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European monetary union.

IN ORDER TO ACHIEVE A MORE RESILIENT MONETARY UNION in Europe, we propose: 1) to form a ' nancing union' through the completion of the banking union and the promotion of an ambitious capital markets union to provide private risk sharing between the countries of the monetary union; and 2) to improve the defective macroeconomic policy framework to avoid a repeat of the mistakes of recent years.

THE LATTER INVOLVES: reforming the European Stability Mechanism / Outright Monetary Transactions framework to clarify its functions and improve its governance system, reforming the European scal rules to make them more e ective to achieve the two desirable objectives of sustainability and stabilisation, and creating a small-scale euro-area stabilisation tool to provide public risk sharing in case of signi cant shocks that members of the monetary union cannot deal with alone and to help manage the euro-area aggregate scal stance. A promising option to carry out these tasks would be to establish a European Unemployment Insurance Scheme.

TO ENSURE THE DEMOCRATIC LEGITIMACY

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1 Introduction

Europe o ers a unique example of economic and political integration of sovereign nations. is integration movement took a signi cant step forward at the beginning of the 1990s with the decision to share sovereignty over the issuance of a common currency and the conduct of monetary policy. e economic consequences of forming a monetary union are substantial[1], so Europe's institutional architecture had to adapt signi cantly and its economic governance had to be radically overhauled.

Good economic governance is de ned by a set of institutions and economic policies (scal, monetary, nancial) that: 1) prevent the build-up of imbalances at macroeconomic, nancial and scal levels, and 2) minimise the cost and disruption caused by crises to the greatest extent possible.

e single currency's economic governance framework, as set out in the Maastricht Treaty, was the result of diverse – and sometimes antagonistic – views and tough negotiations between the countries that founded the monetary union. Maastricht speci ed the main objective as ensuring prosperity through the promotion of price stability and balanced growth, while leaving some leeway at the national level in terms of scal choices (trying at the same time to avoid moral hazard and foster scal discipline as much as possible) and in terms of banking regulation and supervision. However, the global nancial crisis that started in the United States in 2007 and worsened in 2008 a ected Europe very quickly and resulted in a rst recession in 2009-10. e crisis then morphed into a European crisis that revealed the defects of the original euro architecture and resulted in a second recession in 2012[2]. e Maastricht economic governance framework was plagued with institutional aws that during the rst years of the monetary union were hidden behind unsustainable booms in the union's periphery. e booms were mistaken at the time for a convergence in living standards. In reality, signi cant imbalances with housing bubbles and unsustainable current account surpluses and de cits were built up, leading in the end to economic divergence between the countries of the monetary union.

e members of the monetary union entered the crisis without a central bank willing to play the role of lender of last resort in the sovereign debt market.

e euro area lacked the tools to prevent these imbalances from occurring (eg strict and uniform banking supervision) and instruments to manage and solve the crisis once these imbalances started unravelling. In the absence of an exchange rate stabiliser or autonomous monetary policy at the country level, other powerful adjustment mechanisms could have helped countries to absorb asymmetric shocks: labour mobility[3], capital integration or a federal budget. e euro area lacked these three elements and thus entered the global nancial crisis as an incomplete monetary union that was far from being an optimal currency area.

In addition, the members of the monetary union entered the crisis without a central bank willing to play the role of lender of last resort in the sovereign debt market. At a time when de cits and debt-to-GDP ratios were rising quickly because of massive bank bailouts, lower tax revenues because of the recession and bursting bubbles, and higher social expenditures because of huge increases in unemployment, sovereign debts were left vulnerable to self-ful lling crises. As a consequence, the most-a ected countries lost market access or had to pay high interest rates (Figure 1) and thus were not able to use national scal policy as a macroeconomic stabilisation tool as much as necessary, as had been envisaged in the Maastricht

1 Looking at the bene ts and costs of forming a monetary union is beyond the scope of this paper but interested readers can look at the Optimal Currency Area (OCA) literature developed in the 1960s, notably by Mundell (1961), McKinnon (1963) and Kenen (1969), and the more recent literature assessing the impact of the euro on trade or FDI between countries of the monetary union (for instance Santos Silva and Tenreyo, 2010).

2 See Claeys (2017) for a more extensive account of the euro crisis.

3 Even though it has increased since the 1990s (and ever more during the crisis), labour mobility between EU countries is still relatively low compared to the US. In 2006, in the US, between 2 percent and 2.5 percent of the population moved from one state to another, while only 0.1 percent to 0.2 percent of EU15 residents moved to another EU15 country (Bonin *e a* , 2008).

governance framework, leaving monetary policy as the only available tool. However, because

ised resolution process – more similar to that at the US Federal Deposit Insurance Corporation (FDIC) – might therefore be more e ective. Second, even though their probability can be reduced by strict regulation and supervision, systemic banking crises cannot be completely ruled out. In these cases, the need for public sector support cannot be fully excluded, even if strong bail-in rules are in place. If the domestic government nances the support, banking woes could spread to the sovereign, thus reviving the 'doom loop'. In contrast, if a common fund steps in, the costs would be shared and the risk of banking troubles spreading to domestic public nances would be reduced. For this reason, a Single Resolution Fund (SRF), pre-funded gradually by bank levies to reach €55 billion by 2024, was created alongside the SRM to achieve adequate risk sharing in the banking union area. However, in a systemic

changed, but the current structure of the European nancial system is also the result of historical, political, institutional and legal factors and the preferences of European citizens, which will be complex to alter. e US model, which some would like to copy because it seems more balanced between banks and markets, is also the fruit of US institutional and economic history, and it would be ill-advised to try to reproduce it exactly. e Capital Markets Union, while necessary to provide the lacking private risk sharing in the euro area, will be a long-term project because it will surely take several decades to generate a new coherent economic and nancial ecosystem[10].

3 Improving the macroeconomic policy framework

Despite signi cant institutional innovations during the crisis, the scal/monetary component of the economic governance of the euro area remains highly imperfect for two main reasons: 1) the OMT/ESM setup is an essential piece of the euro architecture but important questions remain about the coherence of the setup and its governance; 2) the current macroeconomic policy setup is not able to provide enough stabilisation in case of big shocks, neither at the country nor at the euro-area level.

3.1 The ESM/OMT perfectible framework

e OMT programme is an essential tool of the euro-area architecture to avoid self-ful lling sovereign debt crises. In addition to the 'sovereign bank doom loop', another potential driver of the increase in government yields is related to the existence of multiple equilibria in sovereign debt markets. When sovereign debt is su ciently high, the equilibrium price of a country's debt may not be unique: markets might coordinate expectations either on a good or on a bad equilibrium in which a default is more likely than in the good one[11]. When markets coordinate expectations on the equilibrium with a more probable default, they logically ask for a high interest rate on government bonds. e increase in the cost of servicing debt, in turn, creates the conditions for the government to default, validating *e* the markets' expectations. However, the self-ful lling bad equilibrium can disappear if the country has a central bank ready to play fully the role of lender of last resort (LoLR) on the sovereign bond market to avoid such self-ful lling crises. Indeed, the central bank is the only institution that can bring back markets from the bad to the good equilibrium, thanks to its potentially unlimited resources.

In the euro area, there are good reasons to think that the panic in the sovereign bond market between 2010 and 2012 was, at least partly, driven by the existence of multiple equilibria (rendered possible rst by the debt increase caused by the rescue of the banking sector). Although the ECB accepted as soon as 2008 to play the role of LoLR for illiquid banks, it refused at rst to do the same for euro-area governments on the sovereign debt market. e ECB interpreted its nancial stability mandate in a narrow way because there was no political consensus on what it was allowed to do during a type of crisis that was not envisaged by those who had written the Maastricht Treaty. And when the ECB rst attempted to intervene, with the launch of the Securities Market Programme (SMP), its limited size and the impression that the ECB was doing it reluctantly did not convince the market that the central bank was ready

10 More details and recommendations on speci c reforms to increase private risk-sharing, develop certain markets and give economic agents access to the best possible sources of nancing can be found in Véron and Wol (2016) and Claeys (2017).

11 As shown by Calvo (1988), De Grauwe (2012) and Corsetti and Dedola (2016).

However, the current European scal framework remains, in practice if not in theory, highly ine ective and has contributed to the anaemic economic recovery in Europe, raising questions about why EU budget rules failed to deliver economic stabilisation and public debt sustainability (Claeys *e a* , 2016).

In theory, the current rules should promote these two objectives. In addition to the 3 percent total de cit limit, another key indicator used under the current rules is the structural scal de cit, ie the government de cit, corrected for e ects of the business cycle and one-o expenditures. In terms of counter-cyclical stabilisation, resorting to cyclically-adjusted targets makes sense in theory, and the current structural de cit rule combined with the 3 percent de cit rule should allow automatic stabilisers to operate fully in reasonably deep recessions. In addition, in deeper recessions, countries can decide to provide more cyclical stabilisation than what is allowed by the 3 percent de cit rule during one year, by entering an excessive de cit procedure (EDP). ey can also ask for deadline extensions in order to comply fully with the rules (which allow them to slow down scal consolidation). In terms of sustainability, if the rules are fully adhered to and in the absence of shocks, the public debt ratio should decline to low levels. For instance, with a nominal GDP growth of 3 percent, a structural de cit of -1.0 percent of GDP would ensure that the public debt-to-GDP ratio converges to 34 percent. Given the existence of negative shocks and the potential exemptions from the rules, the debt ratio would be higher but could be low enough to provide enough room for manoeuvre in the case of a recession.

In practice, the scal rules do not ful l these two objectives. e structural budget de cit is hard to measure in real time. Estimates are based on uncertain assessments of the business cycle (ie the output gap) and its impact on government revenues and expenditures. Estimated changes in the structural balance are typically revised by more than half a percent of GDP after one year, more than the yearly adjustment that the rules require. It seems inconceivable that recommendations for scal policies should be based on such an unreliable indicator, especially because during crises, measurement problems worsen at the moment when clear indicators are most needed.

A further problem is that the European Commission's growth and in ation forecasts are a major source of errors, even though the scal rules are based on these forecasts. It would be appropriate to have a scal rule that does not depend on these forecasts. Another important issue is that even though countries can provide additional stimulus for one year by entering an EDP, when a recession lingers for several years, current scal rules allow deceleration of scal consolidation at best, instead of suggesting a necessary repeated stimulus. Because of these issues, policy recommendations were largely mistaken already before the crisis and eventually worsened the economic situation in Europe during the crisis, as most euro area countries started to consolidate their public nances as soon as 2010, instead of waiting for the best time to do it.

ere are other reasons for the recent poor management of scal policy in Europe (eg the self-ful lling loss of market access by some countries or Germany's preference for quicker scal consolidation than that recommended by the Commission) and scal rules might not be the only or even the main culprit, but they nevertheless contributed to these mistakes by providing misguided recommendations to member states.

Figure 2 indicates that, since establishment of the monetary union, scal policy was only really countercyclical in 2009 and has been mostly pro-cyclical the rest of the time. erefore, before the crisis and in 2010-15, the scal framework ensured neither the sustainability of public nances nor macroeconomic stabilisation. During the boom years (2001-07), Spain and Ireland had on average large budget surpluses but clearly su ered from a political economy spending bias with expenditure growth of about 10 percent per year. However, the current rules would not have constrained these countries because of the real-time measurement error leading to an overestimation of their structural balance. As a result, and as shown by Martin and Philippon (2017), we now realise that in countries like Spain and Ireland, scal policies were not counte

boom, and did not build enough margin of manoeuvre to be able to use scal stabilisation in the downturn.

Figure 2: Euro-area aggregate scal stance

Source: Bruegel based on WEO October 2016, IMF.

In these circumstances, preserving the scal framework as it is today would be harmful.

the rule represents the best guidance for their fiscal policies to be both sustainable and supportive of growth.

3.4 A new accountable executive institution: the European Fiscal Governing Council

Another key issue in the current European fiscal framework is the multiplicity and opacity of the flexibility clauses. This leads to endless negotiations between EU member states and the Commission and between member states themselves. Leaders of countries that do not respect fully the rules consider them to be inappropriate and try to disregard them. Leaders of countries that comply with the rules fear that the rules are not imposed on their partners with enough force and that the credibility of the system might be in danger. In practice, the use of these flexibility clauses has given discretionary power to the European Commission. In bad times, this means dogmatic application of rules plagued by measurement and estimation errors is avoided, but there is a risk that in good times, member states will try to use the flexibility of the system to bypass the rules when they should be applied strictly to reduce the debt and build some room for manoeuvre. We propose abandoning flexibility clauses and, since no rule can anticipate all contingencies, replacing them with an institution that would exercise discretion and decide when countries can deviate from the rules, using whatever methods they deem appropriate (the estimation of output gaps and structural fiscal balances being only one of the methods).

We propose that this task would be carried out by an institution composed of an executive board of six members representing the general interests of the monetary union (appointed by the EU Council and approved by the European Parliament in a euro-area setup) and the finance ministers of the countries of the euro area[23]. Given the similarity with the ECB Governing Council, this new institution could take the name of European Fiscal Governing Council (EFGC). An advantage of involving finance ministers (as well as making the new council more politically acceptable to member states) would be that this decision-making body would be the same as the one governing the reformed ESM, which would streamline the governance system of the euro area and give some pre-eminence to the new institution. The executive board would be headed by a euro-area finance minister who would take over the current responsibilities of the Commissioner for Economic and Financial Affairs, the President of the Eurogroup[24] and the Chairperson of the Board of Governors of the ESM (see Figure 3)[25].

To ensure the democratic legitimacy of the EFGC, the members of its executive board (including the euro-area finance minister) should be accountable directly to European citizens. An accountable board should be obliged to inform citizens and their representatives about its decisions and should be able to justify them. This could take the form of regular press conferences and hearings at the European Parliament (in a euro-area format), accompanied by the publication of reports justifying decisions. The European Parliament should be involved in the nomination of the members of the executive board[26], exercise some oversight over the board and should be able to impose sanctions on the body in case it fails to meet its obligations.

23 This setup would share some characteristics with the one proposed in Sapir and Wolff (2016)

24 This would also have the additional advantage of separating the roles of Eurogroup president and national finance minister which could lead to conflict of interest between the euro area's best interests and the national interests of the minister's country.

25 In addition to representing the interests of the whole monetary union when decisions are taken, the EFGC executive board should be responsible for preparing the EFGC meetings, implementing its decisions and managing the day-to-day business of the EFGC, of the ESM and the European Unemployment Insurance Scheme and of the corresponding euro-area fiscal/borrowing capacity.

26 Given the importance of the EFGC's decisions, the required qualifications and appointment procedures of its executive board members should be as strict as those for ECB Executive Board members.

Table 1: ECUIS, net payments/contributions (in % of GDP) to participating countries, and annual and cumulative cash positions of the scheme for the euro area

% of GDP	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Austria	0.00%	0.00%	0.00%	0.00%	0.47%	0.47%	-0.11%	-0.11%	-0.11%	-0.11%	-0.22%	-0.31%	-0.37%	0.10%	-0.63%	-0.51%
Belgium	0.00%	0.00%	0.00%	0.61%	0.49%	-0.07%	-0.12%	-0.12%	-0.13%	-0.12%	-0.24%	-0.34%	-0.42%	-0.57%	-0.68%	-0.54%
Cyprus	0.00%	0.00%	0.00%	0.00%	-0.04%	0.42%	-0.10%	-0.10%	-0.10%	0.53%	0.49%	0.62%	0.90%	1.02%	0.75%	0.75%
Estonia	0.00%	0.00%	0.00%	0.00%	-0.04%	-0.05%	-0.10%	-0.11%	-0.13%	1.53%	1.30%	-0.31%	-0.38%	-0.54%	-0.67%	-0.55%
Finland	0.00%	0.00%	0.00%	0.00%	-0.05%	-0.07%	-0.12%	-0.11%	-0.12%	0.94%	0.73%	-0.32%	-0.40%	-0.55%	-0.67%	0.66%
France	0.00%	0.00%	0.00%	0.00%	-0.06%	-0.08%	-0.13%	-0.13%	-0.13%	0.74%	0.57%	-0.34%	0.48%	0.39%	-0.68%	-0.54%
Germany	0.00%	0.00%	0.00%	0.67%	-0.06%	0.66%	-0.12%	-0.12%	-0.12%	-0.11%	-0.24%	-0.32%	-0.39%	-0.54%	-0.67%	-0.54%
Greece	0.00%	0.00%	0.00%	0.00%	-0.04%	-0.05%	-0.08%	-0.08%	-0.08%	0.72%	0.84%	1.14%	1.30%	1.01%	-0.38%	-0.30%
Ireland	0.00%	0.00%	0.00%	0.00%	-0.05%	-0.07%	-0.11%	-0.11%	0.60%	1.24%	0.85%	0.60%	-0.31%	-0.43%	-0.51%	-0.39%
Italy	0.00%	0.00%	0.00%	0.00%	-0.04%	-0.06%	-0.09%	-0.10%	-0.10%	0.47%	0.37%	-0.26%	0.38%	0.32%	-0.52%	-0.41%
Latvia	0.00%	0.00%	0.79%	0.00%	-0.04%	-0.05%	-0.10%	-0.12%	-0.14%	2.10%	1.51%	-0.29%	-0.35%	-0.49%	-0.63%	-0.51%
Lithuania	0.81%	0.00%	0.00%	0.00%	-0.04%	-0.05%	-0.10%	-0.10%	-0.11%	1.44%	1.31%	0.78%	-0.32%	-0.44%	-0.54%	-0.42%
Luxembourg	0.00%	0.00%	0.00%	0.13%	0.16%	0.12%	-0.07%	-0.07%	-0.07%	0.15%	-0.15%	-0.21%	-0.26%	-0.11%	-0.18%	-0.04%
Netherlands	0.00%	0.00%	0.00%	0.33%	0.36%	-0.07%	-0.12%	12%	12%	12%	12%	1				

Source: Bruegel based on the method in Claeys *et al* (2014). Note: Parameters used in this simulation: single contribution rate for the whole euro area; replacement rate of previous wage: 80 percent; trigger of the scheme: increase in unemployment of 0.5 ppt in one year above 5-year average. The table displays net payments as a percentage of GDP that would have been received by the countries from an EUI scheme since 2000. Positive numbers, in green, represent net payments to the countries, whereas negative numbers, in red, represent net contributions to the EUI scheme. The last 4 rows of the table indicate annual and cumulative cash positions of the scheme for each year (in % of GDP and in € billions). Positive numbers, in green, represent positive cash positions of the scheme that could be saved for the future, whereas negative numbers, in red, represent negative cash positions that would have to be financed by borrowing in capital markets.

It is also important to note that Spain would not have been an isolated case and many other countries would have bene tted from the ECUIS since 2000 and would have been net recipients when they experienced slumps: Austria in 2004-05, Belgium in 2003-04, Cyprus since 2009, Greece from 2009 to 2013, Germany in 2003 and 2005[32] and the Netherlands in 2003-05. e ECUIS in that particular form would therefore ful l fairly well the main goals assigned to a euro-area stabilisation tool: provide stabilisation against asymmetric shocks and cross-border risk sharing without creating transfers between countries that are too persistent or too large[33]. As a result of the relatively frequent use of the scheme by euro-area countries, the ECUIS would have accumulated, at its maximum, a moderate debt equivalent to 1.7 percent of euro-area GDP at the end of 2013, because of the borrowing (the equivalent on average of 0.3 percent of euro-area GDP per year) necessary to nance the scheme during the crisis. In order to avoid a lasting debtor position, the ECUIS contribution rate would be set every year at the level that would have balanced the fund over the past ve years. As Table 1 shows, setting contributions this way would allow the fund to return to surpluses fairly quickly but would also reduce its counter-cyclicality. Given the low frequency of such crises (and the slow recoveries that tend to follow them), the return towards balance could be lengthened by increasing the number of years for calculating contributions from ve to seven, or even 10 years.

Figure 3: Proposed overhauled euro-area economic governance framework

Source: Bruegel. Notes: See section 3.4 for details. EDIS=European Deposit Insurance Scheme, ECUIS=European Catastrophic Unemployment Insurance Scheme, ESM=European Stability Mechanism, OMT=Outright Monetary Transactions, SRF=Single Resolution Fund.

32 e case of Germany is a good example of an additional bene t of having such an instrument in place: in 2003-05 Germany could borrow as much as desired for stabilisation purpose and was never at risk of losing market access in that occasion. However, it did so at the expense of the scal rules in force at the time, thus undermining their

sub-federal entities – could be pursued in Europe. A no-bailout clause combined with a restructuring mechanism and a loosening or even a removal of European scal rules could be credibly applied and would not be too disruptive in the euro area if, and only if, two conditions are met. First, a signi cant share of public spending (and thus taxation) should be permanently transferred to the centre to avoid too much disruption in the provision of essential public services in case of default. Second, banks should have a diversi ed portfolio of sovereign assets thanks to prudential regulation so a potential sovereign restructuring does not lead to a sovereign-bank feedback loop. However, in that case, countries would have to accept that national scal policy could no longer be used as a countercyclical tool (as it would impossible to default and to keep borrowing at the same time). ey would also have to accept some volatility on national debt markets, and possibly some sovereign defaults as a result of self-ful lling liquidity crises if the central bank is only responsible for the federal debt, as in the US. More importantly, countries sharing fully automatic stabilisers and a high share of public spending and taxes would have to harmonise their social institutions accordingly. In that case, scal policy at the euro-area level would not only have a stabilisation function, as contemplated before, but would also have some redistributive and allocative dimensions. is, in turn, would only be desirable if it takes place in a democratic process with the scal union becoming a full political union. is might be an option in the long run if the citizens of the EU are eager to integrate further and form a federal state. However, our view is that, from an economic perspective, this is not absolutely necessary for the short-term survival of the euro.

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