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# The Deepening of the Economic and Monetary Union

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**Abstract**
This article seeks to guide the reader through the developments in the process of EMU deepening, clarifying the economic arguments and identifying the choices made by the decision makers, which led to the current institutional design. In addition, a critical analysis of the different proposals under discussion is made, aiming at identifying the most efficient way, in a long-term perspective, to ensure the proper functioning of the monetary union.

JEL: F02, F15, F36, H77

Keywords: European Integration, Macroeconomic Surveillance, Fiscal Rules, Banking Union.

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## 1. Introduction

### *1.1. The Genesis of the Economic and Monetary Union*

The euro was set up on 1 January 1999 and was a milestone in the process of European integration, achieving one of the objectives of the European Union's Economic and Monetary Union (EMU) established in the Maastricht Treaty signed in 1992. For the first time in contemporary history, a group of sovereign states would forgo their national currency to adopt a common currency, giving rise to the so-called euro area. This significant step brought benefits but also posed important economic and political challenges. Following the economic and financial crisis of 2008, a sequence of events triggered the so-called sovereign debt crisis in the euro area, which led to a sharp worsening of economic and financial conditions in several Member States. This crisis greatly disrupted the normal functioning of the monetary policy, even putting the monetary area at risk.

The economic and social costs of this crisis have been high and have not yet been fully overcome. In this context, it was clear to policy makers in all Member States of the European Union (EU) that reforms to deepen the EMU would be essential to improve its day-to-day functioning and to prevent new systemic crises with unpredictable economic, social and political consequences. This article seeks to describe and evaluate in a simplified way the reform process leading to the deepening of EMU.

The creation of an EMU in Europe has been under discussion since the late 1960s. However, weak political commitment, disagreements on the priorities of European integration and economic crises have limited progress in this area. The Werner Report in 1970 and the creation of the European Monetary System (EMS) in 1979 were intermediate steps in this process. However, only with the Delors Report of 1989 detailed planning for the establishment of the EMU was established, part of which was materialized with the signature of the Maastricht Treaty in 1992. At this stage, good economic performance and the political will to strengthen the project after the reunification of Germany, made it possible to achieve the political and economic commitments necessary for the preparation of the EMU.

Several advantages were pointed to the creation of the monetary area. Firstly, the single currency would complete the creation of the single market, which provided for the free movement of goods, services, people and capital, eliminating exchange rate risk and strongly reducing the transaction costs in the euro area. Secondly, the management of monetary policy by an independent supranational authority - the ECB - would guarantee a price stability regime, thus contributing to economic growth. However, the EMU entailed risks and challenges. In essence, the absence of the monetary instrument did not allow temporary differences in the competitiveness of economies to be accommodated through devaluations, with an impact in terms of continued imbalances in the external accounts. In addition, the regime of low interest rates and ease of access to liquidity facilitated the persistence of macroeconomic imbalances. Finally, the prospect was that financial markets would be able to assess credit risk of individual agents, eliminating the so-called country risk. In this context, the euro area would function as a monetary union within a sovereign state, turning the very concept of external imbalance unimportant.

The requirement to meet nominal convergence criteria for participation in the euro area and the commitment on discipline in public finances, associated with the budgetary rules contained in the Stability and Growth Pact, should ensure the stability of EMU. However, reality has shown that these elements were insufficient and the expectations created were unrealistic. During the great moderation, the financial markets proved unable of distinguishing the different national realities. In the context of the international financial crisis, some segmentation has indeed emerged, especially in countries with larger macroeconomic imbalances, but the fast increase in risk premiums for sovereign debt and private agents posed systemic risks and potentiated macroeconomic adjustments with very marked profiles.

### *1.2. The Difficulties of the Economic and Monetary Union*

The difficulties in the EMU vary in nature. Firstly, questions arise relatively to criteria that the economic literature normally requires for a monetary area to work properly (theory of optimal monetary areas). This theory was first formulated by Mundell (1961), complemented by McKinnon (1963) and later by Kenen (1969) and presents a set of criteria to evaluate the adequacy of a country's participation in a monetary union. These criteria are usually divided into two groups. The first group consists of criteria that reduce the exposure of member countries to asymmetric shocks (which disproportionately affect a given economy), such as similarities in the productive structure and degree of specialization, as well as openness to trade. The second group of criteria considers elements that characterize the capacity of adjustment to asymmetric shocks, such as the homogeneity of preferences, the mobility of workers and elements of fiscal federalism.

The similarity in productive structures means that an exogenous shock is felt in a similar way by all the Member States, allowing a stabilizing response by the common monetary policy. However, if the shock has asymmetric effects across countries, the common monetary policy is not an adequate instrument. A similar argument applies to the degree of specialization of economies (Kenen's criterion). However, the idea that the EMU is based on a deep economic integration, based on full liberalization of trade, introduces an element of tension. Indeed, trade promotes specialization in those sectors where there is a comparative advantage, thus enhancing the likelihood of asymmetric shocks resulting from sectoral disturbances. However, greater openness to trade (McKinnon's criterion) may also lead to a better functioning monetary union.

In the context of high trade integration, the probability of price changes in the tradable sectors being transmitted between countries increases. In this way the nominal exchange rate ceases to be an attractive policy instrument because changes in their nominal value are quickly followed by changes in prices, leaving the real exchange rate unaltered. The existence of homogeneity of preferences between countries in relation to macroeconomic policy parameters (e.g. inflation and unemployment rates) facilitates the conduct of the common monetary policy. In addition, the homogeneity of preferences facilitates the decision-making process, especially in times of crisis. Mobility of workers is another element of adjustment in a monetary union. Increases in unemployment in a country affected by an idiosyncratic adverse shock would lead to outflows of workers to the countries with the highest growth rates of activity. However, it can be argued that the exit of workers, namely the most entrepreneurial and skilled, is in itself a limiting factor of potential growth in the medium and long term. Finally, the elements of fiscal federalism associated with automatic transfers to countries with adverse cyclical developments may have a stabilizing effect, similar to that of automatic stabilizers in individual countries. Such capacity presupposes the existence of common tax instruments and expenditure programs in the monetary union (e.g. unemployment benefits, pensions or investment support programs). It should be noted that the most recent proposals on the existence of centralized budgetary funds targeted at macroeconomic stabilization seek to avoid permanent transfers between countries, focusing instead on elements of risk-sharing, reform and convergence.

An overall assessment leads to the conclusion that the EMU does not meet all the criteria for an optimal monetary area. In particular, the elements of fiscal federalism and worker mobility are very small, especially when compared to the reality of other monetary unions (such as the US). In addition, there is no marked homogeneity of preferences in the Member States, which is also reflected in the existence of tension between the federalist and intergovernmental dimensions that have coexisted since the beginning of the European integration project. In this context, several authors have referred to the idea that European economic integration was based on the hypothesis of endogeneity, i.e. that political integration would automatically follow the increase in welfare achieved through economic integration. In short, the optimistic view believed that the EMU would lead to the creation of conditions for the existence of an optimal monetary area a posteriori, while the pessimistic view advocated that EMU would lead to a worsening of economic divergences.

Secondly, the criteria established for access are strictly nominal in nature. Thus, after entry, countries moving from regimes with higher inflation and interest rates are subject to stimuli on consumption and investment that imply significant increases in imports. A countercyclical fiscal policy is generally not sufficient to mitigate these domestic demand stimuli. Moreover, in economically favourable times, the stance of fiscal policy tends to be pro-cyclical. In addition, the persistence of competitive differentials, when unfavourable to the countries suffering from the shock associated with EMU membership, limits export growth capacity and leads to imbalances in the external accounts. Therefore, the set of criteria for entry into the EMU seems partial and unconnected with competitiveness issues.

Thirdly, the budgetary rules originally included in the legal framework of the EMU have proved insufficient and have been repeatedly reviewed. On the one hand, these difficulties stem from the intertemporal inconsistency of the rules, that is, from the fact that there is a strong incentive to avoid the costs of applying them in times of economic crisis. On the other hand, successive revisions of the rules have introduced a considerable degree of complexity, weakening their practical implementation. To a large extent, the decision-making process is susceptible to political pressure from the countries and has ultimately led to a loss of credibility and effectiveness of the budgetary supervision mechanism. The existence of automatism in the sanctions associated to the violation of budgetary rules has been discussed but it is difficult to implement. In this context, it is important that the reform of European fiscal rules, to be implemented in the near future, translates a genuine political will of all Member States, thereby allowing a significant strengthening of the credibility of the whole macroeconomic supervision mechanism.

Fourthly, the original architecture of EMU left the confidence-building elements of the banking system on the shoulders of Member States. In general, these instruments presuppose the capacity to mobilize financial resources in the event of banking problems with a systemic impact. However, the absence of broad access to liquidity by the Member States does not allow their effective action as lender of last resort or as the guarantee of a deposit insurance system. It should be noted that these are the core subjects in the discussion of the Banking Union and will be detailed throughout this article. In summary, it can be said that in terms of the stability of the financial system, the institutional architecture of the EMU was clearly incomplete at the time of its start-up.

The EMU was not able to properly face the first international economic crisis that emerged after its creation. Following the sovereign debt crisis in the euro area, a number of efforts were made to deepen the EMU and avoid recurring past problems. The current reform agenda is broad and demanding from the point of view of the political commitments to be achieved. While there is significant progress, the reform process is still incomplete in important dimensions. Prolonging the reform process necessarily increases the likelihood that the new EMU architecture will not be implemented in time to adequately withstand a new international crisis that will inevitably arise. The maturity of the current economic cycle adds to these concerns.

This article seeks to guide the reader through the developments in the process of EMU deepening, clarifying the economic arguments and identifying the choices made by the decision makers, which led to the current institutional design. In addition, a critical analysis of the different proposals under discussion is made, aiming at identifying the most efficient way, in a long-term perspective, to ensure the proper functioning of the monetary union.

The political economy arguments underlying the decision-making processes are, for their relevance, taken into account throughout the text. Several points in this article refer to the complexity and inconsistency of existing EMU rules and reform proposals. However, this often results from the negotiation of compromises between a large number of Member States and also between the various European institutions involved in the legislative process (Commission, Council and European Parliament). In this sense, the complexity and inconsistency often pointed out can be seen as the price to be paid to achieve progress in sensitive areas. Nevertheless, this cannot stop progress in critical areas or impede the effort to achieve better solutions in the future.

The remainder of this article is organized as follows: Section 2 presents issues related to macroeconomic surveillance, including the European Semester, the macroeconomic imbalance procedure, structural reform support mechanisms, fiscal rules and mechanisms macroeconomic stabilization. Section 3 examines insurance and crisis resolution mechanisms, including the Banking Union, the European Stability Mechanism and the ECB's Outright Monetary Transactions Program. Section 4 discusses some initiatives to encourage private risk sharing within the EMU: the creation of a risk-free European asset and the Capital Markets Union. Section 5 presents some final remarks.

## 2. Macroeconomic Supervision

### *2.1. The European Semester*

The latest economic crisis has demonstrated the need for stronger economic governance and better policy coordination between EU Member States in order to avoid imbalances and to contribute to convergence and stability across the EU. Until the sovereign debt crisis in the euro area in 2010, economic policy coordination procedures were implemented without articulation. Subsequently, Member States began to synchronize the timetables and streamlined the process in order to align national fiscal, growth and employment policies. In addition, the areas of supervision and coordination of macroeconomic policies have been broadened beyond the fiscal area, including, for example, external imbalances. In this context, in 2010 the European Council decided to create the European Semester, whose legal basis is the so-called "six pack", a set of six legislative acts that reformed the Stability and Growth Pact.

The European Semester corresponds to a set of macroeconomic coordination actions that takes place in the first six months of each year (Figure 1). During this period, Member States align national fiscal and economic policies with the rules and objectives set at EU level, including a set of country-specific recommendations. At the outset, the European Commission economists

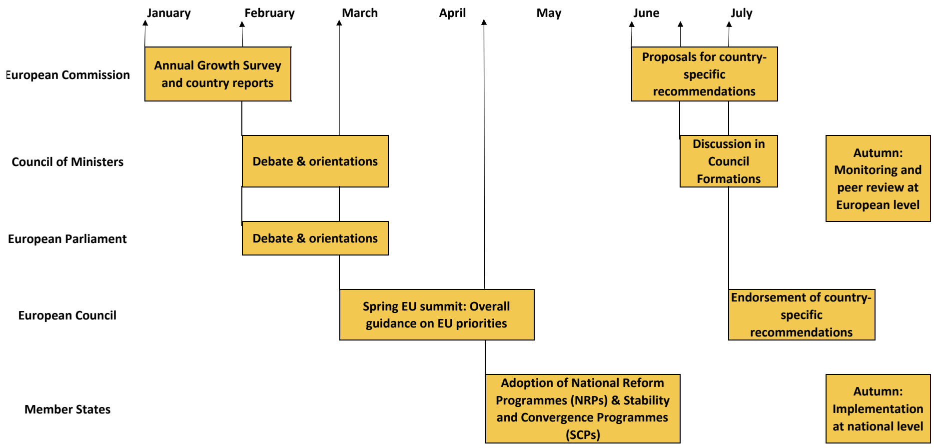


Figure 1: European Semester Time Line

Source: European Commission

visit the Member States for in-depth technical discussions in the various economic areas, followed by the publication of a country report describing the economic and financial situation and the degree of implementation of previous recommendations. Next, countries prepare the so-called National Reform Plan, which includes policy priorities and planned reforms. In parallel, the Stability Programs are presented, containing the three-year budgetary plans, which are independently assessed by the European Commission. Subsequently, on the basis of all the available information, the Commission prepares a set of specific recommendations framed by its assessment of the economic situation. These recommendations focus on actions that can be achieved in the next 12-18 months and are subsequently voted on by the Member States at the end of the first half of the year and are adopted by the national Governments. Country-specific recommendations should be in line with the priorities identified at EU level in the so-called Annual Growth Survey. In the second half of the year, countries should implement the approved recommendations and prepare the new budget cycle (Figure 1).

The first cycle of the European Semester took place in 2011. This reform in the policy coordination architecture has been implemented effectively and has been subject to some adjustments. At present, there is an effort to contain the number of country-specific recommendations and to streamline their process of discussion, through prior consultations with the national authorities. However, the degree of implementation of country-specific recommendations is clearly reduced. According to an evaluation by the European Commission, for the period 2011-2015, 28 per cent of recommendations to countries had made limited progress and 6 per cent had made no progress. In addition, questions have been raised regarding the consistency of recommendations across countries, over time and in terms of their articulation with the euro area. It is also important to point out the strong power of the European Commission in this process because its recommendations are adopted unless the Council decides to reject them by a qualified majority. In discussing the specific recommendations, especially with regard to the euro area, there are often divergences between Member States arising from national policy agendas and differences in preferences for macroeconomic variables.

### *2.2. Macroeconomic Imbalances Procedure*

The macroeconomic imbalances procedure is part of the annual European multilateral surveillance cycle (Article 121 of the Treaty on the Functioning of the EU) and aims at identifying, preventing and eliminating excessive macroeconomic imbalances that are likely to affect economic stability in a particular Member State, the euro area or the EU as a whole. The legal framework is based on regulations 1176 and 1174 of 2011, which are legislative pieces of the so-called “six-pack”. The second of these regulations specifies a mechanism of sanctions associated to the non-implementation of the recommendations of the macroeconomic imbalances procedure, that is, along with the preventive arm, a corrective arm was implemented.

The macroeconomic imbalances procedure is based on a scoreboard with 14 macroeconomic indicators (plus 25 auxiliary indicators), which include budgetary variables, and where the situation in each Member State is compared with pre-established thresholds (Appendix A). This assessment leads the Commission to classify countries in a four-tiered scale starting in the category “without macroeconomic imbalances” and ending with “excessive macroeconomic imbalances with corrective action”. In the latter case, corrective action plans are applied to countries under the Excessive Deficit Procedure.

In the context of the macroeconomic imbalances procedure, the Commission draws up the Annual Report of the Alert Mechanism, selecting the countries for which “in-depth analysis” is necessary. The in-depth analyses are Commission analytical documents to assess the seriousness of macroeconomic imbalances. In-depth analyses may also be carried out in the case of unexpected economic developments requiring urgent analysis. Since 2015, in-depth analyses have been incorporated into country reports of the European Semester. The process of "specific monitoring" of EU Member States with excessive imbalances or imbalances involves an enhanced dialogue with national authorities as well as progress reports and policy recommendations.

At present, the macroeconomic imbalances procedure is an important component of the macroeconomic surveillance process in the EU. However, there are elements of tension. Firstly, the compatibility of some existing indicators in the scoreboard is questioned. For example, compliance with indicators on unemployment rates may be incompatible with the correction of external imbalances, which tend to require reductions in the volume of economic activity. Secondly, some countries dispute the upper threshold for the current account balance as a percentage of GDP, giving rise to a macroeconomic imbalance to be corrected. In particular, the countries concerned claim that such surpluses are structural and therefore difficult or impossible to correct. Lastly, criticisms arise because, even in serious situations, the existing assessments have never led to corrective actions, and the procedure has also been unjustifiably facilitated. This situation is similar to that observed with the Excessive Deficit Procedure and results from the intertemporal inconsistency of the rules, together with deficits of credibility in its implementation.

### *2.3. Support for Structural Reforms*

On 31 May 2018 the Commission presented a proposal for a Regulation establishing a Reform Support Program.[1] The objective of the program is to support the implementation of structural reforms and consists of three instruments: a convergence mechanism (up to €2.16 billion) to provide technical and financial support to Member States wishing to adopt the euro; technical assistance to Member States (up to €840 million), at their request, for the design and implementation of reforms, based on the experience of the Structural Reform Support Service; and the Reform Implementation Tool (up to €22 billion) to provide financial support for the adoption of key reforms identified in the context of the European Semester.

This proposal was welcomed, as it is agreed that there is a need to reinforce potential growth and to increase the level of implementation of the reforms presented under the country-specific recommendations. However, the final contours of the program are still to be defined and there are several points of discussion. Firstly, there are questions regarding the eligibility elements of the countries, and the adequacy of a criterion associated with per capita GDP as a percentage of the EU28 average is under discussion. Secondly, questions have been raised concerning the powers of the Commission and the Council to define the reforms to be supported. Thirdly, legal issues arise in a context in which cohesion and macroeconomic coordination policies have different frameworks. Indeed, the Commission's view that this program is a cohesion policy tool runs counter to the notion that country-specific recommendations are based on the need for macroeconomic coordination within the European Semester.

1. See proposal at: https://ec.europa.eu/commission/sites/beta-political/files/budget-may2018-reform-support-programme-regulation_en.pdf

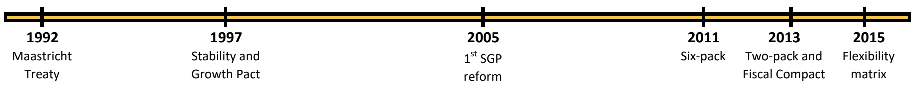


Figure 2: Chronology of the Budgetary Supervision Mechanism in the EU

### *2.4. Fiscal Rules*

Budgetary supervision at EMU is currently based on a relatively large and complex set of legal texts. Since the adoption of the Stability and Growth Pact (SGP) in 1997, there have been significant changes and juxtapositions of budgetary rules and procedures (Figure 2).[2] Although the rules set out at the outset were apparently simple and easy to communicate, their practical implementation proved to be problematic. Implementation issues have largely been at the root of successive reforms. The deficit ceiling of three per cent of GDP was interpreted as an objective by several Member States and there were no mechanisms to ensure a convergence of budgetary positions to a situation close to balance throughout the business cycle. At the same time, there were several attempts to exploit gaps in the statistical procedures that led to successive revisions and clarifications also in this area. The debt criterion was only tentatively put into operation in 2011. In recent years, the critical tone of the EU budgetary surveillance mechanism has expanded. In addition to the lack of effectiveness, the main criticisms are currently focused on the complexity of budgetary rules, the absence of internal consistency and the poor decision making process, which is inevitably politicised.

An analysis of the past effectiveness of the European budgetary surveillance mechanism is difficult given the impossibility of constructing a counterfactual scenario. The recent economic crisis has put the SGP to the test, as the requirement of fiscal consolidation in recessive periods has little support from governments. In periods of economic expansion, the SGP has proved incapable of generating the incentives for the accumulation of buffers, i.e. to counteract the pro-cyclical stance of fiscal policy. However, at present only one euro area country is in excessive deficit and most countries have already reached or are close to their medium-term objective, although the budgetary positions of the different Member States still differ substantially. For this reason, there is a perception that the budgetary surveillance mechanism has to some extent been effective, making it possible to avoid a deterioration in the public finances at

2. For an easy access to all SGP related legislation see: `https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/legal-basis-stability-and-growth-pact_en`

various points in time and in several countries, particularly in those with little tradition of budgetary discipline.

The criticism of the complexity of the budgetary supervision mechanism is easily supported by the constituting set of legal texts, which is very extensive and intricate in content.[3] This legislation includes a multiplicity of rules, not always fully consistent, based on different budgetary indicators (headline budget balance, structural balance, public expenditure and public debt). It adds to the difficulties the fact that some indicators have a relatively complicated and non-transparent calculation formula (such as the expenditure rule) and are based on unobservable variables (such as the output gap in the case of the structural balance). Implementation procedures are equally complex. As a consequence, the degree of predictability in the application of the rules diminishes significantly, creating uncertainty and the possibility of selective choice by policy makers. This makes the communication to the general public even more difficult. The complexity resulted, however, from the sedimentation of the SGP over time. When taken individually, successive amendments and reforms had their own merits in that they sought to improve existing rules and better align them with economic circumstances. For illustration purposes it should be noted that the introduction of the medium-term objective sought to ensure balanced budgetary positions throughout the business cycle, the expenditure rule aimed at improving the control of this aggregate in favourable periods of the business cycle, the debt rule made possible the operationalisation of the debt criterion and tightened the budgetary surveillance, and the "flexibility matrix" (see Appendix B) and the investment and structural reform clauses have intended to modulate the required structural effort to the prevailing economic conditions.[4] In this context the trade-off between simplification and adequacy is evident.

While being fundamental, the rule design does not ensure by itself an effective implementation. The application of budgetary rules, decided by all Member States on the basis of proposals from the European Commission, has been criticized. In the policy-making process, it is difficult for a Member State to censure the fiscal policy adopted by a partner. Apart from the existence of such peer pressure, the SGP provides for a set of pecuniary sanctions which have in practice never been applied. In addition, the introduction of the reversed qualified majority rule at certain stages of the budgetary surveillance process, which represented an attempt to create a greater automatism of sanctions by strengthening the Commission's powers, may have been counter-productive. It may have made it more unlikely the upstream adoption of decisions which could subsequently give rise to a proposal for a sanction.

3. By way of illustration, the current edition of the SGP *Vade Mecum* has 220 pages.

4. The so-called "flexibility matrix" was introduced in 2015 in the preventive arm of the SGP and matches the required structural adjustment to economic conditions and the debt ratio.

The next reform of the SGP is expected to occur by 2025. Reducing unnecessary complexity and eliminating internal inconsistencies should be key objectives of this reform. This will not, in principle, translate into a backtracking to a supervisory system based on too simple rules that have proved ineffective in the past. A number of opinions from institutions and experts published in recent months recommend the public debt ratio as a long-term anchor in the budgetary surveillance mechanism (see, for example, Bénassy-Quéré *et al.* (2018)). This variable would be complemented by an operational indicator which in the short term would ensure the convergence of the debt ratio to a sustainable level. There seems to be some preference for this indicator to consist of a spending rule, net of the impact of discretionary measures on the revenue side and interest expenditure, but defined more straightforwardly than the current one and based on available public information. This option would have, *inter alia*, the advantage of not allowing the use of revenue windfalls to meet commitments, thereby helping to mitigate the pro-cyclical orientation of fiscal policy.[5]

The degree of decentralisation in the decision-making process associated with the implementation of fiscal rules has also been debated in the context of allocating further responsibilities to national public finance councils. However, it is important to note the significant heterogeneity of these institutions in the Member States, particularly in terms of their legal powers, resources and reputation. As such, a more active role for these institutions in the implementation of multilateral surveillance would require a substantial strengthening of its powers in a number of countries.

Although there is a consensus on the need for sustainable fiscal policies in a monetary union, some proposals put forward point to the possibility of budgetary discipline being imposed exclusively by financial markets, without centrally defined rules. The behaviour of markets, however, is difficult to anticipate and at various times in the past their reaction proved to be belated and often too penalizing.

Finally, it should be noted that the degree of ambition in the reform of European fiscal rules will depend crucially on the political will of the parties involved. So far, this ambition has been very moderate.

### *2.5. Macroeconomic Stabilisation*

The debate on the deepening of EMU in the public finances domain has also focused on the need to intensify risk-sharing among Member States. In particular, the creation of an instrument that could take the form of a centralised fiscal capacity whose objective would be

5. These revenue windfalls, very frequent in periods of economic expansion, are not normally captured in the cyclical adjustment of the budget balance, thus contributing to the improvement of the structural balance.

macroeconomic stabilisation is being discussed. This instrument would accumulate contributions from Member States at good economic times to finance expansionary measures in recessive periods. Thus fiscal policy could complement the role of monetary policy in the presence of large macroeconomic shocks, increasing resilience and integration at the EU level.

It is possible to identify some general desirable characteristics for a centralised fiscal capacity. Given the lags in the implementation of discretionary fiscal policy, it should be used only in the case of large macroeconomic shocks and have a sufficient dimension to allow for effective stabilisation. In addition, it should encourage good budgetary practices in order to minimise moral hazard and promote compliance with fiscal rules and the accumulation of buffers in good times. As for the rules of operation, they should be clearly established at the outset and be based on automatic trigger mechanisms. Finally, over a sufficiently long period, a country's position on the fund should be balanced, avoiding permanent transfers between countries. Financial support to Member States with lower levels of per capita income, within the framework of convergence policies aimed at promoting economic and social cohesion, should be provided by other types of instruments not intended to macroeconomic stabilisation.

Several proposals have been put forward for the possible design of a fiscal capacity (see Carnot *et al.* (2017) and Arnold *et al.* (2018)). As regards access criteria, the link with compliance with European budgetary rules is a common denominator in various proposals but with different specifications. In turn, public investment and unemployment benefits are the public expenditure areas most commonly referred to as the focus of the transfers, although several proposals allow more leeway to Member States when deciding where to apply the funds. With regard to the events triggering the recourse to the fund, some initial proposals referred to GDP growth and the output gap, but currently the unemployment rate is the most referenced indicator. There remains, however, a debate on the concrete definition of the criteria. Finally, it remains to decide whether the fiscal fund distributes only the accumulated amounts or whether it has indebtedness capacity, for example by issuing bonds.

As part of initiatives to deepen EMU, the European Commission presented a proposal for a European Investment Stabilisation Function (EISF) at the end of May 2018. This instrument is designed for euro area Member States and for non-participants included in the Exchange Rate Mechanism II. The purpose of this mechanism would be to provide financial assistance to Member States affected by large macroeconomic shocks through loans linked to the Community budget in order to sustain the average level of public investment prevailing the last five years. The proposed total financial envelope amounts to 30 billion euros, which may be considered insufficient to ensure effective macroeconomic stabilisation policy. The criterion for activating this type of support would be based on the level and change of the unemployment rate.[6] Additionally, an allowance covering all interest expenses incurred on the loan is provided. Support under this mechanism would be conditional on compliance with decisions and recommendations in the framework of budgetary and macroeconomic surveillance.[7] In the coming months, this proposal from the European Commission will be subject to the usual process of political debate. In this context, it should be noted that the German and French leaders underlined in Meseberg's statement in June 2018 the relevance of an euro area budget that fosters competitiveness and convergence, making explicit reference to the issue of macroeconomic stabilisation, through a centralised fiscal fund applied to unemployment.[8]

## 3. Insurance and Crisis Resolution Mechanisms

### *3.1. The Banking Union*

The lack of a European banking system, characterized by common supervision and common instruments for crisis resolution, was promptly recognized as a clear fault in the original design of the EMU. Together with the lack of support mechanisms for sovereigns, the onset of the crisis generated the fragmentation of banking systems across national borders, resulting from the strong relation between the banking system and the sustainability of sovereign debt, regardless of the origin of the tensions. Such relation is also present in countries outside a monetary union, but in these cases the central bank is a lender of last resort for banks and sovereigns, and the decision processes are naturally coordinated among the various authorities, besides being expedite and with few restrictions.

On the one hand, that relation results from the direct exposure of the banking system to the sovereign, through sovereign debt holdings, and from the indirect exposure, through the effects of restrictive budgetary measures on banks' credit portfolios, which are essentially composed of domestic assets. On the other hand, the deterioration of banks' balance sheets also generates problem in the sovereign, since a significant part of the liabilities of banks (e.g., deposits) are implicitly or explicitly guaranteed by the sovereign. These tensions accentuate in a crisis scenario, creating the so-called "doom loop" between banks

6. The unemployment rate should be above the average level of the last 15 years and record an annual increase of more than one percentage point.

7. The conditions that have to be met in the previous two years are: (i) under the SGP, no Council decisions of absence of effective action in the preventive and corrective arms; ii) under the MIP, no two consecutive Council decisions/recommendations of absence of effective action. In addition, the Member State can not be subject to a financial assistance programme.

8. See Meseberg's Declaration in: `https://www.diplomatie.gouv.fr/en/country-files/germany/events/article/europe-franco-german-declaration-19-06-18`

and sovereigns, aggravated by the fact that sovereigns are led to save banks. That generates a deterioration of sovereigns' credit risk as assessed by markets, which can generate additional mistrust regarding the banking system. One should further note that provision of emergency liquidity assistance to banks in the euro area is made by national central banks (without risk-sharing at the Eurosystem level), which, in case of significant losses, have to be recapitalized by the respective Treasury. Even if unlikely, this does not contribute to mitigate the aforementioned loop. This characterization of the relation between banks and sovereigns has significant impacts in the transmission of monetary policy, whose effects are strongly mitigated by the lack of operation of the so-called credit channel, even if at the Eurosystem level a highly accommodative stance is followed.

Given the unfolding of the financial crisis and of the sovereign debt crisis, the need for a Banking Union was promptly recognized, and swift steps towards its implementation have been taken. The Banking Union is based on three essential pillars: i) a common supervision for banks; ii) a common resolution mechanism for distressed banks; iii) an harmonized deposit insurance system.

The Single Supervisory Mechanism (SSM) for the banking system, compulsory for euro area countries and under the authority of the ECB, started functioning in full in November 2014. The ECB supervises all banks considered "significant", whereas for all others there is a delegation of responsibilities on national supervision authorities. The ECB can, at any moment, exercise direct supervision of any bank, when needed. In any case the applicable rules are common, within the framework of the designated single rule book. The microprudential supervision is thus marked by a strong European integration. The ECB assumes the leadership and corresponding relevant responsibilities, even if with the active participation of national authorities through the cooperation mechanisms that have been instituted. Regarding the exercise of supervisory powers for less significant institutions, the intervention of national competent authorities is conditioned by the faculty, attributed to the ECB, of issuing regulations, orientations and general instructions.

The Single Resolution Mechanism, which has as its main decision-making body the Single Resolution Council, has been in full operation since January 2016. It acts within the framework of the Single Resolution Mechanism Regulation, and in line with the Bank Recovery and Resolution Directive (BRRD), which focuses on the guiding principle that banks' shareholders and creditors will be involved in their restructuring in order to minimize costs to taxpayers (bail-in).[9]

9. See the Regulation framing the Single Resolution Mechanism in `https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0806&from=ENandtheBankRecoveryandResolutionDirectiveinhttps://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059`

The Single Resolution Mechanism is responsible for the resolution of all banks within the Banking Union, with the Single Resolution Council acting directly on those entities supervised by the ECB - including cross-border groups - and other entities whose resolution plans envisage the use of the so-called Single Resolution Fund. The national resolution authorities shall be responsible for taking decisions regarding all other entities. Member States may, however, delegate their powers and responsibilities regarding all institutions to the Single Resolution Council. In any case, national resolution authorities shall ensure the implementation of the resolution decisions taken by the Single Resolution Council in line with national law. Such decisions may include the sale of part of a bank's business, the establishment of a bridge-bank which will continue to ensure the critical functions of the resolved entity, the segregation and transfer of certain assets and also the application the aforementioned bail-in measures: conversion of debt into equity or the elimination of that debt in accordance with a pre-established order, generally aligned with credit seniority in insolvency proceedings, and which gives special treatment to the deposits of natural persons and of small and medium-sized enterprises.

The aforementioned Single Resolution Fund is made up of contributions from the banking sector, gradually reaching 1 percent of total covered deposits (i.e. guaranteed deposits up to €100,000) in all covered credit institutions. This fund is based on national compartments which will also be gradually converted into a common (mutualised) fund by 2024. This fund may provide loans or guarantees to ensure that the "resolved" banks (not liquidated) continue their activity while being restructured . The fund may also be used with the purpose of absorbing losses or injecting capital into resolved banks upon application of "bail-in" measures: the maximum amount of financial support available to a bank in these cases corresponds to 5 percent of its liabilities, including own funds. This type of support can only occur after shareholders and other creditors assume losses, which must reach the minimum value of 8 percent of the same liabilities. At the same time, national resolution funds, which support resolution measures applied to entities that are not included in the Single Resolution Mechanism (which in practice have little expression), will be maintained.

Finally, an attempt was made to harmonize deposit insurance schemes based on the Directive on Deposit Guarantee Schemes, which provides for the creation of national guarantee funds with similar characteristics, guaranteeing the repayment of deposits up to €100,000 (per credit institution and per account holder), although there are several dimensions of heterogeneity in the transposition of the Directive by Member States. These funds also result of banks' contributions and should reach the 0.8 percent target of deposits covered by guarantee until 2024. The national nature of these funds remains unchanged, unlike the Common Resolution Fund. In fact, there is yet no agreement on a European deposit insurance system. The most that is foreseen in the Directive on Deposit Guarantee Schemes is the possibility of borrowing/lending between national funds.

The Banking Union represents a very important milestone in the institutional evolution of the EMU. Firstly, the homogenisation of supervisory action across participating countries ensures equal requirements and a level playing field in this dimension. It also guarantees greater coordination among national authorities in the case of institutions operating in several countries. Additionally, it allows the pursuit of more impartial oversight by reducing the ability of sovereigns and banks to influence each other. Together with the more demanding regulatory requirements adopted since the outbreak of the crisis (e.g., in terms of capital and liquidity), these elements are crucial to reduce the accumulation of risks and to ensure confidence in the various national banking systems, contributing to mitigate sudden runs on deposits and promoting financial stability. The existence of a single bank resolution system may also contribute to reducing uncertainty in times of stress, in particular in what regards the resolution of cross-border institutions - which requires a high degree of international coordination - and to minimize the involvement of Member States (or taxpayers) in the adopted solutions, mitigating the fragmentation of financial and banking systems along national borders. However, these solutions leave several open questions and have the potential to generate disturbance in times of crisis.

First, the potential lack of autonomy and independence of the Single Resolution Council should be highlighted, since it was granted the status of Agency, rather than Institution, of the European Union. In this context, the adoption of a resolution measure can be objected by the European Commission and by the Council of the European Union. If the Council opposes the resolution scheme on the grounds that the public interest criterion is not met, "... the entity shall be liquidated in an orderly manner in accordance with the applicable national law." This justification may also be invoked by the Single Resolution Board to prevent the implementation of a resolution measure and determine, as a consequence, the liquidation of the institution. The lack of clarity on what constitutes "public interest" in this context generates a great deal of uncertainty regarding the desirable uniform treatment across jurisdictions and the very credibility of the bank resolution principle, which can thus reasonably be interpreted as being of discretionary application.

Second, although the Bank Recovery and Resolution Directive (BRRD) provides, in theory, some room for maneuver to the national authorities before a resolution scenario, the limitations imposed are substantial. For example, the possibility of preventive recapitalisation of banks must comply with very strict requirements and requires central validation by the European Commission and the ECB, which can be slow, cumbersome and generate lack of confidence regarding the banks involved. This may create uncertainty on the fate of a troubled bank and on the degree of involvement of the sovereign.

It is important to recognize that the focus on bank resolution and the principle of bail-in (broadly understood in the sense that shareholders and creditors should contribute first and foremost to absorbing the institution's losses and recapitalisation) reveals the character of compromise that the configuration of the Banking Union has reached. On the one hand, it was intended to decisively mitigate the sovereign-banks nexus within the monetary union. On the other hand, the possibility of a more direct intervention in banks at the Union level was strongly limited. At the same time, perhaps due to the fear of blind application of untested principles, some flexibility was maintained through some of the aforementioned discretionary elements (i) the possibility of preventive recapitalisation of banks by moving away a resolution scenario, which gives Member States some room for maneuver but maintains the sovereign-bank nexus to some degree, and (ii) the possibility for national authorities to liquidate the entities in accordance with national legislation. In this context, it is possible for sovereigns to provide guarantees and compensate bank creditors in the context of the liquidation process, which may contribute to financial stability but does not, once again, contribute to the elimination of the sovereign-banks nexus.

Third, it is not evident that the paradigm of resolution (and "bail-in") resists a financial crisis since it maintains potentially unchanged the sovereign-banks nexus and substantial uncertainty persists concerning the feasibility of applying resolution measures to various banks in several countries simultaneously. It should be noted that the *ultima ratio* possibility of direct intervention in banks has always been preserved in developed economies, and the sovereign-banks nexus may not result in an insurmountable instability in sovereign debt markets (see recent examples of the United Kingdom, the United States, or the Scandinavian countries in the 1990s). There may be good financial stability considerations justifying such intervention, despite the public's understandable opposition and distrust regarding so-called bail-outs, which are in any case often characterized by some degree of bail-in, at least of shareholders.

Fourthly, the creation of a fully-fledged European Deposit Insurance System has not yet been assumed. It should be noted that given the heterogeneity across sovereigns, the national responsibility for deposit insurance contributes to the differentiation of deposits across Member States, which can generate financial fragmentation in times of crisis, contrary to the objectives of the Banking Union. In a context of centralized supervision and resolution, this situation constitutes a substantial misalignment between the levels of decision-making and responsibilities, placing Member States in the position of ultimate guarantors of financial stability, but strongly conditioned by supervisory and resolution decisions and with few instruments to act. This misalignment contributes, for example, to the lack of internalisation by European authorities of the costs of determining that bank liquidation is carried out by national authorities (e.g., those costs related to deposit guarantees). Thus, the declaration by the Union that a resolution scheme does not meet the public interest criterion, leading to the liquidation of the affected banks, may be more likely without a common deposit insurance, which is tantamount to not fully internalising the local systemic perturbation that such decisions may entail.

Finally, it should be referred that the ECB has not evolved towards becoming the true lender of last resort of all banks, which would seem evident in a complete monetary union. In fact, the provision of emergency liquidity assistance to banks, which is possible provided they are solvent and with adequate collateral (but not eligible by the ECB), continues to be carried out by national central banks, and without risk sharing at the Eurosystem level, which means that the ultimate guarantor of financial stability in this dimension remains the sovereign, insofar as it recapitalizes the central bank if required.

It is important to note that the existence of common deposit insurance and risk-shared provision of emergency liquidity to banks would also significantly mitigate the incentives national authorities might have in discouraging the development of pan-European banks. In a context of a deepened Banking Union, the existence of pan-European banks would be important to help achieving private risk sharing within the monetary union. There are clear incentives for national authorities to promote the international expansion of domestic banks through subsidiaries (entities independent of the parent bank) and not through branches (entities dependent on the parent bank), as a way to avoid assuming the risks of the international operations of such banks. In addition, national authorities may tend to make it more difficult for foreign banks to establish themselves in the form of branches - even if this means they do not guarantee deposits or have the responsibility for the provision of emergency liquidity - due to fears of losing control in what regards supervision and resolution, in a context where such branches may be of local systemic importance. Moreover, even if the establishment of international banks takes place in the form of subsidiaries, national authorities will (quite reasonably) tend to adopt risk mitigation measures regarding those institutions, in particular in what concerns so-called national options and discretion. Such measures may involve limiting intra-group exposures, limitations (or resistance) to the possibilities that might exist of relaxing liquidity and capital requirements applicable to subsidiaries, or even by a greater restrictiveness in granting emergency liquidity, resulting in restrictions to the possibilities that banking groups may have in reallocating resources across jurisdictions (possibilities that could result in a behaviour similar to that resulting from branch expansion). Such behaviour results from fears of transfer of risks (liabilities) to their jurisdiction if, for example, problems arise in the parent bank (located in another jurisdiction), even in a context where the subsidiaries are intrinsically sound and only indirectly affected by problems generated in the parent bank.

Beyond these conceptual issues, transition issues remain. For example, there is no final decision on the functioning of the so-called common backstop for the

Single Resolution Fund, which will be the lender of this fund if there is a need to implement one or more resolution measures - involving liquidity provision to resolved entities or their recapitalisation - and there is no capacity of the fund to support them. Whereas it has been decided that the backstop will be the European Stability Mechanism (or a European Monetary Fund), the governance, conditions and timings for the implementation of this support are not yet fully defined. However, a potentially uncertain decision-making process can be anticipated because unanimity (or almost unanimity) is required in the decisions, in line with the current approval protocol of any form of financial assistance by the European Stability Mechanism (see below).[10] This entails risks, resulting in a reduced room for maneuver of the Single Resolution Council, which will be dependent on decisions taken when problems arise and demand a solution, in a context where weaknesses inherited from the crisis persist in several Member States.

The European debates on the backstop, the anticipation of the possibility of full mutualiation of the Single Resolution Fund (i.e. before 2024), a European Deposit Insurance System, among other topics, are marked by the tension between the desire of some Member States to move rapidly towards risk-sharing solutions and the call, by other Member States, for measures to ensure that there are no poorly capitalized banking systems (risk-reduction), a scenario that could generate a transfer of resources between countries, seen as unacceptable. However, between the efforts already made in more vulnerable countries to stabilize their banking systems and systematic changes to previously agreed risk reduction criteria (with increased requirements), which may constitute a disproportionate application of measures with impact on financial stability (e.g., fire sales of some assets or a sharp reduction in banks' exposure to national public debt), it would be desirable to find a balance, motivated by the recognition of the benefits and ultimate goals of the Banking Union. Waiting for the next crisis to complete the Banking Union does not contribute to the deepening of the EMU, and it could compromise it. Although progress is expected to take place when it is really necessary, uncertainty has negative impacts today and can lead to the perception, amplified in the event of a crisis, that there is not a strong safety net available, and that the application of the established principles is not feasible. The risks associated with a deadlock may also pose difficulties to Member States in dealing with idiosyncratic episodes of financial instability, deprived of instruments and subject to an insufficient internalisation by the European authorities of the consequences of their decisions. In another dimension, it can generate the perception, in some Member States, that it would have been preferable not to deepen the Banking Union, which could lead to resistance to further advances compromising any

10. See the Terms of Reference on the backstop agreed in the Eurogroup meeting of 3 December 2018 in `https://www.consilium.europa.eu/media/37268/tor-backstop_041218_final_clean.pdf`

residual degree of autonomy and flexibility, further hindering the impasse or even opening the way to backtrack movements.

### *3.2. Emergency Financial Support and the Outright Monetary Transactions Programme*

*3.2.1. European Stability Mechanism.* The EMU was designed without a lender of last resort for sovereigns. The sovereign debt crisis has shown that the absence of such an insurance mechanism could have dire consequences for the future of the monetary union. At the beginning of the crisis, in May 2010, the European Financial Stability Facility and the European Financial Stabilization Mechanism were established. A permanent mechanism governed by an intergovernmental treaty among euro countries was set up in February 2012: the European Stability Mechanism (ESM).[11] The ESM provides support to countries threatened by financing problems through various instruments: direct lending, sovereign debt purchases in the primary and secondary markets, precautionary credit lines and an instrument for direct recapitalisation of banks. For a small economy whose debt has substantial credit or refinancing risk, the ESM acts as if it swapped risky debt with risk-free debt, since the issuance of debt by the ESM is guaranteed by other countries, with a lower level of risk. In this sense, the ESM plays a role similar to monetary issuance by the central bank, which swaps risky securities with assets without nominal risk (currency), even though both bear inflation risk. The ESM carries out a similar swap provided the amounts involved are a small fraction of the total debt of the ESM members and below its financial capacity.

Despite being a strong safety net for the euro area countries, the ESM design has some weaknesses that undermine its effectiveness in times of crisis. For example, it is difficult for the ESM to act, due to lack of financial capacity (authorization), in a jurisdiction with significant weight in the euro area as a whole, even if, by making that swap of assets, it would have the capacity to reduce tensions in markets. The ECB's Outright Monetary Transactions (OMT) program thus appears to be an important complement within the framework of the monetary union (see below). The decision-making process associated with the ESM can also generate disruptions. A request for assistance has a high political cost, and it generally requires approval by the other Member States, which makes the process time-consuming, uncertain and prone to generate instability. The unanimity required in the approval of a form of assistance by Member States of the ESM is only waived if the European Commission determines that non-approval jeopardizes the "economic and financial sustainability of the euro area". In this case, 85 percent of the

11. For the Treaty establishing the ESM, see `https://www.esm.europa.eu/sites/default/files/20150203_-_esm_treaty_-_en.pdf`

votes are sufficient (according to the ESM capital key), which gives *de facto* veto power to the largest euro area countries.

The Commission presented in December 2017 a proposal to create a so-called European Monetary Fund, which would take over the responsibilities of the ESM.[12]. However, compared to the ESM, the proposed changes are not substantial. It is assumed that this fund will be anchored in the European legal framework (note that the ESM is regulated by an intergovernmental treaty), its role as the common backstop of the Single Resolution Fund is made explicit, but it keeps the essential architecture of the ESM. By analogy with the International Monetary Fund (IMF), one could think that the proposed European Monetary Fund would be more flexible and independent, acting in line with pre-approved financial resources already democratically scrutinized by the Member States, and avoiding the complex political processes within creditor countries, in the sense that the IMF does not consult 189 national governments and parliaments before approving an assistance programme. These characteristics are not part of the Commission's proposal, which simply suggests more expeditious decision-making procedures in cases of urgency and greater involvement of the ESM in the design and monitoring of assistance programmes. It is thus not anticipated that the proposed European Monetary Fund will address the weaknesses in the design of the ESM mentioned above. In a sense, the understandable democratic accountability required for the approval of a programme was not weighed against the low probability of losses (ESM loans are senior relative to other loans, as is the case with the IMF) and the significant turbulence associated with previous requests. Although the creation of this European Monetary Fund is not yet envisaged, the bulk of the above-mentioned Commission's proposals will be considered in the context of the recent reform of the ESM.[13] In this context, it is worth highlighting the willingness of the Eurogroup to revise the conditions for granting prudential assistance in the case of countries with solid fundamentals, but potentially subject to contagion, with a view to addressing the stigma associated with a request for assistance while maintaining a degree of appropriate conditionality.

*3.2.2. ECB's Outright Monetary Transactions Programme (OMT).* As already mentioned, the insufficient financial capacity of the ESM can be partially offset by the ECB's sovereign debt securities purchase program, with no preset quantitative limits: the OMT. The mere announcement of this programme on 6 September 2012 contributed decisively to reversing the

12. See Commission proposal on a European Monetary Fund at `https://ec.europa.eu/info/law/better-regulation/initiatives/com-2017-827_en`

13. See the conclusions of the Eurogroup meeting of 3 December 2018 in `https://www.consilium.europa.eu/en/press/press-releases/2018/12/04/eurogroup-report-to-leaders-on-emu-deepening/`

perceived risk associated with the sovereign debt of several Member States, thus constituting itself as a strong safety net.[14]

However, the activation of OMT requires at least a precautionary credit line with enhanced conditions from the ESM (Enhanced Conditions Credit Line, or ECCL), with the respective conditionality, thus being subject to the uncertainties that characterize the approval of such a programme. In order to get out of this cycle, an adequate and proportional evolution could be characterized by activation of the OMT requiring strict compliance with the commitments made under the Stability and Growth Pact and under the macroeconomic imbalances procedure. This requirement would be an alternative to the requirement of an ESM assistance programme. Such a decision would contribute to financial stability in times of turmoil and to the uniqueness of monetary policy, avoiding financial fragmentation and contributing to achieving the objectives of that policy. The political cost and stigma associated with a request for assistance, as well as the complexity of the political process leading to the adoption of a programme, even if only precautionary, can lead to market turbulence that generates substantial costs by itself. In addition, the design of the current OMT programme, with the conditionality imposed by an ESM programme, can be synthesized by the European rules adopted after the OMT announcement, as they impose additional surveillance and (potentially) conditionality on the economic and budgetary policies of Member States. It should be noted that there is little (if any) additional conditionality associated with a precautionary line with enhanced conditions (ECCL) compared to the conditionality demanded when a Member State is under the so-called "enhanced surveillance" envisaged in one of the Regulations of the 'two-pack', which was designed in such a way as to ensure consistency with the requirements of an ESM assistance programme. It should be noted that the 'two-pack' has been in force since May 30, 2013, i.e. after the announcement of the OMT by the ECB. Finally, such an evolution in the activation conditions could preserve the operational design of the current OMT programme which, together with the above mentioned conditions for its activation, should keep it compliant with the prohibition on monetary financing expressed in the Treaty and in accordance with the decision of the Court of Justice of the European Union of 16 June 2015, which ruled on the legality of the OMT programme.

14. This effect is well explained by economic theory, see Cole and Kehoe (2000), Aguiar and Gopinath (2006), Lorenzoni and Werning (2013), Ayres *et al.* (2018) or Calvo (1988) for examples of articles foreseeing the possibility of so-called multiple expectations-based equilibria rationalizing the sudden and substantial increase in spreads as well as the possibility of a return to the "good" equilibrium, characterized by low interest rates and no default.

## 4. Private Risk Sharing in the Economic and Monetary Union

### *4.1. A European Risk-Free Asset*

The crises have led to a reduction in the supply of safe and liquid assets in the euro area which resulted, for example, from the attribution of credit risk to some sovereigns. At the same time, the demand for this type of assets will tend to increase as a result of the introduction of new liquidity requirements for banks and other entities. Since there has been no political will for the joint issuance of debt (Eurobonds), there have been discussions on the possibility of a private synthesization of this type of issuance, contributing to the increase in the supply of safe and liquid assets in the euro area . One way to achieve this through financial intermediaries would be the simultaneous issuance of two securities guaranteed by a set of sovereign bonds of the various euro area countries, in fixed proportions (an Asset-Backed Security). The first tranche, the so-called senior tranche, would correspond to a given fraction of the total value of the bonds, but would be guaranteed by all such bonds. The second security, or junior tranche, whose amount would correspond to the remaining fraction of the total value of the bonds, would be only the residual beneficiary of the cash-flows available after the payments due to the first security. Naturally, if there is no default in any of the bonds given in guarantee, the two securities would pay investors, at maturity, their nominal value. But obviously, the first security would have a lower risk, and the smaller the risk the smaller the proportion of this security in the overall amount. This is, briefly, the design of the so-called Sovereign Bond Backed Securities (SBBS) proposed by the Commission in May 2018.[15] Such a configuration would, in principle, increase the net supply of safe and liquid assets in the euro area. Besides, sudden movements of flight to quality (into securities of jurisdictions with low credit risk), particularly problematic in a context of incompleteness of the Banking Union, could be mitigated if this security were available, since demand for this senior tranche would increase, and issuers would have to buy a fixed proportion of each country's sovereign debt. In this context, SBBS can be interpreted as a mechanism for sharing specific risks under market discipline, since a part of sovereign debt would remain in the market.

However, the current regulatory framework makes investment in this class of assets - referred to as "structured products" - unattractive, in particular because it discriminates against SBBS (or something similar created by the market, which is in principle possible) relative to sovereign debt. For instance, holdings of public debt by banks do not require additional capital (the so-called "risk weights" are nil) while SBBS, being a structured product, does require

15. See the Commission proposal on SBBS at `https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-400473`

additional capital. It should be noted that, economically, the senior SBBS ought to have a regulatory treatment corresponding to its risk, i.e., at least equal to that currently conferred to public debt. It would even be reasonable to grant it a more favourable treatment, if the SBBS diversification gains were taken into account. There are several alternatives to achieve this: the most obvious would be the imposition of risk weights on sovereign debt, according to the true risk. This could be quite counterproductive in the current context, especially if there were no gradual application of the requirements, even if it resulted in a reduction in banks' exposure to domestic sovereign debt. A more effective option would be to impose concentration limits or risk-weights sufficiently high if significant concentration limits were reached. Initiatives of this type are being considered by the Basel Committee, but there is little prospect of approval or implementation of any change in this spirit. In any event, the SBBS, which have already been widely discussed in European fora following the Commission's proposal, seem to have been put away, at least for now, after the Franco-German Meseberg statement.

While it is clear that the regulatory treatment of these senior SBBS should be more favourable than that currently conferred by prudential regulation, it would also seem clear that other configurations, deviating from the standard one (in terms of the shares of each country in the pool of bonds or of the "thickness" of each tranche) could also have a more favourable regulatory treatment, depending on their characteristics. That is not envisaged in the Commission's proposal, creating a potential dilemma between the desire to favor a specific configuration, which does not discriminate against any Member State, and the introduction of an obvious economic distortion insofar as very similar instruments would have a differentiated treatment (in regulatory terms). Still, not penalizing that particular configuration would be better than maintaining the *status quo*. It should be noted, however, that there are concerns raised by the impacts of this initiative on the (lack of) liquidity of the underlying sovereign debt securities, which could be aggravated if various configurations were possible. In addition, the success of a market for SBBS will also depend on its depth and liquidity. There is thus a potential conflict between the success of these synthetic bonds and the liquidity of sovereign debt markets. There may also be operational difficulties in bringing together the underlying securities of all countries for the various maturities, which could render a complete yield curve for these securities infeasible, especially if coordination among public debt agencies of the various countries is not assured.

### *4.2. Capital Markets Union*

Although the Banking Union can contribute to mitigate financial fragmentation in the event of a crisis, it does not fully eliminate the deterioration of the financing conditions through banks in this situation, especially if the development of cross-border banking groups, allowing for greater risk-sharing among agents of the various Member States, remains subdued. Since it is not certain this will occur, it is relevant to complement the Banking Union with the Capital Markets Union, understood here as a set of initiatives aimed at promoting truly European capital markets, contributing to a greater efficiency in the allocation of resources. This involves reducing barriers to cross-border investment, expanding the sources of financing and integrating European financial supervision and regulation.

The set of measures proposed by the Commission is quite vast, but those approved are still not very significant. While one should recognize the technical, legal and economic analysis complexities underlying the various initiatives, it should be noted that the progress achieved is modest, despite the consensual recognition of the importance of a true capital markets union, which has become more evident after the crises. Among the measures proposed, and not yet approved, are initiatives (Directives and Regulations) related to insolvency regimes, the preventive restructuring of firms, recovery of guarantee assets (by creditors) and sales of credits. These measures are aimed at facilitating the recovery of viable enterprises or quickly liquidating the unviable ones, at low cost, while enabling, making more homogeneous (across jurisdictions) and promoting the sale of credit portfolios of banks to other entities, with smaller losses, and benefiting from the capabilities that banks do not have in the management of unproductive assets. There are also measures being pondered to regulate investment firms and funds, the creation of harmonized European pension funds, and an action plan for Fintechs to frame and exploit the benefits offered. The review of the framework of the European supervisors of capital markets is also given importance. Finally, one should mention an important proposal for a Directive, denoted Common Consolidated Corporate Tax Base Directive, which aims at harmonising the definition of taxable income and, among other objectives, to reduce the current bias of firms in the choice of financing sources, in favour of debt rather than capital. This results, among other factors, from the tax deductibility of interest expenses and the limitations on the deductibility of capital investment and non-deductibility (even notional) of financing costs attributable to capital entry. The more similar treatment between debt and capital may contribute to reduce that bias. However, the elements of uniformity in firms' taxation also provided for in this proposal are particularly delicate and have hindered its acceptance.[16]

It should be noted that, in this context, a large part of the challenges in approving and implementing the proposed measures stems from the tension between the desire for harmonization and simplification at the Union level and some resistance from Member States, motivated by the desire to maintain national idiosyncrasies. However, there is no evidence that there

16. On the Commission's Action Plan on the Union of Capital Markets, see `https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/capital-markets-union-action-plan_en`

are insurmountable difficulties in many of the initiatives, in contrast to what appears to be the case regarding the deepening of the Banking Union. In cases where divergences persist, as in the above-mentioned Tax Base Directive, it would be important to advance at least in the more consensual elements.

Finally, it should be noted that even with deeper financial integration and easier access to a wider range of financing possibilities for businesses, households and investors, banks are expected to remain the most important financial intermediaries in the European context. It is not trivial to move quickly from a bank-based economy to a capital markets based economy (such as the US economy), and it will not be desirable to force this transition. Most likely, European businesses will have to undergo several changes before faster and more extensive transitions occur, notably in terms of size, access to information, transparency; in general, a different corporate culture is presumably necessary. Forcing a change can be counter-productive and generate other inefficiencies.

## 5. Final Remarks

The conclusion of the Banking Union, interpreted as full sharing of the risks generated by the banking systems of the different Member States, is fundamental to the economic and financial stability of the euro area. The establishment of the underlying mechanisms is a clear priority in the process of deepening of the EMU, especially in a scenario of increased risks and a possible reversal of the current positive phase of the international economic cycle. In addition to the already implemented common banking supervision, the Banking Union should include a common resolution fund with a credible backstop and a European Deposit Insurance Scheme. The integration of the responsibilities of a European Deposit Insurance Scheme into a Single Resolution Mechanism also responsible for the possible liquidation of banks, together with greater autonomy and independence of the resulting entity, would be important steps towards a coordinated response to crisis and to the internalisation of the costs and benefits of decisions adopted at the Union level. Furthermore, the degree of involvement in banking system interventions at the Union level should remain flexible. In the long run, it would be desirable that the provision of emergency liquidity assistance to banks be characterized by risk-sharing at the Eurosystem level, even if implementation could continue to be carried out by national central banks. In addition, it is urgent to move forward with the Capital Markets Union, an important element in promoting risk-sharing among agents.

In a context of completion of the Banking Union, the incentives for a high exposure to national public debt by banks diminish, contributing to the reduction of the so-called doom loop. In this respect, it should be noted that the requirements set for banks on the issuance of bail-inable debt also help mitigating such exposure, due to the direct consequences on their financing costs. Even though a penalty for high exposure to the sovereign appears to be acceptable, gradualism is recommended in its implementation. The promotion of a risk-free European asset, along the lines of the Sovereign Bond Backed Securities discussed above, would mitigate the potentially destabilizing impacts of the transition process. The existence of a European Stability Mechanism (or a European Monetary Fund) with an expeditious decision-making process would be important to strengthen the sovereigns' safety net. The ECB's OMT program is also indispensable and can be improved in order to cope with complex decision-making processes and mitigate the potential for disturbances.

The materialization of these steps may attenuate the economic arguments that would justify the need for some form of fiscal federalism within the monetary union. Indeed, national public debt would become less vulnerable to large-scale shocks originating in the banking system and could perform better its role of absorbing other shocks, as it would become more sustainable and less bound by budgetary rules. Nonetheless, the creation of a European fiscal stabilisation capacity could also help strengthening the stabilising role of fiscal policy by creating an additional layer of risk-sharing among Member States. In addition, it could contain elements promoting public debt sustainability. In this respect it should be noted that the implementation of a countercyclical fiscal policy, desirable under certain circumstances, requires that the sustainability of the public debt is ensured.

Regarding the evolution of budgetary and macroeconomic surveillance at the Union level, it is commendable that complexity is reduced and internal inconsistencies be eliminated. Additionally, the national ownership of European rules is essential to ensure an effective implementation and to mitigate tensions between Member States and the Union. Such tensions can pose a threat to economic and financial stability and to the European project itself. In this context, attributing greater macroeconomic and budgetary monitoring responsibilities to the national level, for example via fiscal councils, is an interesting reform proposal. These independent fiscal institutions could be coordinated by a supranational entity, effectively representing a reinforcement of supervisory mechanisms in a first instance, i.e., ahead of the central decision process.

The observation that there is no national ownership of the rules, that the Union faces great difficulties in implementing rules and sanctions and the fact that resulting tensions undermine the Union's deepening and even its stability, have generated proposals that suggest budgetary discipline could be safeguarded exclusively through financial markets, without the need for centrally defined rules. However, such an option entails substantial risks. Indeed, in addition to potentially sudden and overstretched market reactions, public debt would have less capacity to act as a shock absorber. Additionally, economic and financial assistance programmes and debt restructurings could become more frequent, increasing the instability risks in the Union.

Although steps have been taken in the process of deepening the EMU, fundamental flaws persist in several dimensions. The current scenario of partial reforms does not necessarily imply increased preparedness to respond to new crises. The most important considerations in this process are, and will continue to be, political in nature, characterized by the tension between the desire to intensify a political union and the fears of loss of sovereignty. Although the negotiation processes are still ongoing at the European level, it is important to note that the deepening of the EMU does not seem to be a priority for policy makers in the various Member States. Decisive steps in any direction depend on collective choices, which ought to be informed and forward looking.

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## Appendix A: Scoreboard of the Excessive Macroeconomic Imbalance Procedure

The headline indicators and indicative thresholds, covering the major sources of macroeconomic imbalances, are:

- 3-year backward moving average of the current account balance as a percentage of GDP, with thresholds of +6% and -4%
- Net international investment position as percent of GDP, with a threshold of -35%
- 5-year percentage change of export market shares measured in values, with a threshold of -6%
- 3-year percentage change in nominal unit labour cost, with thresholds of +9% for euro area countries and +12% for non-euro area countries
- 3-year percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 41 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries
- Private sector debt (consolidated) as a percentage of GDP with a threshold of 133%
- Private sector credit flow as a percentage of GDP with a threshold of 14%
- Year-on-year changes in house prices relative to a Eurostat consumption deflator, with a threshold of 6%
- General government sector debt as a percentage of GDP with a threshold of 60%
- 3-year backward moving average of unemployment rate, with a threshold of 10%
- Year-on-year changes in total financial sector liabilities, with a threshold of 16.5%
- 3-year change in percentage points of the activity rate, with a threshold of -0.2%
- 3-year change in percentage points of the long-term unemployment rate, with a threshold of +0.5%
- 3-year change in percentage points of the youth unemployment rate, with a threshold of +2%

## Appendix B: Flexibility in the EU fiscal surveillance

| | | **Required annual fiscal adjustment (percentage points of GDP)** | |
|---|---|---|---|
| | **Condition** | Debt below 60% and no sustainability risk | Debt above 60% or sustainability risk |
| Exceptionally bad times | Real growth $< 0$ or output gap $< -4$ | No adjustment needed | No adjustment needed |
| Very bad times | $-4 \leq$ output gap $< -3$ | 0 | $0,25$ |
| Bad times | $-3 \leq$ output gap $< -1,5$ | 0 if growth below potential, 0,25 if above | $0,25$ if growth below potential, 0,5 if above |
| Normal times | $-1,5 \leq$ output gap $< 1,5$ | $0,5$ | $> 0,5$ |
| Good times | output gap $\geq 1,5$ | $> 0,5$ if growth below potential, $\geq 0,75$ if above | $\geq 0,75$ if growth below potential, $\geq 1$ if above |

Table B.1. The "flexibility matrix" in the context of the EU fiscal supervision

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