premia. In the case of a sovereign, risk premia are expected to reflect the sustainability of public finances

Lisbon Treaty-TFEU): this requires isolating sovereign risk from banks' balance sheets and making a sovereign debt restructuring (if not a default) a concrete possibility so that interest rates will correctly price in a sovereign's risk. Another key feature of this approach is that it would require no further transfer of sovereignty, at the price of not allowing for additional risk sharing via common European instruments, i.e. less solidarity.

To sum up, the first option for strengthening the EMU architecture – deeper integration – calls for shared sovereignty as a counterpart to more collective risk sharing; the second option – decentralization – centres on reinforcing national responsibilities, to be balanced by risk reduction through even stricter fiscal and regulatory rules. The two options broadly share the same guiding principle of the unity of liability and control but differ in one major dimension: the first one needs treaty changes that usually require approval by national parliaments and/or referenda; the second one is deemed to be pursued largely under the current legal framework. Even deeper is the difference in terms of the underlying vision: the first route assumes that political union can be the EMU's finish line, while the second one implicitly acknowledges that the euro can survive without a supranational "state".

Against this conceptual background, a source of dissatisfaction about the ongoing process of reforming EMU governance arises from the view that, in practice, neither of these two theoretically "safe" options has been pursued in response to the crisis (Weidmann, 2015). On the contrary, mainly because of policymakers' reluctance to make the necessary – albeit controversial and politically costly – decisions that both of the above options require, the recent reforms of the euro area's architecture are thought to have advanced integration by favouring pragmatic but intermediate "shortcuts" (a "golden medium"): they would initially introduce more fiscal risk sharing without requiring transfers of sovereignty and treaty changes to allow for joint supranational control over national policies. This fault applies even more to the proposals under discussion for a European Deposit Insurance Scheme and common budgetary instruments.

While it is argued (van Riet, 2016) that an incomplete EMU may be acceptable to many governments, because national sovereignty in economic and fiscal policies remains predominant, the *modus operandi* of choosing hybrid, "unsafe" third ways instead of well-policed, "safe" routes towards a deeper EMU is meant to have altered the balance between liability and control, resulting in a key asymmetry between *common* solidarity, i.e. the centralization of functions and instruments at the European level, and *national* sovereignty, i.e. the preservation of country-level control, notably in the fiscal area. This asymmetry is seen as a threat to the stability of the monetary union (Villeroy de Galhau and Weidmann, 2016).

The peril of this asymmetric path to integration is that it would create distorted incentives and risks of moral hazard on the part of individual EMU members: the costs of unsustainable national policies or of insufficient compliance with common rules in the fiscal and financial areas could fall on other euro area member states via spillovers. Without a parallel transfer of control to the central level, additional risk sharing via common backstops might translate into fiscally-strong countries financing, out of national resources, bailouts of undisciplined sovereigns or their banks: the EMU could morph into a much-feared "transfer union". What is perhaps more worrisome from a longer-term perspective, is that by following this pragmatic "golden medium" to integration the EMU governance would end up in a "no man's land" framework of unclearly allocated responsibilities

and, more generally, a sovereign's ability to repay its debt. Market discipline, in other words, assumes the absence of (creditor) moral hazard.

between European and national levels (Weidmann, 2015); the Five Presidents' Report itself would not be immune from similar criticisms.[23]

Overall, despite their incompleteness, the crisis-driven reforms of the EMU constitute critical advances toward strengthening its crisis prevention and resolution capabilities, by affirming the overarching principles that have inspired the whole reform effort: severing the bank-sovereign nexus; fostering ex-ante budgetary discipline; avoiding taxpayer-funded bailouts; restoring proper incentives for markets, bankers and policy-makers alike. At the risk of oversimplifying the reform debate, the practical implementation of these principles requires two complementary set of institutional and regulatory reforms: they aim, on the one hand, at reducing risks in the sovereign and banking sectors and, on the other, at making credible that banks can fail (or be resolved) and governments can effectively tackle sovereign debt problems (including extreme cases of a restructuring/default) without triggering contagion or, worse, a systemic crisis (which would make intervention by governments almost inevitable).

In the banking sector these goals have been pursued by a host of new regulatory reforms and an expanded toolkit for supervisors aimed at ensuring banks' "resolvability" and addressing the "too-big-too-fail" problem (see Section 3.2). In the sovereign area, the establishment of the ESM has provided the EMU with a critical instrument for the management of a sovereign crisis, notably by helping avoid that liquidity strains morph into solvency problems (the ESM is only allowed to support member states that are temporarily illiquid but solvent). An unsustainable sovereign debt requires a restructuring, although a long-standing and even deeper disagreement remains about whether an "orderly" sovereign debt restructuring could ever be engineered, given the risk of contagion. On this front, views start to diverge on two key proposals: (a) whether a statutory insolvency mechanism (or procedure) for sovereigns is needed (possibly involving the ESM),[24] as opposed to the purely contractual approach based on enhancing the Collective Action Clauses already present in sovereign bonds; and (b) whether the current ("privileged") regulatory treatment of sovereign bonds needs to be overcome by introducing risk-weights on banks' holdings of these bonds and concentration limits to contain the fallout of a sovereign crisis on the banking system (other than as a crisis prevention tool).[25]These issues are particularly thorny for the euro area,

[23] In Issing's view (2016), the Report's most dangerous element lies in its ambiguity about achieving additional centralisation without changing the foundational Treaty on the Functioning of the European Union. Saccomanni (2015) sees the Report as a missed opportunity. Baldwin and Giavazzi (2016) lament that the Report is unrealistically ambitious in the long run – to the extent that it essentially aims at something like a United States of Europe – while at the same time insufficiently ambitious in the short run – shying away from reforms that would require a Treaty change.

[24] Proposals by the Deutsche Bundesbank (2016) foresee an automatic maturity extension of bonds issued by a sovereign that enters an ESM programme and expanded collective action clauses. Some proposals would require amending the ESM treaty. Feld *et al.* (2016) call for insolvency mechanisms for sovereigns (inclusive of a creditor bail-in and a rigorous debt sustainability analysis), which would be instrumental in making a sovereign debt restructuring a precondition for ESM support in the event of severe crises.

[25] These proposals are part of a rules-based approach aiming at making an orderly sovereign default a concrete possibility, with a view to strengthening discipline for governments and markets alike. These proposals reflect the view that the main obstacle to a sovereign debt restructuring is not the lack of a formal mechanism but, more substantially, the resilience of the banking system. Proposals to introduce risk weights on banks' sovereign exposure or concentration limits to mitigate the "home bias" are distinctly contentious in ongoing discussions and so far have failed to attract the necessary degree of consensus; these proposals necessitate a comprehensive analysis that goes beyond the scope of this paper. Dell'Ariccia *et al.* (2018) note that there is a trade-off between making sovereign holdings more risk sensitive and limiting regulatory cyclicality; depending on their design, binding exposure limits or risk-sensitive capital weights could increase capital requirements during sovereign distress, encouraging banks to curb or reduce their exposures. See also Weidmann (2015), Lanotte *et al*. (2016), Visco (2016a), Basel Committee on Banking and Supervision (2017). A complementary issue is whether the issuance of common debt instruments, i.e. jointly guaranteed by euro area member states, in the form of Eurobills or Eurobonds, or of a European "safe asset" or sovereign bond-backed securities may help reduce the home bias in banks' portfolios. See European Commission (2012, p. 30) and European Systemic Risk Board (2018).

because of tight economic and financial links, sizeable spillovers between the member states' economies (which increase the risk of moral hazard) and the absence of a central bank with an explicit mandate (or, at least, an established role) to act as a lender of last resort for sovereign borrowers, which *ceteris paribus* may increases the probability of crises (Committeri and Tommasino, 2018).[26]

Major advances notwithstanding, the EMU that has emerged from the crisis has not yet achieved in full the ultimate objective of severing the sovereign-bank nexus. This is mainly owing to the asymmetric progress between risk reduction and risk sharing.

3. An unsafe asymmetry in the EMU: risk reduction versus risk sharing

As evidenced in the previous Section, discussions about the future of the EMU have often been framed in terms of asymmetries to overcome. The historical and most well-known one is that between a single monetary policy and multiple national fiscal policies[27]; but other asymmetries have emerged (or deepened) as a result of the recent reforms of European economic governance.

While banking supervision and resolution have been centralised at the euro area level, by establishing the SSM and SRM, deposit insurance schemes remain decentralised at the national level: the European Deposit Insurance Scheme – the Banking Union's third pillar – has not been established yet.[28] On the institutional front,[29] the reforms are thought to have affected the balance between supranational and intergovernmental decision-making in the EU: measures to increase risk sharing (the ESM, the financing of the Single Resolution Fund[30]), which entail a pooling of financial resources – to make loans, not transfers – have been introduced by means of intergovernmental agreements, as public finances might ultimately bear credit risks. On the contrary, measures aimed at risk reduction in the fiscal and financial sectors (the legislative packages to strengthen economic and fiscal governance – "Six-Pack", "Two-Pack" the Bank Recovery and Resolution Directive but also the SSM and SRM) have been enshrined in EU law (following the "Community method"); the "Fiscal Compact" – another intergovernmental agreement – is a partial (while supposedly temporary) exception (Schimmelfennig, 2015, pp. 189-190; van Riet, 2016, p. 38).[31] It has been argued that the recourse to intergovernmental financing arrangements for the euro area can in part be accounted for by the limited legal options available

[26] These authors review recent proposals on the management and resolution of sovereign debt crises in the euro area, including the introduction of a formal framework for restructuring sovereign debts.

[27] Besides, Wyplosz (2016) distinguishes between fiscal *policy*, which is an instrument decentralized at the national level, and fiscal *discipline*, which is a European requirement grounded on the fact that fiscal policy is a common concern in a monetary union.

[28] Bank deposit protection currently remains under national responsibility although it follows the same rules across the EU. In fact, the proposed EDIS builds on the harmonization of national deposit guarantee schemes (DGSs) achieved through the EU Directive 2014/49, which amended the 1994 Directive to ensure a harmonized level of protection for depositors, faster pay-outs and improved financing of DGS schemes.

[29] The sovereign debt crisis has triggered a debate on whether the European economic governance has become more supranational following the institutional reforms. See Fabbrini and Puesner (2016). In Schimmelfennig's view (2015, pp. 189-190), the new European framework for crisis prevention and management features "*intergovernmental* financial assistance, *supranational* fiscal and economic surveillance, and a Banking Union that combines supranational supervision with more intergovernmental resolution".

[30] Article 19 of the Regulation (EU) no. 806/2014 of 15 July 2014 states that the SRF "should be financed by bank contributions raised at national level and should be pooled at Union level in accordance with an *intergovernmental agreement* on the transfer and progressive mutualisation of those contributions".

[31] Article 16 foresees the incorporation of the Fiscal Compact into the legal framework of the EU within five years of the date of entry into force.

under the Union treaties for creating dedicated crisis management mechanisms for the euro area, the rigid legal framework governing the EU budget, the constraints on the use of EU own resources and the Multiannual Financial Framework ceilings.[32]

Against this background, there is another – perhaps more critical – asymmetry that aptly characterises the EMU's current state of affairs: the significant progress achieved by the recent reforms towards risk reduction in the sovereign and banking sectors is in contrast to the more limited progress towards risk sharing at the European level to address macroeconomic and financial stability risks. The rest of the paragraph substantiates this asymmetry, starting with the sovereign sector.

Before doing that, it should be pointed out that the objective of reducing risks in individual member states is entirely appropriate and progress should continue: strengthening the EMU architecture is no substitute for building resilience at the national level, which is first and foremost the individual responsibility of euro area member states. Robust national frameworks and buffers in the economic, fiscal and financial areas remain the first lines of defence against normal shocks or downturns.

3.1 Risk reduction in the sovereign sector

Sovereign risk in the euro area has been decreased by reducing macroeconomic imbalances and advancing fiscal consolidation in countries under stress, whose efforts to maintain their solvency have been reflected by the massive fall of sovereign spreads from their 2011-12 peaks. The progress in risk reduction is also testified by the fact that, for the first time since the introduction of the euro, in 2019 virtually all EMU member states are expected to have a deficit not above 3 percent of GDP; furthermore, after peaking at close to 95 percent in 2014, the aggregate public debt-to-GDP ratio has been on a downward path and is projected to decline to below 85 percent by 2020.[33]

On the institutional front, the European framework of economic and budgetary surveillance has been substantially strengthened by the previously-mentioned host of new legal acts, namely the Six-Pack, the Two-Pack (which entered into force, respectively, in December 2011 and May 2013), as well as the Fiscal Compact[34], which entered into force in January 2013 in the 25 signatory countries.[35]

To reinforce crisis prevention, a new Macroeconomic Imbalances Procedure (MIP)[36] has been introduced to avert (and correct) the accumulation of imbalances that played a key role in the recent crises. Besides, fiscal discipline through the Stability and Growth Pact (SGP), enforceability of fiscal rules and the involvement of EU supranational institutions in the fiscal sovereignty of member states have all been overhauled. The various measures have resulted in: tighter monitoring and greater *ex ante* coordination of national economic and budgetary policies, centred on the

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[32] Crowe (2018, p. 3). The multiannual financial framework (MFF) is the EU's long-term budget. It sets the limits ("ceilings") for EU spending – as a whole and for different areas of activity – over a period of at least five years. Recent MFFs have usually covered seven years.

[33] European Commission, Spring 2019 Economic Forecast (released May 7, 2019).

[34] This the fiscal part of the Treaty on the Stability, Coordination, and Governance (TSCG) in the Economic and Monetary Union. The name Fiscal Compact, by which the TSCG is usually referred to, was reportedly suggested by ECB President Mario Draghi in a speech before the European Parliament on December 1, 2011. The concept drew inspiration from Alexander Hamilton's statement that "*the origin of all civil government, justly established, must be a voluntary compact between the rulers and the ruled*" (Fabbrini, 2013).

[35] For discussions on this see European Central Bank (2012), European Commission (2012, Section 2) and Eyraud and Wu (2015).

[36] See Bricongne and Turrini (2017) for a recent evaluation.

European Semester; better surveillance of national budgetary plans at an earlier stage (including via a common budgetary timeline) to pursue the correction of excessive deficits; the introduction of an expenditure rule and minimum standards for national fiscal frameworks; a stronger focus on public debt, by making the existing 60 percent of GDP debt limit operational (the "debt criterion/rule") through a debt reduction benchmark;[37] and more emphasis on improving public finances in structural terms (i.e. taking into account the effects on the deficit of an economic downturn or of one-off measures).

Of no less importance is the better automaticity of compliance with the SGP rules arising from the new "reverse qualified majority voting" now required in the European Council to overturn a decision by the European Commission to impose sanctions. Finally, an independent advisory European Fiscal Board has been set up with a mandate to advise the Commission on the overall direction of fiscal policy in the euro area and to evaluate how the EU fiscal governance framework is implemented (something that some view as a way to limit the Commission's margins of flexibility in enforcing fiscal rules).[38]

A further overhauling of fiscal rules has been pursued by the Fiscal Compact, which is meant to have been inspired by the notion that stronger *national* rules and institutions could increase the sense of ownership of *EU* fiscal rules (European Commission, 2017b, p. 4). Regardless of any judgement on its suitability, the Fiscal Compact is considered to be an innovation in terms of centralizing powers to affect and police the budgetary policies of EU member states: by elevating the principle of an annual balanced budget[39] to the constitutional level (or its equivalent), the Fiscal Compact is deemed to have introduced – along with an automatic corrective mechanism – a requirement that is unprecedented in the history of European integration and has the potential to affect the vertical balance of powers between the states and the EU.[40]

Overall, and setting aside any considerations on the effectiveness of the reformed fiscal framework, a key outcome to be highlighted is that the crisis-driven reforms of EU fiscal rules are meant to have resulted in some transfer of fiscal sovereignty from the national to the European level. Baldwin and Giavazzi (2016, p. 29) note that the SGP has been "*substantially stiffened with rather massive amounts of national sovereignty being shifted to European control*". Feld *et al*. (2016) acknowledge that the SGP has been "*effectively tightened, resulting in stronger European control of national financial policy*". In the view of the European Fiscal Board (2018, p. 73), a fundamental change emerging from these reforms is that today the rules aim at providing an "*extremely granular guidance*" for national fiscal policies, with more responsibility shifted to the Commission[41]. These developments seem to be making inroads with regard to meeting the requirement that the

[37] The debt-to-GDP ratio is regarded as diminishing sufficiently and approaching the reference value at a satisfactory pace if the differential of the government debt-to-GDP ratio with respect to the 60 percent of GDP reference value declines by 1/20th on average over a period of three years. The inclusion of this debt reduction benchmark in the Fiscal Compact lifts it to the level of primary law. See Deutsche Bundesbank (2017) for a criticism of the effectiveness of the debt ceiling.

[38] Issing (2016).

[39] The fiscal rule is considered to be respected if the annual structural balance meets the country-specific medium-term objective and does not exceed a deficit (in structural terms) of 0.5 percent of GDP (ECB, 2012).

[40] Fabbrini (2013) notes (p. 9) that the "golden rule" (i.e. a requirement that annual government budgets be balanced) introduced into German law with the July 2009 constitutional reform has served as the model for drafting the golden rule in the Fiscal Compact. Besides, observance of the golden rule has been made a condition for obtaining financial assistance from the ESM.

[41] For example, the Commission's assessment of EU member states' draft budgets is an autonomous legal act that is merely discussed by the Council and does not require any adoption (European Fiscal Board, 2018, p. 74).

establishment of a central fiscal capacity for the euro area be conditioned on more supranational control on national budgetary policies.

Despite various reforms and stricter rules, the ability of the European fiscal framework to achieve its statutory objectives – sustainability of public finances and macroeconomic stabilization – is the subject of fierce debate (see Section 5). A key objection is the increased complexity of SGP rules,[42] which at times can play against national ownership of reforms and their implementation (European Commission, 2017f, p. 12) and may undermine their effectiveness, enforceability and, ultimately, their legitimacy and compliance (Andrle *et al.*, 2015).[43] While, at least in part, the increased complexity is inevitably the consequence of assigning multiple goals to these rules – a sort of attempt to write a "complete contract" – several proposals have subsequently been put forward to simplify them;[44] despite differences, a common element of many such proposals is the introduction of a single operational target (a public expenditure growth rule) usually complemented by a single fiscal anchor (public debt-to-GDP), which promises to strike an appropriate balance between debt sustainability and economic stabilization.

The enforcement capability of the new fiscal rules remains a key test. The Two Pack implies greater involvement of European institutions in national budgetary decisions, in particular the possibility for the European Commission to formulate an *opinion* on national draft budgetary plans or to request a new budgetary draft plan in extreme cases of serious violations of the SGP. However, the current framework does not equip the supranational level with the full power to enforce compliance (for example, a *right* to require a revision of national fiscal decisions that are deemed to be not compliant with the SGP rules).[45]

Moreover, it has been noted that the stricter fiscal rules of the SGP might not be sufficient to adequately strengthen national discipline because their increased complexity results in an expansion of the European Commission's discretion in monitoring the rules, a somewhat paradoxical outcome if one acknowledges that limiting discretion is one of the reasons underpinning the new rules.[46] The Commission is thought to face a conflict of interest owing to its dual role as the guardian of the EU treaty (and enforcer of fiscal rules) and as a political institution (thus pressured to strike a balance between a variety of interests). This conflict of interest may have resulted in the Commission's willingness to accept a compromise at the expense of budgetary discipline. Accordingly, it has been proposed that a separate institution (for example, the ESM) take over some responsibility for fiscal surveillance from the Commission as a step towards a less political approach to enforcing the SGP

[42] See Andrle *et al.* (2015) and European Fiscal Board (2018) for an evaluation of the recent reforms of the EU fiscal governance framework.

[43] This complexity is perhaps best epitomized by the length (220 pages) of the Commission's *Vade Mecum* on the SGP. Wieser (2018) notes that the rules-based system of the SGP has become *nearly unmanageable* due to its complexity, and the constant addition of exceptions, escape clauses, and other factors. Carnot (2017) underlines that complexity acts as a veil masking more fundamental divide. Fabbrini (2014) ascribes the extremely intrusive nature of the rules (not only the SGP's) to the prevailing decision-making processes based on intergovernmental institutions. This has introduced automatic legal measures of intervention, imposed by the Commission, into member states' economic governance that have severely constrained their political discretion (including that of the Ecofin Council).

[44] Claeys et al. (2016), European Fiscal Board (2018), French Council of Economic Analysis (2018), German Council of Economic Experts (2018b), Darvas et al. (2018). Many proposals envisage that nominal expenditure should not grow faster than long-term nominal income; some of them add that nominal expenditure should grow at a slower pace in countries with excessive levels of debt.

[45] This right would require a treaty change (European Commission (2012, p. 26). See Section 5.5.

[46] For example, a source of increased discretion has been the introduction of multiple indicators (i.e. structural balance and expenditure benchmark) of compliance with SGP rules, frequently pointing to divergent assessments that eventually need to be evaluated as part of an "*overall assessment*", which invariably relies on elements of discretion and judgement (European Fiscal Board, 2018, p. 74).

rules.[47] To a significant extent, this discussion is another version of the perennial rules-versus-discretion debate and the many pros and cons that apply.

3.2 Risk reduction in the banking sector

As far as risk reduction in the euro area banking sector is concerned, risks have been massively reduced in three main ways: 1) the establishment of the first two pillars of the Banking Union – the SSM and the SRM; 2) the strengthening of banks' capital, liquidity and leverage requirements through the adoption of a stricter regulatory framework, based on the Basel III standards; and 3) the overhaul of the resolution framework for banks. This effort has centred on such key legal acts as the Capital Requirements Directive IV/Capital Requirements Regulation package of 2013 and the Bank Recovery and Resolution Directive (BRRD) of 2014, which introduced the bail-in instrument.

A further reduction of risks is currently being pursued by the additional important measures on banks' capital requirements and recovery and resolution procedures included in the Banking Package (European Commission, 2016b), proposed by the European Commission on 23 November 2016 and approved by the European Parliament and the Ecofin Council in May 2019. These measures introduce more risk-sensitive capital requirements, binding leverage and net stable funding ratios and the build-up of "bailinable" liabilities, i.e. the necessary amount of capital and debt that each bank in the EU must hold to provide an appropriate loss-absorption capacity, with a view to facilitating a recapitalization in case of resolution and an effective application of the bail-in instrument[48]. Furthermore, following the approval in July 2017 by the Ecofin Council of the Action Plan on NPLs, in March 2018 the European Commission presented a package of measures to address the risks related to high levels of NPLs in Europe.

The substantial progress in reducing risks in the financial sector – in terms of improved banks' capital and liquidity positions and decreased leverage, increased loss-absorbing capacity and a further reduction of NPLs – has been extensively detailed by the European Commission, most recently in a monitoring report released in June 2019 (European Commission, 2018c and 2019).

3.3 Progress on risk sharing

In addition to improved rules for surveillance and policy coordination, the EMU architecture has been greatly improved by means of new instruments for crisis prevention and resolution. A turning point in this regard was the establishment in October 2012 of the European Stability Mechanism (ESM) as a permanent successor to the European Financial Stability Facility (EFSF), set up as a temporary solution in June 2010. The ESM, introduced by an intergovernmental treaty, is a lender-of-last-resort arrangement to provide financial assistance to euro-area sovereigns experiencing or threatened by severe financing problems. Financial assistance by the ESM is usually tied to a macroeconomic adjustment programme with strict conditionality.[49] The main goal is to give sovereigns facing temporary liquidity problems a "breathing space" and restore the sustainability of their public finances, while containing the risk of contagion and negative spillovers for the euro area

[47] Deutsche Bundesbank (2017), Weidmann (2017a). Wyplosz (2016, p. 573) takes a similar view.

[48] These requirements are known as the Total Loss-Absorbing Capacity (TLAC), devised by the Financial Stability Board, and the Minimum Requirement for Own Funds and Eligible Liabilities (MREL), introduced into EU law in 2014 through the Bank Recovery and Resolution Directive. While the TLAC requirement only applies to global-systemically important institutions (G-SIIs), the MREL covers all EU banks.

[49] The ESM has been labelled as "federalism by exception" whereby the supranational level may impose an adjustment programme in times of crisis (Bénassy-Quéré, 2016).

as a whole, notably those arising from bank-sovereign "doom loops": the latter have come to epitomize the sovereign debt crisis, greatly influencing the ensuing policy response.[50]

The risks of observing these (two-way) loops, and more generally the risks of liquidity crises and contagion are more prominent in a currency union for two main reasons: first, euro-area governments issue debt in a "foreign" currency, i.e. one which they do not control by fiat; and second, partly because fiscal policy remains a national responsibility of euro-area member states, the European Central Bank lacks an established role to act, under any circumstances, as a lender of last resort for sovereigns. On the contrary, "stand-alone" countries such as the U.S., Japan and the U.K. issue sovereign bonds in their own currencies and their national central bank can act – and has acted – as a backstop for government funding and a lender of last resort in the sovereign debt markets; this *de facto* implicit guarantee is most notably needed to guard against self-fulfilling dynamics and problems of multiple equilibria (De Grauwe, 2013; Draghi, 2014).[51] The latter materialized in the euro area during the sovereign debt crisis, when spreads on some government bonds exceeded the levels deemed to be consistent with their macroeconomic and fiscal "fundamentals" by incorporating the "redenomination risk", i.e. the risk of a break-up of the euro area (Di Cesare *et al.*, 2012).

The ESM has introduced elements of fiscal risk sharing through two main channels. On the one hand, the interest rates on its loans currently do not include a risk premium and are thus below what countries would be charged by markets.[52] As a result, the ESM permits significant budget savings for all countries that have committed to an adjustment programme, a form of fiscal solidarity. Greece has benefited the most, with budget savings from ESM/EFSF loans approaching 7 per cent of GDP in 2017 (European Stability Mechanism, 2018, p. 41, Table 2).

On the other hand, the official loans provided by the ESM/EFSF to distressed euro-area economies have helped maintain a certain level of public expenditure, which in turn has supported consumption smoothing and reduced consumption growth differentials across countries. Empirical research (Cimadomo *et al.*, 2018) shows that whereas in the early years of the EMU only 40 per cent of country-specific output shocks were smoothed, in the aftermath of the sovereign debt crisis about 65 per cent of these shocks were absorbed because of the operations of supranational financial mechanisms (as well as of higher financial integration). These outcomes point to the power of (private and public) risk sharing mechanisms to improve the EMU's shock absorption capacity.

The ESM has significantly enhanced the EMU's crisis management capabilities and is set to take on an even stronger role going forward to become a keystone of its institutional architecture; several proposals have been put forward to provide the ESM with additional tasks and instruments, also to surmount some design constraints that may have reflected the pressure of the crisis and the urgency of having new tools to address it.

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[50] It is often underscored in the literature that the Euro Summit of 29 June 2012 established the Banking Union on the ground that it was "*imperative to break the link between banks and sovereigns*". As noted by Spolaore (2013, p. 139), the close links between banks and sovereign states in Europe can create not only dangerous spillovers and crises but also clashes between the supranational authorities and national governments.

[51] Winkler (2014) and Claeys (2017) discuss the arguments underlying the ECB's lender of last resort role for banks as opposed to governments. According to its Statute, the ECB is allowed to buy government bonds in the secondary markets as part of its open market operations.

[52] The ESM finances its assistance programs by issuing bonds and bills at very favourable rates because of its high credit rating based on the high paid-in capital. The interest payments to the ESM by programme countries are the same as those the ESM pays in the market.

The EMU Roadmap presented by the European Commission in December 2017 includes a proposal to transform the ESM into a European Monetary Fund (EMF);[53] it would be anchored within the EU legal framework to overcome its current intergovernmental nature, which may impact on governance and decision-making in crisis management (Leipold, 2012). In the Commission's view, this development aims to improve the transparency and efficiency of the EU's financial resources as well as the cooperation with the Commission itself and the accountability to the European Parliament. The change in the legal character of a future EMF is however a key source of debate (and disagreement).

Proposals to reinforce the ESM are also part of the Meseberg Declaration of June 2018[54] and are included in the statement issued on November 1st, 2018 by the ten countries of the New Hanseatic League. A critical difference from the Commission's view is that these proposals keep the ESM as an intergovernmental institution; the Meseberg Declaration postpones its incorporation into EU law to an indefinite "second step", while adding the all-important condition of "*preserving the key features of its governance*" i.e. the decision-making would stay with the member states.

While the transformation into an EMF remains a matter of debate, the ESM will nevertheless be strengthened with the approval of the reforms endorsed by the European leaders in December 2018, which in part reflect some of the European Commission's proposals.[55] The ESM has been officially tasked with providing the common backstop for the Single Resolution Fund (SRF),[56] in the form of a revolving credit line whose size will be aligned with the target level of the SRF (with a nominal cap). The backstop will be a last resort instrument, bound by the principle of fiscal neutrality in the medium-term; it will cover all possible uses of the SRF, including liquidity provision, subject to adequate safeguards.

Furthermore, the reform makes the ESM's precautionary instruments – notably the Precautionary Conditioned Credit Line (PCCL) – potentially easier to access and more attractive, by spelling out that access depends only on meeting *ex-ante* eligibility criteria (and the signing of a Letter of Intent by the country that commits to the "*continuous adherence to the ex-ante eligibility criteria*"): this new qualification is crucial as it makes it clear that access does not require a full adjustment programme with *ex-post* policy conditions (and a Memorandum of Understanding whose signature requires the unanimity of the ESM Board).

[53] In its Opinion of April 11, 2018, the ECB generally supported the Commission's proposal but objected that the term "monetary" is inaccurate, specifically because the objectives and tasks of the ESM are not "monetary" in nature.

[54] See Eichengreen (2019) and Enderlein and Guttenberg (2018) for a discussion of the euro area reforms proposed in the Meseberg Declaration and Roadmap.

[55] Term sheet on the ESM reform, 4 December 2018. Amendments to the ESM Treaty were agreed by the Eurogroup at its meeting of June 13, 2019. For the reform to be effective, the revised ESM Treaty will have to be ratified by all 19 ESM members, which will require the involvement of national parliaments.

[56] The decision to develop a common backstop for the SRF, which would become fully operational at the latest after 10 years, was made by the Ecofin Council of 18 December 2013. The SRF is funded by ex-ante contributions paid annually at individual level by all credit institutions and certain investment firms established in the 19 participating Member States within the Banking Union. The SRF is being gradually built up during a transitional period of 8 years (2016-2023) and shall reach the target level of at least 1 percent (or approximately €55-60 billion) of the amount of covered deposits of all credit institutions within the Banking Union by 31 December 2023. As of July 2018, the SRF has collected about €25 billion. According to the Intergovernmental Agreement (IGA) on the transfer and mutualization of contributions to the SRF, contributions are allocated to different compartments corresponding to each participating Member State (national compartments) during the transitional period. These compartments will be merged progressively and will cease to exist at the end of the transitional period. The Single Resolution Fund can only intervene after applying a bail-in of 8 percent of the total liabilities including own funds of the institution under resolution and with a limit of 5 percent of these liabilities.

As a result, a key benefit expected from this reform is that it can fill what has been identified as a critical access-to-liquidity gap in the ESM toolbox (Claeys and Collin, 2018; Guttenberg, 2018): so far, for countries with strong fundamentals and no risk of insolvency but facing market pressure (possibility due to contagion), a liquidity squeeze and attendant risks of a self-fulfilling debt crisis, there seemed to be no clear European instrument to turn to. All the instruments available in the ESM toolbox to address temporary funding needs have been interpreted as needing some form of adjustment programme that requires negotiations with euro-area partners and can come with a considerable stigma, i.e. political costs for the asking government. By using a "two-fold" conditionality – first, ex-ante eligibility criteria and, second, a formal commitment to continuously respect these criteria – the reform may mitigate some key disincentives to requesting a PCCL.

This clarification helps to better defy the two tracks of ESM action: liquidity and solvency; as a result, the expanded toolkit and reinforced conditionality allow the ESM to become, in a liquidity crisis, the "political validation of debt sustainability", i.e. it certifies the condition necessary for the ECB to activate the OMT instrument, which can only be deployed in conjunction with an ESM programme (such as a PCCL, not necessarily a full adjustment programmes with ex-post conditionality) (Claeys and Collin, 2018).

The reform also expands the ESM's involvement in the management of financial assistance programs and the design of policy conditionality, alongside the European Commission (in November 2018, the Commission and the ESM agreed on a joint position regarding their future cooperation).[57]

Despite their importance in improving the ESM's crisis management capabilities, the practical impact of the reforms remains to be tested and concerns have been raised that it might be somewhat diminished by a number of governance factors (Guttenberg, 2019).

One of the thorniest issues – an "*institutional puzzle*" (Enderlein and Guttenberg, 2018) – is how to strike a balance between allowing fast decision-making while preserving unanimity as the standard voting rule for major ESM decisions, notably those about granting financial assistance. In fact, the effectiveness of a crisis management mechanism greatly depends on its ability to be deployed rapidly as banking crises usually need to be resolved over a weekend.

In the EMU Roadmap of December 2017, the European Commission included a proposal that envisaged in "specific urgent situations" a "reinforced qualified majority" – 85 per cent of the votes – for decisions by the ESM/EMF on financial support, disbursements and the deployment of the backstop facility to the SRF, while maintaining unanimity voting for all major decisions with a financial impact (e.g. capital calls).

Article 4(4) of the ESM treaty already provides for an "emergency voting procedure" – with a qualified majority of 85 per cent – that can be invoked in cases where "*the Commission and the ECB both conclude that a failure to urgently adopt a decision to grant or implement financial assistance would threaten the economic and financial sustainability of the euro area*".

Fast decision-making is clearly necessary also when the ESM deliberates on the activation of the SRM backstop. In December 2018, the proposed ESM reform had retained the unanimity requirement (adding that this would be "*guided by a number of criteria*") for disbursements under

[57] https://www.esm.europa.eu/press-releases/joint-position-future-cooperation-between-european-commission-and-esm
The ESM's FAQs specify that, going forward, the ESM will be more involved in the design of policy conditionality as any future MoU will be signed by both the Commission and the ESM. The Commission and ESM would jointly prepare the financial stability, financing needs, and debt sustainability assessments required to agree on new programs. In cases where the ESM and the Commission do not agree on the debt sustainability analysis (DSA), the Commission would be responsible for the overall DSA assessment, while the ESM could assess the country's ability to repay the ESM loan.

the SRM backstop,[58] while endeavouring to put in place "*procedures…to allow for swift and efficient decision making to fit the timeline of resolution*". In June 2019, the Eurogroup agreed on the revisions to the ESM Treaty and a new Article 18A was introduced to include the above emergency voting procedure. This is an important step for fostering effective crisis management.

More fundamental doubts have been raised about whether the ESM reform truly makes access to the PCCL easier, as the eligibility criteria,[59] of both qualitative and quantitative nature, to access this facility have been made stricter. A simulation by Claeys and Collin (2018) shows that more than half of the euro area countries (including France, Italy and Spain) would not be able to access the PCCL. Besides, one of the eligibility criteria is based on the structural deficit, which is an impractical indicator fraught with measurement issues. Guttenberg (2019) concludes that the reform of the PCCL has worsened the accessibility to ESM precautionary lending, thus weakening crisis prevention and increasing the chance that a full ESM programme remains the most viable option when a crisis has already broken out. Finally, it remains uncertain whether the ECB is ready to recognize the PCCL as an eligible programme through which a country can access the OMT.

Finally, the limited ESM financial resources[60] relative to the size of the euro area government bond markets remains a recurrent issue raised by those commentators who question the ESM's ability to prevent or manage a crisis in a systemic sovereign country. De Grauwe (2012) argues that only with a banking licence (i.e. with the indirect involvement of the ECB and the attendant, potentially unlimited access to the Eurosystem's liquidity facilities) would the ESM gain the credibility needed to effectively address the risks of sovereign liquidity crises, self-fulfilling dynamics and bad equilibria, ultimately all signs of the fragility of an incomplete monetary union. However, in an Opinion published in March 2011 the ECB ruled out this option, by stating that a banking licence would contravene the prohibition of monetary financing in Article 123.

Dosi *et al.* (2018) question the ESM's effectiveness in fostering financial stability and crisis prevention, not only because of its limited resources but also in the face of decision-making constraints from a complex governance structure. They propose moving from a loan-based to an insurance-based structure and gradually transforming the ESM into a guarantor of the public debts of euro-area countries in situations of high-distress, in exchange for risk-based premia that accumulate as capital contributions to an Insurance Fund. The ESM guarantee would allow for a mutualization of sovereign risks by gradually substituting expiring national government bonds with newly issued ESM-guaranteed government securities including risk-sharing clauses. Risk of moral hazard is addressed by the fact that only countries whose sovereign risk is above the euro-area average would be required to pay risk premia. Furthermore, under the authors' proposal, the ESM would also take on a minimal stabilization role, by financing investment projects through the issuance of its own supranational bonds. The latter would contribute, along with ESM-guaranteed government bonds, to the creation of a European safe asset.[61]

[58] Term sheet on the European Stability Mechanism reform (4 December 2018).

[59] The debt benchmark (public debt-to-GDP ratio below 60 per cent or a reduction in this ratio of 1/20th per year); the minimum benchmark (a structural balance providing a safety margin against the 3 per cent threshold under normal cyclical conditions); the deficit rule (government deficit below 3 percent of GDP); not experiencing excessive imbalances; not being subject to the Excessive Deficit Procedure. In addition to these criteria, a sovereign debt should be sustainable.

[60] The ESM has a subscribed capital totalling €704.8 billion, of which €80.5 billion has been paid-in by its members. The part of the ESM capital that is subscribed but not paid is in the form of 'callable shares' that member countries have to disburse *pro quota* upon request from the ESM at any time in the event of need. The ESM lending capacity is capped at €500 billion.

[61] At the European level, consensus on the case for a safe asset remains elusive.

4. Closing the gap between risk reduction and risk sharing

Overcoming the remaining EMU architectural gaps requires closing the asymmetry between risk reduction and risk sharing with a view to complementing efforts at advancing structural reforms and rebuilding buffers in individual member states. This priority builds on the following main arguments: 1) the relevance at the current juncture of macroeconomic risk (and its impact on financial stability); 2) the currently limited degree of overall risk sharing in the euro area; 3) the stabilizing power of risk sharing mechanisms; 4) and the ability of risk sharing to be *in and of itself* a conduit for risk reduction.

The main risk that both sovereigns and banks face going forward is macro-financial risk, arising from a deceleration of growth or, worse, a new recession. It is worth recalling that, until the recovery strengthened in 2015, the euro-area economy had been suffering from low *nominal* growth, i.e. a combination of modest *real* growth – mainly driven by low investment – and low inflation. This made both fiscal consolidation and the sustainability of higher public and private debts resulting from the crisis more difficult. In this regard, it should be noted that, despite the substantial decline in interest rates following the monetary policy response to the crisis, a positive interest-growth differential – partly due to high sovereign risk premia – accounts for the bulk (40 per cent) of the increase in the public debt-to-GDP ratio in the euro area in the years 2008-2013 (Eyraud and Wu, 2015). Low nominal growth also poses risks to financial stability by hitting banks' profitability, which also suffered from high provisioning against elevated nonperforming loans.

The overall degree of risk sharing in the euro area remains lower than in other monetary unions. Allard *et al.* (2013, p. 14-15) note that while the U.S., Canada or Germany manage to smooth about 80 percent of local shocks, the euro area is only able to insulate half that amount. In the same vein, Furceri and Zdzienicka (2013) point out that in the euro area risk sharing mechanisms are not able to provide a level of insurance against normal business cycle fluctuations – let alone severe recessions – comparable to the one in the United States and Germany. Of particular interest is the fact that, before the establishment of the EFSF/ESM, the overall level of risk sharing in the euro area was nearly the same as in the EU. This would suggest that euro-area members had not benefited from any additional risk sharing over and above that seen amongst EU members, despite having sacrificed domestic monetary autonomy (Allard *et al.*, 2013, technical background note, pp. 8-9).

These results are due to a combination of both low market-based (private) risk sharing, as capital markets in the euro area play much less of an insurance role than elsewhere, and non-existent fiscal (public) risk sharing, as the EU budget is only 1 per cent of the area-wide GDP and lacks a stabilization function. On the contrary, in the U.S. fiscal transfers from the federal budget contribute significantly to the absorption of state-specific shocks (10-15 per cent).[62]

Risk sharing mechanisms proved to be most effective in fending off the threat of a euro-area breakup at the peak of the crisis in mid-2012. The establishment of the European Stability Mechanism and the adoption by the ECB Governing Council of the Outright Monetary Transactions (OMT) – never used to date – have marked key turning points in overcoming the crisis.[63] As noted

[62] Fiscal risk sharing for federations has been estimated to range between 10 and 25 per cent of regional income shocks. In contrast, income smoothing via market-based channels is estimated to be much larger, at about 45 per cent through national capital markets and about 20 per cent through credit markets (Allard *et al.*, 2013, technical background notes, p. 8). Besides, financial integration in the EMU remains biased towards (more procyclical) debt finance, as cross-border equity holdings are still modest.

[63] In the press conference of 22 January 2015 introducing the ECB's expanded asset purchase programme, President Draghi underlined that "*in OMT full risk-sharing is fundamental for the effectiveness of that monetary policy measure*". Altavilla *et al.* (2016) finds that OMT announcements decreased the Italian and Spanish 2-year government bond yields

before, empirical evidence shows that the availability of supranational financial mechanisms, such as the ESM and the EFSF, has provided a degree of public risk sharing that has been instrumental in cushioning the fall of consumption in some countries hit by the sovereign debt crisis.

The material contribution of these instruments to improving macro-financial stability offers two main lessons: 1) the sovereign debt crisis was to some extent aggravated by the unavailability of euro area-wide crisis management mechanisms, which the Maastricht Treaty had neglected partly on the grounds that they would act as an incentive to moral hazard (Dyson, 2012, p. 802); and 2) risk sharing tools can be most powerful to restore confidence in the EMU and risks of moral hazard can be appropriately addressed.

Further progress towards increasing risk sharing is particularly important at the current juncture as it can be *in and of itself* instrumental in achieving further risk reduction for a number of reasons.

With monetary policy rates at record lows and fiscal buffers still needing to be rebuilt in some member states, the policy space to address a deceleration of growth in the EMU is currently more limited than in the past. National fiscal buffers alone may be insufficient to deal with asymmetric shocks and large downturns and the tendency of national fiscal policy to be pro-cyclical may have not been addressed by the reformed European framework for fiscal governance (Alcidi and Thirion, 2016). As a result, better countercyclical capabilities at the central level would support growth and reduce macroeconomic risks, which in turn would lower sovereign risk.

Fiscal risk sharing mechanisms can also reduce risks by fostering market discipline in so far as they reinforce the credibility of the no-bailout clause while making sovereign spreads more likely to reflect fiscal fundamentals than self-fulfilling expectations (Berger *et al.*, 2018, pp. 25-26). The U.S. is a case in point in this regard, as both the credibility of the federal "no bailout" commitment and the ability of states to adhere to self-imposed balanced-budget rules depend, at least in part, on the availability of a minimum of fiscal risk sharing (Henning and Kessler, 2012).[64]

Furthermore, fiscal risk sharing mechanisms enable the development of market-based risk sharing as the existence of a credible form of government insurance works to catalyse the provision of market insurance by investors' behaviour and become mutually reinforcing (Allard *et al.*, 2013, p. 16). Contrary to the often-held view that it can be a substitute for further advancing the EMU, private risk sharing follows from a deeper EMU and can only be a complement to public risk sharing (Draghi, 2018).

Finally, risk sharing through a central fiscal capacity can foster risk reduction in so far as it explicitly links supranational support for stabilization to compliance with the macroeconomic and fiscal rules.

A more balanced approach towards completing the EMU requires that risk sharing and risk reduction act as complementary drivers of "safe" European integration. Closing the asymmetry rests on advancing the following well-recognised priorities:

- introducing the common backstop for the Single Resolution Fund earlier than the steady state date of 2024;
- completing the Banking Union by reaching an agreement on a clear timeline for the establishment of a EDIS;
- beginning to gradually establish a supranational macroeconomic stabilization function for the euro area.

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by about 2 percentage points. These authors' simulations show that the reduction in bond yields due to OMT announcements is associated with a significant increase in real activity, credit, and prices in those countries.

[64] See also Section 5.1.

These priorities need to be complemented promptly by actions to advance the Capital Markets Union and increase the scope for private risk sharing.[65]

The December 2018 Euro Summit decision to operationalize the ESM as a common backstop to the SRF is an important step towards developing a more effective European financial safety net. While the backstop is scheduled to be established by 2024 at the latest, it would be of key importance – including from a purely signalling point of view – to introduce it earlier than that deadline, thus recognizing the achieved reduction in risks. The political decision on the early introduction of the backstop is expected to take place in 2020, based on the progress made in reducing NPLs and building up MREL buffers.[66]

Completing the Banking Union is of the essence to deliver on the founding objective of breaking – rather than merely lessening – the bank-sovereign nexus. The latter is characterized by a complex and multidimensional nature and operates through multiple interacting channels (Lanotte *et al.*, 2016; Dell'Ariccia *et al*., 2018): the sovereign-exposure channel (direct balance sheet exposure arising from banks' holdings of sovereign bonds); the safety net channel (implicit and explicit government guarantees for banks); and the macroeconomic channel (the soundness of sovereigns and banks is affected by economic activity). Given this multiplicity of channels, the much-needed measures adopted so far – strengthened sovereign and bank balance sheets, stronger regulatory and supervisory frameworks, higher loss absorption buffers and the bail-in requirement – may have only weakened the nexus and left most of the fundamental links between banks and sovereigns intact (Berger *et al*., 2018). An incomplete Banking Union is thus a risky construct: without a European financial safety net, banks' funding costs could remain closely linked to high sovereign spreads, a systemic banking crisis could still jeopardize a country's fiscal stability while sovereign distress would inevitably remain a threat to the stability of banks (Goyal *et al.*, 2013, p. 19).

4.1 The European Deposit Insurance Scheme

The EDIS is the necessary third pillar of a complete Banking Union. The asymmetry between supervision and resolution at the European level and deposit guarantee systems (DGSs) that remain at the national level generates a mismatch between supranational oversight and national liability.[67]

As a risk sharing mechanism, the EDIS would reduce financial stability risks through three main channels. The EDIS would provide a more uniform degree of insurance for all retail depositors in the Banking Union, thus ensuring that their confidence in a bank does not depend on its location. A case in point is the decision of Nordea Bank AB, a (former) global systemically important bank (G-SIB), to re-domicile its headquarters from Sweden to Finland, effective October 2018. This move might in principle affect financial stability risks in the short term, because the Finnish banking system is estimated to have roughly doubled in size (to 400 per cent of GDP), becoming one of Europe's largest relative to the size of the national economy (Sveriges Riksbank, 2018). This, in turn, leads to a substantial increase in the commitments of the Finnish deposit guarantee system, which also becomes responsible for non-resident depositors given the recently-adopted branch

[65] See European Commission (2018d) for an update.

[66] In particular, an assessment by competent institutions will be made against two indicators: 1) NPLs, with an objective of 5 per cent gross NPLs, and 2.5 per cent net NPLs or adequate provisioning, for all SRB banks and progress thereto; 2) subordinated bail-in buffers, which banks should build up steadily in line with the 2024 targets and 2022 intermediate targets.

[67] Nouy (2017). To underline the need for responsibilities to be rebalanced, Nouy notes: "*If, for instance, the Spanish Banco Popular had actually failed, Portugal's deposit insurance scheme would have had to refund depositors in the Portuguese subsidiary. That is a consequence of having supervision and resolution at European level. The Portuguese authorities would not have been involved in either process*".

structure of Nordea's retail operations.[68] As noted by the Sveriges Riksbank (2018), the currently limited risk sharing within the Banking Union and thereby Finland's increased responsibility may affect the scope for effectively dealing with a crisis; the Finnish deposit guarantee system has a lower coverage ratio than its Swedish equivalent (at the end of 2017, 0.8 per cent – in line with the target level of the EU deposit guarantee directive – versus 2.4 per cent).[69]

Another critical benefit of the EDIS is that it would mitigate the incentives for geographical ring-fencing of banks' capital and liquidity by national authorities: the protection of national DGSs is indeed the main reason usually cited to justify such practices (Schnabel and Veron, 2018). Howarth and Quaglia (2018) argue that in some countries (e.g. Austria and Germany) opposition to the EDIS can be accounted for not only by moral hazard concerns but rather – perhaps mostly – by fears that well-funded national DGSs – especially those of small savings and cooperative banks – could become net contributors to compensate for underfunded DGSs in other member countries; these fears are stronger in countries where DGSs are largely funded *ex ante*, while *ex post* funding may have prevailed in other members' DGSs before the revised 2014 Directive. The authors maintain that national preferences on the EDIS are largely determined by the structure of existing national DGSs, which in turn are closely linked to the configuration of national banking systems.

Equally important, the EDIS would provide a multi-faceted contribution to severing the bank-sovereign nexus. National DGSs can be vulnerable to sizeable country-specific shocks, namely a systemic banking crisis. Gros and Belke (2015, p. 57) emphasize that the banking crises in Iceland and Spain show that the real problem in deposit insurance does not come from strains in individual banks but by systemic risk: a systemic crisis may undermine the solvency of the sovereign and its ability to act as the national fiscal backstop for the DGS when it is needed the most. On the contrary, the EDIS would draw on a larger pool of resources that offers a stronger absorption capacity against large shocks.

Simulations by the European Commission (2016c) using all three models – mandatory reinsurance (as in stage 1 of the EDIS), mandatory lending and a fully-mutualized fund (the steady state under the EDIS proposal) – show that pooling risk delivers in every circumstance a significantly stronger deposit guarantee system than a system of purely national schemes with voluntary lending. The EDIS performs better than the mandatory reinsurance and lending schemes both in providing liquidity and absorbing losses. Besides, while all options offer a neutral solution in terms of the total cost of the intervention, the EDIS offers a more balanced redistribution of losses across banks, which does not penalize banks for their nationality but only for the way they manage their risk exposures.

By providing a degree of risk sharing through a common fund, the EDIS would thus act in and of itself as a conduit for risk reduction, notably sovereign risk, as it lowers the risk that banks' problems translate into a call for a government's financial support when the resources of the national DGS are insufficient. Furthermore, rather than playing a microeconomic role (i.e. failure of individual banks), by acting as a mechanism for reinsurance against large shocks the EDIS would perform a macroeconomic function, namely providing funding in case of a national systemic crisis related to such variables as excessive house prices or corporate leverage (Gros, 2015).

[68] According to the Finnish Financial Stability Authority, in an interview with Svenska Dagbladet, the Finnish deposit insurance system's commitment is estimated to increase by about €80 billion of guaranteed deposits, or almost 150 per cent (Sveriges Riksbank, 2018). In January 2017, Nordea completed the cross-border mergers of its subsidiary banks in Denmark, Finland and Norway, which have been transformed into branches.

[69] On its website, the Finnish Deposit Guarantee Scheme notes that if the target country's deposit guarantee has more extensive cover than the Finnish deposit guarantee, supplementary cover for the branch's deposits may have been requested from the target country's scheme. In the same vein, on its website, Nordea reports that it has also joined the Danish, Norwegian and Swedish deposit guarantee schemes as a supplement to the Finnish coverage.

The proposal for establishing the EDIS was first announced by the European Commission in November 2015 (European Commission, 2015d);[70] it included strong safeguards against moral hazard and envisaged an implementation of the EDIS, in parallel with the building up of the Single Resolution Fund, in three stages: re-insurance, co-insurance and full insurance, the latter set to be achieved only in 2024.

A European Deposit Insurance Fund (DIF) would be established to complement existing national DGSs, funded by contributions levied on banks. The DIF would be distinct from the SRF but would be administered by the SRB with an appropriately modified governance to manage potential conflicts of interest between the resolution and deposit guarantee functions. The (pre-funded) size of the EDIS is proposed at 0.8 per cent of the amount of covered deposits.

In the face of a deadlock on the EDIS proposal, particularly regarding the last (full mutualization) of the three envisaged implementation stages, in its October 2017 Communication on completing the Banking Union, the European Commission presented a revised proposal to introduce the EDIS in a more gradual way, commensurate with the progress achieved in risk reduction and the tackling of legacy issues[71]. More precisely, in the reinsurance phase the EDIS would only provide liquidity to national DGSs in the event of a bank failure, liquidity that would have to be paid back. In the co-insurance phase, the EDIS would also progressively cover losses – starting with a 30 per cent coverage – without recouping them from the national DGS: this would mark a key step toward further weakening the link between banks and their sovereigns. Importantly, moving from the re-insurance to the co-insurance phase would no longer be automatic but rather conditional on an asset quality review (covering NPLs and Level III assets) and a reduction of NPLs on banks' balance sheets.

It is key to note that the revised EDIS proposal no longer explicitly mentions a full mutualization phase, but only refers to a "final stage". As noted by Carmassi *et al.* (2018, p. 11), the Communication does not provide any information on how the progressive increase in the coverage of losses from the initial 30 percent ratio would take place: therefore, the path of mutualization is unclear although full-insurance in the steady state is expected to remain a possibility given the Communication's indication that the original proposal "*remains on the table unchanged*".

Objections to the EDIS revolve around three main arguments: legacy issues; cross-subsidization; and moral hazard risks.

The main objection is that, given the considerable share of sovereign bonds in their portfolios, banks would not be in a position to absorb the impact of a sovereign default or debt restructuring (which imply haircuts): some national DGSs within the EDIS might have to share in the losses suffered by other member states' banks on their holdings of sovereign bonds. As a result, the effects of a sovereign distress could be mutualized under the EDIS via the direct effects on the sovereign' banks: the EDIS could thus end up serving to co-insure the risk of a sovereign default in another country (Demertzis and Wolff, 2016; Weidmann, 2017b). Further concerns arise from the high stock of NPLs in some banking systems, which may raise the risk that common resources could be devoted to paying for national liabilities (Feld *et al*., 2016).

In practice, the EDIS is being held back by proposals that impose a few preliminary conditions aimed at reducing potential risks from legacy issues. A highly contentious proposal calls for the imposition of regulatory capital requirements – i.e. non-zero risk weights – on banks' exposures to

[70] It should be noted that the Commission's proposal relates to a fully-fledged EDIS; an alternative would be a "mixed scheme" whereby national DGSs would intervene first while the EDIS would only step in as a second line of defense. See Carmassi *et al.* (2018).

[71] European Commission (2017e). See Kudrna (2018) for a detailed description of the evolution of the Commission's proposal on the EDIS (as well as on the SRF backstop).

sovereign debt as well as the introduction of concentration limits to such exposures or concentration charges; removing this sort of "exorbitant privilege" for sovereign bonds to reduce sovereign risk is often seen as an "indispensable complement" to the EDIS.[72] A further reduction of high NPL ratios in banks' balance sheets is also called for as another precondition.

These views seem to overlook the fact that since risk sharing, by design, is intended to address future risks, legacy issues should not be allowed to stand in the way of improving the EMU's institutional architecture: if anything, legacy issues should be addressed outside of risk sharing mechanisms (Berger *et al.*, 2018, p. 33). More fundamentally, the direct exposure of banks to a sovereign via government bonds is not the most important channel through which the sovereign-bank nexus operates, as the macroeconomic channel plays a much more significant role regardless of a bank's holdings of sovereign bonds.

The staged approach with a gradual mutualization that characterizes the Commission's proposal for the EDIS aims at overcoming the key objection that the scheme could be employed to solve legacy issues and improving the chance of establishing the EDIS before legacy risks are fully dealt with (Micossi, 2017).

A second argument raised against the EDIS is the risk of cross-subsidization between banks in different euro area countries, i.e. the eventuality of one or several banking systems structurally contributing more and benefiting less from the scheme than other, potentially riskier, systems. Simulations by Carmassi *et al.* (2018) show that by adopting risk-based contributions to the EDIS,[73] the scope for cross-subsidization would be very limited even in severe crises and there would be no risk of *systematic* cross-subsidization in the steady state. The results indicate that a fully-funded EDIS with a target level of 0.8 per cent of covered deposits would be sufficient to cover pay-outs even in very severe crises – even more severe than the 2007-09 global financial crisis.

These results are due to the fact that the probability and magnitude of interventions by the EDIS are likely to be low because of: the overall risk reduction achieved in banks' balance sheets; the new EU bank resolution framework; the build-up of bailinable liabilities; and the introduction of the bail-in instrument. Equally important, risk-based contributions that follow the "polluter-pays approach" and are benchmarked at the euro area level (by applying the "Banking Union methodology") rather than at the national level can internalize the specificities (including risks) of individual banks and banking systems. Cross-subsidization is a possibility only in the most conservative scenarios, in which losses are assumed to be severe. Interestingly, cross-subsidization would increase in an alternative "mixed scheme" – whereby national DGSs would bear the first losses and the EDIS would only intervene afterwards – mainly because contributions would not be risk-based relative to the euro-area banking system.

As far as the risk of moral hazard is concerned, this may arise as the existence of a larger European deposit guarantee fund may in principle incentivize risk-taking behaviour by banks. A number of features can mitigate moral hazard risk. First, the re-insurance structure implies that, at this stage, losses are first borne by the relevant national compartments (DGSs) of the EDIS, with common funds to be tapped only for large systemic crises. Moreover, mutualization will be gradual as the re-insurance phase would only cover liquidity, while coverage of losses would take place in the co-insurance phase, which is conditioned on a set of requirements. Finally, the Commission's proposal calls for a calibration of the deposit insurance contributions based on the banks' risk profiles, to ensure that banks with the highest likelihood of having to use deposit insurance pay the highest share of the contributions.

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[72] Harmonisation of national DGSs and insolvency rules as well as effective access to loan collateral are listed among the other essential prerequisites for an EDIS.

[73] Risk-based contributions to national DGSs have already been introduced by EU Directive 2014/49.

It has been noted that, in trying to make the EDIS more politically feasible, the revised version presented by the Commission of October 2017 may face a credibility problem in so far as the watered-down risk sharing and the unspecified deadlines may reduce the economic substance of the EDIS, ultimately undermining its impact on severing the bank-sovereign doom loops (Kudrna, 2018).

Given the lack of consensus on the Commission's proposal, alternative proposals have been put forward. Bénassy-Quéré *et al.* (2018) and Schnabel and Véron (2018) advocate that the EDIS be financed in a way that is differentiated not only across *banks* but also across *countries*, by charging insurance premia that price in country-specific risks. Gros (2015) proposes a re-insurance scheme where the insured subjects would be the national DGSs rather than the banks; "experience ratings" would be used to ensure that the DGS of a country hit by a large shock pay higher premia upon receiving a pay-out from the EDIS' Deposit Insurance Fund.[74] On the contrary, in Bénassy-Quéré *et al.* (2018) national DGSs would be fully replaced, in the steady state, by the EDIS' national compartments (and a European "mutualized" compartment), which would bear the first losses while common funds would only be tapped in systemic crises. This approach of keeping national compartments in the EDIS – to limit risk sharing and improve political support for the scheme – is questioned by Schoenmaker (2018), who warns that increased contributions on banks to replenish a national compartment, following bank failures in a recession might pose financial stability risks for the national banking system.

Other proposals aim at addressing potential risks arising from the fact that, in the European Commission's proposal, the Deposit Insurance Fund and the Single Resolution Fund (and their respective financing mechanisms) are kept distinct (although the proposal does call for integrating the decision-making for the EDIS into the SRB). This distinction does not exist for the Federal Deposit Insurance Corporation in the U.S., a recognition of the interconnectedness between the functions of resolution and deposit insurance and the risk that two separate funds for deposit insurance and resolution may lead to inter-agency conflicts. With a view to simplifying crisis management and fully exploiting the pooling potential of insurance, Gros and Schoenmaker (2014) propose integrating the SRB and EDIS into a Single Resolution and Deposit Insurance Board as well as integrating the two funds – the Single Resolution Fund and the EDIS' Deposit Insurance Fund – into a Single Resolution and Deposit Insurance Fund.

Overall, the availability of an EDIS would provide the Banking Union with a major confidence-building effect while it might well remain a last line of defence as the probability of its actual use remains limited by several factors. First, in the re-insurance phase the DIF would only be tapped when the national DGS is insufficient, which in turn is only likely to happen in the face of a country-specific systemic crisis. Secondly, recent regulatory innovations, notably the build-up of MREL-eligible liabilities, reduce the likelihood that banks would have to resort to the EDIS. Furthermore, with the SRM in place, when a bank is put under resolution it would not need – in all likelihood – to rely on the deposit insurance system, because part or all of the bank remain operational. Finally, the EDIS would first and foremost be a *private* risk sharing mechanism, since it is financed by bank levies: it is likely that the *public* risk sharing component would (temporarily) only materialize in the event of an activation of a future ESM backstop to the DIF.

Progress on the EDIS has been almost non-existent so far.

[74] Furthermore, Schnabel and Véron (2018) argue that insurance premia on banks depend on whether bank failures are triggered by idiosyncratic shocks versus a "larger crisis", in the latter case the cost of pay-outs would be mutualized. As noted by Micossi (2017), if the risk parameters used to calculate the contributions by national DGSs to the EDIS effectively reflect country risk, this pricing mechanism would reinforce rather than weaken the link between sovereign risk and banking risk.

The June 2016 Ecofin roadmap on completing the Banking Union subjected the start of negotiations on the EDIS to making sufficient progress on risk reduction, notably through the measures included in the Banking Package.[75] The Eurogroup meeting of 4 December 2018, which marked the important step of operationalizing the common backstop for the SRM, was less consequential for the EDIS, as ministers only decided to establish a High-Level Working Group (composed of their deputies) with a mandate to work on next steps. At its meeting of 13 June 2019, the Eurogroup could not help but acknowledge that further technical work would still be needed on defining a transition path to the Banking Union's steady state – including a roadmap for political negotiations on the EDIS – and mandated the Working Group to continue this work.

5. A central fiscal capacity for the EMU[76]

Since its inception, the EMU fiscal governance framework has been centred on the Stability and Growth Pact (SGP), whose rules reflect the EU Treaty requirement (Article 121 of TFEU) that, in a monetary union, national economic policies are a "*matter of common concern*" and need to be coordinated to ensure the viability of the EMU. In this context, SGP rules and national fiscal policies are expected to pursue two main objectives: sustainability of public finances and macroeconomic stabilization, with national fiscal buffers as the first line of defence against normal downturns.

These objectives are interrelated (Claeys *et al.*, 2016). An insufficient counter-cyclical policy in good times can lead to a higher debt level and prevent the build-up of buffers for fiscal stabilization during downturns. An insufficient counter-cyclical policy in bad times can prolong a downturn and, if hysteresis effects are present affect, they can damage potential growth and public finances in the longer run.

Over time, the relative weight of these two objectives has changed in response to successive reforms of the framework, with increasing attention paid to stabilization (Carnot, 2017). The latter is epitomized by the introduction in 2005, in the preventive arms of the SGP, of a country-specific Medium-Term Budgetary Objective (MTO), broadly defined as a structural balanced budget (i.e. a nominal budget balance adjusted by the cyclical component and net of one-off and temporary measures).[77] By meeting the MTO, a member country is expected be able to withstand ordinary shocks by allowing automatic stabilizers to operate without breaching the 3 percent reference value for the government deficit-to-GDP ratio.

Nevertheless, during the recent crises the EU rules-based fiscal framework has dramatically shown its limits on both counts: it not only resulted in a generally insufficient build-up, in good times, of national buffers for countercyclical stabilization but also largely failed to ensure sustainability and prevent the accumulation of fiscal imbalances. In the countries hardest hit by the sovereign debt crisis, market pressure made it inevitable to undertake a large consolidation of public finances, which resulted in procyclical fiscal stances; part of this procyclicality may be embedded in the fiscal rules themselves, a flaw that undermines their stabilization potential, particularly in deep and

[75] See Section 3.2.

[76] Because of the complex and multi-faceted nature of this topic and the abundance of analytical contributions, this section merely aims at providing an overview of the main issues at stake.

[77] The relevance of the structural budget balance is questioned *inter alia* on the ground that, while theoretically sound, it becomes controversial in practice because it is based on an unobservable variable (potential output) whose estimate is subject to uncertainty and measurement errors. Claeys (2017, p. 13) highlights that estimated changes in the structural balance are typically revised by more than half a per cent of GDP after one year, more than the yearly adjustment that the rules require. Potential output takes on a critical importance also in assessing the compliance with the existing fiscal rules.

persistent recessions (Alcidi and Thirion, 2016; Arnold *et al.*, 2018; Beetsma *et al.*, 2018; Darvas *et al.*, 2018).

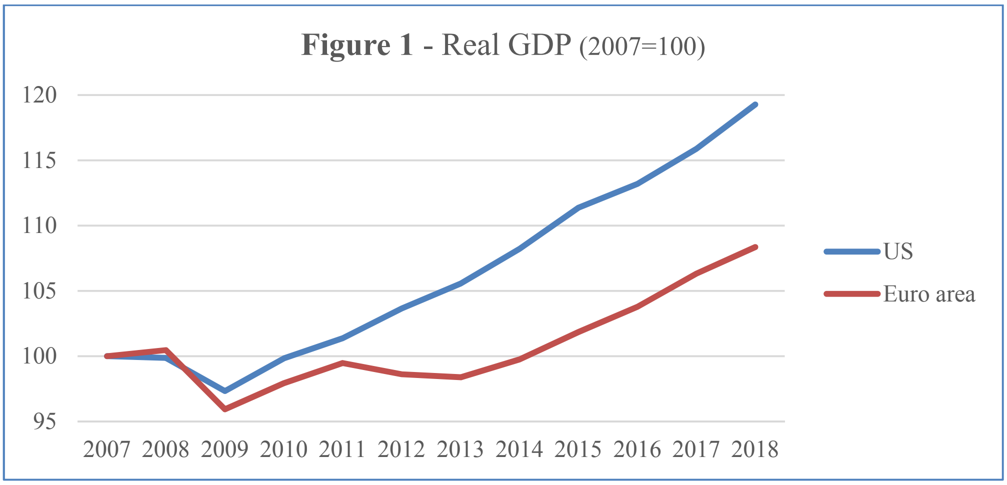
As noted in Section 3, in response to the crisis the EU fiscal governance framework has been reformed by a string of legislative acts. Additional budgetary flexibility and room for stabilization have resulted from the European Commission's Communication of January 2015, which clarified how cyclical conditions should be taken into account in the implementation of the SGP, while also fostering investment and structural reforms.[78]

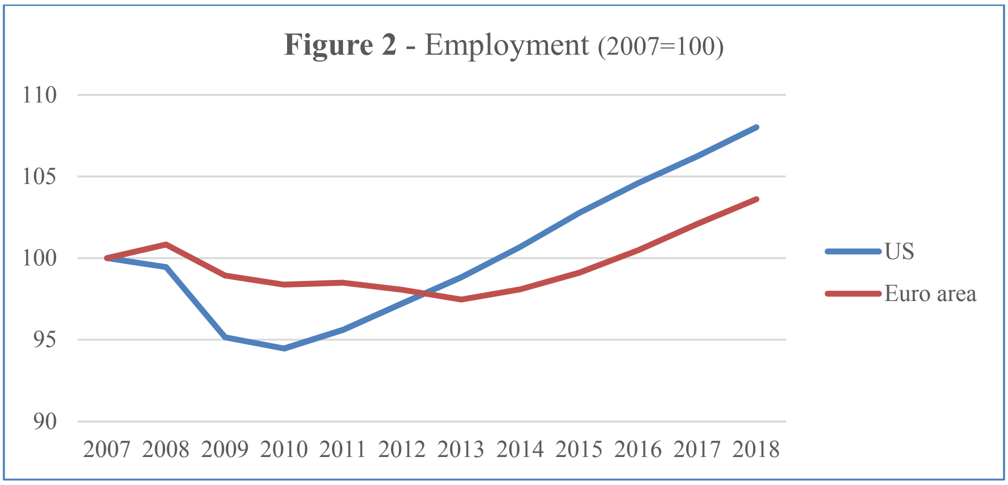
At the same time, there is ample consensus on the fact that the increased complexity of the SGP rules translate into an intricate set of fiscal constraints (Andrle *et al.*, 2015); opinions vary as to whether these constraints undermine the scope for countercyclical stabilization. On the one hand, Dolls *et al*. (2014) provide evidence that automatic stabilizers in the euro area are larger than in the U.S. and played a quantitatively important role for the stabilization of the economy over the period 2007-2014; they conclude that the SGP has not put a brake on the workings of automatic stabilizers and it does indeed leave room for fiscal policy to stabilize the business cycle. On the other hand, the slower recovery in the euro area – in both GDP and employment – when compared with the U.S. (Figures 1 and 2), while largely the outcome of the sovereign debt crisis, may in part reflect the absence of a central fiscal capacity for macroeconomic stabilization.[79] Supranational mechanisms can indeed complement or, in some cases, supplement national budgets in smoothing out the impact of large country-specific shocks.[80] Stabilization of investment is particularly important because its fall accounts for the bulk of the output losses suffered during the global financial crisis. Recent research by the IMF (2018) provides further quantitative evidence of the efficacy of fiscal measures in limiting persistent losses after a recession.

[78] European Commission (2015a). The Communication provides new guidance on how the Commission will apply the existing SGP rules and pursue three objectives: 1) encourage effective implementation of structural reforms: the "structural reform clause" can allow for possible temporary deviations from the MTO (or from the agreed fiscal adjustment path towards it); 2) promote investment: member state contributions to the EFSI can be excluded when defining the fiscal adjustment under either the preventive or the corrective arm of the SGP. Besides, under the "investment clause", member states in the preventive arm of the Pact can deviate temporarily from their MTO (or from the agreed fiscal adjustment path towards it) in order to accommodate investment, under a few conditions (notably, GDP growth is negative or the output gap is greater than minus 1.5 percent of GDP); and 3) take better account of cyclical conditions in calibrating the fiscal adjustment expected from countries under the preventive arm of the Pact: member states will be required to make a larger fiscal effort during better times and a smaller fiscal effort during difficult economic times.

[79] We are here adopting the terminology used in a recent IMF Discussion Note (Arnold *et al.*, 2018), although the terms "fiscal capacity" and "central/fiscal/macroeconomic stabilization function" are more frequent in European reports, for example in the Four Presidents' Report's roadmap of December 2012 and, more recently, the Reflection Paper by the European Commission (2017f). See Section 5.2 for a deeper discussion of the all-encompassing term "fiscal capacity".

[80] While common shocks are meant to be first dealt by monetary policy, some proposals envisage the use of a central fiscal capacity to counter aggregate shocks too, on the grounds that a response by means of national budgets alone would be sub-optimal, including because of free-riding problems (Wolff, 2012). However, size matters and borrowing capabilities are seen as a requirement for the credibility of the response (see Section 5.4).





Source: based on data from Eurostat, Bureau of Labor Statistics and Bureau of Economic Analysis.

5.1 The case for a central fiscal capacity

The lack of a central fiscal capacity has long been identified as one of the most significant design flaws of the EMU: this institutional inconsistency can not only account for a slower economic recovery but can also be *in and of itself* a source of macroeconomic and sovereign risks, most notably when monetary policy space is limited. In fact, it leaves the euro area unable to provide a degree of countercyclical stabilization in case of large asymmetric shocks: given the absence of a national flexible exchange rate as an adjustment tool, in a monetary union these shocks can cause more severe internal – excessive unemployment and negative output gaps – and external imbalances that may result in large cross-country divergences (Berger *et al*., 2018). Perhaps more worryingly, these imbalances may generate self-fulfilling crises, contagion and negative spillovers and may ultimately become systemic.

The EU budget does not pursue macroeconomic stabilisation to foster *cyclical* convergence – i.e. the synchronization of GDP growth across countries – as an explicit objective. The EU is currently empowered, in a limited and pre-established way, to borrow and lend so as to provide financial assistance to its members, with a view to promoting upward *social* and *economic* convergence and, ultimately, the convergence of income levels. While differences in living standards do not threaten the viability of a currency union, persistent divergences in business cycles can undermine the effectiveness of the single monetary policy and become in themselves a source of macroeconomic imbalances (Funke *et al.,* 2019).

In this regard, contrary to what many had expected before the adoption of the single currency, differences in growth rates across member countries have remained as sizeable after the creation of the euro as before (Allard *et al*., 2013, p. 8). The average standard deviation of output gaps was around 3 percent of GDP in the years 2000-2017, reflecting both a common component (about 60 percent) and country-specific developments (40 percent), i.e., idiosyncratic shocks or the asymmetric transmission of common shocks (Buti and Carnot, 2018). Furthermore, divergences in cyclical conditions – in terms of output gaps, unemployment and inflation differentials – increased in the aftermath of the crisis (European Commission, 2018b).

From a theoretical viewpoint, the need for a central fiscal capacity is usually traced back to the theory of optimal currency areas (OCAs).[81] Because the EMU does not fully satisfy the criteria of an OCA, notably in terms of labour mobility and wage flexibility, and given the limits to the availability of national countercyclical instruments, a fiscal capacity is needed as a shock absorber that can mitigate the costs of large asymmetric shocks. For its part, historical evidence from other currency unions provides some support for the view that deeper fiscal integration is "essential" to sustain their long-term success (Bordo *et al.* 2013; De Grauwe 2013; Roth, 2015). The Five Presidents' Report itself recognizes that while there are many ways for a currency union to progress towards a fiscal union – and differences in the degree to which currency unions have common budgetary instruments – all mature monetary unions have put in place a common macroeconomic stabilization function to better deal with shocks that cannot be managed at the national level alone.

In fact, national fiscal buffers for countercyclical manoeuvre, either via automatic stabilizers or discretionary measures, may be unavailable or insufficient for a number of reasons (Buti and Carnot, 2018). Country-specific shocks can have an impact on public finances that is often far stronger than what is conventionally measured by standard fiscal elasticities: empirical evidence shows that cyclical changes in headline fiscal balances typically exceed 3 per cent of GDP every 10 years and 5 per cent every 20 years. As a result, even countries meeting the MTO may lack the fiscal space to respond to large shocks properly. This is all the truer for member states plagued by the legacy of high public debt-to-GDP ratios and thus exposed to rising market scrutiny when public finances deteriorate during a cyclical downturn. This exposure magnifies the potential for self-fulfilling crises – notably a liquidity problem that morphs into a solvency crisis – if a fiscal tightening to allay market pressure becomes procyclical and aggravates the government budget. More generally, the crises in Ireland and Spain show that market pressure may constrain fiscal policy even in countries with initially strong public finances (Pisani-Ferry *et al.*, 2013).

Some structural and institutional specificities of the euro area provide in themselves scope for a central fiscal capacity to deliver value added. The following arguments stand out.

First, as documented in Section 4, the overall degree of risk sharing in the euro area is relatively lower than in other monetary unions. A central fiscal capacity can provide a degree of public risk sharing that supports macroeconomic and financial stability, which in turn is a precondition for financial integration. The latter is a powerful source of (market-based) private risk sharing: in this way, fiscal risk sharing is both an enabling factor for private risk sharing but also a substitute for it in times of severe crises.[82] In fact, empirical evidence demonstrates that market-based risk sharing is procyclical and declines when it is most needed: during the sovereign debt crisis progress towards

[81] Mundell (1961). See Pasimeni (2014) for an application of the OCA theory to the EMU.

[82] Furceri and Zdzienicka (2013) review the available empirical evidence and conclude that the effectiveness of risk sharing mechanisms at the international level is lower than at the interregional level, and that a significant part of the difference is explained by the absence of a supranational fiscal risk sharing mechanism.

financial integration was reversed – e.g. cross-border ownership of financial assets collapsed – and financial fragmentation ensued instead. This demonstrates that, contrary to what is often believed, private risk sharing cannot substitute for fiscal risk sharing. A credible common fiscal capacity thus promises to have benefits that go well beyond macroeconomic stabilization and extend to financial stability and the longer-term viability of the EMU: as noted by the ECB (2018), the strengthening and broadening of the macroeconomic expansion in the euro area has been the main force behind the capital market-driven restoration of financial integration towards its pre-crisis level.[83]

A second key reason for establishing a central fiscal capacity derives from the absence of rules or instruments to directly manage an aggregate fiscal stance for the euro area as a whole (European Central Bank, 2016).[84] [85] The SGP rules can *monitor* national fiscal policies but can hardly *coordinate* them to attain a desired aggregate fiscal stance, mostly because they are plagued by an asymmetry: they can compel fiscal consolidation but cannot force a fiscal expansion because the rules make no provision for countries overachieving their MTOs (European Central Bank, 2016; European Fiscal Board, 2017 p. 64).

The European Commission's Communication of January 2015, while providing more attention to cyclical stabilization, falls short of recognizing that, in the absence of a federal budget, exceptional circumstances may call for exceptional measures at a national level. For example, Balassone *et al.* (2016) note that even under exceptional circumstances a fiscal expansion (i.e. a worsening of the structural balance) is not explicitly allowed: at best a neutral fiscal stance is conceded. In the same vein, Darvas *et al.* (2018) emphasize that current EU fiscal rules at best allow for a slowdown or some postponement of fiscal consolidation; Bénassy-Quéré *et al.* (2016) note that countries that comply with the SGP by definition cannot take advantage of its flexibility and there is no instrument to bind those countries to implementing expansionary policies.

It is also important to emphasize that, in the institutional context of the euro area, the concept of an aggregate fiscal stance is a dual one: it refers both to the *direction* that fiscal policy should take overall and to the quality of its *composition*, in terms of distribution of efforts across countries as well as the types of expenditure and taxes behind it (European Commission, 2016a). In this regard, the EU fiscal governance framework featuring decentralized fiscal policymaking without a centralized fiscal capacity can turn out to be a source of tensions between the euro area and the national perspective. In fact, it has become even clearer that the aggregate fiscal stance for the euro area results from a cross-country distribution that may not be appropriate, with fiscal policy that can be loose or looser than warranted in countries without fiscal space and restrictive or more restrictive than warranted in countries with fiscal space (European Fiscal Board, 2017).

Even worse, in the recent recession the euro area, on aggregate, has been prone to pro-cyclical fiscal consolidation (European Commission, 2018b): because of contemporaneous national efforts to safeguard the sustainability of public finances, the aggregate fiscal stance turned highly restrictive in 2012-13 while the downturn was still serious, further deepening the recession. Empirical analysis by Claeys (2017, p. 13) confirms that the aggregate fiscal stance was only countercyclical in 2009 and mostly procyclical the rest of time; Bénassy-Quéré *et al.* (2016) show that the procyclicality of fiscal policy in 2008, 2012 and 2013 was due to its discretionary component, which overcame automatic stabilizers.

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[83] Price- and quantity-based indicators of financial integration in the euro area remains below the pre-crisis levels (ECB, 2018).

[84] Savona (2018) emphasizes that completing the EU political union and redefining its institutional architecture would be the "main road" to defining an active fiscal policy in Europe.

[85] *In reality…* [the SGP] *…was purely and simply a budgetary stability pact: no economic co-ordination; no instruments to stimulate, co-operate or regulate*" (Delors, 2013, p. 175).

The third specific advantage of a central fiscal capacity relates to the incentives it can provide to adhering to fiscal rules, which could be more strictly enforced and politically acceptable when common countercyclical instruments are available (European Fiscal Board, 2017). There is indeed a close link between the degree of fiscal and financial centralization and the enforcement of responsibilities at the national level (Demertzis and Wolff, 2016 p. 4). In this regard, the U.S. experience provides critical lessons. An intriguing feature is that the U.S. federal government imposed a *de-facto* no bail-out regime only after having assumed – mostly in response to the Great Depression – a full system of important federal powers, not only for bailing out insolvent banks but also for expenditure, taxation and countercyclical macroeconomic stabilization. The latter has proved to be essential for the viability of self-imposed balanced-budget rules at the state level,[86] which to a great extent derives from the fact that the federal government provides a minimum of fiscal risk sharing that can offset the pro-cyclical bias of these rules (Henning and Kessler, 2012).[87]

In the same vein, the European Fiscal Board (2017, p. 65) underlines that, in difficult times, a common stabilization instrument can play the role of a complement to fiscal rules, not of a substitute for observing them. To this end, the instrument should place less emphasis on stabilizing short-term swings in aggregate demand and more on crisis prevention: reinforcement of macroeconomic and fiscal surveillance is indeed explicitly identified as the main criterion for evaluating the scope for a common stabilization facility. The availability of the European Semester as a dedicated vehicle for surveillance would make it easier for the euro area to design this facility properly, subject to compliance with a "*simplified*" set of fiscal rules.

A fourth distinctive benefit of a central fiscal capacity is that it would contain the economic, financial and social costs of country-specific shocks, thus making a bailout less likely. In addition, by limiting the EMU-wide impact expected from these shocks, notably their international spillovers and contagion, a degree of fiscal risk sharing can alleviate the need for ex post financial support to sovereigns; it might also cushion the impact on growth and financial stability potentially arising from a restructuring/default of sovereign debt (Allard *et al.*, 2013; Berger *et al.*, 2018).[88] Both ways contribute to weakening the sovereign-bank adverse loops and improve the credibility of the no-bailout clause.

Relief for an overburdened monetary policy adds to the list of rationales for establishing a fiscal stabilization function in the euro area (Guttenberg and Hemker, 2018). A supportive fiscal policy becomes of critical importance – and is usually more effective – when monetary policy is constrained by the zero lower bound and faces stagnation risks (Sims, 2016; Corsetti *et al.*, 2019); simulations show that the impact of low inflation on public finances can be quite pronounced (Andrle *et al.*, 2015, p. 18, footnote 16).

A final consideration supports the call for a macroeconomic stabilization capacity. The practical impact of the fiscal risk sharing instruments recently introduced in the EMU might be reduced by

[86] "*Critically, the rigidity brought on by balanced budget provisions at the state level is facilitated by fiscal flexibility at the federal level…state and local budgets have behaved procyclically during recessions in the United States. Since the 1930s, the federal budget has helped to stabilise the national economy in countercyclical fashion. Without this, state-level restrictions would have been difficult or impossible to sustain*" (pp. 28-30).

[87] In drawing lessons for the EMU, the authors conclude (pp. 28-30): "*The US experience suggests that the particular path through which rules are adopted and enforced is likely to be critical to their implementation, and that introducing such rules for euro-area member states should be accompanied by a federal system of fiscal powers and a common fund for rescuing and recapitalizing banks… Although automatic stabilisers might play a greater role in some of the national economies in Europe than in the US states, we believe that creating stringent state-level debt brakes in Europe without a capacity for countercyclical stabilisation would be a serious mistake*".

[88] Berger *et al.* (2018, p. 11) highlight that in so far as fiscal risk sharing promotes market discipline, the relationship between fiscal risk sharing and moral hazard becomes U-shaped.

the many strings attached to their actual deployment: as noted in Section 3, the Single Resolution Fund, the use of the ESM as a backstop to the SRF and access to the ESM's precautionary facilities are all characterized by governance structures, rules and eligibility criteria that can cast a shadow on the timeliness and predictability of financing.[89]

5.2 General features

The debate on whether the EMU can survive without supranational fiscal instruments – if not a full fiscal union – is a long-standing one and takes on a broader scope; in some respect, it amounts to asking whether the EMU can remain a "currency without a state", because steps towards a fiscal union necessarily require parallel advances in the political dimension of the union – notably the need for democratic controls on such core sovereign choices as taxation, public expenditure and borrowing (Balassone *et al.*, 2014).

In the current discussions on deepening the EMU, the term "central fiscal capacity" is usually an all-encompassing one that refers to a continuum of budgetary arrangements and instruments of increasing ambition, scope and legal implications: from a mere financial incentive to support structural reforms to an explicit macroeconomic stabilization function and, even further, to a proper budget in the context of a fully-fledged fiscal union, i.e. a European Treasury (and a Finance Minister) with borrowing capacity (Eurobonds and Eurobills).

There are various features that define a fiscal capacity (and many ways of progressing towards a fiscal union): the most important ones are its legal requirements, the functions to be performed – which in turn determine the format and design – and the sources of financing.

A key common feature across the various proposals is the principle that stronger fiscal integration is to go hand in hand with stronger joint decision-making: this means some transfer of control over fiscal policies from the national to the European level, i.e. ultimately a transfer of sovereignty to be enshrined by Treaty changes. However, it is important to underline that a fiscal union in no way necessarily implies a full transfer of core national fiscal powers. This incorrect belief is often a source of confusion and concern that should be avoided for a meaningful and informed discussion to take place. In fact, a supranational institution would only take over some responsibilities from their national counterparts to carry out a few functions at the European level more effectively, in compliance with the subsidiarity principle. To this end, the envisaged European fiscal institutions need to be equipped with common instruments that can allow for risk sharing and "*different forms of fiscal solidarity*" (Van Rompuy, 2012).

Furthermore, contrary to monetary policy, which can be delegated to an independent technocratic institution like a central bank, fiscal policy lies at the core of a government's mandate: it involves choices that may have allocative – if not redistributive – consequences. Accordingly, common fiscal instruments require not only stronger safeguards against moral hazard but, equally importantly, strengthened procedures for proper accountability and democratic legitimacy, commensurate with the amount of fiscal solidarity and the transfer of sovereignty: ultimately, it calls for establishing European institutions and a closer involvement of the European Parliament.[90] In this sense, progress toward fiscal integration inherently implies parallel progress towards a political union.

[89] Feld *et al.* (2016); Merler (2014). The Five Presidents' Report also laments the "restrictive eligibility criteria" attached to the ESM's direct recapitalization instrument (Juncker 2015, p. 11). This instrument is set to be replaced by the common backstop for the SRF to be provided by the ESM.

[90] Stronger legitimacy and democratic control also underpin the proposal, included in the EMU Roadmap of December 2017 (European Commission, 2017f), to incorporate the essence of the Fiscal Compact into EU law. The proposal reflects the European Parliament's argument that, to be effectively legitimate and democratic, "*the governance of a genuine EMU must be placed within the institutional framework of the Union*".

Given the significant implications, the issue of developing a central fiscal capacity is clearly not a technical one: it is mostly about the political appetite for fiscal integration and the attendant transfer of sovereignty. Accordingly, the scope and features of a fiscal capacity and ultimately whether it might constitute an initial step towards closer fiscal and political integration should reflect purely social and political choices and preferences and be left to elected officials.[91]

The rest of this Section focuses on those that can be considered the main issues for discussion on how to develop a central fiscal capacity.

5.3 Functions and formats

The literature on a central fiscal capacity has envisaged a number of functions with ever-increasing ambitions:[92]

- promotion of structural reforms;
- countercyclical macroeconomic stabilization;
- financing of common public goods and pan-European investment.[93]

The rest of this Section focuses on the two objectives that have received most attention: macroeconomic stabilization and support for structural reforms.

5.3.1 Macroeconomic stabilization

In most – if not all – proposals, a fiscal capacity takes the form of a macroeconomic stabilisation instrument (also referred to as a shock absorption function).

The most ambitious proposals (for example, the European Commission's Blueprint of November 2012, the European Parliament's resolution of February 2017 or Arnold *et al*., 2018) envisage a countercyclical tool able to respond to shocks that include those of a*symmetric* nature, i.e. common to the euro area. While these shocks are normally supposed to be addressed by the single monetary policy, a complementary fiscal policy can be useful in circumstances where the monetary instrument is constrained by the zero lower bound on policy interest rates (and fiscal multipliers can thus be larger). Besides, a centrally-provided stimulus may be more effective than national fiscal responses because the latter can suffer from free-riding behaviour.

The ability to respond to common shocks with fiscal policy is however a more elaborate goal, as it may require a fully-fledged fiscal union with a large budget, autonomous power of taxation and a capacity to borrow (i.e. issuance of Eurobonds). As a result, most proposals focus on supranational budgetary instruments that are intended to fill a gap in the toolkit to address shocks of an intensity that falls between two extremes: a small shock that can be dealt with using national stabilization space (first and foremost, automatic stabilizers) and a full-blown sovereign crisis that may call for an adjustment programme supported by the ESM.

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[91] Strengthening the political dimension of the EMU would likely imply a number of relevant shifts such as: from rules to institutions; from coordinated national policies to common policies; from intergovernmental to supranational decision-making; from unanimity to qualified majority voting.

[92] See D'Alfonso and Stuchlik (2016), paragraph 3, for a survey of the various functions put forward for a common fiscal capacity.

[93] Demertzis and Wolff (2016). As noted by Wolff (2012), most public goods would qualify as public goods for the EU rather than the euro area. For the latter, the most important public goods are meant to be price stability and financial stability.

In particular, the shocks should be characterized by three features: they are *asymmetric* (i.e. country-specific or featuring an asymmetric propagation of common shocks); *large* (i.e. unable to be addressed by a country's available fiscal space[94]); and *cyclical* (i.e. temporary, as permanent shocks, which can require structural adjustments, would give rise to unidirectional transfers).

The Four President's Roadmap of December 2012 (Van Rompuy, 2012) took on a rather strict interpretation of fiscal capacity as an asymmetric-shock absorption function based on an insurance-type system between euro area countries.[95] This objective can be pursued through either: a *macroeconomic* approach, where contributions and disbursements are rules-based and linked to either fluctuations in cyclical revenue and expenditure items or to measures of economic activity (e.g. the output gap); or a *microeconomic* approach, more directly linked to a specific public function that is sensitive to the economic cycle, notably unemployment insurance.

A common key feature of many of these proposals is that they envisage automatic (or semi-automatic) financial support (transfers or loans) to individual members drawing from a common pool of resources, often known as a "rainy-day" fund. The latter can display two distinct benefits when compared with a national fund: stronger incentives to accumulating buffers in good times (i.e. a tougher commitment device) and additional countercyclical fiscal space, as supranational financing would be a substitute for national financing of specific expenditure items (Carnot, 2017).

Most proposals follow a *contribution-transfer* scheme and include the setting up of a European unemployment re-insurance scheme.[96] The latter would top up national unemployment insurance schemes, similar to the case of the U.S., where federal insurance provided an average support of around 0.4 percent of GDP per year to the states from 2008 to 2011 (Bénassy-Quéré *et al.*, 2016, p. 14). This form of partial unemployment insurance would be justified by the fact that differences in euro-area unemployment rates are comparable to those in the U.S. (Demertzis and Wolff, 2016, pp. 8-9).

The main benefits of a contribution-transfer scheme include automaticity (to address moral hazard, as changes in cyclical unemployment are outside the control of national governments), a high multiplier effect, a possible stimulus to convergence of national labour market institutions and an explicit European-level attention to the social impact of a crisis. Other proposals pursue stabilization through a unified, centrally-funded public pension system based on a notional defined-contribution scheme (Balassone *et al.*, 2014) or a European fund composed of national compartments and based on a saving-loan structure (Lenarčič and Korhonen, 2018).

An alternative *borrowing-lending* scheme characterizes the European Investment Stabilisation Function (EISF) proposed by the European Commission (European Commission, 2018a and 2018b) as part of the Multiannual Financial Framework for 2021-27. Differently from other mechanisms, the EISF would provide back-to-back loans complemented by a grant component (an interest rate subsidy) through a new Stabilisation Support Fund (SSF). The loan-based nature of the EISF/SSF reflects a widespread political preference for avoiding transfers between euro area countries.

[94] Moreover, limiting the coverage of the insurance mechanism to only large shocks is a safeguard against moral hazard.

[95] Spath (2016) provides for a comparative analysis of three proposed mechanisms for asymmetric shock absorption.

[96] Brandolini *et al.* (2014); Italian Ministry of Economy and Finance (2016); Dullien *et al*. (2018), Beblavý and Lenaerts (2018). For its part, in proposing the establishment of a "Eurozone Budget", the Meseberg Roadmap of June 2018 recognized "*the need for a genuine stabilization function in the Eurozone, without transfers*" and proposed a European Unemployment Stabilization Fund as an option along with a temporary suspension of the contributions to the Eurozone budget for countries hit by a significant shock. Dolls (2018) provides a comprehensive comparison of the various proposals and identified five criteria to classify them: indicator trigger; activation rule; pay-out rule; contribution rule; and existence of a borrowing capacity.

However, this shift is somewhat at odds with the principles set forth in the Five Presidents' Report, which underlined the need to avoid permanent transfers rather than transfers *tout court*.[97]

The explicit focus on maintaining public investment is justified by the fact that this critical component is often one of the first budget items to be cut in a crisis, with consequences that extend beyond the business cycle, given the crucial role of investment as the junction between short-term aggregate demand and longer-term aggregate supply (Visco, 2018); besides, public investment can feature a multiplier of higher than one in a best-case scenario. The European Fiscal Board (2017) supports the protection of investment as a rationale to build a euro-area stabilization function – also in light of its potential to leverage resources from the private sector (along the line of the "Juncker Plan") – while recognizing the desirability of a broader perspective on the role of fiscal policy than one limited to cyclical stabilization.

The central fiscal capacity proposed at the IMF by Arnold *et al.* (2018) sets itself apart for *inter alia* avoiding earmarking the transfers from a stabilization fund to a specific expenditure (unemployment benefits or public investment); it also adds a borrowing capacity to be activated only in case of exceptional *common* shocks, with a view to complementing monetary policy in engineering an adequate countercyclical response.

Although political agreement remains elusive, proposals based on establishing a European unemployment re-insurance scheme have received greater support, as they can strike a compromise between political acceptance and a shock-absorption capacity (geographical and intertemporal insurance[98]); they recognize that a fully-fledged European unemployment insurance scheme is overly ambitious, as it would require a substantial harmonization of labour market regulations and national unemployment insurance schemes in member countries. Another benefit of a re-insurance scheme is that, following a shock, the increase in unemployment below a certain threshold remains the responsibility of the individual member country, a safeguard against moral hazard risk.

A critical dimension of the various proposals is the choice of the indicator and the conditions that trigger the financial support. These choices are consequential as they face a number of important trade-offs defined by: the timeliness of the countercyclical support; its size (the stabilization potential); the available resources in the rainy-day fund; the strictness of the eligibility criteria for accessing the instrument; the amount of the potential cross-country redistribution and the political concern to contain it; the need to support only cyclical unemployment; and the imperative of avoiding moral hazard.[99]

The preference for the unemployment rate that characterizes most proposals is explained because its definition is harmonized across euro area members and is more easily observable than other cyclical indicators such as the output gap or GDP growth, which are subject to revisions. The focus on a trigger defined in terms of deviations of the unemployment rate from its trend aims to ensure that transfers are not linked to high structural unemployment.

In this regard, a distinctive feature of the EISF/SSF proposed by the Commission is that the shock that justifies access to the instrument is measured by a "double trigger criteria"[100] whereby

[97] In this regard, the "Budgetary Instrument for Convergence and Competitiveness" that is being designed at the EU level would be based on a grant, not on a loan (see next Section).

[98] Intertemporal insurance may require issuance of debt, which is a highly controversial issue.

[99] See Balassone *et al.* (2007) for an early discussion of these issues.

[100] (i) in the member state concerned the quarterly national unemployment rate exceeds the average unemployment rate measured over a period of 60 quarters (15 years) preceding the quarter during which the request to access EISF was made; (ii) the quarterly unemployment rate increases by one percentage point above the unemployment rate observed in the same quarter of the previous year. These double trigger criteria have to be fulfilled simultaneously. See Carnot *et al.* (2017).

unemployment must at the same time be historically high and strongly increasing (to further restrict the activation conditions, it is considered that the increase should go beyond a certain threshold). This framework precludes indefinite support and restricts access to large shocks only (in comparison, a simple trigger might allow access also when a recovery is already under way). Simulations using real time data over the past three decades show that the support from the EISF/SSF would have been concentrated in the most severe downturns and would have covered up to half of the euro area members at peak points in 2009-10 and 1993-94 (Buti and Carnot, 2018). Another benefit of the EISF/SSF rests on its automaticity (provided that the country is compliant with EU rules) and lack of conditionality, so that it is seen as a complement to the ESM (Claeys, 2018).[101]

In all the proposals discussed so far stabilization arises from a specific instrument whose activation depends on economic shocks. A more ambitious alternative is a fully-fledged budget, in which case stabilization normally comes as a by-product of its broader allocative and redistributive functions. As a result (and ruling out discretionary fiscal policies), the stabilizing power is usually lower than that of a dedicated instrument (Carnot, 2017).

The stabilization properties of a common budget could nevertheless be significant but would strongly depend on the cyclical sensitivity of the revenues or expenditures that compose the budget – i.e. on EU-level automatic stabilizers – as well as on its size. Simulations (European Commission, 2018b, p. 52) show that a well-designed euro area budget of a relatively modest size can allow for meaningful stabilization properties: a budget of around 2 per cent of euro area GDP, with diversified revenue sources and expenditure, is estimated to substitute 10 per cent of the stabilization achieved at national level and stabilize 4 per cent of shocks (against 17 per cent for national budgets). A budget composed exclusively of a corporate income tax and spending mostly focused on unemployment benefits is expected to substitute around 20 percent of national stabilization.

Finally, while the previous proposals mostly focus on macroeconomic stabilization and on *flow* variables, other analytical contributions focus on *stock* variables and pursue crisis prevention by suggesting various forms of European "redemption" funds; a share of national public debt would be transferred to these funds to achieve a reduction of the public debt-to-GDP ratio and complement prudent fiscal policies.[102]

5.3.2 Support for structural reforms

The key rationale for providing financial incentives for structural reforms is two-fold: reforms usually pose short-term costs, notably for public finances, but their benefits may take longer to materialize; reforms can be a source of positive spillovers for other member states but national governments fail to internalize them. Because of these economic and political costs, reforms may

[101] In European Commission (2018b, p. 29) it is noted that if the triggering and eligibility criteria are met, the decision and implementation of support would be left to the European Commission, without involving a decision from the Council.

[102] See Cioffi *et al.* (2019) for a comprehensive discussion. The first detailed scheme was advanced by the German Council of Economic Experts (2011). The Report of the "Tommaso Padoa-Schioppa Group" proposed a European Debt Agency (Notre Europe, 2012). The mechanism proposed by Cioffi *et. al.* (2019) foresees the transfer of a share of national public debts to the redemption fund. In exchange, each country would transfer a yearly flow of resources to the Fund. The authors show that it is possible to design such a scheme so that it does not entail any ex-ante cross-country redistribution, while providing benefits in terms of overall financial stability through lower annual refinancing needs for member states. The fraction of mutualized debt would be fully redeemed over a reasonable number of years and national commitment to debt reduction would be preserved.

not be implemented without incentives (Dolls *et al.*, 2019). The ultimate goal is to foster economic convergence and build resilience.

Awareness of the divisive views on the need and scope for a common macroeconomic stabilization function may explain why the Commission's Blueprint of 2012 envisaged the "*initial phase*" of the build-up of a fiscal capacity merely in the form of a "Convergence and Competitiveness Instrument – CCI". It would be based on "contractual agreements" between the Commission and euro-area member states in the framework of the Macroeconomic Imbalances Procedure. A CCI was meant to be the financial counterpart for setting-up a mechanism for the systematic ex-ante coordination of all major reforms in the context of the European Semester, given the absence in the EMU of strong forms of policy coordination in the area of structural reforms; it would provide an incentive to implement them by offering "*targeted financial support for the Member States facing adjustment difficulties*" (European Commission, 2012, p. 42).

Official discussions on a CCI broke down in 2013[103] but the idea resurfaced in the EMU Roadmap of December 2017, which includes proposals by the Commission for new budgetary instruments. As part of the Reform Support Programme,[104] a new Reform Delivery Tool[105] (equipped with €22 billion from the EU budget) aims to provide financial support (in the form of grants) with the explicit goal of promoting the design and implementation of key reforms.

The Euro Summit of December 2018 marked a step forward as it mandated the Eurogroup to work on the design, modalities of implementation and timing of a "Budgetary Instrument for Convergence and Competitiveness - BICC" for the euro area (and for ERM II Member States on a voluntary basis). It would be part of the EU budget and its size would be determined in the context of the next MFF for 2021-27.

The main features of the BICC were agreed at the Eurogroup meeting of 13 June 2019 (Council of the EU, 2019), with a focus on supporting, in the form of grants, structural reforms and public investment. Priority would be given to addressing the key challenges for competitiveness and convergence in EMU countries identified in the annual "Recommendation for the Euro Area" resulting from the European Semester.[106] A benefit expected from the new instrument rests in its ability to provide financing more quickly than under the existing European Structural and Investment (ESI) funds; furthermore, it might play a minimal stabilization role in the event of severe downturns, when it is envisaged that the co-financing rates of the individual EMU country could be temporarily reduced.

The latter feature also defines a similar proposal put forth by Fulke *et al.* (2019), whereby the new instrument would support convergence by funding the national co-financing requirements of the ESI funds during downturns. This would create fiscal space by relieving governments from an expenditure cost that is estimated in the range of 0.4-1.8 per cent of annual GDP for smaller euro

[103] See Kudrna (2018) for further details.

[104] The Reform Support Programme, with an overall budget of €25 billion, consists of three separate but complementary instruments: the Technical Support Instrument, the Reform Delivery Tool and the Convergence Facility (European Commission, 2017f and 2018a).

[105] The Reform Delivery Tool would seek to support a broad range of reforms in such areas as product and labor markets, taxation, development of capital markets, improvement of the business environment as well as investment in human capital and public administration reforms. The reforms to be supported would be proposed by the member states themselves in multiannual reform commitment packages "*with clear milestones and targets*" presented and monitored together with the National Reform Programmes (European Commission, 2017f).

[106] Member states would submit policy plans to be approved by the Commission. Funding would be linked to progress in implementation.

area countries (on average, 0.16 per cent of euro area GDP). The mechanism would be financed by a cyclically-sensitive revenue source (e.g. a synthetic corporate tax).

5.4 Size and Sources of Financing

Size is one of the most critical aspects of a fiscal capacity, notably in the form of a macroeconomic stabilization mechanism: the available pool of financial resources actually defines the credibility of the instrument in terms of effective countercyclical power. To this end, the literature suggests that the shock-absorption fund should amount to at least 1-2.5 per cent of GDP (Lenarčič and Korhonen, 2018).

When the (ambitious) objective is stabilizing GDP, Furceri and Zdzienicka (2013) show that a supranational mechanism based on temporary transfers, automatic rules and financed by a gross contribution of 1.5-2.5 per cent of Gross National Product can provide significant stabilization against shocks to GDP, on a par with the fiscal risk sharing observed in Germany and other federally organized countries.

For smaller-scale, insurance-based mechanisms, the literature has documented that they can offer substantial stabilization potential even with a limited amount of contribution (European Commission, 2018b). Arnold *et al.* (2018) simulate the stabilizing power of a central fiscal capacity – financed by annual country contributions of 0.35 per cent of GDP – in the face of a common shock that mimics the recent euro area crisis (and its differentiated impact): the explicit assumption is that transfers are used to mitigate the amount of the procyclical fiscal consolidation. The simulations show that, with a transfer of 0.5 per cent of GDP for every 1 percentage point deviation of a country's unemployment rate from its 7-year moving average, the fiscal capacity provides considerable stabilization: it reduces the impact of the shock by nearly one-third, and even more so (nearly three-fifths) when monetary policy is constrained.

Dolls (2018, pp. 5-6) documents that, by providing interregional smoothing, a re-insurance scheme for the euro area would have absorbed on average 15-25 per cent of the income losses originating from rising unemployment in deep recessions over the period 2000-16; in a variant where activation of the scheme is subject to a 1-percentage point threshold for increases in the unemployment rate, countries like Austria, Finland, France or Germany would have received transfers as well. Importantly, the double-condition rule *à la* Carnot *et al.* (2017) that triggers contributions to, and transfers from, the scheme ensures that no participating member state would turn out to be a permanent net contributor/recipient. Annual average net contributions would have amounted to between -0.1 and 0.1 per cent of GDP.

Dullien *et al.* (2018) assess the stabilization impact of a "compromise" common unemployment insurance fund consisting of both national compartments (for self-insurance) and a joint "rainy-day" compartment (for re-insurance against large shock), financed by an annual contribution of 0.1 per cent of GDP per country over the period 1997-2018. Their simulations show that, by using the scheme, GDP in Spain would have stayed 2.5 per cent higher during the crisis (2008-13); the impact for Italy would have been lower than 1 per cent of GDP because the increase in unemployment was less marked.

The EISF/SSF proposed by the Commission would rely on an envelope of €30 billion (0.3 per cent of euro area GDP) that is assessed as being able to support a limited but non-negligible fraction of a member-state's public investment (which across the EU ranges between 2-4 per cent of GDP). Simulations run for the period 1985-2017 show a maximum annual support ranging from 0.2 to 0.4 per cent of the member state's average GDP over the previous five years (European Commission, 2018b, p. 41); with a higher envelope of €100 billion, the maximum support would reach up to 1 per cent of national GDP.

The stabilizing power of a fiscal capacity depends not only on the size but also on the form of the financial assistance: insurance payouts/transfers *versus* loans. This form impacts the short-term trade-off faced by a shock-hit country: countercyclical support versus sustainability of public finances (European Commission, 2018b).

The EISF/SSF is a case in point in this regard. The main direct impact of such a borrowing-lending scheme operates by providing resources to preserve public investment, while (marginally) reducing the average cost of debt through the interest subsidy component. Its macroeconomic stabilization impact is limited by the fact that, although the financing is cheaper, the loan adds to public debt and needs to be repaid, thus potentially impacting sustainability concerns. As a result, the above-mentioned trade-off is basically unchanged: the fiscal space created would usually amount to the difference between what a country pays to borrow from the markets and what it pays to borrow from the scheme (Arnold *et al.*, 2018). On the contrary, an insurance payout/transfer scheme would improve the short-term trade-off and provide stronger stabilization mainly by allowing a country to adopt a more counter-cyclical fiscal stance – or, at the very least, a less procyclical one – to complement national automatic stabilizers in adverse circumstances; stabilization could also be beneficial for the quality of public finances and for avoiding booms and busts in public investments (European Commission, 2018b).

Against this background, there is also widespread recognition that to reach its highest effectiveness a fiscal capacity should be equipped with an ability to borrow, at least in the form of withdrawals from a rainy-day fund. If the stabilization mechanism cannot borrow against future proceeds, its ability to operate in full becomes dependent on the sequence of shocks and contributions. The European Commission estimates that without a borrowing capacity, the EISF/SSF would not have been able to face the recent double dip recession, even if it had been established in 1985. Besides, allowing the fund to borrow would avoid the first-come, first-served problem faced by some proposals.

As far as the sources of financing are concerned, a European fiscal capacity can in principle rely on three main sources (or a combination of them):[107] contributions from member states' national budgets; dedicated revenues through specific taxes raised at the central level;[108] and borrowing (rainy-day funds; back-to-back loans; Eurobonds/Eurobills). The type of resources made available to the fiscal capacity clearly depends on the functions assigned to it.

The various insurance-based stabilization mechanisms proposed in the literature usually assume that financing is provided through annual national contributions, ranging between 0.1 and 0.35 per cent of GDP in the examples cited before, which accumulate in a rainy-day fund.[109] The Stabilisation

[107] About 98 per cent of the EU budget currently relies on three main types of what are labelled as "own resources": 1) contributions from member states based on their income level measured by the Gross National Income; 2) contributions based on the Value Added Tax (currently 0.3 per cent); and 3) customs duties collected at the external borders of the Union. Although originally designed simply as a balancing system, the GNI-based contributions have become the largest source of revenue (about 70 per cent of total in 2017). As noted in the Monti Report (High Level Group on Own Resources, 2016, p. 68): "*The Treaty of Rome envisaged first the financing of the Community budget via national contributions as a provisional mechanism, to be then replaced by own resources, but the evolution of the own resources system since 1988 has brought back as the main source of financing an own resource which is in fact perceived as a national contribution*".

[108] At present, the EU does not have the power to levy taxes. See Iara (2016) for a comprehensive discussion on the options for funding a fiscal capacity. The author underlines that while scaling up member states' contributions is a straightforward choice, a genuine own resources tax-type (an "EMU tax") presents distinct value-added, including through a stronger perception of provisioning of common goods at the European level and enhanced legitimacy. Besides, revenue sharing on a harmonized basis would help mitigate tax competition across EMU members.

[109] National contributions can come from general revenues or by earmarking a specific source of revenue, for example a fraction of domestic social contributions (Italian Ministry of Economy and Finance, 2016).

Support Fund (SSF)[110] that would complement the EISF sets itself apart as it would be financed by contributions from euro area member states ("external assigned revenue"[111]) equivalent to 6 per cent of the amount of the monetary income – the seigniorage – allocated to their national central banks at the end of the preceding financial year.[112]

The legal form of a fiscal capacity also has important consequences (Crowe, 2018). The new budgetary instruments put forth by the Commission are to be financed through a "dedicated euro area budget line within the EU budget". This choice pursues two main objectives: maintaining the integrity of the EU budget and allowing external assigned revenue to provide additional financing for a fiscal capacity to be established for euro area member states only. This type of revenue excludes non-euro-area members from the decision-making process on the use of the capacity without preventing them from accessing available EU resources.

The Meseberg Declaration envisages that national contributions as well as "allocation of tax revenues" can complement European resources in the financing of new euro-area budgetary instruments. European resources would include not only funds from the EU budget (e.g. the euro area component of the proposed Reform Delivery Tool) but also new sources of revenues such as a Financial Transaction Tax[113] or the newly-proposed forms of EU own resources such as a Common Consolidated Corporate Tax Base and taxation of the digital economy.

The emphasis on these new sources of financing external to the EU budget is due to the fact that in their absence the size of the new euro area budgetary instruments would be limited by the overall resource envelope of the EU budget. The new instruments would thus compete with existing facilities such as the Balance of Payments Facility and the European Financial Stability Mechanism: the total outstanding amount of back-to-back loans available under all these instruments faces a single limit, namely the "margin" available under the own resources ceiling for payments appropriations (Claeys, 2018).[114] This ceiling also constraints the proposed EISF, whose loans would be financed by borrowing from capital markets by the European Commission:[115] while the EU budget would only act as a guarantee, borrowing is capped by the above-mentioned margin.

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[110] The SSF would be set up outside of the EU budget but its revenues would be assigned to the EU budget.

[111] (External and internal) "assigned revenue" (currently amounting to 5-7 per cent of total payments/commitments) is used to finance specific items of expenditure and is an exception to the principle of universality. In the U.S., dedicated revenues (in the form of custom duties) for the central government marked the beginning of the federal budget (Henning and Kessler, 2012).

[112] Clays (2018) estimates these contributions to be €600 million per year. The Monti Report (High Level Group on Own Resources, 2016, p. 68) estimates seigniorage to be around €4-5 billion per year.

[113] Ten euro-area countries are currently considering the introduction of an FTT under the "enhanced cooperation" procedure. It remains to be seen how an FTT levied on a subset of euro area countries could finance a euro-area wide instrument.

[114] The EU's annual budgets must always be established within the expenditure limits set in the Multiannual Financial Framework (MFF). In practice, commitments and payments are usually budgeted below the respective MFF ceilings. The difference, or "margin", between the ceiling and the budgeted amounts provides room for manoeuvre in the event of unforeseen needs.

[115] The EU budget cannot incur debt, as its revenue and expenditure must be in annual balance. However, the EU is empowered to borrow from markets and on-lend (at the same market conditions) to countries to provide financial assistance. This is the case for example for loans provided under the Balance of Payments Facility to support non-euro area member states or under the European Financial Stabilisation Mechanism available to all EU members. Since the funds raised and the corresponding loans are back-to-back operations, there is no direct impact on the EU budget as long as recipient member states honour their obligations. The EU budget thus serves as a guarantee for the borrowed amounts.

On the contrary, the European Parliament's resolution of February 2017 (European Parliament, 2017) called for a "specific additional budgetary capacity" for the euro area. As a first step it should be part of the EU budget, over and above the current ceilings of the MFF and financed by participating members via an external assigned revenue to be agreed between them; once in a steady state, the fiscal capacity could be financed through own resources, following the recommendation of the Monti Report on the future financing of the EU (High Level Group on Own Resources, 2016).

Finally, it has to be noted that a corollary of the above proposals is the expansion of the "galaxy" of intergovernmental and hybrid funds and instruments that co-exists alongside the core EU budget: for example, the Single Resolution Fund is a hybrid achieved by combining its legal basis in the Union Treaties with a more intergovernmental mode of financing (Crowe, 2018, p. 8). The same hybrid nature applies to the initial Franco-German proposal for a convergence and competitiveness instrument: it would be established under both EU law (covering its size, functions and priorities) and an Intergovernmental Agreement (IGA), which would define such aspects as national contributions and voting arrangements. An IGA is also being called for to determine the contributions from euro area member states to the proposed Stabilisation Support Fund.

5.5 Governance and legal requirements

The governance framework of a euro area budget is of primary importance as it would have an influence on its financing, and vice versa. As noted in the Monti Report (High Level Group on Own Resources, 2016, p. 68), in the course of history, the financing of a political entity has been instrumental in its development and capacity to fulfil its tasks: this is therefore not a secondary aspect but a constitutional one.

A key design issue relates to the level and allocation of the political responsibility for managing it. On the one hand, an insurance-type system based on a clearly observable cyclical variable (e.g., changes in the unemployment rate) may only require a relatively limited degree of political integration, as it could be based on rules (including on contributions) agreed upon ex ante by the participating countries (Wolff, 2012). On the other hand, more ambitious proposals (Villeroy de Galhau, 2016; European Commission, 2017f) call for the establishment of an "institution", namely a euro area finance minister (and a treasury).[116] The main rationale is to improve the coordination of national fiscal and structural policies; further tasks include the definition of an adequate aggregate fiscal stance for the euro area and the oversight on the use of common budgetary instruments (when available).

Villeroy de Galhau's proposal rests on the view that the current rules-based framework of economic governance would merely result in a (weak) monitoring of policies, while falling short of ensuring their full coordination. This gap could incur genuine economic costs in terms of growth: for example, a differentiated consolidation effort across euro area members states, in line with the available fiscal space, is pointed out as an alternative coordinated policy response that could have mitigated the GDP loss caused by the simultaneous fiscal consolidation during the sovereign debt crisis. A finance minister would thus mark a shift from the current regime of "monitored national policies" to an intermediate level of integration – labelled "full coordination of national policies" – before moving toward an upper level of "integrated policy". To implement this shift, the minister should be equipped with common instruments of increasingly wider scope: initially a convergence fund that would evolve into a stabilization instrument (e.g. a European layer of unemployment

[116] An alternative proposal (Tabellini, 2016) envisages the creation of a European Fiscal Institute, seen as a natural evolution of the ESM, whose main function would be the management of "stability" bonds issued to finance European public goods and backed by a euro area tax capacity in the form of transfers from member states.

insurance) and, ultimately, into a euro area budget; the minister would also bear some responsibilities for crisis management, namely overseeing ESM operations.

The European Commission's proposal to establish a European Minister for Economy and Finance includes important details on how to enhance his/her democratic legitimacy and accountability. It is suggested that the minister: act within the EU legal framework; be accountable to the European Parliament; and be at the same time the Vice President of the European Commission in charge of EMU and President of the Eurogroup, elected for the whole duration of the European Commission.[117]

In terms of legal requirements, the defining difference of the various proposals on a fiscal capacity is whether their introduction requires EU Treaty changes.[118]

The CCI envisaged in the Commission's 2012 Blueprint was meant to become available in the short term as it could be introduced through secondary law without requiring Treaty changes. In the same vein, these are not required for the new budgetary instruments proposed by the Commission such as the European Investment Stabilization Function. A macroeconomic stabilization function in the form of a European unemployment (re)insurance scheme could also be introduced within the boundaries of the current treaties (Repasi, 2017); the latter could accommodate the appointment of a euro-area Finance Minister, by means of the "double-hatting" proposed by European Commission (2017f).

On the contrary, proposals that move towards greater mutualization of financial risks and more institutions-based policy coordination – i.e. a euro-area treasury and budget – require Treaty changes to ensure more "*collective control over national budgetary policy in defined situations*" (European Commission, 2012, p. 26).

In fact, the recent reforms of the EU fiscal framework – notably the Two-Pack – have exhausted the legislative limits of what is possible under the current Treaties in terms of coordination and intervention at the EU level in the national budgetary process (European Commission, 2012, p. 26). Moving further in terms of supranational control of national budgetary policies, for example by setting up a European *right* to require a revision of national budgets in line with European commitments, would require a Treaty change, as it would modify the current *opinion* on national budgets introduced by the Two-Pack from a non-binding to a binding nature, which would amount to a transfer of national sovereignty.[119]

5.6 Risks and access criteria

The main objection to a central fiscal capacity, most notably in the form of an insurance-type mechanism, is that it may give rise to moral hazard and unidirectional, permanent transfers – i.e. redistribution – particularly if there are large differences in structural convergence among

[117] This "double-hatting" – member of the Commission and President (elected) of the Eurogroup – is already possible within the current Treaties. The Eurogroup has until now been chaired by a finance minister of a euro area country. The current President is elected for a term of two and a half years.

[118] For a comprehensive survey of these legal implications see Repasi (2013) and Crowe (2018). Fabbrini (2017) provides for an in-depth legal perspective of EMU reforms.

[119] European Commission (2012), Section 3.2.1. The Two-Pack does not give the Commission the right to change draft national budgets, nor does it create the obligation for Member States to strictly follow the Commission's opinion. In the Commission's view, the added value of this regulation is the direct guidance that it introduces within the budgetary procedure.

participating countries.[120] While the political costs of an economic crisis far outweigh the potential benefits from moral hazard behaviour, the latter needs to be addressed by a proper, incentive-compatible design of the fiscal capacity.

To design an incentive-compatible fiscal capacity, most proposals[121] include safeguards against redistribution and moral hazard and emphasize that a common unemployment insurance scheme for macroeconomic stabilization would only imply a temporary mutualization of macroeconomic and fiscal risks: over reasonably long-time horizons *all* countries would be net beneficiaries through participating in the scheme. In other terms, risk sharing would not morph into redistribution, mainly because the countries on the receiving end would vary over time[122]. At the same time, this randomness of asymmetric exogenous shocks to serve as the principle for balancing payments over a longer period is itself under criticism, along with the lack of explicit repayment obligations (German Council of Economic Experts, 2018a).

Other common safeguards include limiting the activation of a fiscal stabilization mechanism only in the event of large shocks or explicitly foreseeing some eligibility criteria: for example, access to the EISF/SSI is restricted to countries that comply with the EU macroeconomic and fiscal rules in the two years preceding the request; the central fiscal capacity by Arnold *et al.* (2018) adds a fully-fledged Medium-Term Fiscal Framework as a prerequisite to foster fiscal discipline. Additional design features include experience ratings, “usage premiums”, claw-back rules and caps on transfers.

The absence of unidirectional or permanent fiscal transfers is one of the “guiding principles” set out in the 2012 Four Presidents’ Report Roadmap (and replicated in the 2015 Five Presidents’ Report) for an EMU shock absorption function. In the Commission’s Blueprint of 2012 the necessary condition for avoiding permanent transfers is that cross-country differences in net transfers to a macroeconomic stabilization scheme do not depend on absolute income differences but rather on differences in cyclical positions[123]. The Five Presidents’ Report is even more demanding, as a euro area-wide fiscal stabilization function is noticeably meant to be “*the culmination of a process*” that requires important preconditions: a significant degree of economic convergence, financial integration and further coordination and pooling of decision-making on national budgets, with a commensurate strengthening of democratic accountability. To foster convergence, the Five Presidents’ Report proposes a set of new “common standards” whose ultimate goal is the achievement of “*similarly resilient economic structures*” throughout the euro area.

In the same vein, the European Parliament’s resolution of February 2017 envisages compliance with a “convergence code” as a condition for full participation in the fiscal capacity. The code includes a number of criteria to be met within a five-year period in such fields as taxation, the labour market, investment, productivity, social cohesion, and public and good governance capabilities. For their part, Demertzis and Wolff (2016) underline the importance of structural convergence as an “essential prerequisite” for common fiscal mechanisms to cope with large asymmetric shocks; however, they acknowledge that cross-country structural differences can be persistent.

[120] Furceri and Zdzienicka (2013) also note that a mechanism based on unemployment benefits could be procyclical instead of counter-cyclical due to delays in the response of unemployment to output shocks. In addition, the focus on short-term unemployment is likely to generate only limited risk sharing.

[121] Allard *et al*., (2013); Furceri and Zdzienicka (2013); Brandolini *et al*. (2014); Lenarčič and Korhonen (2018).

[122] Wolff (2012) underlines the concept of distribution neutrality, i.e. no net transfer to any single country over a certain period, assuming that country-specific shocks are random.

[123] Income level differences may persist over decades, while the relative cyclical positions are likely to change sign in the course of a decade (European Commission, 2012, p. 32).

Conditioning access to a fiscal capacity on (institutional and/or economic) "convergence" is a key limitation: this approach might result in a "tiering" of euro area members states – i.e. the fiscal capacity may be accessed by members in better conditions, which do not need it, while being denied to those members that need it the most; ultimately, this approach could be a recipe for paralysis. Crucially, economic convergence most likely depends on macroeconomic stabilization rather than the other way around: this is explicitly recognized in the European Commission's Blueprint, which states that a stabilization tool would help in "*facilitating stronger economic integration and convergence*" (European Commission, 2012, p. 31).

As noted in Section 5.1, cyclical fluctuations in the EMU have remained sizeable since the creation of the euro; the fact that they reflect both common and idiosyncratic factors confirms the importance of asymmetric shocks (Buti and Carnot, 2018). While favouring closer (structural and institutional) convergence should remain an objective, the risk that insufficient convergence may lead to unidirectional/permanent transfers can be tackled more effectively by properly designing a fiscal capacity.

Furthermore, agreeing on a set of high-level "common standards" or a "convergence code" – much less achieving them – in such sensitive areas as labour markets or tax policy might well remain wishful thinking as it involves a lengthy and complex negotiating process with very uncertain time-frames and outcomes (if any).

The abandonment of the 2012 proposals to introduce a Convergence and Competitiveness Instrument and "contractual arrangements" suggests that a structural reforms-for-financial support approach to developing a fiscal capacity is fraught with risks of failure. Besides, EU financing for structural reforms is already accessible to member states through various funds.[124]

In conclusion, while the risks of moral hazard and permanent transfers need to be fully addressed, they should not be exaggerated[125] and all proposals do include safeguards against them. A fiscal capacity for macroeconomic stabilization should be recognized as an end in and of itself towards a fuller EMU; it is an immediate priority that should be gradually established soon rather than at the "culmination" of a difficult, long and uncertain convergence process.

An additional risk that has been pointed out for the new budgetary instruments under discussion relates to the scope for duplicating other facilities that support investment such as the ESI funds and the European Fund for Strategic Investment (EFSI).[126] This risk is not negligible: as noted in the Monti Report, "*the EU budget is primarily an investment budget with some redistributive functions between the Member States*".[127] The European Commission underlines that the new budgetary instruments are designed with a view to maximizing the synergies between various EU-level

[124] In addition to the five European Structural and Investment funds, EU Member States can access financing under the European Fund for Strategic Investments, Horizon 2020, the Connecting Europe Facility and other directly managed EU funds. They can also obtain advice from the Structural Reform Support Service to facilitate the reform agenda (European Commission, 2017a).

[125] The idea that national policymakers would mismanage their country because common instruments are available to rescue them is extreme. Paraphrasing what the former Chairman of the Federal Reserve Ben Bernanke (2014) has said about quantitative easing ("the problem with quantitative easing is that it works in practice, but it doesn't work in theory"), one might say that in some cases moral hazard may work in theory but do not work in practice.

[126] In July 2018, exactly three years after the EFSI came into being, the EIB Group surpassed its initial goal of triggering €315 billion of additional investment in the EU by mid-2018. In 2017 European legislators decided to extend EFSI to €500 billion by 2020. http://www.eib.org/en/efsi/index.htm. The EU budget in the period 2014-2020 aims to mobilize about €480 billion in investment.

[127] High Level Group on Own Resources (2016, p. 6).

instruments and the future InvestEU,[128] which will be the successor of the Juncker Plan. For their part, Dolls *et al.* (2019) suggest that the Reform Delivery Tool should not be financed by a separate budget line but rather by reallocating existing resources from the ESI funds, given the significant amount of unused financing.

Finally, the establishment of a central fiscal capacity faces risks of a political nature. No budget has ever been created mainly for macroeconomic stabilisation purposes (Bénassy-Quéré *et al.*, 2018). A macroeconomic stabilization instrument involves transfers that can be politically difficult to justify: even if they are distributionally-neutral over time, they can be perceived by the public as "hand-outs to spendthrift governments" (Guttenberg and Hemker, 2018). Accordingly, a fiscal capacity might stand more chance of political acceptance if it is equipped with clear budget-like features to make well-defined economic cases on why important policy objectives are best provided at the European level. Ultimately, the choice of whether to equip the euro area with a fully-fledged budget could only grow out of political decisions to provide European public goods (European Commission, 2018a).

5.7 A persistent vulnerability

The abundance of proposals on establishing an EMU fiscal capacity has not translated so far into concrete progress. Defining the forms (dedicated fund or genuine budget) and functions (mere macroeconomic stabilization or, more broadly, provision of public goods) of a central fiscal capacity poses significant trade-offs and difficult political choices. A dedicated stabilization fund usually offers more active countercyclical capabilities but, as noted above, macroeconomic stabilization *per se* can be an insufficient and politically contentious rationale for establishing a common budget. The latter may attract more political interest as it pursues broader roles that can better appeal to citizens; besides, once a common budget exists, even in an embryonic form, a stabilization function stands more chances of being developed.

The proposals by the Commission to establish a European Investment Stabilisation Function (and a Reform Support Programme) are an attempt to break the stalemate. To a great extent, the importance of the EISF/SSF proposal rests on its signalling role: by earmarking financial resources for a specific expenditure, this instrument might constitute a basis for a true supranational fiscal capacity. In fact, the proposal clarifies that the EISF/SSF could be complemented over time by additional means outside of the EU budget.

It is also notable that, in the Commission's views, a stabilization function needs to be considered "*as a package*". In particular, setting up a scheme like the EISF/SSF may facilitate the subsequent introduction by euro area countries of a "voluntary insurance mechanism", as both options may share some similar conditions, for instance the triggering criteria (European Commission, 2018b, p. 58). In the same vein, it is likely no coincidence that the Commission's proposal for transforming the ESM into a European Monetary Fund explicitly refers to the possibility of developing new financial instruments with a view to *inter alia* playing "*a role in support to a possible stabilisation function in the future*".

Recent developments do not bode well for an EMU stabilization function. In December 2018 the Eurogroup conceded that it could not reach a common view on the need for and design of such a function (Council of the EU, 2018); a few days later, the Euro Summit mandated the Eurogroup to

[128] This new integrated investment fund will anchor all centrally-managed instruments inside the EU in a single, streamlined structure and is expected to mobilize more than €650 billion of additional investment across Europe between 2021 and 2027.

work on a budgetary instrument for "*convergence and competitiveness*", thus dropping macroeconomic stabilization from its functions.

As a result, for the time being a fiscal capacity for direct macroeconomic stabilization remains somewhat aspirational. Until this critical fissure in its architecture is filled in, the EMU lacks a key instrument to safeguard its longer-term viability and remains incomplete and vulnerable.

6. Concluding remarks

The strengthening of the EMU institutional architecture in response to the crisis has played a major part in paving the way for an economic recovery in the euro area that has resulted in a decline of the aggregate unemployment rate to around its pre-crisis level.

Yet, there is widespread consensus that the EMU remains incomplete: architectural gaps still create risks for macrofinancial stability as well as for the effectiveness of crisis prevention and resolution. The reforms have magnified a key asymmetry of the EMU: progress in risk reduction has not been matched by parallel progress in risk sharing. This is particularly true in the fiscal area, where stricter rules and more powers at the European level to constrain national fiscal policies have not been complemented by the establishment of supranational instruments for effective macroeconomic stabilization. In the financial area, the Banking Union lacks its critical third pillar, a European Deposit Insurance Scheme; the recent reforms of the ESM still need to be approved and ratified and their effectiveness remains uncertain.

The recognition that the EMU is incomplete might provide an uncomfortable answer to the key question of whether the euro area is ready for the next crisis,[129] at a time when Europe faces major geopolitical developments that pose challenges in the areas of defence, internal security and immigration. These complex issues require common and multifaceted responses that must involve economic and financial policies. Moreover, following the vote in the referendum of 23 June 2016, the United Kingdom's decision to leave the EU – Brexit – aside from its macroeconomic impact, raises the critical question of how issues on the future of the EU will affect the EMU;[130] no less important is the fact that the EMU is likely set to face the next downturn with lower countercyclical capabilities than before the recent crises.

Against this background, further institutional enhancements need to be introduced to dispel uncertainty over the EMU's longer-term viability. Missing the opportunity offered by the recovery to advance integration would be a repetition of the political economy of "good times",[131] whereby satisfactory economic performance in the run-up to the past crisis offered little incentives for more integration. It is also imperative to show that Europe can act pre-emptively, avoiding the pattern displayed during the crisis, when risk sharing mechanisms were introduced hastily only in the face of concrete threats of a euro-area break-up.

Legacy issues such as high public debt and banks' NPLs must continue to be addressed resolutely; but it is important to recognize that, rather than arising from fiscal indiscipline or risky lending practices, legacy issues are to a large extent rooted in macroeconomic factors, namely the double-dip recession suffered by the euro area, the seriousness of which was amplified by the absence of a central countercyclical fiscal response. Stronger and sustained macroeconomic growth would thus

[129] Eichengreen (2019).

[130] Hoeksma (2015) links the doubts on the viability of the euro area to the lack of a proper paradigm capable of explaining the existence and functioning of the EU itself.

[131] Dyson (2012).

be most effective in helping address legacy issues and further reduce risks.[132] Crucially, legacy issues should not be turned into an excuse for delaying progress towards a deeper EMU.

Priority should be given to closing the gap between risk reduction and risk sharing, because at the current juncture risk sharing is *in and of itself* a conduit for risk reduction. The most immediate goals of European policymakers are well-known: completing the Banking Union, by establishing the EDIS; introducing the common backstop for the Single Resolution Fund earlier than the steady state date of 2024 (thus recognizing the substantial reduction in risks); approving the reforms of the ESM and extending its role as a common backstop to the prospective Deposit Insurance Fund. These critical steps need to be accompanied by the gradual setting up of a well-designed central fiscal capacity that can complement national domestic buffers – the first line of defence – in withstanding large idiosyncratic shocks, to limit the permanent loss of output generated by a crisis and facilitate the absorption of public and private debts.

Given the almost unanimous recognition that the current fiscal rules are too complex and undermine compliance, increased public risk sharing through a central fiscal capacity could be introduced in conjunction with a complementary reform of these rules to stand more chance of success. These rules need to avoid procyclicality and ensure growth-friendly incentives to build-up buffers;[133] besides, rules need to be simplified to ensure an unequivocal and transparent assessment of compliance. Fostering compliance with rules should also feature highly in designing a fiscal capacity.

Recent developments offer a mixed picture in terms of political support for overcoming the stalemate on advancing the EMU. On the one hand, the Euro Summit of December 2018 approved some important measures; on the other hand, the timeline for the EDIS remains undefined and the euro area budgetary instrument introduced in the European official agenda has a number of limitations that may greatly diminish its impact: the possible shift from transfer-based to loan-based instruments; the risk of duplicating the investment-support role of existing EU funds; above all, the exclusion of macroeconomic stabilisation as a direct objective. Furthermore, the Eurogroup of June 2019 acknowledged the lack of consensus on the appropriate options for financing this instrument.

The asymmetric progress in risk reduction and risk sharing can be ascribed to technical and political choices in designing and sequencing the various anti-crisis policy responses; however, it may ultimately also reflect a trail of mistrust that lingers among EMU member states, which is largely owing to differences of opinion over the sources of current and future risks – including from legacy issues and the sovereign-bank nexus. While the latter has been substantially weakened by a comprehensive set of measures, another vicious circle seems to have emerged: the perception by some euro-area members that other members are reluctant to fully comply with rules and rein in the remaining risks in the banking and sovereign sector generates mistrust that prevents any progress towards more risk sharing. This in turn undermines confidence, creates resentment and uncertainty over the benefits of European integration, ultimately fuelling further dissatisfaction (if not outright hostility) towards the existing rules.

The sense of mistrust is perhaps best symbolized by the fact that the word "solidarity" – which appears sixteen times in the EU Treaties and is seen as "*the glue that keeps our Union together*" (Juncker, 2016) – in common parlance is at times replaced by "mutualization", which usually has a negative connotation, i.e. it raises the spectre of moral hazard and a "transfer" union.

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[132] *Mutatis mutandis*, as observed by L. Summers ("A world stumped by stubbornly low inflation", Financial Times, March 6, 2016) with reference to the policy response to the high inflation in the 1970s, "*a crucial step was the abandonment of the idea that the problem was structural in nature rather than driven by macroeconomic policy*".

[133] Carnot (2017); European Fiscal Board (2018); Arnold *et al.* (2018).

Lack of trust may well also reflect the absence of the elements for a political union. The strengthening of the EMU institutional architecture has not tackled the key question of whether the euro can survive without addressing its "original sin" of being a "currency without a state". Historical evidence supports the view that all previous monetary unions not embedded in a political union have collapsed. When the euro was launched, the OECD emphasized that "*…long lasting monetary unions among major sovereign nations have never been observed before, without strong political integration*".[134]

To overcome the vulnerabilities and risks posed by its architectural incompleteness, the EMU has often been characterized as currently facing a crossroads: either progressing toward more integration or retreating to a decentralized approach, defined by stronger national responsibilities, stricter rules and less common instruments. The choice between the two alternatives is of course purely political and left to elected officials.

If the preference is for more integration, the EMU needs a qualitative leap to reinforce its political dimension and become "deep, genuine and fair". To this end, more action at an *economic*, *fiscal* and *financial* level must be complemented by concurrent action at an *institutional* and *political* level.[135] European integration poses issues that are complex, multi-faceted and closely intertwined: a holistic approach that aims at making parallel progress across those key dimensions promises to be more effective and may offer a broader scope for mutually satisfying outcomes that ultimately help re-build trust.

This holistic approach offers two main advantages. First, it would replace the piecemeal method of EMU integration followed so far, which despite major achievements has generated reform fatigue that makes successive steps towards integration even more difficult to attain. The stalemate on establishing a European Deposit Insurance Scheme is to some extent a product of this method. Secondly, it would emphasize the scope for cross-fertilization: for example, a fiscal union involves choices that require democratic legitimacy and thus calls for a stronger role for the European parliament; common financial instruments managed by supranational institutions might be used to fund public investment or an unemployment re-insurance scheme as well as to complement the financing of EU-wide public goods such as defense, internal security, infrastructure and environmental protection.

An embryonic example of cross-fertilization can perhaps be found in the willingness expressed by the European Commission to use the "unusual events outside the control of the government" provisions, embedded in the Stability and Growth Pact, to accommodate the net extra costs stemming directly from the refugee crisis, when assessing (ex post) possible temporary deviations from the SGP requirements.[136] Another example is provided in the Monti Report:[137] in emphasizing that the EU budget is still insufficiently focused on the tasks that would generate the most European value added, the Report underscores that by better linking EU revenue with common policies it would be possible to rectify the current bias whereby the EU expresses its political choices mostly through spending and subsidies.

Progress towards deepening the EMU might have the potential of taking on the role of an "integration catalyst", i.e. the political ground where member states can recover the ability to

[134] OECD, 1999 (p. 9). Issing (2016) notes that comparison with the past is misleading as euro-area countries already share a number of the essential elements for a political union: for example, a central bank does not make a state, but it is an important component of statehood.

[135] Visco (2015 and 2016b).

[136] European Commission (2015c, p. 3).

[137] High Level Group on Own Resources (2016, p. 8).

cooperate and display a desire for shared European objectives; progress could also spill outside of the euro area and cross-fertilize more effective solutions for issues that are fundamental to defining a true European citizenship, e.g., defense and internal security.

In forcefully underlining the importance of the draft treaty establishing the European Union, to be approved by the Parliament on 14 February 1984, Altiero Spinelli (1983) stated:

And finally let it not be said that this is too risky, that we must keep our feet on the ground and take small steps forward. You can all see to what a disastrous state this so-called policy of feet on the ground and small steps has led us – a policy called 'pragmatism', while it really is a policy based on a lack of ideas and vision or to put it bluntly, based on intellectual subservience or worn-out and hopelessly inadequate ideas.

Reforms to achieve a more complete EMU – with a broader set of common instruments – need to be designed with a view to, *inter alia*, providing the right incentives to policymakers and markets alike to pursue sound policies and abide by the rules. However, an exclusive focus on incentive compatibility as the guiding principle of each step towards more integration could likely meet Altiero Spinelli's definition of a feet-on-the-ground policy. The quest for advancing the EMU cannot be based on an approach that treats relationships between members largely as a principal-agent scheme; the design of common instruments cannot mimic an attempt to write improbable complete contracts. This approach would be technocratic and divisive; it would neither lead to joint solutions, nor foster their ownership by all members states; ultimately, it would fail to rebuild much-needed trust.

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