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ÖSTERREICHISCHES INSTITUT FÜR WIRTSCHAFTSFORSCHUNG

Policy Brief:
Past and Present of EMU Reform
Reforming the Euro Area – The Road Not (Yet) Taken

Atanas Pekanov

June 2019

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AUSTRIAN INSTITUTE OF ECONOMIC RESEARCH

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Euro area reform has been at the centre of much needed discussions throughout recent years. The Euro area crisis has made it clear that significant vulnerabilities still exist in the current architecture of the European Monetary Union. This has opened an intellectual and policy debate on how to make the EMU more crisis-resilient and whether the Euro area requires more risk-sharing or more market discipline to this end. Along these lines, numerous proposals have been presented by institutions and academics such as the introduction of a common fiscal policy instrument, possible reforms of the current fiscal rules, the creation of a Euro area safe asset to break the sovereign-bank nexus and a common European Deposit Insurance Scheme. This policy brief summarises the discussions and policy proposals for EMU reform of recent years. After intensive debates, the necessary consensus was not found and no significant breakthrough on EMU reform has been achieved to reinforce the ability of the monetary union to withstand future crises. These intellectual discussions have however laid the ground-work for finding the right answers at the particular moment in the future when political compromises will make it feasible to strengthen the Euro area in a healthy and efficient manner.

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Atanas Pekanov

Policy Brief[1]

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1. Introduction

Euro area reforms have been at the center of much needed and heated discussions throughout recent years. While the common currency and the economic union functioned well in their first decade, the global economic crisis showed that weak fundamentals, improper macroeconomic stances at country level and overly optimistic expectations about convergence in real incomes can pose risks not only for the countries concerned but also for the smooth functioning of the Euro area as a whole. Many proposals have been put forward to improve those shortcomings recently. With the ongoing economic recovery between 2016 and 2018, there were recurrent calls from European institutions as well as from academics to use the window of opportunity of economic growth to make the economic architecture of the Euro area more sustainable and more crisis-resilient for the future. The Juncker Commission made the completion of a deepened and fair Economic and Monetary Union one of the ten priorities for its mandate. Alongside many practical proposals, there was also a theoretical debate between two visions for the further development of the EU – between a rules-based approach, with strict rules that are not subject to change, and a centrally governed approach with the accompanying discretion of the institutions in charge, as described by *Brunnermeier – James – Landau* (2016A). While French President Emmanuel Macron tried to push for more EU integration and strengthening the role of EU economic institutions to reinforce the monetary and economic union, other proposals were directed at making current rules more efficient and structural reforms more binding, and thus at better preparing countries to smooth economic shocks on their own.

This Policy Brief sketches the dimensions of these debates in the past two years. Section 2 summarizes some of the identified vulnerabilities for the Euro area and how the economic shocks of the global financial crisis were amplified in the monetary union. Section 3 provides detailed information on the academic and policy debate and ongoing discussions for possible solutions from the past two years. Section 4 concludes, while the Annex provides a summary of the VoxEU Euro Area Reform Debate[2]) with the main messages, problems and policy proposals discussed in each of the contributions.

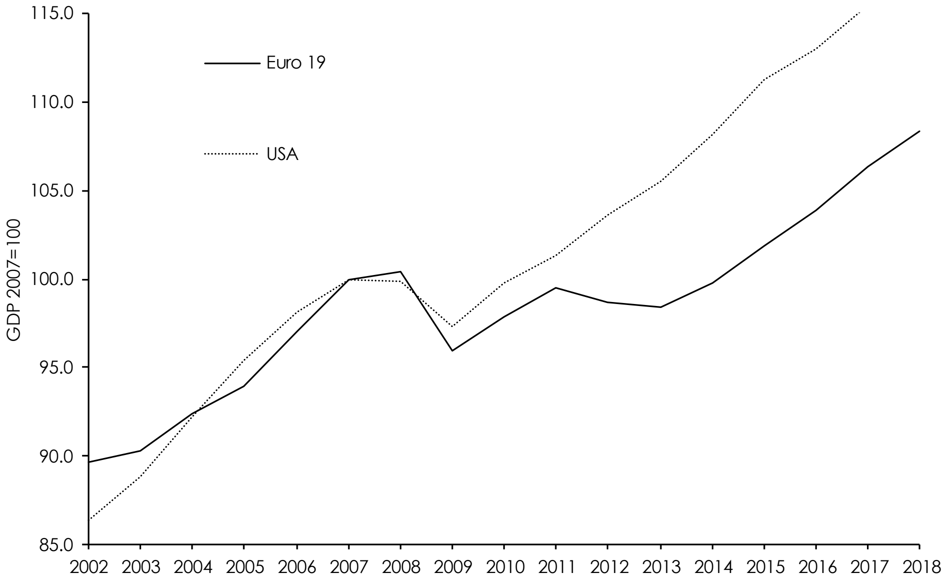
2. Identified problems of the Euro area

The significant and prolonged economic malaise of the Euro area in the aftermath of the shock of the global financial crisis and its extension in the Euro area sovereign debt crisis led to numerous discussions regarding how the European Monetary Union structure can be improved and whether more integration is needed to do so. Figure 1 shows the anemic recovery that has taken place in the Euro area in comparison to the United States in the aftermath of the crisis – while the US recovered to pre-crisis real GDP levels already in 2011, it took the European Union until 2016 to start an economic recovery. Several structural problems hindered a faster recov-

[2]) https://voxeu.org/debates/euro-area-reform.

ery, especially in the periphery. These structural challenges will continue to impede the economic success of the EMU, and a number of priorities were identified for improvement already in the Five Presidents' Report (*European Commission*, 2015). Building on that, the European Commission issued specific policy proposals in 2017 and 2018, while a number of more theoretical contributions by academic economists (see *e.g. Bénassy-Quéré et al.* (2018); discussed below) have also gained traction.

Figure 1: Real GDP, USA and Euro area 19, (GDP in 2007 = 100)



Source: Eurostat.

The reform proposals focus on improving the architecture of the monetary union so that future economic downturns can be handled better than the Euro area sovereign debt crisis. There are three major types of risks that can lead to significant economic downturn in the Euro area, which these proposals aim to address:

- a large outside shock to the whole Euro area;
- a large, asymmetric shock to one country;
- contagion and fragmentation on financial markets and their amplified effects on real activity through the sovereign-bank nexus.

These three risk types can often reinforce each other and arguably all three were observed during the Euro area crisis. Conflating these three scenarios often leads to mixed policy suggestions, so it is helpful to differentiate between these.

In the first case, there is a significant exogenous economic shock to the whole Euro area, as in 2008-2009. In this situation, the European Central Bank can intervene and provide monetary accommodation to smooth the shock. However, if the shock is too large, the ECB can reach the limits of its conventional monetary policy by reaching the effective lower bound of interest rates. In a further step, the ECB can implement unconventional monetary policies, but the effects of these are still under academic discussion (*McKay – Nakamura – Steinsson,* 2015). When the limits of conventional and unconventional monetary policy are reached, while there is still significant negative output gap in place, active fiscal policy may become necessary. As there is no instrument for common fiscal policy in the Euro area, it is up to national governments to implement fiscal stimulus in this situation. But different countries are in different positions of their business cycle and have different fiscal policy paths. Thus, it could be the case that there are countries that can implement the necessary fiscal stimulus and have the fiscal space to do so, but do not want to, while other countries that want to implement fiscal stimulus, cannot do so due to lack of fiscal space (*Buti*, 2017). The possible solutions then include either a common fiscal stabilization function to ensure the Euro area wide necessary fiscal policy stance, a central fiscal capacity to provide funding for smoothing economic shocks in countries that cannot do so or a mechanism that ensures that no country lacks the fiscal space to accommodate the shock on its own.

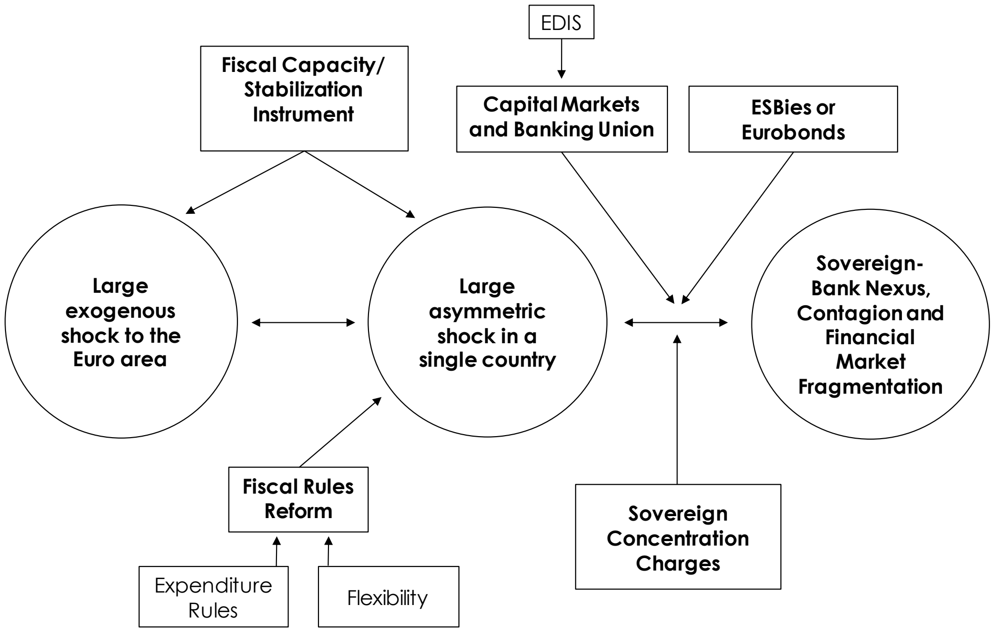
The second crisis scenario involves a large asymmetric shock in a specific country or a number of countries. As the ECB cannot accommodate its monetary policy stance to single European countries, the domestic fiscal policy needs to tackle the shock. But if the country in question is lacking the fiscal space to do so, there might be a need for a European institution to intervene. Opinions are divided between policymakers and Euro area member states whether that means there is a necessity to introduce such a European mechanism for stabilizing asymmetric shocks – such as a central fiscal capacity, a European investment stabilization mechanism or a European Unemployment Benefit Scheme. Opponents of these proposals often argue that ignoring the current fiscal rules has been the main reason some countries have failed to prepare with the fiscal space necessary to accommodate such economics shocks. It is a major source of division on whether this problem require greater risk-sharing or more market discipline in the Euro area, as discussed below.

Finally, the first and the second shock can become significantly strengthened in the European monetary union due to contagion on financial markets, panics regarding possible redenomination risk and self-fulfilling expectations (*Farhi – Martin,* 2018). While part of an initial market reaction on government bond markets can be based on weak fundamentals by specific governments, as was the case in Greece, or on a combination of different improper macroeconomic, regulatory and fiscal policies (*Martin – Philippon,* 2017), these dynamics can become self-fulfilling and compound each other as capital flight sets in from the periphery to Euro area core economies. The explosion in government bond spreads between core and periphery countries could then only be contained by exceptional interventions from the ECB, as was the "whatever it takes" initiative by President Draghi (*Farhi – Martin,* 2018). The theoretical literature points out that in such cases of market panic, there can be multiple equilibria and it is uncertain which outcome will take place (*Leeper*, 1991), as self-fulfilling panics can lead to sustained detrimental effects Ignoring such instabilities due to self-fulfilling crises might make the euro area unsustainable in the long-run (*Aguiar et al.,* 2015). In such cases, central bank interventions can limit investors' uncertainty and fear of redenomination and euro exit and thus lead expectations to the "good" equilibrium (*Bianchi – Melosi,* 2017; *Jarocinski – Mackowiak,* 2017). From a certain point onwards, coordination between monetary and fiscal policies are needed to ensure macroeconomic stabilization and that the good equilibrium will be reached (*Bianchi – Melosi,* 2017; *Corsetti et al.,* 2016; *Hettig – Mueller*, 2017; *Orphanides*, 2017). Furthermore, there could be a divergence between what is macroeconomically optimal from an individual country perspective and for the whole EMU (*Blanchard – Erceg – Linde*, 2015; *House – Proebsting – Tesar,* 2017).

These periods of increased market pressure in fragile countries and self-fulfilling debt crises are enhanced by a doom loop between banks and Euro area sovereigns (*Schnabel – Véron,* 2018), as we explain below. Reform proposals aimed at solving the issue of the sovereign-bank nexus included the introduction of European Safety Bonds (ESBies) or of concentration charges on sovereign debt holdings, as discussed below, but there has still been no progress on this issue.

Arguably, all three scenarios were at play during the global financial crisis and the Euro area crisis. Figure 2 summarizes these risks to the Euro area and how some of the reform proposals discussed below aim at addressing them.

Figure 2: Vulnerabilities of the Euro area (in circle) and selected policy proposals (in square)

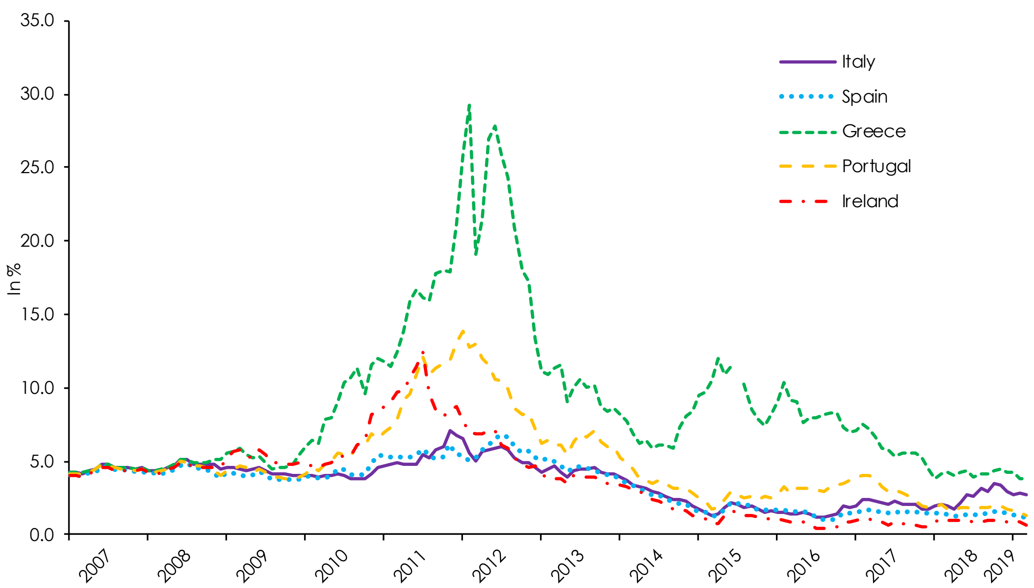


The sovereign-bank nexus and contagion on financial markets

During the Euro area sovereign debt crisis one of these sources of economic shocks has become explicitly pronounced as an amplification mechanism for economic turbulences throughout euro member states. Domestic banks often hold mostly domestic government bonds due to home bias (*Sorensen et al.*, 2007; *Altavilla – Pagano – Simonelli*, 2016), which means they are prone to come under risk as soon as there is significant market stress on the market for governments bonds. At the same time, sovereign governments are also prone to stress when their banking system comes under financial market pressures, as the significant losses from possible bank failures can become a burden for government budgets. In fact, when an important bank in a European sovereign suffers market pressure, this often translates into pressure on the yields of government bonds, that can then also spread through the whole banking sector in this country. This spiral was explicitly visible during the Eurozone crisis and has become known as the doom loop between banks and their sovereign. In the Euro area, the problem was especially enhanced by contagion effects on government bond markets throughout all periphery countries, although they had different fundamentals and have been following different fiscal paths prior to the crisis.

Nevertheless, until the global financial crisis, government bond yields of periphery countries moved together and were priced in by markets as nearly as secure as German government bonds, as shown in Figure 3. Ever since 2009 and especially during the tumultuous years of the sovereign debt crisis, there has been a wide divergence and a significant market fragmentation along the core and periphery countries. This fragmentation on financial markets can impede the efficiency and the pass-through of the monetary policy of the ECB.

Figure 3: Government Bond Yields 10 Years



Source: OeNB.

The ECB was central to calming these alarming trends with its Outright Monetary Transactions program (OMT) (*Altvavilla – Giannone – Lenza,* 2014), as well as by providing conventional and unconventional monetary accommodation. But the predominant role of the ECB as the main economic player also put it under immense pressure – and it has been questioned whether this is always optimal (*Farhi – Martin*, 2018)[3]). Especially in this regard it is questionable whether the ECB can be expected to be the sole institution to ensure macroeconomic stabilization after a shock in the future if it does not manage to return to normal interest rates before that. The credibility and efficiency of a second "whatever it takes" announcement can thus come under question. The call to reform the EMU is partly based on this understanding that the ECB cannot be the sole economic institution responsible for economic recovery of the Euro area.

Risk-sharing versus market discipline

While breaking the vicious sovereign-bank doom loop is essential for ensuring that an initial shock will not be amplified through financial markets, the resilience of the Euro area and of individual member states will always require member states to have the ability and fiscal sustainability to withstand a significant economic downturn. There are diverging and contrasting opinions why this was not the case for some countries during the European sovereign crisis. Once the crisis hit, many of the periphery countries faced high deficits and a rapid deterioration of their public finances. However, as described by *Constâncio* (2018), that was not always caused by an irresponsible performance of governments in the run-up to the crisis: *"Contrary to the main narrative, popular in core European countries, the driver of these imbalances was not fiscal, with the exception of Greece. In 2007, the public debt to GDP ratios of Portugal, Spain and Ireland were respectively 65%, 36% and 25%, well below the euro area average. In Italy, although still at 103%, public debt had fallen 10 percentage points since 1999."*. It can thus be argued that it was the burden of the financial crisis that led to these countries having insufficient fiscal space.

Once the crisis struck periphery countries, the debate regarding fiscal rules moved to whether the Maastricht deficit rules limited the ability of government to withstand economic shocks and by being excessively prohibitive towards fiscal stimulus hindered governments to attenuate the economic downturn. It is crucial to be able to implement a fiscal stimulus exactly when it can have very high fiscal multipliers (*Furman,* 2016; *Auerbach – Gorodnichenko,* 2012). A growing literature has pointed out to the enhanced efficiency of active fiscal policy during deep recessions and when the monetary policy of the central bank is already at the zero lower bound (see *Pekanov* (2018) for an overview). However, an opposing argument points out that the Maastricht rules were actually not effective enough to ensure that governments build fiscal buffers in tranquil times to use them to fight economic downturns. Although based on contrasting views, there seems to be a shared disagreement with the current fiscal rules in the Euro area. As *Bénassy-Quéré et al.* (2018) mention – "Fiscal rules are non-transparent, pro-cyclical,

[3]) https://voxeu.org/article/role-ecb-reform-proposals-cepr-policy-insight-91.

and divisive, and have not been very effective in reducing public debts. The flaws in the Euro area's fiscal architecture have overburdened the ECB and increasingly given rise to political tensions". What is more, the fiscal rules have become excessively complex. The discussion whether the EMU needs more risk-sharing or more market discipline is broadly shaped by this trade-off between making the fiscal rules more stringent or more flexible. In addition, as we describe below, there are opposing views whether the completion of the banking union will help address possible imbalances accruing from the sovereign-bank nexus or worsen them.

Widely diverging policy options result from this divide. A possible introduction of a central fiscal policy function has been proposed as a way to counteract the case where the ECB is overburdened and cannot provide enough monetary stimulus after large negative shocks either in the whole Euro area or in a specific country. The diametrically opposing view is that by completing the Banking and Capital Markets Union, all smoothing of shocks could be done by financial markets, without the need of a new fiscal institution. This view is based on the proposition that the monetary union and fiscal policies will become more sustainable if private finance and public finances are delinked credibly. In practice this means no bail-outs for governments and banks in the European Union, which is already embedded in the EU treaties. Financial markets will then price in any failures of governments or banks to act in line with fundamentals, thus leading to pressures of governments to correct their fiscal positions at the right time. This view ignores nevertheless that even in the presence of complete markets there can be benefits from public risk sharing due to the stabilising effects of public institutions (*Farhi – Werning,* 2017).

For proponents of market risk sharing, the completion of the Banking and the Capital Markets Union would lead to a more sustainable fiscal performance of governments in good times. This would however require also a fully-fledged banking union that does not allow contagion effects, self-fulfilling crises and panics. The problem is that a perfect banking union requires pan-European deposit insurance. However, as the discussion regarding a European Deposit Insurance System below shows, the introduction of such a pan-European Deposit Insurance is also hindered by serious divergence of opinions on its exact structure, timing and composition. Dani Rodrik has thus asked: "What is more likely – a pan-European deposit insurance or a limited fiscal union?"[4]).

Central fiscal capacity and fiscal rules

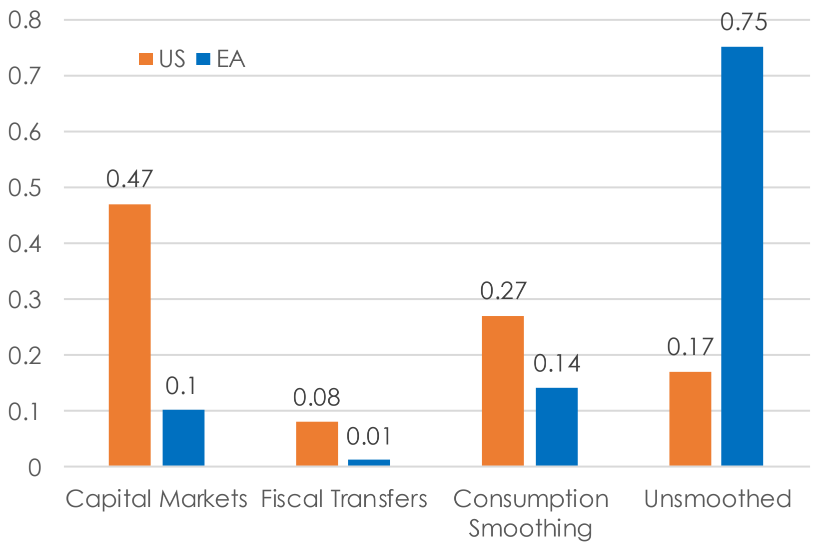
Since fiscal rules have been deemed ineffective or counterproductive, there have been numerous calls to change them. Some of these proposals called for tightening the rules by binding them to a stricter government expenditure rule that limits the growth of nominal expenditure. *Feld et al.* (2018) propose an expenditure rule that binds government expenditure growth to nominal potential GDP growth and an additional correction term for previous structural imbalances. In this framework government expenditures aim at accomplishing a medium-term budget balance and if there were imbalances in the past, they further limit current government

[4]) https://www.project-syndicate.org/commentary/separating-private-and-public-finance-in-europe-by-dani-rodrik-2017-12.

expenditures. This mechanistic rule is criticized by *Bofinger* (2018), as it strictly binds government expenditures and can penalize current governments for possible imbalances accrued by previous ones. *Darvas – Martin – Ragot* (2018) propose a simpler rule that again should direct government expenditures on a path consistent with the debt target, but the exact composition of spending admits discretion on the part of the government and does not require compensating for previous excessive spending, therefore allowing for a more flexible approach. More importantly, as shown by the authors through numerical simulations for France, such an expenditure rule will have a more counter-cyclical nature.

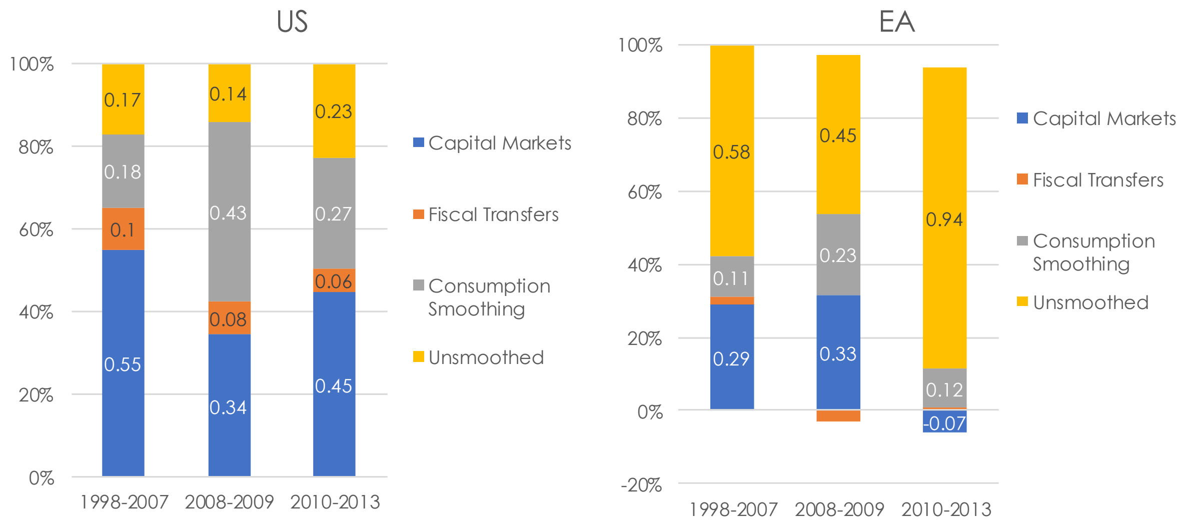
Alternatively to making fiscal rules tighter in an attempt to ex-ante ensure fiscal space for periods of recessions, there have been numerous proposals for new fiscal institutions to counteract large and significant economic shocks when the ECB has reached its limits – these are presented below. However, it is not obvious that the two approaches are in conflict with each other. Figure 4 and Figure 5, from *Alcidi – D'Imperio – Thiron* (2017), provide evidence on the amount of smoothing of shocks in the United States and in the Euro area via different channels. Both figures point to the lack of overall smoothing of economic shocks in the EMU in comparison to the United States. But most importantly, they also point out that all channels of shock smoothing – via capital markets, via consumption smoothing and via fiscal transfers - are still relatively limited in the EMU. Similar evidence has already been presented previously by *Allard – Brooks – Bluedorn* (2013) and a similar decomposition of smoothing channels is found to be in place in other federal states such as Canada and Germany (*Crucini,* 1999; *Hepp – von Hagen,* 2013). Thus both channels of risk sharing – through capital markets and through fiscal institutions need to be advanced further in the EMU.

Figure 4: Income and consumption shocks smoothing in the US vs. Euro area 11 (% smoothed of relevant shock)



Source: *Alcidi – D'Imperio – Thiron* (2017).

Figure 5: US-Euro area comparison of channels for smoothing of economics shocks by sub-periods (comparable data), 1998-2013



Source: *Alcidi – D'Imperio – Thiron* (2017).

The European Monetary Union might therefore need both better risk sharing via financial markets and a fiscal capacity stance at the Euro area level to manage different shocks accordingly. The current set-up of fiscal rules, has been criticized for putting limits on the support the ECB could get from the national government in terms of fiscal stimulus – and especially so when it would be most needed and effective. To address these criticisms, a flexibility clause was added to the Stability and Growth Pact during the Euro area crisis so that no fines for breaching deficit requirements are imposed on countries under exceptional circumstances. While this led to the necessary flexibility to allow countries not to cut spending even more sharply in the most recessionary periods, it was often used to attack the current fiscal rules as lacking credibility or being unnecessarily politicized.

The problems of insufficient aggregate demand and the missing macroeconomic capacity to address it apply both to a major economic shock for the whole of the Euro area, as well as to the case of a large asymmetric shock to one of the Member States. The Stability and Growth Pact was developed at a time when the macroeconomic consensus was on the leading role of the central bank as the dominant institution for macroeconomic stabilization (*Kirsanova – Leith – Wren-Lewis*, 2009). Due to deficit bias, in this view, fiscal policy should be passive and aim only at sustainable public finances. It is however questionable whether this set-up is also adequate for exceptional times – such as when the central bank has reached its zero-lower bound, while the output gap is still significantly negative (*Sims*, 2016, *Blinder*, 2016; *Orphanides*, 2017). In such times, a more active fiscal policy can efficiently address insufficient aggregate demand, lead to crowding-in of investment and therefore produce high fiscal multipliers (*Blanchard – Erceg – Linde*, 2015; *Furman*, 2016; *House – Proebsting – Tesar*, 2017). This has been shown both in the empirical time series literature (*Auerbach – Gorodnichenko*, 2012; *Caggiano et al.*, 2015; *Ramey - Zubairy*, 2018), and based on New Keynesian DSGE models (*Woodford,* 2010; *Werning,* 2011; *Blanchard – Erceg – Linde,* 2015). Furthermore, these multipliers can be even more substantial in the EMU, since there are important spillover effects between countries (*In't Veld,* 2013). Deep recessions can furthermore lead to considerable hysteresis effects – both on the labour market as long-term unemployed lose their skills and motivation, as well as on the productive capacity of the economy due to prolonged under-investment because of insufficient aggregate demand. They thus have the potential to inflict long-term damage on the economy (*Ball*, 2014; *Fatas – Summers*, 2016). An investment stabilization function, such as the one the European Commission proposes, aims to address these issues. In such a setting, the fiscal stimulus might even pay for itself (*DeLong – Summers,* 2012; *Erceg – Linde*, 2014; *Schmidt*, 2017). In this environment of monetary policy at its limits, there is a growing consensus on the need for more active fiscal policy to close negative output gaps and reach inflation targets faster (*Furman,* 2016; *Blanchard – Summers,* 2019; for a detailed overview see *Pekanov,* 2018).

These theoretical and conceptual discussions were the background of the debate that has taken place in the European Union throughout the last two years on how to improve the EMU. We document this debate in the next section, by pointing out important milestone proposals by different institutions and academics, the ensuing debate on them and how they have evolved since then.

3. Ongoing discussions 2017-2019

Ongoing EMU Reform discussions started with President Juncker's White Paper and were deepened by the publication of the Commission Reflexion Paper on Deepening the European Monetary Union in May 2017. On 6th December 2017, the European Commission[5]) published its December Package including a number of reforms that the Commission endorsed for a stronger, more stable and crisis-resilient monetary union. This package included proposals for transforming the European Stability Mechanism (ESM) to a European Monetary Fund (EMF), new budgetary Instruments, a Reform Support Package, integration of the Fiscal Pact in Secondary EU Law, a Stabilisation Function for the Euro area and a Backstop for the Banking Union and a Communication on the proposal to create the role of an European Minister of Economy and Finance.

In January 2018, a CEPR policy letter by 14 French and German economists (*Bénassy-Quéré et al.,* 2018)[6]) was published in an attempt to find a consensus on reform measures that reconcile the more risk-sharing with the more market discipline view on completing the Euro area architecture. The 7 German and 7 French economists thus combined crisis mitigation with

[5]) http://europa.eu/rapid/press-release_IP-17-5005_en.htm.

[6]) https://voxeu.org/article/how-reconcile-risk-sharing-and-market-discipline-euro-area.

crisis prevention measures in an attempt to find a reform program acceptable for both Germany and France. This letter focused on 6 reform areas: breaking the sovereign-bank nexus; improving the current fiscal rules system; introducing orderly sovereign-debt restructuring for Euro area countries; creation of a Euro area fund; creation of a synthetic Euro area safe asset; reforming the institutional architecture. These reform proposals from the letter of the 14 economists caused a number of positive and negative reactions[7]). One of the most pronounced worries expressed was that the Policy Insight puts excessive attention to market discipline and the reduction of moral hazard and that without implementing such reforms gradually and in a well-sequenced manner, they could generate self-fulfilling prophecies and financial distress, requiring more, not fewer, resources (*Buti – Giudice – Leandro*, 2018).

We go into more detail on the proposed reforms and the criticism towards them below, but shortly the concrete reforms of the 14 economists CEPR Policy Insight 91 included:

- Completion of the Capital Markets and Banking Union – by introducing a common deposit insurance with a fiscal backstop from the ESM, improving bank supervision and bank regulation and bail-in rules;
- Breaking the sovereign-bank nexus by introducing European Safe Bonds (ESBies) and limits to banks' exposures to government bonds;
- Reforming fiscal rules by changing them to nominal expenditure rules instead of deficit rules and introducing junior sovereign bonds to fund spending overshoots to strengthen market discipline and therefore limit moral hazard;
- A fiscal stabilisation scheme (or unemployment reinsurance) in the form of one-off transfers to national budgets in significant recessions;
- Introducing a mechanism for sovereign debt restructuring in the EMU;

The CEPR Policy Insight itself was not endorsed by the French or German government, as it included a debt restructuring mechanism, which was uncomfortable for France, while the stabilisation function and the European deposit insurance scheme were not acceptable for Germany and other countries (*Pisani-Ferry,* 2018).

In March 2018, the IMF (*IMF,* 2018)[8]) presented its own, more ambitious proposal for a Euro area central fiscal capacity to smooth country-specific and common shocks, with the necessary size to provide macroeconomic stabilization. It built upon previous work by the IMF arguing for the economic necessity to complete the EMU by setting the foundations of a fiscal union (*Allard et al.,* 2013). In the words of the accompanying communication[9]), "There is no doubt that completing the Euro area institutional setup is politically difficult, but it's also an economic ne-

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[7]) These are summarized in a separate blog and we discuss many of these contributions below: https://voxeu.org/debates/euro-area-reform.

[8]) https://t.co/NcKplF5crl.

[9]) https://t.co/fpE4D6r4EZ.

cessity. Ultimately, without more tangible elements of fiscal union, Euro area will remain fundamentally vulnerable to shocks". This view partly reiterates a growing acceptance that the EMU set-up needs to be enhanced to overcome future economic crises faster via a proper central fiscal policy institution. "While substantial progress has been made to address some architectural issues – conditional lending facilities and key elements of a banking union – we argue in our recent paper that the Euro area needs to build elements of a common fiscal policy, including more fiscal risk sharing, to preserve financial and economic integration and stability. Without some degree of fiscal union, the region will continue to face existential risks that policymakers should not ignore."[10]).

In May 2018, the European Commission launched its proposal for the next EU Budget (Multiannual Financial Framework, MFF) 2021-2027. The original aim of the Commission was to reach agreement between Member States, the European Commission and the European Parliament by April 2019, but this has consequently failed. It included a proposal for a form of a Euro area budget, that has been discussed in length in the ensuing months. As described, these separate proposals have intertwined and institutions and EU member states have sought to reach consensus on them, with little progress in the end.

The next EU Budget

On 2nd May, 2018 the European Commission presented its proposal for the next Multiannual Financial Framework (MFF) – the EU Budget for the 2021-2027 program period. Ideally, the aim was to adopt the next EU budget before the forthcoming European elections, but this was impossible due to considerable divisions. The discussions were complicated by the ongoing negotiations with the United Kingdom to leave the EU, resulting in an expected significant shortfall for the next Budget. Combined with the lack of willingness to abandon older, costly priorities such as the Common Agricultural Policy, this meant that the EU would have to require a very marginal increase in its budget for the next period in relation to Gross National Income (GNI). The Commission thus proposed an enhanced budget of € 1,297.4 billion in commitment appropriations in nominal terms, which would imply an increase of the budget volume from currently 1.03% of GNI to 1.11% of GNI on average for 2021-2027.

However, the feasibility of this proposed MFF will depend on whether and how much the UK continues to pay and mostly on whether new own resources will be agreed upon by Member States. The need to acquire more own resources for the EU Budget was pointed out by the High Level Group on the "Future Financing of the EU" chaired by Mario Monti. The final report of the Group addressed the Commission with three concrete sources – a share of the Common Consolidated Corporate Tax Base currently under negotiation, parts of the revenues from auctioning allowances under the European Emission Trading System, and revenues from a levy on non-recyclable plastic packaging waste. This can help fill the funding gap after Brexit and provide

[10]) https://blogs.imf.org/2018/02/21/the-euro-area-needs-a-fiscal-union/.

the revenues required for an expansion of the EU budget, but it will nevertheless retain its minimalistic size and therefore will be unsuitable for embedding any crisis-mitigation tools in it.

The proposal also included the idea of creating the role of an European Minister of Finance – an institutional change to combined in a representative role the current positions of Eurogroup chief and the Commissioner on Economic Affairs, without devising a new separate budget for it. However, the idea to combine the position of implementing fiscal decisions and overseeing them, has also been criticized. A better solution might have been to strengthen the role of the European Fiscal Council (*Beetsma et al.,* 2018) and developing further the national fiscal councils (*Calmfors – Wren Lewis*, 2011). The European Fiscal Board was developed in recent years and issues annually statements about the proper fiscal stance of the Euro area as a whole. However, so far, the recommendations issued by the European Fiscal Board have had relatively minor influence on policy decisions in member states.

Macroeconomic stabilization function

The combined proposals by the European Commission in December 2017 and May 2018 also included the idea of setting up a macroeconomic stabilisation function inside the next MFF. As discussed above, this idea has been based on the realization that insufficient aggregate demand can lead to prolonged recessions, especially after asymmetric shocks. By including such a proposal, the Commission admitted the importance of aggregate demand shortfalls as a macroeconomic problem for the Euro area and proposed two new instruments to be used as a common macroeconomic stabilization function for the Euro area in deep recessions and after asymmetric shocks. The problem with this proposal was that its sheer scale was not convincing that it will be enough to compensate and stimulate aggregate demand accordingly.

The question for the EMU is then how to ensure that there exists such a stabilization function to provide stimulus in an effective way, without affecting negatively fiscal performance in good times. The European Commission with its proposed central fiscal capacity thus seemed to accept that this indeed is a problem and proposed an European Investment Stabilization Function (EISF) in its package for EMU reform to address this issue. "The crisis highlighted the limitations of means available to individual Member States to absorb the impact of large asymmetric shocks" – concludes the Commission Budget Proposal[11]). "A new tool is needed to prevent protracted recessions and negative spillovers.". The proposal of the Commission thus included two elements of such a fiscal tool:

- European Investment Stabilization Function (EISF) in the form of a rainy day fund to protect investments in an economic downturn, when investment spending declines the most. The proposed instrument consists of up to € 30 billion of back-to-back loans for countries facing asymmetric shocks that they cannot manage on their own, with the condition that countries had sound fiscal and economic policies previously. The idea is similar to the functioning of the ESM, but would avoid the painful and prolonged decision making process in the

[11]) http://europa.eu/rapid/press-release_MEMO-18-3971_en.htm.

ESM due to an automatic trigger. But the sheer size of the proposed maximum loans – € 30 billion, was nothing compared to the size of the economies of the EU. Putting that into perspective, this is a mere 3% of the proposed EU Budget, which itself is only around 1.11% of the whole EU GNI. The ESM for example was funded with a starting capital of € 500 billion and still this did not stop market pressures on government bond spreads, which were only effectively addressed via the OMT programme announcement. This new European Investment Stabilization Function (EISF) could thus have only minimal stabilization capacity – providing loans to countries which have lost market access with relatively low interest rates because the EU will borrow the funds with the EU budget used as collateral.

- In addition to the proposed EISF, there was a small, true risk-sharing component in the form of a rainy day fund as part of the Commission proposals. Countries can contribute to this fund with a share of their seigniorage income and the fund can then provide an interest rate subsidy for countries with an ESM loan. This way they do not pay an interest rate on loans taken in times of stress. This small rainy day fund will thus provide direct help to governments. However, its size was very modest – around € 600 million per year. For comparison, Spain had to pay € 6 billion euro on interest rate payments throughout 2011, as pointed out by *Claeys* (2018).

Thus, although it admitted the problem of the need of some form of a fiscal capacity for the Euro area, the Commission's proposal did not seem to address it sufficiently due to its limited size. Embedding the stabilization tool for the EMU in the EU budget might have been a strategic decision to avoid the seeming impossibility of a change to EU Treaties to introduce a separate new fiscal capacity, but the sheer size of the EU budget and the many political priorities put to it make it impossible for a macroeconomic stabilization function inside of it to have a significant effect. However, as we see below, even this very limited form of a macroeconomic stabilization capacity was politically infeasible in further discussions between member states.

For comparative purposes, the IMF proposal from the end of March 2018 for a similar macroeconomic stabilization fund was much more significant in size (*IMF,* 2018). By gathering contributions in good times to be used in times of stress, it represented a true rainy day fund. "In terms of size, the CFC (Central Fiscal Capacity) should be large enough to play a meaningful stabilization role" was one of the main principles of the IMF proposal. The study by the IMF (*IMF,* 2018) proposed annual country contributions of 0.35% of GDP. According to the Fund's estimations, had such a fund existed during the Eurozone crisis, it would have effectively closed the output gap in the Euro area much faster. Expecting the approach of the Commission, the Fund paper also states that: "Embedding a Euro Area budget line within the EU budget would not provide sufficient resources for stabilization if provided within the current EU budget envelope (less than 1 percent of GDP)", which is a clear judgment on the ability of any proposal to introduce a fiscal capacity inside the current structure of the EU budget as lacking.

As part of the European Commission May 2018 package, two further proposals were presented – on one hand to strengthen the Structural Reform Support Program and on the other – for a dedicated convergence facility for Member States wishing to join the euro. These were initially thought as additional funding as well as technical assistance for converging countries in return for the successful implementation of structural reforms and convergence, but were also criticized as undermining market disciplining mechanisms by promising to reward catch-up countries for doing reforms that are required anyways (*Dolls et al.,* 2018). However, there is little evidence that market pressure itself leads countries to implement the necessary reforms – therefore binding those with additional funding might be a suitable approach. These proposals have partly also been used as background for the initial discussion regarding a possible Euro area budget, as presented below.

European Deposit Insurance System

A European Deposit Insurance Scheme (EDIS) was highlighted as a necessary component of a completed banking union in the Five Presidents' Report of 2015 (*European Commission,* 2015). However, lack of consensus on its exact design between Euro area countries impeded its implementation until now and resulted in a deadlock. Some countries argued that more risk reduction (reduction of NPL ratios) needs to happen before any form of risk sharing by EDIS can be institutionalized. There is a widely shared feeling that EDIS cannot come into place while countries have major differences in the level of NPLs in their banking system and while there are uncertainties regarding moral hazard issues spanning from the introduction of a fully integrated, country-blind deposit insurance system, as the one proposed by the European Commission in 2015. To overcome this issue, there are a number of suggestions to limit cross-border sharing of baking system risk by introducing a form of national compartments in EDIS (*Gros,* 2015; *Bénassy-Quéré et al.,* 2018; *Schnabel – Véron,* 2018). This would mean that the first part of losses is borne at the national level, including partial clawback (*Gros,* 2015) or ex-post fees (*Bénassy-Quéré et al.,* 2018; *Schnabel – Véron,* 2018). However, as argued by *Schoenmaker* (2018), introducing national compartments for the potential future European Deposit Insurance Scheme can be self-defeating as they will have a destabilising effect during a crisis. A deposit insurance scheme that comes under scrutiny exactly at times of pressure might not enhance stability, but rather reduce it. To guarantee stability, a government backstop should be in place to ensure market participants of the crisis-resilience of the system. In summary, even on the issue of an European Deposit Insurance System, which is agreed as a necessity for the completion of the banking union in the long-run, there has been relatively weak progress in implementing a solution throughout the past two years.

European safe asset

A type of a European safe asset has been discussed for a long time as a necessary and helpful addition to the current design of the EMU. It will have two important functions. First of all it will partly counteract the sovereign bank nexus, as in the current set-up banks rely heavily on bonds issued by their own countries. Secondly it can provide fresh funding and direct some funding from government bonds into a common pool, therefore avoiding the flight of investors to safety during crises. Many different proposals for introducing such a common Euro area safety asset have been made (see *Leandro – Zettelmayer* (2018) for an overview). Most of the original proposals of a union-wide safe asset included some limited or full joint liability, which made those politically infeasible, as joint liability might lead to moral hazard issues and would result in common fiscal liabilities which are hard to introduce without a political union. Different previous proposals regarding Eurobonds with joint liability, such as the ones by *European Commission* (2011), *von Weizsacker – Delpla* (2010), *Gros* (2015) and *Ubide* (2015) were thus deemed infeasible.

Thus, a fully-fledged form of Eurobonds has been seen as politically unacceptable, as it represents too much risk sharing for some countries. The idea of European Safety Bonds was developed by *Brunnermeier et al.,* (2016B) as an alternative solution, where sovereign government bonds are pooled and tranched to limit joint liabilities. Due to this diversification and tranching in senior and junior bonds, European Safety Bonds involve no risk-sharing element according to *Brunnermeier et al.* (2016B). These assets can be helpful in limiting the diabolic loop and cross-border flight-to-safety from the periphery to the core of the Euro area. The most senior of the tranches in these ESBies can then play the role of a European safe asset. The authors also show through numerical simulations that the ESBies should be at least as safe as German bonds and can approximately double the supply of Euro area safe assets. A recent report by The High Level Task Force of the ESRB conducted thorough research on the ESBies and endorsed them (*ESRB*, 2018). The Commission was seen as supportive to the ongoing work in the European Systemic Risk Board on European Sovereign Bond and presented a framework for enabling these securities in 2019. However, two major criticisms towards ESBies were expressed. The lack of considerable risk-sharing combined with their complexity, led to comparisons of ESBies with government-like CDOs and with a type of financial engineering that only hides potential risk, but does not decrease it in times of significant stress (*De Grauwe – Ji,* 2018). In this argumentation, ESBies, much alike CDOs in the run-up to the US subprime mortgage crisis, will be assessed as riskless until they become almost worthless after a possible financial meltdown. The problem might be even bigger in the Euro area as there are less bonds and thus less diversification opportunities – government sovereign bonds in the EU are correlated, so a shock to one of them can mean all of them come under pressure from a certain threshold onwards (*Watt,* 2018). Further complications come from the question who will issue these new instruments (*Watt,* 2018), as issuance purely by a public institution will still imply liability, while issuance by a private institution should have already happened if there was demand for that. *Leandro – Zettelmayer* (2018) describe some of these objections as exaggerated, however they find there are competing proposals that are superior to ESBies. The authors however admit that these will require some limited amount of public capital and some limited form of redistribution.

Other proposals

Further discussions included turning the ESM into a European Monetary Fund (EMF) and were part of the European Commission Roadmap for reforming the EMU: "A proposal to establish a European Monetary Fund (EMF), anchored within the EU's legal framework and built on the well-established structure of the European Stability Mechanism (ESM). It will continue to assist euro area Member States in financial distress. In addition, the EMF would provide the common backstop to the Single Resolution Fund and act as a last resort lender in order to facilitate the orderly resolution of distressed banks.". There can be significant advantages from this – such as the fact that an eventual EMF can be used as the much needed fiscal backstop for the Single Resolution Fund, that needs guaranteed funding to be able to decisively resolve failing banks and that a potential EMF can be used as the future body to issue European bonds. However, this proposal had more of a legal and political character, rather than an economic one.

Political discussions

In June 2018, France and Germany issued the Meseberg declaration signing their will for agreeing on decisive EMU reforms[12]). It included commitment to finalize the banking and capital markets union and a backstop for them, considering a European Deposit Insurance Scheme and signalled commitment to an "Eurozone budget" "to promote competitiveness, convergence and stabilization", nevertheless mentioning its purposes would be "competitiveness and convergence", while leaving a European Unemployment Stabilization Fund to be "examined" further[13]).

Further discussions on these issues have followed; a number of countries, (the so-called Hanseatic league countries) have come forward against a stabilization function arguing risk sharing through completed capital markets should be enough to ensure the stability of the Euro area[14]). As part of the academic debate, *Heijdra et al.* (2018) have argued that the potential benefits of a central fiscal capacity can be achieved through stronger financial market risk sharing, completing the Banking and the Capital Markets Union and via more effective use of fiscal stabilisers, by building buffers in national budgets during good times. Thus, the authors have taken a strong position against any additional form of fiscal risk sharing.

Building upon these discussions during 2018, at a Eurogroup meeting on the 3th December 2018, the Eurogroup decided its stance before the EU summit on 14th December 2018. Agreed results were incremental – the necessary backstop for the banking union and the SRF and a strengthening of the ESM. These were the least contentious of all reform proposals discussed above and the ones that seemed from the start as anyway necessary and inevitable for the EMU. Although they are necessary, they do not seem in any way to contribute further to solving any of the trade-offs concerning crisis mitigation versus crisis preventions, fiscal rules and fiscal stabilization or in overcoming the sovereign-bank nexus problematic described above. Although the communication pointed out that a Euro area budget has been agreed upon, it pointed its aim to

[12]) https://www.elysee.fr/emmanuel-macron/2018/06/19/meseberg-declaration-renewing-europes-promises-of-security-and-prosperity.en.

[13]) https://archiv.bundesregierung.de/archiv-de/meta/startseite/meseberg-declaration-1140806/.

[14]) https://voxeu.org/article/more-stable-emu-does-not-require-central-fiscal-capacity.

be only convergence and competitiveness priorities, not stabilization, where significant disagreement have blocked any consensus solution[15]). Figure 6 summarizes the timeline and progress of EMU reform in the past two years.

Figure 6: Euro area Reform – the past 2 years

Euro area Reform – the last 2 years

- **December 2017 – "Christmas Package" of Reform Proposals by European Commission**
  - European Monetary Fund, New Budgetary Instruments, Reform Support Package, Integration of Fiscal Pact in Secondary EU Law, A Stabilisation Function for the Euro area, Backstop for the Banking Union
- **January 2018 – 14 German/French economists letter trying to reconcile risk-sharing with market discipline:**
  - Focus on: breaking the sovereign-bank nexus; improving current fiscal rules system; introducing orderly sovereign-debt restructuring for Euro area countries; creation of Euro area fund; creation of a synthetic Euro area safe asset; reforming the institutional architecture
- **March 2018 – IMF proposes an ambitious Euro area Central Fiscal Capacity (Rainy Day Fund) to help smooth country-specific and common shocks, with necessary size to provide macroeconomic stabilization**
- **June 2018 – Meseberg Declaration by France and Germany – a commitment for EMU reform including completing the banking and capital markets union, considering a European Deposit Insurance Scheme and a commitment to an "Eurozone budget" "to promote competitiveness, convergence and stabilization"**
- **Ongoing discussions whether fiscal stabilization is needed at all, led by the group of Hanseatic countries, which disagree with this view**
- **3rd December 2018 – Euro group meeting and communication on agreement regarding: strengthening the ESM, providing a backstop for the SRF (and the banking union), Euro area budget for convergence and competitiveness, but no agreement on the need for stabilization**
- **14th December 2018 – European Summit of the Heads of state and Government of the European Union**
- **Did we waste the window of opportunity for EMU reform or made incremental, but decisive progress?**

4. Conclusions

Overall, after numerous proposals and discussions throughout the past years and after recognizing the significant challenges in front of the European Monetary Union, it is disappointing that policymakers have not managed to achieve much real progress on improving the architecture of the EMU. Progress on EU integration, especially given electoral attitudes, can be very incremental. In fact, at least, "The Rubicon was crossed on the Euro area budget". However, even this incremental progress is still under discussion and has not been amended officially.

While French President Macron pointed many of the weaknesses in the current design of the Euro area, his priority was set on finding common ground on devising feasible solutions between France and Germany. But obsessing with bilateral agreements might have been the wrong approach as other member states have also voiced concerns with proposed policy solutions for a number of reasons. The Meseberg declaration was seen as a diplomatic success and

[15]) https://www.consilium.europa.eu/en/press/press-releases/2018/12/04/eurogroup-report-to-leaders-on-emu-deepening/.

breakthrough by the time, but it was soon counteracted by the countries known as the Hanseatic league. Thus the realization even of a small Eurozone budget still seems uncertain, while chances for embedding a significant macroeconomic stabilization function seem are very limited. While the message of "fixing the roof while the sun is shining" might have been the right one and current reform proposals might have been going in the right direction, it seems the political constraints are too high at the current moment to move beyond the impasse.

It is important to note that the lack of substantial progress on strengthening the EMU cannot be blamed on any specific European institution or any specific side of these debates. European institutions and academic economists developed essential and workable proposals and pathways to solving some of the challenges at hand. However, EU member states have strongly diverging policy preferences, as well as still significantly heterogeneous structures of their economies and therefore set very different priorities for EMU reform. As long as the opinions and country interests are so divergent, the deadlock will continue. Only by careful consideration of the important benefits they bring can the necessary EMU reforms take place. The overall lack of progress is thus symptomatic of all current broader discussions about the future of the EU and reflect the overall state of the Union.

One should still explicitly warn on the dangers of complacency. Reforming the architecture of the EMU is a long-run prerequisite for making the Euro area stable and crisis-resistant. Even if there are significant trade-offs, this reform should include at the least:

- A reformed set of fiscal rules
- A real macroeconomic stabilization function at the Euro area level – to guarantee active fiscal policy at the ZLB, but also to provide a shock absorption for countries facing significant asymmetric shocks
- Breaking the doom loop and ensuring financial market panics are limited

What is needed as well is more ex-ante solidarity, not ex-post solidarity in the forms of discretionary bailouts, since ex-ante solidarity can ensure important guarantee mechanisms are in place to share the burden of economic shocks. It seems, further movement on EMU reform will require persuading both national governments and European citizens on the seriousness of the problems of the Euro area discussed above and explaining the trade-offs between different solutions.

Completion of EMU is a vital and exciting project. In the words of *Constâncio* (2018): "These are not technocratic goals but vital political necessities for European Union that should protect our citizens in terms of safety and prosperity". In the end, the window of opportunity is not only a catch-phrase but a reality. There will be a next recession in the Eurozone, but there might be no tools to fight it effectively. Failure to see clearly these issues to deal with deep economic shocks would be a fundamental danger for the Euro area. From a political perspective, it is important to ask if the sun is shining now, what would be when it is raining?

In conclusion, we need to reiterate that the window of opportunity for EMU reform is not only a catch-phrase but a political reality. Sooner or later, the European economy will again be faced with an economic recession and if the EU fights it as slowly and as indecisively as the last one, this will have inevitable political repercussions. The failure to see clearly why future deep economic shocks require a better structure of the European Union might become a fundamental danger for the Euro area going forward. Ignoring all of this would mean the next economic crisis might be combined with a further political backlash against the EU. After all the significant reform proposals, the necessary consensus was not found. But the intellectual debate presented above is crucial for finding the right answer at the particular moment in the future where political compromises will make it feasible to strengthen the euro area in a healthy and efficient manner.

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5. Annex

VoxEU CEPR Policy Portal on Euro Area Reform Debate - the following table presents a summary of the main messages, problems and policy proposals discussed in each of the contributions

Authors	Main message and problems
How to reconcile risk sharing and market discipline in the euro area Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, Jeromin Zettelmeyer, 17 January 2018	This policy paper proposes six reforms which, if delivered as a package, would improve the Euro area's financial stability, political cohesion, and potential for delivering prosperity to its citizens. The reforms include: breaking the sovereign-bank nexus; improving the current fiscal rules; introducing orderly sovereign-debt restructuring for Euro area countries; creation of a Euro area fund; creation of a synthetic Euro area safe asset; reforming the EMU institutional architecture.
The crux of disagreement on euro area reform Stefano Micossi, 05 April 2018	Some aspects of the CEPR Policy Insight deserve further clarification and could be counterproductive or unnecessary in their overall implications for EMU financial stability. The author doubts whether reforms that reduce liquidity in some sovereign debt markets and strictly limit moral hazard, would not weaken euro area defences against idiosyncratic shocks, especially as long as financial fragmentation and adverse risk spreads persist. Financial distress conditions and periods of temporary liquidity problems should be separated from and not lead to worries about insolvency and debt restructuring.
Breaking the stalemate on European deposit insurance Isabel Schnabel, Nicolas Véron, 07 April 2018	Proposal to end the deadlock on EDIS with a design that is institutionally integrated but financed in a way that is differentiated across countries, while also introducing sovereign concentration charges and tighter treatment of nonperforming loans (NPLs).
A stronger euro area through stronger institutions Lorenzo Bini Smaghi, 09 April 2018	Important shortcomings of the CEPR reform proposals: setting limits on banks' government bond holding through binding regulation are not sufficient to eliminate the doom loop; substituting the SGP for market discipline; redenomination risk is not addressed.
Blind spots and unintended consequences of the 14 economists' Policy Insight Sebastian Dullien, 11 April 2018	The CEPR proposal fails to address a number of central problems of EMU architecture: boom-bust cycles in the Euro area; excessive trust in financial markets to stabilise economies and discipline governments in desirable ways; harder rules and sovereign debt restructuring procedures will restrict governments to counteract future crises.
The role of the ECB in the reform proposals in CEPR Policy Insight 91 Emmanuel Farhi, Philippe Martin, 19 April 2018	The CEPR Reform Proposal will actually ease the burden on the ECB, reduce the need for it to intervene, and allow the ECB to pursue its inflation mandate and allow the integrity of the Euro area to be better preserved.
Building a stable European Deposit Insurance Scheme Dirk Schoenmaker, 17 April 2018	Deposit insurance, like any insurance scheme, raises moral hazard concerns. Such concerns can be alleviated through a country-specific component in the risk-based premium for deposit insurance and limits on sovereign bond exposures on bank balance sheets. However, proposals to maintain national compartments in a new European Deposit Insurance Scheme are self-defeating, as such compartments can be destabilising in times of crisis.
EMU: Liquidity of solvent member states more important than fiscal stabilisation Vesa Vihriälä, 13 April 2018	The smooth functioning of the EMU requires risk sharing. However this columns argues, that its best use is not in the support of fiscal expansion in recession countries, but in ensuring the liquidity of solvent sovereigns under market pressure. Giving the ESM/EMF access to central bank financing should be explored as a means to facilitate it, while a fiscal stabilisation function might not be very useful.

Analysis of the proposal "A constructive approach to euro area reform" Andrew Watt, 23 April 2018	The EMU reform proposals are welcome, but need to be changed and extended: the fiscal capacity should be a lending facility by the ESM; the threat of destabilising speculation against junior bonds should be addressed; national fiscal stances need to have the space to be counter-cyclical; the MIP needs to be symmetric vis-à-vis deficit and surplus countries.
Deepening EMU requires a coherent and well-sequenced package Marco Buti, Gabriele Giudice, José Leandro, 25 April 2018	The mix of policies of the CEPR proposal seems unbalanced and carries significant risks. The focus of the proposals on reducing fiscal risks could lead to financial distress, ultimately requiring more, not fewer, rescues. Crucial issues such as macroeconomic imbalances and adjustments within the euro area and the redenomination risk connected to acute liquidity and credibility crises should also be addressed. The proposals are mainly geared at increasing market pressure on fiscal policies, but this could also generate self-fulfilling prophecies, with uneven market reactions to changes in perceptions and credibility of governments, destabilising financial markets. A regulatory reform to reduce excessive concentration of sovereign bonds in the banks' balance sheets could work only if such reform were implemented gradually, and as part of a well-sequenced package.
Europe needs a broader discussion of its future Guntram Wolff, 04 May 2018	The CEPR proposal needs to address further the fact that well-being of citizens living in the Euro area requires European public goods, a proper fiscal stance and major national structural reforms.
Refocusing the debate on risk sharing under a European Deposit Insurance Scheme Jacopo Carmassi, Johanne Evrard, Laura Parisi, Michael Wedow, 09 May 2018	Comparing the risk-based contributions to an EDIS exposure shows that there would be no unwarranted systematic cross-subsidisation across member states. Having a mixed scheme for the EDIS with fixed target levels for national funds could in fact lead to more cross-subsidisation than a fully-fledged EDIS, rather than less.
Risk reduction and risk sharing in the EU: The role of better fiscal rules Roel Beetsma, Martin Larch, 10 May 2018	The policy dilemma around a central fiscal capacity can only be overcome if fiscal risk sharing and risk reduction advance in parallel. Therefore, reform of EU fiscal rules needs to receive more attention - a properly designed central fiscal capacity will only emerge if access to the CFC is made conditional on an effective fiscal framework.
Euro area reform: No deal is better than a bad deal Peter Bofinger, 15 May 2018	Specific insolvency risk of Euro area membership is the main risk that should be covered by joint risk sharing, so modest proposals for public and private risk sharing are insufficient in this regard. With a strengthening of market discipline, this risk could even be increased.
Completing Europe's Banking Union means breaking the bank-sovereign vicious circle Isabel Schnabel, Nicolas Véron, 16 May 2018	A realistic approach to completing the Banking Union should focus on breaking the sovereign-bank vicious circle first – by introducing a European deposit insurance scheme, sovereign concentration charges and encouraging cross-border integration.
Fiscal rules and the role of the Commission Thomas Wieser, 21 May 2018	Fiscal rules should be made more stringent by a more strict role for the Commission in implementing them, combined with a strengthened role for Independent Fiscal Boards and a simplification of the rules themselves.
A plan to save the euro Jeffry Frieden, 23 May 2018	Any reform programme for the Euro area must address the concerns of both core and periphery countries.
Make euro area sovereign bonds safe again Grégory Claeys, 24 May 2018	An improved Euro area architecture, including better fiscal rules, macroprudential policy, a credible EDIS and SRF and a reform of the ESM, would make all Euro area sovereign bonds safer, and thus make the provision of safe assets through untested and potentially disruptive sovereign bond-backed securities unnecessary.
Beyond ESBies: safety without tranching Jeromin Zettelmeyer, Álvaro Leandro, 01 June 2018	While objections towards ESBies might be exaggerated, there are competing proposals that are superior to ESBies. However they still require some limited amount of public capital and some limited form of redistribution.

Beyond risk sharing and risk reduction: A Spanish view of EMU reforms Rafael Doménech, Miguel Otero Iglesias, Federico Steinberg, 15 June 2018	Risks can only be tackled with common instruments and policies at the European level, whose mere existence will reduce not only their magnitude but also their asymmetric consequences – e.g. a central fiscal authority (CFA) with its own sources of revenues and ability to issue joint debt; more credible fiscal rules; debt restructuring only as a last option; incentives to be put in place for unpopular structural reforms.
Euro area reform cannot ignore the monetary realm Jérémie Cohen-Setton, Shahin Vallee, 20 June 2018	The EMU reform package also requires recommendations on enhancing liquidity provision and the role of the ECB as a lender-of-last resort. By not complementing their proposals with recommendations in the monetary realm, the authors have missed an opportunity to provide a balanced reform package that would not only increase fiscal discipline and risk sharing, but also enhance liquidity provision.
A 'what if' approach to assessing proposals for euro area reform George Papaconstantinou, 21 June 2018	In the case of Greece, using an expenditure rule could have avoided the huge discrepancy between reported and actual deficit data Greece's fiscal balance; sovereign concentration charges for banks would have acted to effectively reduce the large exposure of Greek banks to the sovereign. It is unclear, however, whether by themselves the CEPR Policy Insight proposals could have avoided the outbreak of the crisis or seriously mitigated its impact. There are further important proposals such as a stronger macro stabilisation in the event of extreme shocks (e.g. a Euro area-level unemployment insurance scheme), and a new form of cohesion and convergence policy for countries with competitiveness and institutional challenges.
Next steps after the Euro Summit Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, Jeromin Zettelmeyer, 10 July 2018	The Statement from the Euro Summit on 29 June (2018) seems disappointing, but represents a constructive first step and crosses red lines that were considered taboos only months ago. However, the summit's commitments still fall short of a comprehensive package in three key pieces – breaking the vicious circle between banks and national governments, improvement of the fiscal framework and a macroeconomic stabilisation.
Risk sharing and market discipline: Finding the right mix Guido Tabellini, 16 July 2018	The compromise found by the 7 + 7 group is not suitable for a country exposed to the risk of debt run – the proposals might in fact increase the vulnerabilities of countries with high legacy debt. Instead of breaking the doom loop, national banks can be used to play a stabilising role in times of stress.
Delivering a safe asset for the euro area: A proposal for a Purple bond transition Lorenzo Bini Smaghi, Michala Marcussen, 19 July 2018	The proposed 20-year Purple bond transition could address important current issues and offer a path to genuine Eurobonds. The 20-year transition with leverage the Fiscal Compact's requirement to reduce excess general government debt above 60% of GDP by 1/20 every year. At the end of the transition period, when Purple bonds will stand at 60% of GDP, these could become genuine Eurobonds.
Whither a fiscal capacity in EMU Lars Feld, 31 July 2018	The CEPR proposal fails to address legacy debt problems convincingly; furthermore the introduction of a fiscal capacity would repeat the mistakes and premature measures taken at the start of the EMU.
Could the 7+7 report's proposals destabilise the euro? A response to Guido Tabellini Jean Pisani-Ferry, Jeromin Zettelmeyer, 20 August 2018	The purpose of the debt restructuring proposal in the CEPR Policy Insight is to avoid cataclysmic defaults, instead seeking orderly, 'pre-emptive' debt restructurings that do not force the country to leave the Euro area.
The economic case for an expenditure rule in Europe Zsolt Darvas, Philippe Martin, Xavier Ragot, 12 September 2018	Improving fiscal rules by implementing a simple rule limiting the annual growth rate of expenditures - requiring that nominal expenditures do not grow faster than long-term nominal income, and grow at a slower pace in countries with excessive debt. This translates into a two-pillar approach: (1) a long-term target debt level (e.g. 60% of GDP); and (2) an expenditure-based operational rule to achieve the anchor; this rule allows more flexibility and more counter-cyclicality.

Refocusing the European fiscal framework Lars Feld, Christoph Schmidt, Isabel Schnabel, Volker Wieland, 12 September 2018	A proposal to redesign the fiscal framework together with a drastic reduction in exception and escape clauses. The modified expenditure benchmark would include an annual operational target and implement the structural deficit rule as its medium-term target through a multi-purpose adjustment account, and a pre-specified debt ratio as its long-term limit achieved with a debt-correction factor. The account would collect deviations of all government expenditures from the forecasts made during the budgetary process.
'Black zero' in disguise Peter Bofinger, 13 September 2018	In devising an expenditure rule for fiscal policy, it is better for a debt reduction target to rely on discretion than on a mechanical rule which lacks a sound theoretical basis.
Euro area reform: An anatomy of the debate Jean Pisani-Ferry, 02 October 2018	Summary of the debate so far and implications for finding a consensus going ahead.
Turning national growth-indexed bonds into European assets Julien Acalin, 10 October 2018	European Debt Agency to issue securitised safe and risky European bonds backed by country-specific growth-indexed bonds
Increasing the effectiveness and ownership of European fiscal rules Pierre Beynet, 11 October 2018	Fiscal rules should be simplified and focus on expenditure growth, while avoiding reliance on unobservable concepts such as structural fiscal balances. To increase ownership and sustainability more flexibility and built-in positive incentives can be embedded, such as allowing deviations when financed with GDP-linked bonds.
Fixing the euro needs to go beyond economics Anne-Laure Delatte, 23 October 2018	There is a current political deadlock about how adjustment burdens should be distributed. Overcoming this coordination failure requires reforming the political governance of the EU, rather than just its economic governance, and may require the introduction of a new European Assembly.
Reforming the EU fiscal framework: A proposal by the European Fiscal Board Roel Beetsma, Niels Thygesen, Alessandro Cugnasca, Eloïse Orseau, Polyvios Eliofotou, Stefano Santacroce, 26 October 2018	A proposal for an overhaul of the EU fiscal framework, to make it simpler and more transparent by using a single budgetary anchor (the 60% reference value for the debt ratio) and a single observable operational target (a constant ceiling on the growth rate of primary nominal expenditure net of discretionary revenue measures). The expenditure ceiling thus includes a built-in debt brake.
A more stable EMU does not require a central fiscal capacity Michel Heijdra, Tjalle Aarden, Jesper Hanson, Toep van Dijk, 30 November 2018	Potential stability benefits of a central fiscal capacity can instead be achieved through stronger financial market risk sharing and more effective use of fiscal stabilisers, without any additional fiscal risk sharing.
A European fiscal capacity can avoid permanent transfers and improve stabilisation Jan Stráský, Guillaume Claveres, 28 January 2019	Fiscal risk sharing brings additional layer of stabilisation compared to national stabilisers, particularly when monetary policy is constrained by the effective lower bound. Further, an unemployment reinsurance scheme could be designed such that it would benefit all euro area members and would not lead to permanent transfers.
Euro area architecture: What reforms are still needed, and why Agnès Bénassy-Quéré, Markus K Brunnermeier, Henrik Enderlein, Emmanuel Farhi, Marcel Fratzscher, Clemens Fuest, Pierre-Olivier Gourinchas, Philippe Martin, Jean Pisani-Ferry, Hélène Rey, Isabel Schnabel, Nicolas Véron, Beatrice Weder di Mauro, Jeromin Zettelmeyer, 02 May 2019	Euro area leaders must finish the job started in 2012 of breaking the vicious circle between banks and national governments. There should be a discussion both on the reforms of the fiscal framework for the Euro area, but also about the appropriate fiscal policy amid economic slowdowns. Priority should be given to the creation of a proper macroeconomic stabilisation tool for the Euro area. The EU should also focus on completing the Single Market, including through Banking Union and Capital Market Union, and an integrated research and investment strategy.