12 A new fiscal and monetary framework for the EMU? The EU presidents' roadmap in 2018

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In December 2012, almost in the midst of the euro crisis, Herman. Van Rompuy, in collaboration with three other presidents of the EU, traced out a roadmap "Towards a genuine Economic and Monetary Union" (Van Rompuy et al. 2012), which was then followed by the *Five Presidents' Report* in June 2015 (Juncker et al. 2015), and subsequently further discussed and developed by the European Commission (2017a, 2017b, 2017c). This chapter provides a short (personal) assessment of this roadmap, mostly based on the experience of these years and the research of the Horizon 2020 ADEMU project, which started with this aim in June 2015. It concludes with a proposal to strengthen the Economic and Fiscal Union (see Chapter 2 of this eBook).

According to the roadmap, Europe's *Economic and Monetary Union* is, and will continue to be, formed by three unions: the *Monetary Union*, the *Economic and Fiscal Union,* and the *Financial Union*. The Financial Union, in turn, encompasses the *Banking Union* and the *Capital Markets Union*. The pursuit of growth and stability, beyond what member countries can achieve on their own, is the *raison d'être* of the EMU. This defines a goal for each of the three unions: the pursuit of price stability, economic stability and financial stability, respectively.

The reason the EMU can do better than the sum of its parts is based on its potential capacity to i) avoid inefficient fragmentations (e.g. of currencies, economic regulations, and financial markets, respectively, for the unions; ii) endogenise externalities within the single market (e.g. competitive devaluations, fiscal dumping and social spillovers, and financial contagion, respectively); and iii) confront time-inconsistency problems.[1] The latter is especially relevant to our discussion.

EMU – originally a monetary union -- emerged not as the design of an 'optimal currency area', but to solve the time-inconsistency problem of monetary policy: the temptation to disrupt price stability *ex post* by generating inflation episodes (and competitive devaluations) (Chari et al. 2016, 2017). The Financial Union has its own time-inconsistency problems to confront: the temptation to bailout 'locally too big to fail' firms and banks, and to transform private liabilities into public liabilities (and also to avoid domestic sovereign debt problems becoming a burden on domestic private investors). Similarly, the Economic and Fiscal Union has a major time-inconsistency to confront: the temptation not to follow proper counter-cyclical policies in good times, and the inability to do so in bad times without incurring 'excessive' debts.

In fact, time-inconsistency problems also imply that it may not be easy to draw the lines between the three unions. In other words, even if a union policy might be more credible than a state policy, if it doesn't succeed in solving its time-inconsistency problems, these will spill over into the other unions. In particular, if the Financial Union does not break the link between private and public financial liabilities, the Fiscal and/or the Monetary Union will need to take care of them. Similarly, insufficient counter-cyclical fiscal policies can result in excessive debts becoming a burden to monetary stability (and in debt crises, if the monetary authority sticks to its mandate).

Furthermore, a time-inconsistency problem arises even within the fiscal union of a federal state. Political scientists refer to 'Hamilton's Paradox' (Rodden 2006),[2] according to which "the problem of federations may not be so much that the federal level is weak but that it is not credibly weak. Hence, it is taken for a free ride by lower-tier governments, forcing the federal government's hand to bail them out with central resources" (Schelkle 2016).

1 There are additional advantages, such as improving (or minimising the loss of) the competitive advantage of the EU in the global economy

2 See also Sargent (2012).

The list of concerns is not complete without accounting for some negative side effects which union may entail, such as: i) the major exposure of global shocks (financial, migration, etc.), ii) the minor capacity to react to local shocks (i.e. with a common currency and strict fiscal restrictions), and iii) exacerbating moral hazard problems (e.g. excessive borrowing or risk-taking, lessening the responsibility of national politicians).

In the original design of the Economic and Monetary Union there was almost no reference to the fiscal and financial unions, as if it were enough to set debt and deficit constraints (what became first the Maastricht euro entry conditions, and later the Stability and Growth Pact) and a 'no bailout of sovereign debts' clause in the Treaties to draw the dividing lines with 'the other unions' and not cross them. Possibly to make the euro politically feasible, the list of concerns was short.

The euro crisis has been a major 'stress test' for the EMU – internal European fault lines have been opened up by an external financial crisis, the lines across the EMU unions have been crossed, and the Economic and Fiscal Union has been shown to not be immune to Hamilton's Paradox. As mentioned above, the EU presidents' roadmap extended the EMU design to cover the three unions, and progress along the roadmap route has been made in recent years. Is it enough to avoid further undesired 'stress tests'? If not, would the completion of the roadmap be enough? Or, alternatively, are there reasons why the roadmap will not, or should not, even be completed? If so, how should we proceed? But before addressing these questions, it is helpful to note that the above strengths, or potential capacities, and problems – particularly of credibility – are also present in advanced federal states.

Not surprisingly, versions of the three EMU unions, with their institutions, also reflect the fiscal, monetary and financial frameworks of developed countries, such as the US. In fact, the more mature Monetary Union and the infant Financial Union share many similarities with similar unions elsewhere. The ECB, as the core institution of the Monetary Union, is an improved design of central bank independence, and it has succeeded during the recent crises not only in maintaining its mandate of price stability (actually, with periods below the target, which has not helped indebted countries), but also in allowing positive spillovers into the other two unions. It provided the Financial Union with much-needed liquidity in the euro area banking sector, and took on board the Single Supervisory Mechanism, while maintaining the dividing line with the

Monetary Union. It aided the Economic and Fiscal Union by defusing the euro debt crisis in the Summer of 2012, promising "whatever it takes" to save the euro, and it took on (selected) debts of 'stressed countries'. In sum, the ECB has emerged from the euro crisis as the strongest – and possibly most trusted – EMU institution.[3]

The Single Supervisory Mechanism (SSM), the (more idiosyncratic) Single Resolution Mechanism (SRM) and the planned European Deposit Insurance Scheme, together with Basel regulations, are complementary mechanisms and regulations aimed at balancing financial development and stability; their strengths and weaknesses are not qualitatively different from similar institutions and regulations in developed countries, except in their degree of (political) complexity and incompleteness.[4] For example, in contrast to the ECB, political accountability of the SRM is not exercised at 'arm's length' but rather 'hands on', in single bank resolutions over a weekend. Incompleteness means that the SRM is still short of guaranteeing the dividing line between private and public liabilities, or that a deposit in euros is worth the same no matter where the bank is within the EMU. According to the current version of the roadmap, this will not only require backup by the private banking sector but also the existence of a 'fiscal backstop', i.e. relying on the Economic and Fiscal Union! The Banking Union is still in its infancy (even more so is the Capital Markets Union, although it should require less institutional development) and, therefore, it is too early to say whether the limitations already detected will be overcome with experience or will become obstacles to fulfilling the Financial Union objectives.

However, it is the Economic and Fiscal Union which is remarkably different from its corresponding unions in advanced economies and federal states. The roadmap sets out some steps that would make it more similar, but even on completion of the roadmap, it would nevertheless remain very different (not that homogeneity with federal states such as the US should be the goal). The EU is not a federal state: "I am a citizen of the EU

3 Even Eurosceptic parties – such as Cinque Stelle and La Lega in Italy – have refrained from criticising the ECB when they have become winning political parties in a major euro area country.

4 See Chapter 8 in this eBook, and the ADEMU Working Papers referenced therein, for a more detailed assessment of the European Banking Union. In particular, note that the author's vindication of a 'narrow banking design' also applies to other developed nation banking systems (Rodriguez Mendizabal 2016).

because I am a citizen of an EU member country; similarly, I am a citizen of the euro area because I am a citizen of a euro area country". Beyond this fundamental difference, stressing the role of the states in the EU, there are differences that set the Economic and Fiscal Union apart – in particular, there are no EU (or euro area) taxes or debts, and the EU budget as a share of GDP is minimal (the euro area budget being nil), while in the member states it is not. Furthermore, there is no treasury or formal fiscal authority that coordinates, links, or simply 'talks with' the ECB, except for the 'informal' ECOFIN and euro area Council . The roadmap is supposed to take care of this lack of a formal fiscal authority, but does not contemplate substantial changes relating to the other differences.

The two key elements of the Economic and Fiscal Union are the Stability and Growth Pact (SGP), which together with the Fiscal Compact should guarantee that member states follow countercyclical fiscal policies in normal times by limiting their deficit and debt capacity, and the European Stability Mechanism (ESM), the first important step in the roadmap launched in 2012 as a crisis resolution mechanism for member states suffering crises threatening the stability of the euro area.

The SGP is complemented by two surveillance mechanisms under the lead of the European Commission. The first is the Macroeconomic Imbalance Procedure (MIP), established in 2011. This is aimed at detecting and preventing risks, implicit liabilities and macroeconomic imbalances, which can trigger the 'excessive imbalance procedure', with the European Council requiring a corrective action plan for any country that deviates from the MIP recommendations. The second is the European Semester (launched in 2011), where the European Commission provides periodic feedback and 'warnings' to EU member states regarding their SGP and other economic policies recommended by the Council. If there are persistent 'excessive economic imbalances', the semester can trigger financial 'sanctions' of up to 0.5% of GDP. In addition, following the roadmap, the independent advisory European Fiscal Board (EFB) was established in 2015 with the objective of providing external advice and assessments to the Commission regarding the evolution of the Economic and Fiscal Union, and cooperating with the national Independent Fiscal Councils.[5]

In sum, the main objective of the Economic and Fiscal Union – namely, economic stability – is in the hands of the member states (as stressed in European Commission 2017d). To confront the underlying time-inconsistency problem (i.e. not following proper counter-cyclical fiscal policies) and, in particular, to guarantee that the Stability and Growth Pact will be respected, there is an elaborate and detailed apparatus of surveillance, advice and possible sanctions. Supposedly, the Fiscal Compact should have played an enforcement role by giving the SGP constitutional status, as it has been done in a few countries (e.g. Spain) and, supposedly, the SGP should have improved since 2015 with its additional flexibility and its capacity to exercise pecuniary sanctions. In practice, sanctions – which must be imposed by the Council on one of its members – do not take place, and the complex surveillance system does not go much beyond providing information and advice, 'peer pressure', and a forum for policy coordination. All these elements are valuable, but do not amount to a credible mechanism to enforce stabilisation policies in the euro area. There are three elements that are worrisome:

- First and foremost, a mechanism to avoid time-inconsistency problems (i.e. not doing ex post what was agreed ex ante) typically has rewards and punishments ('carrots' and 'sticks') conditional on observed performance. The current SGP mechanism has no 'carrots' and cannot credibly use its 'sticks'.[6]
- By mixing the 'watch-dog' surveillance with a non-credible sanctioning mechanism, there is a danger that the information about countries' performance gets distorted or, even if it does not, that it loses value – in contrast, for example, with the information that could be produced by an independent institution (e.g. the EFB) with the same professional capacity.

5 See Beetsma and Debrun (2018) for an assessment of existing Independent Fiscal Councils and the role of the EFB.

6 European Commission (2017c) refers to a "European Investment Protection Scheme" and a "European Uneployment Reinsurance Scheme", together with loans from the ESM and grants from the EU budget, as instruments of a future 'Stabilisation Function". More details are needed to assess them, but they seem to be designed to 'fill in holes' (countercyclically, but in a fairly disperse – although EC-controlled – manner), rather than being a 'stabilisation carrot'.

- Conversely, while looking into a broad range of policies and economic indicators is good practice for an observatory of the economy, having the more political Commission doing it may backfire, since it may be perceived as excessive micro-advising, and as 'telling sovereign states what to do' on a broader set of policies. In other words, it can work as long as national governments can use the Commission's warnings as an excuse to apply necessary but unpopular policies (by blaming the Commission), but it may backfire otherwise.

Of a very different nature and effectiveness is the other main mechanism of the Economic and Fiscal Union, the European Stability Mechanism. While this has 'carrots' (financial assistance), they can only be used in the case of a severe crisis and under *ex ante* conditionality conditions (typically, agreement to a reform/austerity programme). This mechanism has worked and has played a major role in the euro crisis – in particular, providing financial assistance to Greece (ongoing), Cyprus, Portugal, Ireland, and Spain. For example, the ESM holds more than one third of Greece's sovereign debt, which has been transformed into long-term (over 30 years) debt. In fact, it has provided more generous and effective assistance to Greece than the IMF has (Corsetti *et al.* 2017). However, given that the ESM effectively now has long-term contracts with these countries, there are two aspects in which these contracts could be improved:

- *Make the loan contract counter-cyclical.* Spain received financial assistance to solve its banking crisis (in 2012-2013, it used €41.3 billion out of the €100 billion made available). In recent years, the country has been growing relatively fast and has started to repay its loan earlier than required, for which it had to ask permission (which was conceded) on seven occasions. An optimal long-term contract would not have simply conceded, it would have required a higher repayment in those years of higher growth. What will happen 30 years from now with the Greek debt?
- *Make the conditionality ex post, not ex ante.* A counter-cyclical debt contract is a stabilisation contract that effectively provides risk sharing, and should not result in permanent transfers. Properly designed, this contract dominates the existing unconditional long-term contracts, creating incentives for the borrowing country to always satisfy its payments and not default. Furthermore, it can also be designed to address moral hazard problems (i.e. to provide the right incentives to implement needed reforms). These ex post incentives are more effective than the current ex

ante conditional programmes, which tend to depress consumption.

In sum, even in its current design and limited scope (i.e. as a crisis resolution mechanism), by modifying the terms of its contracts the ESM can be a more effective stabilisation mechanism, enhancing its contribution to the Economic and Fiscal Union. Of course, it can also do much more…

The *Four Presidents' Report* (Van Rompuy 2012) called for *"[i]mproving the resilience of EMU through the creation of a shock-absorption function at the central level"* in Stage 3 (post-2014), and the *Five Presidents' Report* (Juncker et al. 2015) stressed:

> *"…all mature Monetary Unions have put in place a common macroeconomic stabilization function to better deal with shocks that cannot be managed at the national level alone",*

but added:

> *"This would be a natural development for the euro area in the longer term and under the conditions explained above, i.e. as the culmination of a process of convergence and further pooling of decision-making on national budgets."*

The idea that '"the EMU would bring convergence across the euro area countries and, in turn, convergence, will make the further development of EMU easier" is an old idea going back to original designs of the EMU. However, it is counterfactual; the euro crisis, for example, has shown a divided euro area, and 'mature monetary unions such as US have had very limited convergence. Furthermore, convergence is not a necessary condition to establish a well-functioning stabilisation mechanism (i.e. risk sharing) that does not generate persistent transfers across countries; nor is it necessary that there should be "further pooling of decision-making on national budgets". More importantly, setting these presidents' preconditions may effectively mean that the 'shock-absorption function' will be postponed *sine die*.

In contrast, the proposal to establish a European Stability Fund, presented and discussed in Chapter 2 of this eBook is an ambitious proposal based on 'constrained efficient mechanism design', allowing the Economic and Fiscal Union to satisfy its 'economic stability' function without generating persistent undesired transfers across countries; however, an important step for its development consists simply in extending the ESM contracts to risk-sharing contracts in normal times and improving their design as mentioned above (i.e. integrating the crisis resolution and risk-sharing functions in one fund with better contracts). Like the current ESM, the ESF does not require that all euro area countries participate at the outset, and it does not require them to suffer a severe crisis in order to participate.

It should be noted that there is a qualitative difference between managing an ESF contract – say, a share of a country's debt[7] – and the current 'surveillance with sanctions' SGP mechanism. First, the ESF contract itself is a counter-cyclical policy; second, it is in the interest of the ESF to properly design the contract and guarantee those conditional payments and transfers, which make the contract safe. Again, this is only one step ahead of the current ESM practice, and therefore there is no need to postpone it *sine die*.

As the ESM has been successfully used to confront specific banking crises, the ESF could also design contracts for specific markets, such as the labour market. As has been discussed in Chapter 3 of this eBook, substantial welfare improvements would be made possible by introducing a European Unemployment Insurance System (EUIS), possibly starting off with a subset of EU countries who could complement it. The underlying contract with a participating country has a simpler ex post conditionality structure (a fixed replacement rate applied to every eligible unemployed and fixed labour tax rate), but it is highly counter-cyclical, providing risk sharing since the country's EUIS contract should only break even in expected terms. From the perspective of optimal contract design there is room for improvement, however in this case a simple modification of the existing systems may be easier to get agreement upon, and to implement.

Last year, the European Commission "encourage[d] a discussion on the specific design of a 'stabilisation function'" (European Commission 2017c) and proposed several "options". The ESF proposal outlined above responds to this 'call for ideas'. More details are needed to assess the Commission proposal, but it is worth to, briefly and

7 As discussed in Chapter 2 of this eBook and in more detail in Abraham et al. (2018), and as is the case right now – for example with Greece – the ESF could manage only a fraction of a country's debt, but taking into account the country's overall indebtedness. Only in cases of extreme over-borrowing will this require debt restructuring as a pre-entry condition.

provisionally, compare it with the ESF. The Commission's "stabilisation function" is based on three "options": a "European Investment Protection Scheme", a "European Unemployment Reinsurance Scheme", and a "rainy day fund". In addition, the Commission also considers loans from the ESM and grants from the EU budget, with "a dedicated vehicle managed by the Commission [bringing] together different sources of funding at European level in an efficient way to provide the stabilisation function" and "[s]ubject to strict eligibility criteria, the Member State facing a large asymmetric shock would automatically be entitled to benefit from the assistance provided through the stabilisation function" (European Commission 2017d).

In this eBook we have already discussed a possible European Unemployment Insurance System (EUIS) in Chapter 3 and I just mentioned above that its EU fund component could be integrated in the ESF. Similarly, in Chapter 2 it has been argued that a 'rainy day fund' was nothing more than a very restricted version of the proposed ESF.[8] To foster growth and, in particular, to overcome existing socioeconomic divisions within the EU, European strategic investments can be a valid policy (i.e. the already existing European Fund for Strategic Investments, or EFSI), but the role of a "European Investment Protection Scheme" as a stabilisation policy is less clear. In particular, if the funds a country receives to continue its 'strategic investments' in times of crisis take the form of a loan, the ESF contract should take care of this, and more efficiently than with a non-contingent debt contract. Alternatively, if the funds take the form of grants or of EU investment transfers, then they should be considered part of other EU policies (EFSI, 'structural funds', 'R&D and innovation policy', etc.). Otherwise, they are likely to violate the principle that "the [stabilization] function should not lead to permanent transfers" (European Commission 2017c), or the principle that a country should have ownership of its own 'strategic investments', unless they are joint EU investments.

The main differences between the two proposals are that (*i*) the ESF is an integrated institutional and contractual proposal which embeds the current ESM, while the European Commissions' 'stabilisation function' is separated from the ESM and relies on a "dedicated vehicle", which coordinates the three "options", provides grants, loans

8 The Commission only mentions that the "rainy day fund could accumulate funds from Member States on a regular basis and disbursements would be triggered on a pre-defined basis" (European Commission 2017d).

with the support of the ESM, and so on;[9] (*ii*) the ESF does not require EU budget funding, while the EC's grants should come from the EU budget; and (*iii*) any EU country can subscribe an ESF contract (with its corresponding risk assessment), while the Commission's 'stabilisation function' has "strict eligibility criteria".

In summary, in spite of the euro crisis and Brexit – indeed, due in part to these events – important steps have been taken "[t]owards a genuine Economic and Monetary Union" since Van Rompuy, in collaboration with three other presidents of the EU, traced their roadmap for the EMU. Mostly based on the recent experience of the EMU and the ADEMU research, I have emphasised:

- First, the important role that properly addressing credibility problems has in the EMU design – this was already true in the establishment of the euro, but it is even more true in the overall EMU design, but it was not very explicit in the presidents' roadmap;
- Second, three aspects concerning the three unions that form EMU: 1) the key role of the ECB as the main institution, not only of the Monetary Union but of the Economic and Monetary Union; 2) the need to complete the Financial Union, basically 'according to the roadmap', although with some caveats regarding its complexity and incompleteness, and 3) the importance of properly addressing the 'economic stability' function of the Economic and Fiscal Union, and in particular, the opportunity to establish, from the current ESM, a second leading institution within the EMU for which the ADEMU project has provided a theoretical and quantitative foundation, namely, a European Stability Fund.

Furthermore, the ESF could also act as a fund for other EMU needs and policies. One – to be the 'backstop for the Single Resolution Mechanism' – is in the roadmap, another – to develop a European Unemployment Insurance System - is in the policy debate to which ADEMU research has also contributed.

9 The "dedicated vehicle" is even less defined than the 'unique legal entity' proposed by the European Commission as the legal institutional form of the ESM, transformed into a European Monetary Fund; see Chapter 10 in this eBook for a discussion of the latter.

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