Future of Europe

Creating a Decentralised Eurozone

CHARLES WYPLOSZ

A decade after the crisis that came close to destroying it, the Eurozone remains fragile. Fiscal indiscipline, a key cause of the crisis, remains a relevant issue. Progress has been made to make the banking system safer, but much more is required to contain risk. Eurozone governance remains weak. This paper argues that six key steps are required to refashion the Eurozone into a robust monetary union capable of dealing with unexpected shocks in the future. These steps are: **1.** Subsidiarity should be rigorously applied to straighten the existing muddled governance structures. **2.** Banking Union needs to be completed to break the doom loop between banks and governments. **3.** Pan-European banks and fully integrated financial markets offer the best solution to absorb national disturbances. Implicit protectionism – through regulations and support for national champions – should not be accepted. **4.** The responsibility for fiscal discipline must lie where the budget authority is exercised: at the national level. **5.** The no-bailout clause is the best protection against fiscal indiscipline. It should be formally restored. **6.** Some countries with large public debts remain vulnerable to market sentiment fluctuations. However, there are ways to reduce these debts without any transfer or mutual guarantees.

Wilfried
Martens Centre
for European Studies

Introduction

From the start, the "European Project" has been bedevilled by a profound disagreement. In the 1950s, the aim was to achieve, at long last, peace. It was felt that shared values and intertwined economic interests would make wars impossible. Beyond that, however, there never was any agreement about the ultimate objective. Monnet, De Gaspari, and other founding fathers had a federal objective in mind – a United States of Europe[1]. Most real-life politicians, perhaps exemplified by De Gaulle and Adenauer, aimed at extensive but strictly limited sovereignty transfers – a Europe of Nations. In the decades that followed some national leaders, like Thatcher, wanted nothing much more than a free trade area.

Decades later, these disagreements remain. What has changed, is public opinion. Post-war generations generally supported successive integration steps, partly because peace was a pressing imperative, partly because there was no "common house" to start with. Now the house is impressive and peace is taken for granted. However, adding more rooms and floors inevitably brings to the fore the divisive question of the ultimate objective. Unavoidable architectural flaws are plain to see, dimming the enthusiasm of the early years. Early warning signals, like the rejection of the European Constitution project in the mid-2000s, were ignored. The Eurozone crisis, which should not have happened, has not only dissolved enthusiasm for the integration process, it also has further reinforced the famed democratic deficit. Public opinion is no longer ready to turn a blind eye to European politics – its actors and institutions. The common house is not yet in flames, but smoke is billowing here and there.

[1] However, it has been recently argued that even the federalist founding fathers did not probably envisage the future United States of Europe in the same way. Different federalist visions emerged at the dawn of European integration. See F. O. Reho, The Four 'Classical' Federalisms, Wilfried Martens Centre for European Studies, 2018. Available at https://martenscentre.eu/sites/default/files/publication-files/classical-federalism.pdf.

At this difficult juncture, the old debates resurface. A first view is that Euro-enthusiasm has to be the response to Euroscepticism. President Macron, for instance, has championed a number of measures, some substantial, some symbolic, to show that Europe is still able to take bold new steps. A second view is that Europe has already gone too far and that Brexit is a warning signal. Doing what it would have taken to prevent the British vote is needed to avoid more departures. A third view is that disagreements must be accepted, especially now that the Union has grown larger and more diverse. In this view, the Europe of Nations must allow for “multiple speed”, with separate clubs coexisting in the same house, as is already the case with the monetary union or the Schengen agreements. Yet another view is that it is possible to “do more with less”, as suggested by the European Commission’s White Paper in 2017[2]. More views and nuances exist of course. This paper’s viewpoint is that being “pro-European” no longer systematically means supporting further integration. As they face the anti-Europe wave, the pro-Europeans must sort out their disagreements and indeed learn to do more with less.

[2] European Commission, *On the Future of Europe: Reflections and scenarios for the EU27 by 2025,* White Paper, COM (2017) 2025 final (1 March 2017).

Why the Eurozone crisis? Three reasons

Getting the diagnosis right ought to be the starting point. While some disagreements unavoidably persist, one way or another three key reasons figure in most analyses of the Eurozone crisis. Importantly, all three of them had been identified even before the launch of the common currency. At the time, policymakers considered that these issues were too sensitive to be confronted, or even mentioned. The Commission's seminal report *One Market, One Money* studiously ignored them, preferring to make promises that could not be achieved –such as immediate increases in intra-European trade which would raise incomes and promote convergence.[3]

Reason 1 - Fiscal discipline

Fiscal discipline is not a choice, it is a universal constraint. Within a monetary union, fiscal indiscipline is a lethal threat. A country whose public debt comes to be seen as unsustainable cannot use monetary instruments in the usual way, to inflate the debt away or to devalue its currency to cushion the contractionary impact of promptly closing its budget deficit. At that stage, the whole monetary union faces the unsavoury choice between leaving the country to face a traumatic crisis or relaxing the common monetary policy and therefore allowing inflation to rise.

Fiscal discipline was never achieved during the first decade of the euro, an outcome that should not have surprised readers of Eichengreen and Wyplosz.[4] Budget balances were improved in the run up to the creation of the euro because one of the entry conditions required that the budget deficit did not exceed 3% of Gross Domestic Product (GDP) – a condition that was flouted by some countries. This condition carried over to the Stability and Growth Pact but most countries relaxed their budgetary efforts soon after joining the Eurozone. The two largest countries, France and Germany, were among them and used their influence to put the pact "in abeyance". Following the global financial crisis, there was a further relapse. Fiscal discipline never was in place in each and every Eurozone member country.

[3] European Commission, One Market, One Money: *An evaluation of the potential benefits and costs of forming an economic and monetary union*, European Economy Papers, No. 44 (October 1990).

[4] B. Eichengreen and C. Wyplosz, 'The Stability Pact: Minor Nuisance, Major Diversion?', *Economic Policy*, 26 (1998): 67-113.

Reason 2 - Banking Union

Controlling the public debt is not just about fiscal discipline. It also requires a stable banking system. The very nature of banking systems is to be crisis prone and no government can stay idle when its banking system collapses. It must intervene forcefully, which may require injecting massive public resources into failing banks. This is precisely what happened in Ireland and Spain. The Irish government had to borrow more than 30% of GDP over a few weeks, which prompted a debt crisis.[5] The same happened in Spain, although borrowing was spread over three years.

The important lesson is that solid bank regulation and supervision, as well as access to large resources in the event of a crisis, is an integral part of fiscal discipline. This requirement, carefully described long before the adoption of the euro in Begg et al., was studiously ignored because it was politically divisive.[6] The eventual crises were unavoidable and dutifully occurred. This led to the Banking Union, too late for the crisis to be avoided, and not yet completed, which is a clear threat for the future.

Reason 3 - Central bank as a lender in last resort

Even with the best arrangements in place, a sovereign debt crisis can never be ruled out. When it occurs, the role of the central bank becomes paramount. Because quickly closing down a budget deficit in the teeth of a crisis is impossible, the only effective containment is lending of last resort by the central bank to governments. Similarly, when banks fail, it is essential that they be urgently provided with cash to quell bank runs (panic among depositors), which calls for lending of last resort by the central bank to commercial banks. No central bank ever pre-commits to act as a lender of last resort because it does not want to encourage fiscal indiscipline and excessive risk-taking by banks, but it is widely understood that it will do so if the need emerges.

The situation is much more complicated in a monetary union because any support by the European Central Bank (ECB) in favour of one particular member country – directly to the government or to its banks – can be seen as a transfer from all other member countries. As unsavoury as such an intervention may be, it may prove to be necessary and procedures must be thought through ahead of time, including to limit or eliminate the transfers. Begg et al. made that point decades ago.[7] Unfortunately, the ECB lost three years before President Draghi finally promised to do “whatever it takes”; however, by then the crisis had affected five countries.

[5] Ireland’s debt to Gross Domestic Product (GDP) ratio rose from 24% in 2007 to 120% in 2012

[6] D. Begg et al., *The Making of Monetary Union*, Centre for Economic Policy Research, Report no. 2 (London, 1991).

[7] Ibid.

Correct lessons from the crisis

Lesson 1 - A Banking Union is indispensable

The central role played by banking problems during the crisis was too obvious to be further overlooked, as were the costs involved. The quick establishment of a Banking Union was therefore natural. Subject to further common regulation, large banks are now subject to surveillance by the Single Supervisory Mechanism (SSM). Importantly, the SSM operates within the ECB. This is not an obvious arrangement.

On the one hand, it creates a conflict of interest. Monetary policy deeply affects banks' profitability, which may interfere with the central bank's overriding objective of price stability. For instance, the ECB could be tempted to keep interest rates low and money abundant if it fears that tighter monetary conditions could harm banks, at least the weakest ones. In addition, bank supervision is not an exact science. It involves judgment and therefore human errors are possible, indeed quite likely from time to time. Such errors stand to affect the ECB's reputation, with potential deleterious impact on its ability to carry out monetary policy.

On the other hand, supervision failures – both in the EU and in the US, and previously in Japan – were directly linked to the weakness of national supervisory agencies. Frequently, the agencies were poorly staffed, both in terms of quality and quantity. They were often too close to governments, which are always sensitive to pressure by banks. The decision to establish the SSM within the ECB acknowledges the importance of this latter consideration. It also rests on the ability of the ECB to adequately manage its now-internal conflict of interest, a bet that we may come to regret but that was well worth taking given the circumstances prevailing at the time.

As is well known, the Banking Union remains work in progress. First, the "doom loop", the two-way dependency between states and their banks, has not been treated. As previously noted, bank failures can morph into a public debt crisis and a public debt crisis can fatally hurt banks that hold large amounts of Treasury bonds.

A bank failure requires prompt public intervention to stem contagion. Bank runs occur when depositors fear losing their money and withdraw cash from their banks. No bank can sustain a powerful run. The time-tested solution is to guarantee bank deposits, up to some amount. In Europe, deposit insurance is standardised at €100,000 per account. The insurance is provided by each government, which means that each government must be ready to inject massive resources, which it must borrow, hence a risk of contamination of public finances. One solution is central bank lending, but this is a last resort. The logical solution is the adoption of a European Deposit Insurance System (EDIS) as proposed by the Commission.[8]

Stemming a bank run is the first step. In some cases, the bank is insolvent and must 'resolved', i.e. closed down. By definition, a failed bank lacks assets to match its liabilities, so that its shareholders and bondholders stand to face losses. This opens a long legal process during which money must be temporarily injected and the amounts may be significant, which again can contaminate the public debt. The solution is a Single Resolution Fund. The Banking Union includes such a fund, but its resources are due to accumulate over many years and could be too modest in the end.[9] What will happen if a serious banking crisis occurs in the meantime or if it requires larger resources? In order to prevent another crisis, the resolution fund must be established much faster and have access to more resources.[10]

The second shortcoming of the banking union is that the Single Resolution Board coexists with national resolution authorities. Officially, they would coordinate and act in concert. However, the tight link between governments and banks is bound to inject political considerations at a time when prompt action is of the essence. This could derail interventions.

Finally, a large number of smaller banks or bank-like institutions, are not supervised by the SSM. The official reason is that small banks can be dealt with at the national level because the costs of potential failures are bound to be limited. Yet, one lesson from banking crises is that they erupt where they are least expected and that their costs are often much larger than foreseen.

[8] European Commission, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme*, COM (2015) 586 final (24 November 2015).

[9] The fund is being gradually built up between 2016 and 2023. The target level is set at "at least 1% of the amount of covered deposits of all credit institutions within the Banking Union" by 31 December 2023. It is not clear that its size will be adequate. Total banking deposits are close to €6 trillion.

[10] In the US, the Federal Deposit Insurance Corporation (FDIC) has direct access to the Treasury, which can make arrangements with the central bank for immediate resources.

Lesson 2 - The ECB as lender in last resort

At the start of the sovereign debt crisis, the ECB was intent on not being directly involved. This was in line with a minimalist interpretation of its mandate; shunning any responsibility for financial stability. Over time, step by step, it has undertaken several programs that involved larger and longer-lasting purchases of various assets. The common characteristic of these interventions is that their sizes were precisely circumscribed. But the unique power of a central bank is that it can create instantaneously an unlimited amount of money. This power allows a central bank to quell rapidly developing financial crises. It is the defining characteristic of lending in last resort. Of course, any instrument can be misused, which is why responsible central banks follow clear rules of engagement. Eventually, in the summer of 2012, the ECB announced its Outright Monetary Transactions (OMT) program, which quickly prompted the crisis to fade away, without the need for actual purchases. Such is the power of lending in last resort.

The OMT should have been started at the very beginning of the crisis. The ECB dithered because it feared adverse political reactions. It was right. Following its actions, the ECB was taken to the European Court of Justice for alleged violation of its mandate. The Court ruled that the ECB's actions were within it mandate. This is an important step toward normalising the ECB, but it might again hesitate during future crises.

Incorrect lessons from the crisis

Incorrect Lesson 1 - Fiscal discipline requires more rules at the EU level

As noted above, fiscal indiscipline– including poor banking supervision – in some countries directly caused the Eurozone crisis. The official interpretation is that the Stability and Growth Pact was too weak. This interpretation has led to several reforms, the two-pack and six pack legislation and the Treaty on Stability, Coordination and Governance (TSCG), which includes the Fiscal Compact. These new layers, added on previous reforms, have resulted in a mechanism that is both remarkably complex and ineffective, as is diplomatically summarised by the Commission's own watchdog body, the European Fiscal Board:

> *"The outcome of the successive reforms and re-interpretations of the Pact is a system that many observers and stakeholders find unsatisfactory. From a simple multilateral framework, primarily focused on the long-term sustainability of public finances, the Pact today is an extremely complex set of rules, in which fiscal surveillance is increasingly granular and governance is more bilateral. Due to its increased complexity, the Pact is considered to lack transparency and predictability, raising doubts about its consistent implementation.".*[11]

The evolution of the Stability and Growth Pact has become sadly familiar. As the pact fails to deliver fiscal discipline in each and every member country, it is reformed by adding new constraints and new procedures. However, the multiplicity of rules opens up possibilities for governments to pick and choose, which leads the Commission to interpret compliance. Such interpretation is unavoidably judgmental, with high political stakes.

Subsequently, the Commission's decisions are often seen as opaque and arbitrary. Recent work on fiscal rules instead argues in favour of few, possibly just one, constraint.[12] A similar view leads the European Fiscal Board to state that "the current system of EU fiscal rules has reached its limits, and new attempts to fix the many issues in isolation without taking into account the more general architecture of the rules would make things only worse".[13]

[11] European Commission, European Fiscal Board, *Annual Report 2018*, (2018), 70

[12] See, for example, L. Eyraud et al.-*Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability*, IMF, Staff Discussion Notes no.18/04 (2018).

[13] European Commission, European Fiscal Board, *Annual Report 2018*, (2018), 70

Incorrect Lesson 2 - A Eurozone budget is needed to insure member countries against adverse shocks

Part of the problem with the Stability and Growth Pact is that it was badly interpreted during the crisis years. In the countries directly affected by the crisis, and others as well, the Commission requested a prompt reduction in budget deficits. As a result, fiscal austerity deepened ongoing recessions or provoked 'double-dip' recessions. One reason for the Commission's requirement was that deficits were deemed excessive according to the pact. Another reason was the view that improving public finances was required to re-establish confidence. This was a startling reminder of the Great Depression of the 1930s when the same argument had been made, with disastrous economic – and then political – consequences. Since then, it is well understood that austerity in the teeth of a recession is a major policy mistake, and yet the very same mistake was made.

This has led some to conclude that the Eurozone needs its own capacity to provide resources to governments that face an adverse shock and yet are already seriously indebted. The proposal is presented as a form of collective insurance. Reference is sometime made to the USA, where the federal budget is used to assist states. These arguments are thoroughly unconvincing, and the proposal is likely to be counter-productive, economically and politically.

Consider first the fraught comparison with the USA. It is true that the federal budget automatically transfers resources from states in good economic shape to states in difficulty. This occurs through the federal budget system. Federal taxes decline during recessions and rise during expansions. As a result, when incomes in a state decline by $100, taxes decline by some $40 while federal spending in US states, including transfers, changes very little. From there, two conclusions follow. First, during the Eurozone crisis, the average decline in GDP was of 7.6% among both the crisis-hit countries (Cyprus, Greece, Ireland, Portugal and Spain) and the others (excluding the more recent members). A US-type federal insurance system would have provided an average support of some 3% of GDP. Transferring 3% of GDP would have been much too small to seriously mitigate the deficit increases to prevent a crisis where it happened.

However, and this is the second observation, this calculation is misleading. The current budget of the EU is 1% of Europe's GDP while the average share of public spending among state members is about 45%, which precludes any insurance scheme sizeable enough to make a difference; even a doubling or a tripling of the EU budget, which is most unlikely, would be very far from sufficient. The comparison with the US, where federal public spending amounts to 21% of GDP (and sub-federal – state and municipalities – public spending stands at 18% of GDP), is simply not relevant.[14]

Thus, the logic of collective insurance is appealing until it faces the acid test of size. This can be summarised by looking at the recent proposal by a group of French and German economists'.[15] They envision a transfer of 0.5% of the recipient country's GDP in the case when the unemployment rate increases by 4 percentage points. Standard estimates of Okun's law indicate that this would occur when GDP falls by 8 to 10%.[16] Such an insurance scheme would provide little relief, while being complicated and quite possibly politically controversial. More importantly perhaps, once fiscal discipline is established along the lines suggested in this report any country can borrow 0.5% of GDP. Borrowing in bad years to pay back in good years is equivalent to being insured, and much simpler in every dimension. Rather than organising transfers, achieving fiscal discipline should remain the key goal.

Incorrect Lesson 3 - Coordination of fiscal policies is possible in real time

The debate over "fiscal space", the ability of a government to adopt an expansionary fiscal policy when needed, sometimes shifts to the issue of fiscal policy coordination. A simple version of the argument goes as follows. Countries with large fiscal spaces – low public debt and budget surplus – could undertake a fiscal expansion when others need it but do not have enough fiscal space. This is a simple example of the more general issue of fiscal coordination, whereby the addition of national fiscal policy stances does not automatically result in the best collective stance. The TSCG endorses this approach (art. 9) and one function of the recently-created European Fiscal Board is to "advise the Commission on the fiscal stance appropriate for the euro area as a whole". Undoubtedly, cooperation is helpful but it is not clear that it is feasible.

[14] Things would be very different, of course, if Europe would adopt a federal structure with a sizeable federal budget.

[15] A. Bénassy-Quéré et al., 'How to reconcile risk sharing and market discipline in the euro area', *VoxEU.org*, updated 17 January 2018

[16] Okun's law relates to how a rise in unemployment affects gross domestic product (GDP), where a percentage increase in unemployment causes a 2% fall in GDP.

A good example is the year 2017 when the Eurozone economy as a whole was strengthening but had not yet recovered from the crisis. At the end of 2016 the Commission stressed the need to differentiate the fiscal effort across Member States ‘by better taking into account their respective position with regard to the requirements under the Stability and Growth Pact, the situation of the euro area aggregate and spillovers across euro area countries’.[17] In particular, it called on Member States with available fiscal space to use it ‘to support domestic demand and quality investments, including cross-border ones, as part of the Investment Plan for Europe’. The other countries were asked to comply with their fiscal requirements”.[18] Reviewing this episode two years later, the European Fiscal Board concluded that ‘based on real-time data, the size of the expansion recommended by the Commission in the autumn of 2016 was not appropriate’[19]. Indeed, subsequent data have shown that the Eurozone economic performance was better than initially expected. This is an important observation. Fiscal policy is slow to be changed and cooperation requires even more time. The decision, implementation and effect lags often undermine good intentions.

Another reason why coordination is difficult can be illustrated by the same episode. The country with the largest fiscal space was Germany, which then was reaching full employment. Italy was among the countries with a poor growth performance and with no fiscal space, since it was then in the excessive deficit procedure. It was unrealistic to ask Germany to raise its public debt to help out fiscally undisciplined countries. Unsurprisingly, the Commission’s recommendation was not followed.

It is most unlikely that, absent a federal arrangement, the Eurozone will be more successful. Coordination of fiscal policies is a highly complex exercise as it interferes with national politics and requires a sense of solidarity that is lacking. The track record of international coordination of fiscal policies has long been poor – with the exception of 2008 – despite constant discussions at the G7 or G20 levels and at international financial institutions (IMF, OECD). Not only are current efforts at promoting policy coordination unlikely to be fruitful, but they also deflect attention from other more pressing needs.

[17] *Annual Report 2018*, European Fiscal Board, 55

[18] ibid, 55.

[19] ibid, 58.

Incorrect Lesson 4 - A European Monetary Fund (EMF)

Under this name lie different proposals. Since 2012, the European Stability Mechanism (ESM) has played a role similar to that of the IMF, mostly alongside the IMF. Its resources are significant, actually much larger than those that the IMF can mobilised for Europe. Like the IMF it lends to countries in difficulty under strict conditions. Relative to the IMF however, it suffers from two shortcomings. First, its lending decisions must be unanimous, and some governments must gain parliamentary approval. This makes ESM lending decisions both difficult and lengthy. Second, the required technical work (evaluation of needs and conditions, follow-up of programs) is not performed within the ESM but by the Commission. There always is something wrong when the one who pays is not the one who evaluates.

If the EMF is an improved ESM with better governance and more comprehensive responsibility and associated technical resources, then it's a progress. Unfortunately, proposals along these lines have not been taken on board in recent discussions. Countries with stronger economic positions are wary of providing 'easy' financing to weaker countries. The risk here is that a change of name remains largely symbolic, only to be eventually seen as one more disappointment.

Six steps to build a decentralised and robust Eurozone[20]

The several issues raised above are tightly connected. If every country is fiscally disciplined, the issue of fiscal space is moot. Fiscal discipline requires a complete Banking Union, which breaks the doom loop between government finances and enhances the resilience of banking systems. Further bank integration makes it possible for the private sector to shoulder shocks through borrowing and lending throughout the Eurozone, the best possible avenue toward risk diversification and the most efficient implicit insurance mechanism.[21]

Understanding the Eurozone: A cocktail of politics and economics

For decades, economists have studied the question of where to locate responsibilities within a multi-layered government (federal or EU level, sub-federal or national level, possibly strictly local). Much is known by now. The theory of fiscal federalism, as it is called, says that functions ought to be centralised when they involve large collective effects – called *externalities* – or when they are more effective – because of *increasing returns to scale*. Conversely, functions should be decentralised when, at the decentralised level, there exist different views about their merits and organisation – preferences are *non-homogeneous* – or when doing it right requires a deep understanding of local conditions, including politics – a characteristic labelled *asymmetric information*. The reasoning is pretty obvious, but subtle because many functions tick several of the four boxes, preventing straightforward conclusions.[22] In the EU, such ambiguous cases are presumed to be solved through the subsidiarity principle, which calls for decentralisation unless the case for centralisation is clearly established. This is not always the case, however, which explains some of the disaffection among public opinion.

[20] Several of the proposals presented here are also developed in Juan Castañeda (2018), 'Rebalancing the Euro Area, A proposal for future reform', *Policy Brief*, Wilfried Martens Centre for European Studies, Brussels.

[21] In the US, it has been shown that private borrowing from other states is the main way of cushioning an adverse state-level shock.

[22] An application to Europe is presented in Charles Wyplosz (2015), The Centralization-Decentralization Issue', European Economy Economic Papers, European Commission, No. 14, Brussels alongside references to the literature

Step 1: Putting the Subsidiarity Principle at the Heart of the Eurozone

In Europe, the division of competences sometimes corresponds to the principles of fiscal federalism, but not always. Symptomatically, instead of the two-way distinction between central and sub-central assignment of competences, the architecture is pretty complex. As expected, ambiguous cases abound, but they are not always subject to the subsidiarity principle. Five categories of assignments of competences exist: 1) exclusive European competences (trade, the internal market), 2) national competences (primary and secondary education, public transport), two different categories of shared competences, 3) exclusive if the EU has a policy and 4) non-exclusive. 5) coordinated competences. Table 1 presents the distribution of competences as described in Title I of Part I of the consolidated Treaty on the Functioning of the European Union (TFEU). Those not explicitly listed are national competences.

Assignment of competences in the EU

Exclusive	Shared		Support, cordinate or supplement
Customs Union	Exclusive if EU has policy	Non-exclusive	Certain human health policies
Competition policy	Internal market	R&D policies	Industry
Eurozone monetary policy	Certain social policy	Outer space policies	Culture
Conservation of marine re-sources	Cohesion policy	Development cooperation	Tourism
Commom commercial policy	Agriculture and fisheries	Humanitarian aid	Education and training
	Enviroment		Civil protection and disaster prevention
	Consumer protection		Administrative cooperation
	Transport		Coordination of economic, emplyment and social policies
	Energy		Common foreign, security and defence policies
	Old third pillar 'Area of freedom, security and justice'		
	Certain public health policies		

Source: European Commission

This complex arrangement and the under-application of the subsidiarity principle reflect the role of politics. Clearly, when some governments strongly feel about some issue, they manage to establish one form or another of shared competence, possibly in exchange for a similar treatment of issues championed by other governments. While this process of give-and-take may make good political sense and is often seen as the hallmark of Europe's pragmatism, it results in an organisation that is not as functional as should be. The Brexit debate in the UK has shown how easy it is to criticise the EU.[23] Ignoring the principles of fiscal federalism is definitely not a good idea.

Unfortunately, there is little appetite to critically scrutinise the current assignment of competences. Suggesting that the *acquis communautaires* are not sacred cows is sometimes seen as being anti-Europe. Quite to the contrary, Europe stands to be stronger and more popular after a clean-up of its ill-designed features. Domains which should be shared include border protection (strong externalities), research (strong returns to scale), some elements of defence, especially in equipment (externalities and returns to scale). Domains which should be returned to national competence include regional development (local information), agriculture (local information and local preferences); strikingly, the Cohesion Funds and the Common Agricultural Policy represent the bulk of current expenditures by the Commission.

There is also a strong case for no central interference in social policies (local preferences, no externality or return to scale), tourism, education, and maybe more. Consumer protection must be harmonised as it directly impacts the Single Market, but it is currently far too detailed. Finally, migration and labour mobility are obviously combustible issues, an indication that the distribution of tasks in these matters are not optimal.

[23] Consumer protection is an endless source of examples, including the number of steps in ladders, the size of water tanks in toilets or the curvature of bananas.

Step 2: Breaking the doom loop with a complete banking union

As noted, Banking Union needs to be completed to establish a Single Resolution Authority, along with a European Deposit Insurance System and a well-stocked and agile Resolution Fund. The logic is very strong: banking crises are notoriously contagious (a major externality) while banks tend to become larger (increasing returns to scale). Opposition to the completion of the Banking Union stems from two main considerations. The first one is asymmetric information. In some countries, some – mostly small – bank-like institutions (saving banks, regional state-owned banks) play a locally-important role that could be overlooked by a European authority. The second consideration is more transitory. Because national authorities have not always performed as well as required, at this stage weak banks are presumed to be more numerous in some countries than others. Since bank resolution may be costly, countries that have been rigorous consider that their taxpayers should not be called upon to pay for other countries with a poorer track record. This legacy from the past, it is argued, must be first dealt with.

The first consideration concerns local arrangements that are often mostly political. Regional authorities benefit from banks on which they can exercise some control. This is understandable but it does not justify the continuing existence of weak banks. These banks can continue to serve regional objectives while being treated like all other banks. Being protected is not just dangerous, it also undermines competition.

The second consideration is more serious, but not as clear-cut as it sounds. To start with, bank resolution does not have to be costly to the taxpayer. Adequate conditions can be applied to protect taxpayers, as was demonstrated during the crisis in Ireland and Switzerland, where the interventions actually turned out to be profitable.[24] Indeed, the Bank Recovery and Resolution Directive (BRRD), adopted in 2014, already provides strong safeguards (shareholders and junior bondholders must bear the first costs, followed by senior bondholders) which can be improved if need be. In addition, the need to pre-

[24] According to Patrick Honohan,(2019), *Currency, Credit & Crisis, Central Banking In Ireland & Europe*, (Cambridge: Cambridge University Press), forthcoming - the Irish National Asset Management Authority made a profit of some 10% on its initial outlay because it bought distressed banks' assets at an average 57% discount. The Swiss authorities made a profit of $ 5.4 billion on the $ 38.7 billion purchase of UBS assets.

vent transfers from virtuous countries to countries with lax supervision must be balanced by the major risk of contagion if a serious banking crisis were to erupt before the legacy is taken care of. In that case, it is likely that the costs would be not just very large but also widely shared, one way or another.

The doom loop problem goes farther. Breaking the loop requires that banks not hold large stocks of own-country public debt. It has been suggested that a cap on these holdings be established.[25] Most governments are against such a measure because domestic banks are natural customers for their public bonds. They fear that a cap would reduce demand for their bonds and thus raise borrowing costs. This is true but not the whole story. Banks purchase their domestic public bonds largely because of the implicit mutual good will that lies at the root of the doom loop. Banks therefore expect to be helped when they need to, whether they face financial difficulties or whether they face competition. In addition, banks already hold a large stock, and they do not want to see it lose value. Beyond perpetuating the doom loop, the arrangement also undermines the ability of financial markets to act as a vigil of fiscal discipline, often referred to as market discipline. As they evaluate public debt riskiness, the markets recognise that domestic banks will always purchase domestic bonds, which is precisely why governments oppose caps. The unhealthy embrace of governments and their banks is a dangerous trap.

[25] An alternative is to charge a fee on banks that hold large amounts of domestic public debt.

Step 3: Pan-European Integration of Banking and Capital Markets

When the euro was launched, it was believed that eventually many banks would become truly European, collecting deposits and providing loans throughout the Eurozone. This has not happened. Bank mergers and acquisitions across Eurozone countries remain a very small proportion of the total. Similarly, banks from other Eurozone countries continue to play a minor role in those countries that house large global banks. This is due to domestic and European regulations that hamper cross-border activities, in spite of the creation of a European statute for banks.

In Europe, banks play a dominant role in the financing of the private sector. Europe-wide banks would be better diversified than national banks. Importantly they would provide an important channel for absorbing local shocks, lessening the need for official risk sharing. It is illogical that much effort be devoted to discussing an unlikely European fiscal capacity when its functions can be largely fulfilled by an integrated banking system. In fact, many national governments seem more interested in protecting their domestic banks, often nurturing national champions, than in allowing for risk sharing inside the Eurozone.

Financial markets are predominantly international and could make up for domestic-centred banks. However, they play a much smaller role in the Eurozone than in the US and the UK, and they remain segmented inside the Eurozone. The ability of European savers and borrowers to meet outside the intermediation of banks stands to strengthen the Eurozone. It would help countries that go through an adverse shock as households and firms borrow and lend, thus limiting the need for public borrowing and lending. It would also lessen the doom loop. Bank failures necessarily require public intervention while asset market crashes may have a strong impact on asset holders but never really endanger systemic financial stability. This would make the Eurozone more resilient.

At the suggestion of the Commission, it has been decided to build a Capital Markets Union, following on the steps of the banking union. Progress has been very slow. Like with banks, protectionism remains a roadblock.

Step 4: Decentralised Responsibility for Fiscal Discipline to the National Level

This paper has explained that fiscal indiscipline produces strong externalities within the Eurozone because debt crises can be contagious. Yet, budgets strongly remain a national prerogative and taxation is strictly national. The presence of strong externalities and local preferences creates a dilemma that cannot be easily resolved. The Stability and Growth Pact has tried to combine central and local responsibilities for fiscal discipline. The result is that the treaty articles that gave rise to the pact and to national budgetary prerogatives stand in contradiction with each other. This is why the pact has failed and will fail. The failure is creating sharp political disagreements between those who want to increase the power of the centre and those who see the pact as encroaching on national sovereignty. These disagreements are wrongly described as pitting pro-Europe advocates against nationalists. The dilemma is structural and should be addressed as such.

Because establishing fiscal discipline in each and every member country is essential for the survival of the euro, effectiveness should be the sole criterion. Effectiveness requires that the ultimate responsibility for discipline should be located where the responsibility for drawing up and implementing the budget lies. Currently and for years to come, this responsibility lies at the national level. Responsibility for fiscal discipline must therefore be decentralised to the national level, which does not preclude some European-level oversight.

Not all Eurozone member countries have adopted best-practice fiscal discipline arrangements. Yet, we have learned a lot over the last two decades or so about ways to establish fiscal discipline. Successful arrangements combine a clear, simple and transparent rule with independent councils, and parliaments that are constitutionally responsible for fiscal discipline. A solid blueprint should include the following.[26] The government makes the political decisions on public spending and taxation. An independent fiscal council – not the Finance Ministry – then performs the technical tasks of translating the budgetary choices of the government into budget balances and of assessing whether the outcome is compatible with fiscal discipline. Its conclusions are taken up by the parliament when it

[26] More details are presented in C. Wyplosz, (2019), 'Fiscal Discipline: From Theory to Practice", European Fiscal Board.

votes on the budget under a constitutional mandate of upholding fiscal discipline duly characterised by the long-run evolution of the public debt.

How about the externality of fiscal indiscipline? There are justified fears that some countries will adopt ineffective fiscal discipline arrangements, which would keep alive the threat that a sovereign debt crisis triggers the same risks that surfaced in 2010. It is essential to make sure that each government has adopted an adequate budgetary framework along the previous lines and that it respects its own constitutional obligations and procedures. A solution would include two steps. First, all national arrangements would have to be certified at the European level by an independent body. We already have a European Fiscal Board that is well equipped to pass judgment. Second, the Board – or the Commission – should have the means of asking the European Court of Justice to declare whether a country violates its own constitutional fiscal discipline obligations. Although not a silver bullet, these steps would come close to establishing fiscal discipline in the Eurozone.[27]

Step 5: Restore and Apply the No-Bailout Clause

The no-bailout clause was meant to be the lynchpin of fiscal discipline in the Eurozone. The principles of fiscal federalism invariably remind us that, in a decentralised system (federal or the EU) a major source of indiscipline is the possibility that a sub-central government will be bailed out by the centre in the event that it faces budget difficulties. This is why the European treaties wisely include a no-bailout clause. Unfortunately, this clause has been effectively shelved in 2010. Fiscal discipline cannot be guaranteed until the no-bailout is formally restored in all its aspects.

This may require strengthening the language of the treaty as well as transforming the ESM into a European version of the Federal Deposit Insurance Corporation (FDIC) in the US, which would achieve two important objectives. First, ESM loans to governments stand in contradiction with the spirit of the no-bailout clause. Closing down this facility is a necessary condition for restoring the clause. Distressed governments can always seek help from the IMF.

[27] There is no arrangement of this kind in the US, where the states are fully independent in budgetary matters, with various constitutional balanced budget rules. These rules were adopted when a no-bailout rule was decided by Congress in the 1840s and has held up ever since.

Second, as noted previously, the Banking Union needs to be completed by a well-stocked European deposit insurance and by a bank resolution fund. The EMS has the resources to fulfil both functions in the same way as the FDIC does. Importantly, the reformed EMS would lend directly to distressed banks or resolve them, without going through governments, a key condition to eliminate the doom loop. Of course, the governance of the EMS would have to be modified to allow for speedy decisions, which requires eliminating the unanimity rule. The better solution would be to make the EMS a European agency not subject to ex ante agreement by members.

Step 6: Deal with the public debt legacy

This is the issue that has the potential to cause most debate, in both public discussion and political debate. Since the creation of the euro, public debts in some Eurozone member countries have risen to very high levels. Very high debts drastically reduce fiscal space. They also require taxes to service obligations. At the present, the debt burden is reduced because of a long period of very low interest rates but this is likely to change. Crucially, they create vulnerabilities. Highly indebted countries face the risk of losing the ability to borrow, which is how debt crises get under way.

Reducing these vulnerabilities ought to be at the top of the policy agenda. There are various ways of reducing public debts. The classic approach is to run budget surpluses – or small enough deficits – for the debt to decline. This requires time, though, in a European context probably several decades. This long drawn out reduction process is simply not politically feasible, nor economical viable, in EU member states today. A rapid decline requires straight-jacketing fiscal policy, which is rarely desirable since it is an important instrument to stabilised the level of activity and employment. In addition, debts are gradually built up and should be reduced gradually too in order to avoid painful front-loaded adjustments.

There are other, non-classic approaches, to restructure a portion of existing debts in a way that is technically viable, easily understood by financial markets and mitigates (if not totally eliminates) moral hazard. A number of these approaches amount to debt repudiation or to transfers that allow Eurozone member states to 'Europeanise' national debts. None of this is acceptable to the low-debt countries of the EU. However, debts can be partly reduced without any transfer across countries.

Pâris and Wyplosz provide an example, which works as follows.[28] The ECB (or a new agency) acquires a proportion of national debts, exchanging them with its own debt to avoid any money creation. Crucially, these purchases are in proportion to the shareholding of the ECB by member countries. In return, member countries give up their rights to receive their shares of central bank's profits, which is called seigniorage, which are used instead to reduce their debts to the ECB. It works because a debt owned by the ECB is effectively wiped out: each government serves its debt by paying amounts that increase the central bank profits, which are then distributed to member countries. There is no transfer across countries since debt purchases (and therefore debt service) and profit distribution are the same because they are conducted as proportion of ECB shareholding. The scheme works because it pre-empts member countries' seigniorage income which is entirely dedicated to service the debt.[29]

Moral hazard is contained by a strict covenant designed to enforce national fiscal discipline. It also requires the inscription into each country's constitution of a watertight budget rule, as mandated by the Treaty on Stability, Coordination and Governance.[30] The adoption of a debt break rule by each Eurozone member would remedy the fear of national capitals reneging on any initial agreement. This plan represents an efficient way of dealing with the legacy debt issue that, if not treated, will haunt Europe for decades to come.

[28] P. Pâris and C. Wyplosz, (2014), PADRE: *Politically Acceptable Debt Restructuring in the Eurozone*, International Centre for Monetary and Banking Studies, Geneva Report on the World Economy: Special Report 3.

[29] Interestingly, the scheme is already in place. Through QE, some 30% of existing public debts have been purchased by the ECB. In effect, these debts are suspended until QE is undone. Going from there to the proposal merely requires member states agreeing to give up their seigniorage incomes until they have fully serviced the debt held by the ECB. An ancillary advantage would to be make the winding down of QE automatic and spread over a long period (which could extend to decades), thus simplifying the task of the ECB.

[30] The Treaty on Stability, Coordination and Governance was introduced in 2012 as the new "stricter" version of the Stability and Growth Pact.

A Roadmap to Reform the Eurozone

Europe is a stunning success, to the point that most citizens take it for granted. Today, European integration has become controversial. In a way, this is normal. No construction can please everyone nor can it be perfect. Moving from a young and weak institution to a powerful but ambiguous construction, the process has moved forward by adding layer over layer of integration steps. Along the way, mistakes were made.

This is not what many pro-Europeans like to think. They prefer to imagine new integration steps, to ‘prove’ that the project is moving ahead. Within policy circles, discussions about new integration steps – along with natural and disagreements along familiar lines – occupy the whole space. At a time when anti-Europe political parties are everywhere on the rise, it is important to focus instead on ways to make the Eurozone resilient and the EU functional for its citizens. Europe can be improved. Removing small and major irritants stand to alleviate criticism. When these irritants are a source of ineffectiveness, dealing with them stands to reconcile citizens with European integration. This paper provides a long, reasoned list of imperfections. Not all of them can be dealt with in one go. Priority should be to prevent another crisis. Here is a summary of the six steps outlined earlier.

1.**Clean up and simplify the allocation of competences.** This implies centralising some tasks, decentralising others and reducing the number of intermediate cases of various forms of shared competences. This can be a slow, incremental process during which the competences are reviewed in terms of need and performance so far. This review could be headed by the European Parliament.

2.**Complete the Banking Union** by adopting the EDIS proposed by the Commission and by transforming the ESM into a bank resolution fund. This would require a new inter-governmental treaty. Bringing all banks, large and small alike, under European supervision would remove risks but is likely to be opposed by regional powers with more domestic centred agendas.

3.**Achieve the original Eurozone aim of pan-European banks and truly integrated financial markets.** This will mostly consist in aligning national regulations that have deterred the hoped-for spontaneous emergence of European financial institutions. Banks that cultivate a close relationship with their respective governments – the source of the doom loop – and benefit for implicit protectionism are likely to use their influence to slow this evolution for as long as possible.

4.Adopt a strong fiscal discipline framework, that is decentralised at the national level. Not all countries have to adopt the same framework, political traditions matter and good institutions are in place in some countries. However, national arrangements must be robust, which requires one form or another of European certification. Decentralising the fiscal discipline framework would make the Stability and Growth Pact redundant. The European Commission stands to resist losing its competence, even though it suffers from being required to carry out an impossible mission. In order to assuage its opposition, the Stability and Growth Pact could be kept alive, if only to play a role in the event that fiscal discipline fails completely in some member countries.

5.The most effective disciplinary device, the no-bailout clause, ought to be restored. This may require rewriting the relevant articles of the treaties and changing the mission of the ESM. It would take a lot of convincing power to make governments ready to abandon what they wrongly see as a major achievement, which they like to describe as a proof of solidarity among member countries. However, this is in fact nothing more than a recipe for future political disputes.

6.Deal effectively with the legacy of dangerously large and growth-reducing public debts. Instead of the slow grind of continuous pressure on fiscal policies, there exist ways of partially reducing public debts – without transfers from low-debt to large-debt countries. This can be achieved in one step and enable the entire Eurozone, a Euro 2.0, to start from a much more robust debt position. This would also make it easier to adopt and implement fiscal discipline rules while opening the space needed to preserve the counter-cyclical use of fiscal policies. It would also dispose of the conflictual debate about insurance mechanisms such as a European budget or Eurobonds which have dominated debates in Brussels over the last decade.

About the author

Charles Wyplosz *is Professor Emeritus of International Economics at the Graduate Institute of International and Development Studies in Geneva where he served as Director of the International Centre for Monetary and Banking Studies (ICMB).*

Future of Europe

Creating a Decentralised Eurozone

CHARLES WYPLOSZ

Credits

The Wilfried Martens Centre for European Studies is the political foundation and think tank of the European People's Party (EPP), dedicated to the promotion of Christian Democrat, conservative and like-minded political values.

Wilfried Martens Centre for European Studies
Rue du Commerce 20, Brussels, BE 1000

For more information please visit
www.martenscentre.eu.

Editors: Eoin Drea, Senior Research Officer, Martens Centre
Federico Ottavio Reho, Research Officer, Martens Centre
External editing: Communicative English
Typesetting: Victoria Agency
Printed in Belgium by Puntgaaf, Kortrijk.

This publication receives funding from the European Parliament.

Wilfried
Martens Centre
for European Studies