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OVERCOMING EURO AREA FRAGILITY

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AT A GLANCE

– The institutional set-up of the Euro Area remains incomplete. The recent return of turbulence in government bond markets resulting from the initially failed attempt to form a government in Italy highlights the ongoing and inherent fragility of the Euro Area.
– Some important progress has been made since the crisis, belatedly and often imperfectly, in reforming the institutional framework of the Euro Area. However, the existential weaknesses – redenomination risk given doubts about financial stability and the effectiveness of the Lender-of-Last-Resort-function of the ECB, together with the inadequacy of measures to address inherent divergence trends between member countries – have not been resolved. For as long as that is so, the Euro Area will remain on shaky ground.
– This report reviews proposals to strengthen the institutional setup of the Euro Area. A package is proposed to complete the banking union, introduce symmetric macroeconomic policies preventing imbalances, and strengthen the institutional reforms underpinning convergence and stability.
– Jointly implemented, the reform package would rectify the over-reliance on the ECB as a firefighter, and put Euro Area institutions and member states – with the involvement of governments, parliaments and social partners – in charge of dealing with intra-euro area imbalances and keeping growth close to potential. The more a preventive approach can be reinforced, the less recourse is needed to euro-level emergency measures, the greater will be the confidence that such measures can be introduced without risking "moral hazard".
– Time is running out – the various proposals are on the table. Choices and trade-offs need to be made, bearing in mind that the perfect must not be allowed to be made the enemy of the good. Policymakers must make those choices swiftly, find the necessary political compromises and implement them before it is too late.

Podcast

by Andrew Watt

on Euro Area reform needs
http://bit.ly/2ykYyCJ

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INTRODUCTION

The institutional set-up of the Euro Area remains incomplete. The recent return of turbulence in government bond markets resulting from the initially failed attempt to form a government in Italy, which saw yields spiking sharply, highlights the ongoing and inherent fragility of the Euro Area. Despite important reforms that have extended the stabilisation capacity of monetary policy, reforms of the fiscal framework and other economic governance mechanisms, not least in the area of banking supervision and resolution over the last years, the Euro Area is still prone to shocks threatening its financial stability and overall macroeconomic performance.

There are three main areas of major, interlinked, institutional weaknesses, as revealed by the crisis and since only partially addressed. First, as widely acknowledged, from an optimal currency area perspective and given its limits on labour mobility, the Euro Area lacks sufficient fiscal and financial integration to adequately cope with asymmetric shocks.[1] More fundamentally there is a built-in tendency to cyclical divergence due to self-reinforcing imbalances (Horn and Watt 2017). For a common nominal interest rate, real interest rates are lower in booming economies with a tendency to higher inflation, than in stagnant, low-inflation economies. Because counter-acting forces (e.g. countercyclical fiscal policy) and institutions are too weak, this generates boom-bust cycles, the build-up of competitive and current account imbalances, and the phenomenon of what Olivier Blanchard termed "rotating slumps".

Secondly, a fundamental uncertainty hangs over the public finances of Euro Area member states because they are not fully backed by their own currency-issuing central bank, and the Lender-of-Last-Resort (LOLR) function at Euro Area level is so far limited to the ECB's promise to do "whatever it takes" and the untested and conditional OMT program. National sovereign bonds can be subject to self-fulfilling speculative attacks. Holders of such bonds – and of private-sector assets – nowadays not only face the risk of haircuts, but of fundamental "redenomination risk", i.e. the perceived threat of Euro exit and subsequent devaluation fears, despite the fact that this is explicitly ruled out in the Treaties. The Euro Area as a whole lacks a safe asset, a security whose nominal value is secure even in a crisis. Linked to this is the so-called "doom loop" between national governments and the domestic banking system, in which either declining values of government bonds held by domestic banks or banking crises requiring government intervention become mutually reinforcing.

The third critical area relates to the rules governing member state economic and especially fiscal policy. Many of them are asymmetrical – only constraining countries with debt and deficit ratios considered excessive. They work procyclically in practice – because supposedly "structural" measures actually contain a substantial cyclical component. They do not safeguard, indeed they give incentives to cut back, public investment in a downturn. And they give scant regard to the need for an appropriate aggregate fiscal stance, leaving monetary policy overburdened in a crisis.

Since the crisis, the EU and the member states have together embarked on a substantial programme of institutional reform. We review the main elements and examine what has been achieved and where significant gaps remain. That the gaps are still significant is reflected in the ongoing flood of proposals: from the European Institutions, e. g. the Five Presidents' Report (Juncker 2015); from national governments (most notably the proposals by

1 For more detailed expositions see e.g. Bayoumi and Eichengreen (1993, 2017), De Grauwe (2011), De Grauwe and Ji (2013), Illing and Watzka (2013), Krugman (2012).

French President Macron)[2], and also from academics and policy-advisory bodies. We review some of the main ideas below. We then present against this background our own set of proposals for institutionally stabilising the Euro Area.

If anyone was in any doubt about the urgency of the reform requirements – and it appears that many, not least in Germany, have been – financial market reactions to the tortuous government formation in Italy have brought home that Europe will have to make a qualitative leap forward to complete the half-finished architecture of EMU, otherwise it risks being swept into the dustbin of history.

SHAKY STATUS QUO: THE EURO AREA AFTER POST-CRISIS REFORMS

The ECB under its president Mario Draghi is widely credited with having ended the Euro Area debt crisis that had festered for several years and seemed likely to lead to a breakdown of the currency union in the summer of 2012. After initially being slow to adequately respond to the financial and economic crisis – it temporarily even raised its policy rates in 2011 and lagged behind other central banks in subsequently reducing interest rates and adopting unconventional policy measures – the ECB became the key player in stabilising the Euro Area economy, in the face of the failure of fiscal policy to offset a renewed downturn. It was ECB action above all else that ended the long recessionary period and avoided deflation. With his by now famous "Whatever it takes"speech, ECB President Mario Draghi informally established a lender-of-last-resort function for the ECB (Watzka, 2017). This crucial function of any central bank, i.e. acting as liquidity-provider to solvent but illiquid banks and states, had been notoriously absent from the ECB statutes.

It is hard to overstate the importance of Mario Draghi's speech, and the ECB's policy package that followed, essentially the Outright Monetary Transactions (OMT) program.[3] **Figure 1** shows impressively how the announcement and the mere establishment of OMT – which has never actually been deployed – lowered the spreads on government bond yields between Spain or Italy, and Germany; effectively eliminating "redenomination risk", the risk of individual countries exiting the Euro Area.

The other important change in the ECB's policy was its belated, but then increasingly determined move towards a more expansionary monetary policy stance, culminating in January 2015 in its adoption of the so-called Asset-Purchase-Program (APP), the ECB's version of QE. Aiming to prevent defla-

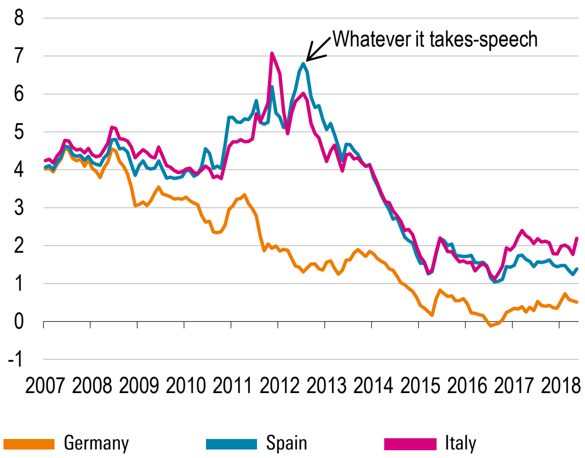
2 The prominence given to Europe and EMU reform in the coalition agreement of the new German government is also striking. The entire first chapter of the agreement – called "A new dawn for Europe" – is concerned with how to make Europe more social, democratic, stable, and how to foster solidarity within Europe. Alongside the governance issues on which we focus here, it refers for instance to minimum standards for social welfare systems, minimum wages in Europe, fighting tax evasion, and minimum corporate taxes.

3 Unfortunately, despite all his diplomatic skills, the ECB president failed to convince the president of the German Bundesbank to follow his fellow council members and support the OMT program. The Bundesbank even drafted a strong judicial statement against OMT when the program was eventually brought to the German Constitutional Court. The lack of unanimity raises questions about whether OMT can be relied upon to ensure the LOLR function in a future crisis.

Figure 1

Government bond yields, 10 year

in percent



Source: Macrobond.

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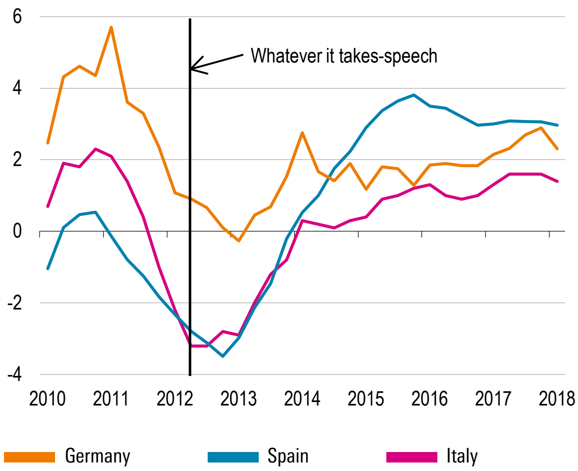
Figure 2

GDP growth rates

in percent



Source: Macrobond.

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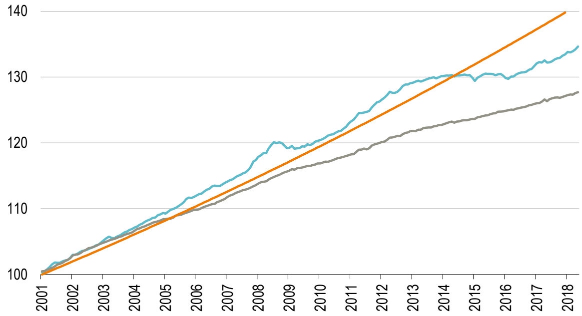
Figure 3

Inflation shortfall in Euro Area

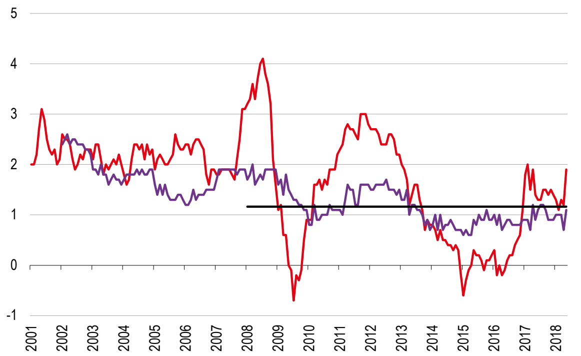
a) Price level

rebased 01.01.2001=100



Euro Area, HICP, all-items, index
Euro Area, HICP, overall index excluding energy, food, alcohol & tobacco, index
HICP inflation at 2% each year

b) Inflation



Euro Area, HICP, all-items, change Y/Y
Euro Area, HICP, overall index excluding energy, food, alcohol & tobacco, index, change Y/Y
Mean of Euro Area, HICP, all-items, change Y/Y (since 2008)

Source: Macrobond.

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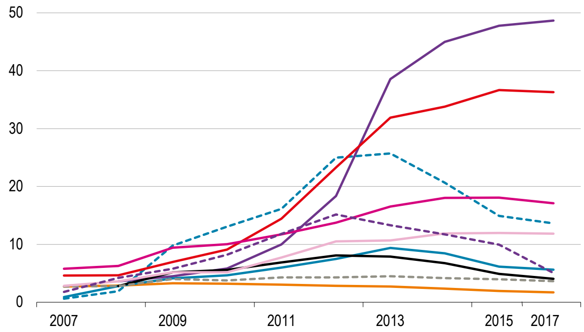
Figure 4

NPL - Bank nonperforming loans to total gross loans, assets

in percent



Cyprus
Italy
Portugal
Spain
EU
Greece
Ireland
Slovenia
France
Germany

Sources: Macrobond; World Bank.

tion from taking hold of the Euro Area, the program helped stabilise the economy and set the path towards recovery (**Figure 2**). Whilst the exact degree to which the ECB's measures contributed to the recovery in the Euro Area remains a debated issue (OFCE et al. 2016: 91ff.), by lowering relevant long-term interest rates and a depreciation of the euro exchange rate the measures succeeded to stimulate demand in the Euro Area (Deutsche Bundesbank Monthly Report August 2017). In contrast, fiscal policy was restrictive until 2014 and subsequently only broadly neutral. The demand recovery was thus exclusively reliant on monetary policy.

However, despite the undoubted success of the ECB in stabilising the Euro Area economy, avoiding deflation, and promoting the recovery, inflation in the Euro Area remains subdued and in fact for over a decade has now been far below the ECB's target rate of below but close to 2%. The cumulative inflation shortfall is striking as shown by the rising gap between the actual and the "optimal" price level paths (**Figure 3**).

The project of establishing a fully-fledged banking union was politically initiated at the Brussels summit in late June 2012. Policy makers agreed on the need to stabilise the banking system by harmonising supervision, resolution, and deposit insurance and transferring it to the level of the Euro Area, in practice to the ECB. The first two pillars of the banking union, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), are now in place and almost fully functional. However, the Single Resolution Fund would need to be substantially enlarged to make the financial system of the Euro Area effectively stable.[4]

Nevertheless, a critical piece is still missing: an area-wide deposit insurance scheme that safeguards private sector bank deposits up to €100 000 irrespective of which member state the bank is located in. As a consequence depositors will remain wary in which jurisdiction they deposit their funds and in times of crisis retreat from jurisdictions perceived as vulnerable to safe havens. Without the envisaged European Deposit Insurance Scheme (EDIS), financial instability will remain inherent in the institutional set-up of the Euro Area.

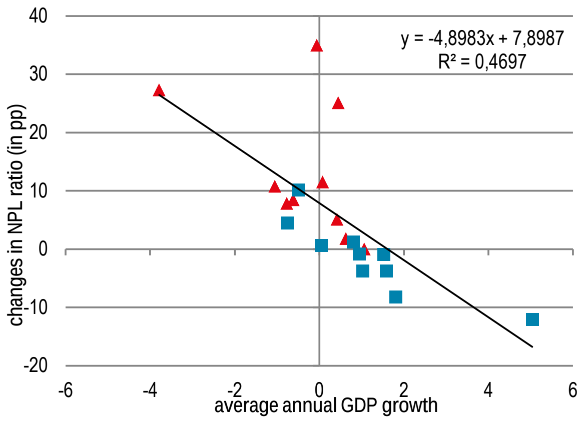
The stock of non-performing loans (NPL) and their share in gross bank loans are currently still at elevated levels and in particular still high in those countries hardest hit by the crisis. However, since

4 As of 30 June 2017 the SRF holds an amount of €17.4 billion (https://srb.europa.eu/en/node/362. See Lindner et al. (2014) for why this is hardly sufficient to stabilise the system in case of a large shock.

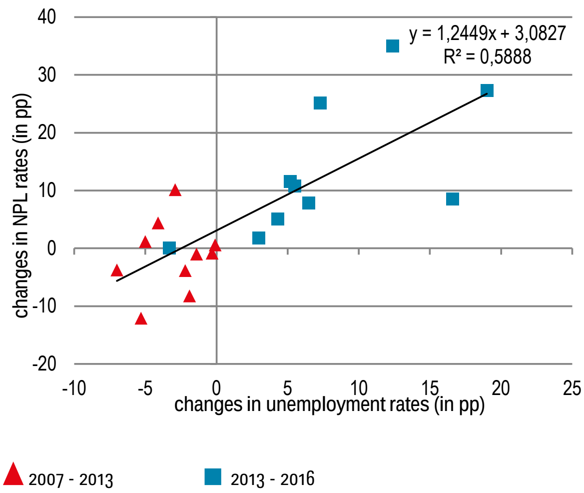
Figure 5

NPLs over the business cycle

a) Changes in NPL ratio and GDP growth



b) Changes in NPL ratio and changes in unemployment rates



Source: Macrobond; IMK calculations.

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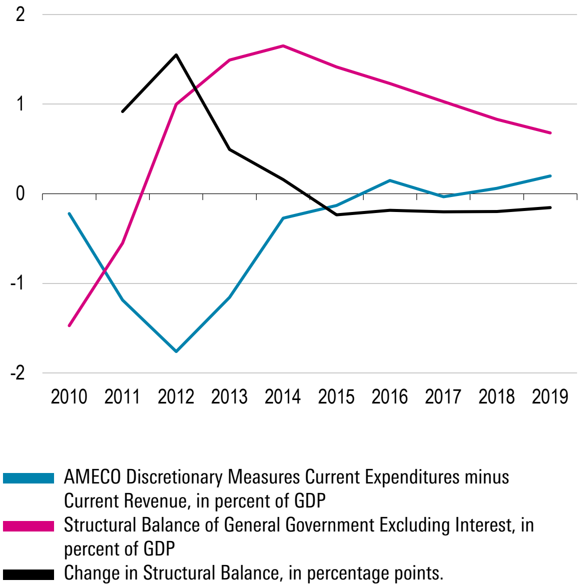
Figure 6

Euro Area fiscal stance

in percent



Source: Macrobond.

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the economic recovery of the Euro Area in around 2014, both the stocks and shares of NPLs have been declining throughout the currency union **(Figure 4)**. There is a close correlation between business cycle developments and NPLs **(Figure 5)**, showing that with sufficiently high economic growth it is possible to resolve the NPL issue (Mohaddes et al. 2017). The ongoing reduction in risk, assuming the current recovery can be maintained, should clear the way for the successful implementation of EDIS.

There is a risk that so-called legacy problems are used to delay the process of further European integration. It is important to explicitly define what is meant by "legacy" and to agree on a specific timetable for EDIS with exact criteria to be satisfied at the various stages. After all, European banking union in its present form with a single supervisor and resolution board will have been in place for more than eight years when EDIS should finally be fully implemented by 2024. This corresponds to the maximum time span for completely provisioning NPLs according to the supervisory guidelines, as proposed in a recent initiative of the Spanish government (ECB 2018a, Spanish Ministry of Economy, Industry and Competitiveness 2018).

Fiscal policy, after an initial effort at stabilisation in the wake of the financial crisis, turned pro-cyclical as early as 2011. Austerity in countries that were forced to reduce relative wages and prices, and reverse fiscal and current account deficits was not offset by expansionary policies in surplus countries, especially Germany. Only since 2014 did fiscal policy in the Euro Area move to a neutral stance; but this merely avoided further damage and did not contribute much to the recovery, which relied exclusively on monetary policy **(Figure 6)**.

In the wake of the crisis a substantial number of economic governance reforms were implemented, either as short-term crisis management or with a view to a longer-term strengthening of policy coordination. The surveillance of national fiscal and other economic policies was strengthened with the introduction of the European semester, reforms of the fiscal rules (so-called six-pack and two-pack) and the introduction of the Macroeconomic Imbalance Procedure (MIP).

The European semester seeks to concentrate economic policy coordination and deliberation in the first half of each year, based on a strategic orientation given by the Commission and Council at the end of the previous year, reports by the member states and an evaluation by the European authorities including the European Parliament. The second half of the year focuses on implementation by the member states. Recommendations and evaluations are also made within this process for the Euro Area as a whole; this is supposed to close the identified gap in determining an aggregate fiscal stance or macroeconomic policy more generally. This cannot, though, offset the lack of an actor, especially for fiscal policy, at central level and thus a specific addressee of the recommendations.

On top of this the fiscal rules were appreciably tightened under the six- and two-pack and the intergovernmental fiscal compact. This is true both in procedural terms (with debt brakes having to be established in national law) and substantively: all member states are to run a balanced budget over the cycle, with no provision for public investment, while those with above-target debts and deficits are required to make appreciable annual adjustments in "structural" terms. The use of supposedly "structural" budget positions to evaluate policy tends in practice to lead to pro-cyclical outcomes because of difficulties in assessing the cyclical and structural components in real time (Kusi 2017, Paetz/Rietzler/Truger 2016). This has led the current EU Commission to be flexible in its interpretation of the rules in order to avoid too contractionary recommendations.

The overall impact is, however, deflationary and the policy implies at least theoretically the abolition of public debt in the long run, which amongst other things would lead to a drying up of "safe assets" within the financial system. Meanwhile the fiscal rules have become incredibly complex – the recent Vade Mecum describing them runs to over 200 pages.[5] And the rules have been applied inconsistently, creating political frictions. The evaluation of the fiscal rules does not systematically consider competitive and current account position.

An important element of institutional reform came in 2011 with the MIP, which benchmarks countries against a scoreboard of indicators. It marked belated recognition of the crucial role of competitive and current account imbalances within the monetary union, which most pre-crisis analyses had ignored or downplayed (Horn and Watt 2017: 15ff.). At least in principle, failure to meet benchmarks is subject to a procedure similar to the fiscal rules, meaning that, ultimately, sanctions can be imposed on recalcitrant member states. In practice, however, this has not happened, partly because of the multitude of indicators and partly because the responsibility for inadequate performance is harder to pin down than in the case of government budgets. While less one-sided than the fiscal rules, the scoreboard is asymmetric, focusing either only on indicators of inadequate competitiveness or – most prominently in the case of the current account position – with a more restrictive threshold for deficits than surpluses. The overall effect, against the background of the simple fact that competitiveness within monetary union is a relative concept, is to impart a deflationary bias to policymaking.

Separately institutionally from the MIP, but linked thematically, are the so-called productivity boards: expert bodies at national level, modelled on the fiscal councils that supervise national fiscal policy, to assess competitiveness and productivity-related issues. These boards were foreseen in the Five Presidents' report and a Council recommendation for their introduction was made in late 2016; they are due to take up their duties in the course of 2018.[6]

In short, despite quite substantial reform of economic governance since the crisis, national fiscal policies – and economic policies more generally – remain to a considerable degree uncoordinated, while at the same time the coordination that does occur is often counter-productive. Critical weaknesses remain. The EU budget is still very small in macroeconomic terms (around 1% of gross national income) and is largely devoted to longer-term structural measures (agriculture, cohesion funds). With no borrowing capacity it cannot play an effective stabilising function, neither in aggregate nor with respect to country-specific shocks. Coupled with the pro-cyclical fiscal rules, this has led to excessive and highly costly austerity and a severe deepening of the depression in the countries affected most by the euro crisis (Banque de France 2017, Rannenberg et al. 2015).

RECENT PROPOSALS FOR REFORM

A series of reports from the EU institutions – notably the so-called Five Presidents' report (Juncker 2015) – has sought to sketch out options for renewal and deepening of monetary union. The most recent and concrete of these was the Reflection paper on the deepening of EMU (EU Commission 2017) followed by the road-map and so-called Nicolaus Package of proposals presented in December 2017.[7] Key points include:

First, the European Stability Mechanism, currently intergovernmental, is to be transformed into a European Monetary Fund (EMF) as a fully-fledged EU institution but with few functional changes. The main task of crisis-lending to member states in need and the related ability to issue bonds to raise finance remain. New is the proposal for the EMF to backstop the Single Resolution Fund as part of the banking union. By providing guarantees or a credit line, and in parallel by reducing the policy areas subject to unanimity, the EMF would be able to offer swift

5 https://ec.europa.eu/info/sites/info/files/economy-finance/ip075_en.pdf

6 http://www.europarl.europa.eu/legislative-train/theme-deeper-and-fairer-economic-and-monetary-union/file-national-productivity-boards

7 http://europa.eu/rapid/press-release_IP-17-5005_en.htm

assistance in the case of banking crises, plugging a notable hole in the policy framework. Reference is made to the possibility for the EMF to develope new financial instruments "over time". This is a door left open to an extension of borrowing – and thus stabilisation – capacity in the future.

The EMF is not foreseen to play a key role in disciplining member states and ensuring the implementation of structural reforms in normal times. Oversight responsibility is to remain unchanged (i.e. divided between the Commission and the Council).

In a formally similar way, second, the intergovernmental Treaty on Stability, Coordination and Governance (better known as the fiscal compact) is to be integrated into the EU treaties. There is no substantive change, but it is important in that the negative aspects of the TSCG's fiscal rules will acquire "constitutional" status.

Third, while rejecting the setting up of a specific budget for the Euro Area, the Commission has proposed various budgetary instruments to support Euro Area countries within the existing EU budget; they are quantitatively very limited, though. There is a proposal for an area-wide stabilisation function, but it has the limited goal of preventing countries in recession from having to cut public investment.

Fourth, a proposal is made for a European Minister of Economy and Finance, whereby he or she is to be simultaneously Vice-president of the Commission and President of the Eurogroup. He or she would represent the interest of the Euro Area as a whole, vis-a-vis the member states and outside world. It would go some way to reduce the intransparency about "backroom deals" in the intergovernmental Eurogroup. The precise functions of the minister are left open.

The ESM is not foreseen to develop into an independent "enforcer" of structural reforms and there is no mention of enhancing "market discipline" on government finances (i.e. sovereign debt restructuring), both key elements of the "Maastricht 2.0" approach (see below). Equally there are no ambitious proposals for automatic stabilisation mechanisms or large counter-cyclical buffers, neither a boost to the EU (or EMU) budget to create room for financing public goods, tapping new sources of finance, as proposed by President Macron in his Sorbonne Speech,[8] nor a Euro Area borrowing capacity. A door is left open for the latter, however, via future EMF financial instruments. The proposals are overall broadly in the spirit of President Macron's call for a great leap forward in economic governance, yet they remain very limited in ambition.

It is useful to contrast these proposals with what is termed here the "Maastricht 2.0" approach (e.g. Bundesbank 2016:57-61, Andritzky et al 2016)[9]. The basic logic is that increased risk-sharing has not and will not be accompanied by moves towards deeper political integration. Therefore re-establishing the link, central to ordoliberalism, between rights and responsibilities (thus avoiding "moral hazard") means ensuring the credibility of the existing rules governing, in particular, national fiscal policy. In short: if it is not possible (or desirable) to exert bureaucratic control over member state fiscal policies, then national governments must themselves suffer the negative consequences of fiscal laxity.

According to the Maastricht 2.0 view, the no-bail-out rule must be rendered credible once more. Steps must be taken to ensure that contagion from one country to another is limited as much as possible; otherwise recalcitrant states will persevere with harmful policies because they know that, ultimately, other countries and/or the EU institutions will be forced to bail them out. Sovereign debt defaults cannot and should not be ruled out, in this world-view, because they are considered a necessary disciplining device.

Proposals involving common debt-raising capacities, automatic cross-border stabilisation and debt mutualisation are, obviously, precluded in this approach. Instead the fiscal rules should be simplified and room for political discretion removed; any emergency lending for short-term insolvency must be tightly constrained; legacy bank liabilities and exposure to home-country sovereign debt must be reduced and bail-ins made possible, so that the taxpayer only intervenes in a systemic crisis. The ESM is tasked with crisis-prevention and emergency lending, whereby it is to apply rules for "orderly" government bond defaults (sovereign debt restructuring).

The Maastricht 2.0 approach poses serious risks to the good functioning and even the very survival of monetary union (OFCE et al. 2017, ch. 3; Watt 2017a). It is also arguably politically unworkable. It puts a sub-set of countries back into a situation resembling that in the previous European Monetary System. Even in good times, countries whose currencies and sovereign bonds are perceived as weak would pay an interest premium over "hard-currency" countries. This perpetuates and even exacerbates cross-country income differentials within the monetary union. Leaving the job of imposing discipline primarily to the financial markets is to rely on an institution that has been revealed to be systematically incapable of consistently providing measured and predictable assessments of credit-worthiness. Any deterioration of the economic or fiscal outlook would lead financial market participants to demand an excessive increase in risk premiums and interest rates. This would exacerbate the cost of debt servic-

8 For the text in English: http://international.blogs.ouest-france.fr/archive/2017/09/29/macron-sorbonne-verbatim-europe-18583.html

9 A very concise statement is in a non-paper of the German finance ministry to the Eurogroup, October 2017, available at: http://media2.corriere.it/corriere/pdf/2017/non-paper.pdf

ing, worsening the fiscal outlook and, via knock-on effects on private loans, also depress the economy, further weakening the capacity to service debts. Moreover, solvency is a highly problematic, and arguably impossible, concept to apply to sovereigns (Lindner 2015).

Last but not least, only the state can provide (nominally) risk-free, low-return assets. If countries are not able in a crisis to issue risk-free debt, which can ultimately be purchased by the central bank, crises are much more likely to be self-fuelling. Voluntarily depriving itself of the ability to create risk-free assets is therefore a wholly misguided policy (Tober 2015; Theobald and Tober 2018).

At the start of 2018 a group of 14 prominent economists, seven each from France and from Germany, issued a comprehensive proposal for reform of the Euro Area (CEPR 2018) that seeks to strike a balance between risk-sharing or collective insurance and a Maastricht 2.0-type approach. The key proposals are as follows:[10]

To break the doom loop between banks and sovereigns the report proposes strict adherence to bailing-in bank bondholders, as already agreed in principle in the Banking Recovery and Resolution Directive of 2014, the de-privileging of government bonds (removing their zero risk weighting), introducing changes in the legal statutes of government bonds to make sovereign debt restructuring easier to implement, and introducing a common deposit insurance scheme with country-specific risk rating.

A major reform of the fiscal rules is proposed focusing on an expenditure rule. Based on an assessment of medium-run nominal GDP growth by an independent fiscal council, a spending cap is set (excluding some cyclical elements such as unemployment benefits) that will ensure medium-run convergence of the debt-to-GDP ratio to a target (such as 60%). Spending in excess of agreed limits would have to be financed by issuing junior bonds that are ineligible for purchase by the ECB, would be subject to restructuring and thus carry a higher interest rate. Apart from the expenditure rule itself, this largely is in the Maastricht 2.0 tradition.

On the other hand, a number of fiscal stabilisation measures are proposed. Sovereign bonds are to be pooled in so-called ESBies to provide an allegedly safe asset for the financial system and to contain financial market pressures on countries at risk of speculative attacks.[11] A rainy day fund is to be built up from which countries – provided they are in compliance with the fiscal rules – can draw in the event of crisis. And the ESM is to be permitted to offer non-emergency lending to compliant countries.

A strength of the CEPR proposal is the attempt to bridge the gap between seemingly contradictory political positions and overcome the "discipline through punishment" approach, which has manifestly not worked, without far-reaching federalisation, which seems politically infeasible. However, serious shortcomings mean that the package cannot be recommended in its present form.

The expenditure rule will still bear one-sidedly on countries with high debts and deficits. Countries with external surpluses and below-average inflation will not be forced to use fiscal policy to expand demand. The proposals are skewed – notwithstanding the claim to be a marriage of the risk-sharing and disciplinarian approaches – in favor of the latter. The excessive emphasis on "moral hazard" issues in the design of a number of the policies prevents a clear line being drawn under the crisis. Under the various strictures imposed on them, such as higher interest rates and deposit insurance fund contributions, countries hit hardest by the crisis will struggle to catch up. They will constantly be confronted with the question whether they are not better off regaining their own monetary autonomy. This is all the more so given that the stabilisation measures are very limited. There is substantial doubt about the stabilisation capacity of the untested ESBies (especially in view of likely high correlation between bond yields, particularly when most critical, in an economic crisis). The limited size of, and tough conditionality on, support from the rainy day fund and ESM lead to a serious risk that countries getting into difficulties will at some point transgress against the expenditure rule, will lose access to support measures and will be faced with debt restructuring. Knowledge of this fact will induce anticipative speculation.

In short, such a currency union will remain fundamentally unstable and the future of the common currency will continually remain in doubt.

WHAT IS REALLY NEEDED TO MAKE THE EURO AREA STABLE?

Our proposals for reforms of the Euro Area seek to set out a coherent and practicable framework to address the critical weaknesses. In a number of areas, different policy tools can be deployed to achieve similar outcomes ("functional equivalents"), usually involving specific trade-offs; choices in one policy area thus have knock-on effects on others. What is vital is that the overall package is effective. For this reason we have grouped policy measures where appropriate, describing a number of alternatives, while refraining from being overly specific and prescriptive concerning individual measures.

The clearest and most obvious, in a sense, solution to the neither-fish-nor-flesh nature of the Euro would be to equip it with the normal trappings of a monetary union in a federal state: a unified tax and social insurance system, interregional transfers

10 For a more detailed analysis see Watt 2018.

11 Pooling does not apply to the junior bonds mentioned above.

coupled with strict controls on lower-tier government spending. However, virtually all commentators agree that rapid progress to such a *finalité* is politically highly unlikely. Even the much more modest vision of President Macron, with a substantially larger common budget and a finance minister with real powers seems unlikely to come to fruition, at least for now.

Like most – but by no means all – observers, we believe that, whatever its weaknesses, dissolving the Euro would come with incalculable transition costs. It also would represent a long-term missed opportunity to strengthen European unity and give the continent an important voice on the global economic and political stage: of course for this potential to be realised the common currency's serious weaknesses must be overcome. The present authors would be very much in favour of moves in a federal direction, leading to a substantially larger EU budget, a finance minister, and possibly also other ministers, at the level of the Euro Area. The need for reform is urgent, though, and we focus here on pragmatic reforms that can be implemented on a timescale of months and years.

We take as our starting point three interlocking facts, from which we draw a conclusion that guides the policy recommendations.

1 It is crucially important to remove the fundamental uncertainty hanging over the individual member states (and thus the currency union as a whole). This implies the need for measures offering collective insurance (such as deposit insurance) and macroeconomic risk sharing, and an effective lender of last resort function.
2 The main – but often ignored – driver of the problems that manifest themselves in sovereign debt crises is the systemic tendency towards divergence. The implication is that to avoid future imbalances building-up in the first place symmetric macroeconomic counterweights (from fiscal, macroprudential and incomes policies) are needed. This is a fundamental precondition for stability, whereas collective insurance measures are "end-of-pipe" solutions.
3 The basic premise underlying the Maastricht 2.0 view that the more risk-sharing is provided (issue 1), the greater is the risk of moral hazard, which is also destabilising, is in itself correct. Risk-sharing is necessary, and this makes measures to reduce moral hazard also necessary.

The policy conclusion is that the right balance must be found between unconditional central bank or fiscal support for member states, which is stabilising but invites moral hazard, and imposing strict conditionality on risk-sharing measures, which limits the risk of moral hazard, while inviting destabilisation through financial markets.

However, it is wrong to believe that the solution lies in imposing, even more strictly, asymmetrical rules and relying on market-based discipline, which both make the likelihood of crises greater, not smaller, as those in the Maastricht 2.0 tradition.

Instead the solution to the insurance versus moral hazard dilemma lies first, as a preventive strategy, in insisting on point (2) above: the importance of symmetrical and effective counter-cyclical policies in all member states. In economic policy terms this preventive approach means two things: reforms to promote symmetrical counter-cyclical policies to ensure balanced demand growth that avoid substantial shifts in relative competitiveness between countries; and the incorporation of relevant actors, especially the social partners, to increase the political acceptance ("ownership") of commonly agreed targets.

More effective prevention increases confidence amongst relevant actors (national governments, central banks, the EU authorities, social partners) that counterparts in partner countries are willing and able to orient policies towards consistent goals. This reduces the expected frequency and extent of recourse to European-level funds and other forms of collective provision, which increases their political acceptance; and this acceptance is required to establish the conditions for the survival of the currency union (point 1).

The greater the mutual trust that can be built up in the willingness of member states to adhere to agreed guidelines and set policy with the Euro Area interest in mind, the more risk sharing and solidarity can be privileged. The Euro Area governance regime could be moved steadily towards a high trust equilibrium, reversing the trend of recent years in which trust has been eroded and economic performance has deteriorated in a mutually reinforcing downward spiral. On this basis a staged system of collective insurance and solidarity can then be made available (cf. for instance Claeys 2018). Support of limited size and duration can be provided unbureaucratically and quickly, without conditionality and thus loss of sovereignty, to address liquidity crises; quick provision is of the essence in avoiding self-fuelling crises that would subsequently require larger interventions. The greater the level and duration of support measures, the more it is reasonable to insist on "conditionality", i.e. constraining the behaviour of the member state in accordance with the needs also of partner countries that are exhibiting solidarity.

When enforcing conditionality, lessons should be drawn from behavioural economics: instead of threatening the use of short-term penalties, often at the wrong time in business cycle terms, and thus often not actually applied, countries that comply with the new symmetrical rules should be rewarded in the medium to long term. Access to structural funds would represent a possible tool. What is important is that constraints or conditionality and ultimately sanctions are applied evenly to deficit and surplus countries.

Having set out this framework we seek to apply its principles in different policy areas.

Completing the banking union

Two major pillars of banking union have been established so far: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) took up their duties in 2014 and 2016 respectively. However, without a fully-fledged deposit insurance scheme the Euro Area banking sector remains vulnerable to systemic, more precisely country-wide, bank runs. As mentioned above, this risk results from a toxic combination of the doom loop between banks and sovereigns and the redenomination risk which can swiftly lead from a single failing bank in one member state, to a run on all other banks in that country, precipitating contagion effects to other member states.

The logical complement to single supervision and single resolution is a single insurance scheme. Thus the third pillar of banking union foresees a European Deposit Insurance Scheme (EDIS; ECB 2018a). Regulation is in place to avoid moral hazard, now insurance must follow. Thus, it is high time for European and national policy makers to finally implement this last pillar. Importantly, it must be a system in which national compartments no longer exist in its final steady-state, i.e. the system needs to be truly "country-blind" in terms of its insurance fund (Schoenmaker 2018). The same does not necessarily have to hold for the contribution payments made by banks. However, bank contribution payments to EDIS should in the full-insurance phase ideally be entirely institution-specific vis-à-vis all other credit institutions of the banking union (ECB 2016). EDIS should be implemented over a transition period during which legacy risks (i.e. non-performing loans) will be further reduced, such that when EDIS is fully established and implemented in 2024 there will not be any systematic cross-country subsidisation of national banking systems (ECB 2018b).

Another source of potential risk in the banking sector is the ongoing dependence of banks' asset holdings on their home-country sovereign debt. There are proposals for reducing and limiting those holdings before EDIS should finally be implemented. However, the evidence is unclear as to whether restricting bank holdings' of home-country sovereign debt would in fact reduce risks in the banking sector (Constancio 2018). The lack of a truly area-wide safe asset is the key reason why banks' holdings of their home-country sovereign debt are both necessary and problematic at the same time.

Irrespective of that, we are highly skeptical regarding sovereign debt restructuring under current conditions for a number of reasons.[12] First, sovereign debt restructuring will always be disruptive to any modern financial system; second, with the Eurosystem now being the biggest holder of Euro Area sovereign debt[13], a debt-restructuring would lead to losses for the Eurosystem and should in particular be regarded as a form of monetary financing which is prohibited by the Treaties; third, as long as basic public goods and services in the EU remain provided for by national member states alone (police, justice, welfare, etc.), any restructering must be such as not to threaten the provision of basic public goods and services.

This would change only if there was an area-wide safe asset which could be used to finance public goods and services at the level of the Euro Area and which would guarantee a reasonable degree of financial market stability even in the case of an individual member state deciding to restructure its debt. Mechanisms for dealing with sovereign debt restructurings would necessarily need to go hand in hand with the introduction of European safe assets like Eurobonds. Importantly, such a safe asset would need to be truly safe, i.e. issued jointly by member states or the European Commission. We are sceptical that a pooling of some fiscal risk through the use of ESBies or SBBS can effectively substitute for a genuine safe asset, as they are only likely to work reliably when financial markets are calm, and not in a crisis when they are most needed.[14] A specific proposal extending the CEPR and ESRB proposals is made in Tober and Theobald (2018).

To fully complete the banking union and reduce risks of financial instability, a common fiscal backstop is required to financially support the Single Deposit Insurance Fund (DIF) in case the DIF is depleted before the last depositor is reimbursed. For avoiding bank runs it is crucial that depositors know that there is a fund with sufficiently deep pockets in place. The backstop must be unconditional. The precise institutional setup still needs to be discussed, but a sensible approach would be for the common fiscal backstop to back the ESM which would itself back the Single Resolution and Deposit Insurance Fund (Schoenmaker 2018).

Finally, the Lender-of-Last-Resort function of the ECB needs to be strengthened and made permanent. Only the ECB can guarantee ultimate backstop-liquidity in the Euro Area. As highlighted most recently when Italian government bond spreads were widening, the ECB should seriously reconsider its collateral framework. Government debt of any Euro

12 This is irrespective of whether they are supposed to be automatic, semi-automatic, or entirely non-automatic.

13 Euro Area here should in fact read as Euro Area ex-Greece because the ECB's APP does not involve purchases of Greek government bonds.

14 For a critical review of the CEPR-proposal in periods of financial stress, see De Grauwe and Ji (2018).

Area member state was once regarded as sacrosanct in the ECB's monetary policy framework. The Maastricht Treaty was meant to ensure fiscal discipline of member states and was enforced through the European Commission. When the Maastricht Treaty's conditions and requirements were weakened in practice, the ECB subsequently changed its collateral framework to prevent moral hazard on the part of governments and started to only accept government debt of sufficient rating by private sector major credit rating agencies (Orphanides 2018). In effect, the ECB was already blurring the lines to fiscal policy as it is neither the role of the ECB, nor of private sector rating agencies, to safeguard public finances in the Euro Area. The latter is to be taken care of by the member states and the European Commission. In addition, this change in the collateral framework gave a totally disproportionate and dangerous weight to the views of private-sector ratings agencies and put the ECB in a position of being seen as intervening in highly political decisions. This suggests that the ECB's current collateral framework should be reconsidered to accept as "adequate" collateral all Euro Area government debt that is deemed sustainable in a fundamentals-based debt sustainability analysis (Claeys 2018; Orphanides 2018).

Together, completing banking union and strengthening the Lender-of Last-Resort-function of the ECB would be major steps towards stabilising the Euro Area. However, member States might be tempted to abuse the LOLR cover. To reduce the corresponding likelihood, a preventive approach should be reinforced, as discussed below. Even so, at some point in time, where abuse can be clearly verified and self-fuelling dynamics in a crisis can be avoided, the LOLR has to become subject to political conditionality. Currently OMT activation requires this from the outset. Given an approach with several tracks to ESM backing (see below), conditionality can be introduced in each case on the basis of an explicit and politically legitimated decision.

Symmetric macroeconomic policies preventing imbalances and insuring against macroeconomic risk

The box below presents a conceptual framework which is used to guide our various proposals to ensure more balanced demand and output growth between Euro Area countries.

Infobox 1

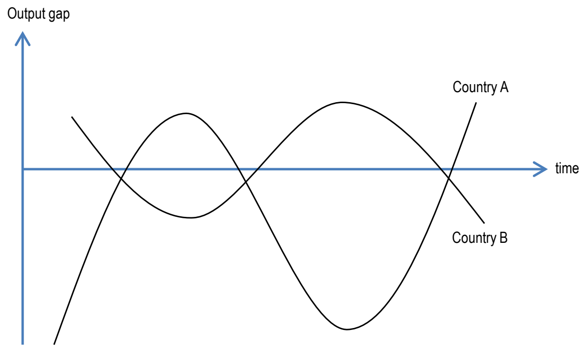
Conceptual analysis of policy making in an asynchronous monetary union

Conceptually, the problem of optimal macroeconomic policymaking in a currency union can be visualised in a stylised way as in **Figure 7**. Assume the business cycles of the two countries forming the currency union are not synchronised at all. Whilst this is of course an extreme case chosen purely for presentational reasons, a comparison of the actual output gaps of Germany and Spain (**Figure 8**) impressively shows how relevant this extreme case is in depicting real-world problems of the currency union.

For a given central bank interest rate, one country can be in recession when the other country is enjoying a boom. Optimal macroeconomic policy making for the currency union as a whole, and for each country individually, would aim to minimise the output or inflationary gaps for each country individually, and boost aggregate demand in the country in recession whilst at the same time avoiding overheating in the country experiencing a boom. Clearly, the single central bank policy rate does not fit both countries here. Not only does one size not fit all, as we have shown, the real interest rate is "perverse", low in the booming and high in the stagnant country, driving countries further apart. This makes it critically important that other macroeconomic policies like fiscal policy, incomes policy, or more longer-run structural policies are employed to optimally manage aggregate demand in member countries to ensure balanced, crisis-free growth. In particular, the

Figure 7

Asynchronised business cycles – a schematic depiction



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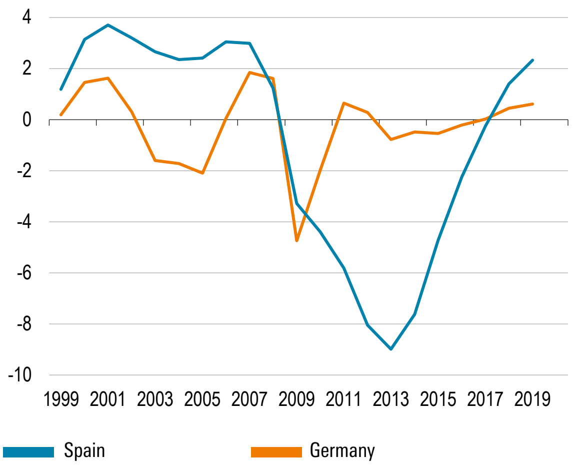
two countries can insure each other, with each benefiting from the insurance as both countries could smooth out their individual output or inflationary gaps. However, moral hazard concerns arise because the insurance might induce worse macroeconomic policies to begin with.

Apart from the important concern of moral hazard, if the countries' macroeconomic policies are carried out in an uncoordinated way, this could severely worsen the recession periods as spillovers are found to play an important role in international business cycle transmissions (Banque de France, 2017).

Another crucial difference between a currency union and a nation state is the virtual non-existence of automatic-stabilisers working across national borders in the currency union. The contrast with the US has often been noted.[1] Finally, particularly when interest rates approach the zero-lower-bound, the currency union's central bank might encounter difficulties to safeguard the overall optimal level of aggregate demand for the union. In such a situation, as during the deep recessionary years of the euro-crisis of 2010-13, the aggregate fiscal policy stance of the Euro Area becomes itself an important tool for macroeconomic stabilisation (Draghi 2014, Wolff 2018).

Figure 8

Output gaps: Germany versus Spain



Sources: AMECO, Macrobond.

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1 "When a US state's economic activity slows relative to the rest of the country, the taxes that its individuals and businesses pay to the federal government decline, and the funds that it receives from the federal government (for unemployment benefits and other transfer programs) increase. Roughly speaking, each dollar of GDP decline in a state like Massachusetts or Ohio triggers changes in taxes and transfers that offset about 40 cents of that drop, providing a substantial fiscal stimulus. There is no comparable offset in Europe, where taxes are almost exclusively paid to, and transfers received from, national governments (…) a reflection of Europeans' unwillingness to transfer funds to other countries' people in the way that Americans are willing to do among people in different states." Feldstein (2011)

Fiscal policies with expenditure rule and proposals to stabilise public investment

The CEPR (2018) Policy Insight acknowledges that fiscal rules in the Euro Area should be reformed and proposes a carefully laid out concept based on an expenditure rule with a debt target. We generally support this proposal and believe an expenditure rule would go a long way to improve clarity and transparency, as (non-cyclical) government spending is actually under the full control of the government. At the same time, it allows for countercyclical fiscal policy and still leads to reduced government debt ratios in the future (Claeys et al. 2016).

Of course the democratic legitimacy of the process is vital. The proposed recourse to independent national fiscal councils and a proposed Euro Area fiscal watchdog for monitoring and enforcing the rules raises question-marks. Ultimately national governments and parliaments or their various committees should be responsible for fiscal planning and presenting the proposed expenditure plan to the European institutions, which in the future might include a Euro Area Assembly.[15]

We also advocate institutionalising another important concept from the public finance literature in order to stabilise investment spending particularly during crisis times: the famous "golden rule" for public finances according to which net public investment can be financed by government deficits (Truger 2016). As such this would be a clear break with the balanced-budget rule now unfortunately enshrined in the fiscal compact and many European countries' legal frameworks. This would represent a major step, but one that is well justified by econom-

15 For the concept of Euro Area Assembly as a means to make Euro Area governance more democratic, see e.g. Piketty (2017). The Assembly would be comprised of representatives from national Parliaments (four fifths of the Assembly) and of representatives from the European Parliament (one fifth of the Assembly).

ic theory – the payoffs from longer-term investments accrue to future generations who should help to finance them – and was long considered the orthodoxy, also in Germany. While there are difficulties in defining investment (Truger 2016: 12ff.) and concerns about possible abuse, a pragmatic solution would be to exclude all net public investment from the relevant deficit numbers of the preventive and corrective arms of the current Stability and Growth Pact (Truger 2018).

Other options to ensure continued public investment involving common financing should also be considered. The Investment Plan for Europe, more commonly known as the Juncker Plan, was launched in 2015. The most important element, the European Fund for Strategic Investments (EFSI), which provides an EU guarantee via the European Investment Bank, to mobilise private investment. According to the EIB,[16] by June 2018 funding of around €100 billion had been signed or approved, with a claimed total investment volume of just under EUR 300 billion; the target for the end of 2020 is half a trillion Euro. The programme was extended once at the end of 2017. Despite question-marks regarding additionality, given the crucial importance of the areas receiving substantial funding (such as clean energy, digital infrastructure), a conversion to a permanent programme should be considered.

Most recently the EU Commission has proposed a European Investment Stabilisation Function[17] (alongside a fund to support member states in implementing structural reforms). The fund will be available to countries having suffered a rise in unemployment due to a shock (but one that does not entail loss of market access, for which the ESM is responsible). At EUR 30 billion – financed out of member states' seignorage revenue – the fund is small, but the Commission notes that it could be stocked up, for instance if member states were willing to pool resources to this end, or with additional ESM backing. Access is conditional on having adhered to recommendations under the Stability and Growth Pact and Macroeconomic Imbalances Procedure. Disbursement is conditional on maintaining public investment.

While the initially envisaged fund is too small to offset a large shock affecting several small or even one large country, and the structures (a mixture of loans and interest-rate subsidies) are complex, the proposal marks a concrete attempt to give meaning to the idea that collective support measures are needed to offset the loss of policy autonomy that members of currency union face.

A more far-reaching proposal (Bibow 2013) to give effect to the principle of the Golden Rule would be to create a Euro Treasury which emits collective securities, revenues from the sale of which are lent to member states conditional on them being used for public investment. In this way member states can continue to finance investment up to an agreed annual percentage of GDP at low interest rates, even if they face a shock and costly market access. Fiscal rules continue to apply, but only to current spending.

Cross border automatic stabilisation

Given the above analysis (Infobox 1) it is clear that a system of automatic cross-border fiscal stabilisation could potentially play a very important stabilisation role. It would essentially dampen down demand in booming countries (or regions) by syphoning off demand and making it available to those experiencing a down-turn. Once an effective mechanism, with agreed triggers and volumes, is in place the system should work swiftly and invisibly (as it does in monetary unions like the US and still does within EU member states such as Germany) without the need for political haggling.

While clearly advantageous in theory, the question of how it might be operationalised is a thorny one. Alongside the familiar moral hazard issues, there are also many technical issues relating to triggers and thresholds, the definitions of the cycle etc.

The set of proposals on which most research has been done to date is one to introduce a partial Europeanisation of unemployment insurance (Andor 2014, Dullien 2014). Many different versions of the basic proposal exist. Seemingly a consensus is emerging on one fundamental point: any scheme should be a reinsurance scheme for national systems, rather than a genuinely European scheme making individual payments. Important principles are that, over the long-run countries should both be net recipients and beneficiaries of the scheme. Incentives to reduce structural unemployment must be maintained. Both these premises clearly argue in favour of a focus on short-run cyclical unemployment.

Recently the Grundwertekommission (2018) of the German SPD has lent its support to a reinsurance scheme along these lines. In an interview,[18] German Finance Minister Olaf Scholz has endorsed such a scheme in principle, albeit providing loans rather than grants, possibly suggesting that it is an idea whose time has come.

We believe that such automatic cross-border stabilisation schemes are necessary. We remain open regarding concrete implementation, but note that it is not sufficient merely to identify (real or imagined) drawbacks of an unemployment reinsurance scheme. These need to be weighed against those of alternative proposals such as reliance on measures of output gaps. In any case it would be sensible to consider the size of national automatic stabilisers a

16 http://www.eib.org/efsi/

17 http://europa.eu/rapid/press-release_MEMO-18-3971_nl.htm

18 http://www.spiegel.de/international/germany/interview-with-finance-minister-olaf-scholz-a-1211942.html

matter of common concern – as countries benefit from the stabilisation provided by others – and coordinate efforts within the European Semester to encourage a "race to the top" (Watt 2011).

Fiscal capacities and emergency lending

Arguably the most logical way to stabilise investment spending is to move it up to the Euro Area (or EU) level and have more and better public goods provided at this level (e.g. Guttenberg and Hemker 2018, Wolff 2018). Apart from the stabilisation aspect, there may also be efficiency arguments for such provision in some fields. President Macron, among others, has called for a budget for the monetary union overseen by a specific EMU finance minister. The budget would need to be substantially larger than at present and/or have a borrowing capacity. The political obstacles are well-known: overcoming the legal prohibition of EU borrowing would require Treaty change. The EU budget outline for the next seven-year period is already visible and is very limited, not least as a result of Brexit. Yet it is not too late, and Germany could lead a campaign to create at least some additional "head-room" within the EU budget, raising its own contribution. More effective still – as it would reduce the salience of the whole net contributor versus net recipient divide – would be to demarcate sources of own resources; proposals for suitable tax bases include carbon-dioxide, financial transactions or profits of multinational corporations.

The policy debate has centered more on specific funds and "fiscal capacities" to support member states encountering fiscal difficulties with the aim of avoiding them being forced by either the markets or the fiscal rules into pro-cyclical tightening. A large number of proposals has been made. As a sign that the debate is well advanced, even Chancellor Merkel indicated in a recent interview (FAZ 2018), that Germany is about to acquiesce to the introduction of such funds under the ESM, albeit of limited volume and with rather tight conditionality. In particular the attached conditionality is to be seen critically because it is believed to contain – the Chancellor remained vague on this point – possibilities of, or requirements for, sovereign-debt restructuring.

All proposals face the basic trade-off between needed stabilisation and the necessity to limit moral hazard. Amongst others, Claeys (2018) has proposed a three-stage support regime all delivered by the ESM and linked to the LOLR function of the ECB discussed above: An unconditional first "track" for pure liquidity crises. In addition to providing quick (but limited) support, the implementation of this track would legitimate action by the ECB under the OMT provisions without the need for costly and time-consuming negotiations of support programmes and countries having to surrender policy autonomy (which leads to delays). This removes doubts as to whether LOLR actions (OMT) will be deployed, so that crises can be nipped in the bud. A second track offers a precautionary credit line with some conditionality but no debt restructuring. Only in the case of a fundamental threat to fiscal solvency would a full programme be applied implying a considerable loss of national policymaking autonomy. Here restructuring of bonds held by the private sector could be considered, in Claeys' view, but this would be reserved for extreme cases. As already argued, in our view large-scale restructuring does not work as a disciplining device and the threat of default imposes huge costs, at least under current conditions.

Institutional reforms to underpin convergence and stability

Earlier it was argued that by strengthening the preventive approach, rendering it more effective and symmetrical, the currency union could move towards a high-trust equilibrium with stronger risk-sharing elements. Koll and Watt (2018) sets out a reform concept aimed at promoting macroeconomic policy convergence and coherence, with an emphasis on soft coordination mechanisms to bolster the preventive approach. The goal is to bring relevant actors together to ensure that fiscal and macroprudential policies are set in such a way that aggregate demand is maintained close to potential in each member state, prices and nominal unit labour costs are in line with the price stability target, so that competitive and current account imbalances are limited. Against this background monetary policy can provide favourable monetary conditions for growth and employment in the medium run, with favourable impacts also on potential output.

Specifically, we propose, as illustrated in **Figure 9**: The establishment (1) of a body to develop scenarios and options for balanced and prosperous economic development that respects the fundamental stability and growth conditions within a monetary union[19] – an Advisory Board for Macroeconomic Convergence, and (2) a political body to assess and implement such appropriate development paths while respecting the autonomy and independence of the actors – a Macroeconomic Dialogue. The Macroeconomic Dialogue brings together representatives of governments (fiscal policy), central banks (monetary and macroprudential policy) and the social partners

19 For a detailed explanation see Koll and Watt (2018, p. 27ff.). In a nutshell, and starting from a position of "equilibrium" in terms of competitive positions and closed output gaps, price inflation and unit labour costs should grow at the target inflation rate of the ECB in aggregate and, at least in the medium run, in each member state. Macroeconomic policy targets high levels of (non-inflationary) employment and economic growth. The conditions are adjusted symmetrically where there is a need to offset existing competitive or other imbalances.

(incomes policy). Both bodies should be established at both national and EMU level.

Existing structures can be used and built upon: the advisory European Fiscal Board and the National Productivity Boards (mentioned above), for the expertise, and the Eurogroup and the EU Macroeconomic Dialogue, integrated into the European Semester, for policy. The decisive innovation is that the remit of both advisory and policy bodies needs to be extended beyond the previous limitation to fiscal and (asymmetric) competitiveness objectives to the macroeconomic policy mix.

There is only one completely new body in each Member State to be set up, a Macroeconomic Dialogue at national level, which, within the framework of the single monetary policy, coordinates national fiscal and wage policies in order to meet the conditions needed for stable economic development. Determining the appropriate policy stance and the required adjustment, and so ensuring the coherence of national strategies, is the task of the two bodies at the Euro Area level. To this end the Macroeconomic Imbalance Procedure – which, it is to be recalled, contains the possibility to impose sanctions – can be given a heightened role, albeit after changes to render the process symmetrical in application. The incorporation of all the actors relevant for macroeconomic policy, at both national and Euro Area level, gives a substantial boost to the "ownership" that has been lacking up to now.

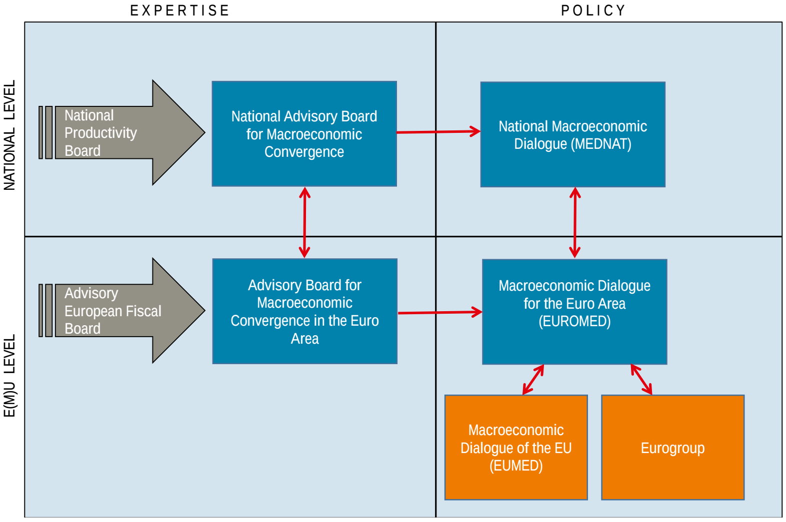
Wage and price developments in the member states play a special role here. To the extent that member state social partners, in cooperation with state actors (for instance in setting minimum and public sector wages, but also via competition policy), have retained a capacity to influence the course of nominal wage and price developments they should bring this influence to bear.[20] Even in highly coordinated systems, though, appropriate (i.e. counter-cyclical) fiscal policy and possibly macroprudential policy (for instance to deflate a housing bubble) will be required. Drawing on expertise from the advisory board and the views of the relevant actors in the Macroeconomic Dialogue, alternative policy combinations to achieve the desired trajectories of demand, prices and nominal wages can be examined and evaluated. Articulation between the national-level and EMU-bodies will help to ensure coherent aggregate outcomes and prevent destabilising beggar-thy-neighbour strategies.

To the extent that a functioning social partnership exists or can be established and is given an appropriate place in a stronger economic governance, and at the same time national fiscal and macroprudential policies are systematically and symmetrically oriented towards stabilisation, rather than arbitrary and counter-productive rules, recourse – in terms of both frequency and extent – to area-level support and solidarity measures will be reduced substantially. This increases, in turn, the political acceptance of risk-sharing, bolstering the willingness to set up and subsequently expand and reinforce corresponding institutional arrangements.

The institutional proposals to promote convergence are pragmatic and can be easily and quickly realised. They emphasise "soft" coordination methods, but under the shadow of the sanctions foreseen for persistent non-cooperative behaviour under the MIP/European Semester; as already noted above the form taken by these sanctions should be reconsidered. While by themselves they will not fundamentally alter the economic governance of the Euro Area, they make it more likely that, in designing macro-level measures along the "solidarity/moral hazard continuum", policymakers can emphasise the former because the risk of the latter is reduced. This will tend to encourage mutually reinforcing steps that can help the Euro Area to move from a low-trust equilibrium with generally poor and volatile outcomes to one which is generally better performing. Above all it will substantially reduce the risk of protracted periods of stagnation and economic crises, leading to the sort of political dramas that have played out in Greece and risk being repeated in Italy.

Figure 9

Proposed institutional changes at national and European level



Source: Koll and Watt (2018).

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20 Collective bargaining structures have been weakened in many countries; in the course of the post-crisis adjustment, existing structures have even been dismantled (see Watt 2017b, p. 82ff and the literature cited there). Where they are lacking, the stabilisation task falls to fiscal (and maybe also macroprudential) policy working through the Philips Curve.

CONCLUSION: A SOCIAL MARKET ECONOMY FOR EUROPE

The European project is currently at the crossroads. This is particularly the case for the euro area. The project of monetary union began almost 20 years ago and was initially regarded as a great success to strengthen European integration. But a decade of deep economic crisis affecting many member states has contributed to the rise of populist, nationalist and euro-sceptic parties throughout the continent and a resurgence of xenophobic sentiments and clichés that were once believed to have been overcome. Greece was almost forced to exit the euro area in June 2015. The current threat now stems from the uncertain developments in Italy, the third-largest member state. The voices openly calling into question the future of the common currency grow louder. Time is running out for meaningful reform of the euro area.

Some important progress has been made since the crisis, belatedly and often imperfectly. Notably, the ECB has taken on a partial lender of last resort function, there have been some improvements in reforming the rules governing member state economic policy. First steps towards banking union have been made, but effective deposit insurance is still the important missing piece. The existential weaknesses – redenomination risk given doubts about the effectiveness of the LOLR function and the inadequacy of measures to address inherent divergence trends between member countries – have not been resolved. For as long as that is so, the euro area will remain on shaky ground.

This report reviewed a number of interlocking proposals that would substantially strengthen the institutional setup of the euro area. In each area different options exist. Together, a package of proposals would rectify the over-reliance on the ECB as a firefighter, and put euro area institutions and member states – with the involvement of governments, national central banks and social partners – in charge of dealing with intra-euro area imbalances and keeping growth close to potential. The more a preventive approach can be reinforced, the less recourse is needed to euro-level emergency measures, the greater will be the confidence that such measures can be introduced without risking “moral hazard”.

Time is running out – the various proposals are on the table. Choices and trade-offs need to be made, bearing in mind that the perfect must not be allowed to be made the enemy of the good. Policymakers must make those choices swiftly, find the necessary political compromises and implement before it is too late.

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