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Bretton Woods, Brussels, and Beyond

Redesigning the Institutions of Europe

Edited by Nauro F. Campos and Jan-Egbert Sturm

A VoxEU.org Book

CEPR Press

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Web: www.cepr.org

ISBN: 978-1-912179-14-5

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ETH zürich KOF Swiss Economic Institute

Centre for Economic Policy Research (CEPR)

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Foreword

The debate on reforming Europe in the face of rising economic and political opposition is by no means short of ideas on what must be done. But what it does lack is an order of priorities of which mechanisms and institutions should be addressed, when, and by whom.

This eBook argues that focusing on institutional questions is of fundamental importance for the future of European integration. The authors break down the lessons from the Bretton Woods institutional framework, and the wave of globalisation that followed it, to ask whether the current institutions and those being proposed – foremost the European Monetary Fund – are sufficient, and what others are needed. Ordered in to five sections, the eBook analyses European integration in the context of first Bretton Woods and then other existing institutions. It also addresses labour mobility and monetary union design, before examining the case for redesigning key institutions.

The authors conclude that the European integration project "needs reform and it needs it now", for fear that it may not survive another economic downturn. They recommend that we should first think about institutions and their designs, and then how financial and fiscal reforms can be designed for greatest impact. In this way, the institutional approach they propose naturally complements the one advocated in the recently published CEPR Policy Insight no. 91.

CEPR thanks Nauro Campos and Jan-Egbert Sturm for their careful editorship of this eBook, and Anil Shamdasani and Sophie Roughton for their excellent production of it. CEPR, which takes no institutional positions on economic policy matters, is glad to provide a platform for an exchange of views on this topic.

Tessa Ogden
Chief Executive Officer, CEPR
May 2018

Acknowledgements

The editors would like to thank Richard Baldwin, Katharina Bloch, Vera Eichenauer, Richard Jong-A-Pin, Katharina Michaelowa, Tessa Ogden, Sophie Roughton, Corinne Schibli-Lozano, Anil Shamdasani, Romesh Vaitilingam, and Beatrice Weder di Mauro for the support, encouragement and advice throughout this project. KOF/ETH and SNF (Swiss National Science Foundation) provided financial support for a conference in Zurich, March 22-23, 2018, at which draft chapters were discussed.

Preface

Charles Wyplosz
Graduate Institute, Geneva; ICMB and CEPR

In most countries on the continent, Europe has become contentious, to put it mildly. For good (rather, bad) reasons. The euro area debt crisis came as a shocking surprise; the authorities were totally unprepared, and it showed. In the event, the banking system has become fragmented, the precise opposite of what the single currency was designed to deliver. For more than a decade, the middle classes have stagnated while the famous 'top 1%' have become much richer. Meanwhile, those at the bottom were preserved from the onslaught of globalisation and the shake-up from technological change. The immigration crisis has demonstrated the inability of the EU to deal with the consequences of freedom of movement. And, of course, Brexit has broken the taboo that Europe is a much-desired one-way street.

Most of these humiliating developments had been, or should have been, anticipated. Policymakers chose to ignore warnings. The 'system' did not produce the kind of critical introspection that is vital for long-term success. When problems surged, the EU proved unable to react properly. True, there were innovations, but none is satisfactory yet. The Banking Union remains work in progress. The Stability and Growth Pact was reformed a few more times to become a machinery of great complexity and limited usefulness. Some countries are saddled with huge debts likely to be unsustainable, but no official will talk about this risk. Denial and complacency remain the order of the day.

This is all a failure of European institutions. The editors of this eBook must be commended for having brought together an impressive array of authors who focus their contributions on institutions. Collectively, they do not offer a blueprint of what has to be done, but the disconnect between their analyses and what policymakers debate suggests

that, once again, the EU is not ready to take serious remedial action ahead of trouble. This eBook should be required reading for all those who care deeply about Europe and, especially, for its policymakers.

1 Europe's future: The value of an institutional economics perspective

Nauro F. Campos and Jan-Egbert Sturm
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One can no longer be sure whether Europe is just at a crossroads or on the brink. The multi-faceted economic crisis has deepened. It has also become a widespread political crisis. There is little disagreement that the European integration project needs to be reformed and that this needs to be done now, before the next economic downturn. The costs of doing nothing are large and rising, and we must think of innovative ways to make reform happen in a democratic, efficient, and sustainable manner.

Economists have debated what to do and how but have been mostly silent on who and when. Which institutions and rules are needed? In our view, not even asking the question, "Which institutions should be redesigned or even created from scratch to carry out reform in Europe?", goes a long way towards explaining why reforms have not been implemented.

This eBook argues that addressing such institutional questions is of fundamental importance for the future of European integration.

The individual chapters distil the lessons from the Bretton Woods institutional framework and from the globalisation wave that followed it. The overarching questions that motivate the eBook are: Is a European Monetary Fund (EMF) sufficient? Are other institutions needed? How should these other institutions be designed and implemented? And how should they fit into the existing institutional framework?

The eBook is organised into five parts. The first examines the Bretton Woods system and European integration. The second looks at prominent European institutions (the European Parliament, the Structural Funds, and the ESM). The third focuses on financial institutions and on labour mobility. The fourth discusses key monetary union institutional aspects. The fifth and final part highlights strategies for, and obstacles to, redesigning European institutions.

Bretton Woods and European integration

Harold James documents that the idea of a 'European Monetary Fund' has been around for the last four decades. This shows that the Bretton Woods system, which collapsed in the mid-1970s, is a valuable idea for Europe and can potentially provide institutional solutions to manage its integration processes. He considers the problems to which Bretton Woods-style institutions might be of assistance, chiefly, current account imbalances (a German feature throughout except during reunification), debt sustainability, conditionality and ownership (which are capabilities developed over time by the IMF in terms of debt reduction and structural reforms, respectively), and security linkages and leadership. He concludes that a successful EMF would be an instrument for strengthening other European institutions, in particular the Council.

Axel Dreher draws upon research on the operations of the Bretton Woods institutions to distil lessons for the design of European institutions. He notes that any new European institution will need to ensure its lending operations focus on developmental projects and complement (and clearly not substitute) private funding. Given the nature of such projects, he suggests an independent panel of evaluation experts to enforce lending rules. Lending decisions from a European Monetary Fund need to be guided by strict and unambiguous rules that cannot easily be amended due to short-term political interests of powerful governments. Without such strict rules and careful scrutiny, Dreher warns that an EMF risks ending up providing funds to those who need them the least or those that are more politically connected.

Nicholas Crafts evaluates the economic benefits from European integration using the UK's sojourn. Reviewing the evidence, he argues that the benefit-cost ratio of EU membership has been favourable and that these net benefits were mostly driven by

strengthening competition in product markets. He notes that the political sustainability of these benefits was due to enhanced social safety nets (for example, the rise in social transfers as a share of GDP). He stresses the symmetry of this argument with respect to the vote for Brexit – the evidence shows that a fairly modest reversal of austerity or reduction of fiscal cuts might have been enough to prevent an electoral victory for the Leave campaign. Finally, the political and economic deterioration in the UK since the referendum could serve as an argument against leaving, especially at a difficult time when some recently formed European governments face the need for reforms in Europe.

Giuseppe Bertola argues that the European integration project can only be properly understood from a political economy perspective. From the outset, it has been based on close and intricate links between its economic-monetary and political-security aspects. A key lesson is that Europe has to rely on trust and self-enforcing cooperative behaviour. Achieving a cooperative equilibrium may actually be easier when members are heterogeneous across various dimensions and the Union itself has multiple complementary purposes, making it possible to negotiate compromises across different policy areas over time. Brexit and other nationalistic political sentiments have challenged this mode of operation, which has in the past proved capable of discouraging opportunistic behaviour and preventing open conflict. If properly understood and reformed, it can continue to foster trust and cooperation in the future.

Harald Badinger provides a critical perspective on the debate on the future institutions of Europe. He argues that the severity of the moral hazard problem and the desirability of risk sharing are central. From the five scenarios in the Commission's 2017 White Paper on the Future of Europe, he argues that two are most deserving of consideration: doing less more efficiently, and doing much more together. He argues that these options are incompatible because of theoretical reasons that for different policy fields there should be different optimal levels of centralisation. There are policy areas with positive net benefits from centralisation (that is, where doing more together is justified), such as migration, security, defence, competition, and environment. However, for most policy areas theory gives less guidance about the optimal degree of integration.

European institutions

Since the first elections in 1979, the European Parliament has become a powerful institution. **Simon Hix, Abdul Noury** and **Gerard Roland** study how its workings have changed recently. They document that the Parliament has experienced a shift away from the traditional left-right divide towards a new cleavage between anti-globalisation (mostly on the extreme right and extreme left) and pro-globalisation. In the Parliament, this takes the form of a pro- and anti-EU cleavage. This became evident in the 2009 Parliament, and even more so in the 2014 Parliament. They show that for some policy issues – such as employment, environment, gender, and the internal market – the left-right cleavage is still powerful. For others – such as budget, economic and monetary affairs, foreign affairs, and international trade – the pro/anti-EU dimension now dominates.

Sascha Becker, Peter Egger, and **Maximilian von Ehrlich** analyse structural funding operations. The main goal of such transfers is to foster the convergence of fiscal capacity and, ultimately, of per capita income. They argue that, on average, the scheme is effective in terms of per-capita income growth. Yet, its employment effects are hard to detect and there is evidence of a crowding out of private investment. They also document that the scheme is least effective in poor regions with low levels of absorptive capacity (e.g. low levels of human capital). Since the crisis, structural funds operations have worked differently: effects on per-capita income growth have been smaller than before the crisis, while the effects on employment have been larger. Finally, the authors find the scheme triggers positive per-capita income growth effects relatively quickly, but the effects do not seem permanent.

Kari Korhonen offers a history of one of the newest, less well-known and yet most influential European institutions, namely, the European Stability Mechanism (ESM). In 2017, member states agreed to focus on two issues for the June 2018 summit: completing the Banking Union and transforming the ESM into a European Monetary Fund. The ESM and its predecessor (the European Financial Stability Facility) were put in place in response to the financial crisis. With a lending capacity of €500 billion (compared to the IMF's $750 billion), the ESM is the largest of the regional financing arrangements, operating mostly with front-loaded loan programmes, at lower rates and

longer maturities than the IMF. Korhonen shows how the ESM has acquired various new tasks over time and how it has developed closer coordination with other institutions (for example, a cooperation agreement with the European Commission in April 2018).

Financial institutions and labour mobility

Isabel Schnabel and **Christian Seckinger** argue that the disintegration of the European banking sector experienced after the global financial crisis was at least partly triggered by regulatory intervention and was highly costly. Policy measures fostering disintegration in crisis times are harmful because they destroy a key mechanism for risk sharing when, particularly in a currency union, it is needed most. They show that the presence of foreign banks via branches and subsidiaries is particularly important to buffer the adverse effects of domestic financial constraints. Therefore, promoting financial integration should be high on the political agenda of European policymakers. A special focus should be put on promoting resilient capital flows, which implies favouring equity over debt, long-term over short-term debt, and retail over wholesale funds.

Mathias Hoffmann, Egor Maslov, Bent Sørensen and **Iryna Stewen** postulate that cross-border interbank lending is not sufficient to have better risk sharing. Following the crisis, this type of banking integration was quickly reversed and thereby actually exacerbated macroeconomic asymmetries among euro area countries. As can be seen from state-level banking deregulation in the US in the 1980s, deep cross-border integration is highly desirable, either through direct cross-border lending of banks to firms and households or through cross-border consolidation of banks. It improves the access of bank-dependent firms to credit, making it easier for firms to finance investment and wage payments, and making labour income and investment less sensitive to asymmetric productivity shocks. However, as firm profits become more volatile, this makes further capital market integration more important.

Chris House, Christian Proebsting and **Linda Tesar** draw upon model-based simulations to show that differences in austerity across countries can account for roughly two-thirds of the observed variation in GDP after the crisis. Most countries cut government spending, and those that cut this most experienced the sharpest declines in

output, leading to increased debt-to-GDP ratios. Although in European countries there is a net inflow of workers when unemployment is relatively low, this effect is roughly three times larger in the US. If Europeans were as mobile as Americans, their model simulations show that the variation in unemployment rates across euro area countries would have declined by almost 40%. A similar result emerges under flexible exchange rates while keeping labour mobility low. Hence, the authors conclude that labour mobility can operate as a substitute for floating exchange rates.

Davide Furceri and **Prakash Loungani** discuss labour mobility within Europe in comparison to that in the US. Even before the introduction of the euro, many economists warned that the lack of this potential adjustment mechanism could endanger the effectiveness of the currency union. The evidence they amass shows a convergence of adjustment processes in Europe and the US, reflecting both a fall in interstate migration in the US and a rise in its role in Europe. Within Europe, the role of migration as a shock absorber is considerably larger for Central and Eastern European than for Western European countries. Overall, mobility has picked up since the financial and euro area crises and has thereby played an important role in labour market adjustments. Yet migration has run into strong political headwinds. Recipient countries threaten with barriers, despite ample evidence on the economic benefits of migration.

Monetary and fiscal union

Jakob De Haan and **Patrick Kosterink** argue that fiscal discipline is a necessary precondition for national fiscal policy to play a role in the stabilisation of both idiosyncratic and common shocks. The need for fiscal risk sharing hinges on the relevance of idiosyncratic shocks and the potency of national fiscal policy to stabilise the effects thereof. If governments ensure sustainability of fiscal policy, they can use national fiscal policy to stabilise idiosyncratic shocks (which have become less important than in the past). Under those conditions, fiscal risk sharing beyond that in the Banking Union is probably not needed. Coordination of monetary and national fiscal policies, on the other hand, may support the monetary policy of the ECB to stabilise common shocks. This would only be feasible after current levels of government debt have been reduced to sustainable levels.

Paul De Grauwe and **Yuemei Ji** argue that financial engineering cannot cure the fundamental instability in the euro area sovereign bond markets that is created by national governments issuing debt in a currency that is not their own. Recent proposals to create a safe asset through engineering 'sovereign bond-backed securities' (SBBSs) cannot work because this does not eliminate national government bond markets and thereby the potential for destabilising capital flows across borders. As the senior tranche of the SBBSs will also consist of national bonds that investors want to dump, it is unlikely that these can maintain their status of a safe asset in times of crisis. Investors will flee the senior tranches to invest in what they then consider super-safe national sovereign bonds. Real stabilisation can only be achieved through a backstop of the ECB and the introduction of Eurobonds based on joint liability of the participating national governments.

Philippe Martin notes that the European fiscal rules have allowed for too lax a policy during good times and forced too much austerity during crisis. Stronger rules on the financial architecture and more effective fiscal rules are needed. Furthermore, the financial and economic costs of sovereign debt restructuring, which must remain a last resort option inside the euro area, need to be reduced. This can increase the credibility of the no-bailout rule, allow for more fiscal flexibility because of more fiscal responsibility, and reduce the pressure on the ECB to intervene. Creating fiscal capacity at the EU level to help countries facing large negative shocks would also prevents a situation whereby the ECB is the sole institution capable of providing macroeconomic stimulus. Such a fiscal architecture is to be seen as a complement to, and not a substitute for, the other elements, in particular regarding the financial architecture.

There is a strong push towards a fiscal union. **Lars Feld** argues that fiscal competences of the EU should be introduced after its transition into a democratic federal system with sufficiently well-developed legal control. The euro crisis has made clear that national responsibility for fiscal policy is not sustainable unless the doom loop between banks and sovereigns eases. Therefore, the completion of a Banking Union is needed. However, the proposals towards a fiscal union induce strong moral hazard problems. For instance, the introduction of a rainy-day fund reduces willingness to reform as it rests on the fiction that the consequences of economic shocks are independent from labour or product market institutions, and national policies. Furthermore, a precautionary

credit line of the ESM is problematic, because it depends on the enforcement of ex ante conditionality. The European track record in complying with fiscal rules does not raise confidence that this scheme will work properly.

Redesigning euro area institutions

Xavier Vives argues that the attempt to impose fiscal and market discipline through the Maastricht Treaty and Stability and Growth Pact has failed. The game now is to find a solution in which countries remain sovereign and engage in risk sharing, while maintaining market discipline in order to control moral hazard. When countries can suffer runs on their sovereign debt denominated in a currency they do not control, an international lender of last resort may be required. It can avoid self-fulfilling crisis and excessive liquidation of entrepreneurial projects while at the same time impose discipline-enforcing restructuring policies when the danger of moral hazard is high. The European Monetary Fund could build a sufficient amount of risk sharing while keeping market discipline. The EMF should then be responsible for liquidity and solvency problems of countries, allowing the ECB to concentrate on liquidity help for banks in need and on monetary policy.

Clemens Fuest agrees that while financial stability and resilience to economic shocks require risk sharing, hard budget constraints and sufficient incentives for sound policies need to be preserved. Instead of being substitutes, these may actually be complements: more diversification in government debt holdings of banks reduces the costs of debt restructuring and improves market discipline. A lack of trust between member states and in European institutions does not appear to allow that view. Trust grows with the experience of successful common undertakings in areas such as defence, border protection, migration, as well as research and education that offer huge opportunities for adding value over and above what individual member states can achieve. However, relying on current institutions until trust has grown is risky. Reforms with a balanced combination of improved risk sharing and more market discipline – such as the European safe asset proposal or the development of the ESM into a European Monetary Fund – offer the chance to reduce the cost of the next crisis significantly.

What have we learned and what should we do next?

The Bretton Woods agreement set up new institutions: the World Bank and IMF (both operational by 1950), and an International Trade Organisation that only came into being in the 1990s (as the WTO). The European integration project was launched in this context. When the Bretton Woods system started to wane in the late 1960s, Europe looked for new solutions (for example, the 1969 Werner Report on monetary union). The Single Market Act was a response to the Eurosclerosis of the 1970s and 1980s. The 1990s saw waves of globalisation and integration that the 2007 financial crisis stopped in their tracks. Monetary integration progressed so that, whenever and in whichever form Brexit occurs, for practical purposes the euro area will become the European Union. The US recovered from the 2007 crisis while Europe suffered a second double-dip setback in 2011. The future of Europe has been in check ever since.

Yet a severe omission in the future of Europe debate, in our view, is that the institutional question has not been raised. It must be. Thinking about 'who' may unlock the difficulties in compromising on 'what' and 'when'. We studied a few selected institutions above, but this list was not exhaustive and there are many we have not touched upon, such as labour market institutions (Blanchard 2018). An institutional map of Europe should be a priority for future research.

The European integration project needs reform and it needs it now. The next economic downturn may have severe political and economic consequences if it finds Europe unprepared. The costs of doing nothing are enormous. We must be creative, determined, and able to implement the needed reforms in a democratic, efficient, and sustainable manner.

How does the 'institutional approach' compare with others in the future of Europe debate? The main difficulty in answering this lies in the multitude of different proposals, suggestions, and policies that have emerged in the last five years or so. Indeed, the European Parliament has created a website that tracks such proposals and prepared a report comparing them (European Parliament 2018a, 2018b). Yet the most important proposal in our view is that from the '7+7' French and German economists (Bénassy-Quéré et al. 2018), many of which kindly contributed to this volume. Their proposal

encompasses reforms of the financial, fiscal, and institutional architectures. In our opinion, the reform of the institutional architecture should receive greater priority and greater weight and should have been fleshed out more ambitiously.

We are aware this eBook cannot fully address the many issues surrounding the institutional question of how to design a new framework for the European integration project. We are convinced, however, that if it succeeds in raising and adding these issues to the current debate on the future of Europe, our task has been accomplished.

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Part I

Bretton Woods and European integration

2 What modern Europe can learn from Bretton Woods

Harold James
Princeton University

Europe has long had a Bretton Woods fixation. Bretton Woods created both an international monetary system with rules, designed to maintain an open trading regime, and an institution to arbitrate and enforce those rules, the IMF. After the breakdown of the 'Bretton Woods system', with fixed but adjustable exchange rates, in the early 1970s, France and Germany tried to find an equivalent on a European level. In 1978 an initiative by President Valéry Giscard d'Estaing and Chancellor Helmut Schmidt led to the creation of a European Monetary System (EMS), with fixed but adjustable exchange rates, and the agreement provided for the establishment of a European Monetary Fund (EMF) within two years. But in practice, the opposition of the German Bundesbank meant that nothing came of the initiative, and time simply passed over the two-year provision. In the 1990s, after the middle of turmoil in the EMS, the idea of an EMF was revived by some academics (Buiter et al. 1998). In spring 2010, as Europe struggled with Greek debt the idea came back again (Gros and Mayer 2010, Corsetti and James 2010). Wolfgang Schäuble, the German Finance Minister, was a major enthusiast for this idea, and he came back to the proposal at the end of his term of office. But the question has also generated substantial pushback, along the lines that it would take a long time to build the technical competence of the IMF in a European setting, and that the whole exercise would increase rather than reduce moral hazard (Wyplosz 2017).

The case for a European version of the IMF is relatively simple. First, the IMF follows established procedures. This reduces moral hazard, and erodes the assumption that a country can, just by letting matters slip and getting into a bad situation, trigger a costly international rescue operation. It minimises the possibility of adopting arbitrary ad hoc decisions. Second, the attraction of an IMF programme lies in taking some of

the political sting out of support operations. In the mid-1990s, for instance, a purely bilateral support operation by the US for Mexico would have revived memories of a century-old history of US interventions. The first two arguments, however, might be thought to suggest that Europe could just leave matters to the IMF, and that no new institution is required. Thus it is the actual experience of the euro area crisis that drives the search for a regional institution. Relations between the three members of the 'troika' – the IMF, the European Commission, and the ECB – had become strained and politicised, and it became tempting to think that Europeans might after all want to act on their own. Moreover, there may be a greater wariness of global institutions because of perceptions that the US has become unpredictable.

I will consider problems to which Bretton Woods-style institutions might offer a solution. The first three are technical-economic in nature, the final one is concerned with political economy:

- Current account imbalances
- Debt sustainability
- Conditionality and ownership
- Security linkages and leadership

Current account imbalances

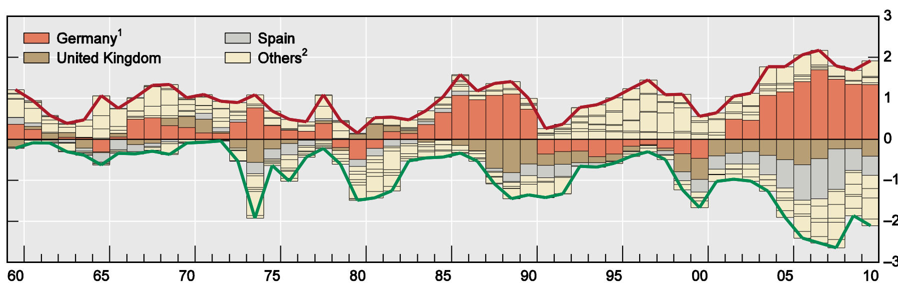
The first rationale for a new institution looks back to the original intentions behind the Bretton Woods architecture. The question of adjustment in the international financial system has always been contentious, and the debate about international order at Bretton Woods was shaped by lessons drawn from the unsuccessful attempt to create a stable order after WWI. Originally, Keynes wanted both deficit and surplus countries to pay charges to a bank that would act as a credit cooperative. Both would be under equal pressure to adjust. That never looked as if it was acceptable to Americans.

The issue of large surpluses has always – at least for 50 years – played a role in the European debate. Other European countries often worried about what they sometimes described as Germany's currency manipulation, which they saw as a mercantilist strategy of securing permanent trade and current account surpluses that would give

Germany a commanding control of resources. In each phase of European monetary integration, Germany's partners in consequence tried to devise an institutional mechanism to control German surpluses, and they believed that an institutional move to Europeanisation would admirably do that job. It was the surge in German trade surpluses in the late 1960s that drove the original discussion of a European monetary union that culminated in the 1970 Werner Plan. In the later 1970s, angst about the German surpluses re-emerged and produced the EMS initiatives. In the late 1980s, the increase in the German surpluses pushed both the US at the G7 level and France at the European level to produce schemes for control. There is a path from Edouard Balladur's proposals to the Delors Committee to the Maastricht Treaty. Only in the 1990s were there no German surpluses – that was the consequence of German unification. German surpluses in the later 2000s formed the background to much of the discussion of the euro area architecture.

The IMF, while it has often provided excellent analysis of imbalances on a global level, has never really found a satisfactory way of addressing the issue. An attempt in 2007 to strengthen exchange rate regime surveillance ran into the sands, because of Chinese opposition and then because of the outbreak of the Global Crisis. In a European setting, imbalances could only be really dealt with successfully by more extensive coordination of fiscal policies, and it is hard to see that the analytical side of an EMF would have the political heft to tackle the issue.

Figure 1 Sum of current account balances,1960-2010 (share of GDP)



Source: James (2012); data from OECD Economic Outlook; European Commission, BIS Annual Macro Economic database.

Debt sustainability

The second point relates to the more recent experience of the IMF. Over recent decades, it developed a substantial competence in debt management and sustainability. Many of the influential current proposals for the operation of the EMF (e.g. Weder di Mauro and Zettelmayer 2017) suggest an automatic principle of debt reduction as part of a country programme. If that proposal were to be realised, Europe would offer a model for how to fix a problem that is actually global in scope – and one that is likely to become more intense, as the pressures of political populism lead countries to run larger deficits again. There are substantial risks, however, that an absolutely automatic approach to debt restructuring could trigger creditor runs in times of general financial stress.

Ownership and conditionality

Over time, the Fund evolved an approach to the politics of economic reform that made it uncomfortable with the enforcer or whipping boy role that it had traditionally been given by the international community (i.e. the big and powerful states). Since the 1990s it increasingly emphasised 'ownership' – reforms do not work unless they are carried by a deep political and social consensus. But the idea of the Europeans in calling in the Fund in the debt crisis was precisely to find a substitute for the lacking consensus about economic reform.

The most problematical aspect of the troika arrangements was not so much the presence of the IMF, but the way that the central bank – a non-political and technocratic institution – was pushed into making political choices. Thus the ECB was drawn deeper into political arguments. The most obvious turning point was the two letters sent by President Jean-Claude Trichet in August 2011 demanding fiscal reform in Italy and Spain, as well as a broad range of other conditions. In 2012 the new President Mario Draghi gave a spectacular promise to save the euro, the implementation of which involved the prospect of Outright Monetary Transactions (OMT), purchases of government bonds in the secondary market, with a formal framework of "strict and effective conditionality".

The key to the effectiveness of the ECB's monetary promise lay in the extent to which it had – and was believed by the markets to have – the backing of the German government. IMF participation was also crucial for the design of a country programme. In this case, the lack of clarity about where, how, and why the ultimate decisions would be taken looked like both a problem of leadership and a problem of democratic accountability.

Security issues

The politics of support for a broad array of economic reforms may raise issues different to those generated in a purely economic analysis. Bretton Woods was designed as a multilateral and multipolar system, the expression of the wartime coalition (the United Nations), in which security and economic stabilisation were joined at the hip. Today Europe has its own non-economic vulnerability. The nature of the European problem was transformed in 2014-15, first by the Russian occupation of the Crimea and the fighting in eastern Ukraine, and then in 2015 by the large-scale inflow of refugees from Syria, but also from other areas. At first it looked as if the new shocks would prove fatal to the European idea; then some people came to believe that the older debt issue was more easily solved in the context of multiple challenges. Brexit and Trump only increased that impression, and Europe – especially after the election of Emmanuel Macron as President of the French Republic – mobilised to produce a response. It looked as if it was having a 'leadership moment', analogous to that taken so spectacularly by the US at Bretton Woods.

Leadership works by translating between different understandings and different interests – or between a vision and its practical realisation. As in the case of the global system, management cannot come from one country alone, as that would not be legitimate. Multilateral institutions are ways of both diffusing leadership, and of making real leadership effective. But their role needs to be precisely defined. They can establish greater trust by monitoring commitment, assessing the viability and the sustainability of promises. This is precisely the role of "delegated monitor" envisaged by Jean Tirole (2002).

Conclusions

A Bretton Woods-style institution in Europe could facilitate – through the technical advice it gives on debt, on reform proposals, and on market conditions – a stronger framework for policy discussion. But because much of the assessment will focus on cross-border effects and linkages, there is no reason to think that this task is better done at a regional than at a global level. On the other hand, the resources raised for programme interventions might well be local, and this is where the developing of the ESM mechanism will be helpful. The fundamental trade-offs and the assessment and calculation of the appropriate response to strategic risks can only be made at the political level. That requires a strengthening of the European institutions, and in particular of the Council. The EMF would be an instrument, but it could and should not be expected to be the engine of the revolution.

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3 Political influences in IMF and World Bank operations: Lessons for the design of European institutions

Axel Dreher
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The IMF and the World Bank Group are governed by their member countries. Daily business is delegated to their Executive Boards, with directors representing countries or, in most cases, groups of countries. Of course, not all countries are equal – some are more equal than others. So-called weighted voting governs the organisations, largely determined by the constellation of power after WWII, and only broadly in line with countries' economic power. The resulting vote share of the US, the single largest shareholder of both organisations, exceeds 17% in the IMF (and is of similar magnitude in the World Bank). Japan and China follow, with around 6% each, then Germany, the UK, and France. Most decisions require a majority of more than 50% (though in the IMF formal votes are rarely taken), giving these few countries a substantial say in the organisations' lending decisions.

Observers of IMF and World Bank lending patterns might be surprised to learn about these organisations' primary goals. The Bank aims to "to end extreme poverty by 2030 and boost shared prosperity in every developing country" while the "IMF's primary purpose is to ensure the stability of the international monetary system". Still, the World Bank mainly finances projects in middle income countries, many of which substitute for private capital and only vaguely contribute to development. Most starkly, this holds for the private sector arm of the World Bank Group – the International Finance Corporation (IFC). Among the 'development' projects the IFC has financed are the five-star Mövenpick Hotel in Ghana's capital Accra and the expansion of a German

supermarket chain (Lidl) in Eastern Europe. The IMF extends loans to some (poor) countries on an almost permanent basis (Easterly 2005) and to other (rich) countries for reasons that are hardly justifiable based on economic considerations alone (such as the very large loans to countries with obviously unsustainable debt).

The importance of political interests of Bank and Fund shareholders for these organisations' lending decisions can be illustrated along a number of dimensions. First, consider the election of its president and managing director, respectively. If you hope that filling the top jobs is mainly according to qualification, you will be disappointed. First of all, it's about politics. Traditionally, Europeans nominate the managing director of the IMF, while the president of the World Bank is an American in return. EU leaders first agree on a common candidate for the top job at the Fund. If the candidate is acceptable to the US, she will be it. The EU has a total of a voting share of about 30% in the Executive Board, the electoral body, so that in tandem with the US – and voting by simple majority – the common candidate can be easily enforced. The US gets its preferred candidate elected at the Bank in turn.

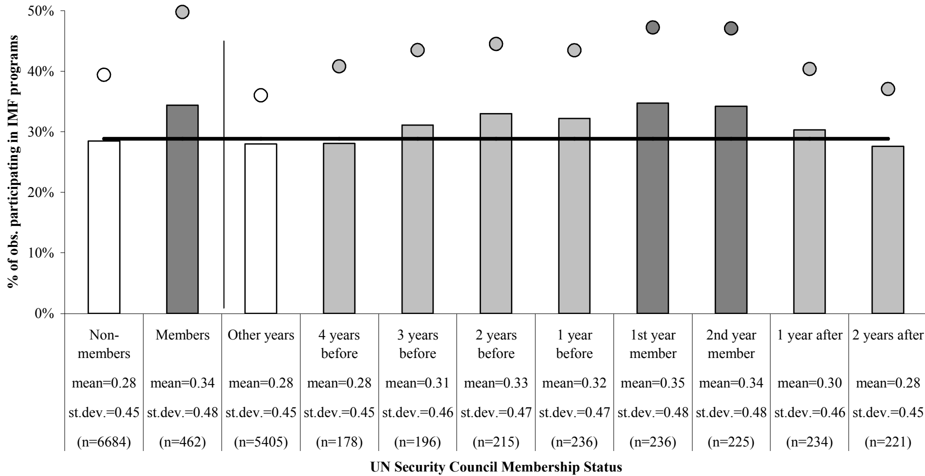
Second, Bank and Fund credits and loans frequently go to countries with irresponsible economic policies. The disbursement of loans is formally linked to conditions, designed to better these policies. Politically well-connected countries can, however, risk breaking the conditions without losing access to the money. Again, the decision about whether to disburse the next tranche of money will be made by the Executive Board, which means that the G7 countries and especially the US have the final say. Fund and Bank clients where these important member countries have some stakes will not lose access to the loans – even if Fund and Bank staff would wish otherwise.

Third, countries that are important for major shareholders have a higher probability of receiving funding in the first place, with better conditions. As one example, temporary members of the United Nations Security Council get better terms (Dreher et al. 2009a, 2009b, 2015). We have calculated how often countries have received IMF loans if they were a member of the UN Security Council or not (see Figure 1).

It turns out that membership on the Security Council increases the likelihood of obtaining an IMF programme by 6 percentage points. This probability increases even before a country is elected, as it is often known several years in advance whether a

country will be elected to the Council. Immediately after leaving the Security Council the frequency with which countries are under an IMF programme falls. The picture looks similar for the Bank (Dreher et al. 2009b).

Figure 1 Participation in IMF programmes by non-permanent UN Security Council membership over time



Note: The horizontal line shows the average IMF participation rate across the entire sample. The dots reflect the results where only low- and lower-middle-income countries are included.
Source: Dreher et al. (2009a).

The results of my studies with Jan-Egbert Sturm and James Vreeland show that temporary Security Council members not only receive more loans, but that they receive them on better terms than non-members. They get higher loan amounts when they vote more often with the US in the Council, and smaller loans otherwise (Vreeland and Dreher 2014). These results hold if we control in a statistical model for other influences on lending. They suggest that the US used the Fund and Bank to support their geopolitical interests. A 2006 study by two US economists (Kuziemko and Werker 2006) showed that bilateral loans from the US go rapidly upwards once a country is elected to the Security Council. The US uses its foreign aid to influence voting in the Security Council, and applies its influence in the IMF and the World Bank to support this goal.

Another example of the importance of political influence in the IMF are its economic forecasts. These are systematically too optimistic with regards to economic growth (Dreher et al. 2008). Inflation forecasts for countries that vote in the UN General Assembly with the US more often get better forecasts than others, on average. This result further highlights the importance of political horse-trading: positive forecasts in return for votes at the General Assembly. Turning to the World Bank, the countries with direct representation on the Executive Board receive larger loans (Kaja and Werker 2010, Morrison 2013). This even holds for IFC lending to the private sector, where the joint interests of the companies implementing the project (which are mostly from high-income countries) and the government of the country where the project is executed distort the allocation of funding away from purely developmental projects (Dreher and Richert 2017).

The lending patterns of the IMF and the World Bank offer valuable advice for the design of European institutions. Designed to foster development and alleviate temporary balance-of-payments disequilibria, the organisations have changed tremendously over time, following their own institutional interests but also the short-term political considerations of their major shareholders. With respect to development lending, any new institution would need to make sure that lending is indeed additional to private funding, rather than merely substituting it, and would focus on projects that are truly developmental. Given that such projects are typically riskier and less profitable, such rules should be enforced by an independent panel of experts who evaluate each project application. Regarding the transformation of the European Stability Mechanism (ESM) to a 'European Monetary Fund', lending decisions need to be guided by strict and unambiguous rules for access that cannot easily be amended due to short-term political interests of powerful governments. For example, changes to the rules should need the unanimous agreement of the member countries of the 'EMF' and any member should hold the right to test the Fund's lending decisions in court. Without strict rules, any European Bank or Fund will likely follow the examples of their global sister institutions and provide the bulk of funds to those who need it least (or are best connected to those who hold power).

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4 The economic benefits from European integration: Lessons from the UK's EU sojourn

Nicholas Crafts
University of Warwick

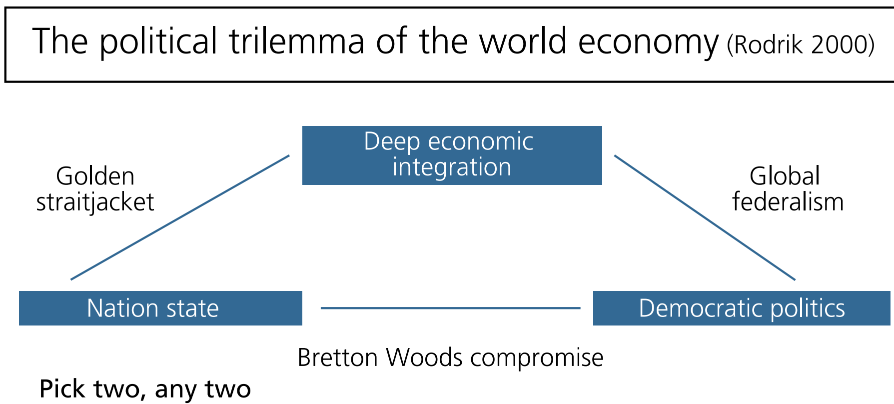
The UK joined the European Economic Community (EEC) late and is about to leave the EU early after a temporary stay of 46 years. Entry into the EEC brought substantial net economic benefits, while Brexit will almost certainly entail significant net economic costs. Moreover, if the UK wants to leave even though it is economically harmful to do so, presumably other countries may seek to follow the same path. So, what can be learnt from the UK's experience that may be helpful in guarding against future European economic disintegration?

The UK became a member of the EEC in 1973 at the end of the 'Golden Age' of European economic growth (1950-73) during which labour productivity in the EU15 had grown at an average rate of 4.9% per year. The evidence suggests that European economic growth was boosted in these years by trade liberalisation which raised the long-run income level. Using a gravity model, Bayoumi and Eichengreen (1995) estimated that intra-EEC trade among the original six members was increased by 3.2% t per year between 1956 and 1973, implying that membership of the EEC may have raised income levels by 4% to 8% by 1970 (Eichengreen and Boltho 2008). The total long-term effect of post-1950 reductions in trade protection, including reduction of external tariffs through GATT, raised European income levels by nearly 20% by the mid-1970s, according to the estimates in Badinger (2005).

The postwar reconstruction of the international economy saw economic integration restricted by controls on international capital flows (the 'Bretton-Woods Compromise'). The idea of the 'Bretton-Woods compromise' was to sacrifice some aspects of economic

integration to provide sufficient policy space to make saving the remaining aspects – in this case, moving back to freer trade – politically acceptable. This can be seen as a choice within the 'political trilemma' posited by Rodrik (2000), reproduced in Figure 1, which states that it is generally only possible to have at most two of the following: deep economic integration, democratic politics, and the nation state.

Figure 1 The Rodrik trilemma



The policy space was used to underpin acceptance of greater openness by developing much better social safety nets (see Table 1) in line with the analysis in Rodrik (1998).

The success of the EEC encouraged other countries to join. The synthetic-controls analysis by Campos et al. (2014) suggests that accession generally raised the long-run level of income appreciably (Table 2), presumably through reduced trade costs and increased trade volumes which raised productivity. The gain for the UK after ten years is estimated to have been 8.6% of GDP. A similar estimate is obtained by using gravity-model estimates of the trade impact and an estimated elasticity of income to trade (Crafts 2017). This is much larger than any reasonable estimate of the 'EU membership fee' that the UK has paid. The main components of this fee are budgetary transfers, notably including the costs of the Common Agricultural Policy and costs of badly designed regulations, which have typically amounted to 0.5% and 0.9% of GDP, respectively (Crafts 2016). The benefit-cost ratio of EU membership has been very

favourable. A substantial part of the benefits accrued from strengthening competition in product markets, which was a key part of the Thatcher reforms as was underlined by strong UK support for the Single Market Act of 1986.[1]

Table 1 Social transfers (% of GDP)

	1930	1960	1980	2005	2013	"2030"
Austria	1.2	15.9	22.6	27.1	28.3	33.3
Belgium	0.6	13.1	23.5	26.5	30.7	37.0
Denmark	3.1	12.3	25.2	27.7	30.8	33.7
Finland	3.0	8.8	18.4	26.2	30.5	36.2
France	1.0	13.4	20.8	30.1	33.0	35.8
Germany	4.8	18.1	23.0	27.3	26.2	30.1
Greece	0.1	10.4	11.5	21.1	22.0	24.8
Ireland	3.7	8.7	17.4	16.0	21.6	25.3
Italy	0.1	13.1	18.0	24.9	28.4	30.4
Netherlands	1.0	11.7	24.1	18.1	24.3	29.4
Norway	2.4	7.8	16.9	21.6	22.9	28.0
Portugal	0.0		10.8	23.0	26.4	29.1
Spain	0.1		15.5	21.1	27.4	30.3
Sweden	2.6	10.8	28.6	29.1	28.6	31.2
Switzerland	1.2	4.9	13.9	20.3	19.1	23.3
UK	2.2	10.2	16.6	20.5	23.8	26.2

Note: "2030" adds to the 2013 figure increases through 2030 from health and long-term care in the absence of cost containment (de la Maisonneuve and Oliveira Martins 2013) and from pensions expenditure (OECD 2013)

1 As Leader of the Opposition, Mrs Thatcher was a very strong advocate of staying in the EEC during the UK referendum of June 1975. Only in the late 1980s did she become a Eurosceptic.

Table 2 Post-accession differences between the level of actual and synthetic GDP per person (%)

	After five years	After ten years
Denmark	10.3	14.3
Ireland	5.2	9.4
United Kingdom	4.8	8.6
Greece	-11.6	-17.3
Portugal	11.7	16.5
Spain	9.3	13.7
Austria	4.5	6.4
Finland	2.2	4.0
Sweden	0.8	2.4

Source: Campos et al. (2014)

Several papers have estimated the long-term economic impact of Brexit in terms of a levels effect on GDP, and their results are summarised in Ebell and Warren (2016). The methodology is typically based on a gravity model estimate of the trade effects of various alternatives to EU membership, with the trade effect then converted into an impact on GDP. Not surprisingly, the impacts depend on what replaces EU membership, with larger losses the 'harder' the Brexit. Reverting to WTO rules is typically reckoned to cost nearly 8% of GDP; much of the gains that EU membership has brought might be lost. On these estimates, the benefit-cost ratio of Brexit does not look promising – this is a very expensive way to save a net budgetary contribution of about 0.5% of GDP.

Some caveats to these conclusions should be noted. First, the gravity-model evidence does not explicitly cover the case of a former EU member. History does seem to influence trade volumes and, implicitly, trade costs (Eichengreen and Irwin 1998). This suggests that the adverse impact on trade may be lower than the conventional calculations assume.[2] Second, the post-entry trade effect on productivity that the UK experienced in the 1970s and 1980s came largely from increased competition at a time

2 An interesting example is the ending in 1979 of the long-standing currency union between Ireland and the UK. Econometric analysis suggests that this had no effect at all on trade (Thom and Walsh 2002) even though, on balance, the literature predicts that a significant reduction was to be expected.

when this addressed a major weakness in supply-side policy. Brexit will probably not have an equal and opposite effect. The UK has addressed some of its problems of corporate governance and industrial relations, and it has a much more effective competition policy regime.

If Brexit were necessary to allow radical changes to policies which affect the growth rate, then an economic case in favour might be made. After all, there is much that could be done to improve UK supply-side policy, for example in the areas of education, infrastructure, innovation, and the tax system. However, reforms are not precluded by EU membership. The obstacles to better policy lie in Westminster, not Brussels, and are related to British politics rather than constraints imposed by the EU. Whereas 40 years ago entry into the EU did help to improve supply-side policy by strengthening competition, today there is no problem area to which Brexit is required to provide an answer.

So, if at the macroeconomic level EU membership has been economically highly beneficial and Brexit will be costly, why did Leave win the referendum vote? Three big points deserve to be highlighted. First, while the costs of the UK's net budgetary contribution are a 'fact', the costs of reduced trade are opaque to the person in the street and are, in any case, an estimate which can be portrayed as unreliable. Second, EU membership entails acceptance of the free movement of labour, but a significant proportion of the British electorate want to 'take back control' of immigration. Analysis of survey evidence by Goodwin and Milazzo (2017) found that if a voter thought Brexit would reduce immigration the probability of a vote to leave was increased by 0.5, that 80% of Leave voters (compared with 40% per cent of Remain voters) thought Brexit would reduce immigration, and that 55% of Leave voters were 'intensely opposed' to immigration (compared with 13% of Remain voters). Third, the vote took place after many years of 'austerity', reflected in a fiscal squeeze which was quite considerable in some districts. An analysis of district-level voting by Becker et al. (2017) found that a fairly modest reduction in the imposition of fiscal cuts might have been enough for Remain to have won (see Table 3). Votes for UKIP picked up dramatically in areas with grievances against globalisation and weak socioeconomic fundamentals after

the austerity programme was initiated in 2010 (Becker and Fetzer 2018). Individuals evaluating their financial situation as 'quite difficult' or 'very difficult' were more likely to favour leaving the EU (Liberini et al. 2017).

Table 3 Reversing the referendum result

	Actual	To reverse
Population share aged ≥ 60 (%)	24.0	12.3
Unemployment rate (%)	5.3	0.6
Fiscal cuts/ person (£)	448	407
Population share with no qualifications (%)	35.4	33.6
EU accession migrant growth rate, 2001-2011 (%)	1.7	-0.5

Note: 'To Reverse' is the value of the variable based on regression analysis that would give 'Remain' 50.01% of the vote (holding all other variables constant).

Source: Becker et al. (2017).

Lessons from the UK's Brexit vote can be understood in terms of the political trilemma. Given that 'global federalism' (a 'United States of Europe') is infeasible, the deep integration of the EU co-exists with nation states on the basis of rules or, in Rodrik's terminology, a 'golden straitjacket'. This tendency has been reinforced by the euro area crisis, notably by the Fiscal Compact of 2012 (Crum 2013), which is likely to require large primary budget surpluses if public debt-to-GDP ratios are to be reduced in the prescribed way. But the vote for Brexit indicates that a strategy of maintaining European integration through strict rules that enforce austerity potentially at the expense of social transfers that cushion its adverse impacts and which preclude democratic control over sensitive issues like migration runs the risk of provoking a backlash that unleashes forces which threaten the viability of the EU.[3] A new version of Rodrik's 'Bretton Woods Compromise' which loosens some constraints on policy may be in order, since the economic costs of leaving the EU are not necessarily a sufficient deterrent to disintegration.

3 Although, according to Eurobarometer, opposition to free movement has been strongest in the UK in five other countries (Austria, Belgium, Denmark, Italy, and the Netherlands) more than 20% disapproved in 2016; an analysis of the responses suggests that there is 'a ready reservoir of negative opinion' to be exploited by Eurosceptic political movements when an opportunity arises (Vasilopoulou and Talving 2017).

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5 European Economic and Monetary Union: Past performance and future returns

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Europe's peaceful economic and monetary integration process is unprecedented in history, but its designers took into account historical lessons that currently appear forgotten. At the global level, supporters of the Trump administration's tariffs and competitive devaluation threats disregard the unfortunate role played by such policies in the 1930s. In Europe, discussions of possible euro exit options seem somewhat oblivious to the similar and much more recent European experience of actual exchange rate instability in the 1970s and 1980s, and redenomination risk in the aftermath of the Great Recession.[1]

History does not however offer easy solutions. The past is often burdensome, and memories can be manipulated to build myths in support of national interests. Only trust in future cooperation can support current cooperation, but opportunistic and shortsighted behaviour can easily disrupt peaceful international relations. Peace is in fact unusual in history. Broader economic integration underlies both material progress and socio-political conflicts, and has most often been forced by conquest (Findlay and O'Rourke 2009).

Whether peaceful economic interactions can take place across political borders depends on whether those who would in autarky enjoy relative scarcity or monopoly power can be subdued or compensated. Social welfare schemes can help in this respect, and

1 See https://www.welt.de/finanzen/article174560810/Euro-Nicht-nachhaltig-Notfallplaene-der-Oekonomen-Sinn-und-Fuest.html.

public budgets can buffer shocks that originate abroad, but these and other tools may or may not be effective, depending on politico-economic and geopolitical factors that underlie globalisation's ebbs and flows in history. Rich countries did implement social and fiscal policy broadly as post-war trade grew strongly in Europe, across the Atlantic, and globally.

Now, even as international economic interactions increasingly involve integrated production chains (Baldwin and Rodriguez 2015), the political appeal of international economic integration is weakened by systems competition (Sinn 2003), which makes it is difficult for national governments to enforce taxes and regulations that economic agents can easily escape across borders. In both respects, the efficient scale of production and policy has become larger than the nation states that proved capable of managing globalisation after the demise of empires, but cannot shelter from increasing inequality the lower-middle classes that are politically decisive in a democracy.

The process that developed into the EU navigates the eternal yet ever-changing straits of national political tension and unavoidable international economic integration. It did so successfully for a remarkably long time, but is now finding it very difficult to deliver results in line with past performance. Some of the current European woes echo those of the 1920s. Then, problematic debt stocks originated in war victories and defeats (Tooze 2014). Debt also looms large in times of great structural transformation. Adoption of a common currency and enlargement triggered financial flows that in the late 1990s and early 2000s were comparable to those seen during the Great War, and justified in the eyes of both lenders and borrowers by expectations of economic convergence (Bertola 2017). Those expectations were falsified by the Great Recession, and the resulting euro crisis environment is unfortunately like that which Keynes (1922) characterised as an "atmosphere of distrust and hostility". Much the same conflicts of interest as in the 1920s are currently relevant to the conduct of the single monetary policy and in the implementation of fiscal policy constraints: creditors favour high interest rates and low inflation, even as this makes debt service more onerous for those who favour monetary and fiscal expansion.

History often rhymes but does not repeat itself (not least because now Germany is cast as the creditor, not as the debtor it was in the 1920s). The next decades need not resemble the 1930s and 1940s, but to prevent open conflict it is key to recognise conflicting interests and find ways to reconcile them, in a climate of reciprocal trust, with suitable compromises across issues and over time.

While the legal framework of the EU can play a role in fostering trust, sovereign nations need not respect rules. Threats of expulsion, and the availability of exit options, shorten the planning horizon, encourage opportunistic behaviour, and foster instability. To function properly, a club of nations has to rely on self-enforcing cooperative behaviour on the part of their members (EEAG 2018: Chapter 3).

If it can be trusted to be long-lasting, then opportunities to reconcile conflicting interests over time can make it preferable to exit, hence indeed long-lasting. Achieving this cooperative equilibrium is in fact easier when members are heterogeneous across multiple dimensions and the club itself has multiple complementary purposes, making it possible to negotiate compromises across policy areas.

The original design of the European integration project does require member countries to satisfy conditions for take-it-or-leave-it accession to a comprehensive, evolving, single policy framework. Such a package deal may be disagreeable in some respects for some members at any point in time, but can be preferable to dissolution alternatives if it is trusted to last over a different future. Brexit and nationalistic political sentiment in many member countries currently challenge this mode of operation, which has in the past proved capable of discouraging opportunistic behaviour and preventing open conflict. If properly understood and implemented, it can continue in the future to foster trust, cooperation, and a constructive long-term perspective on problems and solutions.

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interactions with European economic and monetary unification. He has applied similar methods also to exchange rate and money-market policies, interactions between growth and distribution, households' durable consumption and borrowing, and educational systems.

6 A critical perspective on future European integration[1]

Harald Badinger
WU Vienna

'The future of Europe' is not only an economic topic. It also has a political science, a legal, and a sociological dimension; and it has a foreign, security, and defence policy dimension, which is closely related to a geo-political dimension. Through which institutional setup can the EU best fulfil its self-assigned role along these dimensions?

This question clearly transcends the borders of the discipline of economics and can only be addressed by a (more than book-length) interdisciplinary treatment. This chapter has the more modest goal to share some observations and assessments from the author's predominantly (but not solely) economic point of view.

We can take a positive perspective: What will the EU look like in the future? Niels Bohr's famous quote comes to mind: "Prediction is very difficult, especially if it's about the future." Hence, I will not make a prediction how the EU will look like in 2050 – such an attempt is bound to fail. Let us, for example, travel back in time to 1950s. Who at that time had envisaged the spectacular progress that European integration would be making over the next six decades: the expansion from originally six to 28 EU member states, the Single Market, the establishment of European institutions (the European Commission, Council, Parliament, Court of Justice, etc.), the introduction of a common European currency, and so on? On the other hand, let's look back to 2005. Up to then, European integration was characterised by steady progress, the European Project in its substance undisputed, success taken for granted, and a failure and a break-up of the EU

1 This chapter is an abridged version of presentation at the conference "From Bretton Woods to Berlaymont: Globalisation, Integration and the Future of Europe", KOF/ETH Zurich, 22-23 March 2018. The full version is available at http://epub.wu.ac.at/6249/1/wp264.pdf.

not even conceivable. Who at that time had predicted that – over the next decade – the EU would be sliding into a severe economic and institutional crisis, that there would be a serious threat of a euro area breakup, and that these developments would culminate in the most severe backlash against European integration, namely, the British vote on leaving the EU?

Alternatively, we can take a normative perspective: What should the EU look like in the future? Which recommendations can we give to policymakers? There are many (economic) questions, where scientists can give precise, clear-cut recommendations that are shared by the vast majority of the scientific community. However, for the broad topic at hand – European integration and the future institutions of Europe – I am very reluctant to spell out clear-cut recommendations, since this topic not only transcends the borders of the discipline of economics, it also transcends the borders of scientific analysis.

Accordingly, a clear line has to be drawn between what is desirable from a scientific perspective, which can be judged by objective standards, and what is desirable from a political perspective, which will vary with political preferences. It is a straightforward consequence of believing in democracy to admit that there are different, equally valid views on what the EU should look like in 2050. As a consequence, I am happy to see that even the European Commission – in its recent White Paper on the Future of Europe (European Commission 2017) – has spelled out this thought clearly by enumerating and describing five scenarios for the future of the EU. Fortunately, in Brussels the view has arrived that there are alternatives to "enlargement and deepening at any price", that there is more than one way for the EU to survive, and that there is more than one attitude towards the future of the EU which is consistent with being a good European.

Due to space constraints, I will focus on two perspectives enumerated by the Commission: i) doing less more efficiently, and ii) doing much more together. On second thought, these two options are inconsistent with each only other at a general, aggregate level of consideration. Different policy areas require different solutions. Economic theory, public choice theory, and the theory of fiscal federalism all lead to the conclusion that for different policy fields, there will be different optimal levels of

centralisation or integration. When judged on a case-by-case basis, there are likely to be policy fields where integration should be cut back and other policy fields where more supranationality is warranted.

Hence, a reasonable future scenario for the EU would be doing less in some areas, doing more in others. The obvious question then is: where to do what? Or to put it differently: where do we need more supranationality, and where do we need more subsidiarity?

Economic theory spells out trade-offs revolving around economies of scale, heterogeneous local preferences, transaction and coordination costs, spillover effects, the provision of local public goods, and so on.[2] Based on such an analysis, there are certainly policy areas where the benefits of centralisation outweigh its disadvantages – migration, security, defence, competition, and the environment are examples that come to mind immediately. "Doing much more together" would be the right approach in these fields.

But for the vast majority of policy areas, (economic) theory gives us much less clear guidance about the optimal degree of centralisation. Yet, as Danthine (2017) points out, subsidiarity is still the key to Europe's institutional problems; he even refers to it as a forgotten concept at the core of Europe's existential crisis.

I do not want to delve into an enumeration of the pros and cons of alternative governance models, this is well documented in the literature. If there is a general conclusion to be drawn, it is that in many (even narrowly defined) policy areas there is no governance model that is optimal under any internal and external circumstances and constraints. Since no one can reasonably predict how these internal and external circumstances and constraints will evolve over time, each choice within a certain range appears equally justified.

2 There is one issue, however, that is hardly addressed in such comparisons, namely, the possibility that policy failures – such as the lack of ability to respond to shocks in a timely manner, the choice of solutions that are biased towards the interests of (a subset of) single member states, or the lack of coordination and absence of a coherent policy – may become more likely under more complex governance structures of large-scale institutions such as the EU. In my view, the handling of the financial and economic crisis as well as the refugee crisis are two cases in point.

In the end, for many if not most policy areas, it boils down to one question: How much risk sharing is desired and how severe is the problem of moral hazard? Obviously, there are different (legitimate) assessments regarding the number of, and the weights assigned to, criteria of a social objective function, which includes more than purely economic variables.

If there is a range of possible, workable solutions, their ultimate choice should also be guided and influenced by political preferences, i.e. the democratic will of the European populations. This process of political clarification is of utmost importance and should be given the same priority and importance as the scientific, economic analysis.

Let me turn to my conclusions, which I will draw around two quotes. *"Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity." (*Monnet 1950). Monnet's vision has always been that economic integration comes first while political integration follows, and it follows in small steps and at a moderate pace. Over the last years, there may have been a disturbing mismatch in the speed of these two interrelated processes.

"*The Single Market and active competition policy remain the cornerstone of efforts at EU level to improve European growth performance. They represent a foundation without which other efforts would be wasted.*" (Sapir et al. 2004: 158). Several shortcomings highlighted in the (15-year-old) Sapir report do still exist, and many recommendations are still valid. This is a serious problem, since no institutional setup can overcome shortcomings in the design of the European market (Alesina and Giavazzi 2007).

Putting these arguments together, my recommendation is to focus on and speed up economic integration and carefully pursue political integration at a modest pace, but not without listening to the electorate. The alternative – forcing political integration first to be able to implement the required reforms, bypassing or evading the constituent – would be wrongheaded in my view. Further integrating economically first while pursuing a policy of small steps with respect to political integration is certainly the more cumbersome way; it will have to take some detours and it will be difficult to stay on track. But ultimately, this is the democratic way, the sustainable way, and the only way that is likely to be successful.

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Part II

European institutions

7 The changing battle lines in the European Parliament

Simon Hix, Abdul Noury and Gérard Roland
LSE; NYU Abu Dhabi; University of California, Berkeley and CEPR

In the aftermath of the 2008 crisis, one has observed in advanced democracies a recomposition of the political landscape suggesting that the main dimension of politics may be shifting to a new division, between anti-globalisation forces (mostly on the extreme right and extreme left) and pro-globalisation forces (Kriesi et al. 2012). Recent elections – the Brexit referendum in 2016, the election of Trump as president of the US in 2016, and the successes of Le Pen and Mélenchon in France's 2017 presidential election, of AfD and die Linke in Germany's 2017 election, and of Lega and M5S in Italy's 2018 election – can be interpreted in this way.

Guiso et al. (2017) have recently shown that economic insecurity following the 2008 crisis has led to a loss of trust in traditional left-wing and right-wing parties. Populist parties have emerged to cater to this decline of trust and compete with mainstream parties, who have now started to also defend populist policies instead of vigorously opposing them. Dustmann et al. (2017) document a strong correlation between unemployment shocks at the regional level, trust deficit in political institutions, and votes for populist parties in the European Parliament elections. Similarly, Algan et al. (2017) found for EU countries a strong link between high increases in unemployment following the Great Recession and votes for populist parties and also a decline in trust in national and European political institutions.[1] Anti-globalisation forces in Europe also generally campaign against the EU and the euro, following the Brexit model.

1 Inglehart and Norris (2016) argue that cultural values, rather than economic factors, provide the most consistent explanation for voting support for populist parties.

Does this all mean that the left-right cleavage that has been dominant in advanced democracies for decades is being replaced by a pro- versus anti-globalisation cleavage?

Changing cleavages in the European Parliament

This is exactly what has been happening in the European Parliament, as we document in this chapter and in a longer new working paper (Hix et al. 2018). All our previous work (e.g. Hix et al. 2006, 2007), based on all collected roll call votes in the European Parliament, had shown that the left-right division was the main dimension of political conflict in the European Parliament, explaining the individual voting behaviour of the members of the European Parliament as well as the competition and coalitions between the European political groups. This has started to change substantially, especially since the election of the eighth European Parliament in 2014. In contrast to previous decades, the main dimension of politics in the European Parliament has shifted in a clear way, from left-right to pro/anti-EU, where the new pro/anti-EU conflict mirrors the pro/anti-globalisation conflict we increasingly see in national elections in Europe. This dimension had always been a second, less important dimension in the European Parliament, but the evidence we present suggests that it is now becoming the most important political dimension in the Parliament.

Table 1 shows the composition of the sixth, seventh and eighth directly elected European Parliaments. The two main families in the European Parliament have been the Christian Democrats/Conservatives (EPP) and the Social Democrats (SOC), but their seat shares have gone down over time. The Liberals (ALDE) have a smaller seat share, but have often been pivotal and have split along left-right lines due to their centrist position. The Radical Left (GUE/NGL) regroups communist or former communist parties and extreme left parties. The Greens (G/EFA) are pro-environment parties allied with some left-wing regionalist parties. Outside these five groups, the other groups have been less stable. They regroup parties to the right of the EPP, anti-European parties and radical right parties. For example, in the seventh parliament, the British Conservatives broke away from the EPP to form a separate party group with more ‘nationalist’ conservative parties, mainly from central and eastern Europe.

Table 1 Political composition of the sixth, seventh and eighth European Parliaments

Party Description	Abbr.	Sixth Parliament (June 2004)	Seventh Parliament (June 2009)	Eighth Parliament (June 2014)
		Seats	Seats	Seats
Transnational Party Groups				
Christian Democrats & Conservatives	EPP	288 (36.7%)	265 (36.0%)	219 (29.2%)
Social Democrats	SOC	217 (27.6%)	184 (25.0%)	189 (25.2%)
Liberals (ALDE)	LIB	104 (13.2%)	84 (11.4%)	68 (9.0%)
Greens (G/EFA)	GRN	43 (5.5%)	56 (7.6%)	52 (6.9%)
Radical Left (GUE/NGL)	LEFT	41 (5.2%)	35 (4.8%)	51 (6.8%)
Anti-Europeans (EFD)	ANTI	22 (2.8%)	27 (3.7%)	44 (5.8%)
National Conservatives	UEN	40 (5.1%)		
British Conservatives and allies (ECR)	CON		55 (7.5%)	71 (9.4%)
Extreme Right (ENL)	RIGHT			36 (4.8%)
Non-attached members	NA	30 (3.8%)	29 (3.9%)	20 (2.6%)
Total MEPs		785	736	750

How do the European party groups vote and form coalitions on roll call votes in the European Parliament, and along what dimensions do they vote? In Hix et al. (2006, 2007), using scaling programs developed by Poole and Rosenthal (1985, 1997) and Poole (2000) to identify dimensions of politics in the US Congress, we consistently found for the European Parliament that the first and main dimension, which accounts over 80% of individual voting decisions, could be explained by the standard left-right cleavage. There was also a second dimension, although substantively less significant (explaining an additional 2-5% of individual decisions), that could be explained by support for or opposition to the European integration process. We find the same when looking at the location of MEPs for the sixth Parliament (EP6, 2004-09) and the seventh Parliament (EP7, 2009-14).

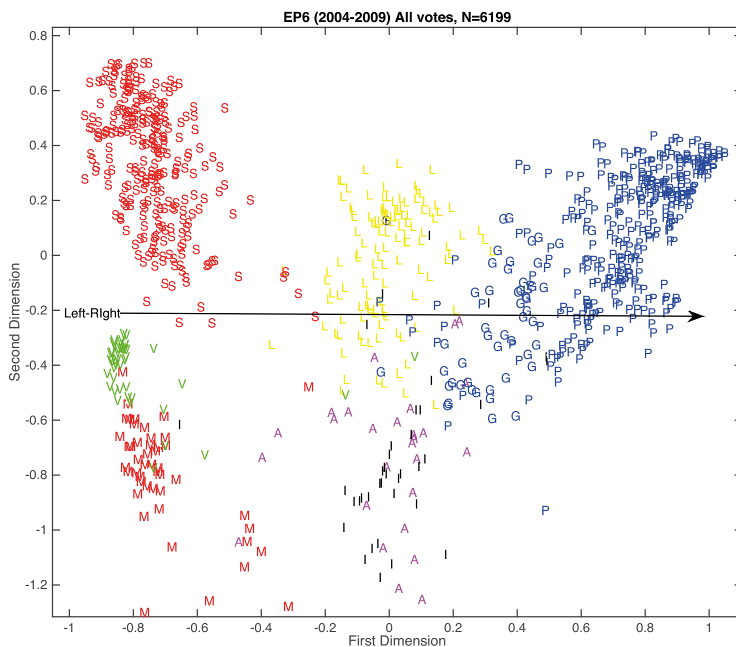
This can be seen in Figures 1a and b. The first dimension, along the horizontal line, in EP6 and EP7 is clearly related to the left-right dimension. On the left-hand side of the spatial map we have left-wing parties such as the radical left GUE-NGL (M in red in Figure 1), the Greens (V in green), and the Social Democratic parties (S in red in Figure 1). In the middle we have the centrist ALDE (L in yellow). On the right we have the EPP (P in blue) as well as other right-wing parties (G in blue and C in purple). The second dimension, along the vertical axis, in EP6 and EP7 is related to attitudes towards European integration. Pro-EU parties are located on the top part of the map (essentially the Social Democrats, Liberals and Conservatives), while anti-EU parties are located on the bottom of the policy space (all the other parties).

This two-dimensional spatial picture, with the left-right dimension as the main dimension and the EU dimension as a subsidiary second dimension, effectively explains European politics from most of the period since the first direction elections to the European Parliament in 1979.

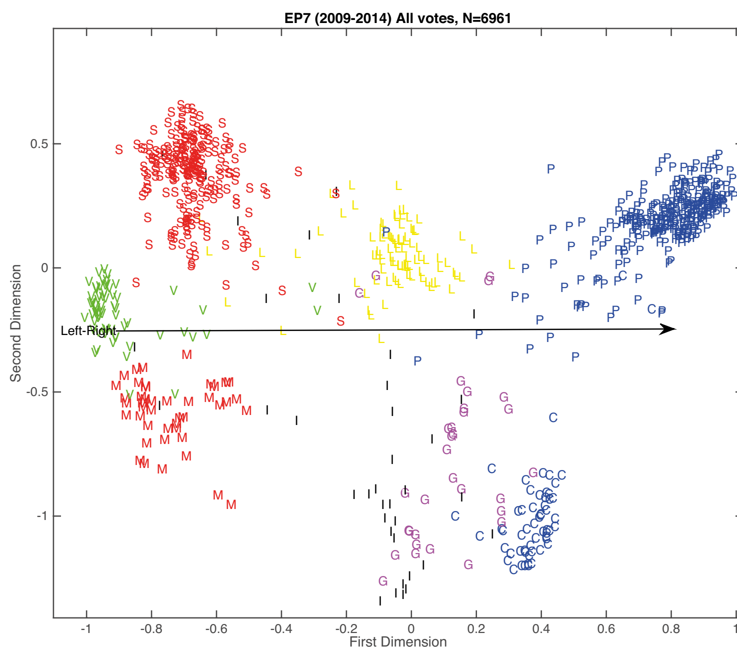
The eighth parliament (EP8, elected in 2014), however, shows a quite different configuration. Looking at Figure 1c, the two-dimensional space appears to be partially rotated clockwise. The first dimension cannot be clearly interpreted. It appears as if the new first, dominant dimension is a combination of the prior two dimensions, with the left/anti-EU forces on the left-hand side of the new main dimension and the right/pro-EU forces on the right-hand side of the new main dimension.

Figure 1 Two-dimensional ideal points in the European Parliament

a) The sixth European Parliament



b) The seventh European Parliament



c) The eighth European Parliament

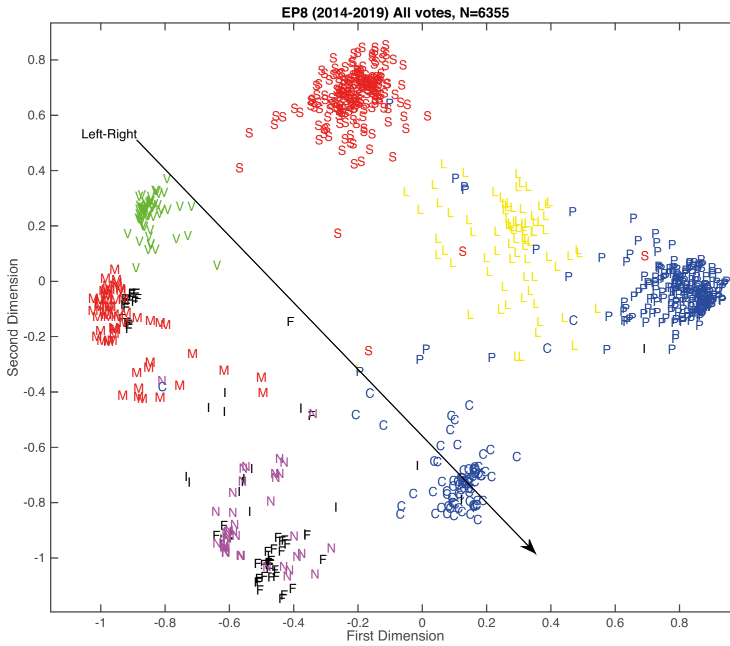


Figure 1 is based on all roll call votes in EP6, EP7 and EP8. We have also carried out a similar exercise to the one above but divided by policy area (Hix et al. 2018). For some policy issues the first dimension was left-right in EP6, and remained so in EP7 and EP8. Those issues include employment, the environment, gender, the internal market and consumer protection, and industry, research and energy. For other policy issues, we observe some notable changes. For the budget, economic and monetary affairs, foreign affairs, and international trade, voting was traditionally always along the left-right dimension, but in EP7 and especially in EP8, the dividing line has been pro/anti-EU. Some of these changes started to happen in EP7, but they have been accelerating since EP8, clearly confirming that votes in the European Parliament are increasingly cast in terms of attitudes towards European integration, and increasingly less in terms of the traditional left-right dimension that had been dominant since 1978.

Policy conclusions

The change that is taking place in the dominant political cleavage in the European Parliament has several implications.

First of all, it is possible that national party groups will form new European party groups following the recomposition that we have been observing in France, where Emmanuel Macron's centrist pro-globalisation party has become the first party in the French Parliament, overcoming the traditional left-right divide. If this is the case, it could become a European-wide phenomenon.

Second, this is not necessarily good news for the future of European integration. Debates in the European Parliament along the left-right dimension have created true democratic European politics, with shifting coalitions (for example, with a centre-left coalition winning on some issues such as the environment and standards, and a centre-right coalition winning on other issues such as market deregulation). This well-oiled, coalition-based structure of European politics could be pushed aside by more intractable conflicts over the nature of European integration, for example over whether there should be deeper integration in the euro area or whether there should be common EU refugee policies to resolve the migration crisis. Moreover, in this new structure of politics, if the democratic pendulum swings against the pro-EU/globalisation forces, as it is doing in many countries at the moment, we could see steps to undo parts of European integration. This does not necessarily mean the end of Europe, though, as other multi-level democratic polities have experienced phases of decentralisation or recentralisation over time.

Third, it is not clear whether what seems to have become the new cleavage in advanced democracies will be a temporary or a lasting phenomenon. Judging from history, it will most likely be a temporary phenomenon. History has also shown that such large political disruptions can lead to widespread conflict. Anti-globalisation forces tend to breed nationalism and hatred for other nations and ethnicities, which can easily spill over into conflicts that more than 60 years of European integration have managed to eliminate. In any case, the European Parliament arising from the 2019 election is still likely to reinforce the increasingly dominant pro-/anti-globalisation cleavage.

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8 Institutions and convergence in Europe: The case of Structural Funds

Sascha O. Becker, Peter H. Egger, and **Maximilian von Ehrlich**
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Most federations – whether national or supra-national in scope – rely on a system of fiscal federalism with transfers across jurisdictions. The goal of such transfers is the equalisation, at least partially, of fiscal capacity and per capita income among participating jurisdictions. The EU's structural operations are viewed as a fundamental pillar of cohesion through such redistribution from 'richer' to 'poorer' subnational regions in the EU.

The lion's share of the EU's fiscal equalisation transfers is spent under the auspices of the Structural Funds programme (starting in 1989), and its most important funding schemes are the following:

- The Convergence Objective (formerly Objective 1),
- The Regional Competitiveness and Employment Objective (formerly Objective 2),
- The European Territorial Cooperation Objective (formerly Objective 3).

Under a broader perspective, a main reason behind the support of cohesion and convergence through the structural operations is its support of the 'poorest' regions in order to provide for a better footing of the Economic and Monetary Union and the common currency, which all member countries and regions of the EU are envisaged to be part of sooner or later. Hence, the pursuit is one of establishing a more homogeneous macroeconomic environment that comes closer to what economists call an optimum currency area (Mundell 1961).

There are other forces, foremost the European Single Market (since 1993) with its four freedoms of movement (of goods through the abolishment of tariff and non-tariff barriers to trade, of capital, of services, and of workers), which should help in establishing such an area. However, it is held that the pro-common market environment will not be capable of establishing homogeneity at the national and subnational level as swiftly as desired. Accordingly, transfers as the ones defined in the structural operations are introduced to facilitate the the process.

Policy design

Structural operations are organised into programming periods: 1989-93, 1994-99, 2000-06, 2007-13, 2014-20. The eligibility for transfers of different kinds is determined at two regional levels –NUTS2 (800,000 to 3,000,000 inhabitants) and NUTS3 (150,000 to 800,000 inhabitants) – and the defining characteristics for transfer eligibility are specified in years immediately prior to the aforementioned programming periods. Overall, virtually all NUTS3 regions get some funding (which to some extent defies the idea of redistribution in its most stringent form), but eligibility for funding under the Convergence (Objective 1) line, which is the biggest budget subline and determined at the NUTS2 level, is more exclusive.

Clearly, as any redistribution scheme involves administrative slack, a minimum requirement for it to be justified is its effectiveness. However, evaluating the effectiveness of the structural operations is difficult because poorer regions tend to grow faster anyway and they are also more likely to receive funding, and more of it, than others. Hence, there is a mechanical positive correlation between receiving funding and growing faster, which should not be confused with causation – poorer EU regions would grow faster anyway in the absence of the structural operations.

However, the very design and some of the related arbitrary rule-making provide for the possibility of identification of the causal relationship between (at least some of) the funding and economic growth and other outcomes (Becker et al. 2010). For example, Convergence/Objective 1 treatment (the largest sub-programme) establishes eligibility for funding only if an NUTS2 region's GDP per capita (corrected for purchasing power differences) falls short of 75% of the EU average (also corrected for purchasing power

differences). There are still some problems with this: time inconsistency and change of regional delineations of NUTS2 and NUTS3 regions in the national interest of getting better access to funding, but also Brexit; and the fuzzy implementation of the rules whereby not all eligible regions receive funds while some ineligible ones do. However, these concerns appear manageable towards an identification of the causal effect of structural operations programmes in view of available statistical methods. Moreover, fuzziness in the sense of treatment of ineligible regions and non-treatment of eligible regions declines when considering the Convergence/Objective 1 treatment: of the 187, 209, 253, and 253 NUTS2 regions in the programming periods 1989-93, 1994-99, 2000-06, 2007-13, about 7%, 8%, 7%, and 2%, respectively, had a treatment status different from their eligibility status (Becker et al. 2018).

Effectiveness of the structural operations

From a bird's eye view, an evaluation of the structural operations' convergence target can be summarised as follows:

- **The scheme is effective for per-capita income growth on average** in the sense that every euro spent generates somewhat more than a euro in per-capita income (i.e. the scheme appears to induce more than just a one-for-one consumption effect). However, the scheme does not trigger much of an employment effect in the short run (adjustment may be more sluggish there) and there is some evidence of a crowding-out of private investment.
- **The scheme is least effective where it is most needed, namely, in poor regions with low levels of absorptive capacity (little human capital and a lot of corruption).** In such regions, funding is a wash (and macroeconomic conditions are not improved by the transfers received; Becker et al. 2013).
- **The scheme 'worked less well', or at least differently, during the crisis**: the effects on per-capita income growth were smaller, though those on employment were larger than before. However, regions which were more strongly hit in an adverse way by the crisis (as measured, for example, by a larger government bond yield spread of the country they are located in) were not shielded successfully by

the funds received (in part, perhaps, due to the lack of capacity to co-finance the received funds).

- **The scheme triggers positive per-capita income growth effects relatively quickly, but the effects are not very long-lived**. Taking the funding away leads to a reversion to per-capita income levels (corrected for purchasing power differences) prior to when the funding had first been received – this may entail an un-cushioned loss for receiving regions in the UK after Brexit.

Outlook

The design and implementation of the EU's structural operations are obviously in need of reform. In the past, the European Commission did not systematically and rigorously evaluate the effectiveness of its regional policy, as it has started to do in the more recent past. For a serious attempt at stimulating long-term growth, the programming periods appear short, and the associated relatively short planning horizon potentially reduces the longevity of the effects.

Apart from targeting economic growth, the Commission might wish to tie transfer treatment to institutional change (such as quality of government, monitoring of expenses used, education, and so on). The amount of money spent could be reduced without lowering the effect if it is spent more wisely.

This does not call into question the institution of structural operations as such, but the design and ramifications of its implementation.

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9 An institutional innovation in the euro debt crisis: The ESM

Kari Korhonen[1]
European Stability Mechanism

The firewall and crisis resolution mechanisms established in the midst of the euro debt crisis demonstrated Europe's commitment to multilateral cooperation. But there is general agreement that the Economic and Monetary Union needs further deepening and development. In December 2017, the heads of government agreed to concentrate on two issues for the June 2018 summit: completing Banking Union and transforming the European Stability Mechanism (ESM) into a European Monetary Fund.

The ESM and its predecessor, the European Financial Stability Facility (EFSF), had to be put in place promptly to defend the euro area as markets derailed in response to a financial crisis unleashed in the US. G20-coordinated stimulus and liquidity support policies led to increasing public deficits, and debt in some countries. Then came a home-grown crisis, the European debt crisis, as markets refocused on negative debt dynamics, accelerating public deficits and debt, and a loss of competitiveness in some countries. Some countries in particular had been running ill-advised policies for an extended period and already suffered from heightened vulnerability (Jansen 2011, Regling 2018b, ESM 2017a).

The ESM was born as the lender of last resort for sovereigns in the euro area. When Greece was shut out of financial markets in early 2010, there was no institutional solution at hand despite general efforts to ensure stability. The Greek Loan Facility, created in 2010, drew on bilateral loans from the euro area members. But to ensure a

1 The views expressed in this chapter are strictly those of the author and do not necessarily represent those of the ESM or ESM policy. No responsibility or liability is accepted by the ESM in relation to the accuracy or completeness of the information presented.

more timely mobilisation of sufficient volumes of financial assistance, the EFSF was created as a temporary and lean institution to finance stability support (Strauch 2018), one which signalled European commitment to the integrity of the euro area. The EFSF's effectiveness as a lender was dependent on maintaining the highest possible credit rating – achieved through a lending capacity based on highly rated guarantors. As challenges emerged, the EFSF was adapted – its size was increased, funding strategy improved, and operational flexibility expanded. But political leaders decided it was necessary to build a permanent entity to reassure investors of the euro area's commitment to resolving the sovereign debt crisis (Jansen 2011, Regling 2018a). The IMF's lending policies and capacity would not have been enough on their own to cover the financing needs of some crisis-hit euro area countries (Kincaid 2016).

The euro area established this permanent institution as an international financial institution to "safeguard the financial stability of the euro area as a whole" as part of a comprehensive policy response. Countries would also need to do their homework by reining in public deficits and modernising their economies, thereby regaining competitiveness. The ESM was not the only innovation, though. Unorthodox monetary policy also played a crucial role in calming markets. In addition, the European fiscal rules were tightened, and the European Commission received stronger powers to monitor and sanction budget offenders. Economic surveillance was also broadened (Regling 2018a). The crisis revealed more prevalent cross-border effects than had been expected, a result of the currency union's level of integration and economic openness. The gains from policy coordination therefore outweighed the attendant costs.

The leaders endowed the crisis resolution mechanism with a capital structure to underpin its issuance capacity and high creditworthiness. This avoided a statistical rerouting of ESM liabilities to member states and therefore limited the burden on members' public debt. With a lending capacity of €500 billion, the ESM is the largest of the regional financing arrangements (RFAs) that, together with the IMF, form the global financial safety net (see IMF 2017 or ESM 2014 for an overview of RFAs).

Euro area finance ministers form the ESM's Board of Governors, and each nominates a member for a non-resident Board of Directors. These bodies take formal decisions on financial assistance and institutional issues. The size and political importance of the ESM's financial assistance justifies a close relationship with its member states.

Members often discuss formal decisions in advance at the Eurogroup, a euro area formation of the Ecofin Council also comprised of the finance ministers. This overlap between the memberships of the ESM Board of Governors and the Eurogroup creates a close political link between the European institutions and the ESM.

While the EFSF's tasks concentrated on raising and disbursing the financing needed, the ESM has gradually taken a more active and broader role in the provision of stability support. The ESM Treaty of 2012 assigned certain policy tasks to peer institutions to ensure early operational capacity, meaning programmes are therefore always joint operations with the European Commission and ECB. In addition, the IMF has been involved as a programme partner whenever possible. Having quickly gained credibility as a professional organisation, the ESM has now, for example, formalised its current more intensive working relationship with the European Commission. This agreement extends the working arrangement and information sharing to programme design, management, and ex post engagement (ESM 2018).

An independent evaluation of EFSF/ESM financial assistance (ESM 2017a) found that the institutional framework governing the cooperation between the EFSF/ESM and partner institutions worked during the crisis. This is important as assistance is subject to strict economic reform programmes, similar to the cash-for-reform approach applied by the IMF. The joint nature of the programmes required a strong alignment of objectives among the partner institutions. Less formal working relationships complemented the institutional framework. The alignment of objectives turned out to be challenging at times, as programme governance faced multiple stakeholder interests (ESM 2017a). The problem of numerous principals can be found more generally in international organisations, with repercussions for the consistency of their strategy (Lamdany and Martinez-Diaz 2009).

Table 1 EFSF and ESM financial assistance

Country	Financing institution	Formal request	Facility agreement entered into	Programme completion	Amount approved, € billion	Amount disbursed, € billion	Financing partners
Ireland	EFSF	20 Nov 2010	22 Dec 2010	8 Dec 2013	17.7	17.7	EFSM, IMF, bilaterals
Portugal	EFSF	7 Apr 2011	27 May 2011	18 May 2014	26.0	26.0	EFSM, IMF
Greece	EFSF	8 Feb 2012	15 Mar 2012	30 Jun 2015a	144.6	141.8	IMF
Spain	ESM	25 Jun 2012	25 Jul 2012	31 Dec 2013	100.0	41.3	..
Cyprus	ESM	25 Jun 2012	8 May 2013	31 Mar 2016	9.0	6.3	IMF
Greece	ESM	8 Jul 2015	19 Aug 2015	28 Aug 2018b	86.0	45.9c	..

Source: ESM. Further details on the crisis assistance in Appendix G. Crisis timeline of the EFSF/ESM evaluation report (ESM 2017b) and on the ESM website.

Notes: [a] Expired; [b] End of availability period; [c] Disbursed at end-March 2018.

The euro area's strategy has worked. Having approved €383 billion in total assistance, the EFSF and ESM have disbursed €279 billion (Table 1), largely in front-loaded loan programmes and at perceptibly lower rates than the IMF loans, generating substantial budgetary savings for the beneficiaries. Simultaneously, the EFSF and ESM provided financial assistance at longer maturities than IMF loans, and these maturities were subsequently extended further for some countries (in the case of Greece, up to 32.5 years), thus substantially smoothing their repayment profiles. At end-March 2018, €254.5 billion of loans was outstanding. As a creditor, the members granted the ESM seniority immediately after the IMF.

To conduct this business, the ESM raises funds from investors by issuing securities, unlike the IMF and the other RFAs whose members fund them from their foreign reserves. The ESM can do so at favourable rates because of a high credit rating based on its €80.5 billion paid-in capital. As key issuers, the EFSF and ESM are recognised by their inclusion in major government bond indices. But market financing, often at fixed rates, generates a limitation – for example in comparison to the IMF. When members benefit from a strong recovery, as Spain and Ireland did, they would often like to proceed with early reimbursements and the EFSF/ESM could face a replacement cost that would normally be recovered from the member.

Lessons for institutional development

The ESM has responded effectively to member states' crisis needs as part of the broader European framework. The *Five Presidents' Report* of 2015 (Juncker et al. 2015) and the subsequent reflection paper (European Commission 2017) structured the debate on future euro area reform needs, including thoughts on developing a European Monetary Fund (EMF). The general objective is an institution with a greater responsibility as a crisis resolution mechanism, while interested parties are debating other potentially attached mandates and governance features. Emphasis on the Banking Union in the short-term agenda is in line with a broader G20 tendency to concentrate on financial sector risks (Cheng 2016), given financial rescue operations can increase feedback effects from bank risk into sovereign risk (Erce 2015). Most likely to emerge from this debate is a fiscal backstop to the bank resolution fund.

The other building blocks of the euro area debate are risk-sharing through capital markets or fiscal arrangements, such as rainy day funds (Lenarcic and Korhonen 2018), and a sovereign debt restructuring framework to be operated in connection with future EMF lending. These can take various forms, and the ESM could play some role in their operation if member states so decide (Regling 2018c).

More specifically, according to the recommendations of the high-level evaluator's report, the ESM could strengthen its operation as a firewall by taking the following steps:

1. The independent evaluator recommended that ESM members discuss a broader preventive capacity for the financial stability of the euro area. The ESM's early warning mandate is limited in purpose to the monitoring of countries after a programme; a future EMF could have a peace-time monitoring function. Review of access criteria to some instruments could also support readiness to request assistance when problems cannot be solved at the national level. The issue of late request for assistance is well-known at the IMF, but has been difficult to tackle, despite the Fund's long experience and regular country surveillance.
2. More narrowly within its current mandate, the ESM should focus on programme credibility and seek ways to support programme ownership. The programme governance framework should therefore evolve to align stakeholder objectives early on in the process. This entails a programme design with clear objectives and priorities that constitute measures capable of delivering significant macroeconomic effects. Countries also need to address financial sector issues upfront, and associated disbursements can be more directly linked to progress in a financial-sector specific strategy.
3. More intense cooperation between the European institutions can also achieve benefits. Formal cooperation agreements such as the one agreed with the Commission in April 2018 clarify roles and ensure that the ESM has the necessary information available. Similar action with supervisory authorities and the IMF would strengthen the capacity to deal with often rapidly evolving circumstances.

4. The evaluation also recommended various steps to enhance programme transparency and evaluability, including through more consistent public reporting.

Looking ahead, a strengthened firewall could help to make the monetary union more robust and support the effective functioning of banking union. The ESM is more actively engaged than its predecessor, and many members want the ESM to play an even greater role. It is the euro area leaders' prerogative to consider how to best implement a preventive capacity that can help the area tackle the next crisis, and how to further focus assistance to deliver the most significant effects.

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Part III

Financial institutions and labour mobility

10 The real costs of financial disintegration

Isabel Schnabel and **Christian Seckinger**
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After a substantial deepening of banking sector integration in Europe before the global financial crisis, the process saw a sharp reversal with the onset of the crisis. Banks reduced their lending in foreign countries and closed branches and subsidiaries. Such disintegration is common in times of financial crises, as has been documented by Cetorelli and Goldberg (2011), Giannetti and Laeven (2012), as well as De Haas and van Horen (2013).

Particularly in Europe, regulatory and political pressure appears to have reinforced the process of fragmentation. Motivated by the fact that internationally active banks had to be rescued by national governments, regulators and national authorities started to act in a protectionist manner. Politicians conditioned the rescue packages in many cases on measures that reinforced fragmentation. For example, Commerzbank was rescued under the condition of shifting their focus on lending towards German small and medium-sized firms. In the UK, banks could obtain cheap central bank funding under the condition of supporting local corporations. On a supra-national level, the European Commission investigated the rescue of European banks with respect to their compliance with European state aid regulations. As in the case of German Landesbanken, they often asked for restructuring measures that implied a substantial reduction of foreign business.

In spite of subsequent attempts to foster financial reintegration, for example through the establishment of the Banking Union, the European banking sector remains more fragmented today than it had been before the crisis. European policymakers are concerned about this development because banking sector integration may

affect European growth prospects, the transmission of the ECB's monetary policy, and financial stability. Especially in a currency union, financial integration is a key mechanism for risk sharing.

Real growth effects of banking sector integration in crisis and non-crisis times

In a recent paper (Schnabel and Seckinger 2015), we analyse the real growth effects of the fragmentation process in European banking markets after the financial crisis. Using data from 2000 to 2012, our dataset covers the period of integration before the global financial crisis and the following period of fragmentation. We specifically analyse whether the effects of banking sector integration differ between crisis and non-crisis times, phases of domestic bank deleveraging and other times, as well as times of disintegration and integration.

Using industry-level data from Eurostat, we apply the methodology of Rajan and Zingales (1998) and investigate production growth differentials on industry level. We assume that industries with a high dependence on external finance are more constrained in their growth potential by financial frictions than industries with an inherently lower need for external capital. Deeper banking sector integration may reduce these frictions and increase the differential of industry production growth between financially dependent and non-dependent industries. The main advantage over country-level approaches is a more credible identification. Since industry-specific growth is unlikely to affect the development of banking sector integration, reverse causality is less of a concern than in country-level studies. Moreover, given the three-dimensional feature of the data set (country, industry, and time), the approach allows us to control broadly for unobserved heterogeneity by including the full set of two-dimensional fixed effects. Thereby, one can control for national business cycles, industry-specific trends, as well as time-invariant country-specific industry characteristics.

Our study intends to identify short-run growth effects of integration. Therefore, the analysis relies on annual data rather than long-run averages as in the original Rajan-Zingales analysis. Banking sector integration is measured by total assets of foreign banks over GDP. Hence, we focus on the overall amount of foreign bank assets rather than the composition of bank assets.

Our analysis suggests that the financial fragmentation process generated significant growth losses, which emphasises the need for financial reintegration in Europe. In particular, we find substantial positive growth effects of banking sector integration in EU member countries over the entire sample period. Interestingly, growth effects are more than four times bigger during times of crisis than in normal times. Similarly striking differences are found in phases of strong domestic bank deleveraging compared to other times, but less so in periods of financial disintegration. This seems to reflect the importance of foreign capital as an insurance mechanism against negative shocks to domestic bank lending in times of crisis and deleveraging. We further analyse the impact of cross-border lending on industry growth differentials. For cross-border lending we find mixed results, whereas our main results on foreign bank assets prove to be robust to this modification. This suggests that in particular the presence of foreign banks via branches and subsidiaries is important to buffer the adverse effects of domestic financial constraints. Results are also robust to measuring banking sector integration by foreign loans to non-financial corporations instead of foreign bank assets.

The importance of fostering financial reintegration in Europe

Based on our results, we conclude that banking sector integration plays an important role for economic growth in the EU. Especially in times of domestic crises and deleveraging, financial disintegration can have large negative real effects. Therefore, concerns of European policymakers about the adverse growth effects of financial disintegration in the European banking sector seem to be justified. Especially when domestic banks shrink their balance sheets, financial fragmentation has exceptionally strong negative growth effects. The robust finding of strong negative growth effects of financial fragmentation calls for additional international efforts to overcome

protectionist tendencies on a national level. They also cast doubts on measures by the European Commission fostering financial disintegration. Finally, they emphasise the importance of projects promoting financial integration at the European level.

This includes completing the Banking Union by establishing a well-designed European Deposit Insurance Scheme (EDIS) (see Schnabel and Véron 2018 for a recent proposal), a phasing out of geographical ring-fencing with respect to capital and liquidity, the strengthening of the Single Rulebook, a reduction of regulatory options and national discretion, as well as a further harmonisation of insolvency laws and rules for consumer protection. These would also set incentives for pan-European bank mergers. Furthermore, it speaks in favour for the acceleration of the development of a Capital Markets Union as a complement to Banking Union. A special focus should be put on promoting resilient capital flows, which implies favouring equity over debt, long-term over short-term debt, and retail over wholesale funds. This suggests removing the existing debt bias by further strengthening the Single Resolution Mechanism and by conducting tax reforms that remove the debt bias in taxation. Capital Markets Union would also benefit from strengthening ESMA, which may serve as a catalyst for a further legal harmonisation in rules and implementation, and a standardisation of financial products. The Banking Union and the Capital Markets Union may set the stage for a new era of European financial integration, which we believe is an important building block of future growth perspectives in the EU.

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11 Shocks and risk sharing in the EMU: Lessons for Banking and Capital Market Union

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The divergent fates of the euro area economies highlight the need for institutions that can help insure country-specific risk and that, at the same time, are robust to systemic shocks. Capital (i.e. equity and bond) market integration in the euro area has remained relatively limited since the inception of the common currency, and European firms tend to more dependent on bank finance than their US counterparts. Therefore, recent policy discussion about risk sharing mechanisms for the EMU (Buti 2018) has focused on Banking Union and fiscal insurance mechanisms. However, fiscal transfers absorb only about 10-15% of shocks among the regions of established monetary unions, whereas private capital markets absorb about 50% of shocks on average (the US has been extensively studied but similar results hold in other federations – e.g. Feld et al. 2018 for Switzerland). Given these magnitudes, and considering the political barriers to anything resembling US-style federalism in the euro area, Hoffmann and Sørensen (2012) argue that better integration of capital and banking markets is of first order magnitude in the euro area. In recent work, we further study the role of banking integration and its relation to capital market integration. Based on this research, this chapter argues that a deepening Banking Union is going to accentuate the need for deeper capital market integration – Banking Union and Capital Market Union are complements, not substitutes.

Using the accounting framework of Asdrubali et al. (1996), the main components of risk sharing are private income smoothing, countercyclical net transfers from the federal government, and procyclical savings behaviour. Briefly, the mechanisms are as follows: output of a given country will generate income in other countries if ownership of firms is diversified across countries. As dividends and capital gains accrue to owners across countries, this helps diversify income, making it less volatile – this type of risk sharing is therefore often labelled income smoothing or 'capital market' risk sharing. Further, for given income, countries can isolate consumption from fluctuations by selling or purchasing assets; that is, from countercyclical savings behaviour. This helps making consumption less volatile, and is therefore often labelled consumption smoothing.[1] In several recent papers, we address the role of banking integration using this framework and draw three main insights.

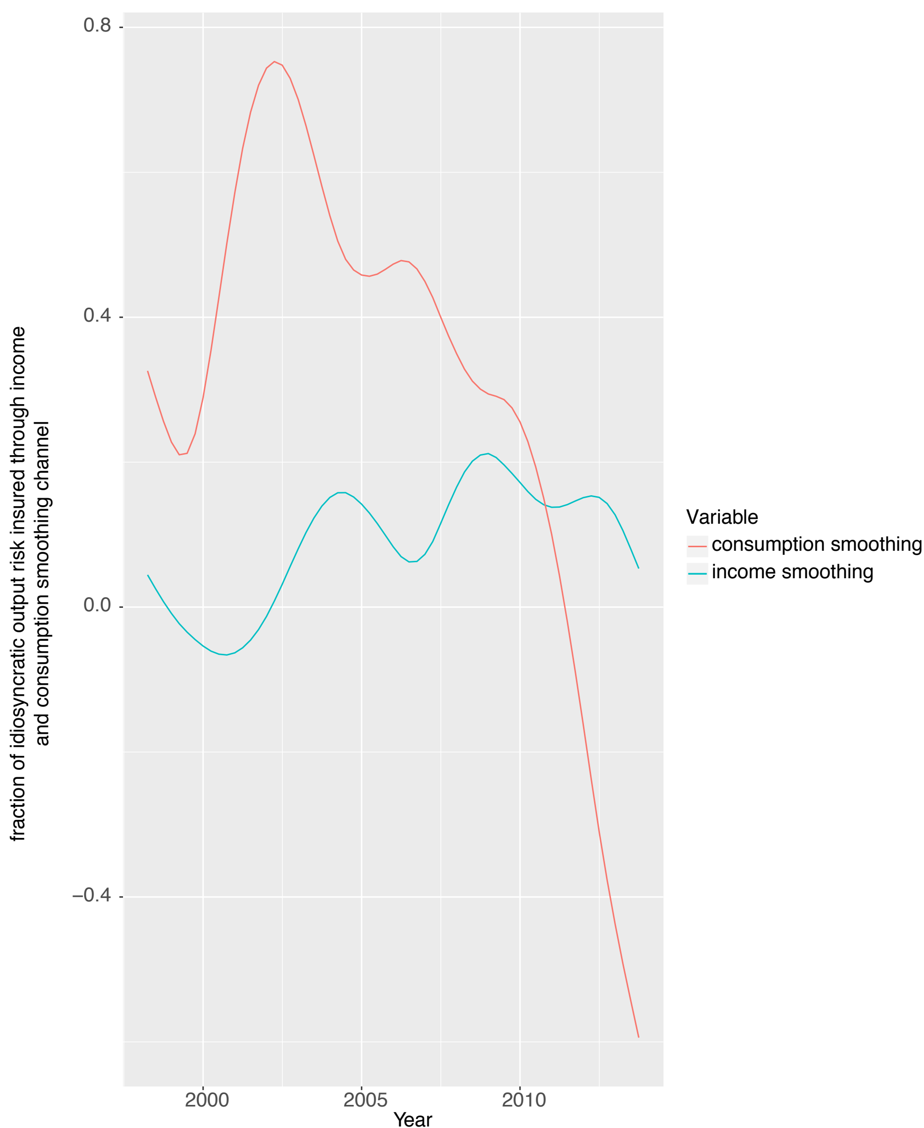
1.'Deep', not just 'interbank', banking integration is needed for better risk sharing and resilience to systemic shocks.

The inception of the euro was a catalyst for banking integration, but the nature of this integration was uneven. Hoffmann et al. (2017) argue that the euro created an integrated interbank market, but it did not achieve what we call deep cross-border integration in the banking sector – i.e. through direct cross-border lending of banks to the real sector or through cross-border consolidation of banks. Even though there were no formal restrictions for individual banks to move into other markets in the euro area, in the years prior to the crisis few banks entered retail markets in other member countries and the extent of cross-border lending to the non-bank sector remained very limited. Hoffmann et al. (2017) show empirically that this focus on interbank banking integration meant that banking integration was quickly reversed during the crisis and that it exacerbated, rather than smoothed, macroeconomic asymmetries among EMU countries after 2008. Countries with high levels of dependence on domestic banks and sectors with many

1 The literature also sometimes refers to this channel as 'credit market smoothing', even though the sale and purchase of assets for consumption smoothing happens in other markets as well.

bank-dependent small firms suffered the most. Hoffmann et al. (2018) extend this analysis to look at the channels of risk sharing in the EMU before and after 2008 using a quantitative model that explicitly separates deep and interbank banking integration.

Figure 1 Income and consumption smoothing in the euro area, 1998-2013



Notes: The figure plots the degree of income smoothing (green line) and consumption smoothing (red line) for the Eurozone economies from the first quarter of 1996 to the fourth quarter of 2013.

Source: Hoffmann et al. (2018).

Our results, summarised in Figure 1, show that risk sharing was weak during the years after 2008, exactly when it was most urgently needed. We show that consumption smoothing accounts for most of this decline in risk sharing. By contrast, income smoothing remained relatively stable (though at a low level). This drying-up of consumption smoothing is strongly associated with a decline in cross-border interbank flows. Direct cross-border banking integration, by contrast, is strongly associated with better income smoothing and held up well during the crisis. These results suggest that only deep banking integration makes risk sharing resilient against systemic shocks.

2. The situation in the euro area today is reminiscent of that of the US prior to state-level banking deregulation in the 1980s

As in the euro area today, the pre-1980 US had a common interbank market, but little deep interstate banking integration (Hoffmann et al. 2017). Interestingly, the risk-sharing channels and their (lack of) resilience to aggregate shocks resembled what we observe in the euro area today. Hoffmann and Shcherbakova-Stewen (2011) show that prior to state-level banking deregulation, interstate risk sharing increased in US-wide booms, but dried up in aggregate recessions – this was due in particular to the procyclical nature of consumption smoothing. This is exactly the pattern that Hoffmann et al. (2018) document for the EMU during the crisis.

Banking deregulation in the US changed this pattern in two important ways. As shown by Demyanyk et al. (2007), deregulation of state-level banking markets led to more income smoothing among US states, consistent with Hoffmann et al. (2018) finding direct banking integration to be associated with better income risk sharing in Europe. The increased level of income smoothing in the US also made risk sharing more resilient to aggregate downturns. Hoffmann and Shcherbakova-Stewen (2011) show that the procyclicality of interstate risk sharing vanished after state-level deregulation. Banking deregulation in the US is therefore akin to the step towards deep banking integration that is still largely missing in Europe. The euro area needs a genuine banking union that will encourage cross-border consolidation of banks and lead to more direct cross-border lending to firms and households.

3. Deep banking integration increases the need for increased capital market integration

Our empirical results for the US and the EMU suggest that direct cross-border banking integration has risk-sharing benefits similar to those of increased cross-border ownership of equity: it leads to more income smoothing and is resilient to persistent asymmetric, as well as common, shocks. This suggests that deep banking integration could substitute for equity market integration; however, Hoffmann et al. (2018) demonstrate that deep banking integration and equity market integration are complements, not substitutes. The reason for this is that, as shown by Demyanyk et al. (2007) and Hoffmann and Shcherbakova-Stewen (2011), banking integration improves the access of bank-dependent firms to credit, making it easier for firms to finance investment and wage payments, and thus making labour income and investment less sensitive to asymmetric productivity shocks. However, firm profits become more volatile, which increases the importance of cross-border dividend income flows – i.e. capital market integration.

Our research suggests that Capital Market Union and Banking Union are complements. If further integration of the euro area is to be successful, both unions need to be completed. At the same time, the results surveyed here suggest that the risk-sharing benefits from banking integration are only robust to large global financial shocks if banking integration is sufficiently deep – i.e. it is focused on cross-border lending between banks and the real sector (or on cross-border bank consolidation) and not predominantly on cross-border interbank lending. One key precondition for such deep banking integration to be achieved is to decouple banks' fate from the solvency of their regulating sovereign (i.e. to break the 'doom loop') through the creation of a common deposit insurance system for the euro area and the implementation of the Single Resolution Mechanism with a meaningful fiscal backstop, as suggested, for example, by the group of 14 French and German economists recently (Bénassy-Quéré et al. 2018). The creation of Europe-wide credit registries, as well as the removal of special national laws favouring public and regional banks in the member states that de facto block entry and cross-border consolidation in many local banking markets, are additional measures to be considered.

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12 Austerity and migration in Europe

Christopher House, Christian Proebsting, and **Linda Tesar**
University of Michigan; École Polytechnique de Lausanne; University of Michigan

Did austerity in Europe save the region from an unsustainable escalation in public debt, or were austerity policies to blame for the prolonged period of economic stagnation in the wake of the Great Recession? Would greater labour mobility between countries in Europe have helped or hurt the recovery? By now there is a sizeable literature documenting the extent of austerity policies and (the lack of) labour mobility in Europe, though there is little consensus about their ultimate effects.

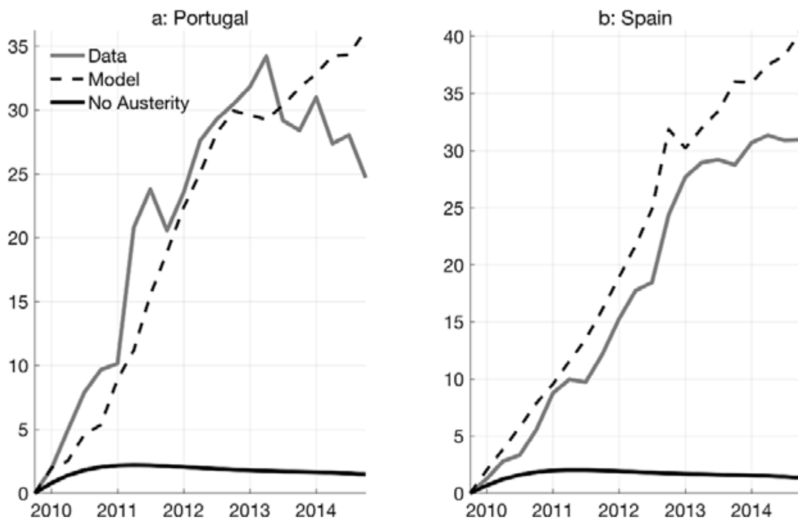
There are many ways economists attempt to answer questions like these. Our approach is to use model-based simulations combining insights from economic theory with empirical observations to analyse alternative scenarios called 'counterfactuals'. Specifically, we have developed a quantitative model that includes 29 European countries and reflects bilateral trade shares, country sizes, and the monetary policy regimes for each country (i.e. whether or not the country is part of the euro area). Key features that allow this model to generate patterns observed in the data are trade in intermediate goods, sticky prices, hand-to-mouth consumers, and financial frictions.

In a recent paper (House et al. 2017), we use this tool to document the extent of austerity policies during the 2010-2014 period. Differences in austerity across countries – defined as government purchases below forecast – account for roughly two-thirds of the cross-sectional variation in GDP during this post-recession period. At a time when faltering economies required stimulus, most countries in Europe cut government spending and those that cut spending most experienced the sharpest declines in output. In our sample, the cross-sectional multiplier is approximately two. Other austerity policies, such as cutting transfer payments or increasing taxes, do not explain the cross-sectional variation in output. We find little evidence that austerity in government purchases is a

consequence of the run up of government debt during the Great Recession. Austerity policies were pursued by virtually all European countries regardless of their debt-to-GDP ratios in 2009.

The model allows us to consider the dynamics of the debt-to-GDP ratio under different conditions. The main rationale for austerity was to reduce debt and bring debt-to-GDP ratios back to historical norms. However, our model suggests that reductions in government spending had such a severe contractionary effect on economic activity and tax revenues that debt-to-GDP ratios in many countries actually *increased* as a result. Figures 1a and 1b show the increase in debt-to-GDP in Portugal and Spain relative to 2009Q4. The grey line in each figure is the actual increase in government debt to GDP, excluding interest payments. The dotted line shows the trajectory for debt to GDP generated by our model, under the assumption that the economy is at the zero lower bound (ZLB). The black line shows a counterfactual generated by the model when the country does not pursue austerity but still experiences the effects of the shared euro area monetary policy. In both countries, the model with austerity and the ZLB tracks the actual path of debt to GDP quite closely. The model overshoots the data by roughly 5 to 10 percentage points. This could be because our model does not include some of the tax changes that were imposed during this period.

Figure 1 Increases in debt to GDP



In more recent work (House et al. 2018), we extend our analysis to allow for labour mobility. Statistically, migration rates are substantially higher in the US than in the euro area. In the data, net migration flows at the business cycle frequency are strongly associated with unemployment rate differentials; that is, there is a net inflow of workers when unemployment is relatively low. This is true across states in the US and across countries in Europe, though the strength of this effect is roughly three times greater in the US.

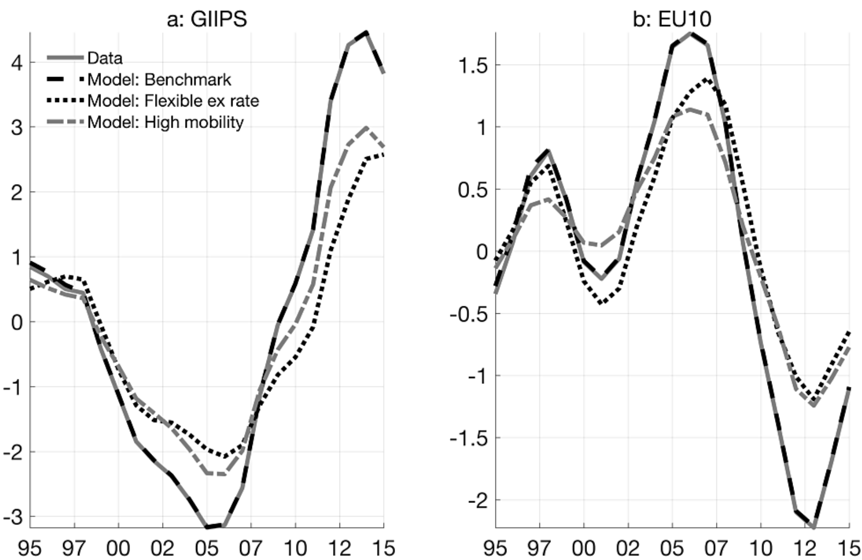
When we add job search and unemployment to the multi-country model, these frictions give rise to realistic unemployment differentials across regions and provide a motivation for cross-border labour mobility. To simulate labour migration in Europe, we calibrate the model to match the observed response of net migration to unemployment rates in the European data. Similarly, we can simulate inter-state labour migration in the US by setting the model's parameters to match observed responses of net migration to unemployment differentials in the US data.

In a classic paper in 1961, Robert Mundell argued that labour mobility was a necessary precondition for an optimal currency area. We use the model to evaluate Mundell's conjecture. More specifically, we use the model to consider two counterfactual scenarios: first, we ask what the European experience would have been had migration been as strong in Europe as it is in the US; second, we ask what would have happened if all of the countries in Europe had flexible currencies and could conduct independent monetary policies.

The model reveals that Mundell's conjecture was surprisingly accurate. The outcome in Europe under flexible exchange rates but low labour mobility would be very similar to the outcome with fixed exchange rates but labour mobility at US levels. To illustrate this point, Figures 2a and 2b display simulated paths of unemployment rates for the GIIPS economies (Greece, Ireland, Italy, Portugal, Spain) and for the EU10 (Austria, Belgium, Estonia, Finland, France, Germany, Luxembourg, Netherlands, Slovenia, and Slovakia). Because we are interested in cyclical movements in labour driven by unemployment differentials, we adjust unemployment in each country by subtracting out its long run average rate and by subtracting the average unemployment rate in Europe each year. This residual then tells us if unemployment in a given country is high relative to its historical rate and high relative to other countries in Europe. The

heavy dotted line shows unemployment rates for the baseline case – not surprisingly, given the way we choose the demand shocks, it lines up perfectly with the data. The line with short dashes shows the path for unemployment if exchange rates are flexible but labour is immobile. Such a policy would have reduced cross-sectional variation in unemployment rates across countries by about 40% in the euro area. The line with long dashes shows the alternative where the currency union remains in place but Europeans are as mobile as Americans. The implied path of unemployment rates would have almost been as smooth as in the previous experiment. The cross-sectional standard deviation in the euro area would have declined by 36% (versus 40% in the experiment with floating exchange rates).

Figure 2 Unemployment rates: Migration versus floating exchange rates



We interpret these results as confirming Mundell's conjecture that labour mobility can operate as a substitute for floating exchange rates. The required population changes associated with labour mobility in the absence of exchange rate adjustment, however, are quite big. The GIIPS countries would have lost almost 8% of their population between 2009 and 2014, whereas the EU10 would have gained about 2.4%. Whether

such large population movements are politically acceptable is an open question. The alternative may be large unemployment differentials across countries that cannot be offset by a one-size-fits-all monetary policy.

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13 Labour mobility and the European Project

Davide Furceri and **Prakash Loungani**
IMF

At the launch of the euro, there were fears that a lack of labour mobility would doom the viability of a single currency. On 21 September 1992, four famous professors – Olivier Blanchard, Rudi Dornbusch, Stan Fischer, and Paul Krugman – took part in a panel discussion at MIT on the merits of the proposed unification of European currency. Echoing a view common among US-based academics at the time, all four agreed that "a common European currency would have unfavourable economic repercussions". Blanchard noted that "currency unification works in the United States because labour can move between states. The labour mobility in Europe is negligible."

How has labour mobility evolved over the subsequent 25 years? Recent research suggests mobility within Europe has been picking up while intra-US mobility has been slowing down, bringing the two currency unions closer in this respect.

Measuring mobility: The canonical model

The canonical way of describing regional evolutions is due to Blanchard and Katz (1992). Their results suggested a very rapid and robust response of inter-state mobility in the US in response to regional shocks. Early extensions of the Blanchard-Katz methodology to Europe (Decressin and Fatas 1995) suggested a much weaker response of mobility, establishing the conventional wisdom that Europe lacked one of the necessary mechanisms for a successful currency union.

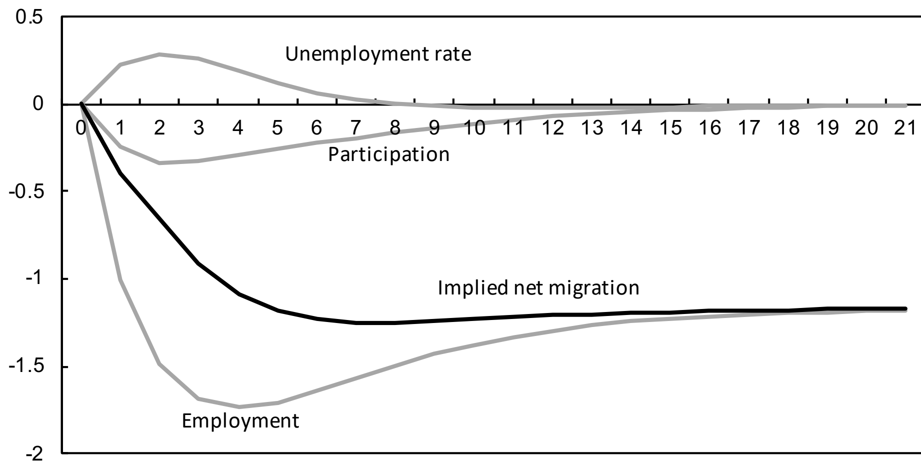
Figure 1 updates the Blanchard-Katz empirical exercise with 20 additional years of US data. A 1% shock to state employment raises state unemployment that year by about 0.2 percentage points and lowers state participation rates by about 0.25 percentage points.

The implied labour mobility is the difference between the size of the employment shock and the sum of changes in unemployment and participation. In terms of number of people, the Blanchard-Katz exercise suggests that out of every ten workers who lose their job in a US state due to an adverse shock, two workers become unemployed, two workers drop out of the labour force, and six workers move out of the state.

Declining US mobility

While the update shows broad support for the overall thrust of the Blanchard-Katz findings, a closer look suggests the response of mobility may be declining over time (Dao et al. 2017). The longer time series permits two important tests of the original findings. First, it permits tests of sub-sample stability to see if the implied response of migration has changed over time. Second, there are now better data on migration flows, which allows a direct cross-check on the estimates of implied migration.

Figure 1 Response of US migration to regional shocks: Blanchard-Katz, 20 years later



Note: the horizontal axis measures years

Both implied mobility (using the Blanchard-Katz methodology) and direct estimates of mobility using migration data point to declining mobility over time in the US. While inter-state migration still spikes up during recessions, during normal times there has been a trend decline in the adjustment through migration. Between 1985 and just prior to the Great Recession, the propensity to migrate within the first year in response to a state labour demand shock decreased by more than half. Instead, workers were much more likely to drop out of the state labour force. The finding of declining US migration has been corroborated in many other papers using different data sets and methodologies (see Austin et al. 2018 for a survey and additional evidence).

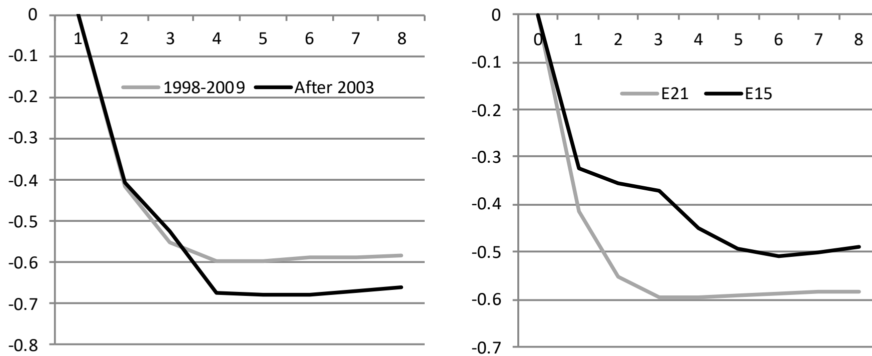
Increasing European mobility

In Europe, the trend appears to have been in the opposite direction. Dao et al. (2014) replicated the Blanchard-Katz analysis using data for 173 regions for 21 European countries over the period 1998-2009. On average over the whole sample, a 1% adverse shock to regional labour demand raises the unemployment rate in the first year by about 0.15 percentage points and lowers the participation rate by 0.6 percentage points. That is, out of every ten workers that lose employment, one worker becomes unemployed, six drop out of the labour force, and three workers migrate out of the region within the first year following the shock.

In contrast to the case of the US, there is evidence of increasing mobility over time in Europe. The medium-run response of migration over the 2004 to 2009 sub-sample has increased when compared with the full sample results, while the role of participation rate has decreased (Figure 2 left panel). The response of migration is also stronger outside the EU15 countries.[1] As shown in the right panel of Figure 2, the role of migration as a shock absorber is considerably larger in the case of the EU21 than for the EU15 countries. Hence the response of migration to regional labour demand shocks in Central and Eastern European countries has been on average larger than in Western European countries.

1 The EU15 consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the UK.

Figure 2 Response of migration: European regions



Note: the horizontal axis measures years

Many other studies report similar findings, notably Beyer and Smets (2015), who conclude that "we detect a convergence of the adjustment processes in Europe and the United States, reflecting both a fall in interstate migration in the United States and a rise in the role of migration in Europe".

Mobility since the Great Recession

During the Great Recession, inter-state migration again picked up in the US; hence, while mobility was becoming somewhat more dormant as an adjustment mechanism, it is certainly not dead and does respond in the face of severe regional shocks. Migration also remained high among European regions: a comprehensive study by Arpaia et al. (2016) finds that "since the start of the 2008 crisis, mobility has played a more important role in the adjustment of labour markets than in the past". Overall, the results suggest that Europe has been moving to strengthen one of the adjustment mechanisms needed for a successful currency union.

Of course, migration has since run into stronger political headwinds. Barriers are being threatened by recipient countries, despite ample evidence on the economic benefits of migration to them (Kahanec 2016). Research documents that immigrants alleviate skill shortages, enhance productivity through creation of new firms and industries, and lower prices for domestic consumers. There is, however, a lack of awareness of such benefits and also perception gaps about the extent of migration and the motivation of

migrants. In France, for instance, opinion polls suggest people think that immigrants make up almost 30% of the population, whereas the actual number is 10%. Similar misperceptions about the extent of migration are prevalent in other European countries. Moreover, a common characterisation of migrants is that they are motivated by the desire to receive welfare payments. Kahanec (2016) presents some evidence, however, that causality actually goes the other way – in areas with greater migration, there tends to be a policy response that leads to increases in welfare benefits, perhaps as an attempt to compensate any domestic workers who might be affected by migration.

While migration faces political barriers, it is still worth touting the benefits of schemes (e.g. temporary worker programmes) that could help on the economic front without encountering stiff political opposition (Rodrik 2007). Labour mobility remains an important adjustment mechanism in the face of asymmetric shocks within a currency union and thus is important for the success of the European Project.

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Part IV

Monetary and fiscal union

14 The case for more fiscal risk sharing and coordination of fiscal and monetary policy

Jakob de Haan and **Patrick Kosterink**
De Nederlandsche Bank and University of Groningen; De Nederlandsche Bank

The euro area economy is currently performing remarkably well. But although several institutional changes have been introduced under the pressure of the sovereign debt crisis, the euro area's architecture is widely considered to be in need of further reform. Recently, several proposals have been put forward that include fiscal risk sharing (e.g. Arnold et al. 2018, Bénassy-Quéré et al. 2018). According to some, the absence of decisive steps towards fiscal union even poses an existential threat to the currency union (Berger et al. 2018). The current economic situation may provide a good window of opportunity for further institutional reform. However, the political will among European policymakers to move towards a fiscal union seems to be rather limited (in part because some fear that it will lead to a permanent system of transfers). But Berger et al. (2018: 1) argue that "accepting political constraints as unchangeable will leave Europe ill-equipped to mitigate the harsh economic reality of a modern-day currency union operating in an environment of volatile international financial markets".

At the same time, several policymakers have argued in favour of better coordination of European monetary and fiscal policies. For instance, ECB President Draghi argued in his speech at Jackson Hole in 2014 that "[...] it would be helpful if fiscal policy could play a greater role alongside monetary policy, and I believe there is scope for this, while taking into account our specific initial conditions and legal constraints" (Draghi 2014). Likewise, in the letter of intent accompanying Juncker's 2016 State of the Union address, the President of the European Commission endorsed "a positive fiscal stance for the euro area, in support of the monetary policy of the European Central Bank".

In this chapter, we discuss what – in our view – are the key issues in the debate on fiscal risk sharing and the coordination of fiscal and monetary policy. Before turning to these issues in detail, it is important to first distinguish between idiosyncratic and common shocks. Idiosyncratic shocks are asymmetric in nature (i.e. not all member states of the currency union are affected by them), whereas common shocks hit all member states (although their transmission may be asymmetric). Euro area member states have foregone the possibility to adjust their exchange rates to mitigate the effects of idiosyncratic shocks. The question is how costly this loss in flexibility is and what can be done to compensate for it. Is some form of fiscal risk sharing needed? Common shocks, on the other hand, can, under normal circumstances, be countered by the monetary policy of the ECB. But now this policy is less effective as policy rates have reached the effective lower bound, the question is whether coordinated national fiscal policies can be of any help.

Against this backdrop, we will review the case for (more) fiscal risk sharing and coordination of monetary policy and national fiscal policies in turn.

Fiscal risk sharing

The case for more fiscal risk sharing in the euro area hinges on six considerations.

First, risk sharing via financial markets is relatively underdeveloped in the euro area compared to other currency unions, such as the US (Alcidi et al. 2017). Furthermore, euro area financial markets are more debt-based than equity-based. And debt finance turns out to be much more pro-cyclical, in large part because its pay-offs lack the state contingency of equity-like flows (ECB 2016). Therefore, in bad economic times, when default risk is most prominent and investors' risk appetite diminishes, firms find it most difficult to refinance their debts. This helps explain why market-based risk sharing within EMU collapsed during the recent crisis, exactly when it was most needed (Kalemli-Ozcan et al. 2014, Furceri and Zdzienicka 2015).

Second, even if financial markets were complete (i.e. contracts are offered to insure for every possible state of the world), private risk sharing is still inefficiently low. As such, a role emerges for government intervention (Farhi and Werning 2017). The main

reason for this is that private investors do not internalise the (positive) macroeconomic stabilisation externalities of their portfolio choices. Accordingly, fiscal risk sharing is Pareto-improving.

Third, explicit fiscal risk sharing may reduce moral hazard compared to the current implicit bailout perceptions (Berger et al. 2018). Although there is a formal no-bailout rule, sovereigns in the currency union may rationally decide to support a fellow member state in financial distress. This is driven by the fact that the costs of default may be higher than those of a bail out. As financial markets understand this logic, they will fail to impose the discipline that averts moral hazard. However, the presence of a formal arrangement to share some fiscal risk may alter that cost-benefit calculation (see Berger et al. 2018 for the analytical underpinnings). This might be particularly so for (more) explicit fiscal risk sharing in the context of the Banking Union (i.e. the European Deposit Insurance Scheme and a common backstop for the Single Resolution Fund) as it reduces the 'doom loop'. Whether it also holds for other proposed risk-sharing schemes like a macroeconomic stabiliszation fund (Arnold et al. 2018) or a European unemployment insurance scheme (Dullien 2014) is, however, less clear.

Fourth, if fiscal risk sharing indeed alters governments' default/bailout decision, sovereign default may be more likely. If so, financial markets may better impose fiscal discipline (i.e. demanding risk premia that are proportional to the intrinsic risk profile of the debtor). As such, the view that there is a trade-off between fiscal risk sharing and market discipline may be wrong. However, this hypothesis is in dire need of empirical support.

Fifth, if more market discipline is imposed, there may be less reliance on fiscal rules to enforce fiscal discipline. Up until now, these rules have been poorly complied with (this holds true for the preventive arm of the Stability and Growth Pact (SGP); see de Haan et al. 2015) and inconsistently enforced. A more credible no-bailout clause, which enhances market discipline, would therefore be a move in the right direction. We are, however, under no illusion that with better market discipline, fiscal rules will become obsolete. In fact, they remain necessary as a backstop for markets reacting too much and/or too late. But discussing whether these rules should be the current ones or new ones, and how adherence to these rules should arranged, is beyond the scope of this contribution.

Finally, the case for (more) fiscal risk sharing ultimately hinges on the relevance of idiosyncratic shocks and the potency of national fiscal policy to stabilise these shocks. In their seminal paper, Bayoumi and Eichengreen (1993) showed that only in a small core of current euro area member states were shocks highly synchronised, while in the periphery shocks were significantly less synchronised. However, following the same methodology, more recent research has shown that this pattern has weakened (Campos and Macchiarelli 2016). Bayoumi and Eichengreen (2017) even report that Portugal, Ireland, Italy, Spain, and Greece belong to the core of the euro area, where the core is defined as countries whose aggregate supply and demand shocks are relatively highly correlated with those of Germany. This is consistent with evidence that business cycles have become more synchronised (De Haan et al. 2008, Campos et al. 2017). Gächter and Riedl (2014) even conclude that the adoption of the euro has increased the synchronisation of business cycles above and beyond the effect of higher trade integration.

In addition, the idiosyncratic shocks hitting euro area member states can be stabilised by national fiscal policies. Empirical estimates by Bayoumi and Masson (1995) suggest, for instance, that national fiscal policies in the euro area are able to perform a similar degree of stabilisation as fiscal transfer systems in the US and Canada. Likewise, more recent research by Dolls et al. (2012) suggests that a larger percentage of both income and unemployment shocks is absorbed by automatic stabilisers in the euro area than in the US, although the heterogeneity between member states is considerable.

Coordination of monetary and national fiscal policies

Under normal circumstances, monetary policy is supposed to deal with common economic shocks in the euro area. But the policies of the ECB are currently running out of steam due to the fact that they are operating at the effective lower bound. Against this backdrop, Eggertson (2011), has shown that the effect of a government spending shock is much larger under the effective lower bound than under normal circumstances. This finding has recently been confirmed by Bonam et al. (2017).

However, fiscal policy in the euro area is implemented at the national level, rather than the central level. The mandate of national budgetary authorities is to adhere to national needs and wishes. Therefore, national fiscal policy doesn't take the euro area output gap and spillover effects of national fiscal policy into account (Beetsma and Guliodori 2004 and Pogoshyan 2017 provide evidence for these spillovers). From a euro area perspective, failing to internalise these externalities leads to a suboptimal aggregate fiscal stance (Beetsma et al. 2001, Gali and Monacelli 2008). But that is not the only reason that European monetary and fiscal policies may be inconsistent. Even at the national level fiscal policy is often pro-cyclical, reflecting the unsustainable fiscal positions several member states had. It is therefore no wonder that the aggregate euro area fiscal stance and monetary stance are so often poorly aligned. As it turns out, since the start of EMU, both only complement each other in a little over 50% of the time (Figure 1).

As such, much can be won by a policy effort to better align the euro area fiscal stance with the monetary stance. This, however, also requires better national fiscal discipline. At present, those member states that are most in need of fiscal expansion are generally not in the position to increase their indebtedness any further. In particular, building sufficient fiscal buffers in good economic times is therefore most necessary.

Figure 1 Complementarity of the euro area monetary and fiscal stance

Note: Grey shaded areas indicate periods in which the two policy stances share the same sign. $Fisc_{EA}^{HP}$: euro area fiscal stance calculated using the HP filtered output gaps; $Fisc_{EA}^{P}$: euro area fiscal stance calculated using the output gaps from the production function approach; Mon^{K}: monetary stance based on Krippner's (2013) shadow rates; Mon^{WX}: monetary stance based on Wu and Wia's (2017) shadow rates. Figure provided by Nikki Panjer.

Conclusions

The need for (more) fiscal risk sharing ultimately hinges on the relevance of idiosyncratic shocks and the potency of national fiscal policy to stabilise the effects thereof. In our view, if governments ensure sustainability of fiscal policy, they can use national fiscal policy to stabilise idiosyncratic shocks (which are probably less important than in the past anyway), preferably by using automatic stabilisers but, if needed, by discretionary policy. Under those conditions, fiscal risk sharing beyond that in the Banking Union is probably not needed. Coordination of monetary and national fiscal policies, on the other hand, may support the monetary policy of the ECB to stabilise common shocks. But again, this only is feasible after current levels of government debt have been reduced to sustainable levels. Our main conclusion therefore is that fiscal discipline is a necessary precondition for national fiscal policy to play a role in the stabilisation of both idiosyncratic and common shocks.

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15 Financial engineering will not stabilise an unstable euro area

Paul De Grauwe and **Yuemei Ji**
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The sovereign bond markets in the euro area are characterised by a fundamental instability. The source of this instability can be described as follows (see De Grauwe 2011, De Grauwe and Ji 2013). National governments in a monetary union issue debt in a currency that is not their own, but is equivalent to a foreign currency. As a result of this lack of control over the currency in which the bonds are issued, these governments cannot guarantee that the bondholders will always be paid out at maturity. This contrasts with governments of countries issuing their own currency. These governments can give a full guarantee to the bondholders because they know that the central bank stands ready to provide liquidity in times of crisis. All this leads to a situation in which government bond markets in a monetary union can be hit by self-fulfilling crises: investors distrusting the capacity (or willingness) of a government to continue to service its debt sell the bonds, thereby raising the yields and making it more difficult for that government to rollover its debt. A liquidity crisis erupts which results from a fear that the government will be hit by a liquidity crisis. This usually happens during recessions when budget deficits and government debts increase automatically. Investors will then single out those governments perceived to be most at risk, sell their bonds, and acquire bonds issued by governments perceived to be less risky. As a result, massive capital flows across the borders of the monetary union are set in motion, destabilising the whole system. This is exactly what happened during the sovereign debt crisis of 2010-12.

The instability of the government bond markets in a monetary union is aggravated by a possible doom loop between the banks and the sovereign. When banks are in trouble, the sovereign that is obliged to save the banks will also be hit by a liquidity,

and possibly a solvency crisis. This was the problem for Ireland. The reverse can also happen: a sovereign debt crisis leads domestic banks, holding large amounts of domestic sovereign bonds, into illiquidity and insolvency (the Greek problem). The doom loop amplifies a sovereign debt crisis. That does not mean, though, that sovereign debt crises and the ensuing destabilising capital flows cannot erupt in the absence of a banking crisis.

Can financial engineering cure this instability? Recently, the European Systemic Risk Board proposed the creation of a 'safe asset' that, as is claimed by the authors, would eliminate the destabilising capital flows across the borders of the monetary union and thereby help to stabilise the system (ESRB 2018). Will it do this? This is the question we now turn to.

In contrast with earlier proposals to create Eurobonds (De Grauwe and Moesen 2009), Delpla and von Weizsäcker 2010), which assume that participating governments are jointly liable for the service of the national debts, the 'safe asset' proposal makes no assumption of joint liability. Instead, in this proposal national governments are individually liable for their own debt. There is no pooling of risks.

The 'safe asset' is created when financial institutions (private or public) buy a portfolio of national government bonds (in the primary or in the secondary markets) and use this portfolio as a backing for their own issue of bonds, called 'sovereign bond-backed securities' (SBBSs). The latter have the following characteristics.

- One tranche, the junior tranche, is risky. When losses are posted on the underlying portfolio of government bonds the junior tranche takes the hit.[1]
- The second tranche, the senior tranche, is safe.

The proponents of these SBBSs take the view that a 30% junior tranche is a large enough buffer to take potential losses on the underlying sovereign bonds so as to make the senior tranche (70%) risk-free. Based on simulations of some presumed risk patterns, the authors claim that their proposal will allow the size of safe assets in the euro area to be more than doubled. In addition, they claim that the existence of SBBSs will replace

1 In the ESRB (2018) proposal, this tranche is split further into two tranches: a junior tranche proper with the highest risk (10%), and a mezzanine tranche (20%) which takes the losses after the junior tranche has been depleted.

the destabilising capital flows across national borders in the euro area by a movement from the risky asset (the junior tranche) into the safe asset (the senior tranche), thereby eliminating the instability in the euro area.

How likely is it that these SBBSs will help to stabilise the euro area? Note that in the way we formulate the question we do not dispute that, in normal times, the creation of a safe asset may not increase the efficiency of the financial system in the euro area. It probably will do so by supplying a new type of asset that can provide for a better diversification of normal risks. The issue is whether the safe asset will be an instrument for dealing with systemic risks in times of crisis. Our answer is negative for the following reasons.

First, the creation of a safe asset does not eliminate the national government bond markets. This is recognised by the proponents of a safe asset (ESRB 2018, Brunnermeier et al. 2016). In fact, these proponents have made the continuing existence of national sovereign bond markets a key component of their proposals. According to the ESRB, "the SBBS issuance requires price formation in sovereign bond markets to continue to be efficient" (p. 33). The markets for sovereign bonds must remain large enough so as to maintain their liquidity. That is also why the ESRB proposes to limit the total SBBS issuance to at most 33% of the total outstanding stock of sovereign bonds.

This constraint on the issue of SSBSs implies that national sovereign bond markets will be 'alive and kicking'. As a result, the major problem that we identified earlier – the potential for destabilising capital flows across the borders of the monetary union – will still be present. However, since the markets of sovereign bonds will have shrunk, the yields are likely to be more volatile during crisis periods.

Table 1a Correlation of yields before crisis (2000M1-2009M12)

	Germany	Finland	Netherlands	Austria	France	Belgium	Italy	Spain	Ireland	Portugal	Greece
Germany	1.00										
Finland	0.97	1.00									
Netherlands	0.97	1.00	1.0								
Austria	0.94	0.99	0.99	1.00							
France	0.98	1.00	1.00	0.99	1.00						
Belgium	0.95	1.00	0.99	1.00	0.99	1.00					
Italy	0.89	0.97	0.96	0.99	0.96	0.98	1.00				
Spain	0.94	0.99	0.99	1.00	0.98	1.00	0.99	1.00			
Ireland	0.61	0.78	0.76	0.83	0.74	0.81	0.88	0.83	1.00		
Portugal	0.90	0.98	0.97	0.99	0.96	0.99	0.99	0.99	0.87	1.00	
Greece	0.68	0.83	0.82	0.87	0.80	0.86	0.92	0.88	0.96	0.91	1.00

Note: The yields are yields on 10-year government bonds.

Source: ECB and authors' own calculation

Table 1b Correlation of yields during crisis (2010M1-2012M09)

	Germany	Finland	Netherlands	Austria	France	Belgium	Italy	Spain	Ireland	Portugal	Greece
Germany	1.00										
Finland	0.98	1.00									
Netherlands	0.99	0.99	1.00								
Austria	0.89	0.93	0.91	1.00							
France	0.83	0.89	0.87	0.98	1.00						
Belgium	0.45	0.58	0.54	0.74	0.80	1.00					
Italy	-0.66	-0.57	-0.58	-0.34	-0.21	0.28	1.00				
Spain	-0.62	-0.60	-0.55	-0.48	-0.34	0.02	0.81	1.00			
Ireland	0.16	0.24	0.24	0.28	0.38	0.68	0.38	0.44	1.00		
Portugal	-0.62	-0.52	-0.54	-0.32	-0.19	0.29	0.88	0.73	0.54	1.00	
Greece	-0.82	-0.79	-0.78	-0.62	-0.50	-0.13	0.81	0.81	0.23	0.85	1.00

Note: The yields are yields on 10-year government bonds.

Source: ECB and authors' own calculation

Table 1c Correlation of yields after crisis (2012M10-2017M12)

	Germany	Finland	Netherlands	Austria	France	Belgium	Italy	Spain	Ireland	Portugal	Greece
Germany	1.00										
Finland	1.00	1.00									
Netherlands	1.00	1.00	1.00								
Austria	1.00	0.99	1.00	1.00							
France	0.99	0.99	0.99	0.99	1.00						
Belgium	0.99	0.99	0.99	0.99	0.99	1.00					
Italy	0.92	0.91	0.92	0.93	0.95	0.95	1.00				
Spain	0.90	0.90	0.90	0.92	0.92	0.94	0.97	1.00			
Ireland	0.93	0.93	0.93	0.95	0.95	0.96	0.97	0.99	1.00		
Portugal	0.78	0.78	0.79	0.82	0.83	0.85	0.93	0.93	0.92	1.00	
Greece	0.31	0.31	0.31	0.35	0.34	0.38	0.45	0.58	0.55	0.57	1.00

Note: The yields are yields on 10-year government bonds.

Source: ECB and authors' own calculation

Second, we observe that during crises, the correlation pattern of yields changes dramatically. During normal times all yields are highly positively correlated. During crisis times, as investors are looking for safe havens, the yields in the safe assets tend to decline sharply and become negatively correlated with the high-risk yields. This pattern was very pronounced during the sovereign debt crisis of 2010-12. In their simulations of the risks involved in SBBSs, Brunnermeier et al. (2016) do take into account the fact that risks can be correlated. However, this correlation pattern is fixed, while during crisis periods correlation patterns change dramatically. We show this feature in Table 1. We find that during the sovereign debt crisis of 2010-12, the government bond yields of the periphery countries under stress were highly positively correlated. At the same time, these yields were negatively correlated with the yields of the core (safe) countries (Germany, Finland, France, the Netherlands).

The implication is that during crises it is very unlikely that the senior tranche in the SBBSs can maintain its status of safe asset. It will consist of bonds that investors dump and 'safe-haven' bonds. The senior tranche will continue to depend on the cash flow generated by bonds that panicking investors deem to be extremely risky. The perception that this senior tranche is equally safe as the safe-haven sovereign bonds (e.g. German bonds) is very unlikely when markets are in panic mode. As a result, it is also likely that investors will flee the senior tranches of the SBBSs to invest in the 'real thing', i.e. super-safe sovereign national bonds.

Conclusion

Stabilisation by financial engineering will not work. Real stabilisation of the euro area requires three mechanisms. The first is the willingness of the ECB to provide liquidity in the sovereign bond markets of the euro area during times of crisis. The ECB has set up its OMT programme to do this. However, OMT is loaded with austerity conditions, which will be counterproductive when used during recessions (which is when crises generally occur). That is why a second mechanism is necessary. This consists in creating Eurobonds that are based on joint liability of the participating national governments. Without such joint liability, it will not be possible to create a common sovereign bond market. The creation of such a common bond market is the conditio sine qua non for

long-term stability in the euro area. Finally, stabilisation of the euro area will also require completing the Banking Union so as to eliminate the doom-loop between the sovereign and the banks

The political willingness to create a budgetary union and a full Banking Union, however, is non-existent today. There is no willingness to provide a common insurance mechanism that would put taxpayers in one country at risk of having to transfer money to other countries. Under those conditions, the sovereign bond markets in the euro area will continue to be prone to instability, leading to instability in the banking systems of the euro area.

The danger of financial engineering proposals is that they create a fiction allowing policymakers to believe that they can achieve the objective of stability by some technical wizardry without having to pay the price of a further transfer of sovereignty.

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16 A euro area fiscal architecture

Phillipe Martin
Sciences Po and CEPR

The starting point of the proposals made in the recent CEPR Policy Insight (Bénassy-Queré et al. 2018) for the euro area's fiscal architecture is that the present fiscal rules have failed. Despite several reform attempts, they have not worked well. In some countries, excessive public debts have accumulated because of banking crises and the Great Recession, but also because countries either did not abide by European fiscal rules or because the rules were not sufficiently stringent in good times. At the same time, the Stability and Growth Pact (SGP) has constrained fiscal stabilisation policy during the euro area crisis of 2010-2013, contributing to the overburdening of the ECB.

The euro area crisis was not solely generated by fiscal issues (see Martin and Philippon 2017) – public debt was not the main driver of the crisis and fiscal policy was not the only mismanaged policy during the crisis. However, there was a bias towards too lax a policy during the good years before the crisis and too much austerity during the crisis. This is one of the deficiencies that Bénassy-Queré et al. (2018) address.

In a recent paper (Martin and Philippon 2017), my co-author and I analysed, in the context of the euro crisis, the role of fiscal policy in relation to household leverage and interest rate spreads (and therefore ECB policy). We build our analysis on a mix of theory – a model with financially constrained households, where fiscal policy is biased by political economy considerations and constrained by borrowing costs and spreads themselves are affected by past private and public borrowing, as well as bank recapitalisation needs and the possibility of euro breakup – and empirics – in particular, an identification strategy of the impact of expectations of a breakup of the euro area through a comparison with the US, where such a breakup was not at work. Focusing on Spain, Ireland, Greece, and Portugal – the four periphery countries that were hit hardest

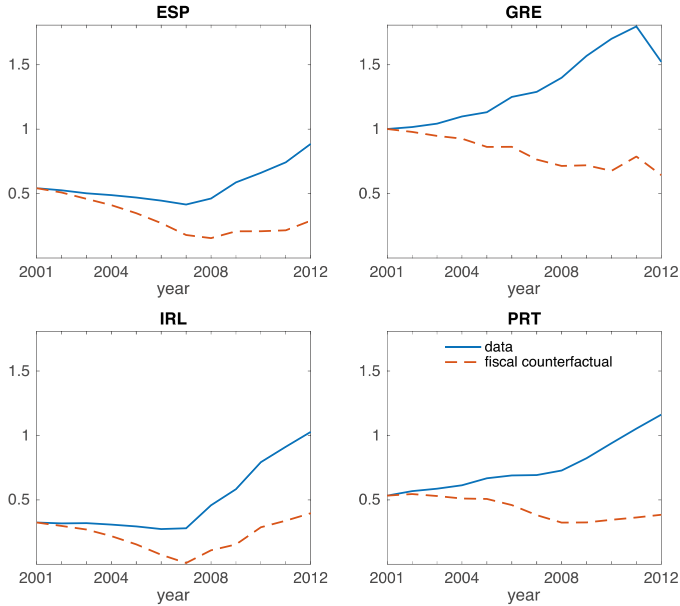
by the crisis – we find that a drift in spending and in social transfers have characterised the fiscal rule of Greece in the boom years. This political economy bias in fiscal policy was also present, but to a lesser extent, in Ireland and Spain.

We analysed several counterfactuals. First, we removed in these countries the political economy bias that was at work before the crisis. Figure 1 shows that for Greece, a more conservative fiscal policy during the crisis would have indeed stabilised GDP by reducing the boom and bust cycle. In this case, Greece would have entered the crisis with a much lower level of public debt, so that spreads would not have increased as much and it would not have been pushed so much into fiscal austerity. For the other three countries, the fiscal narrative is much less important. Indeed, for Spain and Ireland in particular, fiscal imprudence was not the main issue.

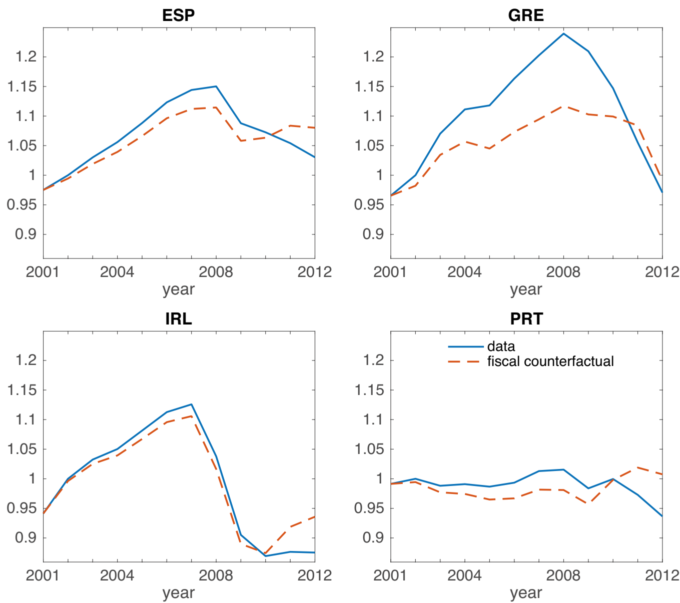
An effective macroprudential framework, which would have constrained the private debt build-up, would have helped to reduce the boom-and-bust cycle more than fiscal prudence alone (see Figure 2) in these two countries. However, we show that in presence of a political economy bias, Spain and Ireland would, with an effective macroprudential framework, have increased their public debt. Macroprudential policies that do not come with a more prudent fiscal rule may not have been sufficient to generate a fiscally sustainable stabilisation of employment. In this sense, macroprudential policies to constrain private leverage and prudent fiscal policies to constrain public debt are complements, not substitutes. This is consistent with our policy recommendations in Bénassy-Queré et al. (2018), where we favour both stronger rules on the financial architecture and more effective fiscal rules.

Figure 1 Data and counterfactual with conservative fiscal policy in the boom

a) Public debt



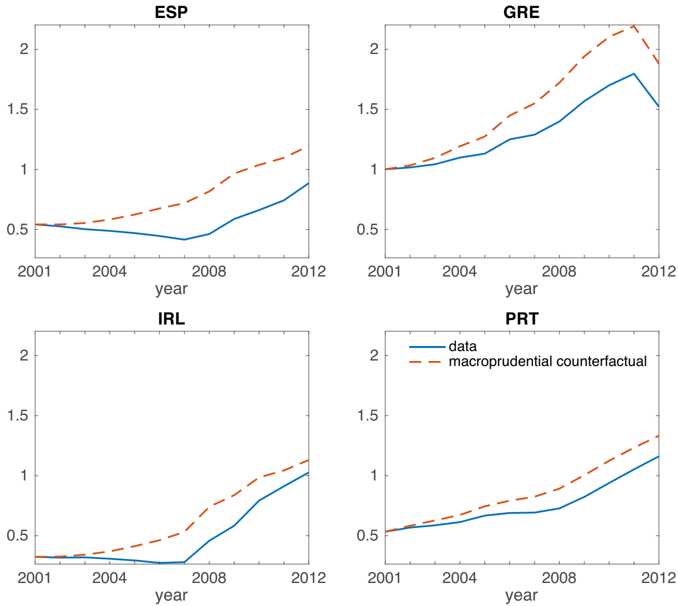
b) GDP



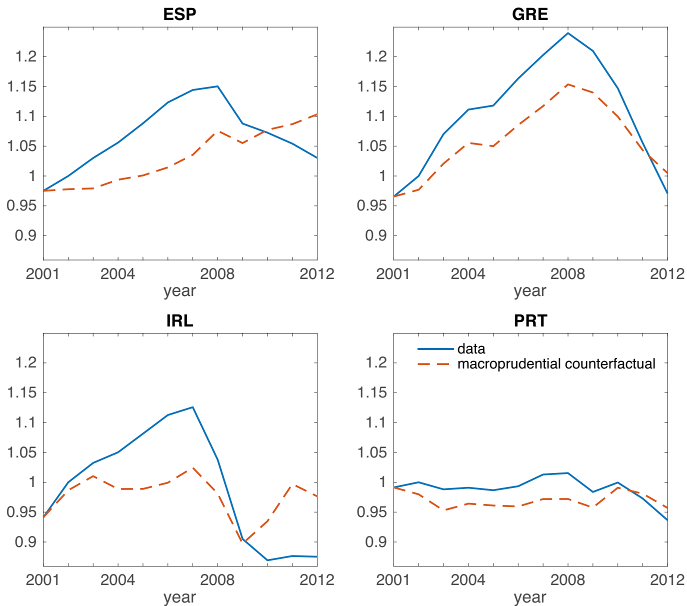
Source: Martin and Philippon (2017).

Figure 2 Data and counterfactual with macroprudential policy in the boom

a) Public debt



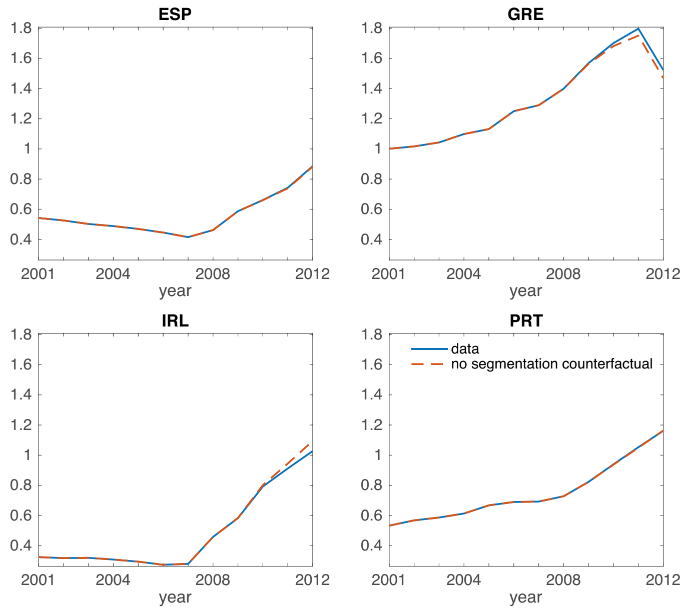
b) GDP



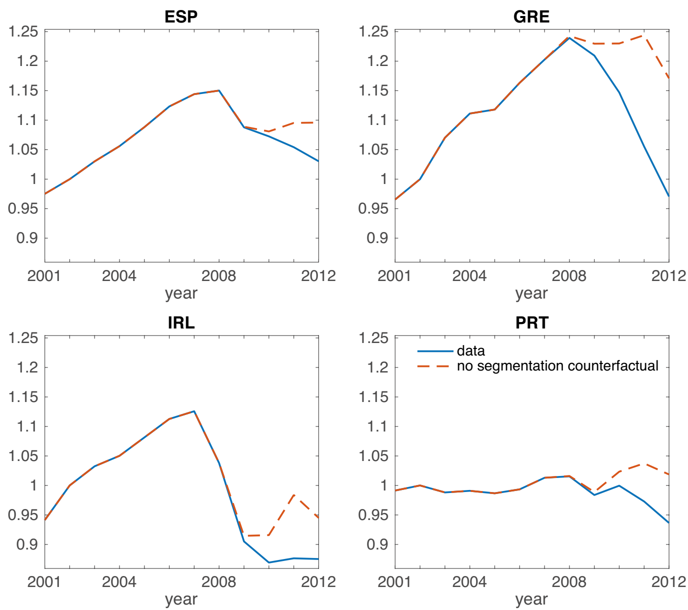
Source: Martin and Philippon (2017).

Figure 3 Data and counterfactual with "whatever it takes" in 2008 rather than 2012

a) Public debt



b) GDP



Source: Martin and Philippon (2017).

In another counterfactual in Martin and Philippon (2017), we ask the following question: what would have happened if the announcements of July 2012 (Mario Draghi's "Whatever it takes" declaration) and September 2012 (the OMT programme) had come earlier, i.e. in 2008? These announcements were successful in reducing the risk of a euro breakup, financial fragmentation, and the sudden stop. In this case, all countries would have fared better in terms of GDP (not public debt) because spreads would not have exploded, and this would have reduced fiscal austerity during the crisis (see Figure 3). This also suggests that policy proposals that reduce the 'doom loop' between banks and sovereigns, and therefore the risk of a euro breakup with very large increases in spreads (that then push countries into fiscal austerity in a crisis), are key for the sustainability of the euro area. This is what we propose in Bénassy-Queré et al. (2018). This also means that a euro area where the ECB does not take into account the possibility of financial instability through self-fulfilling crises and does not act against it with a mix of strong commitments and actions, such as OMT, is not sustainable in the long term (Aguiar et al. 2015).

This is the argument my co-author and I make in Farhi and Martin (2018), where we clarify the role of the ECB in the proposals in Bénassy-Queré et al. (2018).

First, by allowing and facilitating debt restructuring inside the euro area as a last resort action in case of unsustainable sovereign debt, we make it easier to differentiate between a debt crisis due to redenomination risk and a debt crisis due to sustainability. Our proposals will reduce the financial and economic cost of a debt restructuring and the collateral damage of a sovereign debt restructuring, which must remain a last resort option inside the euro area. This collateral damage is the main reason we believe that flexible and responsible fiscal rules are necessary in the euro area – without constraints on fiscal policy, or with fiscal rules (like those present) that do not allow for effective macroeconomic stabilisation (in booms and busts), the risk is that the no-bailout rule loses credibility. In the situation where a country loses access to markets and expectations of a default or of a euro exit increase, creditor countries will find it less costly to bail out the country at risk rather than to let a messy default or exit unfold with a financial crisis and contagion costs to other countries. These contagion costs (Gourinchas et al. 2018) suggest that reducing the cost of sovereign default (in last resort but without euro exit) can both increase the credibility of the no-bailout rule (and therefore allow for more

effective market discipline) and allow for more fiscal flexibility because of more fiscal responsibility. This is the rational of the fiscal rules on expenditure growth that we propose in Bénassy-Queré et al. (2018), which allow for both more flexibility (the 3% deficit rule can be breached) and more responsibility (junior bonds to finance excessive public spending). This should also reduce the pressure on the ECB to intervene and the probability that the actions of the ECB stretch its legal mandate by morphing into partial bailouts for countries with unsustainable fiscal positions.

Second, by weakening the 'doom loop' between banks and sovereigns through the introduction of concentration charges on sovereign debt, our proposals mitigate one of the key mechanisms that may catalyse self-fulfilling expectations of exit of financially fragile countries.

Third, our proposals for a fiscal capacity to help countries in case of large negative shocks should also prevent a situation where the ECB is the sole institution with the possibility to provide macroeconomic stimulus.

The fiscal architecture that we propose in Bénassy-Queré et al. (2018) is to be seen as a complement to, and not a substitute for, the other elements in particular on the financial architecture. In a situation where a fully integrated fiscal policy with a large euro area budget is not on the table in the near future, our proposals allow for both more risk sharing and solidarity, flexibility, and responsibility.

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17 The need for a fiscal capacity

Lars P. Feld
University of Freiburg, Walter Eucken Institute and German Council of Economic Experts

The debate about a reform of the architecture of the Economic and Monetary Union (EMU) is intensifying as the EU is heading towards the June 2018 summit. The European Commission, the European Parliament, and several heads of state are aiming to decide on pressing reform questions before the electoral campaign for the European elections taking place in 2019 will start. Fiscal policy is the main concern of the current discussion. Not only is the Commission proposing additional resources for the EU budget, but also several initiatives – most prominently in several speeches by French president Emmanuel Macron – are pushing towards a fiscal union in EMU.

The discussion about a fiscal union is not new (Committee for the Study of Economic and Monetary Union 1989). The Commission has proposed it repeatedly in its desire to obtain more competencies and more funds. Traditional discussions between proponents of flexible and fixed exchange rates also considered the necessity of fiscal union. In particular, proponents of flexible exchange rates emphasised that a monetary union would not work without a fiscal union, whereas proponents of fixed exchange rates recognised the potentially disciplining effect of monetary union on national fiscal and economic policies (Feldsetin 1997, Beetsma and Giuliodori 2010).

However, fiscal policies as well as labour market and social policies are prone to intensive distributive struggles. These distributional concerns must be solved politically by elected representatives who are controlled by the rule of law. Despite elections to the European Parliament, the EU is not a federal state, and neither is democratic and legal control sufficiently well-developed. During the discussions of a European constitution (which became the Lisbon Treaty), a fundamental criticism was the EU's lack of a 'demos', i.e. a European public such that European citizens are aware of the political proposals in different member states. A European demos implies that citizens look at

these political discussions not only from their national point of view, but also from a European point of view. Moreover, democratic control should be as intensive as in national electoral campaigns. The fate of Martin Schulz as leading candidate of the Social Democratic Party in Germany illustrates that the EU is far from achieving the intensity of national campaigns.

A pragmatic analysis instead requires identifying the main shortcomings of the current EMU architecture. Don't fix what ain't broke – identify the main problems, consider the trade-offs that possible solutions entail, and aim at piecemeal social engineering.

The main shortcoming of the EMU architecture

The main elements of the EMU architecture are the Europeanisation of monetary policy and national autonomy for fiscal and economic (including labour market and social) policies. National autonomy in fiscal and economic policies implies national responsibility. The no-bailout clause and the prohibition of monetary financing of national budgets are means to achieve this. Indeed, after the restructurings of Greek government debt in 2012, every creditor knows that default risk of government debt of EMU member countries exists. The Stability and Growth Pact only provides for a crutch that should help member states to arrive at solid fiscal and economic policies. It has not questioned the budgetary autonomy of member states in general.

During the euro crisis, it became obvious that the idea of national responsibility for fiscal policy even in the sense of debt restructuring is not sustainable unless the 'doom loop' between banks and sovereigns eases. Banks have incentives to hold debt of national sovereigns because there are no capital requirements or large exposure limits regarding public debt. The default of government debt would thus endanger the stability of the banking system, making a default less probable and in turn creating the incentive for banks to hold more government debt. Sovereigns have incentives to bail out banks if bank restructuring leads into a banking crisis and drains its possibilities to issue government bonds. Banks thus have incentives to incur higher risk in private credit markets. Excessive public and private debt are the consequences of this relationship between governments and banks (Feld et al. 2015, 2016).

The policy reaction during the euro crisis correctly addressed this problem through the creation of the Banking Union. Significant banks are supervised by the ECB's Single Supervisory Mechanism (SSM), capital requirements for significant banks are increased and their possible restructuring is framed by the Single Resolution Mechanism (SRM) establishing bail-in of banks' creditors and a Single Resolution Fund (SRF) to provide liquidity in case of bank restructuring. The ECB serves as lender of last resort for solvent banks. It has also stabilised the euro through its Outright Monetary Transactions (OMT) programme and quantitative easing (QE). The European Stability Mechanism (ESM) offers credit lines for countries in a liquidity crisis in exchange for an adjustment programme framing the restructuring of government debt by requiring collective action clauses for government bonds.

Regarding risk sharing when economic shocks affect member states differently, these policy solutions aim at facilitating private risk sharing between member states. Together with Capital Markets Union, Banking Union helps to establish a common credit market in Europe. The credit channel, together with risk sharing through factor markets (free flows of capital and labour), provide for by far the largest share of private risk sharing in existing federations (Feld and Osterloh 2013, Feld et al. 2018). In contrast, the European credit market is highly fragmented.

However, as Farhi and Werning (2017) show, private risk sharing may be insufficient because investors in financial markets do not fully internalise the macroeconomic stability consequences of their portfolio decisions. There may thus be some role for fiscal policy in providing for risk sharing in the monetary union. Consider a banking crisis in one member state of EMU. If one bank's refinancing difficulties induce contagion and affect other banks of that country, this may easily infect the whole European banking system. In such cases, the SRF can be quickly exploited such that a breakdown of the system can only be prevented if there is a fiscal backstop to the SRF. The introduction of such a fiscal backstop is necessary to complete Banking Union. Whether an additional European Deposit Insurance Scheme (EDIS) is also necessary depends on the design of the fiscal backstop to the SRF. Moreover, such a fiscal backstop should not provide incentives for moral hazard such that its introduction depends on preconditions such as a reduction of non-performing loans.

The problems of fiscal union

A fiscal backstop must be understood as part of the Banking Union as it only sets in under certain conditions that originate in the banking system and its regulatory framework. Discussions about fiscal union instead consider a macroeconomic stabilisation facility that provides funds to member states in case of economic shocks and under certain conditions. Several proposals have been discussed, including a European finance minister with his or her own budget for macroeconomic stabilisation, a European Monetary Fund, a rainy-day fund with or without the possibility to issue debt, a European unemployment (re-)insurance scheme, and so on. These proposals differ in many respects, an important one being the allocation of competence (i.e. as part of the EU budget or as an element of the ESM). Given the difficulties of realising any of these proposals without treaty change, a new role for the ESM appears to be more probable.

Without discussing these proposals in detail, it is obvious that each of the mechanisms induces strong moral hazard problems. Bénassy-Quéré et al. (2018) propose two options: (1) the introduction of a rainy-day fund (without debt issuance) providing reinsurance in case large shocks lead to large increases in the unemployment rate; and (2) a precautionary credit line of the ESM that a member state could access if it complies with ex ante conditionality (i.e. with fiscal rules) and has a strong policy record otherwise. The first mechanism rests on the fiction that the consequences of economic shocks are independent from labour or product market institutions, social policies, tax policies, and the like. However, shocks tend to be more severe the less flexible labour and product markets are (Blanchard and Wolfers 2000). Such a scheme would thus provide a premium for reform-reluctant member countries. The second scheme is problematic because it depends on the enforcement of ex ante conditionality. The track record of EMU member countries in complying with fiscal rules does not raise confidence that this scheme would work properly.

Are we all fiscal now?

It seems that the debate about reform of the EMU architecture is obsessed with the desire for fiscal space. However, fiscal space in EMU is also a function of the fiscal space of member states. Consolidation of public finances in good times – i.e. now – increases fiscal space to fight future adverse economic shocks. In case of another severe banking crisis, a fiscal backstop of the SRF will serve the purpose of preventing the European banking system from breaking apart. The existing institutions, like the ESM or the mutated role of the ECB, provide for additional insurance against economic shocks in EMU. Fiscal policy competences of the EU should be introduced if its transition to a federation is completed. European policymakers should not repeat the mistake of taking the second step before the first.

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Part V

Redesigning euro area institutions

18 The European Monetary Fund and the euro experiment

Xavier Vives
IESE Business School and CEPR

The foundations laid in the Maastricht Treaty of 1992 that opened the gate to the euro have proved flimsy. The Treaty established tight fiscal rules (a debt limit of 60% of GDP and a deficit limit of 3% of GDP) as well as a no-bailout clause according to which countries that got into trouble were on their own. The fiscal rules were to be implemented by the Stability and Growth Pact (SGP) of 1997 as well as several reinforcements to monitor its compliance that came afterwards. This design failed to provide stability to the euro and the sovereign debt crisis that started in 2010 put in danger the whole house until, in 2012, Banking Union was agreed and Mario Draghi stated that he would do “whatever it takes” to save the euro. The attempt to impose fiscal and market discipline had failed, with the SGP violated many times as well as the no-bailout clause as the ECB started to buy sovereign bonds to fend off the crisis. The origin of the failure to impose market discipline was out a fear of implosion of the European banking system when peripheral countries in the EU could not make good the debt they had with the banks of the central countries. There were no instruments to deal with sovereign insolvency crises in an orderly manner.

The euro area crisis was a ‘sudden stop’ crisis not so different from those of emerging economies (Baldwin and Giavazzi 2015). The cross-border capital flows from core to peripheral countries stopped, triggered by the subprime crisis, and hurt those countries running current account deficits. Lenders became suspicious about the viability of both peripheral sovereigns and banks. Both had deep links because governments were the lender of last resort of banks, and banks were in turn buying their sovereign debt. Governments could not devalue, and therefore the loans in euros were effectively

in a foreign currency and the euro area governments had no lender of last resort. To make matters worse (and in contrast to the US), the financing of the private sector was predominantly in the hands of banks.

In response to the crisis, the European Stability Mechanism (ESM) and Banking Union were created. The ESM was used to provide assistance to countries like Greece that needed a macroeconomic adjustment programme, or like Spain for bank recapitalisation. Banking Union has three pillars: the Single Supervisory Mechanism, with the ECB as main supervisor of banks in the euro area; the Single Resolution Mechanism (SRM), consisting of a Single Resolution Board (SRB) and Fund (SRF) to deal with banks in trouble; and the yet to be established European Deposit Insurance Scheme. Furthermore, the SRF does not yet have a proper backstop that can deal with a banking crisis. Both euro area-wide deposit insurance and the backstop are not yet established for good reason: they both entail a higher degree of risk sharing and fiscal integration than the status quo. At the same time, the ECB is questioned when buying sovereign bonds, since this action collides – at least in spirit – with the no-bailout clause in the Treaty.

How to stabilise the euro

There is a solution to stabilising the euro that is agreed on by the former finance ministers of both Germany and Greece, Wolfgang Schäuble and Yanis Varoufakis. This is political and fiscal union – transforming the euro area into the United States of Europe with a European budget, taxes, debt, and unemployment insurance. This would provide an euro area safe asset and a European Treasury, which would anchor the ECB. Unfortunately, this solution does not seem politically viable since it would imply that the current nation states completely relinquish their sovereignty. The US mutualised its debt and implemented a no-bailout clause on the states. Can the market discipline solution work in a monetary union with no fiscal integration?

The SRM has been established, together with the Bank Recovery and Resolution Directive (BRRD) that aims at ending bailouts by making bank equity and debtholders investors bear the costs of failure. As of January 2016, bail-in of 8% of a bank's liabilities is required even under systemic stress, for example out of a macroeconomic shock. According to some views, the elimination of bailouts will permanently sever the link between banks and the sovereign in the euro area, and therefore the need for

fiscal union vanishes. Completing the Banking Union with an integrated but limited deposit insurance mechanism and resolution fund would be enough. However, given a macroeconomic shock such as the one derived from the subprime crisis and subsequent sovereign debt crisis, a bailout may be needed to prevent systemic institutions from failing and contaminating other institutions and the whole economy. Indeed, under the present rules, uninsured wholesale funding (junior to retail) would withdraw immediately at the first sign of trouble. In fact, the evolution of bail-in in practice did proceeded in a consistent way through 2017, as the cases in Italy make clear. The credibility of the procedure is at stake. It is necessary, then, to have a sufficient backstop in the resolution fund and a resolution procedure that accounts for systemic problems. A case in point is the success of the TARP programme in the US in stemming the 2007-09 crisis by providing capital to systemic entities, which by now has been paid back. Furthermore, even the lender-of-last-resort function of the euro area system of central banks is limited when resolving an entity in that emergency liquidity assistance is in the hands of the national central bank with strict collateral rules. It could well be that an illiquid but solvent bank does not get the needed assistance to confront a liquidity crisis.

Lacking the extreme solutions – pure market discipline with no lender of last resort and full integration – the game is to find hybrid solutions in which countries partially cede sovereignty to provide sufficient risk sharing and at the same time maintain market discipline in order to control moral hazard. Here we have already witnessed a tension between France pushing for more risk sharing and Germany worrying about moral hazard (Bénassy-Quéré et al. 2018).

The need for an international lender of last resort and a European Monetary Fund

When countries can suffer runs on their sovereign debt, and in particular when the debt is denominated in a foreign currency, the presence of an international lender of last resort may be required to avoid self-fulfilling crisis and excessive liquidation of entrepreneurial projects (Gale and Vives 2002). This is much like the need for a lender of last resort for banks to avoid situations where the bank becomes illiquid despite being solvent. The classical prescription is due to Bagehot and consists of unrestricted lending to solvent but illiquid banks with the backing of good collateral and at a

penalty rate. In order to improve welfare, however, the lender of last resort facility must be complemented with an orderly failure resolution facility that provides help to restructure barely insolvent banks when the moral hazard problem is moderate, and a prompt corrective action facility that intervenes for barely solvent banks when the moral hazard problem is severe. The same applies to countries. An international lender of last resort can avoid sovereign debt panics at the same time as it imposes discipline by restructuring policies in an early intervention when the danger of moral hazard is high, or by providing help to restructure debt when the country is barely insolvent and the danger of moral hazard moderate (Rochet and Vives 2004).

The question is whether the IMF can play such a role or whether the euro area needs a European Monetary Fund (EMF). President Juncker has formalised the proposal for an EMF recently. The Fund would be the heir to the ESM, with agile decision making in the face of a crisis as a European institution not requiring unanimity for all decisions. The EMF would provide the backstop to the SRF and would act as lender of last resort to banks in resolution. It would continue to help countries with debt-financing problems with new financial instruments. The argument in favour of the IMF lies in taking seriously the no-bailout clause of the Treaty and in having a tough, politically independent institution to manage debt restructuring when needed. The argument in favour of the EMF lies in providing one necessary component to build the sufficient amount of risk sharing while keeping market discipline for the euro area to survive.

The EMF, together with the ECB, could implement the optimal design of an international lender of last resort for the euro area in the following way. The EMF would have responsibility for liquidity and solvency problems of countries. Liquidity help to sovereigns by the EMF would allow the ECB to concentrate on liquidity help to banks in need and monetary policy open market operations. The ECB itself should carry the Emergency Liquidity Assistance function. An orderly failure resolution and prompt corrective action mechanisms at the EMF would control moral hazard, as suggested by Rochet and Vives (2004). The orderly failure resolution mechanism would help sovereigns in trouble that are in good standing to recover and put them on a sustainable fiscal path. A European sovereign debt restructuring mechanism would deal with insolvency as last ratio, together with a reform of the regulation of the sovereign exposures of banks (with appropriate risk weights and concentration limits). The EMF

should have early intervention capabilities that allow the institution to implement prompt corrective action policies for sovereigns that are barely solvent and heading for trouble. For this, the EMF would need supervisory powers. The EMF would provide the fiscal backstop to the SRF; it would need decision taking by qualified majority; and to operate as a European institution to improve accountability and legitimacy.[1] A further reform of the financial regulatory architecture would be to merge the future European deposit insurance fund with the SRF and manage it via a unified deposit insurance and resolution board like the FDIC in the US, as proposed in the early Banking Union proposal by Vives (1992).[2]

The establishment of the EMF with the mentioned parameters would constitute an essential component for stabilising the euro and would imply an increase in the degree of fiscal integration.

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1 The proposal is aligned with the recent scheme in Sapir and Schoenmaker (2017).

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19 Reforming Europe, the role of trust, and the cost of doing nothing

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The euro area needs balanced reforms that combine more risk sharing with stronger market discipline. A key reason for political resistance to reform is a lack of trust both between member states and in European institutions. At the same time, the weaknesses of the status quo and the costs of no reform are underestimated. Successful common undertakings in policy areas other than the euro may help to build trust and make progress in euro area reforms as well.

Euro area reform needs to combine risk sharing and market discipline

The euro area has survived the euro crisis but it continues to be fragile. As a currency union of sovereign states, it faces a number of challenges countries with national currencies do not face. While financial stability and resilience to economic shocks requires risk sharing across countries, hard budget constraints and sufficient incentives for sound economic and fiscal policies need to be preserved. Can these two objectives be achieved? In the debate about possible directions for reform, there are two opposing views on this.

The first view is pessimistic and claims that achieving these two objectives simultaneously is impossible. This view implies that Europe needs to choose between two extremes: either the euro area needs to be transformed into some kind of quasi federal system, or it will never be much more than a fixed exchange rate system (Stiglitz 2016) which will

fall apart sooner or later. The federal solution would require the creation of a federal euro area government with the right to tax and issue debt, following the model of the US. This would be a fundamental change in the constitutional setup of the EU.

I call this view pessimistic because it effectively implies that the euro cannot survive. At least for the foreseeable future, the populations of the member states would not support a massive transfer of sovereignty to a European federal government. Claiming that the European Currency Union can only survive if underpinned by a federal political union is equivalent to claiming that it is doomed.

The second, more optimistic view is that the euro area can work as a currency union of sovereign member states if common institutions are created which provide a balance between risk sharing and market discipline (Bénassy-Queré et al. 2018). Here the assumption is that certain, mostly technocratic tasks and functions can be delegated to common institutions like the ECB, but the ultimate responsibility for economic and fiscal policy will remain at the level of the member states, as will democratic control of these policies.

The original architecture of the euro area – with its focus on fiscal rules, the no-bailout clause and the prohibition of monetary financing of public spending – was in line with this approach. However, it proved to be inappropriate in practice because its institutional architecture was incomplete. This became evident long before the euro crisis. The fiscal rules and the governance framework of the Stability and Growth Pact were unable to effectively constrain the economic and fiscal policy of the member states. The interdependence between banks and public finances was neglected, and when the crisis came, the downturn in the euro area was severe and the no-bailout rule was circumvented, mainly because the risks associated with its application under the circumstances prevailing at the time of the crisis were considered too large.

Since the crisis, several measures have been taken to improve the ability of the euro area to deal with economic shocks and crises. This includes the creation of the ESM and the first steps towards a European Banking Union. But these steps are not enough. The current institutional setup provides neither enough stability in the event of crises nor sufficient incentives for sound economic and fiscal policies. Government debt in the euro area is much higher than before the crisis, which means that there will be much less fiscal space to respond to the next crisis when it comes. The financial nexus

between banks and national governments is still strong. Deposit insurance continues to be national and the European bank resolution fund (the Single Resolution Fund, or SRF) is large enough to deal with crises of individual banks, but too small to confront a systemic crisis.

The no-bailout rule is not credible because banks continue to hold large amounts of domestic government debt. Applying the no-bailout rule – that is, restructuring the debt of insolvent member states – would trigger a banking crisis with high costs for the rest of the economy. Therefore, policymakers will shy back from applying the rule even in cases where government debt is unsustainable. Since investors in international capital markets know that the no-bailout rule is not fully credible, in particular not in the case of larger member states, they will lend carelessly to these countries, at artificially low interest rates. This destroys incentives for sound economic policies and fiscal consolidation in good times.

Why is it so difficult to agree on reforms?

The basic idea that the euro area needs reforms that combine improved risk sharing with improved incentives for sound policies and harder budget constraints is shared widely. Nevertheless, finding agreement about concrete reform steps is proving to be difficult. Why is this the case? One issue is that euro area reform debates often portray risk sharing and market discipline as substitutes. This is misguided. It is certainly true that risk-sharing mechanisms may undermine incentives. But as emphasized in Bénassy-Queré et al. (2018), adequately designed institutions for risk sharing and institutions to foster market discipline may also be complementary. The no-bailout clause will only be credible if there is a degree of risk sharing that cushions the consequences of restructuring government debt. For instance, more diversification in the government debt holdings of banks would reduce the costs of debt restructuring and would therefore improve market discipline. One way of achieving more diversified government debt holdings, among others, would be to introduce a 'European Safe Asset' as proposed by Brunnermeier et al. (2011).

The lack of trust

The failure to take into account the complementarity between risk sharing and risk reduction or market discipline is not the only reason, and probably not even the main reason, for resistance against euro area reform, though. The most important obstacle is a lack of trust between member states, as well as a lack of trust in European technocratic institutions. The European Safe Asset proposal is a good example.

From the perspective of those who want to improve the credibility of the no-bailout clause, the European Safe Asset should be considered a good idea, provided that the rules are respected: only private institutions issue the European Safe Asset, the ECB does not intervene in the market for the junior tranche, banks cannot hold the junior tranche without appropriate equity underpinning, there are no public guarantees for the European Safe Asset, the price at which national governments sell their bonds to the institutions issuing the safe asset is determined in the market, and so on. The credibility of the no-bailout rule would be enhanced because the existence of the safe asset will reduce exposure of banks to sovereign risk. Public debt restructuring would only hit the junior tranche, and this tranche would be held by investors who are prepared to absorb losses. As a result, market discipline would be stronger.

Despite these properties, the European Safe Asset idea has been rejected even by countries that favour more market discipline. The reason is that there is little trust in the reliability of the rules (e.g. Scientific Advisory Board to the German Ministry of Finance 2017). Clearly, in a crisis scenario where the yields on the junior tranche may be high or the markets may freeze, political pressure to intervene politically will grow. The ECB might argue that the transmission mechanism does not work properly if trade in junior bonds comes to a halt. Another justification for intervention could be that there is market failure or 'denomination risk' in the market for the junior tranche. As a result, the safe asset would become a vehicle for introducing debt mutualisation 'through the back door'.

Similar issues play a role when it comes to the proposal to develop the ESM into a European Monetary Fund (EMF). The current intergovernmental structure of the ESM implies that there is a strong influence of the national governments, in particular of large countries like Germany, who have veto power. In the case of ESM programmes,

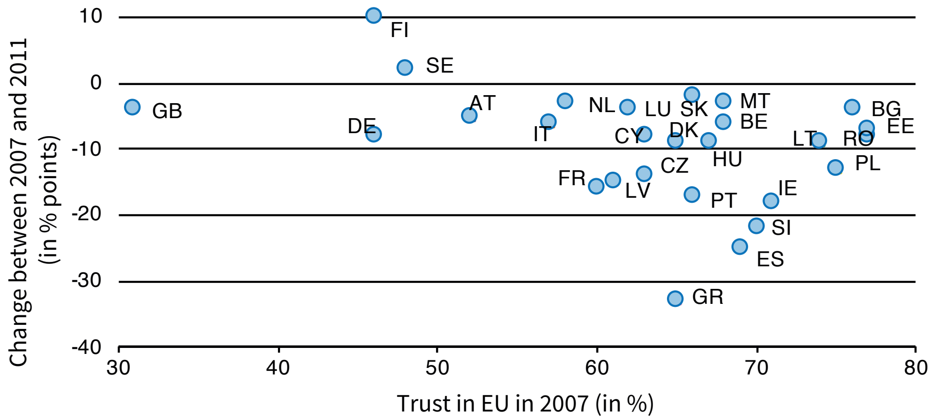
this easily leads to confrontational debates between creditors and debtors such as those between Greece and Germany in the summer of 2015. Transforming the ESM into an EMF enshrined in EU law would offer opportunities. It could reduce political conflicts between member states and bring about more acceptance for assistance programmes and their conditionality. It may even offer a more neutral assessment of government debt sustainability and thus put adjustment programmes on a better basis, provided that this assessment is shielded from political influence by either national governments or European political institutions. However, trust in the ability of a more 'European' institution to run assistance programmes more effectively is limited. For instance, in their letter about euro area reform, eight Northern European countries[1] have argued that the ESM should "possibly" be transformed into an EMF but that "[d]ecision making should remain firmly in the hands of Member States". The same letter states that "… it is of the essence that we do our utmost...to regain public trust…" and concludes that "priority should be given to areas with the greatest convergence of views between Member States". Clearly, the appetite to create new European institutions and trust that they will make the right choices for the whole of Europe is limited. This may partly be driven by the interest of national governments to preserve their influence and power, but a lack of trust in European institutions plays an important role.

To some extent, this lack of trust is a result of the euro crisis. This is mirrored in survey data about trust of the population of different countries in European institutions, illustrated by Figure 1.[2] Unsurprisingly, the largest decline in trust occurred in Greece. But levels of trust have even declined in countries where the direct economic impact of the crisis in terms of employment or economic growth was less severe.

1 See here.

2 One should note that trust in national institutions also declined during the crisis.

Figure 1 Percentage of people expressing trust in the EU in 2007 vs the difference in that support between 2011 and 2007



Source: EEAG (2018).

Implications for euro area reform

What does the decline of trust in European institutions imply for euro area reform? First, trust grows with the experience of successful common undertakings (EEAG 2018). There is agreement that policy areas like defence, border protection, migration, the border crossing infrastructure network, as well as research and education offer huge opportunities for common activities that add value over and above what individual member states can achieve. If Europe is able to make progress in these policy areas, the impact on euro area reform can only be positive. But this process will take time, and doing nothing until trust has grown would be risky.

Second, it is important to remind the public in all member states that the status quo has significant disadvantages. Simply relying on the existing institutional setup may be imprudent. It is likely that the next crisis will again lead to capital flight from the most affected countries, with the effect that the cost of the crisis will be higher than necessary. Since nothing has been done to reduce the cost of public debt restructurings, pressures will be high to bail out countries even if their fiscal position is unsustainable. If a large country like Italy is unable to stabilise and eventually reduce its public debt in the years to come, pressure on the ECB, and maybe also among decision makers in the ECB, will be strong to buy more and more Italian government bonds, a process

which could undermine the independence of monetary policy further and lead to severe political conflicts between member states. Reforms with a balanced combination of improved risk sharing and more market discipline offer at least the chance to reduce the cost of the next crisis significantly. All of this implies that the cost of doing nothing is large.

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Conventional wisdom holds that a main constraint to reforming the European project is not a shortage of ideas or of tools, but a lack of priorities. To put it differently, economists have discussed extensively what to do and how, but have been broadly silent on who and when. Which institutions and rules are needed, and when? This eBook shows that such institutional questions, although seldomly raised, are of fundamental importance for the future of European integration. The individual chapters distil the lessons from the institutional framework underpinning Bretton Woods and the globalisation wave that followed it. For example, and accounting for its prominence, we ask whether a European Monetary Fund is sufficient or whether other institutions, rules, and agencies are needed, and if so, how these should be designed and implemented.

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