May 2017

Europe's Political Spring

Fixing the Eurozone and Beyond

Edited by Agnès Bénassy-Quéré and Francesco Giavazzi

A VoxEU.org eBook

CEPR Press

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Foreword

The election of Emmanuel Macron in May 2017 has opened the door to a 'reboot' of the Eurozone. This is an urgent priority: the euro's economic architecture is still incomplete, meaning any large shock could reignite the Eurozone crisis. Economists have differing views on the details of how this might happen, but they agree on what needs fixing to better prevent this from happening.

This eBook – written by leading economists from across Europe – proposes solutions that are politically and practically feasible. The authors argue that Europe must advance on two fronts: to fix the Eurozone and make it more resilient; and to start a wide and inclusive consultation on the future of Europe that stresses both growth and social protection. The authors' key proposals include reinforcing the euro's architectural resilience; setting up a mechanism to control aggregate demand when interest rates are at their lower bound; boosting the credibility of the 'no-bailout clause' by eliminating the 'doom loop'; and completing the banking union.

The fixes proposed are detailed and thus technical, but that is what is needed at this stage. Failing to address the set of issues discussed in this eBook could keep the euro in a static-state, and hence jeopardise further debates on EU integration.

CEPR is grateful to Professors Agnès Bénassy-Quéré and Francesco Giavazzi for their editorship of this eBook. Our thanks also go to Anil Shamdasani and Simran Bola for their extremely swift handling of its production. CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this important topic.

Tessa Ogden
Chief Executive Officer, CEPR
May 2017

1 Introduction

Agnès Bénassy-Quéré and Francesco Giavazzi
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The election of Emmanuel Macron to the French presidency offers an opportunity to move forward on the European agenda. Macron was elected on a platform that combines structural reforms at home and a reorientation of the EU towards a "Europe that protects", a concept which includes common policies in the areas of defence and security, a common budget at the Eurozone level, social standards across the EU, and more active trade policies vis-à-vis non-EU countries (in the areas of tax competition and environmental standards, for example. Of course, this platform will have to be discussed with all EU partners, especially those who consider that Europe should do less, not more, in the area of social rights and tax coordination, and those who view a common budget essentially as a 'transfer union'.

The inevitable starting point is that EU countries have different preferences in terms of the efficiency–equity trade-off. The question, then, is whether making progress in parallel along the two sides of this trade-off may be acceptable politically, given that progressing along only one dimension is unlikely to be on offer.

These debates will take time. The European Commission has offered some thoughts with its white paper on the future of the EU, its proposal of a European pillar of social rights, and, most recently, its communication on harnessing globalisation. Interesting as these contributions are, we are entering a phase in which the process will be led by governments and politicians, not by 'Brussels' and technocrats. Considering the issues on the table – and notwithstanding the new vision and enthusiasm that France will bring to that table – such discussions are likely to last for quite some time. Steps ahead on a shared framework to address migration flows and the need for a more significant EU defence capability could be easier to agree upon – particularly if the 'enhanced

cooperation' mechanism were to be used. But any decision that involves the efficiency–equity trade-off will inevitably take time.

Economists have very different views among themselves on the future of the EU and of the Eurozone, as illustrated by several contributions to this eBook. But they tend to agree on what would be urgently needed to 'fix' the Eurozone. These solutions do not involve any form of 'transfer union', neither do they change the traditional understanding of the subsidiarity principle. In most cases, they could be implemented within the perimeter of the existing treaties.

We believe that waiting for the European Council to decide on issues that, admittedly, could be considered as more important for the future of the EU then technical fixes to the Eurozone would be a mistake. We are always reminded of Rudi Dornbush's observation that "[c]rises take longer to happen than you might think, and then they happen faster than you thought". And as Patrick Honohan puts it in his contribution to this eBook, "[i]t would be nice to be able to say that the euro has emerged stronger from the experience, but that is not yet the case".

A two-handed strategy

This is what this introduction is about: recapitulating the main fault lines of the Eurozone and offering a selective overview of coherent solutions to address them. In doing so, we have drawn upon the contributions you will read in this eBook, but we have not felt constrained by them. This is our way to frame the solutions. We therefore do not implicate the authors of this eBook except for noting the ideas we have borrowed and, importantly, the degree of consensus, or lack thereof.

Of course, we recognise that the EU crisis is as much a political identity crisis as it is a governance and economic crisis. The biggest risks to the European project today seem to be less economic (bank failures, sovereign debt runs, etc.) than political (a radical candidate/party winning an election, for example). Renewing a positive view of Europe among the electorates, especially the younger ones who voted heavily for Le Pen and largely favour the Italian 5S Movement, overshadows any good technical proposals that we might have.

We believe, however, that in the coming weeks, a two-handed strategy should be followed: fix the Eurozone to make it more resilient; and, simultaneously, start a wide consultation on the future of Europe along a growth/protection agenda – one that hopefully is capable of making Europe 'popular' again. It is hoped that the two hands would reinforce each other. To make progress on the future of European integration, European leaders will need political space, and to not be distracted by emergency decisions related to a new crisis. Reciprocally, political momentum for a new, consistent integration strategy will help break the deadlocks that currently prevent technical decisions that need to be made for the Eurozone to become more resilient.

This is a (hopefully useful) contribution to the first 'hand' of this strategy – making the Eurozone more resilient.

Four fault lines that need to be urgently addressed to make the euro sustainable

- The ability of the Eurozone to withstand a financial shock arising from a sudden stop in capital flows, from a shift to a 'bad equilibrium', or from a banking crisis;
- The absence of a tool to control aggregate demand when interest rates reach zero and monetary policy becomes largely ineffective;
- A clarification of the debt-restructuring rules for sovereigns which, together with the elimination of the 'doom loop' linking banks and sovereigns, are essential to make the no-bailout clause credible;
- Completion of the banking union, which means the size of the Single Resolution Fund, the enforceability of the bail-in rules foreseen in the Resolution directive, a solution to the non-performing loans issue, and the introduction of a stabilising 'safe' asset.

These four issues do not represent an exhaustive list of the problems faced by the Eurozone. For example, they do not address the issue of how to deal with the legacy of exceptionally high sovereign debt levels. But they are, in our opinion, the minimum set of fixes to avoid the risk of a blow-up of the Eurozone were a new crisis to erupt. They would also guarantee a smoother flow of credit from banks to the economy.

Postponement -- for instance of a mechanism to deal with sudden stops, or the bank-sovereign "doom-loop" -- could prove to be very dangerous.

Reinforcing the European Stability Mechanism

One of the positive responses to the crisis was, in 2012, the creation of the European Stability Mechanism (ESM). The *Five Presidents' Report* identifies the ESM as the instrument to respond to the risks posed by a sudden stop (Juncker et al. 2015). The report emphasises that the ESM should play such a role avoiding permanent transfers without undermining incentives for sound fiscal policy at the national level. As it is, though, the ESM may no longer work in the future for various reasons: (i) the unwillingness of member states to ask for emergency assistance given the perceived loss of sovereignty related to the associated conditionality; (ii) the unwillingness of member states to extend new assistance to countries whose debt sustainability may appear doubtful; and (iii) the lack of resources for the ESM to play its stabilising role. To be really useful, the ESM would require some adjustments which are by no means uncontroversial (as proposed in Uribe 2015 and Tabellini 2016).

- **The first is governance**. Today, the decision to provide support to an ESM member is taken by unanimity and requires prior approval by some national parliaments. This makes its implementation highly uncertain when it is needed the most, namely, when only prompt action can provide the assurance and certainty needed to calm a brewing crisis. Abandoning unanimity would raise the issue of democratic legitimacy, since the ESM relies on national budgets (not the European budget). National parliaments would then need to be consulted in a way that does not block the decision-making process (e.g. through a form of qualified majority rule). Alternatively, the European Parliament could be involved (as suggested by Tabellini in this eBook) – all major ESM decisions would have to be approved by an ad hoc committee of the European Parliament, or by the European Parliament itself, restricted to Eurozone representatives.
- **Next is resources.** The current ESM resources (a maximum lending capacity of €500 billion, or about 5% of Eurozone GDP) are far from sufficient to address a large systemic crisis. Many Eurozone nations have banks with assets that are several

multiples of their GDP. To increase its lending capacity, the ESM borrowing limits should be significantly extended. One possibility is that all Eurozone members agree in advance to transfer to the ESM (upon request by the ESM and in addition to the guarantees already existing) a given fraction of their yearly tax revenue for the purposes of serving ESM debt. This authority would be given for a pre-established ceiling and would have a pre-determined end date. The transfer would correspond to the same percentage of GDP for all countries, and the ESM would also have the authority to request extraordinary transfers of revenue from member states to meet exceptional debt service needs. The ability of the ESM to draw on national resources if needed would reinforce the signature of the ESM on the bonds market. In this way, the ESM would participate in the making on a Eurozone 'safe asset' that will be necessary to make the banking sector more resilient (see below). It would also provide a euro-wide instrument for monetary policy, since the ECB will be more comfortable to hold ESM bonds than national sovereign bonds in its portfolio, especially if the latter become 'defaultable'.

- **Finally comes the role of the ESM**. The ESM has been designed to offer financial assistance to countries suffering a sudden stop in capital inflows, conditional on an adjustment programme. This role raises three questions:
  - The first is that, although the ESM is not supposed to lend to a country whose debt is considered unsustainable, it may be pressured to do so, or it may genuinely confuse a liquidity crisis with a solvency crisis. As we learned in 2010-12, however, sudden stops, particularly if not swiftly addressed, can induce a recession with the accompanying fall in tax revenues and increase in non-performing bank loans – *i.e.* they can turn into a solvency crisis. To avoid this risk, the rules for debt restructuring need to be clarified, and above all their credibility needs to be enhanced by making the banking sector resilient to a debt restructuring (see the following bullet).
  - The second question is over the willingness of member states to ask for ESM assistance due to the high political cost of an adjustment programme. To address this problem, the ESM could offer precautionary lines to all member states that comply with some ex ante conditionality (e.g. fiscal and external deficits below certain thresholds). These lines would be available for a limited period (say, one year), beyond which a debt restructuring and/or fully-fledged programme would

need to be decided upon. Importantly, this approach would relieve the ECB from the task of dealing with liquidity crises with its Outright Monetary Transactions (OMTs).

- The third question is whether the ESM could be involved not only in emergency assistance, but also in the stabilisation of aggregate demand in the Eurozone, especially when interest rates have reached zero. The precautionary credit lines could play a role in this respect since they would prevent liquidity-constrained countries from carrying out procyclical policies during a crisis. Going beyond this role by moving the ESM into a Eurozone Treasury would be more controversial (see below).

Reinforcing the ESM along the lines depicted above has received repeated support from economists and experts, although the technicalities vary. However, some – including Eichengreen and Wyplosz in this eBook – to reject the idea of a 'European Monetary Fund', which would, in their view, lead to further politicisation of the economic debate within the Eurozone. They prefer to outsource the job directly to the International Monetary Fund, which has extensive experience and will, with 189 member countries, always have the opportunity to maintain its skills concerning crisis management.

Clarifying debt restructuring rules for sovereigns and solving the 'diabolic loop'

Debt restructuring is a necessary threat if fiscal discipline is to be enforced by financial markets, as a complement to fiscal rules that have proved difficult to enforce. As mentioned above, it is also necessary to reduce the risk of the ESM being forced to refinance debts that are unsustainable. Without a framework that allows for an orderly debt restructuring, the fund will never pull the trigger on countries that, ex post, do not respect conditionality. (The importance of allowing for sovereign default as a counterpart to lending of last resort is made in Corsetti et al. 2016).

The introduction, in 2012, of Collective Action Clauses (CACs) was an important step forward, but a number of clarifications are still missing. These concern clarity over seniority rules and jurisdiction (which favours creditors) and rules to avoid repossession of bailout funds by creditors (which favours debtors); both are important

elements in allowing debt restructuring to occur orderly. Free-rider incentives should also be addressed – in particular, creditors' incentives to hold out and let others bear the costs of restructuring, as well as preventing costly delays in the restructuring decision (i.e. gambling for redemption). This could be achieved by linking any financial assistance going beyond lending of last resort to debt sustainability, with time limits. But ultimately, the decision of whether to restructure should be made by the sovereign.

The idea that markets can enforce fiscal discipline is however highly controversial. The risk is that markets, if put in charge of enforcing fiscal discipline, might fluctuate from good to bad equilibria. And the idea of orderly debt restructuring when debt is at 130% of GDP could prove an illusion. This is why the issue of debt restructuring cannot be separated from that of making the banking sector resilient to a debt restructuring.

Indeed, a precondition to make debt restructuring a concrete possibility is to eliminate (or at least significantly attenuate) the bank–sovereign 'diabolic loop' arising from the high concentration of national sovereign risk in the banks of some countries. To do so, it has been proposed to reduce the concentration of sovereign exposures by waving the exception to the 'large exposure rule' (which binds a bank's exposure to a single issuer to 25% of its equity, except for sovereign bonds), or to introduce risk weights for holdings of sovereign bonds. The transition, however, could be problematic if sales of excess domestic bonds in some countries (especially in Italy and Portugal) were not met by higher cross-border holdings, thus inducing fire sales. Some computations (e.g. de Groen 2015) suggest that to avoid this problem, it might be sufficient to raise the maximum exposure to any one sovereign from 25% of a bank's own capital to 50% (see Lanotte et al. 2016 for a different view, however). Alternatively, the transition could be smoothed by exempting the senior tranche of national debts, or diversified baskets of sovereign bonds, from the application of the new rule, as suggested by the ESRB Scientific Advisory Committee (Beck et al. 2011). Another possibility, explored further below, would go through tranching domestic sovereign bonds (or a basket of them) to make a senior (safe) bond and a junior (unsafe) one, the former being exempted from large exposure or risk-weighting rules.

As a matter of fact, making sovereign bonds 'defaultable' will make the banking sector more vulnerable to liquidity crises. Hence, it will make it necessary to introduce some form of 'safe' asset. An additional benefit of tranching sovereign bonds would be to

make debt restructuring more credible in the event of debt unsustainability, since it would apply only to the junior tranche that would hopefully be held by institutions (such as hedge funds) that are in a better position than banks to absorb the losses.

Although the practicalities differ and there is disagreement over some proposals – in particular, concerning the risk associated with waiving the exception to the large exposure rule – there is broad consensus among experts on the need to make progress simultaneously on the clarification of debt restructuring rules and on the elimination of the ‘diabolic loop’.

Completing the banking union

The idea of creating a monetary union without a banking union, while 90% of money in circulation is created by commercial banks, was a major flaw of the Maastricht Treaty. The banking union has allowed a centralisation of bank supervision alongside a single rulebook and common bail-in rules to reduce moral hazard and protect taxpayers’ money. These were important first steps, but a number of issues remain to be fixed:

- **The first is the ‘second pillar’ of the banking union, namely, the resolution mechanism.** The resolution fund – the backstop in a banking crisis – is being built up through the contributions of banks, but the process is too slow. At the current rate, the fund will reach a size equal to 1% of covered deposits six years from now, by 2023. Member countries could speed up the process by lending the funds today and being reimbursed by banks over time. Conversely, there may be less urgency to set up a Eurozone deposit insurance: after 8% of a bank’s total assets have been bailed-in, and with a stronger resolution fund, it is very unlikely that deposits below €100,000 would need to be attacked. Not even in Cyprus did this happen (of course, bail-in rules need to be enforceable – the experience of Italy shows the difficulty in suddenly applying the bail-in rules to retail creditors who purchased the banks bonds before the rules were in place).
- **The second issue is non-performing loans (NPLs)**. A large stock of NPLs can result in zombie lending (throwing good money after bad) and prevents efficient resource allocation. The solution to this problem so far has been to introduce bad banks at the national level (or even at the bank level). As argued by Daniel Gros

in this eBook, a bad bank should normally be profitable as it is able to buy assets at a distressed price and carry them until the market's risk aversion is reduced. In terms of risk diversification, however, it is sub-optimal to keep it at the national level. The proposal of the European Banking Authority to set up an Eurozone asset management company addresses diversification, but it should consider removing the risks on ultimate recovery rates from the good banks' balance sheets (see Thorsten Beck's contribution to this eBook).

- **The third issue is the need to stabilise the banking sector through the supply of a liquid Eurozon safe asset** (similar to US treasury bonds). During a crisis, spreads on Eurozone sovereigns increase as a result of a 'flight to quality' and variations in liquidity. This destabilises banks that use sovereign bonds as collateral to obtain liquidity on the repo market, not to mention the losses they may incur on their trading books. Several proposals have been made regarding how to build such a 'safe' asset based on existing sovereign bonds (e.g. von Weizsäcker and Delpla 2010, Bofinger et al. 2011, Brunnermeier et al. 2016a,b). In 'stand alone' jurisdictions (De Grauwe and Ji 2013), there is an implicit understanding that, as a last resort, the central bank will buy the sovereign bonds that the market is no longer willing to hold. In the Eurozone, a similar guarantee would violate the Treaty. But if such a 'safe' asset were available, the ECB would not run the risk of incurring a loss and, hence, of financing governments (Corsetti et al. 2016).

The third element – the need for a 'safe asset' – is the most controversial among experts. Although the principle of 'normalising' the euro with respect to other jurisdictions is broadly understood, the idea of pooling national bonds encounters strong resistance due to the lack of trust among member states over long-term reciprocal commitments, especially given the moral hazard issue, and the risk that the whole thing would degenerate into a 'transfer union'.

A complementary strategy to completing the banking union is to accelerate the build-up of the European capital markets union, which will give companies across the Eurozone access to a common pool of market financing. The capital markets union will reduce the economic cost of keeping some 'zombie banks' and of possible banking crises, since it will offer companies alternative ways to finance themselves. It will require structural reforms at the national level (for instance, common rules for bonds issuances,

bankruptcy proceedings, and so on) and a centralisation of market supervision in a similar way as the Single Supervisory Mechanism has organised bank supervision across the Eurozone. These changes are not very controversial among experts, and they would not involve treaty changes.

The fiscal union issue

After having reinforced the ESM, clarified debt-restructuring rules, addressed the 'diabolic loop' and completed the banking union, the Eurozone will still lack a tool to control aggregate demand when interest rates reach zero and monetary policy becomes largely ineffective. In an environment where the equilibrium real interest rate is likely to remain very low for a long time, such a situation may in fact repeat itself and therefore needs to be addressed.

Although there is broad consensus on the need for counter-cyclical fiscal policies (at least through automatic stabilisers), experts have different views on how to set them up. Barry Eichengreen and Charles Wyplosz, in their contribution to this eBook, argue that fiscal policy should be returned to national governments. The EU level should only check that each member state has a balanced-budget rule in its constitution, and an independent, well-functioning fiscal watchdog – two requirements of the Treaty on Stability, Coordination and Governance in EMU (TSCG). At the zero lower bound, however, fiscal spillovers are more significant across member states, so a coordination of fiscal policies may be required. However, fiscal coordination has proved extremely difficult in the Eurozone.

Recognising the difficulty of 'mimicking' a euro-wide counter-cyclical fiscal policy, some experts have proposed the introduction of a small budget at the Eurozone level. Some (including Paul de Grauwe and Agnès Bénassy-Quéré in this eBook, and Daniel Gros in other work) have proposed a European unemployment insurance scheme to provide a federal layer of automatic stabilisation for either individual countries or the Eurozone as a whole. These proposals, however, are highly controversial; many experts point to the risk of moral hazard relating to any form of common insurance.

On the whole, it is fair to say that there is no consensus among experts on how to provide a tool for fiscal stabilisation at the aggregate level, when monetary policy is not enough to deal with shocks.

Along a different line, several scholars have argued in favour of a Eurozone investment budget (including Thorsten Beck in this ebook) and/or a substitution of a golden rule for existing fiscal rules, allowing national governments to finance public investment through debt. These proposals are also controversial, but for different reasons. First, it is already the task of the EU budget to invest in convergence of individual regions and in EU-wide projects yielding large spillovers (such as cross-border infrastructure or R&D). Before adding a new Eurozone layer, it would probably be necessary to revisit the structure of the EU budget. Second, the golden rule has its own weaknesses (excessive emphasis on investment in physical rather than human capital, investment-washing of public spending, manipulation of investment returns). Third, although financing public investment partially through debt is justified if the investment is to increase potential growth, the ratio of gross debt to GDP will continue to be a key indicator of debt sustainability.

Whether a Eurozone budget would be used for macroeconomic stabilisation or for investment, common debts would have to be issued at least in bad times, which in turn would have to be served based on a common resource. Since the Eurozone has no capacity to raise taxes, the budget would need to rely, at least in a first phase, on national contributions. Then, there is a risk that the logic of '*juste retour*' prevails for the Eurozone budget, as it has prevailed so far for the EU budget. One way to circumvent this problem is to adjust national contributions over time. However, a Eurozone budget should not be confused with the ESM, which offers loans, not transfers.

The problem is made more difficult due to the extraordinarily high levels of public debt in some countries. Some experts argue that, as long as interest rates remain very low, high debt ratios are not an issue (except for the need to roll them over). Others, in contrast, highlight the fragility of indebted Eurozone countries who will not have the capacity to react to shocks. Legacy debts also tend to block any form of insurance scheme across member states, since they involve different probabilities of crisis across countries. Accordingly, some proposals have been made to redistribute the burden of legacy debt over time and to a minimal extent, if any, across countries (see Corsetti et al.

2016 for an insightful analysis of the issue; PADRE, as proposed by Pâris and Wyplosz, 2014, is a plan that implies zero cross-country redistribution).

For all these reasons, we think that the issue of a 'fiscal union' does not belong to the list of 'easy fixes' discussed above. It will likely require further political integration, but also lower level of debts and some form of economic and structural convergence across the member states. So far, the "corrosive distrust between debtor and creditor countries" (as Patrick Honohan puts it in his contribution to this eBook) has blocked any progress in the area of fiscal union. These difficulties should not represent an excuse to muddle through, but rather an invitation to link the fiscal union agenda to structural issues.

Structural surveillance: Too much or too little?

The Irish and Spanish crises have been rightly interpreted as the result of large accumulated imbalances in the private sector rather than – as in Greece – the public sector. Subsequently, a complete reshuffling of macroeconomic surveillance was introduced with the European semester and, more specifically, with the Macroeconomic Imbalance Procedure (MIP). Unfortunately, the process is complex and has proved rather inefficient in incentivising national governments to carry out the recommended reforms.

The question of structural reforms raises similar issues to those raised by fiscal policies: to what extent should the EU be involved? On the one hand, low growth in one member state of the Eurozone may raise a systemic issue, since this will involve rising debt burdens. This justifies an involvement of the 'centre' in national affairs. On the other hand, the EU level has poor instruments to enforce structural reforms at the national level, and its actions may create a backlash due to a rejection of intrusions by 'Brussels' into national affairs. To overcome this dilemma, in her contribution to this eBook, Agnès Bénassy-Quéré suggests launching a comprehensive project of a 'jobs union' whereby structural reforms at the national level would go hand-in-hand with a level playing field on the European labour market and further protections at the individual level. As with the Schengen project in 1985, a few countries could volunteer to make the first steps through informal cooperation, then moving to enhanced cooperation, and finally to an EU-wide scheme.

The issue of structural reforms has been much less widely discussed among experts than that of banking union, debt restructuring, or fiscal union. It is time for them to make concrete proposals in this area. Some taboos will need to be broken. For instance, it may be preferable in some countries to apply a one-off wealth tax rather than risk debt restructuring or imposing large primary surpluses over a long period. Along a different line, it may be in the interest of creditor countries to break the subsidiarity principle and 'invest' in the growth capacity of some debtor countries, for example through funding a programme to train local teachers and providing technical assistance. It is the task of independent experts to break such taboos and highlight the trade-offs. The politicians will then decide.

How to use the new political capital

The political malaise across the EU goes beyond the malfunctioning of the euro. It has to do with real and perceived inequalities, but also with the lack of understanding of who decides in the EU and with a discontent over intrusions by 'Brussels in national affairs, at a time of slow growth and rising insecurity. Fixing the euro cannot be the only objective of the new European leaders. In the coming months and years, the heaviest risks may well be related to social and political discontent rather than bank or sovereign crises. However, making the Eurozone more resilient should definitely be part of a comprehensive strategy for Europe. Should the Eurozone have to face a new crisis with existing institutions, the currency may not survive. If it were to survive, it would be thanks to new financial and political efforts spent on crisis management rather than on building-up a common strategy for the future of the EU – as the experience of dealing with Greece has taught us. Negotiations on Brexit will already absorb part of the member states' energies, and possibly divide them. In an environment where monetary policy will progressively become less accommodative, it is important to secure the euro so that the heads of states and governments can envisage the future with more serenity and concentrate on what really matters for the people: jobs, equity, and security. Reciprocally, the new impetus of EU's integration strategy could help break the deadlocks that currently prevent technical decisions that need to be made for the Eurozone to become more resilient by encompassing them into a broader design of a common future.

Fixing the Eurozone is, however, a very delicate task. Given the often-conflicting interests of the various member states, and the legal and political difficulties, there is the risk that something is done to show that Europe is moving forward, but that this turns out to be a step in the wrong direction. We already have examples of such mistakes, such as retroactive bail-in rules. They are technically and legally feasible, they benefit the countries with more bargaining power, and they attempt to address a real problem – until they create unexpected consequences at the first sign of trouble. The differences of opinion highlighted in this introduction are a feature of the different weight various experts attribute to these risks. We hope that by highlighting them, we have provided a useful service.

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2 Looking back at a lost decade; avoiding a second one

Thorsten Beck
Cass Business School and CEPR

The Eurozone is about to complete a 'lost decade' in terms of lack of growth, stubbornly high unemployment (especially among the young) and sluggish recovery from the banking crisis that affected large parts of the Eurozone. As a new leader in France takes office, a new and broad coalition in the Netherlands is preparing to take office, and with the upcoming elections in Germany potentially bringing in some new players, now is the time to think about policies that can prevent a second lost decade.

Figure 1 GDP per capita (constant international $)

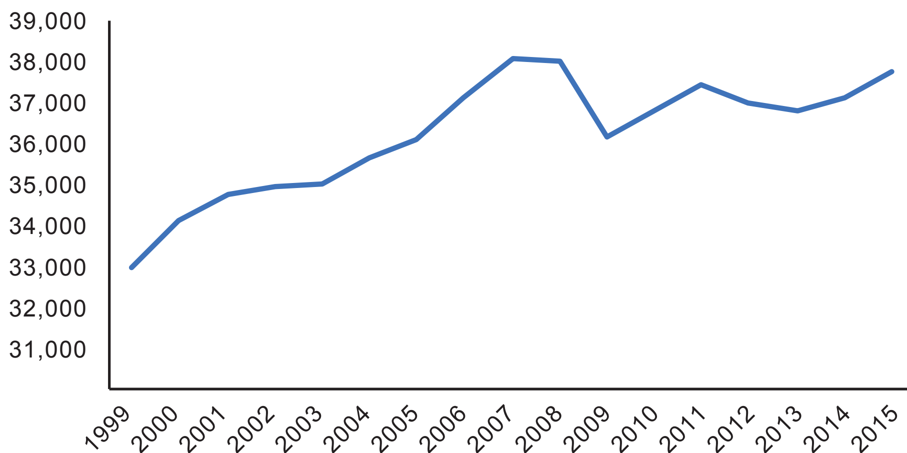
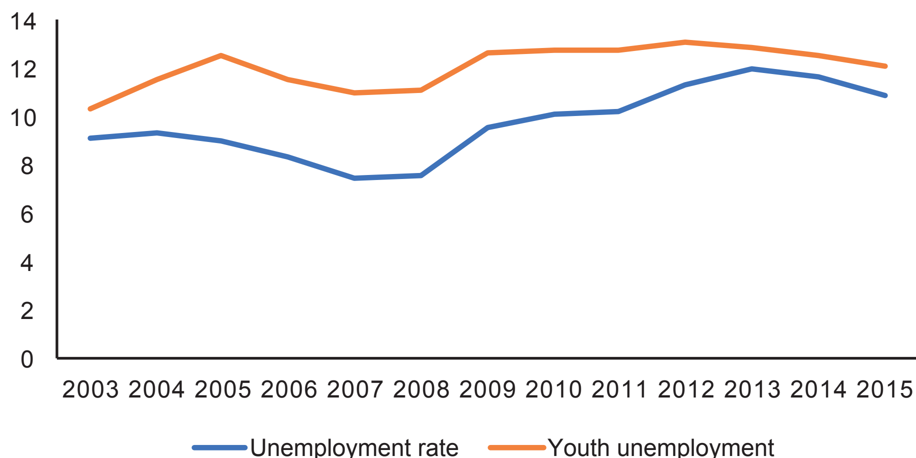


Figure 2 Overall and youth unemployment rates (ILO methods)



The Eurozone crisis has many causes, and as in Tolstoy's *Anna Karenina*, each crisis country suffered a crisis in its own way.[1] There are several underlying themes, however, including serious structural inefficiencies in labour and good markets, banking sector problems, and sovereign overindebtedness.[2] The combination of the failure to address market inefficiencies – especially in labour markets and banking sectors – and fiscal austerity has not only failed to bring the Eurozone out of the crisis, but has made the crisis worse and significantly undermined support for the European integration project, which in turn has fuelled support for populist and anti-democratic parties.[3] Addressing these problems will ultimately lead the Eurozone out of the crisis and turn it into a sustainable currency union. One important constraint, however, is that some of the most obvious solutions might require treaty changes, which seem all but outside the political reality at this stage. But there are other suggestions that, if added up, can make a difference. In the following I will focus on two, one concerning the continuous banking problems throughout the Eurozone and the other concerning a first step away from the failed austerity policies towards a common fiscal policy.

1 "Happy families are all alike; every unhappy family is unhappy in its own way", *Anna Karenina* by Leo Tolstoy.

2 For a consensus narrative of the causes, see http://voxeu.org/article/ez-crisis-consensus-narrative.

3 See discussion in Beck and Underhill (2017).

An asset management company for the Eurozone[4]

If there is one consistent lesson from decades of banking crisis resolution across the developed and developing world, then it is that the quicker losses are being recognised, absorbed, and distributed, the quicker the recovery. The Eurozone has been an example of how not to proceed: non-performing assets were evergreened away and failing banks were propped up by outright bailout or regulatory forbearance, as shown by the Comprehensive Assessment in 2015. One important reason for the delay in addressing losses was the inability of several peripheral states to pay up for losses, especially as creditors in some core countries expected to be made whole no matter what (supported by their governments).

While the Comprehensive Assessment and the start of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) have been hailed as a turning point, the problem of non-performing loans (NPLs) keeps down banks' balance sheets. According to the ECB (2016), at the end of 2015, the largest 130 Eurozone banks held around €1 trillion in non-performing assets, with NPL ratios above 10% in Slovenia, Portugal, Ireland, and Italy, and above 30% in Cyprus and Greece. And while the aggregate non-performing exposure ratio dropped somewhat from end-2015 (7.2%) to mid-2016 (6.8%), the ratio of reserves to NPLs remained broadly unchanged between end-2015 and June 2016, at around 46%. The problem thus remains unresolved. The high stock of NPLs held can result in zombie lending (throwing good money after bad) and prevents the necessary adjustments in resource allocation, which is necessary for economic recovery (Hoshi and Kashyap 2015).

While mostly suggested by academics, a recent paper by the European Banking Authority (Haben and Quagliariello 2017), supported in a speech by the EBA chairperson Andrea Enria, also makes a strong case for a European asset management company (AMC) to reduce the pressure caused by non-performing loans across the Eurozone. Centralising the restructuring and recovery of bad loans is a technique that has been used repeatedly over past banking crises (Klingebiel 2000), including in Sweden during its crisis in the 1990s. It has also been used during the Eurozone crisis in Ireland (via the National Asset

4 For a more extensive discussion of this proposal, see Beck and Trebesch (2013) and Beck (2017).

Management Agency) and Spain (via the Fund for Orderly Bank Restructuring). It involves the purchase of non-performing loans from banks in order to free their balance sheets and staff. By taking over non-performing assets, such an agency can prevent pressure on banks to undergo fire sales and thus additional losses. Such a centralised approach also allows scale economies to be exploited in working out non-performing loans, by concentrating expertise and manpower in one agency. In addition, it would allow links to be broken between banks and borrowers, which are often a problem in banks with weak governance structure and lending protocols (Klingebiel 2000).

While AMCs have been traditionally set up at the national level (consistent with national budget sovereignty), there are strong arguments for a Eurozone-level AMC. First, there might be high costs of setting up such an agency at the national level, so there are clear scale economies. Second, the direct and indirect exposure of large EU banks to NPLs across borders results in an NPL overhang preventing the reestablishment of a single market in banking. Third, there is the tragedy of commons argument (Tornell and Westermann 2012) – as banks have access to a lender of last resort and (as discussed above) do not have incentives to address their non-performing assets, there is limited pressure at the national level for a work-out of these assets, which calls for a Eurozone solution. While the establishment of the SSM has reduced regulatory discretion on provisioning, there is still no solution in place to actually address the (previously) hidden losses.

However, the proposal by the EBA does not foresee an immediate recognition of losses if banks sell loans to the AMC above the ultimate recovery value, but rather the issue of equity warrants to governments, that can be triggered after three years if the final sale price of assets sold is lower than original price banks received. While this provides important incentives for banks and avoids any additional taxpayer money being committed upfront, it does delay the process of the necessary bank restructuring and might simply postpone the ultimate resolution of bank distress. Beck and Trebesch (2013) made a somewhat more radical proposal to set up a temporary 'Eurozone Restructuring Agency' (ERA) for restructuring and resolution purposes. This temporary agency would be jointly owned by the 17 Eurozone members (in the same proportion as their shares in the European Stability Mechanism) and hosted at the ECB. All liabilities, but also assets and equity stakes in the good banks, would thus indirectly be owned by

European taxpayers. Both creditor and debtor nations would thus participate in the downside and upside risks of this AMC.

Why now?

A healthy banking sector is critical for a revival of the Eurozone. If European leaders want to avoid a second lost decade, now is the time to act. This reform does not require any treaty change. Critically, it would help with phasing-in the completion of the banking union, as the establishment of full risk-sharing has been impeded by the political reluctance of creditor government to share in past losses through a post-crisis insurance tool. Addressing the legacy losses can open the path for a forward-looking risk-sharing mechanism.

A first step in common fiscal policy

Austerity policies across the Eurozone have contributed to the lack of a robust recovery. While some countries clearly needed a permanent adjustment in government consumption, others have been prevented from applying countercyclical macroeconomic policies through Eurozone restrictions, while the burden of banking and sovereign solvency problems has been almost exclusively imposed on debtor countries. The current situation, where market discipline on sovereigns is not being imposed, while the 'Brussels discipline' is not only ineffective but also anti-democratic, is unsustainable. While many economists agree that a common fiscal policy will make the Eurozone a stronger currency union, such a construct is in the far future, both due to the need to adjust treaties but also for political reasons, most importantly the parliamentary budget prerogative. Not surprisingly, the US, which can be seen as historical example for a currency union growing together over two centuries, took quite some time to get to a large federal budget and risk-sharing mechanism.

Notwithstanding these political and legal barriers, small steps are possible. My second proposal, which offers a relatively easy win, therefore builds closely on a proposal by Zettelmeyer (2017), namely, a small Eurozone budget comprising perhaps 2% of Eurozone GDP, which can be financed through a dedicated taxation source. These budget

resources should be used for specific cross-border Eurozone-level projects, including infrastructure but most importantly to address youth unemployment through hiring subsidies, apprenticeship programmes that have been successful in some Eurozone countries, and mobility incentives (for a detailed diagnosis of the problems of youth unemployment across the European Union see Dolado 2015). Providing additional funding incentives to implement necessary labour market reforms might help reduce political resistance to such reforms, though reforming labour markets or even achieving convergence across the Eurozone is certainly a long-term process. Seeing a common fiscal fund being put to good use to pull the Eurozone out of crisis will ultimately create a constituency for further fiscal integration.

The young generation have been the main losers from the lost decade in the Eurozone; however, it is the young generation that is the future of Europe and it is their support that is critical for the future of the European project. Sending a clear signal that Eurozone leaders care about the young generation is critical for the European project to advance, in socioeconomic terms but also, as importantly, in political terms.

Moving towards more integration, with a positive view

Economists have pointed to solutions to the Eurozone crisis, both for short-term repair and to guarantee long-term sustainability, over the past nine years. While there are differences in approaches (informed by different schools of thinking and different emphases on micro versus macro problems), there has been an overwhelming consensus in the broad picture.

The political leaders of the Eurozone have adopted some of the proposals that were made early on in the Eurozone crisis by independent economists, including – most prominently – the banking union. However, there has been a reluctance to go further in addressing the crisis legacy and building the fundamentals for a sustainable currency union. The increasing reluctance to take bold steps has gone hand-in-hand with the rise of populism across Europe. The Eurozone is currently in a halfway house – too afraid to move forwards to further integration where necessary, and not able to move back towards purely national policies lest the euro fail.

As described vividly by political scientists and economists in Beck and Underhill (2017), the European crisis is as much an identity crisis as it is a socioeconomic crisis. The European project has been increasingly associated with crisis and austerity rather than with opportunities and growth. This is a challenge for policymakers, but also an opportunity as many of the policy solutions to avoid a second lost decade are at the Eurozone rather than the national level.

There is a fear that further steps towards burden sharing – be it backward-looking in the form of cleaning up legacy problems, or forward-looking with a move towards more fiscal and economic integration – will further fuel populism. However, it is exactly the lack of such steps that will strengthen populist, illiberal parties and politicians further by undermining the long-term stability of the Eurozone. Conversely, by taking initiatives that help growth and the most vulnerable, the positive spirit of European integration can be reignited. It is time for political courage.

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3 Making the Eurozone sustainable

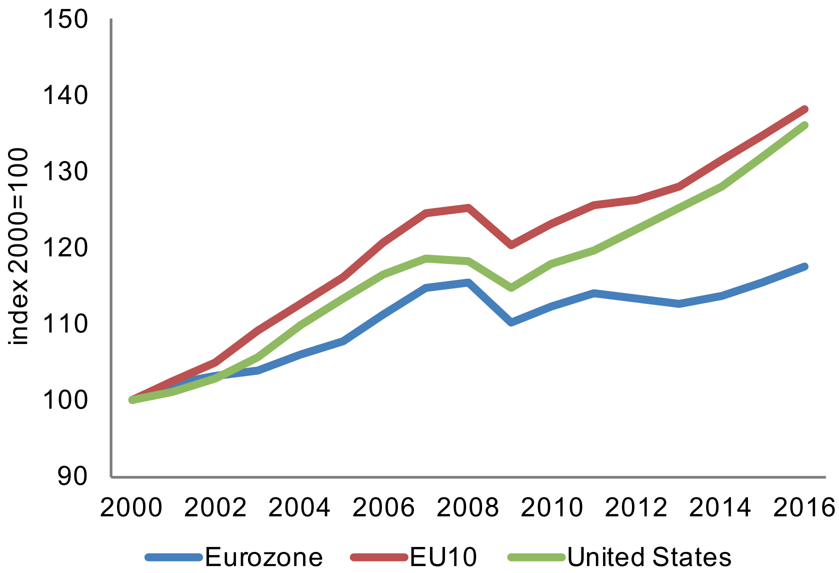
Paul de Grauwe
London School of Economics and CEPR

The election of Emmanuel Macron to the French presidency creates new opportunities for taking initiatives that will ensure, first, that the Eurozone becomes a source of economic growth; and second, that its long-run survival is guaranteed. At this moment, none of these two objectives has been realised. In this chapter, I first analyse how a new growth impetus can be brought in the Eurozone, and second how the long-run sustainability of the Eurozone can be ensured. The first objective can be realised without intrusive institutional changes, the second will require deeper institutional changes in the Eurozone. Yet small steps can be taken today that do not require Treaty changes.

The failure of the Eurozone as a source of economic growth is illustrated by Figure 1, which compares the evolution of real GDP of the Eurozone with the US and with the EU10 (defined as the group of EU members that are not in the Eurozone). The contrast between the EU10 and the Eurozone is stark. The former group of countries that decided not to be in the Eurozone has managed to recover much better from the recession of 2008-9; the Eurozone has experienced quasi stagnation since 2008. There has been some recovery in the Eurozone since 2014, but the gap with EU10 has not narrowed.

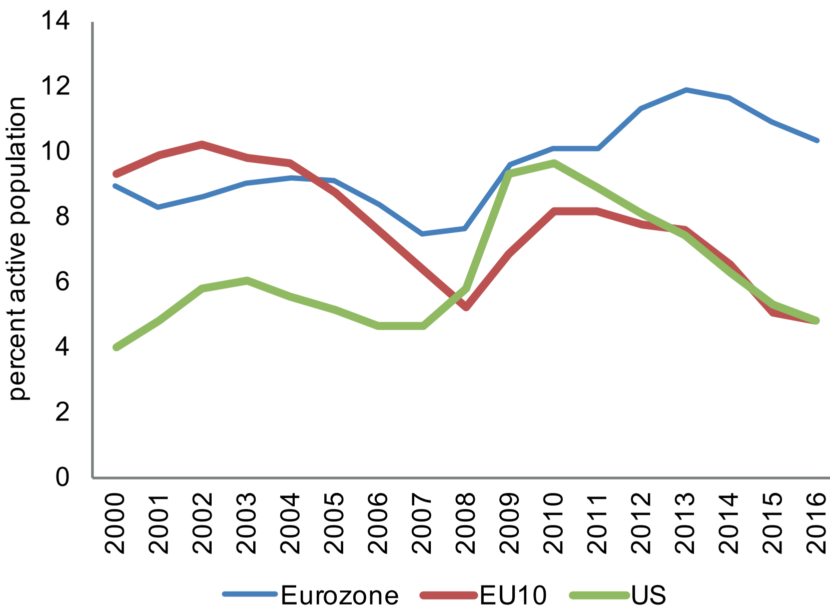
The dismal economic performance of the Eurozone compared with the EU10 is also made clear in Figure 2, which shows the evolution of unemployment rates in these two groups of countries (together with the US). It is disturbing to find that while in 2000, the rates of unemployment in the Eurozone and the EU10 were approximately equal, in 2016 the Eurozone unemployment rate was twice as high as in the EU10. Again, the recent decline in unemployment in the Eurozone has been insufficient to narrow the gap with the group of EU countries that remain outside the Eurozone.

Figure 1 Real GDP in Eurozone, EU10 and US (2010 prices)



Source: European Commission, Ameco.

Figure 2 Unemployment rate in Eurozone, EU10 and US



Source: European Commission, Ameco.

At the start of the Eurozone, this historically unique monetary experiment was hailed as one that would promote economic growth and welfare for its citizens. It has to be admitted that these promises have not been realised. On the contrary, the Eurozone countries, on average, performed worse than the EU countries that decided to stay out of the monetary union. Of course, this average hides large differences within the Eurozone. Northern countries like Germany and the Netherlands have performed relatively well. This, however, also implies that many Eurozone countries economic performances have been even more dismal than the Eurozone average suggests.

The poor economic performance of the Eurozone explains why, in a number of member countries, discontent with the euro has been on the rise, feeding populist parties with promises that an exit from the currency would help to improve economic performances.

What should be the priorities for Eurozone policymakers to redress the dismal economic performance and to put the Eurozone on a sustainable path? I concentrate first on the role of public investment in boosting the Eurozone economy, and then on new initiatives for improving the governance of the Eurozone.

Boosting the Eurozone economy through public investment

Public investment has been one of the many casualties of the austerity programmes that were imposed on the Eurozone countries since the sovereign debt crisis. This is paradoxical, since it is public investment that is key to the recovery in the Eurozone.

There are two reasons why public investment is central for promoting economic growth. First, the private sector is still very risk averse and fails to invest enough. This has to do with the lack of confidence in the future. The way to deal with this is for the public authorities to show the way and kick-start public investments. This will stimulate economic growth and create more confidence in the future, which in turn is likely to stimulate private investment.

Second, public investment is needed to achieve long-term objectives of sustainable growth. The latter requires investment in alternative energy sources, the environment, and in public transportation.

Unfortunately, public investment is discouraged by a rule that the members of the Eurozone have imposed on themselves, namely, that public investment cannot be financed by bond issuance; it has to be financed by current tax revenues. This prevents public investment from taking off, from sustaining the recovery, and from developing a green economy.

It is often argued that public authorities should not increase their debt; on the contrary, that they should reduce it. Some countries of the Eurozone periphery undoubtedly have limited capacity to add to public debt.[1] But others, such as Germany, France, Belgium, the Netherlands, and Finland, surely can. The governments of these countries can borrow today at very long maturities almost for free. There are certainly many investment projects that have a rate of return of more than 0%.

A government that issues bonds at close to 0% and channels the money into projects that will have rates of return far exceeding 0% would promote economic growth and make the future repayment of the debt easier. This was also stressed by the IMF in its *World Economic Outlook* of 2014, in which it concluded that "debt-financed projects could have large output effects without increasing the debt-to-GDP ratio, if clearly identified infrastructure needs are met through efficient investment" (IMF 2014: 104-107).

Put differently, what matters is not gross debt, but net debt of governments. Debt issuance that makes it possible to invest in assets with a much higher rate of return than the cost of borrowing will reduce net debt in the future. Unfortunately, Eurozone countries, pushed by European policymakers, continue to be mesmerised by gross debt numbers, and as a result fail to do the obvious.

European authorities have put great emphasis on structural reforms to boost long-term economic growth. Econometric analysis of the relationship between long-term growth and structural reforms (IMF 2015, De Grauwe and Ji 2016) suggests that these reforms have a weak effect on growth. These same studies, however, reveal that public and private investments are far more important in boosting economic growth.

1 Some of these countries may also lack the appropriate governance to ensure that public investments raise productivity (Gros 2014, IMF 2015).

Yet, by imposing a balanced budget on its member countries and thereby outlawing the financing of public investment by the issuance of bonds, the European authorities discourage public investment in the Eurozone. They do this even at a time when the financial conditions for borrowing are more favourable than ever.

It is often said that governments today cannot issue more debt because this will place a burden on our grandchildren. The truth is that our grandchildren will ask us why we did not invest in alternative energy and public transportation, and thereby made their lives miserable, when we faced historically favourable financial conditions to do so.

The use of a more intelligent rule that is conducive to economic growth would be easy to implement if the political will exists to do so. This is where President Macron may make the difference. An agreement between the member states of the Eurozone could be reached that allows for a current budget and a capital budget to be distinguished. The former would be subject to the structural balanced budget rule of the Fiscal Compact; the latter could show a deficit reflecting the financing of public investment by the issue of bonds. This is sometimes called the 'Golden Rule' of fiscal policy, and it has been proposed by many economists in the past.

The Juncker investment plan that was launched in 2014 is certainly the right approach, but it is clearly insufficient to lift the Eurozone onto a higher growth path. It has to be supplemented by the capacity of national governments to boost public investment.

There are certainly problems with the Golden Rule, one of which is that politicians may manipulate the rule so as to increase current spending by relabelling it as capital spending. There is a role here for Eurostat to set up a monitoring system aimed at preventing the improper use of the Golden Rule.

Boosting the prospect of the Eurozone by improving its governance

One of the main design failures of the Eurozone is that national government bond markets continue to exist, while national governments lack the support of a central bank that is capable of supporting its sovereign's bonds in times of crises. This is a problem that is likely to arise with each recession, when investors will flee from the bond markets that

are perceived to be less safe towards the bond markets of safe countries. The ensuing capital movements within the Eurozone will be destabilising and will prevent countries from using the automatic stabilisers in the budget. Put differently, the Eurozone has stripped national governments of their capacity to stabilise the business cycle, thereby increasing the hardship for those hit by a recession. If not remedied, this is likely to intensify the hostility of millions of people towards a system that fails to provide some protection against the booms and busts that capitalism inevitably produces.

The first-best solution would be to consolidate national government bonds into a common bond. This would amount to a fiscal union. It is clear that today there is no political appetite for moving into such a union. That does not mean, however, that it should not be maintained as a long-run goal aimed at making the monetary union sustainable.

The only viable strategy for reaching this long-run goal is one of small steps. This should be designed in such a way that it is clearly seen as a step towards that long-term goal.

My favourite proposal is a common unemployment (re)insurance scheme. There have been many such recent proposals (for a survey, see Beblavy at al. 2015; see also the *Four Presidents' Report* (Van Rompuy 2012). The essential features are, first, that it keeps the insurance dimension intact, thereby avoiding that it degenerates into a scheme making permanent transfers from one group of countries to another. This would lead to a dreaded 'Transfer Union' so feared in Germany. A second feature is that it should also be allowed to provide not only inter-country insurance, but also inter-temporal smoothing. The reason is that the business cycles in the Eurozone are highly correlated (albeit with different amplitudes). Thus, the common unemployment insurance scheme is likely to be underfunded during recessions and overfunded during booms. As a result, it should be allowed to issue bonds (Eurobonds) during recessions and to retire these during booms. Such a scheme would therefore combine inter-country insurance and smoothing over time. Via its capacity to issue bonds, it would be a precursor of a more ambitious scheme of debt mutualisation to be realised in the long run.

Clearly, a common unemployment scheme such as this must start small, and therefore will be insufficient to take care of all stabilisation needs in the Eurozone. However, its

existence will show the direction in which the Eurozone countries wish to go to make the Eurozone sustainable in the long run.

To conclude, the Eurozone is an ambitious project. However, it is also an unfinished project and if left unfinished, it will destroy itself. It is therefore of the utmost importance that steps are taken to make the monetary union sustainable. The political configuration after the election of Macron to the French presidency has created a window of opportunity to take these steps.

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4 Which fiscal union?

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One of the main lessons of the financial crisis is that, to preserve full financial integration and financial stability, the Eurozone needs to build elements of a common fiscal policy (Obstfeld 2013 and Tabellini 2015; see also the *Five Presidents Report* (Juncker et al. 2015)). In this chapter, I discuss the principles and priorities of how this could be done.

Realising such a deep transformation would require Treaty changes and constitutional reforms in member states, something that does not appear politically feasible in the near term. Yet, at some point the Eurozone will have to grapple with these issues, and the more thoroughly they are discussed, the sooner they will fill the political agenda. Moreover, the task of economists is also to discuss hypothetical reforms, so that they can be swiftly implemented once political conditions allow it. Of course, a large literature already exists on this topic. In what follows, I draw in particular on Ubide (2015) and Sapir and Wolf (2015) (see also Corsetti et al. 2015 and Paris and Wyplosz 2014).

Priorities

Unlike for the US and other federations that achieved integration at an early stage of state development, all Eurozone countries already have large – arguably too large – government spending and taxation. Under any foreseeable scenario, most of these government functions and capacities will have to remain national. The fiscal union

1 This is an updated version of a chapter published with the same title in the VoxEU eBook, *How to fix the Eurozone*, edited by Richard Baldwin and Francesco Giavazzi, 2016. I thank Massimo Bordignon for helpful comments.

should have a few main purposes and priorities, namely, to complement the monetary union in three main ways:

1. by providing an arrangement that allows fiscal stabilisation at the level of the Eurozone as a whole;
2. by providing resources to withstand systemic financial crisis (banking crisis and sovereign debt crisis); and
3. by strengthening the enforcement of fiscal rules to insure fiscal discipline in member states.

Point (1) was emphasised in the *Five Presidents Report* (Juncker et al. 2015). The Eurozone needs a policy tool with which to manage aggregate demand and stabilisation policies during large recessions in the currency zone. European monetary policy should bear the primary responsibility for cyclical stabilisation during normal times, but in exceptional circumstances, monetary policy alone becomes over-burdened and is constrained by the zero lower bound on nominal interest rates. A major lesson of the financial crisis is that, when this happens, monetary policy should be coordinated with fiscal policy to sustain aggregate demand. Given current deflationary trends, it is quite possible that the zero bound on interest rates will be a recurrent threat during recessions for years to come. If so, the lack of an aggregate fiscal policy tool will be a major handicap for the Eurozone. A primary goal of the fiscal union should be to remove this handicap. Of course, the common fiscal policy tool should aim at the Eurozone average and be activated only in exceptional circumstances, leaving idiosyncratic national shocks to be dealt with by member states.

Corsetti et al. (2016) emphasise a second problem with the current arrangement, which is particularly relevant for highly indebted countries. Suppose that a country is hit by a large adverse macro shock, and that the appropriate response would be to expand the fiscal deficit. If the country has a large public debt, the fiscal expansion may increase default risk. The reason is lack of commitment: the deficit increases now, but the promise of having larger fiscal surpluses in the future may lack credibility. If the country had its own currency, the higher default risk would also lead to an exchange rate depreciation, with an additional expansionary effect on aggregate demand. But inside the Eurozone, the currency cannot depreciate, and a fiscal expansion may become self-defeating because the higher sovereign default risk would have contractionary effects

on domestic demand. In other words, the loss of monetary sovereignty also makes fiscal policy less effective as a stabilisation tool for a highly indebted Eurozone member state. In principle, fiscal rules are supposed to prevent this problem. In practice, however, we have seen that the enforcement of these rules is highly problematic (more on this below).

Point (2) – a backstop for financial and sovereign debt crises – is perhaps more controversial, because it can be argued that the European Stability Mechanism (ESM) already performs this function. The ESM arrangement is certainly an important step forward, but it is doubtful whether its current structure is adequate to prevent the risk of sudden stops.

- First, its resources (a maximum lending capacity of €500 billion, about 5% of Eurozone GDP) may be insufficient to deal with large systemic crisis; in many European countries, bank assets are several multiples of GDP.
- Second, the decision to provide stability support to an ESM member is taken by unanimity and requires prior approval by some national parliaments.[2] This makes it highly uncertain and open-ended whether and how the ESM resources would actually be available.

For these reasons, the risk of euro exit and of sudden stops remains a significant concern. To be viable in the long run, the monetary union needs an effective system of risk-sharing in exceptional circumstances, such as sudden stops and systemic financial crisis (Obstfeld 2013). Conditioning such an arrangement on the approval of national political majorities vastly reduces its effectiveness, both ex ante and in the case of need.

In a recent contribution, Gros and Belke (2015) argued that risk-sharing through a well-functioning banking union and capital market union may be sufficient to absorb losses from most financial crises without the need of a fiscal union, provided that a common system of deposit re-insurance is in place. A discussion of this issue goes beyond the goal of this chapter, but I note the following.

2 When the European Commission and the ECB both conclude that a failure to urgently grant financial assistance would threaten the economic and financial sustainability of the Eurozone, unanimity is replaced by an 85% qualified majority. In this case an additional reserve fund needs to be set up as a buffer (Art 4 of the ESM Statute).

- First, current arrangements limit the resources needed from the newly constituted Single Resolution Fund in the event of a banking crisis, because they impose very demanding bail-in requirements on bank creditors. This increases the risk of contagion and domino effects, however, and may not be a viable solution in the event of systemic banking crises.
- Second, a truly trans-national banking union is unlikely to emerge in Europe, even in the long run, if the risk of euro exit and of sudden stops remains significant. In the presence of this risk, banks will retain a large home bias even if supervision is common (rather than national).

A comparison with the US, where state debt is negligible and a fiscal union already exists, is misleading. A fiscal union is a prerequisite for a well-functioning capital market and banking union, although it may be true that once credible elements of a fiscal union are in place, the banking system could evolve so that most of the risk would be shared by financial markets and the losses born in the private sector, rather than by taxpayers.

Point (3), on the need to better enforce fiscal discipline, is becoming more and more manifest. The 'Six Pack' procedure is very articulate and ambitious, but the evidence so far is that it has very little bite. Several member states have repeatedly found a reason to claim exceptions to the fiscal rules, with no relevant cost or disincentive. To enforce fiscal discipline on a reluctant member state, more interference with national sovereignty is needed than under existing rules.

Points (1) and (2) deliberately do not include another controversial issue, namely, whether a fiscal union should also perform some of the risk-sharing functions towards individuals that are currently performed by national governments. I do not think this is a priority at the current stage. Risk-sharing between countries is required in a monetary union, but should mainly be limited to exceptional circumstances, such as sudden stops and systemic financial crisis, or very large shocks. A European system of unemployment insurance (or other welfare programmes directly insuring individual risks) may be politically or symbolically attractive, but would entail great difficulties. To avoid moral hazard and permanent transfers between countries, a common system of unemployment insurance would require strict harmonisation of national labour

market institutions, which is difficult and perhaps undesirable. Such a system would also have small economic benefits, for two reasons. First, all members states already have the capacity to directly insure their own citizens. Second, if countries do not lose market access, they should be able to self-insure against small shocks and business cycle fluctuations. What is most important is to insure against large shocks or events that could entail the loss of market access or threats to financial stability. It is in such circumstances that individual member states are powerless, and that systemic externalities are most threatening.

An implication of the foregoing remarks is that the Eurozone does not need to build a large tax capacity of its own. What it needs is the ability to enforce the collection of transfers from member states, not necessarily in very large amounts at once, but possibly for very long periods of time. This would enable the Eurozone to issue its own debt at times of crisis, or for fiscal stabilisation purposes. As in the proposals by Ubide (2015) and Corsetti et al. (2015), this debt would be backed by specific tax revenue collected by member states, but earmarked for servicing Eurozone debt.

According to Corsetti et al. (2015), member states would pledge specific sources of future revenue – such as seignorage, a fraction of the VAT, or the proceeds from a recurrent wealth tax – for, say, 50 years. The Eurozone could then issue 'Stability Bonds' backed by these future sources of revenue. In the their proposal, the proceeds of the Stability Bonds would then be used to retire national debt from circulation, until all national public debts have reached 60% of GDP in all member states. The main goal of the proposal is to reduce the fragility of the Eurozone by getting rid of the legacy of high public debts.[3] Since the current stock of national debt differs between countries, the Stability Bonds would be backed in greater proportion by pledges from the currently highly indebted countries, which need to retire larger amounts of their debt. This is a drawback of the arrangement, which could undermine the rating of the Stability Bonds. Another drawback is that in the long run, the Eurozone may exhaust all its borrowing capacity to redeem national debts, with no margin left to smooth cyclical fluctuations or other emergencies.

3 Paris and Wyplosz (2014) formulate an alternative proposal of debt reduction, based on pledging larger amounts of future seignorage revenues.

Ubide (2015) proposes a similar scheme, except that pledges of future revenues would be in the same proportion of GDP for all member states, and the Stability Bonds would primarily be used for fiscal stabilisation and risk-sharing in exceptional circumstances, rather than for national debt reduction. He envisages capping the Stability Bonds at 25% of Eurozone GDP. Below I discuss in more detail how this arrangement could work. As in Ubide (2015), debt would be backed by the same GDP percentage of revenue from all member states, and it would be used mainly as an instrument of aggregate demand or crisis management.

In this respect, the Eurozone would exploit its key prerogative of being a super-national institution. In pledging and earmarking specific future sources of revenues to the Eurozone in predetermined amounts, member states would accept an irreversible transfer of sovereignty over those revenues. On their own, member states would not have the commitment capacity to credibly earmark future sources of revenue for, say, a sinking fund designed to retire outstanding public debt, or to back a senior debt instrument in times of emergency. An international agreement (with the associated autarky costs of unilaterally breaking the agreement) would provide this commitment capacity. Such an arrangement would give the Eurozone the ability to access financial markets in favourable terms, without necessarily having developed its own tax capacity.

Governance

Achieving a common fiscal policy means, first of all, having a Eurozone policymaker in charge – a European Fiscal Institute (EFI) perhaps (to adapt the name from the precursor of the ECB). Coordination of national fiscal policies will not do, because enforcement of coordination is inevitably imperfect, and policy needs to be guided by a Eurozone perspective rather than by national interests.

The EFI could be the logical evolution of the ESM, as it acquires new functions and additional resources, and as it adapts its governance structure to the new greater responsibilities. Sapir and Wolf (2015) have suggested modelling the EFI on principles

similar to those used for the ECB, clearly a well-functioning European institution.[4] The key governing body is the Eurogroup (a council of national economic and finance ministers that already acts as the Board of Governors of the ESM) plus a smaller Executive Committee with agenda-setting powers and consisting of appointed individuals. The Chairman of the EFI is also the chairman of the Executive Committee, like the ECB President, and would resemble a Eurozone Treasury Minister. Most decisions are by simple or qualified majority, depending on the subject matter, with Executive Committee members having considerable weights.

The key innovation here is the abandonment of unanimity in most decisions. This is inevitable, because if national vetoes can block the implementation of a common policy, then the EFI would not be very different from the Eurogroup, and we have already seen the difficulties of this body in reacting to the financial crisis. This poses the challenge of how to give democratic legitimacy to the Common fiscal policy – unlike monetary policy, fiscal policy also concerns redistribution and cannot be guided exclusively by efficiency criteria. The obvious answer is to involve the European Parliament – all major policy decisions of the EFI also have to be approved by an ad hoc committee of the European Parliament, or by the European Parliament itself, restricted to Eurozone representatives.

Stability Bonds

The main responsibility of the EFI would be to manage a debt instrument of the Eurozone (following Ubide 2015 and Corsetti et al. 2015, I call this Stability Bonds), backed by a Eurozone tax capacity. Here is how this could be done (following Ubide 2015):

4 Sapir and Wolf (2015) call it the Eurosystem of Fiscal Policy (EFP). In their proposal, the EFP could impose specific targets (for fiscal deficit or surplus) to all member states, with the aim of achieving an appropriate fiscal stance in the Eurozone as a whole. This would be less effective than a fiscal stabilisation achieved through Stability Bonds, however, since the fiscal expansion (or contraction) would only occur in some countries and not necessarily in the countries that need it most. Guiso and Morelli (2014) suggest the creation of a European Federal Institute, but they are less specific about institutional details, and they don't discuss Eurozone debt.

- All Eurozone member states agree to transfer to the EFI a given amount of their yearly tax revenue (expressed as a percentage of their GDP), upon request by the EFI, up to a pre-established ceiling and up to a pre-determined future date. The transfer is the same percentage of GDP for all member states, to avoid redistribution between countries. This would provide the back bones of a Eurozone fiscal capacity with which to service the Stability Bonds over time.
- At the time of issue, the overall amount of Stability Bonds cannot exceed a predetermined percentage of aggregate GDP, say, 25% of GDP (as in Ubide 2015). Of course, the EFI debt ceiling and the ceiling on the pre-committed national funds would have to be mutually consistent. These ceilings could only be changed under unanimity rule. Ubide (2015) and Corsetti et al. (2015) provide different numerical hypothesis and also include a discussion of which sources of government revenue (including seignorage from the ECB) could be most easily pledged.

To achieve liquidity of the new debt instrument, the EFI would start by gradually issuing a minimum amount of Stability Bonds (until it has reached up to, say, 10% of aggregate GDP). The proceeds from the Stability Bonds would be returned to member states (also in proportion to GDP, to avoid redistribution), who would have to retire their own national debt. In a similar proposal by Corsetti et al. (2016), the EFI would purchase national debts, rather than disbursing the proceeds to member states. But this would have the disadvantage of backing the new Eurozone debt with the existing national debts, leading to a mutualisation of legacy national debts. Disbursements of cash (to redeem national debt in circulation) is preferable, because it clarifies that the new Stability Bonds are backed by the own tax capacity of the Eurozone, and not by national debt instruments of heterogeneous rating inherited from the past.

The main purpose of the Stability Bonds, however, would be to give the Eurozone a new instrument for intertemporal aggregate demand management without relying on fiscal policy coordination. Thus, during deep Eurozone recessions, the EFI would issue additional amounts of Stability Bonds and give the proceeds to member states (also in proportion to national GDP), who would be free to use them as they deem appropriate. In particular, the debt proceeds from the Stability Bonds could be used to enact a counter-cyclical fiscal policy in the Eurozone, if necessary in coordination

with monetary policy (including so as to replicate the economic effects of 'helicopter money', as suggested by Turner 2015).

Note that, because both tax collections and disbursements are in proportion to GDP, there is no redistribution between member states – this would not amount to a 'Transfer Union'. Nevertheless, if one wanted to achieve some risk-sharing between member states against idiosyncratic cyclical fluctuations, debt proceeds could be distributed according to projected or trend GDPs, while transfers would be collected in proportion to actual GDP.

Similarly, in the event of major systemic financial crisis or sudden stops, the EFI could use the debt proceeds (or part of the yearly transfer from member states) to restore financial stability by lending to member states who have lost market access, under strict conditionality, or to supplement national deposit insurance or to directly recapitalise insolvent financial institutions. In this, the EFI would undertake some of the roles currently attributed to the ESM, which would cease to exist and would merge its procedures and activities in the EFI.

Once the outstanding stock of Stability Bonds is sufficiently large to be liquid, the EFI would manage it so as to avoid excessive debt accumulation. Thus, in normal times the transfers from member states would be used to retire the Stability Bonds that were issued during previous large recessions (or no new transfers would be collected, if the stock of outstanding debt is deemed appropriate).

This arrangement would have several benefits. The Eurozone would acquire a fiscal policy tool with which to stabilise aggregate demand or to grant emergency lending. Over time, the public debt composition in the Eurozone would also become more efficient. The Stability Bonds would be relatively safe, because they could be senior to national bonds, circulating in relatively small amounts, backed by a pool of revenues from several member states, and managed by a technical body less easily captured by domestic political uncertainties. They could be used by the ECB for quantitative easing and by domestic banks to diversify their portfolio, reducing the risk of the bank–sovereign 'doom loop' that was at work during the crisis. At the same time, national debts would become smaller in size (although only by a small amount). Finally, the stronger enforcement capacity of the EFI compared to current arrangements would

give more credibility to the goal of debt reduction in the highly indebted countries, and would more easily prevent new accumulation of national public debts (more on this below).

A natural question is how to ensure that the Stability Bonds enjoy a high rating and are a safe nominal asset. For instance, suppose that a member state defaulted on its obligations because it left the EU. In such extreme circumstances, the predetermined transfers by the remaining member states could be insufficient to service the Stability Bonds. Alternatively, major economic and financial shocks could have similar implications, or induce a funding crisis that prevents the Stability Bonds from being rolled over, even if no member states were in default.

There are at least two (not mutually exclusive) alternatives for addressing these issues. One possibility, proposed by Corsetti et al. (2016), is to make the Stability Bonds a joint liability of the EFI and of the ECB. In this way, they would be risk free because they would be redeemable in euros at maturity. The alternative is to give the EFI the authority to request exceptional transfers in excess of the predetermined amount, if this were motivated by exceptional debt service needs, and according to pre-specified procedures. This more open-ended commitment of resources to back Eurozone debt should be accompanied with a greater ability of the EFI to interfere with national budgetary policy, as described below. In choosing between these two alternatives, the trade-off is between central bank credibility and interference with national sovereignty.

Note however that the maximum amount of yearly national resources pledged by member states to back the Stability Bonds need not be large. Suppose that Stability Bonds amount to 20% of GDP, that they have a balanced maturity of 10 years, and that they earn a nominal interest rate of 4%. The debt service needs in each year (interest plus redemption) would be less than 3% of GDP. And the flow of interest payments, if debt were rolled over indefinitely, would be less than 1% of GDP.

Supervision of national debt policies

Besides managing the common fiscal policy, the EFI would also assume the role currently performed by the European Commission, together with the European Council, of enforcer of fiscal discipline in member states. With the stronger risk-sharing capabilities discussed above, moral hazard would be an even bigger concern than under current arrangements. Moreover, care must be taken to avoid the danger that Stability Bonds would pile up on unsustainable national debts, rather than leading to an overall debt reduction. Thus, in exchange for the enhanced risk-sharing capabilities, member states would have to accept more intrusive external interference in national fiscal policy.

Specifically, the EFI should also have authority to veto national budgets and impose specific targets for deficits or surpluses, as suggested by Sapir and Wolf (2015). This interference with national political decisions would have to be justified by exceptional circumstances, such as a country being in gross violation of the debt sustainability requirement. The main goal here is to insure adequate fiscal discipline in all member states, but it is also conceivable that the EFI could impose a more lax fiscal policy than approved at the national level, if a fiscal expansion is justified by a major Eurozone-wide recession.

Evolution

Over time, the EFI could evolve into a more accomplished fiscal union for the Eurozone. On the one hand, the fiscal union could evolve so as to fund a small set of European public goods such as border patrols, European infrastructures, a European defence system, or scientific research.

On the other hand, the revenue collection system could also evolve. Rather than relying on transfers from member states, the EFI could be given its own tax bases (or fractions of national tax bases, such as VAT) on which to levy its own tax rates. This could have symbolic and political benefits, but it would require some centralised tax collection or monitoring capacity to avoid moral hazard in the enforcement of tax collections. A true Eurozone tax would also entail the risk of excessive expansion of public spending at the Eurozone level, something to be avoided given the size of national government spending.

Concluding remarks

The arrangement described above entails two obvious political obstacles. First, countries have to give up sovereignty over a fraction of their tax revenues. It is important to stress, however, that the sacrifice needs not be large in terms of size of yearly revenue. Stability Bonds don't need to be a large fraction of aggregate GDP in order to insure adequate fiscal stabilisation or to provide risk-sharing during emergencies. What is essential is the long-term horizon – the pledge to transfer national revenue to the Eurozone should extend for a long period of time. A pledge over several decades can provide adequate backing, even if the yearly transfer is relatively small, provided that the arrangement is credible and lasting. In other words, setting up a fiscal union along these lines entails an important element of irreversibility. Without the expectation of irreversibility, the pledge would lack credibility and the arrangement would fail. But the expectation of irreversibility is at the core of the single currency, and it is meant to distinguish it from a fixed exchange rate regime.

The second political obstacle is that the benefits of this arrangement may not be perceived as symmetric. The weaker and highly indebted countries are more likely to lose market access, or to be involved in a sudden stop. The benefits of Stability Bonds are likely to be greater for them than for the stronger member states. On the other hand, the arrangement also entails a greater expected loss of sovereignty for the weaker or highly indebted member states, which are more likely to incur a veto by the EFI over their national budgets. In other words, there is an implicit exchange: in order to enjoy the potential benefits of this arrangements, the weaker member states have to accept a temporary loss of sovereignty if they don't meet the sustainability requirements established ex ante. This, of course, is a greater loss of sovereignty than that envisaged by ESM conditionality (which member states are always free to refuse). This makes the distribution of net benefits more symmetric across countries, and strengthens long-run sustainability. And of course, the benefit of a stronger and more viable monetary union accrues to all.

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5 Try again to complete the Banking Union!

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The 'normalisation' of the Eurozone's economy which followed the progressive stabilisation of financial markets has been slow. But the recovery has been steady, leading to a strong upturn in employment, and for three years the growth rate in the Eurozone has been close to that of the US, at least when measured in per capita terms. The sense of urgency to reform has thus abated. Can a new political impetus revive the fortunes of Eurozone reform?

The last two years, in particular, have also shown that the banking system is no longer close to collapse, but there is little sign that it has become resilient to future shocks. The new political environment created by a 'europhile' president in France should thus be used to take a second look at reforms that remain very important, even though they may no longer appear to be urgent.

Completing the Banking Union should thus be reconsidered. There is, almost, a general consensus that the one piece missing for a complete Banking Union is deposit insurance, which has remained a purely national responsibility until now (Rebooting Consensus Authors 2015). However, a common deposit insurance is not compatible with the current practice of banks holding very large amounts of the government debt of their own government. An insolvency of the sovereign would bankrupt the banks, with the costs to be borne by the entire Eurozone.

The problem is entirely political. A concrete proposal has been made by the Commission (European Commission 2015), but no progress could be made as no compromise could be reached. Germany insisted on the point that any mutualisation of risk via deposit insurance would have to proceed in line with the reduction of risk, i.e. limits

on the concentration of sovereign debt holdings. Italy has so far objected, because its government fears that its funding cost might skyrocket if Italian banks are no longer allowed to buy a large proportion of its debt, and maybe also because its banks depend on the profits from higher interest earnings of their large holdings of Italian public debt.

France has so far remained on the side lines in this dispute, although important French contributions to the debate have accepted the link between deposit insurance and limits on the concentration of sovereign debt holdings (Pisani-Ferry 2016). What is needed now is a renewed push by France in this direction, but it remains to be seen whether in this case an Italo-German agreement is needed much more than a Franco-German one.

Another element of the 'risk reduction' approach was supposed to be the full implementation of the EU Bank Resolution and Recovery Directive (BRRD). This should, in principle, significantly reduce the need for public funding for banks in difficulties since the BRRD requires that the Single Resolution Fund (SRF) can be used only if at least 8% of the liabilities (except equity) have been bailed-in beforehand. This would be a powerful instrument to reduce the risk that public funds will again be needed to bail out banks. Assuming full application of the bail-in rules, Willem Pieter de Groen and I show that the target size of the SRF (about €55 billion) should be sufficient to deal with a financial crisis even as severe as that experienced by the Eurozone over the last few years (De Groen and Gros 2015). Recent events in Italy, however, have shown that, in reality, governments remain extremely reluctant to allow a bail-in, mostly because of the political cost of inflicting losses on voters or other financial institutions that might hold the bail-inable capital (*Financial Times* 2016).

The high political cost of bailing in creditors of the banks, rather than taxpayers, is caused in the first instance by concentration risk. This can be illustrated with reference to a real example. Some banks in Italy had sold their customers large amounts of their own (often subordinated) bonds. A bail-in of subordinated bonds, which in principle should be bought only by investors who know the risk, would have wiped out the life savings of thousands of families. According to press reports, about €4.5 billion worth of bonds were held mainly by about 40,000 retail bondholders. This would imply an average holding of over €100.000. In many cases, this sum must have presented the bulk of the savings of the entire family. It is understandable that the government was

reluctant to force this relatively small group, which was concentrated in one region, to accept large losses.

By contrast, if these bonds had been dispersed over all of Italy in small amounts as part of millions of portfolios, maybe as a small part of investment funds, the losses would have been too small to notice for most. The key point was thus the concentration of risk.

The two issues – risk reduction (or rather risk diversification) and risk mutualisation – need to be tackled in tandem for economic and political reasons, but the required solutions are quite different in terms of their legal and institutional requirements. Diversification of sovereign debt holdings can be enforced by a low-level change in some obscure details of banking regulation (and maybe even by the ECB on its own), whereas a common deposit insurance requires the creation of a new institution.

Diversifying sovereign risk

The instability created by large holdings of sovereign debt by banks has been widely recognised (most recently in ESRB 2015). The problem is not how much government debt banks hold, but the concentration. In many countries, banks hold debt of their own sovereign equivalent to more than 200% of their capital. This means that any sovereign restructuring would bankrupt the banking system. Formal sovereign defaults are rare, but even a sharp increase in the risk premium, which would depress the market price of long-term debt, would put the banks in difficulty.

An example can illustrate the importance of this feedback mechanism: risk premia of 5 percentage points (as reached in Italy and Spain at the peak of the crisis) can reduce the market value of long-term government debt by almost 40%. Given that Italian banks held about 250% of their capital in Italian government debt, this kind of risk premium would wipe out their capital. It is true that banks are not required to mark their holdings of government debt to market. The official capital ratios were thus not affected by the risk premium. But in 2011/2, the market saw through the official balance sheets and marked down Italian, and peripheral, banks.

The situation of Italian and Spanish banks would have been quite different if they had held a diversified portfolio of Eurozone government debt. In this case, the fall in value of peripheral government debt would have been compensated by an increase in the value of core country debt (the price of German debt went up as capital fled back from the periphery). It would not have mattered whether the banks had held 250% of their capital or even more in government debt – with appropriate diversification, the high and variable risk premia during the Eurozone crisis would have had little differential impact on the solidity of banks in different countries.

The key problem is thus the concentration of sovereign risk on bank balance sheets, not how much government debt banks hold (see also ESRB 2015 and Gros 2013a). This problem is compounded by the large size of bank balance sheets in Europe (Advisory Scientific Committee 2014).

How could diversification be achieved? Banking regulation already embodies the general principle that banks should not be exposed to any one debtor by an amount greater than 1/4th of their capital. The purpose of this general rule is clear: the insolvency of any one debtor should not put the entire capital of the bank in jeopardy. Unfortunately, this rule is not applied to sovereigns. I (and others) have thus proposed simply to apply this general 'large exposure' rule to government debt as well (e.g. Gros 2013a). Banks would then be forced to hold a diversified portfolio of (Eurozone) government debt.

Action along these lines is thus needed. Until now, it has proven impossible get peripheral governments to agree on some diversification rules for bank holdings of government debt, because every government likes to have its own banks as captive customers for its own debt.

Governments in peripheral countries like to make the argument that imposing a diversification requirement would lead to such a sharp drop in demand for their bonds that they might no longer be able finance themselves. But these fears are likely to be exaggerated because a diversification requirement would not diminish the overall demand for sovereign bonds, only their regional concentration (De Groen 2015). Banks tend to hold government bonds because they are needed as collateral for certain operations (repos, for example) and in order to satisfy the regulations on liquid assets.

There is thus little danger that there would be no demand for Italian government bonds if a risk diversification requirement were to be introduced. What Italian banks would be forced to sell would be bought by German banks.

Another reason source of opposition to sovereign risk diversification is that banks in the periphery would lose the income they earn from holding the higher yielding bonds of their own government. This is important for the banks – even if the difference in interest rates between national government debt and the Eurozone average is only 1-2 percentage points, holdings of national government debt (instead of a diversified Eurozone portfolio) would mean a lower return on equity of between 2.5 and 5 percentage points when banks hold 250% of their equity in government bonds. Given that the return on equity is now in single digits for many banks, this represents an important loss for shareholders. But dealing with the second issue, deposit insurance, could provide a way to overcome this resistance.

Deposit insurance

A full banking union should not only encompass common supervision and a common restructuring mechanism, but also a common defence of retail deposits to prevent bank runs; this is the case in the US. In Gros and Schoenmaker (2012), my co-author and I argue that one should work backwards from the end game – when a bank is failing and depositors need to feel protected – to restructuring as a way to avoid outright failure and supervision to ensure that banks do not take undue risks. This implies that the US example, with the Federal Deposit Insurance Corporation (FDIC) which encompasses all three ‘pillars’, would be the best approach to follow.

However, the US experience does not necessarily imply that resolution and deposit insurance have always to be located in the same institution.

Bank resolution and deposit insurance are of quite a different nature, and the rationale for fully centralising deposit insurance is much weaker than for resolution. The purpose of bank resolution is to avoid a formal insolvency, with all the costs and contagion effects it might generate. Resolution thus aims to ensure continuity of those main functions of a bank that are deemed to be of systemic importance. Public funding is

needed only to the extent that no private-sector solution can be organised at short notice. The purpose of a resolution fund is to finance investment in a new bank (to be carved out of the failing one) – not to give money away. A well-run resolution fund should thus be profitable. By contrast, a deposit insurance fund can only make losses, as it is used when a bank has failed and the losses are so large that depositors cannot get their money back. In short, a resolution fund invests in the future, whereas a deposit insurance fund pays for losses from the past.

Several European banks have very large balances sheets, close to one year's worth of national output. Large banks active in several member states would represent a problem for any national resolution fund, but much less so for national deposit insurance funds because of a crucial difference between resolution and deposit guarantee. Deposit insurance is organised by country. Any national deposit guarantee scheme would only have to make good on the losses suffered by its own resident depositors (provided the retail operations are organised via subsidiaries, rather than via branches). By contrast, resolution funding is needed for the entire group. This is another reason why a single resolution fund is needed for large, internationally active banks, but not necessarily a single deposit insurance fund.

Moreover, the direct benefits of insuring depositors are quite local, as cross-border retail deposits remain a rarity. It thus makes sense to keep the costs local as well. All this implies that the argument for centralising deposit insurance is much weaker than for bank resolution.

The one public function that national deposit insurance funds are not well equipped to perform is that of maintaining the confidence of depositors when the entire banking system of a country is under stress. In a systemic banking crisis (systemic at the national level), the accumulated funds in the national deposit insurance scheme are likely to be insufficient. But the government of the country in question is likely to be under pressure as well, so the national fiscal backstop is likely to be weak when it is needed most.

This implies that what is needed to complete the Banking Union is a system to ensure the stability of national deposit insurance system, in other words, re-insurance (for large, systemic shocks at the national level).

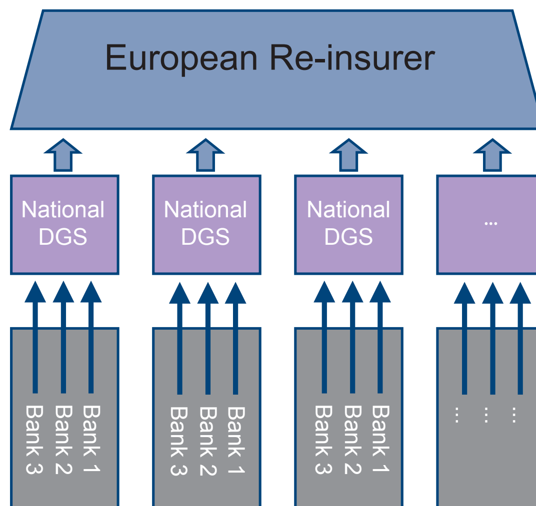
The Commission has proposed a variant of this re-insurance approach, but only as a transitional arrangement (European Commission 2015).

The re-insurance approach: A schematic presentation

Under the pure re-insurance approach, national deposit guarantee schemes would continue to function as before, but each would be forced to take out insurance coverage against large shocks. This (re-)insurance could be managed under the European Deposit Insurance System (EDIS), as it is called in the Commission's proposal. The funding for the re-insurance could come from a common fund (such as the Deposit Insurance Fund, or DIF, also proposed also by the Commission).

The funding for this common fund, in turn, would come from the national deposit guarantee schemes, which would have to transmit part of the fees they are levying on individual banks to the European level (i.e. the DIF). Schematically, there would thus be two tiers of deposit insurance: from the national deposit guarantee schemes in relationship to 'their' banks, and from the European re-insurer in relationship to the national deposit guarantee schemes.

Figure 1 The two-tier approach to deposit insurance: Re-insurance



This two-tier system would react differently to the failure of a small bank than to a systemic problem at the national level. This is illustrated in Figures 2 and 3.

Figure 2 The case of a single bank failure

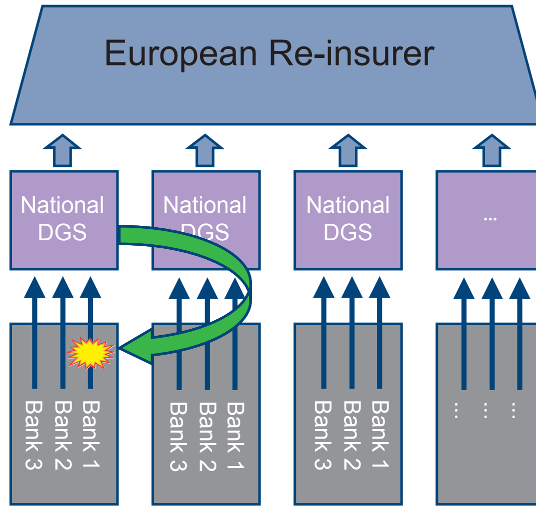
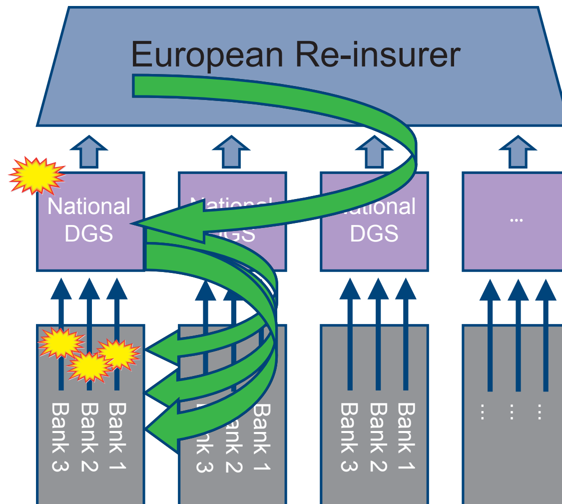
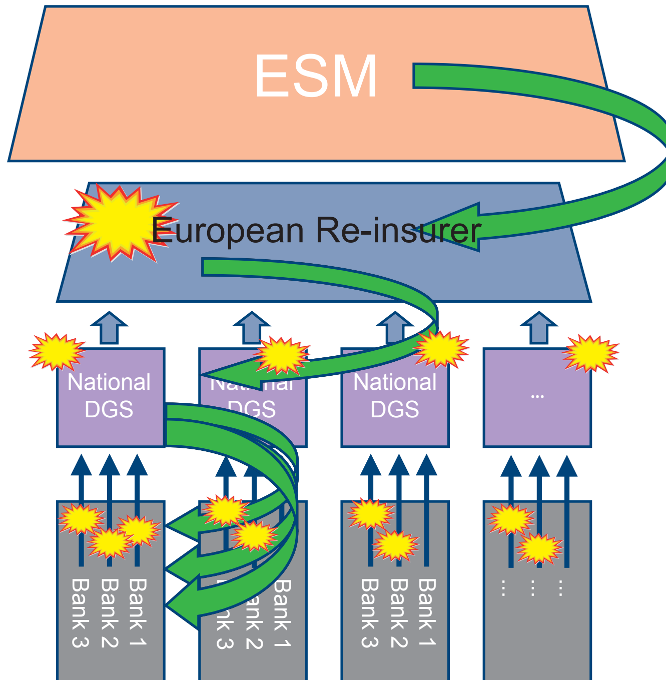


Figure 3 Systemic crisis at the national level



The European re-insurer (i.e. EDIS with its fund, the DIF) would thus intervene only if so many banks fail in any given country that the national deposit guarantee scheme is overwhelmed.[1]

Figure 4 The case of a Eurozone-wide systemic crisis and the need for a fiscal backstop



It is clear that the resources of any normal deposit insurance are always too small in the event of a systemic crisis. This also applies to the Eurozone as whole. If there is a systemic crisis at the Eurozone level (as opposed to a national crisis), any European

1 The one risk that cannot be properly priced and prevented is that of re-denomination, or rather exit from the euro. It is clear that no common deposit insurance could be asked to fully pay out €100,000 to all depositors in a country where the government has decided to re-introduce a national currency. The 'Grexit' problem cannot be solved either by fully centralised deposit insurance or via the re-insurance approach. The only solution one can imagine is that any country that leaves the euro will have to rely on its national deposit guarantee scheme, which could claim from EDIS and the DIF only the amount of premia it had paid in previously.

insurance scheme would need a fiscal backstop. This applies to the re-insurance approach as well as the case in which there is one single European deposit insurer. Figure 4 depicts schematically the case of a Eurozone-wide crisis, assuming that the European Stability Mechanism (ESM) would constitute the fiscal backstop.

The European re-insurer should thus be backstopped by the ESM. This would be a natural evolution of its role, since it was set up to backstop countries and can already now lend directly for banking resolution.

How to price and deal with systemic, macro risk

One key aspect of the re-insurance approach is that it is a macroeconomic function. Its main concern will not be the risk parameters of each individual bank in each country, but rather the systemic risk that arises from developments at the macroeconomic level (such as rising housing prices, increasing leverage in the corporate sector, etc.). In principle, this expertise is already available in the European Systemic Risk Board (ESRB). It would thus be important to find an institutional solution under which this expertise can be used to determine the re-insurance risk premia.

Pricing macroeconomic risk will always remain imperfect, but some risk pricing is better than none. In Gros (2015), I illustrate how one could introduce an element of 'experience rating' to minimise the scope for cross-country transfers if that were to prove politically needed.

Systemic crises are rare, but very costly, events. One thus needs to ensure they are as rare as possible, but also to create mechanisms to deal with them once they arrive.

The Eurozone already has procedures designed to prevent systemic problems in the form of the Macroeconomic Imbalances Procedure and the Stability and Growth Pact. These procedures are designed to induce member states to follow macroeconomic policies – such as fiscal policy, labour market policies, and so on – that reduce the probability of a large crisis.

However, crisis prevention can never by perfect. Should a crisis erupt, the ESM can intervene to mitigate the cost and prevent the spread of the crisis, and stabilise the

financial system of the Eurozone. This implies that, as assumed above, the ESM would be the natural body to provide back-up financing in the unlikely case that the crisis engulfs the entire Eurozone banking system.

Conclusions

Nation states are usually able to deal with small shocks themselves, but they need support when the shock is so large that access to the capital market is impaired (Gros 2014). In completing the Banking Union, one should heed the lessons from the economics of insurance and provide protection against large, systemic shocks. It follows that nation states could remain responsible for deposit insurance in case of the occasional individual bank failure, but a common fund is needed to provide support (re-insurance) when the shock is so large that it would overwhelm national resources.

A similar principle should be applied to banks – they should be able to survive the failure of any one of their debtors, including the failure of their own government. But this means that banks should not be allowed to lend more than a fraction of their capital to their own government.

Peripheral governments still resist mandatory diversification of sovereign risk for banks, but would like more risk-sharing through a common deposit insurance. Germany takes the opposite position. The package of sovereign risk diversification by banks and risk-sharing through re-insurance of deposit insurance could represent a political compromise that makes economic sense, since sovereign risk diversification by banks would lower the danger of systemic crisis caused by imprudent fiscal policy.

The key problem in breaking the deadlock between the core and the periphery is that the relative calm in financial markets has made establishing a common deposit insurance – or at least some form of re-insurance of national deposit guarantee schemes – appear a distant need. However, banks in the periphery fear an immediate loss of income. This suggests that a workable compromise could be the gradual introduction of both risk mutualisation and sovereign risk diversification on bank balance sheets. The new political environment created by the defeat of populists in France creates an opening to make progress on Banking Union on this basis.

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6 Europe's fiscal conundrum

Barry Eichengreen and Charles Wyplosz
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The tension between monetary policy and fiscal policy has been at the heart of the European construction ever since the Maastricht Treaty was negotiated in 1991-92. On the one hand, there is what might be called the 'assignment-problem view', that if monetary policy is assigned to price stability, then fiscal policy should be assigned to output and employment stability. If European member states commit to a single monetary policy, then they need the freedom to pursue fiscal policies tailored to national circumstances, even more so than otherwise. If the monetary hand is tied behind their back, then they need even greater freedom to use the fiscal hand, as this point is sometimes put.

On the other hand, there is what might be called the 'German view', that fiscal flexibility is dangerous – even more dangerous than usual in a monetary union. National fiscal policies must be restrained by rules at the level of the union. Actual policies must be monitored by supra-national officials capable of applying sanctions and levying fines against governments that violate these guidelines. These requirements must be further reinforced by a credible no-bailout rule. The rationale underlying this view is that national fiscal policies, when formulated and executed without their implications of the union as a whole, can destabilise the entire Eurozone. They are beggar-thy-neighbour. They put pressure on the ECB to inflate in order to prevent borrowing costs from rising for the profligate member. They jeopardise the stability of Europe's banking and financial system and engender doubts about the very integrity of the euro if the ECB hesitates to move in this direction.

The debate between adherents of these two views has been going on now for a quarter century. (Happy 25th anniversary.) But it could be better informed by experience accumulated in the course of that period.

We draw two key lessons from that experience. First, the cross-border spillovers from fiscal policy emphasised in the German view are smaller than commonly assumed. The direct effect of Greek fiscal policy on the German economy is vanishingly small. Indeed, the direct impact of German fiscal policy on the Greek economy is similarly minor. This is what theory suggests. A German fiscal expansion will positively affect economic activity in Greece insofar as more spending in Germany leads German households to suck up more Greek exports, including tourism. But that same fiscal expansion will negatively affect economic activity in Greece insofar as more spending in Germany drives up interest rates not just at home but also abroad. To a first approximation, the two effects cancel out. This theoretical finding is strongly supported by empirics. It is supported by the literature on international policy coordination, which finds that coordinating national policies so as to internalise cross-border spillovers yields only minor welfare gains (Oudiz and Sachs 1985). That fiscal spillovers within the Eurozone are second order has been documented by researchers at no less than the ECB (Attinasi et al. 2017).

The evidence is similarly inconsistent with the strong fiscal-dominance view that fiscal problems will inevitably lead the ECB to inflate. When Ireland ran into fiscal problems in 2008, the ECB instead sent the government a letter warning that in the absence of an officially approved adjustment programme, the central bank would curtail the country's access to central bank credit.[1] When fiscal problems deepened across Europe in 2011, the ECB raised interest rates (twice!) rather than lowering them. Large deficits and problem debts have not exactly produced an eruption of inflation.

The remaining concern is that fiscal policies in one member state can jeopardise financial stability not just at home but across the Eurozone. We return to this problem and its solution below.

The second lesson of experience is that the threat of sanctions and fines, and supra-national oversight of national fiscal policies more generally, will not work. The two of us anticipated this from the start. More precisely, before the start (Eichengreen and Wyplosz 1998). Fiscal policy is a valued national prerogative. Nothing is more delicate

1 See the ECB's "Irish Letters" at https://www.ecb.europa.eu/press/html/irish-letters.en.html.

than the national decision of who to tax, how to tax, and on what to spend the revenues. The idea that these decisions, or even significant influence over these decisions, could be turned over to technocrats in Brussels was always illusory, short of political union which, recent events remind us, is not in the cards.

The original deficit and debt ceilings of 3% and 60% in the Stability (now the Stability and Growth) Pact were always arbitrary. Arbitrary rules inevitably lack credibility. In an effort to regain credibility lost (or never attained), the initial list was expanded to include the structural fiscal deficit, the planned path of deficits, and public spending and income projections over a three-year horizon as submitted annually, among other measures. The Stability and Growth Pact has been supplemented by the European Semester, the Two Pack, the Six Pack, and any number of other Packs. These additional indicators make the process seem less arbitrary, but they also make it more opaque. It has become harder, not easier, for citizens of the member states to understand what they have signed up for.

No list of indicators, no matter how extensive, and no formal procedure, no matter how detailed, can change the fact that fiscal autonomy is an essential attribute of national sovereignty. Recent elections across Europe are a reminder that national sovereignty is something that European countries, euro or no euro, are not yet prepared to abandon. One can argue that cases like Greece, where countries are in deep crisis, constitute an exception. But then, by definition, Europe's fiscal rules have already failed.

One response would be to attempt to strengthen the rules still further. But recall Albert Einstein's definition of insanity: doing the same thing over and over again and expecting different results.

A more rational response would be to turn responsibility for fiscal policy back to national governments. Member states can pursue the fiscal policies they prefer. And they can be made to bear the consequences if those policies are irresponsible. Direct fiscal spillovers are small (viz. above). The inflationary implications are negligible: the ECB has already developed rules for distinguishing liquidity support, a valid function of a central bank, from monetary bailouts of insolvent sovereigns, something that is precluded by its statute. It already excludes countries with severe fiscal problems from operations like its Outright Monetary Transactions and the security purchases

associated with quantitative easing. If desired, these distinctions could be elaborated further in a revised ECB statute.

The role for the EU should be limited to two areas. First, the EU has a role in mandating the adoption of state-of-the-art fiscal institutions. The 2012 Treaty on Stability, Coordination and Convergence (TSCG) already requires member states to adopt high-level legislation – "if possible" in the constitution – and institutions dedicated to fiscal discipline. Unfortunately, the TSCG is vaguely worded, and its implementation varies widely across countries. We recommend amending it to require each country to include in its constitution a provision that obliges the government to balance its budget in the medium term – that is, over the business cycle. The German 'golden rule' is an example, but one can imagine minor variations on this theme.

The TSCG also requires member countries to establish an independent body to produce economic forecasts and evaluate the conformance of budget legislation with the statutory obligation. Here, too, implementation has been patchy and the fiscal councils in several countries lack the means and visibility to weigh on the budget process. Examples of better practice include the Swedish Fiscal Council and the Dutch Bureau for Economic Policy Analysis, and one can again think of additional variations on this theme. The European Court of Justice is also empowered to censor governments that violate their own fiscal stability obligations as inscribed in their constitutions, but under conditions that make it not credible.

Second, the EU, operating through the European Banking Authority and the Single Supervisor of the ECB, should eliminate the diabolic loop between sovereign debt markets and banking systems. The principal obstacle to repatriating fiscal policy to national governments is that fiscal problems could infect and destabilise the banking systems of not just the home country but also its neighbours, whether because banks are heavily invested in government bonds or because they lend to one another through the interbank market. Contagion from the bond market to the banking system and from one banking system to another remains a serious risk. This risk can be reduced by eliminating the fiction that government bonds are risk free and requiring banks to hold additional capital against them. It can be reduced by applying rules on portfolio concentrations to government bonds, just like other assets. It can be reduced by raising capital requirements more generally. To remove the risk of fiscal dominance, the ECB

should conduct its open-market operations not with national debt instruments, but with European instruments of the kind indicated below.

Bullet-proofing the banking system is a precondition for making Europe safe for fiscal autonomy. These measures will make bank lending more costly, to be sure. But this is not a bad thing if one believes, as we do, that Europe is overbanked.

We conclude with two open issues. One is where the responsibility for emergency fiscal assistance should be located. European officials have recently revived the idea of creating a full-fledged European Monetary Fund to provide conditional assistance to member states with deep fiscal problems (Brunsden and Kahn 2017). This is seen as freeing Europe from dependence on the IMF for finance, monitoring, and the design of conditionality, a dependence with has been problematic from the vantage point of European officials in cases like that of Greece. Our preference would be, to the contrary, to vest this responsibility with the IMF. Creating a European Monetary Fund would only politicise rescue packages, as the European governments that are shareholders in this entity jockey to advance their preferred national policies and approaches. Better would be to outsource this function to a global body in which European voices are only a minority of those represented.

Finally, there is the question of whether bullet-proofing Europe's banking system requires the creation of a European safe asset along the lines suggested by Brunnermeier et al (2011). A safe banking system needs a safe asset to hold as capital, both to inspire confidence among its creditors and to be transformed into liquidity as needed. If limits on portfolio concentrations prevent the banks from holding domestic government bonds, there then arises the question of what to hold instead. One answer is the government bonds of other European countries, or that subset of bonds with investment-grade ratings. But such bonds may be in short supply; there may not be enough German bunds to go around, in other words. There may then be an argument for an entity like the European Stability Mechanism to create additional safe assets by buying up sovereign bonds in exchange for newly issued securities of its own, where those new asset-backed securities are divided into a senior (safe) tranche and a junior (risky) tranche, the first of which can then be held by banks as capital.

Whether this kind of scheme can be made to work has been questioned (Minenna 2017). Our perspective suggests that it needs to be considered further.

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7 Restoring an effective fiscal stabilisation capacity for Eurozone countries

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As other challenges move centre stage – migration, Brexit, the threat of protectionism from across the Atlantic – there may be a temptation to think that the Eurozone no longer needs radical strengthening. It is true that the currency zone has survived despite a sequence of linked financial shocks on a scale well in excess of anything that had been envisaged when the system was being designed.

The Eurozone's recovery from the crisis has been much slower than that of other regions. The disappointing performance can be largely attributed to the undermining of the recovery by losses of market confidence and to the inability of over-indebted countries to employ countercyclical fiscal policy.

Furthermore, after the initial tendency in 2008-9 for each member state's government to protect national economies from external spillovers, there has been a considerable degree of cooperation and joint efforts to contain and correct the emerging imbalances. The EU-IMF programmes of support for five countries, involving the newly established European Stability Mechanism (ESM), displayed some willingness of member states to provide a degree of mutual support. The centralisation of bank supervision in the Single Supervisory Mechanism (SSM), the procedures for bank resolution, and the improved rules governing budget deficits are all moves in the right direction. The ECB's move to innovative and effective monetary accommodation has prevented a slide into deflation or a triple-dip recession.

It would be nice to be able to say that the euro has emerged stronger from the experience, but that it not yet the case. Instead, it has to be acknowledged that the years of the

Eurozone Crisis have left political and financial scars that do not promise well either for a sustained recovery or for resilience against future shocks. Government debt levels remain high, inhibiting the capacity for future national fiscal responses to downturns.

Above all, a corrosive distrust between debtor and creditor countries has persisted now for several years.

This is not merely a reflection of the poor outcome of the Greek programme or of the design missteps in the restructuring of Cypriot banks. Above all, it reflects a reluctance to put the financial heft of Europe as a whole behind the correction of macroeconomic downturns.

A long list of financial engineering solutions has been proposed, designed in one way or another to deploy more effectively the aggregate financial strength of the union in reducing the impact and duration of the crisis. Few of these solutions, beyond the establishment of the ESM as a kind of regional multiplier of IMF funds for conditional lending to member state governments, have gone beyond the drawing board of academic commentators, and those that have are still embryonic.

The problem lies in the fault-line of distrust between debtor and creditor countries, already present before the crisis but becoming deeper and wider during the crisis. It is no longer the only important line of demarcation in European policymaking, but it still inhibits progress in equipping the Eurozone for the next downturn. Each suggestion for innovation has been met in creditor countries with a suspicion that all innovations will be exploited to effect permanent wealth transfers to debtor countries. The dialogue is dominated by zero-sum calculations (even for schemes like the ESBIES safe bond scheme (Brunnermeier et al. 2011), despite that being explicitly designed to preclude risk mutualisation among the issuers).

Admittedly, some of the schemes that have been mentioned may indeed have been advanced by some with the covert intention of achieving such a transfer. But when it comes to issues of redistribution, it must be recognised that the divide between creditor and debtor countries is not at all the same as the divide between more and less prosperous parts of the union. Any regime of permanent transfers based on attempts to reduce inequality in the union should not be defined by reference to over-indebtedness or adverse macro-financial shocks.

Nevertheless, the Eurozone does need more in the way of what may be called 'financial engineering' to be able to cope with future macro-financial shocks. Some of what has been proposed and agreed in principle will help in specific circumstances, especially if there are large bank failures.

For example, the bank resolution fund, gradually growing and with a gradual increase in its mutualisation, could be useful in lubricating the resolution of complex banks. (Although many commentators wilfully ignore the agreement that this fund is not a first recourse to protect creditors of failing banks, but has specific limited uses to complement the bail-in rules of the Bank Recovery and Resolution Directive.)

Also offering some limited protection would be the Commission's proposal – currently stalled – for a common deposit insurance scheme. This would, for example, remove the risk of any recurrence of the Eurogroup's initial misguided proposal for bail-in in the case of the Cypriot banks.

The creditors' reluctance to move forward more quickly with either of these embryonic schemes reflects their perception that not all of the legacy issues in banking have been fully resolved, and that participation in such schemes implies accepting some burden of past policy failures. Over time, as legacy issues are finally dealt with, these schemes will likely come into fuller effect.

But these banking-specific schemes will not be enough. It is plausible to forecast, as in the pre-crisis decades, that most future macroeconomic crises will not be associated with widespread bank failure.

For this reason, there is much to be said for refocusing attention on the European mechanisms that could, and should, be in place to ensure that countercyclical fiscal tools can be used effectively to limit the depth of future downturns, including those affecting only parts of the Eurozone, and to speed the recovery.

And this is not just a hypothetical issue to be dealt with in the future. With the persistently growing current account balance of payments of the Eurozone, and with average (albeit falling) unemployment not much below double digits, it is clear that even at present, aggregate demand in the Eurozone is both insufficient and poorly distributed.

If the macroeconomic imbalance procedure were more effective, it would already have achieved a greater fiscal impulse in Germany and a lowering of its current account surplus, and this would be a step in the right direction. But it is not in Germany that insufficiency of aggregate demand is showing up in high unemployment. From the perspective of unemployment and underutilisation of economic potential generally, the shortage of aggregate demand is geographically elsewhere.

To emphasise the need for sufficient aggregate demand in speeding the recovery is not to deny the vital importance of structural reforms in underpinning a sustained return to prosperity in the stressed parts of the Eurozone. Nor can it be denied that lower debt ratios would help a lot. But to starve countries and regions of fiscal resources is unlikely to be an efficient or politically acceptable lever for delivering the needed reforms. Instead, macroeconomic policy should support reform efforts by sustaining sufficient levels of aggregate demand throughout the Eurozone during the recovery. Equipped with the tools for achieving this, the Eurozone would also be able to deal much more effectively with future downturns.

Some of the long list of debt mutualisation proposals which have been floated during the crisis could possibly have helped provide some room to allow otherwise heavily indebted national governments to engage in countercyclical demand management in a future downturn. But they were not specifically designed to address this lacuna in European countercyclical policy. Besides, as mentioned, all of these proposals were shot down from the creditor side, reflecting the lack of trust and specifically the fear that they would be used to engineer a long-term transfer from creditor to debtor.

While debt levels remain as high as they are, this gap in the policy toolkit is certain not only to result in deeper recessions than necessary, but also to hold back business confidence and investment, resulting in a perpetuation of the slow growth in the Eurozone that risks becoming endemic.

If a move to fiscal federalism is not on the cards, can some middle course be devised? This, I believe, should be the central thrust of a new political partnership at the heart of macroeconomic policymaking in Europe. It needs a tool that can allow the financial strength of the Eurozone as a whole to be expressed in ensuring an adequate countercyclical fiscal stance in each region of the currency union. For example, the

mechanisms of cross-border borrowing, already strengthened through the creation of the ESM, could be further developed to ensure that heavily indebted member states can have the necessary headroom without facing prohibitive borrowing costs in the financial markets.

There are various ways in which this could be engineered, including some versions of proposals that have already been advanced. For example, instead of simply relying on conventional debt instruments, an augmented ESM arrangement could use GDP-linked repayment contracts in a form of debt-to-equity swap. Such contracts could be designed both to retain the incentive for effective stabilisation policy and to minimise the impact of additional stabilisation-driven public borrowing on the cost of the country's access to market finance.

Indeed, I have long imagined that a carefully calibrated debt-to-equity swap of Greece's current official debt could represent a politically sustainable resolution of the ongoing charade concerning the question of debt relief. One of the obstacles to debt relief has been the reluctance of the government of other borrowing countries to grant Greece any special concession that they were not able to obtain for themselves. But of course, the contraction of Greece's economy from its peak is far deeper and prolonged than that experienced by any other country. A (non-linear) GDP-linked contract could be calibrated to represent an effective relief for Greece without it causing borrower's remorse in other adjusting countries.

Any step towards deeper fiscal cooperation in Europe will be resisted as a result of the creditor distrust that has blocked so many proposals to date. But if there is not sufficient cooperation, the macroeconomic outlook will be relatively bleak. The need for macroeconomic policy cooperation was recognised in the major initiatives taken in the midst of the crisis. Without the lending programmes of the ESM (with the IMF), the Eurozone would have fractured.

At present, the risks and challenges caused by heavy government indebtedness are being masked by the effectiveness of the very accommodating monetary policy stance of the ECB. But that stance is driven not by fiscal concerns but by the need to bring inflation back on track; it cannot be relied upon indefinitely.

There is no doubt that a major political initiative is needed to enrich the fiscal policy toolkit for dealing with demand deficiency in different regions of the Eurozone. The Commission has recently disappointed in the lack of ambition of its proposals in this field. Strong political guidance is needed to energise this agenda and ensure that the Eurozone does at last emerge from the crisis stronger, both in terms of economic structure and performance, and with an effective toolkit that deploys the collective financial strength of all to counter the transitory macroeconomic weakness of some.

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8 Jobs union

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After Monetary Union, Banking Union, and Capital Markets Union, what is still missing for the Eurozone to function well? Some suggest a Eurozone budget, others some form of debt mutualisation, and finally some argue for a European unemployment insurance scheme. These various ideas are highly relevant in substance but hardly acceptable to some member states. The German side fears that any form of mutual insurance, be it for debts or workers, would pave the way for moral hazard. Such a concern is not completely misplaced.

One possible way forward would be to link the fiscal union with a common agenda of structural reforms. After all, the European Resolution Fund for the banking sector came together with a complete reshuffling of bank surveillance and resolution; likewise, the emergency assistance supplied by the European Stability Mechanism is tightly linked to adjustment programmes that include some structural reforms on top of fiscal adjustment. Strikingly, though, structural reforms of labour markets are still conceived on a country-by-country basis, through the European semester process that ends in country-specific recommendations. This approach is sometimes counterproductive since it confines the European Commission to a role of sermoniser instead of being the conductor of a common future.

In practice, the fiscal union issue could be thought of within the broader framework of a jobs union – a union for jobs and career opportunities. This ambitious project could rely on three pillars.

The first pillar would occur in the form of labour market convergence between the countries of the Eurozone. It would of course not be about the harmonisation of the innumerable diverging characteristics of national labour markets. Rather, it would define criteria ensuring the effective functioning of national labour markets, such as

a limited use of precarious contracts, a minimal protection of workers, an efficient system of vocational training, a minimum wage, and so on. Any impetus for solidarity is doomed to fail as long as significant discrepancies remain between the performances of the different labour markets. However, a balance will have to be found in order to avoid both moral hazard (related to persistent structural divergence) and another intrusion of 'Brussels' into national affairs. A starting point could be the 20 principles of social rights proposed by the Commission on 26 April 2017. These are organised under three headings – equal opportunities (in particular education, training, assistance to job search), fair working conditions (including wage level), and social protection (including unemployment insurance) – but also cover other issues, such a gender balance or minimum income, that may not be directly relevant to a jobs union.

The second pillar would be a single European labour market: effective recognition of diplomas (possibly through a system of EU labelling), full and transparent portability of workers' rights (training, unemployment insurance, pensions), mobility aids, and modern tools to fight social fraud, for example in the area of displaced workers (Aussilloux et al. 2017). This second pillar would also include a European investment effort in initial and lifelong training, paying particular attention to the skills experiencing shortages across Europe.

Finally, the third pillar would be about solidarity. According to Cernat and Mustili (2017), the European Globalization Adjustment Fund (EGF) – which is supposed to support EU workers who have lost their jobs due to relocation – helped a total of 142,578 workers over the 2007-2016 period, representing a mere 0.05% of the EU workforce. The Fund has suffered from rather restrictive access conditions and from long approval procedures. Meanwhile, over 2007-2014, the European Social Fund (ESF), which has a broader scope, claims to have helped "almost 10 million Europeans to find a job" (i.e. 4% of the labour force), but with pre-allocated national envelopes. The EGF could be reshaped and renamed in order to support areas hit hard by unemployment, whatever the origin of this mass unemployment, through a swift process that would not need case-by-case approval by the European Parliament. Such a transformation would rely on a partial reallocation of ESF funds (which total €83 billion for the 2014-2020 period, compared with the €150 million maximum budget for the EGF over the same period) and would involve moving away from the national pre-allocation logic.

As a complement, a US-style unemployment scheme could be introduced, whereby a European worker would benefit from a temporary extension of her benefits when the national employment situation deteriorates significantly. The US system allows for a targeted income transfer to those who need it most – those who cannot borrow to maintain their level of consumption. This intervention is therefore both visible to individuals and effective in terms of macroeconomic stabilisation. As for moral hazard, it is limited by the fact that the federal level intervenes only temporarily, following a sharp rise in unemployment.

In the US, the states are in charge of unemployment insurance; eligibility criteria, replacement rates, and the duration of compensation all vary across states. The federal government intervenes only if unemployment increases sharply in a state, by co-financing a temporary extension of the duration of compensation. At the height of the crisis, this federal support amounted on average to 0.5% GDP for the states – a considerable 'macroeconomic' sum. The annual contribution amounts to 0.6% of the first $7,000 of each employee's annual wage, i.e. a maximum of $42 per worker. With a total of 145 million non-farm employees, and assuming that the cap of $42 is reached for all of them, the annual budget is around $6 billion, or 0.03% of US GDP. The federal scheme, which only intervenes in case of very bad weather, thus represents a very small budget – less than the ESF, whose cost is approximately 0.08% of EU GDP per year. It could be introduced in Europe as a dedicated fund based on automatic (or semi-automatic) rules, and managed by the European Stability Mechanism (or a subsidiary of it), which would only require an amendment of the inter-governmental ESM treaty.

This third pillar of the jobs union will unlikely be accepted by countries with low unemployment rates unless the first two pillars are effective. Otherwise, they will fear that more protection of workers would degenerate into permanent transfers to countries unable or unwilling to reform their labour markets.

A jobs union may seem overly ambitious. However, by setting long-term objectives (say, ten years) with stages and criteria, as the EU already knows how to proceed, it would actually help to get out of the rut. It would also be a concrete project, likely to change the lives of workers, as Erasmus has achieved for the students. In a services economy where skills and mobility are more important than ever, such a project would also contribute to restoring robust growth.

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This eBook identifies the main fault lines of the Eurozone and offers a set of coherent solutions to address them. It proposes a two-handed strategy: fix the Eurozone to make it more resilient; and, simultaneously, start a wide consultation on the future of Europe along a growth/protection agenda – one that hopefully is capable of making Europe 'popular' again. It is hoped that the two hands would reinforce each other. To make progress on the future of European integration, European leaders will need political space, and to not be distracted by emergency decisions related to a new crisis. Reciprocally, political momentum for a new, consistent integration strategy will help break the deadlocks that currently prevent technical decisions that need to be made for the Eurozone to become more resilient.

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