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Rebuilding a Monetary Union for Europe

From mutual insurance to fiscal federalism

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The crisis has cracked the intellectual and political consensus underpinning the architecture of the monetary union enshrined in the Maastricht Treaty. The mutualisation of economic risks, started tacitly through various mechanisms (European Stability Mechanism, interventions by the European Central Bank), cannot succeed without a profound rebuilding of the monetary union, involving a move towards fiscal federalism.

Introduction: the original sin

The financial[1] crisis that erupted in 2008 became a distinctly European crisis in October of 2009[2] when the newly elected Greek government turned the music off and switched the lights onto the abysmal state of its public finances. Since then, the European policy response has largely focused on dealing with the financial symptoms rather than the economic and political root causes of the euro area crisis. It has focused on fiscal adjustment efforts across the currency union that largely rested on a wrong diagnosis about the supposed fiscal nature of the crisis. It is only in the spring of 2012 that European policymakers started to recognise and accept publicly that the very architecture of the monetary union itself was flawed and at least partially at the origin of the crisis and its continued worsening. In particular, the most visible deficiencies emerged in relation to the absence of a framework to manage banking failures and respond to the loss of market access by a Member State. This has sparked a vivid intellectual debate about the ways and means of rebuilding the monetary union.

Earlier in the monetary integration process, the consequences of monetary unification on the budgetary architecture and on fiscal policy had been studied in depth but were deliberately ignored in the years leading up to the Maastricht Treaty. This contrasted somewhat with the international experience of monetary unions and with previous work on the matter ordered by European authorities themselves. The Werner Report (1970) had for instance already highlighted that the monetary union would require public budgets to be

[1] The author thanks Eric Monnet and Jean Pisani-Ferry for useful discussions as well as Carlos De Souza for research assistance. The views *expressed here* are those of the author and do not represent those of the European Council and of the Bruegel think tank.

[2] Bruegel has also made available a detailed timeline of the crisis available on its blog: http://www.bruegel.org/eurocrisistimeline/

decided at the Community level[3]. The MacDougall report (1977) suggested that a monetary union required at least a budget of 2 to 2.5% of GDP in a pre-Federal stage, then 5 to 7% in a federal stage in order to absorb economic shocks and provide a minimum degree of income convergence[4]. But even though technical reports piled up to make this case, the single currency appeared ever more distant. It was only in June 1988 that Jacques Delors, freshly re-elected at the helm of the Commission, was tasked to form a Committee to revive the monetary integration and unification process. Departing from the tradition of ambitious and technical reports on the matter, Delors steered the *Committee for the Study of Economic and Monetary Union* to produce the key features of a politically acceptable staged roadmap[5] towards a minimalist monetary union.

The *Delors consensus* essentially rested on the idea that the European Monetary Union was perfectly achievable without a commensurate degree of budgetary integration. This consensus largely reflected the political common denominator of the time and was essentially betting on the idea that economic integration would deepen and accelerate to such an extent that it would reduce the need for a common budgetary authority able to stabilise the economy. This political imperative crystallised and found its way to the Maastricht Treaty.

As a result, coordination of national economic policies[6] rather than genuine common instruments, and rules to contain adverse fiscal developments rather than pooling of decisions over national budgets, were unequivocally seen as both economically and politically preferable to a real and complete federalisation of economic policy in all its aspects.

But the crisis that erupted in 2009 has cracked the *Delors consensus* open and revived a deeper soul-searching about the consequences of monetary unification. It also initiated a movement of de facto mutualisation of economic risks that has been minimised and concealed but now needs to be formalised.

The end of the *Delors consensus* and the new political economy of the monetary union

At the onset of the crisis, there was no instrument in place to deal with large economic shocks affecting the zone as a whole. National automatic stabilisers alone proved insufficient and in a context of low fiscal multipliers, discretionary fiscal policy by Member States proved largely ineffective. Monetary policy, which is normally best able to respond to symmetric shocks of large magnitude, was quickly hampered by financial distortions that undermined the monetary policy transmission mechanisms. It was also more fundamentally shackled by diminishing returns to monetary policy expansion as the benchmark interest rate came closer to the "lower bound[7]". There was even less thinking and instruments to respond to shocks affecting individual Member States. Whether these shocks were the result of the normal

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[3] Pierre Werner, (1970) "Interim Report on the Establishment by Stages of Economic and Monetary Union", Commision of the European communities, Brussels.

[4] McDougall, Donald, (1977). "Report of the Study Group on the Role of Public Finance in European Integration". Commision of the European communities, Brussels.

[5] Report on economic and monetary union in the European Community, Committee for the Study of Economic and Monetary Union, Presented to the Council in April 1989

[6] The principles of macroeconomic policy coordination were laid out by Alexandre Lamfalussy in an annex to the final Delors Report but he expected the extent to which coordination of economic policies in other monetary unions relied on much more integrated framework than what was being arranged in Europe.

[7] See Woodford discussion at Jackson Hole in August 2012. Woodford, Michael, Methods of Policy Accommodation at the Interest-Rate Lower Bound, Columbia University, August 20, 2012.

business cycle or the outcome of more profound fiscal, external or banking crises, European and national authorities had built a policy apparatus not only largely incapable of dealing with them but in fact obstructing policy action to address their consequences. In the face of adverse shocks leading to a loss of market access by a Member State, European policymakers were stuck between the rock of their refusal to accept sovereign defaults and the hard place of their rigorous interpretation of Article 125 –the so-called "no bailout" clause– of the Treaty. After months of costly hesitations, Europeans initiated a process that would lead to mechanisms of mutual financial assistance largely grounded on inter-governmental guarantees arranged inside an insurance mechanism, the so-called European Financial Stability Facility (EFSF), which would later be adapted and turned into the European Stability Mechanism (ESM) after a modification of Article 136 of the Treaty. This was formally the end of the Maastricht architecture but not quite yet the beginning of a new one.

The predominant – but inaccurate – narrative of the crisis being essentially a public debt crisis has helped to promote a number of deep changes to improve arrangements to ensure fiscal discipline in order to remedy the shortcomings of the Stability and Growth Pact. But even though fiscal discipline is an important pillar of a monetary union, it is not sufficient to ensure its stability. Historical and international experiences suggest in fact that a stable monetary union requires a comprehensive budgetary union that should address the following:

Risk sharing arrangements for the financial sector: The financial sector has, in principle, strong stabilisation capacity allowing the absorption of economic shocks both across regions and inter-temporally. This was an important contribution of the literature in the 1990s, notably by Asdrubali, Yosha and Sorensen[8] who demonstrated the extent to which the US financial system could smooth economic fluctuations. Yet few economists understood the degree to which mechanisms to internalise the consequences of financial integration should be an essential feature of the European Monetary Union. It is now accepted that the fragilities of the financial sector might indeed come to reduce tremendously its theoretical shock absorption capacity, or worse that it could itself become a source of economic disruptions that could contribute to fragment the currency union. This requires the creation of a framework allowing common resolution in addition to arrangements to commit fiscal resources as an ultimate backstop when necessary[9]. This should be the very nucleus of a common fiscal capacity for the euro area, which would in effect only be used to respond to contingent financial risks that occur rarely but that require risk sharing when they do.

Fiscal policy coordination: Fiscal policy coordination has been generally weak and hasn't allowed member states to maximise the effectiveness of fiscal policy for the purpose of macro-economic stabilisation. Today, the fiscal stance of the euro area is the simple sum of national fiscal stances largely decided independently of each other. Fiscal multipliers and spill-over effects are ignored and no coordination efforts are deployed to achieve an appropriate fiscal stance for the euro area as a whole. As a result, the ability for fiscal policy to deliver macroeconomic stabilisation is limited. But in order to coordinate effectively, there needs to be an executive authority that can decide on the appropriate aggregate stance and

[8] Asdrubali, Pierfederico, Sorensen, Bent and Yosha, Oved, (1996), "Channels of Interstate Risk Sharing: United States 1963-1990", *Quarterly Journal of Economics*, Vol. 111, No. 4, pp. 1081-110.

[9] Pisani and Wolff (2012), "The fiscal implications of a banking union" http://www.bruegel.org/publications/publication-detail/publication/748-the-fiscal-implications-of-a-banking-union/

apportion the national targets accordingly. This would overhaul the current loose coordination but would inevitably raise more fundamental questions of accountability and legitimacy[10].

Asymmetric shock absorption: In the context of a monetary union, national automatic stabilisers might be too small to respond to deep or protracted output loss. There might, in addition, be a natural tendency to free-ride on the automatic stabilisation of one's neighbour. The ESM only intervenes *ultima ratio* and it is quite possible that other limited, but more pre-emptive instruments could actually facilitate adjustments and reduce the probability of resorting to the ESM. Therefore, new instruments to assume such asymmetric shock absorptive features should be pursued. These can be achieved by different mechanisms of pooling of resources and transfers to countries experiencing shocks based on deviation from potential growth, deviation in borrowing cost (spreads), deviation in employment. These could be financed by pooling a small portion of fiscal revenues (e.g. a portion of income, sales or corporate tax for instance) and should still be complemented by existing national automatic stabilisation mechanisms.

Creation of safe and liquid assets : The euro area remains marked by the absence of a unified, deep and liquid government bond market. The fragmentation in sovereign bond markets has at least two important consequences. The first is that it has encouraged a degree of home bias where banks felt compelled to build large exposures to their national sovereign debt[11]; this lack of diversification in turn increases the risks of financial instability and the vicious feedback loops between the banks and their respective sovereign. The second is that the absence of a real, deep and liquid "risk free" government bond market curtails the rise of the euro as a leading reserve currency and limits the area's ability to enjoy the benefit of an overall lower liquidity premium. A common "risk free" asset would greatly contribute to financial stability domestically, limit risks of destabilising dispersion of borrowing costs and finally play an important role for the global attractiveness of the euro and eventually increase the stability of the international monetary system[12].

Provision of public goods: Ultimately, the creation of a euro area budget could also take charge of the more efficient delivery of some public goods further relieving national budgets. These would have to be defined in more detail but they could range from some parts of higher education, energy infrastructures to transport and defence, reducing expenditure burdens on national budgets and securing efficiency gains and economies of scale for the provision of these public goods. However, the fundamental question of whether these public goods are specific to the euro area or inherently linked to the EU, raises very complex institutional debates. This is particularly complex in a union where all Members States are not meant to eventually join the monetary union.

Towards a new architecture: from inter-governmental insurance to fiscal federalism

[10] See Nicolas Veron testimony to the US Senate Committee on Foreign Relations Subcommittee on European Affairs hearing on "The Future of the Eurozone: Outlook and Lessons" http://www.iie.com/publications/interstitial.cfm?ResearchID=2186.

[11] For an early account of risks related to accumulation of national public debt in banks balance sheets, see Barry Eichengreen, and Charles Wyplosz, (1998), "Stability Pact? More than a minor nuisance?", Economic Policy, 67-113.

[12] Bruegel (2011), "Global currencies for tomorrow: a European perspective", CEPII Research Report 2011-01, Bruegel Blueprint 13.

Mutual insurance: Because the treaties ignored the need for mechanisms to absorb shocks and provide assistance to member states in difficulties, these have had to be developed under duress and emergency. In the last two years, the euro area has set up the European Financial Stability Facility (EFSF), which is now turning into a permanent ESM[13]. In addition, the ESM will now be allowed to recapitalise banks directly[14]. Finally it has become the cornerstone of the Open Market Transaction (OMT) of the ECB that aims to provide a form of insurance against extreme financial fragmentation[15] through interventions in sovereign debt markets. The increasing number, size and scope of these instruments recognises the economic interdependence and the need for mutual insurance between Member States that the *Delors consensus* failed to grasp fully. But these mechanisms as they are structured represent a contingent risk on national budgets and therefore justify mutual controls. This is very much, if unconsciously, reflected in the logic of the recent governance changes in the euro area such as the 6-pack, the TSCG and the two pack that are all contributing to gradually move the disciplining devices beyond ex post monitoring and sanctions to a much a more pre-emptive and binding set of mechanisms constraining national budgets. However, these intrusive mechanisms are either outsourced to the European Commission (6-pack and in the future, two-pack) or based on automatic rules (TSCG) that limit the actual intrusion by Member States on each other's economic policies reflecting a democratic discomfort with actual economic policy *ingérence*. So if solidarity mechanisms do function through a clear and explicit intergovernmental logic, where national parliaments can object and block assistance programs, the control dimension is far less accepted because the notion of a national authority or parliament censoring or challenging another one is fundamentally problematic from a democratic legitimacy point of view. All in all, these developments highlight a real intergovernmental mutual insurance dynamic[16] but this logic appears economically insufficient and politically unsustainable, as the reluctance to outright and direct intrusion illustrates.

Economically the limited nature of these mutual insurance arrangements, in scope and size[17], calls for additional instruments to absorb and share economic risks more efficiently. A more pre-emptive system that would organise some risk-sharing *ex ante* rather than *ex post* would have stronger stabilising properties and would also reduce the final costs of support. A form of common debt issuance could allow all member states to insure themselves more effectively against adverse shocks by ensuring that they can all borrow at a lower rate. A number of "Eurobond" proposals with varying structures and properties have been laid out producing more or less similar effects on borrowing costs for member states. They vary in a number of technical aspects[18], such as the type and amount of shared guarantees, or whether

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[13] The European Stability Mechanism (ESM) was established on 27 September 2012 and will replace the temporary European Financial Stability Facility (EFSF). The EFSF will continue to manage existing commitments until they are fully repaid and can make additional loans until the middle of 2013.

[14] Conclusions of the European Council (28/29 June 2012), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131359.pdf

[15] https://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html

[16] Jean Pisani-Ferry has highlighted the limitation of such a model where national parliaments cannot integrate the broader European common interest which shows the practical and democratic limitation of this approach. http://www.bruegel.org/publications/publication-detail/publication/719-the-messy-rebuilding-of-europe/

[17] The ECB has indeed explained the extent to which the OMT, although unlimited in principle would be constrained. See Michiel Blijsma, Shahin Vallee, http://www.bruegel.org/nc/blog/detail/article/842-the-creation-of-euro-area-safety-nets/

[18] For a more detailed analysis of a number of these options see, Claessens, Mody and Vallee (2012) http://www.bruegel.org/publications/publication-detail/publication/733-paths-to-eurobonds/.

they chose to focus on the flow of new debt or on the stocks. But they all rely on a similar logic of mutualisation of national debts.

However, the path followed in creating such common debt has important political consequences. In reality, the current mechanisms of mutual insurance already produce a form of common debt, the debt now issued by the EFSF with the underlying guarantees of member states. But risk pooling is in fact much larger than the official resources committed if one considers the debt implicitly socialised by the ECB via its Securities Markets Program and in the future through its Outright Monetary Transactions. The euro area has therefore already started to mutualise debt without the explicit creation of "Eurobonds". In this context, it is useful to connect economic principles to their political and institutional translations and consider them as a system. The prospect of expanded pooling of national debt within the current insurance and control framework poses important questions. Beyond the usual debates revolving around incentives, moral hazard and legality (compliance with article 125 and 136 of the Treaty), this would raise very fundamental political questions about budgetary sovereignty. Indeed, in order to develop real Eurobonds, it is very likely that member states would seek to contain the risks weighing on their national budgets by expanding controls possibly as far as seeking the right to veto budgets ex ante. Yet it is hard to imagine that Member States would sustain vetoes by fellow Member States or by the European Commission acting effectively on the basis of an intergovernmental mandate rather than a genuine community one. This approach would undoubtedly lead Member States that are reluctant to accept more intrusions in their national budgets to meet those that are not willing to accept the risks associated with greater mutual insurance. This impasse highlights the inherent limitations of the current mutual insurance system.

Fiscal federalism: This political difficulty created by intrusion in national budgetary sovereignty cannot be completely evaded by fiscal rules or by outsourcing these prerogatives to the European Commission. A more formal pursuit of debt mutualisation in exchange for more direct controls such as veto rights on national budgets overlooks both the fact that the Treaty precisely limits the European Commission's prerogatives when it comes to binding national economic policies. This economic governance *dark matter* makes the rebuilding of the currency union a much taller order than it seems and explains why debt mutualisation has remained largely *ad hoc* and concealed rather than proper and transparent. More fundamentally, this questions the ability both economically and politically to perform all the necessary functions necessary for the success of the monetary union, within the existing institutional and legal set up and the current mutual insurance logic.

The international history of fiscal federalism can prove a useful guide in this respect[19]. Indeed, various experiences illustrate how the pooling of national debt without an appropriate governance structure can have profoundly damaging consequences. In their lesson of US history for the architects' of Europe's fiscal union, Henning and Kessler[20] recalled quite clearly that even though the assumption of the war of independence's debt in 1790 by the Federal Government orchestrated by Hamilton really set in motion America's fiscal federalism and largely redefined the institutional and power balance set out in the 1787 Constitution, it also fell short of providing the real backbone of a complete and stable fiscal

[19] Bordo, Michael, Agnieszka Markiewicz and Lars Jonung (2012), "A fiscal union for the euro: Some lessons from history", NBER Working Paper No. 17380.
[20] Randall, Henning and Kessler, Martin (2012), "Fiscal federalism: US history for architects of Europe's fiscal union", Bruegel Essays and Lectures Series and Peterson Institute Working Paper 12-1.

union, as the States' defaults in the 1840s and ultimately the Civil War in 1870 would later come to demonstrate. Indeed, Hamilton only obtained part of the fiscal union he had sought, failing to achieve an effective design of the economic prerogatives of the nascent federal government and a clear definition of its relationship with States.

This is very close to the current debate on EMU's architecture and the future shape of fiscal federalism in Europe. If the mutualisation of debt has powerful economic effects, alone, it is a poor substitute for a comprehensive definition of the system that organises the relationships between the Member States and the federal level. The creation of an embryonic euro area budget with appropriate functions could therefore address the shortcomings of the current architecture and the weaknesses of the mutual insurance system. In the beginning, it would not need to replace it altogether and could potentially evolve as its natural extension by delivering the mutualisation of economic risks needed through a central, democratic and accountable authority that the current system cannot produce. This should not only provide for what Musgrave[21] referred to as the stabilisation function, usually best delivered at the central level, but also help define the relationship between the central and national authorities in a clear and transparent manner. Pursuit of the existing or additional controlling devices can therefore only be envisaged by federalising the existing mutual insurance tools and subsequently building additional mechanisms allowing a minimum level of stabilisation, therefore amounting to the foundation of a euro area budget. However, beyond the definition of essential prerogatives and an agreement on its resources, the creation of this euro area capacity raises a number of political and transitional challenges.

Transitional considerations: Other experiences of fiscal federalism highlight two salient points. The first one is that some mutualisation of economic risks alone is necessary but clearly not sufficient. The Hamiltonian experience of mutualisation of State debt in the absence of adequate political and economic institutions cemented structural divergences and inadequate incentives. Nonetheless, Hamilton took the very basic foundational step on which an evolutionary process could take root. The federal budget evolved from a small shell in 1790 to a large one today through successive small steps and larger ones as a result of the Rooseveltian response to the Great Depression for example. Interestingly, the balanced budget rule that binds most US States today was never imposed by the Federal Government but rather self-imposed as a result of serial defaults in the 1870s.

For the Economic and Monetary Union today, one could consider the recent mutual insurance tools and the associated mutualisation as forming the basis of a proto-budget. Formalising this would require integrating the sum of ad hoc mutualisation instruments into a new compact that would lay the foundation of Europe's fiscal federalism. In particular, it would involve defining the contours of a few key prerogatives to be conducted at the central level for the proper functioning of the euro area (asymmetric shock absorption, coordination of fiscal policy, risk sharing for the financial system…) and would justify modifying existing intergovernmental instruments while designing and anchoring the appropriate decision making processes into Community law.

This embryonic euro area budget should, as a result of its prerogative, be able to issue debt in common, which more than pooled national sovereign debts would be a proper federal debt instrument. The creation of this joint federal fiscal capacity could limit the need for

[21] Musgrave, Richard (1959). The Theory of Public Finance: A Study in Public Economy, Mc Graw Hill.

direct interference and control of national budgets, as it would curtail undue bailouts. However, even if the objective could be to apply a strict no bail-out rule in the future, during the transition phase, the stock of national debts is probably going to remain so large and the euro area central budget so small that the no bail-out rule would lack credibility. It is therefore reasonable to expect that the EMU's fiscal federalism would, during this period, probably resemble the current German fiscal federalism where Member States, just like the Länder today, would retain a large degree of independence over their fiscal matters under a formal no bail-out rule that would be only weakly enforced. Indeed, in practice, the no bail-out rule in Germany is largely circumvented by the *Solidarpakt*, as it would be in the EMU by the recourse to the ESM financial assistance (interestingly, even in the context of bail-out by the Federal Government, Länder are hardly subjected to the type of policy conditionality and intrusion that program countries are undergoing).

But after this potentially long transition phase, there are various possible models of fiscal federalism that will require decisive political choices fairly early in the transition process. A Swiss model with a relatively small federal budget (about 10% of GDP) under control and time-bound taxing authorisation of the Cantons, for instance, or a more American model with a larger Federal Budget (about 25% of GDP) and a strict and enforced no bail-out rule on States. These different models would correspond to the broader evolution of the political architecture of the Union. A confederation would certainly involve a more limited federal budget with greater powers and responsibilities at the national level than a real federation. But in any case, the creation of a euro area fiscal capacity and the transfer of national economic policy prerogatives to the European level would be more consistent with Europe's political tradition than an ever more stringent and ever less democratic intrusion and interference with national economic policy through veto rights on national budgets. Indeed, a more federal system would provide for a system where democratic legitimacy and accountability is more clearly aligned with decision-making at the national and European level, respecting an appropriate degree of autonomy for Member States while recognizing the fundamental interdependence and the need for collective action tools that the previous architecture purposefully ignored. This debate has become essential to secure the economic political sustainability of the monetary union. Multi-national currency unions as opposed to national ones are fragile constructs that are fundamentally dependent on the political compact on which they are based[22]. In the case of the EMU, the underlying compact has become *de facto* null and void because the consensus on which it rests is no longer up-to-date. In order to rebuild the monetary union and salvage the European integration process, it has become urgent to propose a new compact, redefine executive economic prerogatives and settle the associated governance structures.

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[22] Cf. Bordo, Michael and James, Harold, (2008), "A long term perspective on the euro", European Economy, Economic Papers 307.