



European Fiscal and Monetary Policy: A Chicken and Egg Dilemma

Michael Emerson and Alessandro Giovannini*

Executive Summary

This project's enquiry into the optimal mapping of the European policy field in terms of core and periphery or other configurations of variable geometry leads in the case of fiscal and monetary policies, straight into the well-known terrain of optimal currency area theory, and to the concrete question of what the optimal, or at least sustainable, contours of the Eurozone should be. Official doctrine holds that the Eurozone, now recovering from its existential crisis of recent years, should gradually expand again in due course towards the frontiers of the EU itself, subject still to one or other long-term opt-out cases.

However, in the course of the recent crisis the Eurozone has seen emerge a complex hierarchy of *de facto* concentric circles, between north and south, within the south between actual and potential sovereign bailout cases,

The launch of the euro saw the creation of a two-tier Europe, but systemic defects led subsequently to the current crisis of the Eurozone, resulting in a much more complex and problematic set of core-periphery relations between north and south. The preeminent role of Germany in the north is pointing to the lack of democratic legitimacy in the whole construction. The idea of creating a banking union and fiscal union is in principle aimed at restoring unity to the Eurozone and ensuring its effectiveness. While negotiations over the banking union are ongoing, the recent fiscal innovations are not even approaching the constitution of a sustainable fiscal union. A more federalistic fiscal structure is needed, but this demands major political leadership.

ABSTRACT

* Michael Emerson and Alessandro Giovannini are respectively Associate Senior Research Fellow and Associate Researcher at the Centre for European Policy Studies (CEPS). The authors are grateful to Daniel Gros, Cinzia Alcidi and Nathalie Tocci for helpful comments. All remaining errors are ours.

and within the north the primacy of Germany. The south is still suffering from a five-year recession, which has given rise to serious social and political tensions and rising Euroscepticism. Moreover, this *de facto* regime is strikingly lacking in democratic legitimacy, to the point of questioning the Eurozone's medium to long-term sustainability.

On the more positive side, there is at least an understanding that the Eurozone needs now to be buttressed by a banking union and some kind of fiscal union. The emerging banking union takes its place alongside reform of financial market regulation within the EU single market, with elements of banking union being kept open to non-Eurozone member states; in this case, the frontiers between the EU and the Eurozone are being soundly managed.

But this still leaves major questions about the future content of the fiscal union. The minimalist view that it is only about implementing more stringent rules for restraining national budget policies still seems to be the official position in much of the north, whereas many independent economists, often from the south, and the EU institutions themselves are exploring the possibility of mechanisms such as Eurobonds and regional shock absorbers. Such mechanisms seems necessary in order to ensure the long-term sustainability of the Eurozone, but it is going to require exceptional political leadership to move beyond the status quo.

1. Introduction

At the outset of this project,¹ we were asked to test a number of hypotheses by way of mapping models for the EU, for example core and concentric circles, or multiple clusters, or forms of associated membership to complement the core. The purpose of reviewing these hypothetical options would be to try to identify systemic improvements that would enhance both the unity and policy effectiveness of the EU in a number of sectors – including the fiscal and monetary policy domain discussed in this paper.

¹ As outlined in Nathalie Tocci and Giovanni Faleg, "Towards a More United and Effective Europe: A Framework for Analysis", in *Imagining Europe*, No. 1 (October 2013), <http://www.iai.it/content.asp?langid=2&contentid=992>.

The governance of the EU's economy is already divided between the plenary EU of 28 and the Eurozone of 17. However official doctrine at the EU level has a clear answer to the mapping question: after recovering from the sovereign debt crisis of the last few years, the Eurozone's membership should gradually expand towards the frontiers of the EU. While the new member states have accepted the obligation to join the Eurozone, there may still remain some dissident opt-outs for a long time, and maybe indefinitely. Moreover, this official view is an inadequate representation of what both economic theory and empirical evidence has to say.

At the heart of the question lies the theory of the Optimal Currency Area (OCA).² Beyond having a single sound central banking structure, the OCA has to have adjustment mechanisms to deal with asymmetric shocks and to compensate for the loss of exchange rate flexibility. The American literature on this point highlights the possibility for labour market flexibility to allow significant migratory movements from competitive regions to uncompetitive ones, while of course the European reality on this account is much more constrained by factors of language and national culture. A further adjustment mechanism comes from the theory of fiscal federalism, according to which a substantial federal fiscal capacity allows for both union-level macroeconomic stabilisation and significant inter-regional financial redistribution that automatically evens out the impact of region-specific economic shocks. On this account also the European reality is weak in the absence of a central budget of macroeconomic significance.

For these reasons economists tend to agree that it is not surprising that European monetary integration has had a bumpy history. There was the first failed experiment of the 1970s, starting in 1972 when all the member states of the enlarging EC joined in the "snake" mechanism for fixed but adjustable exchange rates. The frontiers of this monetary area rapidly contracted under the impact of dollar and oil market shocks, with the UK withdrawing after only two months of failing central bank intervention, followed by a cascade of withdrawals, leaving in 1974 only a rump DM zone of Germany and the Benelux as the minimalist European monetary area. The reconstruction effort resumed in 1979 with the European Monetary System, and the subsequent move towards monetary

² See Robert A. Mundell, "A Theory of Optimum Currency Areas", in *The American Economic Review*, Vol. 51, No. 4 (September 1961), p. 657-665, <http://www.aeaweb.org/aer/top20/51.4.657-665.pdf>; Richard Baldwin and Charles Wyplosz, *The Economics of European Integration*, New York, McGraw Hill, 2004.

union prompted by the completion of the single market. Here the complete liberalisation of capital movements necessitated strong monetary union structures, with a central bank and a single currency. While the central monetary mechanism was established, albeit with inadequacies on the banking supervisory front, the other elements of the optimal currency area remained conspicuously lacking, with limited labour market flexibility and no central budget of macroeconomic significance. The Eurozone crisis of the last few years has thus been another painful experience in terms of testing the frontiers of the optimal (or at least sustainable) European monetary area. While the euro was successfully defended against collapse, the depth of the resulting economic, social and political tensions in much of southern Europe has reignited debate on the optimal frontiers of the European Monetary Union (EMU), with various voices arguing for either a new northern hard monetary union, or for withdrawal from the euro by some southern states. This re-mapping of the Eurozone has not happened. While the European Central Bank has been ready to do “what it takes” to save the system, and the peripheral countries have undertaken their macro adjustment programmes, the challenges of making good the systemic inadequacies of the Eurozone system remain a work in progress, with nothing like a convincingly strengthened system yet in sight.

Against this sobering background this paper proceeds as follows. The next section summarises the current economic performance of the EU and various groupings of member states in the wake of the global financial crisis of 2008 and the subsequent crisis of the Eurozone. The story has been one of both recession at the overall macroeconomic level, and increased divergences on most measures between member states, between north and south in particular.

The third section reviews the cascade of complex macroeconomic policy arrangements adopted at EU or Eurozone levels to try to constrain national fiscal policies within bounds considered necessary for the sustainability of the monetary union. These various “pacts” and “packs” and treaty provisions amount to an evolutionary search for some new compromise between national and European-level powers over national budgets. The aim is to have a *sui generis* European regime for macroeconomic regulation in the absence of a large “federal” budget. The jury is still out on whether this will work effectively, in terms of either its economics or its politics. These arrangements reveal some fuzzy mapping frontiers between what applies to the EU as a whole versus only the Eurozone.

The fourth section summarises developments in the field of financial market regulatory policies, which responded quite impressively in the first stage of the crisis. However this broad field had become ever more complex as the need for a banking union has become apparent, leading now to major systemic developments in European-level regulation, supervision and resolution. Negotiations in this area are still ongoing, but there is at least consensus on the need for systemic change. Whether this is just a necessary, but insufficient step for securing the sustainability of the Eurozone is another question which the paper goes on to address.

In the fifth and sixth sections the remaining systemic weaknesses of the Eurozone are discussed, namely the absence of adequate fiscal powers for public borrowing (“Eurobonds”) and for absorbing region-specific economic shocks, and the problem of labour market adjustments. However, for both Eurobonds and region-specific shock absorbers there are a plethora of ideas in circulation. The increasingly important role of the European Central Bank is assessed in the seventh section, with critical comments on the obsolete arrangements for the representation of the Eurozone in various international institutions.

The final section draws conclusions. On the one hand, the pressure brought to bear by the financial markets to develop strong policy responses to the crisis has led to advances in European institutional integration in some economic and monetary areas up to levels hardly conceivable before the crisis. On the other hand, these developments still seem to fall far short of what would be necessary to ensure the long-term economic and political sustainability of the monetary union. The shortfall in sufficient fiscal federalism and the perceived weakness in the political legitimacy of the EU reveal a “chicken and egg” type of dilemma. A sound Eurozone for the future will require more quasi-federal powers, but these developments would have to be based on support from the European demos, which today is lacking, or at least on greatly improved trust between north and south over responsible policies on both sides. For this political legitimacy to be built up there would have to be good results delivered by the EU and the Eurozone, but for this the systemic advances seem necessary prerequisites.

2. Macroeconomic recession and divergence

While the introduction of the euro led, as expected, to a more or less common rate of inflation, which suggested at first a well-functioning convergence process, the outbreak of the crisis has shown the deep divergences that still exist, at both Eurozone and EU levels, in economic performance and policies.

The global financial crisis triggered in 2008 by the collapse of Lehman Brothers was not the cause of the crisis that followed in the Eurozone, but only its detonator. While the severity of the crisis in the Eurozone has different roots and possible interpretations, it is undeniably linked to the progressive divergence in competitiveness among Eurozone countries. Much of northern Europe has recovered from the recession to the extent of moderate gains in GDP, albeit with the recovery still now fragile. By contrast, the south of Europe has remained in recession, such that these countries as a group have registered five years of non-stop recession or stagnation. The consequences for the labour market have been dramatic, with huge increases in unemployment in the south, alongside approximate stability in the north (see Figure 1).

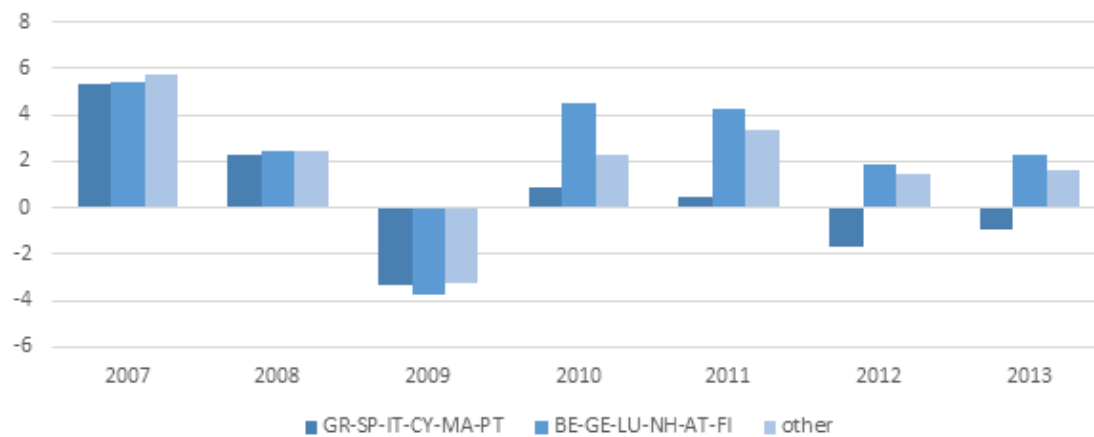
Similarly, there has been a story of massive and sustained divergence in the current accounts of the balance of payments. The north has been in substantial surplus, with the German surplus now exceeding the 6% of GDP threshold for triggering the Macroeconomic Imbalance Procedure (MIP – see further below). This procedure puts the political spotlight on the German surplus, as at least requiring a balancing gesture in relation to the pressures that bear upon the sovereign debtors in difficulty, but it is not evident what policy implications could follow from the “in-depth” study now in progress.³ The south has avoided large deficits, but this has mainly been due to the drop in domestic demand.

³ Daniel Gros and Matthias Busse, “The Macroeconomic Imbalance Procedure and Germany: When is a current account surplus an ‘imbalance’?”, in *CEPS Policy Briefs*, No. 301 (13 November 2013), <http://www.ceps.be/node/8593>. The authors point out that Germany cannot determine monetary policy, and that if it chooses fiscal expansion it will find itself breaching EU fiscal rules whose rigorous implementation it is the first to advocate. The introduction of a high minimum wage would be the surest way to boost demand in the short run, but is hardly a recommendable long-run solution.

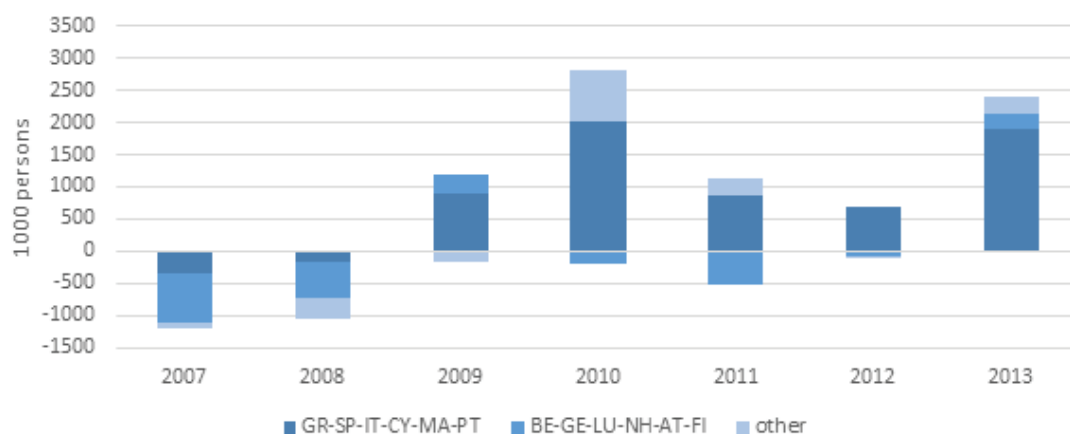
IMAGINING EUROPE

Figure 1. GDP, unemployment, current account balances, 2007-2013

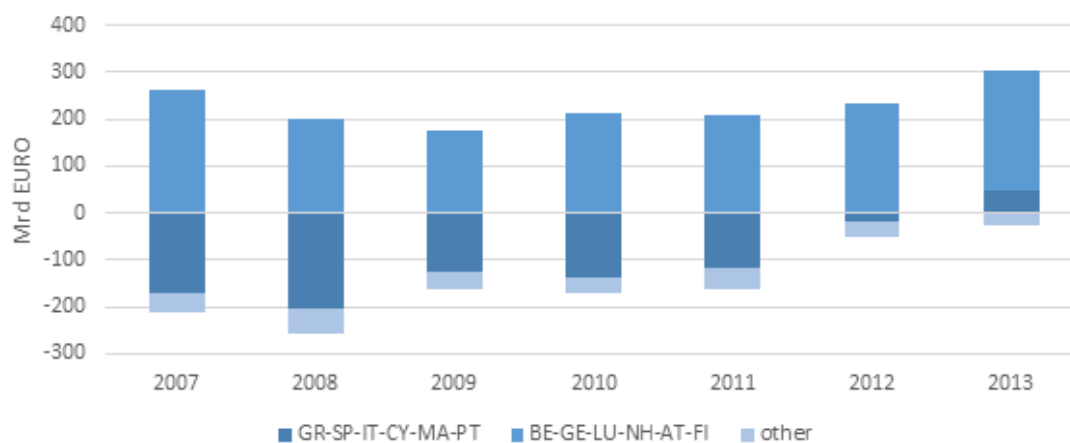
GDP yearly % changes



Unemployment yearly changes



Current account balances

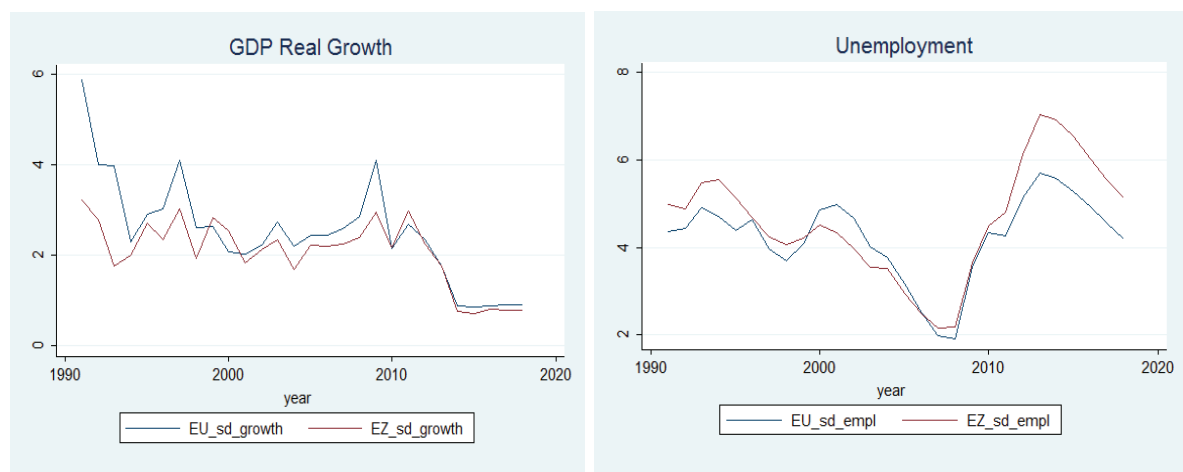


Source: European Commission, 2012.

IMAGINING EUROPE

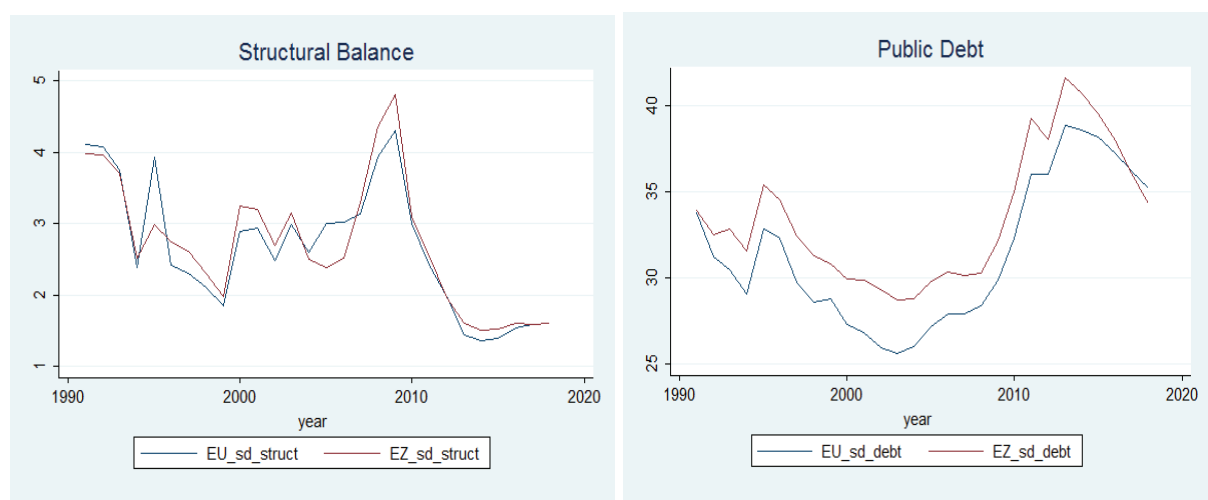
Divergences in performance are measured more systematically in Figures 2 and 3, with standard deviations of results for EU and Eurozone countries. It is to be noted that these figures extend from 1990 to 2018, with the long forecast or projected data between now and 2020 based on International Monetary Fund (IMF) estimates.⁴ Given the extent of the unknowns for such a long forecast period, the estimates have to be viewed as having a considerable normative content.

Figure 2. European convergence in macroeconomic indicators (standard deviations)



Source: IMF, 2013.

Figure 3. European convergence in fiscal indicators (standard deviations)



Source: IMF, 2013.

⁴ IMF, *World Economic Outlook*, October 2013, <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40432.0>.

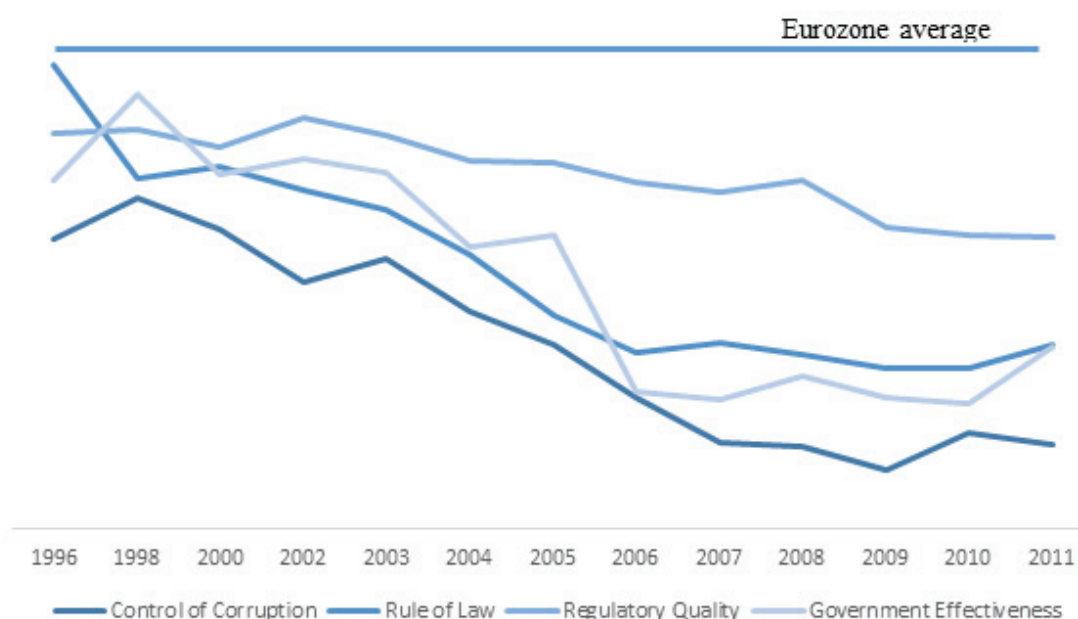
Regarding the fiscal indicators the spectacular increase in divergences of the 2000s is now giving way to a sharp reversal in the divergence of deficit levels, due to the severe austerity policies introduced almost everywhere, whether autonomously or under the conditions of assistance programmes. The same can be said of economic growth levels: despite moderate real GDP growth, the IMF estimates that these are relatively similar between the different European countries.

However, these flow indicators (i.e. the fiscal deficit and real GDP growth) can adjust much faster than the “stock” indicators (i.e. the levels of public debt and unemployment). The latter will require a long time to be fully absorbed, and will therefore continue to make the situation considerably different across European countries, possibly creating conflicts in the definition of economic policy objectives at the European level.

Going deeper into the causes of divergent economic performance, one can look also at various indicators of the quality of economic governance. The Worldwide Governance Indicators (WGI) published by the World Bank⁵ measure the quality of governance on several scores (see Figure 4). The main story emerging from this data is that the four southern member states experiencing sovereign debt crises (Greece, Italy, Portugal, Spain) utterly failed, albeit to different degrees, in the run-up to the introduction of the euro and in its early years to improve their governance systems and to keep their financial regulatory systems under control. In fact, their performance worsened, and only stabilised from 2008 onwards after the onset of the financial crisis.

⁵ World Bank, *Worldwide Governance Indicators* (WGI), 2012, <http://www.govindicators.org>.

Figure 4. Governance indicators for the average of Greece, Italy, Portugal and Spain relative to the Eurozone average



Source: authors' elaboration from World Bank, 2012.

As we shall see below, systemic defects or inadequacies in the policy mechanisms of the Eurozone have been important, and play their part in explaining the disappointing and divergent economic performance of the Eurozone during the recent years of recession. How far the defects in the Eurozone system have influenced the quality of national economic governance is difficult to determine. However, it can be argued that the early years of the Eurozone created illusions of easy economic gains, starting from the reduction of interest rates for government borrowing, and continuing on with the supposition that current account imbalances “no longer matter” in a monetary union as compared to national currency regimes. This may be part of the reason why there has been no real convergence in governance quality so far.⁶ The illusions of the early euro years may now

⁶ See Alessandro Giovannini, *The Impact of the Euro on Foreign Investors' Decisions*, mimeo 2013, for an empirical assessment of the relationship between governance indicators, the euro and private financial flows in the Eurozone.

have been largely shattered, and there has certainly been a considerable amount of labour market adjustment of wages and employment conditions in response to recession. However the political processes of adopting reform measures remain very tough.

3. Macroeconomic policy regime development during the crisis

Before the crisis the cornerstone of the EU's macroeconomic architecture was the **Stability and Growth Pact (SGP)**. This originated in the Maastricht Treaty and was carried into the Lisbon Treaty in Articles 121 and 126 TFEU, supplemented by Protocol 12, which defines the two key reference values of 3% of GDP budget deficit and 60% of public debt, beyond which the "excessive deficit procedure" is triggered. Article 126 TFEU sets out how the Commission and Council should work together in handling cases of excessive deficit or debt, with the ultimate possibility of penalising non-complying member states with a requirement to make non-interest bearing deposits with the EU, or through the imposition of fines. These provisions are basic EU law, applicable to all member states.

Nevertheless, already before the crisis it was generally recognised that the SGP was not proving effective, with recurrent unwillingness of member states to keep in line with its norms and recommendations, and of the Council to impose any of the financial sanctions provided for.

For this reason, several sets of measures have been incrementally added in the past three years in an attempt to reinforce the effectiveness of the SGP, with a presumption that at least Eurozone member states should accept more strictly binding commitments and procedures.⁷

The **European Semester**⁸ was developed in 2010 and has been operational since the first half of 2011. It is a mechanism for ex ante coordination of national economic policies. Each

⁷ For a more complete account of the different elements of the system summarised here, see European Commission, *Six-pack? Two-pack? Fiscal compact? A short guide to the new EU fiscal governance*, 14 March 2012, http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm.

⁸ Council of the European Union, "The European Semester", in *Special Reports*, 15 March 2013, <http://www.consilium.europa.eu/special-reports/european-semester>.

year, the economic policies of member states are analysed and assessed together by the Commission, which also sets specific recommendations for the following 12 to 18 months. The European Semester applies to all member states.

The **Euro+ Pact**⁹ was signed by 23 member states (Eurozone states plus Bulgaria, Denmark, Latvia, Lithuania, Poland and Romania) in March 2011. This commits those member states to highly detailed structural measures to improve competitiveness, employment, the sustainability of public finances and financial stability, along with a debate over tax systems. It is integrated into the European Semester, and its implementation measures are supervised by the Commission, although non-compliance does not lead to sanctions.

The Six-Pack is made up of five regulations and one directive. It entered into force in December 2011, and applies to all member states, running in parallel with the TSGC (see below). It strengthens the SGP in the following ways: i) it introduces the reverse qualified majority voting procedure in the case of a decision to impose financial sanctions of up to 0.5% of GDP on a Eurozone state that does not comply with its obligations;¹⁰ ii) it makes the debt criterion of the SGP more operational, requiring member states whose public debt level exceeds 60% to enter into a quantified path for returning to compliance; and iii) it sets new “expenditure benchmarks” to guide member states towards their medium-term budgetary objective (MTO), placing a cap on the annual growth of public expenditure according to a medium-term rate of economic growth. The Six-Pack is designed also to reduce macro-economic imbalances of the EU member states, creating a system of macroeconomic surveillance under a new **Macroeconomic Imbalance Procedure (MIP)** which is intended to give advance warning of imbalances, including impending excessive macroeconomic deficits.

The **Treaty on Stability, Coordination and Governance (TSCG)** was signed by 25 member states (all except the UK and the Czech Republic), and entered into force in January 2013. The TSCG is binding on all Eurozone member states, while other member states are bound only if they wish to be (possibly just on selected provisions), or will be once they adopt the euro. The cornerstone of this Treaty is the fiscal section, usually referred to as

⁹ See European Commission, *Six-pack? Two-pack? Fiscal compact?*, cit.

¹⁰ The reverse majority procedure means that a qualified majority of member states is required to block a decision proposed by the Commission, rather than to authorise it.

the **Fiscal Compact**, that fixes more precise rules and implementing procedures than those contained in the SGP, as follows: i) it requires signatory states to implement a balanced budget rule in their national legislation through permanent, binding provisions (preferably constitutional laws) by the end of 2013; ii) it limits annual structural government deficit to not more than 0.5% of GDP; iii) it extends to all signatory states the commitment made by Eurozone states to adopt Council recommendations and decisions under the excessive deficit procedure by means of the reverse qualified majority voting rule; and iv) it requires signatory states to design in advance restrictive fiscal measures to be automatically implemented in the event of a significant deviation from the agreed budget target. It foresees **Eurozone Summit meetings** of heads of state or government at least twice a year. It is an intergovernmental treaty which is not integrated into EU law, although member states have committed themselves to transfer its substance into the EU legal framework within five years.

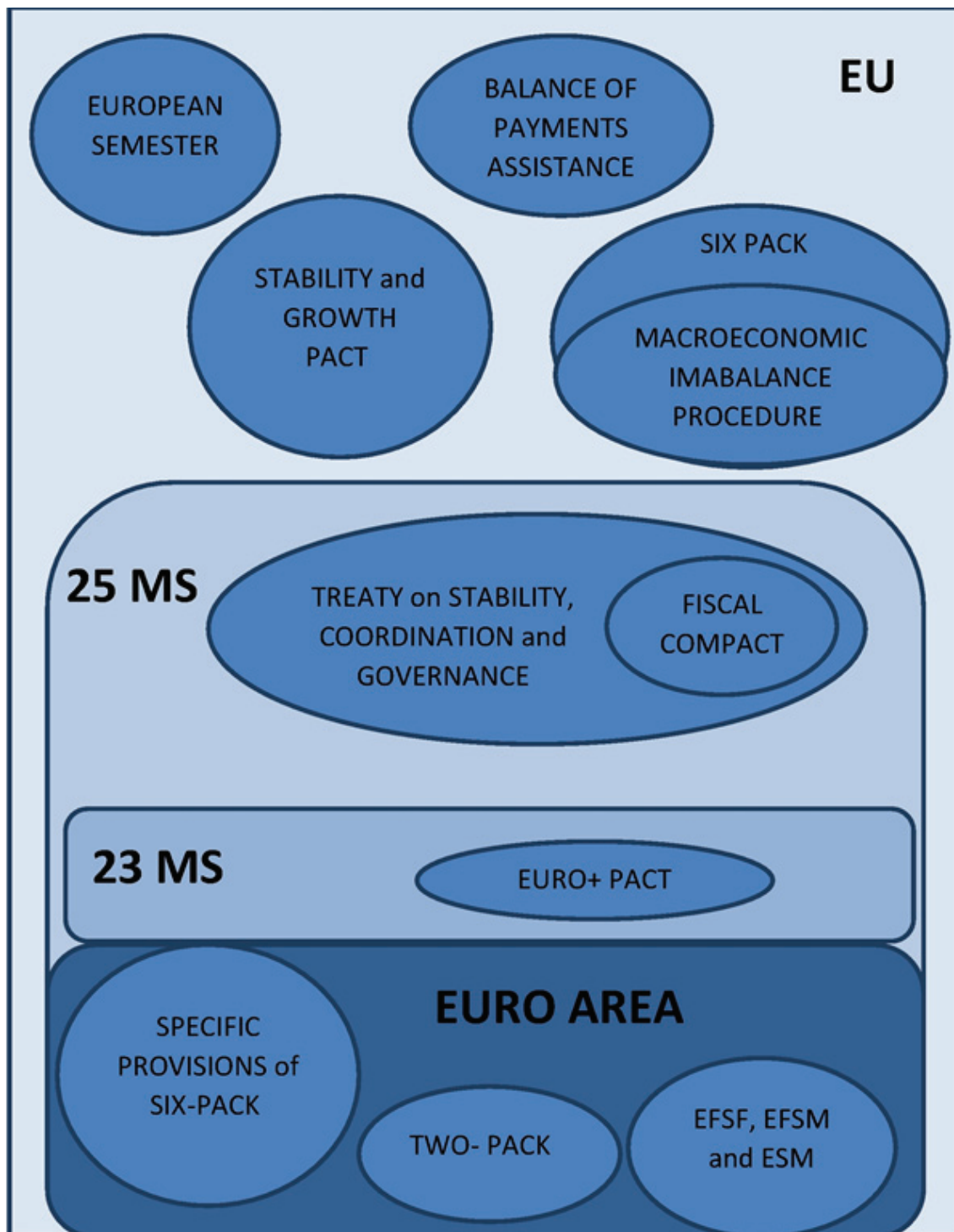
The **Two-Pack**, applicable only to Eurozone member states, strengthens the legal basis and specific provisions of the European Semester as from the 2014 cycle of budgetary procedures. It requires draft national budgets to be submitted by 15 October, and after assessment allows for the Commission to request changes to be made to bring them into compliance with established norms. It also provides for the recognition of the special needs of Eurozone member states under severe financial pressure.

The whole set of procedures is supported by several **Macro Financial Assistance Facilities**: the temporary **European Financial Stability Facility (EFSF)**, established in 2010, and the permanent **European Stability Mechanism (ESM)**, operational since 2012, represent the two stabilization mechanisms of the Eurozone. In addition, there are two other assistance instruments: the **European Financial Stabilization Mechanism (EFSM)** for Eurozone states, and **Balance of Payment Assistance (BoP)** for non-Eurozone states.¹¹

¹¹ For a clear description of the functioning of these instruments, see Alessandra Casale et al., "The Use of EU Instruments for Macro-Financial Stability: Implications for the EU and National Budgets", in *CEPS Special Reports*, No. 64 (September 2012), <http://www.ceps.be/node/7257>.

IMAGINING EUROPE

Figure 5. The emerging system of European economic governance



Source: authors' elaboration.

As emerges from this short overview, and as simplified in Figure 5, the European system of economic governance has evolved with layer upon layer of initiatives in recent years. These initiatives have a highly complicated variable geometry, involving either all the EU, or just the Eurozone, or the Eurozone + “pre-ins”, with most legislation adopted within the EU’s legal framework, but with some intergovernmental elements at least temporarily outside it.

Returning now to the initial question about the mapping of the system, the mushrooming of rules and procedures provoked by the Eurozone crisis has not led to a normative divide between the Eurozone and the rest of the EU. The substantive economic norms are basically a single standard, and the main difference is that the Eurozone states, and up to a point the “pre-in” states also, are committing themselves to stricter implementation, but even that has not yet been decisively tested in practice. The onerous level of detail in the commitments being made in some of these procedures, and the prospect of sanctions in the event of non-compliance, is causing unease in many governments, and feeding controversy in public opinion.

4. Financial market supervision and banking union

Following the outbreak of the financial crisis in 2007-2008, the institutions of the EU have initiated a deep process of regulatory reform to strengthen the existing system of monitoring and supervision. The crisis brought to light serious shortcomings in the existing framework of European financial market supervision. The main problem lay in the fragmentation at the national level of competences related to supervisory tasks, despite the strong financial interdependence due to large cross-border financial operations, which in turn led in the crisis to contagion effects between member states.

In January 2011, following publication of the Larosière report, the system of supervision was completely redesigned, replacing the former supervisory committees and building a new financial supervisory architecture based on two pillars.

First, **macro prudential supervision**: the **European Systemic Risk Board (ESRB)** was created to monitor risks to the stability of the European financial system as a whole. It is

designed to warn in advance of systemic risks that might appear, and to elaborate recommendations, which however do not bind member states. The ESRB is strongly connected to the European System of Central Banks and, most of all, to the ECB, which provides logistical and administrative support staff.

Second, **micro prudential supervision**: this is based on three new European supervisory authorities: i) the **European Banking Authority (EBA)** based in London; ii) the **European Insurance and Occupational Pensions (EIOPA)** based in Frankfurt; and iii) the **European Securities and Markets Authority (ESMA)** based in Paris, which supervises credit rating agencies, and can ban products that might undermine the stability of the overall financial system in emergency situations. All together, with the network of national financial supervisors, these agencies constitute the **European System of Financial Supervision (ESFS)**. National supervisors are represented in all three agencies in order to ensure consistency in national supervision, to strengthen oversight of cross-border groups, and to establish a **European Single Rulebook** applicable to all financial institutions.

This new architecture, nevertheless, is set to change, following the decisions taken at the European Council and Eurozone summit at the end of June 2012 to establish a **banking union**. After the publication of the SSM legislation in the Official Journal on 29 October 2013,¹² the first block of this project has been formally established, with the creation of the **Single Supervisory Mechanism (SSM)**, led by the ECB.

The SSM is intended for all Eurozone states, but is also potentially open to other member states willing to be integrated in the system through close cooperation between their competent authorities and the ECB. The ECB will be the key institution within the SSM, of which the national authorities are also part. Within the SSM, the ECB will be responsible for ensuring the consistent application of the Single Rulebook, and will directly supervise banks with assets of more than EUR 30 billion, or which constitute at least 20% of their home country's GDP, or which have requested or received direct public financial assistance from the ESM. The other financial institutions will be monitored, as nowadays, by national supervisors, which however will in turn be supervised by the ECB. The ECB could

¹² Council Regulation (EU) No 1024/2013 of 15 October 2013, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:32013r1024:en:not>; Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:32013r1022:en:not>.

also decide to supervise directly minor banks in cases in which the consistent application of high supervisory standards is necessary. Where the national competent authorities and the ECB Governing Council disagree on particular issues, the SSM governance structure foresees the establishment of a mediation panel.

The EBA will continue to develop the European Single Rulebook applicable to all member states and to carry out regular stress-tests, but its functioning will be adapted and reinforced. To safeguard non-Eurozone member states, EBA decisions on mediation and on technical standards will need a double majority, i.e. a majority of the member states participating in the SSM and of the non-participating member states. The Single Rulebook will represent the key tool for ensuring the sound functioning of the EU's internal market in financial services, and most of all will provide the common ground on which the banking union proposals can be built without fragmenting that market. However, tensions have emerged over the role of the committee of national regulators, which the chairman of the EBA considers unwieldy and to impair the capacity of the system to respond promptly in crisis conditions.¹³

The Single Rulebook will be built up alongside the implementation in the coming years of the **Capital Requirements Regulation (CRR)** and the **Capital Requirements Directive (CRD IV)**, adopted by the EU Council in June 2013,¹⁴ which represent the EU's application of the Basel III reforms agreed at G20 level. The adoption of the two acts creates for the first time a single set of harmonised prudential rules with which all EU banks must comply, thereby ensuring the uniform application of Basel III. In the previous set-up there was a large number of national options and discretionary provisions, limiting the effective functioning of the internal market.

As regards the application of the CRR and the CRD IV, the EBA will play a crucial role in coordinating a Single Rulebook Q&A process and providing practical guidelines to promote common supervisory approaches and practices.¹⁵ The EBA will also have, over the coming

¹³ Patrick Jenkins and Sam Fleming, "Euro bank watchdog attacks unwieldy governance", in *The Financial Times*, 17 November 2013, <http://www.ft.com/cms/s/0/a732237c-4f8e-11e3-b06e-00144feabdc0.html>.

¹⁴ The CRD IV package which transposes - via a regulation and a directive - the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework, entered into force on 17 July 2013.

¹⁵ Article 29 of *Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010*, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:32010r1093:en:not>.

years, to develop a single supervisory handbook, in order to avoid divergences between the supervisory practices of the SSM and the rest of the EU. Discrepancies could translate into incentives for European banks to exploit regulatory arbitrage advantages, thus fragmenting the single market.

Other than the SSM, the only semi-institution already set up is the **European Stability Mechanism (ESM)**. At present the ESM can recapitalise banks only indirectly, i.e. by providing a loan to the government of the Eurozone country in question, which can then use that loan to recapitalise its banks (as in the case of ESM assistance to Spain). But this adds to the beneficiary country's budget deficit and public debt (i.e. reinforcing the link between that country's public finances and its banking sector). For this reason, Eurozone finance ministers agreed in June 2013 to let the ESM directly recapitalise ailing systemic banks once the SSM is fully operational. The ESM will be able to re-capitalise financial institutions, with appropriate conditionality, up to 60 billion euro (of the total 500 billion euro ESM capacity), which is roughly equivalent to 0.2% of the Eurozone banking sector. Moreover, the ESM will be able to act only when a bank has reached a core tier one capital buffer of 4.5%, while any recapitalisation required to achieve this minimum level will fall on the national government.

Despite the formal establishment of the SSM, and the subsequent possibility for direct recapitalisation of banks by the ESM, the path towards a fully-integrated banking union is long and full of delicate issues, notably the design of an integrated restructuring and resolution framework, and a common system for deposit guarantees.

Regarding the restructuring and resolution process, a **Bank Recovery and Resolution Directive (BRRD)** has been proposed by the Commission. The Commission's proposal sets out a bank resolution regime built on three pillars: i) prevention and preparation: it forces banks and resolution authorities to prepare recovery and resolution plans for possible situations of financial stress and/or crisis; ii) early intervention: in this phase the authorities will have more power to intervene when a financial institution fails to meet its regulatory capital requirements; and iii) resolution: when a bank is about to fail, the competent authority can directly apply several tools to ensure that essential functions of the distressed bank are preserved. Such tools include requiring the sale or merge of the business or setting up a temporary bridge bank to operate critical functions, in order to ensure that

shareholders and creditors bear an appropriate part of the losses (the so called “bail-in” already applied in the Cyprus financial assistance plan). In this framework, the EBA will provide strong coordination during the first two phases, in order to ensure consistency in the parameters used by the authorities of the member states.

The key new institution in this process will be the **Single Resolution Mechanism (SRM)**. The proposal of the Commission for the SRM would create a single resolution authority with pooled resources, to be fully operational in 2015. The negotiations between the Council and the European Parliament are still on-going, and final agreement may be reached before the end of 2013.¹⁶ The Commission proposal foresees three main players in the bank resolution procedures: i) first, the ECB, as single supervisor, is required to signal when a bank needs to be “resolved”; ii) then an ad-hoc **Single Resolution Board (SRB)**, an agency consisting of representatives from the ECB, the Commission and the national authorities of those member states in which the bank in question has its headquarters as well as branches and/or subsidiaries, should prepare the resolution of that bank and decide how far the **European Resolution Fund** should be financially involved;¹⁷ and iii) finally the Commission, on the basis of the recommendations already made, will decide whether, when and how to place a bank into resolution, and will give the green light for the use of resolution tools and the fund.¹⁸ This extra role of the Commission is intended to ensure the consistency of the resolution process with rules on state aids.

This framework provides again for a strong interconnection between EU authorities and national resolution authorities: while the latter would be in charge of the practical execution of the resolution plan, the SRB would oversee the entire resolution process and be empowered to address executive orders directly to troubled banks in cases where the national resolution authorities do not carry out the agreed plan.

¹⁶ See European Commission, *Proposal for a regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund ...* (COM(2013) 520 final), 10 July 2013, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52013pc0520:en:not>.

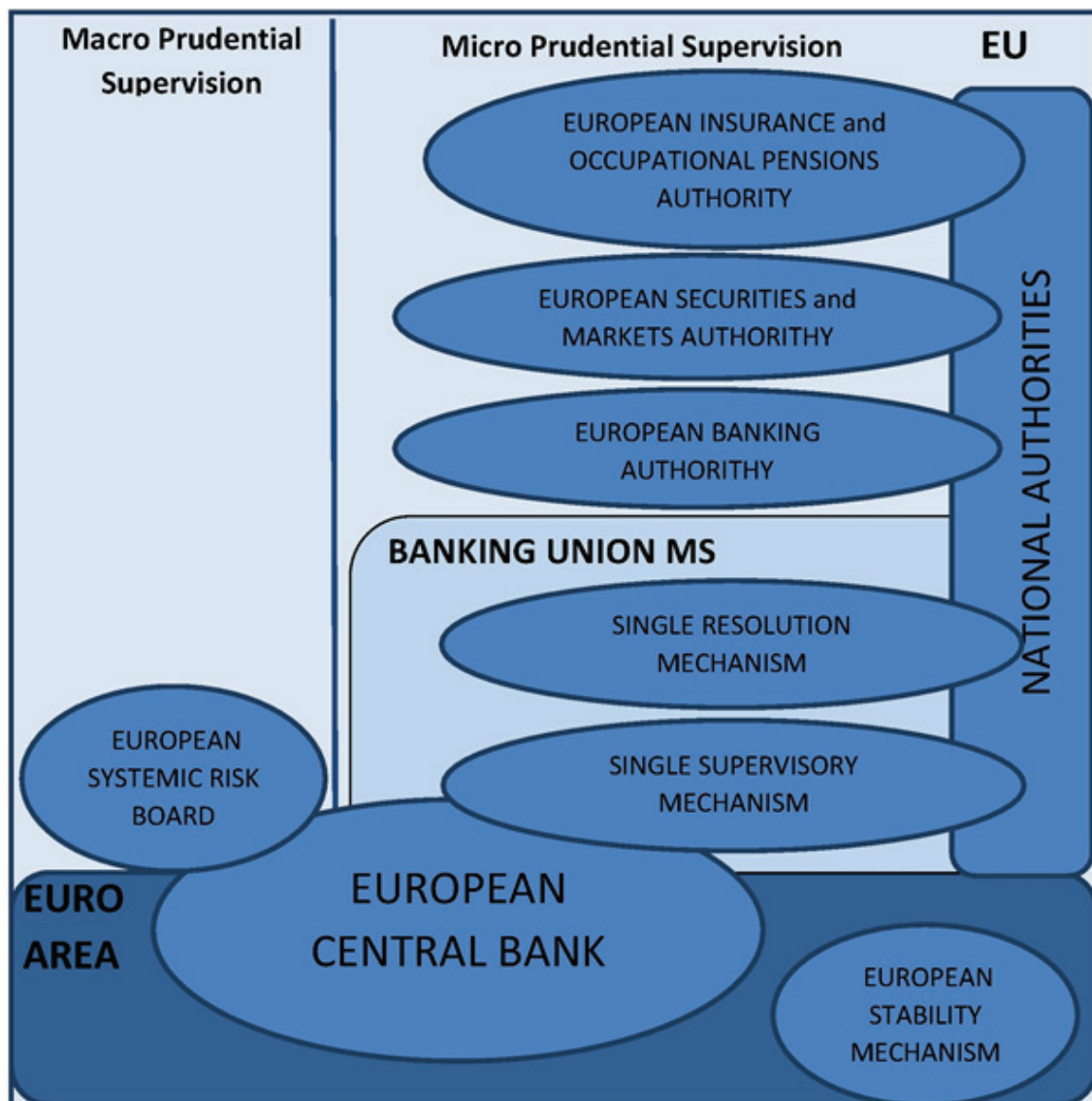
¹⁷ This fund would be financed by contributions from the banking sector, replacing the current national resolution funds and it would be under the direct control of the SRB.

¹⁸ For a clear description of the functioning of the SRM Regulation and the BRR Directive, see Stefano Micossi, Ginevra Bruzzone, Jacopo Carmassi, “The New European Framework for Managing Bank Crises”, in *CEPS Policy Briefs*, No. 304 (21 November 2013), <http://www.ceps.be/node/8620>.

IMAGINING EUROPE

These complex interconnections are present also in the draft proposal for the third component of the banking union, the **Deposit Guarantee Schemes (DGS)**. While the current debate is around a draft directive currently under preparation by the Commission, it is commonly assumed that the governance structure that will emerge will be based on both EU and national authorities, through the establishment of a common “network” of national deposit guarantee schemes.

Figure 6. Financial market supervision and the emerging banking union



Source: authors' elaboration.

The establishment of banking union and the management of the transitional phase must be carefully designed. This is not an easy task, since divergences are still large, and the adoption of tighter rules could hurt national financial institutions. As and when tighter rules for capital requirements are applied, balance sheet assessments of several banks could reveal significant capital shortfalls, which could increase the fragility of the European banking system. In order to avoid this risk, the SRM should be put in place as soon as possible, thereby reducing uncertainty in financial markets and leaving the ECB free to conduct its balance sheet assessments.

Returning to the initial question about the mapping of the system, what emerges in the microeconomic regulatory field is an intense reconstruction of the system, with substantial transfers of power from national authorities to the Eurozone and EU levels, albeit retaining an important dimension of networked collaboration with national authorities. The consistency between the rules of the emerging banking union and those of the single market as regards the regulation of financial institutions has received due attention, and the mechanisms of the banking union will therefore be open to non-Eurozone member states.

5. Quid fiscal union?

The first failed attempt at monetary union in the 1970s (the Werner Plan¹⁹ and the “snake in the tunnel”) was criticised retrospectively for having relied too exclusively on monetary mechanisms and for having lacked an adequate fiscal regime.²⁰ In response, the Commission launched a research project in the mid-1970s to investigate the fiscal properties of the advanced monetary unions, and notably those of the advanced federations such as the US, Canada, Australia, and, above all, Germany.²¹ All the advanced federations buttress their monetary unions with large federal budgets of the order of 20-25% of GDP, which

¹⁹ Pierre Werner (ed.), *Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community* (Werner Report), Luxembourg, 8 October 1970, http://ec.europa.eu/economy_finance/emu_history/documentation/documentation_chapter5.htm.

²⁰ The Werner report of 1970 actually advocated a system with balanced monetary and economic/fiscal aspects, but its implementation was essentially monetary, consisting of a reduction in exchange rate fluctuation margins. See Daniel Gros and Niels Thygesen, *European Monetary Integration. From the European Monetary System to European Monetary Union*, London and New York, Longman and St. Martin's Press, 1992.

²¹ Donald MacDougall (ed.), *Report of the Study Group on the Role of Public Finance in European Integration* (MacDougall Report), Vols. I and II, Brussels, April 1977, http://ec.europa.eu/economy_finance/emu_history/documentation/documentation_chapter8.htm.

have important macroeconomic stabilisation and inter-regional redistribution functions. The inter-regional distributive effects of federal finances were found also to take place between regions of unitary states of the EU, although they have diverse systems of regional government (for example Spain, whose system borders on the federal). Overall, for both federal and unitary states the impact of adverse macroeconomic shocks at the regional or state levels is absorbed or compensated to a substantial degree by central fiscal mechanisms, by a margin of between one half and two thirds.

The findings of this report, while widely disseminated in academic circles, were completely ignored at the official level. These inconvenient truths were considered irrelevant. However when the single market programme was embarked upon in 1985, the then Commission president, Jacques Delors, argued that it had to be accompanied by a substantial increase in structural funds to help poorer regions adjust to new and harsher competitive conditions. This was done, to the point that structural funds rose to account for around one third of the EU budget.

After the single market programme had got well under way, and as thoughts were turning towards monetary union, Delors invited the late Tommaso Padoa Schioppa to lead a group of independent economists to develop a strategy for the overall European integration process. The resulting report argued in favour of a balanced combination of all three classic functions of public finance as established in both theory and practice, i.e. allocation, stabilisation and redistribution.²²

However, in the run up to the creation of the euro no further consideration was given to any “fiscal federalism” in the sense of an increased EU budget (again the inconvenient truths). All attention was devoted to constraints designed to prevent national budget deficits from undermining monetary stability, as in the case of the Stability and Growth Pact and its subsequent derivatives discussed above.

In the current political debate, the idea of an enhanced EU redistribution function is referred to in Germany under the label of “transfer union”, and indeed the German federation features an elaborate system of fiscal equalisation through inter-Länder transfers (*Finan-*

²² Tommaso Padoa Schioppa et al., *Efficiency, Stability and Equity. A Strategy for the Evolution of the Economic System of the European Community*, Oxford, Oxford University Press, 1987.

zaugleich). At the same time, this is mentioned only to be excluded at the European level, until and unless there is also “political union”. However, the notion of political union is itself undefined, beyond some vague references to classic federal structures in some speeches of political leaders in Germany, as also notably in Italy and Belgium, but such notions are in turn rejected by the political leaders of at least two of the founding member states, France and the Netherlands, let alone other more Eurosceptic member states.

Clearly there is an absolute blockage over replicating any kind of classic fiscal federalism at EU level which would entail an EU budget of major macroeconomic proportions for both expenditures and taxation. Nevertheless, in the course of the Eurozone crisis, debate over some elements of fiscal union for the Eurozone have emerged under two generic headings: Eurobonds and shock absorber mechanisms. There has been a plethora of technical variants advocated under both headings.

Eurobonds, different forms of which are proposed, could be a plausible means of strengthening macro-financial stability at the EU level. They would imply a move from the current system, in which each member state is responsible for its own debt, to a system of joint and several guarantee, in which all member states are jointly responsible for common debt issuance.²³ Mutualisation of national sovereign debts would restore confidence in the Eurozone and reassure markets of the solvency of member states. Most of the schemes proposed recently entail a joint and several guarantee limited to a certain amount of national debt. The proposal by Delpla and Weizsäcker²⁴ would see the EU pool up to 60% of GDP of national public debt in common “blue bonds”, whereas debt beyond the 60% limit would have to be financed nationally with “red bonds”. By contrast, the German Council of Economic Experts has proposed a redemption fund which would take over public debt beyond the 60% level.²⁵ Monti has proposed a European Debt Agency to issue Eurobonds, with the proceeds to be lent on to member states for amounts up to 40% of GDP levels.²⁶ Various formulations for Eurobonds have now tentatively entered into

²³ For a thorough account of proposals see Alessandra Casale et al., “The Use of EU Instruments for Macro-Financial Stability: Implications for the EU and National Budgets”, cit.

²⁴ Jacques Delpla and Jakob von Weizsäcker, “The Blue Bond Proposal”, in *Bruegel Policy Briefs*, No. 2010/03 (May 2010), <http://www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal>.

²⁵ See the German Council of Economic Experts’ website: *A European Redemption Pact*, <http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1>.

²⁶ Mario Monti, *A new strategy for the single market. At the service of Europe’s economy and society*, Report to the President of the

the range of ideas expressed in official EU documents, such as the Commission's communication on "genuine economic and monetary union"²⁷ and the document issued by the so-called "four presidents".²⁸

Regarding economic stabilisation or shock absorber mechanisms there has also recently been a proliferation of proposals around whether the Eurozone should have its own budget. The Commission's communication referred to above contains a section entitled "Central budget providing for a fiscal capacity with a stabilisation function".²⁹ This talks of a 50% European contribution towards funding unemployment benefits (as in the US), and other unspecified mechanisms for compensating economies hit by asymmetric economic shocks. The Commission acknowledges that this would imply a major transfer of sovereignty to the EU level, which would have to be accompanied by unspecified steps towards political integration, and so the topic is pushed into the future with no time horizon.

This was shortly followed by the related document by the "four presidents" referred to above, which outlined "guiding principles for the shock absorption function of an EMU fiscal capacity".³⁰ There would be an insurance-type system between Eurozone member states, with "[c]ontributions from, and disbursements to, national budgets" fluctuating according the "each country's position over the economic cycle".³¹ There would not be unidirectional and permanent transfers between member states, with this shock absorber mechanism categorically distinguished from income equalisation transfers.

European Commission, 9 May 2010, http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

²⁷ European Commission, *A blueprint for a deep and genuine economic and monetary union. Launching a European Debate* (COM(2012)777 final), 28 November 2012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52012dc0777:en:not>.

²⁸ Herman van Rompuy et al., *Towards a Genuine Economic and Monetary Union*, 5 December 2012, http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf.

²⁹ European Commission, *A blueprint for a deep and genuine economic and monetary union*, cit., p. 31-33.

³⁰ Herman van Rompuy et al., *Towards a Genuine Economic and Monetary Union*, cit., p. 12.

³¹ *Ibidem*, p. 10.

Among the European think-tanks there has been a proliferation of ideas on how to develop such as system.³² A common feature of these proposals is their focus on insurance principles, i.e. with individual countries alternating between being contributors or beneficiaries, and payments in any year being a sum of contributions and disbursements, such that the net budgetary cost could over time be nil, while the wider macroeconomic benefits in terms of dampening recessionary episodes could be very substantial.

In November 2013 the IMF entered into the debate with a staff paper on fiscal union.³³ This makes a comprehensive review of the options for making good “critical gaps” in the Eurozone’s architecture. The paper draws a distinction between *ex post* crisis management measures such as those which have been developed (the EFSF, the ESM), and *ex ante* measures in the category of insurance schemes. The former have proved extremely expensive, with the total resources mobilized by the ESM and the EFSF amounting to 700 billion euro, or 7.5% of GNP, in addition to the massive macroeconomic and unemployment costs accumulated because of the late (*ex post*) intervention. The paper estimates that annual contributions of between 1.5% and 2.5% of GNP to a shock absorbing insurance fund could have contributed to a large degree to smoothing economic results (up to 80%), contrasting with the devastating five-year recessions experienced in the Eurozone south. The IMF paper draws on the historical experience of the advanced federations, including the findings of the MacDougall report of 1977. Its calculation of the cost of an insurance fund is of the same order as the 1% to 2.5% of GNP estimate of the MacDougall report. The IMF paper also notes that the introduction of such mechanisms has generally followed grave economic crises, starting from that which occurred in the US in the 1790s (the state bankruptcies of the civil war), and that it has usually been coupled to the strengthening of central fiscal powers. This in turn reduces the risks of moral hazard of unintended incentives for irresponsible policies. In the current Eurozone context centralising actions would mean giving binding effect to the procedures described above for

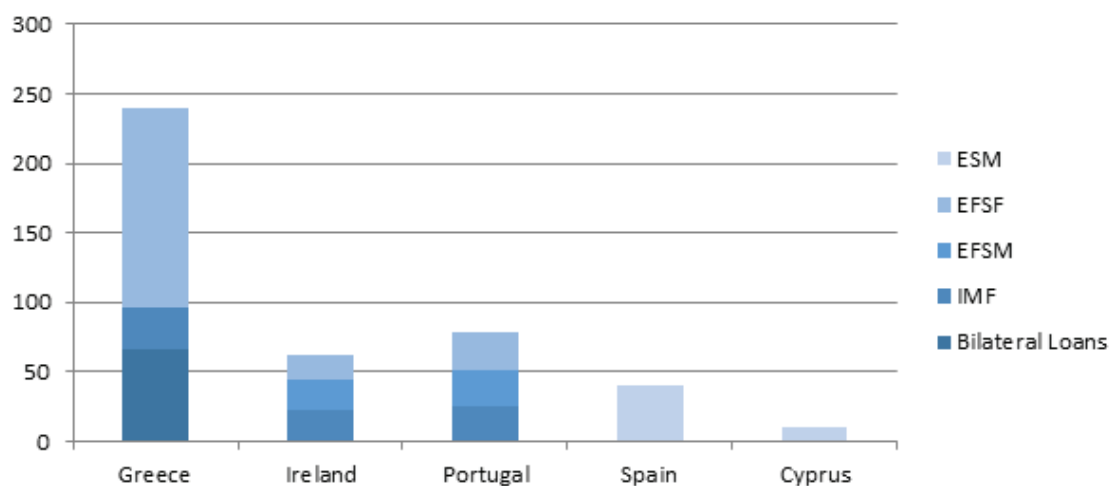
³² Jean Pisani-Ferry, Erkki Vihriälä and Guntram Wolff, “Options for a Euro-area fiscal capacity”, in *Bruegel Policy Contributions*, No. 2013/1 (January 2013), <http://www.bruegel.org/publications/publication-detail/publication/765-options-for-a-euro-area-fiscal-capacity>; Henrik Enderlein, Lucas Guttenberg and Jann Spiess, “Blueprint for a cyclical shock insurance in the euro area”, in *Notre Europe-Jacques Delors Institute Studies and reports*, September 2013, <http://www.eng.notre-europe.eu/011-16659>; Bernard Delbecq, “Proposal for a Stabilisation Fund for the EMU”, in *CEPS Working Documents*, No. 385 (October 2013), <http://www.ceps.be/node/8494>; Daniel Gros, “The European Banking Disunion”, in *CEPS Commentaries*, 14 November 2013, <http://www.ceps.eu/node/8596>.

³³ Céline Allard et al., “Toward a Fiscal Union for the Euro Area”, in *IMF Staff Discussion Notes*, No. 13/09 (September 2013), <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40784>.

the European Semester, Two Pack etc, alongside introducing fiscal insurance mechanisms for shock absorption.

At present the only common EU securities issued for reasons of macro-financial stability are those issued by the EFSM and those intended to finance balance of payments assistance, both of which are guaranteed by the EU budget. The former are currently used only to support Eurozone member states up to 60 billion euro (48.6 of which is outstanding), while the latter are used to assist member states that have not yet adopted the euro up to 50 billion euro (11,4 billion of which is outstanding). The EFSF and the ESM are currently the only two institutions that are able to issue debt securities. However, these are not instruments of “joint and several” responsibility, and each member state has only a quota of limited responsibility (by contrast, Eurobonds would be “joint and several”, and therefore have to be backed by a common fiscal capacity). The resources raised by these two institutions have been used to provide financial aid to Ireland, Portugal, Greece, Spain and Cyprus of a total of up to around 240 billion euro over three years, as set out in Figure 7.

Figure 7. Macro-financial assistance to Eurozone member states



Source: authors' elaboration.

Returning now to this project's principal question about organisational models to optimise both the unity and effectiveness of the EU, the present section has an unequivocal answer. Structural inadequacy in the "fiscal union" content of the Eurozone has contributed, together with manifest mistakes in certain national policies, to extremely negative results in terms of both unity and effectiveness, to the point that the euro experienced an existential crisis. The damage to unity is represented by the *de facto* hierarchy of states within the Eurozone, which strains the democratic legitimacy of the EU and Euro governance to the absolute limit. The poor effectiveness is shown by the five year recession of the south of the Eurozone, with huge losses of economic welfare and increases in unemployment. At least these systemic shortcomings are now being recognised in the profusion of proposals to build a more adequate system, even if such proposals have not yet been agreed in principle at the top political level, let alone implemented.

6. Quid the European labour market?

The labour market illustrates how the EU and the Eurozone are proving both divisive and ineffective. The EU's unemployment rate has increased by around 3.5 points compared to its level in 2007, while that of the Eurozone has increased by 4.5% over the same period. But these averages cover a dramatic divergence between on the one hand Germany, with a 4% reduction, and on the other hand increases of 18% in Greece and Spain. More than 25 million people living in the EU are out of work, ten million more than in 2007. The youth unemployment rate in the Eurozone is more than twice as high as the adult rate (24% versus 10%), and these levels are 10% higher than the average level in the 2000-2007 period.

What conclusions can be drawn in terms of the responsibility of the EU to rectify this situation? What does it mean for the sustainability of the Eurozone?

The EU and especially the Eurozone have responsibility for the overall macroeconomic policy environment, which depends on the setting of monetary and fiscal policy. Much public discourse has shifted in favour of "growth" as opposed to "austerity". The attempts notably by Italy and France to translate this into action have achieved some slight easing of macroeconomic policy guidelines on the speed of the reduction of public deficits, and may also have facilitated the easing of monetary policy by the European Central Bank.

But the political pressure for the EU level to intervene more directly on the labour market has been building up ever more intensely. The 2012 Spring European Council³⁴ paved the way for an employment package adopted in April 2012 by the Commission,³⁵ with the intention of bringing the employment rate up to 75%, as agreed in the Europe 2020 targets. In addition, the 2013 Spring European Council was devoted to the unemployment problem, with a special focus on youth unemployment.³⁶ However these “packages” of measures largely consist of recommendations for national action, since the EU does not have competence for the main instruments of labour market policy, such as hiring and firing regulations, unemployment compensation conditions, and tax burdens or incentives for employment.

The actual policies of the member states for the labour market are highly divergent, as the huge differences in structural unemployment rates imply. EU legislation in the labour market defines certain standards for temporary or part-time work, but even here the range of policies set by member states varies widely, as Figure 8 shows.

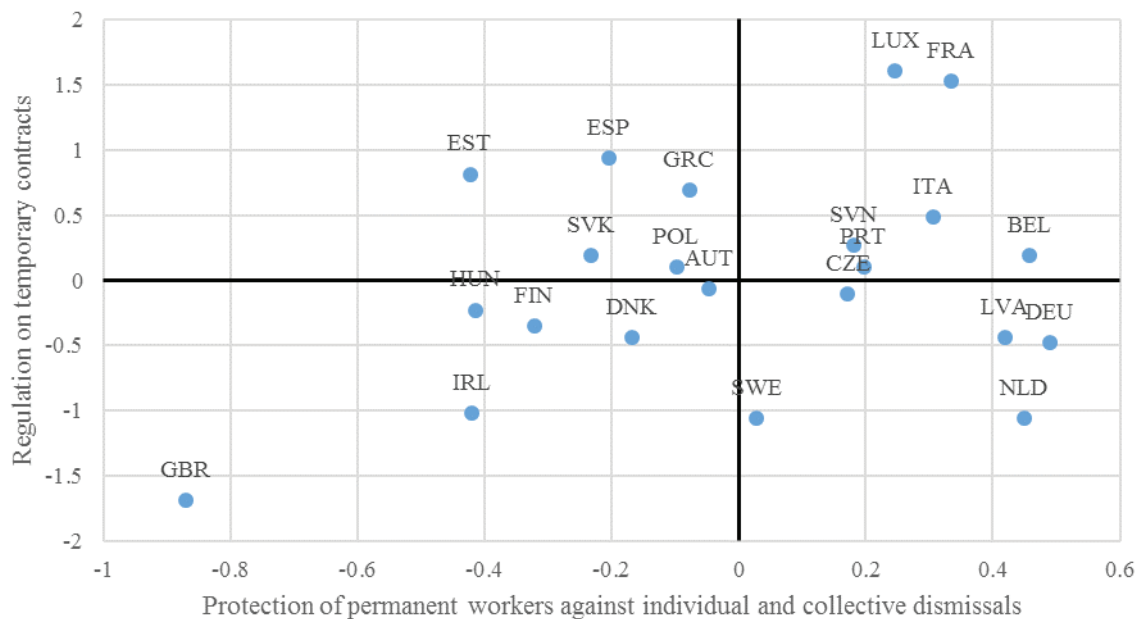
Are these differences significant for the questions posed about the mapping of groups of member states, in either the EU as a whole or the Eurozone? The answer is hardly. The range from the most liberal to the most heavily regulated member states cuts across Eurozone and non-Eurozone states, and across north versus south. The UK is the most liberal in terms of both firing rules and temporary contracts, which explains why it objects to EU harmonisation in this field. Germany for its part is at the liberal end for temporary contracts, but at the restrictive end of the scale for dismissals. France is at the most heavily regulated end on both accounts.

³⁴ European Council, *Conclusions of the European Council 1-2 March 2012* (EUCO 4/3/12 REV 3), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/128520.pdf.

³⁵ European Commission, *Towards a job-rich recovery* (COM(2012) 173 final), Strasbourg, 18 April 2012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52012dc0173:en:not>.

³⁶ European Council, *Conclusions of the European Council 14-15 March 2013* (EUCO 23/13), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/136151.pdf.

Figure 8. The differences in labour market regulation in the EU (centre: EU simple average)



Source: authors' elaboration from OECD, 2013.

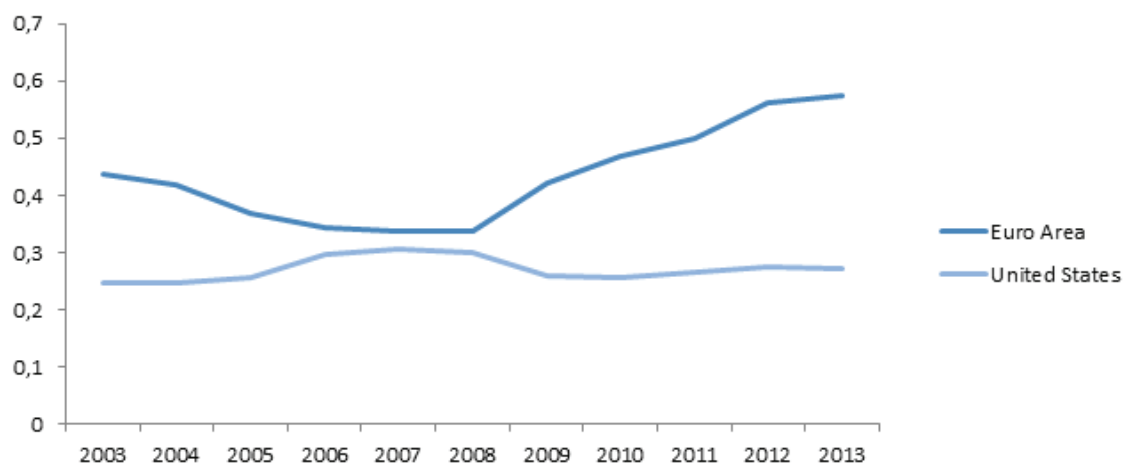
Should the EU intervene more strongly in the direction of harmonisation in the labour market and social policy domains? Opinions are sharply divided on this question. In some member states, notably France, political discourse stresses the need to combat “social dumping”. Others, and not only the UK, argue that basic social security provision and labour market regulations should remain the competence of member states, given also that while the divergences between member states are significant the minimum standards across the EU are high when compared to much of the rest of the world. At a time when the balance of competences between the EU and its member states is under explicit discussion, it is clear that very deep social structures and traditions are built into the striking differences in unemployment rates. To harmonise these more rapidly than through a long process of social learning looks like political fireworks. The social dumping argument is strong when comparisons are made with Bangladesh for example, but hardly within the EU.

While solving the unemployment problem is an objective *per se*, there is an additional reason for addressing it at European level, which flows from economic theory. In the literature on the OCA, labour market flexibility with respect to inter-regional migration is seen as one of the main stabilizing instruments, in the absence of exchange rate flexibility, to cope with asymmetric changes in demand. In the EU, the principle of free movement, employment and residence of people is firmly established in EU law and practice. People are free to migrate between member states in search of work. Moreover, in the last two decades, EU policy on the mutual recognition of professional qualifications and other actions by the Commission have gradually relaxed some of the major regulatory barriers to work in other member states.

But regardless of the removal of all legal restrictions on the movement of workers, the EU is far from having an integrated labour market. The obvious reasons for limited intra-EU labour mobility are language barriers and national/cultural identities. This contrasts with the US “melting pot”, where inter-state migration is considered a much lighter matter than that between European countries. Interestingly, these contrasts are borne out by current empirical evidence. Figure 9 shows that whereas in the last decade the variation of unemployment rates between the states of the US has not changed despite the recession, in the EU there has been a clear increase in these variations. As a concrete example, at the end of the 1980s Massachusetts managed to reduce its unemployment rate differential relative to the US as a whole through emigration.³⁷ Equilibrium in the job market did not happen only through a fall in relative wages, but also through the movement of workers to other regions of the US.

³⁷ As argued, for instance, by Paul Krugman: “Revenge of the Optimum Currency Area”, in *NBER Macroeconomics Annual 2012*, p. 439-448, available at <http://krugman.blogs.nytimes.com/2012/06/24/revenge-of-the-optimum-currency-area>.

Figure 9. Coefficient of variation of unemployment rates in the US and the Eurozone



Source: authors' elaboration from European Commission and US Bureau of Labor Statistics, 2013.

What can realistically be done at EU or Eurozone level? Should labour migration from Spain to Germany, for example, be advocated as a significant instrument of labour market adjustment policy? Of course there are movements of unemployed people from Barcelona to Munich, but this is hardly on a scale to make an impact on the aggregate unemployment numbers. The statistics on movements during the current crisis from Greece, Italy, Portugal and Spain to Germany illustrate this (Table 1).

Table 1. Unemployment levels and recent migratory flows to Germany from Greece, Italy, Portugal and Spain

	(1) Total unemployment, 000s, 2012	(2) Migration to Germany, 000s, average in 2007-9	(3) Migration to Germany, 000s, in 2012	(4) = (3) - (2)	(5) = (4)/(1) %
Greece	1,248	8	34	26	2.0
Italy	2,803	19	34	23	0.8
Portugal	1,780	16	42	6	0.3
Spain	5,935	9	12	21	0.4

Source: German Federal Statistical Office, 2013.

In 2012 these migrations had doubled or tripled by comparison with the pre-crisis levels, so some adjustment has been taking place. But nevertheless the amplitude of these movements has hardly been of macroeconomic significance. (movements in the single year 2012 amount to between 0.3% from Portugal to 2.0% from Greece as a proportion of total unemployment). To be sure, there may also be an increasing integration of labour market services across the EU for recruitment.³⁸ However, the recent enlargements of the EU have seen refusals by many member states to immediate and complete openings of their labour markets to the new member states. The imminent lifting of the last remaining restrictions on Bulgarian and Romanian citizens is provoking visible tensions in many immigrant member states.

To conclude this section, we return to the first question about the possible mapping of different groups of member states according to labour market structures. The differences are substantial, but cut across all conceivable groupings of member states by geography, or Eurozone membership, or any other explanatory factor. As to the question of what the EU or Eurozone can do about the high and divergent unemployment rates, the answer is that direct labour market measures remain largely a matter of national responsibility, so that the EU can do little more than debate and advocate best practices. Greater harmonisation of labour market policies could be desirable if it were to see a convergence on “best practice”, but there is no agreement on what this should be, and so negotiations with this objective would be intensely political and contested at national level, beyond legislation on certain minimum standards in labour market law. As regards how the macroeconomic policy environment affects unemployment, here the responsibilities of Eurozone policy-makers are fundamental, and this brings us back to the need for adequate regional shock-absorbing mechanisms and a sound fiscal policy regime to complement the monetary authority.

³⁸ The current European Job Mobility Portal (EURES), despite its worthy usefulness in providing information, advice and job-matching services, is still far from representing an effective European recruitment/placement integrated service.

7. The European Central Bank through the crisis and beyond

Starting in May 2010, in the exceptional circumstances that Trichet described as the “most difficult situation since the Second World War – perhaps even since the First World War”,³⁹ the ECB had to adapt its activities, from having an inflation target as its sole goal to making the financial stability of the Eurozone and indeed its very survival its main immediate priority. In the last four years, under both Trichet and Draghi, the ECB has adopted several major policy initiatives to address the severe tensions in the European financial markets: i) the Security Market Program, based on the acquisition of country-specific sovereign bonds in the secondary market; ii) the decision to change the eligibility of debt instruments issued or guaranteed by the governments of the most troubled countries, in order to accept them as collateral in monetary policy operations; iii) two Long Term Refinancing Operations under which the ECB lent money at a very low interest rate to Eurozone banks to boost demand for the most troubled sovereign bonds in peripheral countries; iv) the Outright Monetary Transaction program, prepared to enable the purchase of sovereign bonds of member states in the secondary markets, in the event of distressed circumstances and on condition that financial assistance programs would be put in place (this program has not had to be activated, but its announcement had an important and positive impact). In this perspective, the choice of the Maastricht Treaty to give exclusive competence for monetary policy to the ECB has proved justified, as it has been the only EU institution capable of a robust response to the crisis.

The ECB has also entered into the processes of fiscal policy through its participation with the IMF and the Commission in the Troika missions to negotiate conditional financial support for troubled Eurozone countries. The role of the ECB is due to expand further in the coming years through its new responsibilities for bank supervision. Adding the task of ensuring financial stability by means other than those of standard monetary policy could however potentially erode the ECB’s political independence.⁴⁰ The still imperfect design

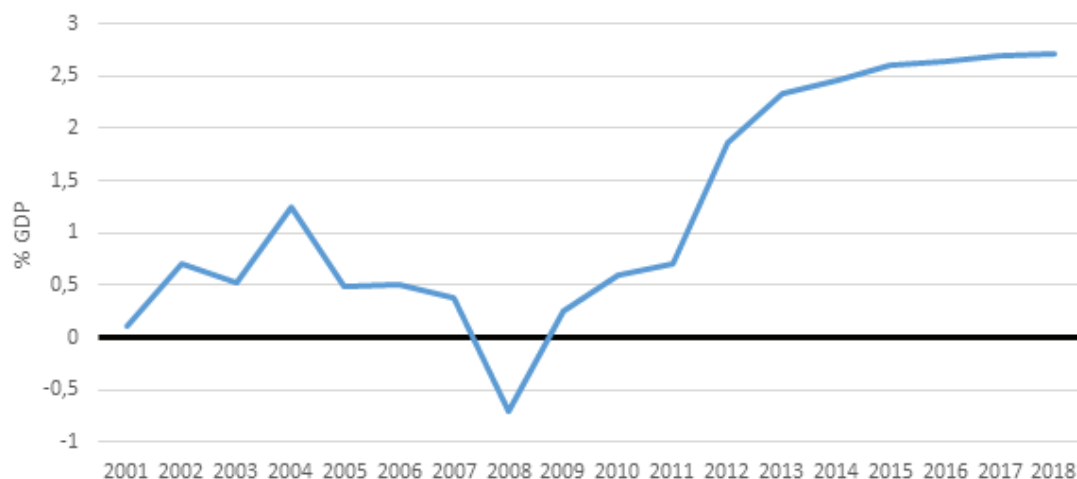
³⁹ Jean-Claude Trichet, “A ‘Quantum Leap’ in Governance of the Euro Zone Is Needed”, in *Spiegel Online*, 15 May 2010, <http://www.spiegel.de/international/europe/european-central-bank-president-jean-claude-trichet-a-quantum-leap-in-governance-of-the-euro-zone-is-needed-a-694960.html>.

⁴⁰ As argued by Cinzia Alcidi and Alessandro Giovannini, “The ECB Dilemma - Financial Stability or Independence?”, in *Reconciling Governance and Model. A Five-fold Narrative for Europe*, Brussels, Madariaga College of Europe Foundation, August 2013, p. 50-64, <http://www.madariaga.be/publications/books/865-reconciling-governance-and-model-a-five-fold-narrative-for-europe->.

of Eurozone economic governance puts the ECB in a delicate situation. It will require well-designed policy responses at EU level in the coming years in order to preserve its credibility in pursuing its core function, i.e. keeping the inflation under control.

A second potential institutional challenge for the ECB in the coming years will come from its role in the global arena. According to the IMF's economic scenario, thanks to the gradual re-absorption of internal imbalances, the Eurozone is going to run a substantial current account surplus of around 3% GDP in the years ahead, after ten years of approximate overall balance (see Figure 10).

Figure 10. Current account balance of the Eurozone



Source: IMF, 2013.

The monetary policy strategy of the ECB does not contain a target for the euro exchange rate,⁴¹ thus facilitating its focus on the maintenance of price stability. However, the future surplus of the Eurozone could risk the excessive appreciation of the euro, and thus put the ECB under pressure to adopt an interventionist policy, which in turn could prejudice its priority objective of monetary stability. The recent shift in monetary policy by the Bank of Japan is an illustration of how such pressures can build up.

⁴¹ The ECB's exchange rate policy is referred to in Articles 127 and 219 TFEU.

Moreover, more and more, monetary policies require strong coordination between the central banks of the major global economies. Since the outbreak of the crisis, the ECB has been playing an increasing role in certain international financial institutions, notably the Financial Stability Board (FSB) and the Bank for International Settlements (BIS), where it has full representation.

The role of the ECB in the IMF and the G-20 is more complicated. At the IMF, the ECB is only an observer in selected Executive Board meetings where the agenda is of direct relevance to the ECB, and the ECB President is an observer in the International Monetary and Financial Committee. These limitations follow the formal rules of the IMF's Articles of Agreement, which restrict membership to member states, although there is the possibility for a monetary union to have full representation if its member states cede their places, which the Eurozone member states show no sign of doing at present. The ECB is invited to those Executive Board meetings that deal with activities linked to the IMF's two main publications (the *World Economic Outlook* and the *Global Financial Stability Report*), and to discussions linked to Article IV procedures regarding the Eurozone, EU member states and accession countries, and the United States and Japan. However, the ECB cannot participate in Article IV discussions regarding China and other systemically important countries, or in a large number of Executive Boards discussing crucial IMF policy issues. Moreover, the activities of the two bodies intended to ensure European coordination in the Fund, the EURIMF (based in Washington) and the SCIMF (based in Brussels), tend to merely result in complex coordination procedures, with weak enforcement in the Executive Board of policy positions previously agreed by member states.

This lack of common positions inside the IMF Executive Board is not the fault of the ECB, but rather of the obsolete institutional design of the representation of the EU and Eurozone in the Fund. Rationalisation of the constituencies of member states in the Executive Board to reflect EU or Eurozone membership would seem to be an obvious and realistic move, but this has not been done. A natural step forward, but a more radical one, would be to have a common, single representation of the Eurozone at the IMF. This is foreseen in the Commission's communication on "genuine economic and monetary union", but considered to be only a long-term prospect.

At the G-20 the situation is much better. The EU has full rank as the 20th member, and the presidencies of both the Commission and the European Council participate. However the Eurozone is not represented as such in the summit meetings, but the ECB participates in meetings of Finance Ministers and Central Bank Governors and Deputies.

In answer to the principal question of this project, it can be said that the ECB now ranks as an important example of both unity and effectiveness at the Eurozone level. What is most striking compared to the workings of the Council is the ECB's capacity to make important decisions by majority voting, with some instances of objections of its biggest national central bank being overridden in the perceived interests of the Eurozone as a whole.

8. Conclusions

In relation to the various hypotheses presented in the concept paper⁴² there is one formulation that fits the fiscal and monetary policy sphere as it is viewed normatively in official circles. The basic reference remains the EU, whose single market, legal order and institutions are already to historic achievement. According to this formulation, the Eurozone, having survived the existential crisis of recent years, will gradually expand to include non-Eurozone member states, and thus largely re-establish the unity of the EU, with exception of some outliers, mainly the UK (whether seceding, or remaining an opt-out case within the EU).

While not dissenting from this normative view, the current Eurozone and EU have in practice seen emerge a highly complex, *de facto* multi-tiered, concentric circle regime, which is both defective in terms of effectiveness and damaging to the political legitimacy of both the Eurozone and the EU as a whole. Beyond the primary division between Eurozone and non-Eurozone states, secondary but still deep divisions have emerged between Eurozone creditors and debtors (actual or potential), or between north and south; within the north, Germany has emerged as the innermost core. Meanwhile, two EU institutions, the Commission and the ECB, have joined up with the IMF in the influential troika which oversee debtors, and this particular mix of the quasi-federal and the inter-governmental has further undermined the political credibility and legitimacy of the EU.

⁴² Nathalie Tocci and Giovanni Faleg, "Towards a More United and Effective Europe: A Framework for Analysis", cit.

The terms “banking union”, “fiscal union” and “political union” are used to signal the desire to re-order this *de facto* set of concentric circles towards a more effective and unified system. While these three terms flow easily together in political discourse, the reality varies drastically between each of them.

Banking union, coupled to recent advances in financial market regulation, is at least the subject of formal proposals and intense negotiations, and thus relatively advanced compared to the other two unions referred to. However, divergent positions in negotiations over many important features are still proving difficult to resolve, and devil is still very much in the detail.

The idea of fiscal union is not yet in good shape. There has been a great deal of innovation in coordination procedures and normative standards, as for example with the European Semester, and various “pacts” and “packs” and treaty provisions. But the search for a workable compromise between national and EU level powers over national budgets is still a work in progress, to say the least. There are recurrent sequences of new initiatives intended to have a more binding effect, followed by weak implementation. Going beyond coordination procedures, there has been a profusion of proposals, more often by independent economists than EU institutions, for both Eurobonds and region-specific shock absorbing mechanisms. These would be moves in the direction of a more quasi-federal fiscal system. The difference between coordination methods versus quasi-federal mechanisms is of fundamental political significance. The coordination method, coupled to negotiated conditionality for aid to sovereigns in difficulty, has led to the politically problematic hierarchy of concentric circles described above, whose innermost core is a single member state, Germany. The quasi-federal elements would re-establish greater political unity and perceived legitimacy of the system. Although many ideas are in circulation for Eurobonds and shock absorbing mechanisms, there are not yet official proposals on the table.

Finally, the questions posed at the outset can be answered quite bluntly. The systemic weaknesses of the monetary union resulted in crisis. This could only be resolved with the *de facto* emergence of multi-tiered concentric circles within the Eurozone, which is politically unsatisfactory to the point of being unsustainable. Optimists in various official positions may claim that with the worst of the crisis now over, there will be a gradual return to normality and unity within the Eurozone (for example, Ireland is now exiting

the bail-out regime). But overall this is a rather rosy scenario. Further systemic innovations towards fiscal union will be required to ensure the economic and political sustainability of the Eurozone. But this would require political will among member states and public opinion to innovate faster and deeper than has so far appeared possible. In order to restore the perceived political legitimacy of the EU to the point of enabling such decisions to be taken and ratified, the current wave of Euro-scepticism would have to be reversed: either by “good news” delivered by the EU, or by new grave threats that impose systemic innovations (although such threats can neither be wished for nor anticipated), or by exceptional political leadership.

The European policy-maker is thus trapped in a “chicken and egg” dilemma. The Eurozone economy needs systemic improvement to achieve better economic performance, but this would almost certainly require treaty changes, which would require greater political legitimacy than is evident at present, which in turn needs to be restored on the back of improved economic performance (“output legitimacy”). Given this negative circular logic, the other route of exceptional political leadership beckons.

References

Cinzia Alcidi and Alessandro Giovannini, "The ECB Dilemma - Financial Stability or Independence?", in *Reconciling Governance and Model. A Five-fold Narrative for Europe*, Brussels, Madariaga College of Europe Foundation, August 2013, p. 50-64, <http://www.madariaga.be/publications/books/865-reconciling-governance-and-model-a-five-fold-narrative-for-europe->

Céline Allard et al., "Toward a Fiscal Union for the Euro Area", in *IMF Staff Discussion Notes*, No. 13/09 (September 2013), <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40784>

Richard Baldwin and Charles Wyplosz, *The Economics of European Integration*, New York, McGraw Hill, 2004

Alessandra Casale et al., "The Use of EU Instruments for Macro-Financial Stability: Implications for the EU and National Budgets", in *CEPS Special Reports*, No. 64 (September 2012), <http://www.ceps.be/node/7257>

Bernard Delbecq, "Proposal for a Stabilisation Fund for the EMU", in *CEPS Working Documents*, No. 385 (October 2013), <http://www.ceps.be/node/8494>

Jacques Delpla and Jakob von Weizsäcker, "The Blue Bond Proposal", in *Bruegel Policy Briefs*, No. 2010/03 (May 2010), <http://www.bruegel.org/publications/publication-detail/publication/403-the-blue-bond-proposal>

Henrik Enderlein, Lucas Guttenberg and Jann Spiess, "Blueprint for a cyclical shock insurance in the euro area", in *Notre Europe-Jacques Delors Institute Studies and reports*, September 2013, <http://www.eng.notre-europe.eu/011-16659>

European Commission, *Annual macro-economic database (AMECO)*, 2013, http://ec.europa.eu/economy_finance/db_indicators/ameco

European Commission, *A blueprint for a deep and genuine economic and monetary union. Launching a European Debate* (COM(2012)777 final), 28 November 2012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52012dc0777:en:not>

European Commission, *Proposal for a regulation establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund ...* (COM(2013) 520 final), 10 July 2013, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52013pc0520:en:not>

European Commission, *Towards a job-rich recovery* (COM(2012) 173 final), Strasbourg, 18 April 2012, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=celex:52012dc0173:en:not>

European Council, *Conclusions of the European Council 1-2 March 2012* (EUCO 4/3/12 REV 3), http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/128520.pdf

German Council of Economic Experts, "Euro area in crisis", in *Annual Report 2011/12*, <http://www.sachverstaendigenrat-wirtschaft.de/schuldentilgungspakt.html?&L=1>

German Federal Statistical Office, *Statistisches Bundesamt dataset*, 2013, <https://www.destatis.de/EN>

Alessandro Giovannini, *The Impact of the Euro on Foreign Investors' Decisions*, mimeo 2013.

Daniel Gros, "The European Banking Disunion", in *CEPS Commentaries*, 14 November 2013, <http://www.ceps.eu/node/8596>

Daniel Gros and Matthias Busse, "The Macroeconomic Imbalance Procedure and Germany: When is a current account surplus an 'imbalance'?", in *CEPS Policy Briefs*, No. 301 (13 November 2013), <http://www.ceps.be/node/8593>

Daniel Gros and Niels Thygesen, *European Monetary Integration. From the European Monetary System to European Monetary Union*, London and New York, Longman and St. Martin's Press, 1992

IMF, *World Economic Outlook*, October 2013, <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40432.0>

Paul Krugman, "Revenge of the Optimum Currency Area", in *NBER Macroeconomics Annual 2012*, p. 439-448, <http://krugman.blogs.nytimes.com/2012/06/24/revenge-of-the-optimum-currency-area>

Donald MacDougall (ed.), *Report of the Study Group on the Role of Public Finance in European Integration* (MacDougall Report), Vols. I and II, Brussels, April 1977, http://ec.europa.eu/economy_finance/emu_history/documentation/documentation_chapter8.htm

Stefano Micossi, Ginevra Bruzzone, Jacopo Carmassi, "The New European Framework for Managing Bank Crises", in *CEPS Policy Briefs*, No. 304 (21 November 2013), <http://www.ceps.be/node/8620>

Mario Monti, *A new strategy for the single market. At the service of Europe's economy and society*, Report to the President of the European Commission, 9 May 2010, http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf

Robert A. Mundell, "A Theory of Optimum Currency Areas", in *The American Economic Review*, Vol. 51, No. 4 (September 1961), p. 657-665, <http://www.aeaweb.org/aer/top20/51.4.657-665.pdf>

OECD, "OECD Indicators of Employment Protection", in *OECD Employment Outlook 2013*, <http://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm>

Tommaso Padoa Schioppa et al., *Efficiency, Stability and Equity. A Strategy for the Evolution of the Economic System of the European Community*, Oxford, Oxford University Press, 1987

Jean Pisani-Ferry, Erkki Vihriälä and Guntram Wolff, "Options for a Euro-area fiscal capacity", in *Bruegel Policy Contributions*, No. 2013/1 (January 2013), <http://www.bruegel.org/publications/publication-detail/publication/765-options-for-a-euro-area-fiscal-capacity>

IMAGINING EUROPE

Nathalie Tocci and Giovanni Faleg, "Towards a More United and Effective Europe: A Framework for Analysis", in *Imagining Europe*, No. 1 (October 2013), <http://www.iai.it/content.asp?langid=2&contentid=992>

US Bureau of Labor Statistics, *Labor Statistics dataset*, 2013, <http://www.bls.gov/data>

Herman van Rompuy et al., *Towards a Genuine Economic and Monetary Union*, 5 December 2012, http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134069.pdf

Pierre Werner (ed.), *Report to the Council and the Commission on the realization by stages of economic and monetary union in the Community* (Werner Report), Luxembourg, October 1970, http://ec.europa.eu/economy_finance/emu_history/documentation/documentation_chapter5.htm

World Bank, *Worldwide Governance Indicators* (WGI), 2012, <http://www.govindicators.org>

Imagining Europe

As the unprecedented financial crisis and ensuing economic recession push Europe to the brink, a critical question arises as to what the foreseeable trajectories for EU governance are in the decades ahead. The crisis has already accelerated EU policy and institutional evolution in key policy areas, but the integration project remains torn apart by centrifugal political and economic forces. The “Imagining Europe” series aims at delineating what kind of governance models the EU could head towards, and which of these models is best suited for the purpose of a more united, effective and legitimate EU. In particular, the research sheds light on the degree and nature of integration at the “core” of Europe and the relationship of that core with those member states (current and future) which opt to remain outside it. It does so by exploring five policy areas: fiscal and monetary policy, infrastructure and communications, security and defence, migration and citizenship, and energy and environment.