DEEPENING THE EMU: HOW AND WHEN?

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2017 has seen Europe re-gain confidence both economically and politically. This favourable environment provides a window of opportunity for improving the resilience of the EU economy and tackling weaknesses in the euro area architecture, which requires completing the Banking and Capital Markets Union, making Eurozone fiscal rules more binding and creating a fiscal capacity. Monetary policy has supported growth but it cannot be a substitute for structural reforms, which are essential in many Member States to improve the business climate, raise potential output growth and reduce unemployment.

Despite some economic and institutional progress, the euro area still faces structural weaknesses and imbalances, which need to be addressed. A macroeconomic stabilisation and convergence function (or a limited fiscal capacity) without necessarily creating additional permanent transfers and without debt mutualisation could be envisaged in the euro area to better absorb the costs of internal adjustments of a Member State in case of an asymmetric shock and to support national structural reforms, provided that sufficient minimum economic convergence is achieved. In any case, developing ownership and incentivizing reforms remains a short run key priority.

1. Despite some economic and institutional progress, the euro area still faces structural weaknesses and imbalances, which must be addressed

1.1. A monetary union without a sufficient degree of economic convergence is not sustainable

In the EMU, monetary policy is centralized but important parts of economic policy remain national. EU monetary union's sustainability depends on the degree of macroeconomic convergence and consequently on national economic policies.

The introduction of the euro however was never intended to solve the structural problems faced by the different economies in the euro area. It was not conceived as a mechanism for equalizing diversified economic structures. Member States are liable for the increase of their potential output and the harnessing of their comparative advantages within the currency union. Balance of payments remain national. The Euro area is not a federal state. Countries can successfully function together in a Monetary Union even with different income levels as long as they avoid excessive macroeconomic imbalances. Given that external adjustments are no longer an option anymore, divergences in competitiveness can only be achieved through internal devaluation, structural reforms and adjustments to labor costs and real wages.

As the no-bail out clause forbids federal transfers at the EMU level, rules of sound governance and convergence were set up as an alternative to what exists in the US (i.e. fiscal capacity to cushion asymmetric shocks and a sovereign benchmark security which is sizeable enough to maintain cross-border flows in case of asymmetric shocks). Hence, the Maastricht Treaty and the Stability and Growth Pact focused on convergence criteria as a prerequisite to make the euro area viable.

1.2. Significant progress has been made since the crisis to make the euro area more resilient

Substantial progress has been made mostly because many national governments did their homework and adjust (e.g. Baltic countries, Spain & Ireland). Initiatives at the EU level were also taken to make the rules of convergence more binding (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union). They also monitor the competitiveness of Member States (Macroeconomic Imbalance Procedure) in order to deepen the Economic Pillar of the EMU.

Additionally, the EMU has been equipped with a crisis management tool (ESM). The ESM is in a certain sense an embryo of a Euro IMF. It provides financial assistance against conditionality. Progress on the integration of banking and financial markets have also been pushed forward politically with the implementation of the Banking Union (Single Supervisory Mechanism, Single Resolution Mechanism including a Single Resolution Fund) and the action plan of the Capital Market Union. The 'Investment Plan for Europe' (2015) has also

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proved useful in encouraging a sustainable increase in investment in Member States.

1.3. However, the convergence trends between Member States have proved partly illusory

The rules of the Stability and Growth Pact have not been enforced sufficiently vigorously:

- Although deficit ratios have declined overall, public debt ratios are very high in many euro area countries (France and Spain at around 100% of GDP, Italy at 133% of GDP and Greece at 179 % of GDP in 2016) and for some are still increasing. These countries may face rising sovereign spreads when accommodative monetary policy is reduced.
- Additionally, many euro-area countries face deep-rooted structural weaknesses and imbalances. For instance, a comparison between France and Germany shows major economic and fiscal discrepancies. In France, public expenditure is well above the average level of the Eurozone (56,2% of GDP in 2016 against 49% for the EU). The budget is in surplus in Germany but is in deficit in France (3,3% in GDP in 2016). There is full employment in Germany now while unemployment is still at 10% in France. In this context, French export performance has deteriorated over the past 15 years while in Germany, the current account surplus reached 8,7% of GDP in 2016. The too high level of public expenditure in France has led to excessive levels of taxes and social welfare contributions which has weakened the competitiveness of French enterprises. In the same vein, Italy urgently needs to balance efforts to reduce its debt with support for growth.

1.4. The symmetry of economic adjustments should also be a priority focus

Germany's considerable trade surpluss is not sustainable within a balanced monetary area. Within a monetary union, there must be a symmetrical adjustment mechanism to prevent long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. The design of EMU presupposed that market forces would provide for fairly rapid self-adjustment. This has not materialised.

The major differences in economic performance between the main euro area countries – for instance, budget and trade deficits in France, compared with budget and trade surpluses in Germany – are being compounded by the failure to to rebalance competitiveness between the surplus and deficit euro area Members. Once the deficit countries embark on the structural reforms needed to address their competitiveness gap (reducing public spending in relation to GDP, reforming the labour market, health systems, pensions, professional training, etc.), surplus countries would be expected to accept higher relative unit labour costs, be it through higher real wages, higher price increases or strong domestic infrastructural spending.

Thus Germany could embark, for instance, on a major infrastructure modernisation programme. Considering its low unemployment rate, such a programme could push up German wages and prices, reducing its surpluses. Such an effort would help adjust the competitiveness of the countries that are facing difficulties. The rollout of such an economic expansion programme would benefit Germany's key trading partners provided that their industrial base could cope with this increase in demand.

1.5. Persistent financial fragmentation is also a challenge

Capital flows between EU countries are far from pre-crisis levels. Moreover, cross-border banks operate in a fragmented European market and cross-border operations in the banking sector are still declining. There is in particular significant national discretion in implementing banking rules. Cross-border banks indeed face additional liquidity, capital requirements on their subsidiaries located in the euro area. Symptomatic is the treatment of additional capital charges for systemically important banks related to cross-border euro area exposures, which are still considered as international exposures from a regulatory perspective and which hinders cross border consolidation.

Regulatory reform should ensure that no difference of treatment should be made among the different creditors of a same group and that group support could be enforceable at European level given thus a solid base for group solidarity as the basis for consolidation. Indeed while supervisory decisions are taken at the European level, the consequences of potential bank failures are still predominantly national. National considerations therefore continue to affect supervisory decisions. Therefore more regulatory reform should move forward to secure the Eurozone's recognition as a single jurisdiction.

In addition, there is indeed not enough trust between Home and Host countries within the Euro-area due notably to the lack of effective convergence between the core countries of the Union and the important role of subsidiaries of cross-border banks in the financing of the economy of Host countries (see IV).

2. Lines of action currently proposed to deepen the EMU seem unrealistic as long as minimum economic convergence is not achieved

A comparison with the United States helps to understand the well-functioning of a Monetary & Economic Union.

4 COMPONENTS OF AN EMU	UNITED STATES	EUROZONE
RULES OF SOUND GOVERNANCE	✓ Adopted at the State level around 1840	✓ Not binding rules for all MS
STABILIZATION FUNCTION	✓ A flexible labor market and US federal budget including an unemployment scheme	X None
SAFE ASSET	✓ Federal debt since the 30s	X No EMU-wide safe asset
INTEGRATED BANKING & FINANCIAL MARKETS	✓ Effective single financial market: unique security rights, FDIC with backstop (Treasury support), GSEs....)	On going process (SSM, SRB, SRF) but no agreement on EDIS

- First, the United States benefits from rules of sound governance that have been adopted at a state level. Indeed, American states adopted balanced budget rules of varying strength during the nineteenth century after some of them went bankrupt. These rules limit debt accumulation and are equivalent to the Maastricht criteria in certain respects as their aim is to make sure that each participating nation shares solid-rock economic fundamentals and is labelled as safe when issuing sovereign debt.
- Secondly, the American States benefit from a flexible labour market and a macroeconomic stabilization function, i.e. federal budget including automatic stabilizers such as the US federal unemployment scheme (New Deal and World War II). In the Euro zone, this function and a flexible labour market do not exist.
- Third, the federal budget also fulfills its stabilizing objective through another powerful channel. It provides a large supply of liquid bonds labelled as 'safe'. This in turn enhances a sustainable form of financial integration which fuels convergence and helps to cushion economic shocks well. In the EMU, states, which comply with the rules of the Stability and Growth Pact, are supposed to be equally safe but there is neither a mutualization of sovereign debt underwriting nor a significant federal budget as in the United States

The rationale of deepening the Eurozone: enshrining a credible convergence process

Overall, there are 3 lines of policy actions to build a credible process of convergence by implementing the rules more vigorously; smoothing internal adjustments of Member States with a stabilization function; and further breaking the sovereign-bank loop and restoring cross-border capital flows with the creation of an EU safe asset.

These three lines of actions are as follows:

- Reinforcing the fiscal and economic rules in order to make them more binding. The objective is much more effective enforcement of the existing fiscal rules.
- A macroeconomic stabilization function to better absorb the costs of internal adjustments of a Member State by protecting either public investment or social welfare and amenities in case of an asymmetric shock.
- A sovereign risk sharing mechanism (EU safe asset) to further break the sovereign-bank loop and in order to restore cross-border capital flows.

Strict compliance to the existing fiscal & competitiveness rules seems to be a pre-requisite to achieve a potential agreement on these proposals. Indeed, both a fiscal capacity and a sovereign risk sharing mechanism involve mutual liability, which, in a decentralized Economic Union, can create wrong incentives.

More precisely, there is a risk that mutualizing liability will increase euro-area incentive to run up debt instead of strictly complying with the existing rules. Hence, either a macroeconomic stabilization function or a sovereign risk sharing mechanism would have to be combined with more binding rules and lasting compliance with the rules before their implementation.

2.1. Achieving much stronger enforcement of the economic & fiscal rules

- *The rationale*

Only domestic structural reforms can solve structural weaknesses in Member States, raise output and productivity growth and reduce competitiveness problems and the recourse to debt.

Regarding this line of action, many changes have already been brought into the framework - Two Pack, Six Pack, European Semester, Macroeconomic Imbalance Procedure (MIP) - but there are still big economic and fiscal discrepancies among the Member States and the competitiveness gaps remain wide, despite painful post-crisis adjustments in some countries (see 1.3). These revisions added complexity, making them harder to understand and more difficult to communicate and considerable more room for discretion has been opened up.

In addition, the implementation of the Country Specific Recommendations, for instance, remains weak. In fact, only 2% of the MIP-related 2016 Country Specific Recommendations have been fully implemented, the worst performance in MIP history[1].

- *Features:*

The European dimension can reinforce national efforts to comply with existing rules. Structural reforms should be coordinated at the EU level notably because a number of aspects of these measures have cross-border effects. Incentivising compliance with existing rules could be done for instance with a mutually agreed contract, the costs of enforcement of which would be smoothed by financial support. According to this line of action, a federal fiscal incentive would be provided to countries that really embark on credible structural reforms: more fiscal transfers with conditionality would be the idea.

In this line, a relevant proposal is the introduction of a 'Convergence and Competitiveness instrument' supported by the Commission in 2013. It consists in a mutually-agreed contract, the costs of enforcement of which are smoothed by financial support. It could require the creation of a 'Rainy Day Fund'[2], either based on dedicated contributions (based on a Gross National Income-key) or on the proceeds of specific financial resources (Corporate Tax, VAT). One key benefit of such a proposal would be to foster the national ownership of reforms and break a political stalemate, i.e. when reforms involve near-term costs.

- *Feasibility*

This approach could be achievable in the short-to medium-term, as it would not necessarily require changes in the EU Treaties. It requires leadership and to take into account the limitations on further sovereignty sharing within the existing legal framework.

2.2. A macroeconomic stabilization function

A second way to deepen the EMU is to set up a macroeconomic stabilization function in the Eurozone to absorb asymmetric economic shocks across euro area countries without necessarily creating additional permanent transfers[3] and without debt mutualisation. There are two approaches:

Option 1

A macroeconomic stabilisation function (or a limited fiscal capacity) without creating additional permanent transfers and without debt mutualisation could be envisaged in order to better absorb the costs of internal adjustments of a Member State in case of an asymmetric shock. The central fiscal function would be designed to temporarily cushion economic fluctuations, and not to persistently transfer resources for re-distribution. It would not aim to correct structural differences among Member States, such as competitiveness or specialization gaps.

This project was first acknowledged as a possible way forward in the 'Four Presidents' Report' published in 2014. Its role would be to provide enhanced risk sharing without creating permanent transfers or debt mutualisation.

- *Features*

Different institutional set-ups have been envisaged for such macroeconomic stabilization function:

- First, the simplest way of arranging temporary transfers would be through a 'Rainy Day Fund'[4]. Such fund would collect revenues from Member States at all times and make transfers to countries when they experience negative shocks. Disbursements could be either triggered on a discretionary basis or on the basis of indicators of the position of the Member States in the business cycle. With a dedicated flow of revenues, the fund might even be able to borrow at low cost to smooth the impact of downturns throughout the union. It would not involve any devolution of spending responsibilities to the center and would provide ex-ante support, namely before the shock turns into a funding crisis.
- Another option would be to set up a Euro-wide unemployment insurance scheme[5]. This supplementary mechanism should be used to finance cyclical (and not structural) unemployment insurance expenses related to exceptional economic scocks, when the national unemployment rates exceed a threshold[6].

  This common basic benefit scheme could, for example, provides those who have been out of work for up to one year (the most cyclical component of unemployment) with benefits worth 50% of their previous wage. Financing for the scheme could be levied on a harmonized tax base, such as the total wage

bill. To reduce the risk of moral hazard and incentives to reduce structural unemployment, the initial Member States' contributions could be individualized and updated periodically on past trends. In the interval between two updates, joint debt issuance to cover the potential cash requirements of the common scheme would enhance stabilization capacity. The basic benefit scheme could be topped up by a national benefit in accordance with the preferences of each Member State.

The size of this fiscal capacity that can absorb asymmetric shocks would not overburden Member States' public finances, as 1-2% euro area GDP would constitute a sufficient buffer that could be accumulated over a number of years[7].

It has also recently been proposed that this stabilization and convergence function must be coupled with a stronger enforcement of fiscal rules to make sure public finances remain sustainable[8].

- Limits and Feasibility

The implementation could be achievable in the short- to medium-term, as it would not necessarily require changes in the EU Treaties. The framework should be such that moral hazard and free-riding behaviour should be avoided making the proposal broadly acceptable by all parties.

An agreement on a Rainy Day Fund or on a Euro-wide unemployment insurance scheme shoud "only"require the achievement of some minimal economic convergence among core countries of the EU in order to restore trust between Member States.

Option 2

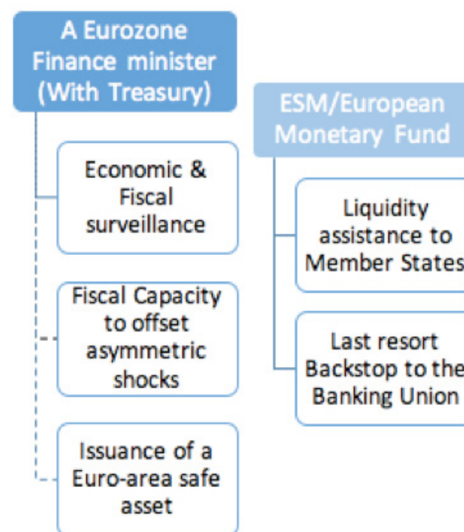
Some propose a more ambitious option: sharing fiscal sovereignty with the appointment of a European finance minister empowered with a common budget. This Minister would chair the Eurogroup and could also chair the Economic and Financial Affairs Council (ECOFIN) according to the ideas of the EU Commission[9]. With the support of a Eurozone Treasury, he would coordinate national fiscal policies and would be empowered with a common budget. Such developments would require a change to EU treaties and abandonment of a certain degree of fiscal sovereignty.

- Rationale

The rationale is to pool some risks while sharing more economic sovereignty. In this vein, the 'finance minister of the Eurozone' could be empowered with a common budget in particular to absorb regional shocks or even offset negative effects of reforms (see (3)). He could also coordinate the issuance of a common safe asset (see (2.3.). A complementary option would be to place the European Stability Mechanism under the supervision of the 'Finance Minister'.

- Features

Such a budget would necessarily entail changes in governance. A 'finance minister' would be in charge of the budget and be accountable to a Eurozone Parliament.



The budget could finance ongoing public investment expenditure and be channeled to projects offering the best socioeconomic return, with a particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training). It would therefore prevent cuts in public investments during times of crisis and improve macroeconomic stability. If chiefly aimed to catching-up countries, it could also kick-start lasting economic convergence in the euro area.

Financing for the euro zone budget could come either from the euro zone bailout fund, the wider EU budget, or from separate sources like each country contributing a share of its GDP or tax income based on 2 common consolidated tax bases (VAT and corporate tax), or from direct borrowing on the market. In case the budget is financed by a fixed percentage of a common consolidated tax base, shaving these tax rates would help to shore up the economy in a recession.

- Limits and feasibility

Such developments would require a change to the EU treaties or a new intergovernmental treaty and abandonment of a degree of fiscal sovereignty. With more decisions taken at the euro area level, it will also be essential to ensure greater parliamentary oversight of common economic, social and financial instruments and policies.

A political agreement on such mechanism seems unlikely if the economic and fiscal fundamentals are not strong enough to avoid the risk of disproportionate

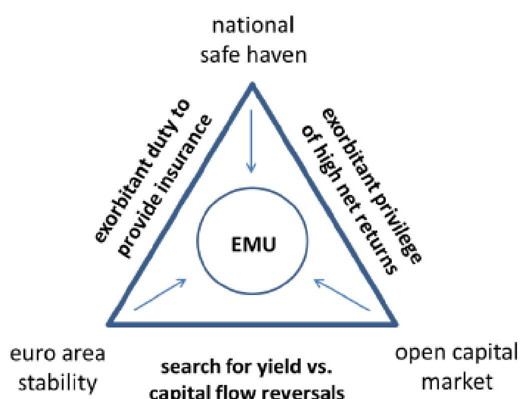
support. Strict and lasting compliance with fiscal solvency, disciplined by effective and applied sanctions, is a prerequisite to progress towards a transfer union in the Eurozone. Additionally, major structural differences (e.g. social security systems and labor market regulations) between Member States are currently a major obstacle for the creation of such a stabilization function.

2.3. A sovereign risk sharing mechanism ('European Safe Assets')

- *The rationale*

Creating a common European "safe asset" would enhance the resilience of the euro area economy and promote financial integration. It would facilitate cross-border risk sharing and create a uniform benchmark risk-free rate for other assets. It could also help avoiding cross-border flights to safety. This could be a European fixed-income instrument with ample liquidity, comparable to that of the U.S. Treasury market.

The four presidents' report mentionned the need for a EU safe sovereign asset. This assessment is based on the idea that keeping a national safe asset is incompatible with having free capital mobility and maintaining economic & financial stability. This threefold tradeoff is summed up in the so-called 'Safety trilemma'.



Source: Ad Van Riet, "Addressing the safety trilemma: a safe sovereign asset for the Eurozone", Working paper of the ESRB (Feb 2017)

According to the supporters of this approach, a monetary union such as the Eurozone with free capital mobility and a national 'safe haven' asset will see investors from a safe country searching for a higher yield across the risky member countries in quiet times while they will quickly return to the safety of their home country when it appears that negative risks could materialize. The sharp reversal of capital flows triggered by a major shift in market sentiment back to safe countries each time could cause financial fragmentation along national lines and destabilize the monetary union, as seen during the 2011-2012 crisis. In the same vein, a comparison with the United States also support the supply of an area-wide safe asset on par with US Treasuries. This trilemma can be solved in 2 ways:

Option 1: Make national debt equally safe. This requires a strong commitment of all participating countries to honor their debt and fiscal obligations. This solution is equivalent to strict compliance with the rules of sound fiscal policy (see (1)).

Option 2: Introduce a supranational sovereign benchmark security. A European safe asset, sizeable enough to become the benchmark for European financial markets, which could create numerous benefits for financial markets and the European economy. In particular, it would help diversify the assets held by banks, and help to address the interconnection between banks and sovereigns. To some extent,however, this option is even less likely to be feasible before a sustainable trend of convergence is observed.

- *Features and limits*

In recent years, several proposals of 'safe assets' have been put forward with different design features – ranging from full to partial common issuance, some based on mutualization and others entailing no joint liabilities. There are 2 approaches to the provision of a European safe asset:

No mutualization:

Sovereign bond-backed securities (SBBS) would avoid mutualisation of liabilities among euro area Member States. The SBBS would entail issuing senior and junior claims on a pooled portfolio of euro area sovereign bonds, where the senior bond could take on the role of a common euro area-wide safe asset.

A proposal investigated by the European Systemic Risk Board (ESRB)[10] is the creation of 'Sovereign bond-backed securities' that does not entail joint liability among sovereigns. A special vehicle (either private or public) would finance a diversified portfolio of governments bonds with senior and junior claims on that portfolio. Sovereign bond-backed securities (SBSs) would be issued in tranches, with junior tranche first in line to take any losses that might arise in the event of sovereign default.

: Balance sheet of a special vehicle issuing SBS

Assets	Liabilities
Diversified portfolio of sovereign bonds	Senior SBS
	Junior SBS

With an appropriate tranching point, senior SBBs (or 'European Safe Bonds' (ESBies)) would constitute liquid and low-risk assets with a senior claim on government bonds across Europe. In short, a Euro-area sovereign safe asset would act like federal Treasuries — but without common issuance by a joint Treasury. They would offer a way to strengthen Europe's economic and monetary union, while respecting its existing laws and treaties. Governments would indeed remain responsible for servicing their own debt instruments, which would be issued at market prices.

- *Limits*

SBSs would allow banks, insurers and other investors to diversify their government bond portfolios but it is arguable whether transaction costs would not be prohibitive for some countries' banks who should benefit from the proposal. Moreover, it would not mitigate the differences in sovereign risk default and banks in the stronger performing countries (e.g. Germany, Netherlands, Finland) who are not likely to change their risk sentiment and accept risk sharing mechanisms with other Eurozone countries as long as fiscal consolidation, convergence and structural reforms had not taken place in all parts of the Eurozone.

More generally, the limits of such a proposal are the followings:

First, currently German sovereigns bonds are the benchmark regarding liquidity and safety and replacing this benchmark sets a very ambitious target for SBBS. As SBBS will unlikely be perceived as having a better credit quality compared to German sovereign bonds, they would need to be significantly more liquid to be seen as the European "safe asset" by investors. Potentially lower issuance volumes compared to the most liquid markets and spliting into several tranches makes a high level of liquidity difficult to attain.

SBBS would require a common politically backed initiative of euro area countries. Generating a sizeable market for SBBS requires a strong longer-term commitment to issue this instrument, coordination among countries in generating the underlying bonds and harmonization of conditions to create a homogeneous product. Otherwise, it is difficult to see that SBBS could overcome the ramp up problem of competing with bunds. For a functioning liquid bond market, it is also important to build the related futures' market.

As part of the political initiative, a dedicated regulatory treatment would need to be devised for SBBS to make them comparable to government bonds and attractive for banks, pension funds, insurance companies and other investors. SBBS would otherwise be treated as securitised products in the current framework, which imposes a higher regulatory cost in many cases compared to government bonds.

However, since SBBS issuers would buy sovereign bonds, their introduction might reduce the depth and liquidity in national bond markets. Should investors prefer SBBS versus domestic sovereign bonds, this might further impact the demand on the remaining traded sovereign debt, causing increased liquidity risks and funding costs. This is a high price to pay for some sovereigns and is therefore an impediment to a joint political initiative.

Second, since national sovereign bonds and SBBS would coexist, there are doubts whether SBBS can address flight to safety issues and help stabilise the Eurozone in stressed times. The dynamics of flight to safety would only be transformed to some extent, depending on what share of sovereign debt would be financed by means of SBBS. The SBBS cannot prevent destabilizing flows from more risky to safer sovereigns as long as national bond markets co-exist. In an environment of flight to safety, investors might prefer the senior SBBS tranche, but in case of bigger or systemic shock, even the senior tranche could come under pressure.

This problem would be exacerbated for the junior tranche. The SBBS issuer would have difficulties finding investors for the junior tranche in times of stress, increasing the required yield. This would drive up financing costs and limit overall issuance including that of safe tranches. The issuer of sovereign-backed securities would therefore not be able to support the stressed sovereign by increasing demand in bad times. This would reduce the depth of national debt markets and the high risk of the junior tranche even further.

Third, technical aspects regarding the liquidity management of the issuing vehicle need to be discussed in more detail. Cash flow mismatches between the SBBS and the portfolio of sovereign bonds backing them create costs and liquidity risks, which must be managed.

In sum, at the time when it is most needed, issuance of the safe asset would be reduced. In contrast, an example of a safe asset that does exactly the opposite are ESM and EFSF bonds, which are safe bonds, issued in bad times to support a risky sovereign that needs to issue more than markets can take.

<u>Partial joint debt issuance</u>:

Other proposals for union-wide safe assets engender some form of joint liability, rendering them susceptible to political problems and incentive issues. In contrast to the previous option (SBSs), an important benefit would be for Member States to share the safety premium of risk-free sovereign bonds for part or all their debt.

- 'Eurobills[11]': The Eurobill proposal envisages a permanent common issuance of short term notes by a euro area Debt Management Office (DMO). Member States would give up their right to issue short term debt. The Euro-area DMO would conduct auctions to satisfy the needs of all Eurozone countries, subject

to the constraint that no country can have more than 10% of its GDP in Eurobills outstanding at any point in time. Additionally, participation in Eurobills emissions would be conditional on satisfying criteria of economic governance and budgetary discipline.

- 'Blue debt/red debt[12]': According to the Blue bond proposal, sovereign debt in euro area countries would be split into two parts. The first part, the senior tranche (or 'Blue debt') of the amount of public debt up to 60% of GDP, would be pooled among participating countries and jointly and severally guaranteed. The 60% GDP limit would be a safeguard to guarantee the quality (AAA) of the Blue Bond.
- The second part, the junior tranche (or 'Red debt'), would keep public debt in excess of 60% of GDP a purely national responsibility. The annual allocation of Blue bonds would be proposed by an independent stability council staffed by members who would enjoy a similar degree of professional independence to the board members of the European Central Bank (ECB). This allocation would then be voted on by the national parliaments of participating countries, having the ultimate budgetary authority required to issue the Blue bond mutual guarantees. Entry to the system would be conditional upon enhanced fiscal credibility.
- Debt Redemption Fund[13,14]': The Debt Redemption Fund would allow Member States to offload a certain portion of its public debt (debt exceeding 60% of GDP for instance). The fund would issue bonds above a maturity of 2 years so that national debt can be rolled over into medium-to long-term euro area debt. It would receive earmarked revenues from Member States to repay their European debt. Once the repayment has been accomplished, the Fund would expire. Its two years maturity bonds would still be, for a while, a Euro-area safe asset.
- 'Eurobonds[15]': The most 'extreme' option is to fully mutualize the underwriting of sovereign debt.

- *Limits of joint debt issuance:*

As the EU Commission pointed out in its paper[16], this "raises a number of legal, political and institutional questions that would need to be explored in greater detail".

More importantly, the stronger performing countries (e.g. Germany, Netherlands, Finland) are not likely to absorb higher borrowing costs because of states who do not meet their fiscal liabilities among the other euro-area member states. Members of the Monetary Union will never accept financing current public deficits generated in other euro area Members that do not follow the rules. Mutualizing part of sovereign risk requires fiscal solvency and compliance with the fiscal rules in the first place. Indeed, sharing sovereign risk doesn't eliminate the different sovereign risks. Virtuous countries are not likely to accept either higher borrowing costs or riskier sovereign bonds in their bank's balance sheet. Therefore, an agreement at the EU level seems difficult to achieve as long as core countries (e.g. France, Italy, Spain) do not meet their liabilities to the other euro-area Member States. The mutualization of public liabilities requires a relationship of trust among Member States, based on a much stronger fiscal framework.

It is also important to point out that legally, the mutualization of debt through joint & several guarantees requires an EU Treaty change and changes in Member States constitutions.

3. Developing ownership and incentivizing reforms is a short run key priority

Respect for the fiscal rules remains a key challenge in some Member States:

So far, there is a lack of consensus concerning the EU rules which has resulted in increasing complexity. Decision makers too often forget that these rules are designed in the interest of Member States in the first place. Compliance with the existing rules should be obvious, regardless of the near-term costs of enforcement.

In such a context, what can be done at the European level? The Commission can build or revive the consensus concerning the soundness of the rules.

A well-functionning monetary union requires a credible and sustainable fiscal framework: the euro area fiscal rules need to be binding, less complex, predictable and effective. For instance, the practice of some countries to be satisfied by a reduction of the past trend of increases in public expenditure should not be accepted. What is needed is a reduction of these public expenses **and not** a lesser increase in the countries where public expenditure are significantly high.

The EU Commission can also provide a diagnosis of the common challenges of the European countries (demographic decline, unsustainability of social systems, sluggish productivity growth) and propose specific solutions for each Member-State.

Mechanisms to incentivize structural reforms should also be enhanced. For instance, a regular dialogue looking at competitiveness gaps and divergent trends between euro area members could be established between Europe's institutions and euro area Member States to encourage ownership. This approach should make it possible to reinforce the level of engagement among national parliaments, social partners and the civil society for structural reform programs.

The euro itself and ultra-loose monetary conditions cannot solve structural weaknesses of Member

States. This is why implementing structural reforms remain of the essence. The European dimension can reinforce national efforts. Structural reforms should be coordinated at the EU level notably because a number of aspects of these measures have cross-border effects. Incentivising compliance with existing rules could be done for instance with a mutually-agreed contract, the costs of enforcement of which would be smoothed by financial support (as proposed in 2.1)

Moreover, much greater integration of markets in energy, transport and digital services would certainly boost productivity and capture the huge unrealized network benefits of a fully integrated Union. Provided there is a genuine, transparent, fluid internal market of huge scale, the development of global sized EU firms will be encouraged with more Member States cooperation to favor strong, global leaders in digital/data, defense, climate change, finance etc.

4. Responding to host countries' concerns is a key priority in order to improve the effectiveness of the Banking Union's existing pillars (SSM, SRM)

Ultimately, the single currency is embedded in an incomplete single market and only a partial Banking Union. Enhancing private risk sharing in the euro area, especially through the completion of the Banking Union and a true Capital Markets Union remains a key policy priority. Well-functioning and integrated banking and financial systems would indeed mitigate the propagation of financial shocks to the real economy.

In this perspective, it is essential to identify and address the concerns of host countries within the Banking Union if we want to improve the effectiveness of the Banking Union's existing pillars (SSM, SRM).

For financing their national economies, the vast majority of the Member States (Belgium, Luxembourg, Baltic States, Slovakia, Poland, Hungary, etc.) are essentially dependent on subsidiaries of banks whose headquarters are located in other countries within the Banking Union (Austria, France, Italy, Finland, etc.) or the EU (Sweden, Denmark). These local subsidiaries have a central and essential position for financing their economies.

Political leaders in these host countries are concerned that if one of these local banks was to leave or one of these banking groups was to experience difficulties, this might penalise severely their national economy or cause difficulties for their deposit guarantee system. In this respect, these countries are concerned about the slow pace that characterises the resolution of non-performing loans in certain Union countries and that makes them doubt the effectiveness of the EU crisis management framework.

These host countries are also concerned about the lack of economic convergence between Germany on the one hand and certain leading Union countries (France, Italy, Spain) and the strengthening of the sovereign bank links that can be seen in many Banking Union countries. These weaknesses are compounding the risk of banking groups withdrawing from these host countries and encouraging these states to set up local regulatory constraints (e.g. capital, liquidity, internal MREL, macro-prudential framework based on national decisions).

These concerns seem to explain the host countries' attitude to the ECOFIN Council (see discussions underway regarding CRR/CRD, BRRD, etc.). Indeed, they refuse to accept that the regulatory constraints for banking groups can be defined essentially at a consolidated level, while calling for a series of regulatory constraints to be set at a local level for primary legislation.

Once all these concerns expressed by the host countries have been clarified and understood, European leaders will need to respond to them by adjusting the roles and missions of the national authorities responsible for supervising cross-border groups in order to provide a guarantee for each Member State that none of the supervisors will favour their own banking system and their own depositors first. This is expected to result in an increasingly European framework for the operations and governance of European authorities (SSM, SRB, and European Supervisory Authorities), similar to what is already in place for the Monetary Union and the ECB.

Such an alignment will also need to be considered for home supervisors located outside the Banking Union.

These developments will lead eventually to the creation of the EDIS and to a permanent backstop for the Single Resolution Fund.

5. Brexit offers an opportunity to accelerate the implementation of the CMU

The departure of the largest non-Banking Union Member State is an opportunity for the EU27 to further develop and integrate their capital markets and increase the role they play in the financing of the EU economy. In this perspective, it is essential to move towards more efficient and consistent regulation and supervision of capital markets at the EU level, which involves notably strengthening the powers of ESMA. Moreover the EU authorities have to monitor the possible transfer of some financial activities from the City to the Continent in an appropriate way without creating financial instability or unlevel playing field issues (e.g. avoiding letter box entities; insufficient binding supervisory cooperation, etc.).

More generally, enhancing supervisory convergence and consistency in the implementation of financial rules across the EU is essential, which requires reviewing the powers, operations and governance of the European Supervisory Authorities (ESAs).

In sum, achieving economic convergence in all parts of the Union remains the key priority.

More than anything else, the Euro Area needs economic reforms and prudent fiscal housekeeping at the national level. Economic and fiscal policies remain in the competence of the Member States. “The EU cannot make the hard policy choices for the Member States, nor can it be accountable for them to the people. It is the Member States that need to take ownership of economic and fiscal policies and the responsibility of their consequences. The EU can advise and assist, but the ultimate responsibility should not be blurred[17]

Deepening the EMU, -either through sovereign risk sharing mechanisms or a fiscal capacity-, cannot be achieved as long as sovereign risk is not mitigated and excessive imbalances and rigidities remain uncorrected. Concerns about the weakening of incentives for sound national policies have to be addressed before serious progress is observed. In other words, an effective economic convergence and vigorous enforcement of the rules among all Member States would facilitate an agreement to create either a macroeconomic stabilization function and/or a sovereign risk sharing mechanism. It would also enhance the resilience of the euro area, restore trust between the Member States, restore cross-border investments in the euro area and accelerate private risk sharing within the EU. Therefore, some Member States urgently need to commit to convergence to further deepen the Eurozone.

If the fiscal rules are still not followed by all core countries, an adverse scenario has even been envisaged aiming to make the no bail-out clause more credible. As opposed to the common idea of pooling risks while complying with the rules, a proposal has been made to reinforce the corrective effect of financial markets which is currently weakened by accommodative monetary policy. The ESM/EMF[18] would decide on a declaration of sovereign default and conduct negotiations between insolvent sovereigns and creditors so as to restore the sustainability of public finances. Such a mechanism would re-evaluate risk premiums on countries who do not comply with the solvency criteria and provide a framework for sovereign debt default.

This is a political divorce approach - i.e. no risk pooling and counter to the deepening of EMU should compliance with the rules remain unachievable. The question that arises is then: is a ‘political divorce’ (decentralized approach) the way forward for Europe?

Europe is at the crossroads. Structural reforms at the national level are necessary and remain the priority to improve sustainable growth and employment. In this perspective, existing rules need to be enhanced and the governance of the euro area be reinforced since the existing coordination framework was unable to prevent public finances from worsening and economic imbalances from buiding up. In addition, more integration appears to be the most straightforward solution to restore confidence in the euro area. To that end, euro area Member States should clearly have to allow a comprehensive sharing of sovereignty and powers at the European level which in turn would require greater democratic accountability. It is up to politicians to design this new framework, which needs to balance liability and control.

But if we want to achieve a viable longer solution more solidarity will have to appear. As long as structural reforms and lasting fiscal discipline take place, some form of mutualisation of certain expenditures of the system must not be discarded systematically.

[1] Implementation of the 2016 Country Specific Recommendations. EU Parliament (March 2017)

[2] A rainy day or rainy day fund is a reserved amount of money to be used in times when regular income is disrupted or decreased in order for typical operations to continue.

[3] While the EU budget is small, the poorer EU countries receive up to 3% of EU GDP every year, which is already significant also in view of absoption capacity.

[4] Report of the Padoa-Schioppa group (2012)

[5] French Treasury (June 2014)

[6] M. Centeno, "Prioritizing EMU advancement domains to increase convergence and well-being", Eurofi Magazine, Tallinn, September 2017

[7] K. Regling:"A window of opportunity to strengthen economic and monetary Union further", Eurofi Magazine, Tallinn, September 2017

[8] B. Le Maire: "Three steps to strengthen the euro area", Eurofi Magazine, Tallinn, September 2017

[9] EU Commission, "Reflection paper on the deepening of the Economic and Monetary Union", May 2017

[10] Brunnermeier, Garicano, Lane, Pagano, Reis, Santos, Thesmar, Van Nieuwerburgh & Vayanos (2011); Working paper of the ESRB (2016)

[11] T. Philippon & C. Hellwig, (2011), Eurobills, not eurobonds, Vox-EU

[12] J. Von Weizsacker & J. Delpla, (2010), "The Blue Bond proposal", Policy Brief 3, Bruegel.

[13] German Council of Economic Experts, (2012). After the euro area summit: Time to implement long-term solutions. Special Report.

[14] Expert Group on Debt redemption and Eurobills (2014). Final Report.

[15] European Commission (2011), Green paper on stability bonds.

[16] Recent EU Commission paper on the deepening of the Economic & Monetary Union (May 2017).

[17] P. Orpo, "Member States need to take responsibility for reforms", Eurofi Magazine, Tallinn, September 2017

[18] The idea of turning the ESM into an EMF to provide a Euro-area resolution framework in case of a sovereign default has been first developed by economists Thomas Mayer and Daniel Gros. In case a Member States become insolvent, the EMF would decide on a declaration of sovereign default and conduct negotiations between insolvent sovereigns and creditorsin order to restore the sustainability of public finances. This proposal could lead to a re-evaluation of the risk premiums of the country whose public debt does not comply with the solvency criteria. The declaration of sovereign insolvency could be done either through a rules-based mechanism (when outstanding sovereign debt exceeds a certain level) or through the appointment of a 'finance minister' who would interfere in a country's fiscal sovereignty to make it comply with European rules and decide when it is no longer solvent.